

FEDERAL RESERVE BANK  
OF NEW YORK

[ Circular No. 9193 ]  
[ November 24, 1981 ]

MARGIN REGULATIONS

**Proposed Changes in Criteria for List of OTC Margin Stocks**

*To All Banks, Brokers and Dealers, and Persons Extending  
Securities Credit in the Second Federal Reserve District:*

Following is the text of a statement issued November 19 by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board today proposed for comment amendments to some of the criteria that over-the-counter (OTC) stocks must meet and continue to meet to be included on its list of OTC Margin Stocks.

The Board requested comment by January 29, 1982.

More than 1400 stocks are now on the list and subject to the Board's regulations.

The Board's proposal would eliminate the current requirement that an issuer be organized under the laws of the United States or a State, thereby making stocks of foreign issuers that are traded on the OTC market eligible for margin credit if they meet the other criteria for listing. It would also eliminate certain criteria now in use and reduce some financial criteria to more closely resemble requirements of major exchanges.

Enclosed — for institutions subject to Regulations G, T, and U in this District — is the text of the Board's proposal. It will be published in the *Federal Register*, and will also be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216).

Comments on the proposal should be submitted by January 29, 1982 and may be sent to our Regulations Division.

ANTHONY M. SOLOMON,  
*President.*

Title 12 - Banks and Banking

Chapter II - FEDERAL RESERVE SYSTEM

SUBCHAPTER A - BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Part 207 - Securities Credit by Persons Other than Banks, Brokers, or Dealers

Part 220 - Credit by Brokers and Dealers

Part 221 - Credit by Banks for the Purpose of Purchasing or Carrying Margin Stocks

[Docket No. R-0372]

Proposal to Revise Criteria for Initial and Continued  
Inclusion on the List of OTC Margin Stocks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed amendments.

SUMMARY: The Board proposes to amend the requirements set forth in Regulations G, T and U for inclusion and continued inclusion on the List of OTC Margin Stocks ("OTC List"). Brokers and dealers may not extend credit on stocks which are traded over-the-counter unless such stocks appear on the OTC List. Loans by banks and other lenders that are used to purchase stocks that appear on the OTC List are subject to the Board's margin requirements.

The proposed amendments would modify three areas in the existing rules for initial and continued OTC List eligibility. First, they would permit equity securities of foreign issuers and American Depository Receipts ("ADRs") to be considered for OTC List inclusion. Second, the proposals would replace certain criteria which must currently be met in the alternative and replace them with mandatory requirements. Finally, existing financial criteria would be relaxed to more closely resemble requirements established by major exchanges.

DATE: Comments should be received by January 29, 1982.

ADDRESS: Comments, which should refer to Docket No. R-0372, may be mailed to the Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551, or delivered to Room B-2223 between 8:45 a.m. and 5:15 p.m. Comments received may be inspected at Room B-1122 between 8:45 a.m. and 5:15 p.m., except as provided in section 261.6(a) of the Board's Rules Regarding Availability of Information [12 CFR § 261.6(a)].

FOR FURTHER INFORMATION CONTACT: Robert S. Plotkin, Assistant Director, Laura Homer, Securities Credit Officer, or Jamie Lenoci, Financial Analyst, Division of Banking Supervision and Regulation (202-452-2781).

[Enc. Cir. No. 9193]

SUPPLEMENTARY INFORMATION: In July 1969, the Board adopted criteria for including stocks on the OTC List. In discussions leading to the selection of such criteria, the Board indicated generally that (a) stocks to be included on the List should have market characteristics similar to exchange-listed securities, (b) manipulation by issuers to be included or excluded from the OTC List should be made as difficult as possible, and (c) fluctuations in the number of stocks on the List should be minimized.

The changes now proposed in the OTC List criteria are the result of a review of the OTC margin stock listing and continued listing requirements in light of recent developments in the securities markets in general, the OTC Market in particular, and staff experience with administering the requirements. It is believed that revising the criteria is especially appropriate at this time because of a recent decision to revise the List three times a year commencing in 1982, rather than twice a year as is the current practice. This has been a frequent recommendation of the securities industry. The following is a discussion of the specific proposals to amend OTC List criteria.

