July 15, 2024

VIA ELECTRONIC DELIVERY

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Petition for Rulemaking on Exchange Listings of Penny Stocks

Dear Ms. Countryman:

Virtu Financial, Inc. ("Virtu")[1] respectfully petitions the Securities and Exchange Commission (the "Commission") under Rule 192 of the Commission's Rules of Practice[2] to initiate rulemaking proceedings that would prohibit National Securities Exchanges from listing high risk "penny stocks" and mandate additional disclosures from issuers that would facilitate investors' ability to assess the risks typically inherent in such stocks.

Background

In 1990, Congress passed the Penny Stock Reform Act (Reform Act),[3] which directed the Commission to adopt rules designed to address sales-practice abuses and manipulation involving speculative, low-priced over-the-counter securities by requiring broker-dealers to provide investors with material market and other information before effecting a transaction in a penny stock. In response, the SEC adopted rules defining the term "penny stock" (Rule 3a51-1) and requiring broker-dealers to provide disclosures concerning the risks of transacting in penny stocks (Rules 15g-2 through 15g-6). Under the SEC's rules, penny stocks generally are defined to include securities priced under $5 and that have very low market capitalizations, among other attributes.

The objective of the Penny Stock Reform Act and the Commission rules promulgated thereunder was to protect investors by identifying the attributes of high-risk securities, requiring broker-dealers to provide heightened disclosures about their risks, and instituting a cooling off period of two days from the date the disclosure was provided before allowing penny stock transactions to occur.

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[1] Virtu is a leading financial firm that leverages cutting-edge technology to deliver liquidity to the global markets and innovative, transparent trading solutions to its clients. Virtu operates as a market maker across numerous exchanges in the U.S. and is a member of all U.S. registered stock exchanges. Virtu's market structure expertise, broad diversification, and execution technology enable it to provide competitive bids and offers in over 25,000 securities, at over 235 venues, in 36 countries worldwide.
[2] 17 CFR. § 201.192(a).
[3] Public Law 101-429, 104 Stat. 951 (Oct. 15, 1990).

Under the Commission's rules, however, securities listed on National Securities Exchanges are exempt from the definition of a penny stock on the premise that exchange listing standards are stringent enough to weed out the riskiest issuers. All of the major stock exchanges have rules requiring listed companies to maintain a minimum share price of $1 or risk being delisted. Historically, there were only a handful of companies at any one time that were at risk of being delisted for dipping below $1. As noted in a recent *Wall Street Journal* report, there were fewer than a dozen such companies in early 2021.[4] In recent years, however, that number has spiked substantially. As of December 2023, 557 U.S. listed stocks were trading below $1, with the vast majority of those listed on the Nasdaq Stock Market.[5] This is unsurprising because of NASDAQ's more lenient listing standards, especially on the NASDAQ Capital Market tier, which includes many early-stage companies with relatively lower market capitalizations than other exchanges.

The issuers whose shares are trading below $1 on National Securities Exchanges generally fit a similar profile in terms of the risks that they may pose to retail investors. A primary attribute of these issuers is that they feature capital structures that result in serial dilution of the ownership interests of public purchasers of their securities. Ownership of their shares is opaque, with much of their equity owned by insiders and parties who purchased significant amounts of the issuers' outstanding common shares and derivative securities that convert into common shares in unregistered private offerings, although in some instances also registered offerings. Often, their derivative securities convert to common shares at a discount to current market prices, which incentivizes short sales by the holders of these securities as both the short positions and the conversions of their derivative securities benefit from the activity. As a result of the dilutive effect of these capital structures and the serialized dilutive practices, these issuers often cannot maintain a price above $1 and inevitably fail to meet the continuing listing standards of the exchanges.

Exacerbating the problem is a tactic many companies at risk of delisting have increasingly employed in recent years – reverse stock splits. A company with a stock price trading at 50 cents (which is in violation of exchange rules) can magically cure the deficiency with a 10-for-1 reverse split that results in a $5 share price. Many companies are engaging in reverse splits of much greater magnitude, e.g., 50-for-1 or 100-for-1, and companies engaging in reverse stock splits to avoid delisting is becoming increasingly commonplace. As reported by the *Wall Street Journal*, there were 495 reverse splits of exchange-listed stocks in 2023, up from 288 in 2022 and the largest annual number in the past two decades.[6]

Issuers that have engaged in excessive and frequent reverse stock splits often have multiple public and private offerings, the effect of which is a significant dilution of existing shareholders and the inevitable depressed stock price. The securities of these issuers frequently experience aberrational trading patterns with the price of the issuers' securities increasing exponentially for no apparent fundamental reason or because the issuers' securities are being touted on message

[4] Wall Street Journal, *Hundreds of Stocks Have Fallen Below $1. They're Still Listed on Nasdaq* (Dec. 3, 2023), available at https://www.wsj.com/finance/stocks/hundreds-of-stocks-have-fallen-below-1-theyre-still-listed-on-nasdaq-c8e36abf#.
[5] *Id*.
[6] *Id*.

boards. As a result, these issuers frequently are subject to volatility and Limit Up Limit Down ("LULD") halts, which also increases operational risk for broker-dealers as they must move massive amounts of orders to participate in the re-opening auctions.