A. Deleting Requirement that Issuer Be Organized Under the Laws of the United States or a State.

As early as 1964, when the SEC first recommended a broadening of the Federal Reserve's margin authority to encompass over-the-counter stocks, the Board indicated that securities, to be eligible for credit at a broker, should meet the prerequisites of (1) market depth, (2) a reliable system of quotations, and (3) sufficient issuer disclosures. The National Association of Securities Dealers Automated Quotation System ("NASDAQ"), now in operation for ten years, has greatly improved the efficiency of the OTC market and has addressed the first two concerns of the Board. The SEC, over the past few years, has improved and strengthened its disclosure rules, so that financial information on foreign as well as domestic issues is available to the public in a comprehensive and timely fashion. In addition, the National Association of Securities Dealers ("NASD") requires that its domestic and foreign issuers file financial data with it as a prerequisite for trading on NASDAQ.

None of the approximately one-hundred eighty (180) foreign stocks currently in the NASDAQ system can be placed on the OTC List, as they do not meet the existing criterion, which requires all OTC List candidates to be "organized under the laws of the United States or a State." A growing number of requests have been received from both investor groups and the general public to include foreign OTC stocks on the OTC List. When the Board first adopted its criteria for inclusion on the List, there was insufficient financial disclosure for foreign issues. This problem has now been remedied. Furthermore, foreign issues can and do list on national exchanges and are therefore automatically eligible for margin credit.

In this connection, the Board also proposes to allow American Depository Receipts ("ADRs") to be eligible for inclusion on the OTC List. ADRs are receipts issued against securities of foreign issuers deposited in

an American depository, and are exempt from registration under Section 12 of the '34 Act. There are approximately sixty (60) ADRs currently in NASDAQ. The Board would allow ADRs to be considered for inclusion on the OTC List, provided the foreign securities against which the ADRs are issued are registered pursuant to Section 12 of the '34 Act, which imposes certain reporting requirements upon the foreign issuer. This approach is consistent with the policy currently employed by stock exchanges with respect to exchange listings \*/ and with the Securities and Exchange Commission's current proposal to allow ADRs to be designated as national market system securities. \*\*/

B. Deleting Alternative Criterion Requiring a \$5 Million Market Value and Making Remaining Criteria Mandatory

The second proposal to change OTC List criteria involves the alternative requirements with respect to the size and character of the issue and issuer. At present, a stock can fail one of the three criteria of a \$5.00 minimum price, \$5 million capital and surplus (hereinafter capital), or \$5 million in market value and still be placed on the OTC List. A study of price movements over the past six years indicates that the price criterion, as an alternative to capital, is too sensitive as an objective measurement for marginability. Each revision of the OTC List is influenced by the price trends of the survey period used and many stocks that meet the price criterion during a high price cycle fail during the subsequent low cycle. A staff study showed that 26% of the stock added to the recently revised OTC List were failing the criterion by the time the OTC List was published.

Although the capital criterion has never been amended, the growing number of stocks placed on the List without meeting the \$5 million minimum capital requirement since the 1976 changes has been of concern. Currently, the List includes approximately one hundred companies reporting less than \$5 million in capital (35% of the stocks added to the April 6, 1981 List reported less than \$5 million). These companies are often highly speculative promotional companies with no actual production that are designated as "developmental companies" under SEC rules. Although the OTC List is not designed to be one of principally "quality-oriented" stocks, it would seem that the inclusion of such companies does not adequately enable the Board to meet its inherent responsibility of investor protection. Companies reporting low capital themselves have sometimes voiced concern that inclusion on the OTC List might result in an increase in speculative trading activity in their stock. The NASD has also recently adopted higher qualification standards for initial inclusion on NASDAQ. The standards, which were adjusted to reflect "ongoing economic realities," included raising the capital requirement from \$500,000 to \$1 million. At present, the New York Stock Exchange requires capital of \$16 million and the American Stock Exchange requires capital of \$4 million before a stock may be listed.

\*/ An exchange will list ADRs only if the underlying foreign security also is listed and, therefore, registered under Section 12.

\*\*/ SEC Release No. 34-18131.

As indicated before, the third alternative criterion -- an aggregate market value of \$5 million -- is also partially a price determinant criterion. This criterion is of limited value, since it only affects stocks worth between \$5 and \$10 per share. In other words, the criteria of \$5 minimum price and one million publicly held shares would automatically provide a \$5 million aggregate market value. During the past two years, only seven per cent of the stocks added to the List failed the aggregate market value test. Accordingly, it appears that retention of this test is not justified.

Deletion of the \$5 million market value test would leave only two remaining alternative criteria: a \$5 minimum price per share and capital of \$5 million, both of which would be mandatory. This would lessen the effect of systemic fluctuations which have indirectly been affecting the size and composition of the List.

C. Reducing the publicly held share requirement from 500,000 to 400,000 shares and the capital requirement from \$5 million to \$4 million.

The Board has received complaints that in some respects the present OTC criteria are more stringent than some exchange listing requirements. In response to these complaints and in order to lessen the impact of the switch from alternative to mandatory requirements, the Board believes that some of the financial criteria can be reduced. These changes would bring the Board's OTC margin criteria more in line with those of the American Stock Exchange.

The Board, therefore, proposes that the publicly held shares requirement be reduced from 500,000 to 400,000 shares and that the capital requirement be reduced from \$5 million to \$4 million.

D. Continued Inclusion on the OTC List.

The Board proposes that corresponding changes to the criteria for continued inclusion on the OTC List be made. The continued listing criteria, which are less stringent than the initial criteria, would contain mandatory requirements of an average minimum of \$1 price and \$1 million in capital, rather than \$3 per share and \$2.5 million as at present. These changes would promote stability of the List and would also lessen the impact of the switch from alternative to mandatory requirements.

If the proposals are adopted, the Board at this time would expect to apply the new criteria only to newly added stocks. Current OTC margin stocks would be "grandfathered" under the existing continued criteria for two years. If their capital position does not increase or they otherwise fail to meet the continued listing criteria at that time, they would be subject to deletion from the OTC List.

Accordingly, pursuant to §§ 7 and 23 of the Securities Exchange Act of 1934, as amended (15 U.S.C. §§ 78g, 78w), the Board proposes to amend Regulations G, T and U (12 CFR Parts 207, 220 and 221 respectively) as follows:

PART 207 -- SECURITIES CREDIT BY PERSONS OTHER THAN BANKS, BROKERS, OR DEALERS

A. Section 207.5 -- SUPPLEMENT

\* \* \* \* \*

(d) Requirements for inclusion on list of OTC margin stocks

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) the issuer has been in existence for at least three years,

\* \* \*

(7) There are 400,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors or beneficial owners of more than 10 percent of the stock,

(8) The minimum average bid price of such stock, as determined by the Board, is at least \$5 per share, and

(9) The issuer has at least \$4 million of capital, surplus, and undivided profits.

(e) Requirements for continued inclusion on list of OTC margin stocks.

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public,

(5) There are 300,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors, or beneficial owners of more than 10 percent of the stock,

(6) The minimum average bid price of such stocks, as determined by the Board, is at least \$1 per share, and

(7) The issuer has at least \$1 million of capital, surplus, and undivided profits.

Part 220 -- CREDIT BY BROKERS AND DEALERS

A. Section 220.8 -- SUPPLEMENT

\* \* \* \* \*

(h) Requirements for inclusion on list of OTC margin stocks

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) the issuer has been in existence for at least three years,

\* \* \*

(7) There are 400,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors or beneficial owners of more than 10 percent of the stock,

(8) The minimum average bid price of such stock, as determined by the Board, is at least \$5 per share, and

(9) The issuer has at least \$4 million of capital, surplus, and undivided profits.

(i) Requirements for continued inclusion on list of OTC margin stocks

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public

(5) There are 300,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors, or beneficial owners of more than 10 percent of the stock,

(6) The minimum average bid price of such stocks, as determined by the Board, is at least \$1 per share, and

(7) The issuer has at least \$1 million of capital, surplus, and undivided profits.

PART 221 -- CREDIT BY BANKS FOR THE PURPOSE OF PURCHASING OR CARRYING MARGIN STOCKS

III. A. Section 221.4 -- SUPPLEMENT

\* \* \* \* \*

(d) Requirements for inclusion on list of OTC margin stocks.

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) the issuer has been in existence for at least three years,

\* \* \*

(7) There are 400,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors or beneficial owners of more than 10 percent of the stock,

(8) The minimum average bid price of such stock, as determined by the Board, is at least \$5 per share, and,

(9) The issuer has at least \$4 million of capital, surplus, and undivided profits.



(e) Requirements for continued inclusion on list of OTC margin stocks.

(1) The stock is registered under section 12 of the Securities Exchange Act of 1934 ("the Act"), or is an American Depository Receipt ("ADR") of a foreign issuer whose securities are registered under section 12 of the Act, or is a stock of a foreign issuer required to file reports under section 15(d) of the Act,

\* \* \*

(4) Daily quotations for both bid and asked prices for the stock are continuously available to the general public,

(5) There are 300,000 or more shares of such stock outstanding in addition to shares held beneficially by officers, directors, or beneficial owners of more than 10 percent of the stock,

(6) The minimum average bid price of such stocks, as determined by the Board, is at least \$1 per share, and

(7) The issuer has at least \$1 million of capital, surplus, and undivided profits.

INITIAL REGULATORY FLEXIBILITY ANALYSIS:

The Board requests comment on proposed amendments to the requirements for inclusion and continued listing on the List of OTC Margin Stocks. These requirements are designed to identify those stocks traded in the over-the-counter market which have the degree of national investor interest, depth and breadth of market, the availability of information respecting the stock and its issuer and the character and permanence of the issuer to meet the Board's statutory responsibilities.

Many of the proposed changes relax the listing criteria that OTC stocks must satisfy, both to qualify for inclusion on the OTC List and to remain on it. For example, foreign stocks would become eligible for inclusion, and many of the financial requirements of the OTC List would be altered to resemble more closely those of the American Stock Exchange. However, one significant proposed change working in the direction of tightening standards would eliminate the practice of using alternative criteria and thereby make the capital criterion mandatory.

Because the proposals involve a mixture of relaxing and tightening changes, it is not easy to judge the overall impact on small domestic entities--primarily those small-sized corporations whose stocks are traded in the over-the-counter market. While the proposed relaxations

in specific criteria would make it easier for some firms to qualify for the List and remain on the List, the proposed elimination of alternative criteria will deny OTC margin eligibility to other stocks. In particular, the proposal to make all criteria mandatory, including the proposed minimum net worth listing requirement, would deny initial access to the List to those firms with less than \$4 million in capital, surplus, and undivided profits whose stocks are traded OTC. Had this criterion been in effect in recent years, a substantial number of stocks that were added to the List would be excluded.

Of course, exclusion from the OTC List does not necessarily preclude a stock from becoming marginable; the issuing firm can alternatively take steps to list that stock on a national exchange. Such listing automatically confers eligibility for margin credit to stock; however, such listing does involve additional cost to the company.

It should be noted that the NASD has recently announced changes to its NASDAQ National List listing requirements, some of which became effective November 17, 1981. The changes will require some time for adjustment--by investors, traders, and issuers alike--and could change the characteristics of over-the-counter trading. Accordingly, the Board believes the use of the National List--which has been suggested as an alternative to its own criteria--is premature at this time. As soon as experience is gained with the National List the Board will weigh its use in view of its statutory responsibilities.

By order of the Board of Governors of the Federal Reserve System,  
November 18, 1981.

(signed) William W. Wiles  
William W. Wiles  
Secretary of the Board

[SEAL]