What's more, the reverse splits are often rushed through with little notice to the market, which creates a significant operational risk to FINRA member firm broker-dealers that must ensure they are all properly accounted for in their back-office systems. If they are not, the broker's total number of shares will not be reduced by the amount of the reverse split, potentially leading to serious operational errors related to the number of shares available in an account. Although precise figures are not available on the costs, brokers have likely lost tens of millions of dollars, if not more.

The negative impacts of reverse stock splits are not only felt by broker-dealers and their shareholders, but also by retail investors. Given the potential for a lack of notice for a reverse stock split, there could be a misunderstanding by a retail investor of the impact of a reverse stock split on the value of the adjusted stock/share. As a result, an investor could unwittingly sell shares in positions they do not hold, which could lead to substantial losses with little recourse to address the error after the trade. Notably, FINRA has cautioned investors about the potential risks associated with reverse stock splits, observing that if "a reverse split is announced and actually occurs, proceed with caution. Reverse splits tend to go hand in hand with low-priced, high-risk stocks. This is especially true with reverse splits that result in a post-split share price that is many times the price of the stock's current price."[7]

Despite the prevalence of increased risks and greater costs for investors, exchanges like NASDAQ are incentivized by listing revenue to keep penny stocks listed. Under NASDAQ's rules,[8] for example, issuers have a period of 180 calendar days to bring their stock price above $1 to remain listed. And if, after 180 days a company has not achieved compliance, under certain conditions it may be granted a second 180-day grace period to achieve compliance.

Notably, NASDAQ itself seems to acknowledge that enhancements need to be made to its continuing listing rules, as evidenced by a recent rule filing that would make it harder for issuers to come into compliance with the minimum bid requirements through reverse stock splits.[9]

[7] FINRA, For Investors, *Stock Splits*, available at https://www.finra.org/investors/investing/investment-products/stocks/stock-splits.

[8] NASDAQ Rule 5810, *Notification of Deficiency by the Listing Qualifications Department* ("NASDAQ Rule 5810").

[9] Under Nasdaq's current rules, if an issuer engages in a reverse stock split to meet the minimum bid requirement, and the reverse stock split causes the issuer to violate another listing requirement – for example, the minimum number of shares requirement – Nasdaq would notify the issuer about this new deficiency and the issuer would be afforded 45 calendar days to submit a plan to regain compliance and could be afforded up to 180 calendar days to regain compliance. Nasdaq's rule filing would prevent issuers from benefiting from additional time for the subsequent deficiency that was ultimately caused by the company's non-compliance with the Bid Price Requirement. *See* Nasdaq Proposed Rule, SR-NASDAQ-2024-029 (June 21, 2024), available at https://listingcenter.nasdaq.com/assets/rulebook/nasdaq/filings/SR-NASDAQ-2024-029.pdf.

However, minor tweaks to NASDAQ's listing rules are insufficient to address the problem. We submit that a more substantial overhaul is needed.

These are classic penny stock companies that are often tied to pump-and-dump trading activity and other forms of market manipulation. They are exactly the type of stocks that the Penny Stock Reform Act and Commission rules intended to keep off the major exchanges to protect investors. Yet, under today's listing rules, these stocks are eligible for listing on exchanges despite their substantial risks – and can remain listed for long periods of time even when they violate the exchanges' continuing listing requirements.

Many of these issuers are holding companies that are incorporated in, and conduct much of their operations in, foreign jurisdictions. Many such issuers have disclosed in their SEC filings that, as companies incorporated in foreign jurisdictions, they are permitted to adopt certain home country practices concerning corporate governance matters that differ significantly from the NASDAQ corporate governance requirements. The issuers' disclosures acknowledge that these practices may afford less protection to shareholders than they otherwise would under rules and regulations applicable to U.S. domestic issuers. As a result, public shareholders of such companies may have more difficulties in protecting their interests in the face of actions taken by management, members of the board of directors or controlling shareholders than they would as public shareholders of a company incorporated in the U.S.

As these examples demonstrate, Main Street investors are being exposed to significant risk from issuers that have the imprimatur of being listed on an exchange when they are no different from penny stocks listed on the OTC market. Securing a listing on a National Securities Exchange is a seal of approval. Most broker-dealers allow their customers to trade any exchange-listed stocks, but impose substantial restrictions on their customers' trading in riskier, OTC stocks; however, this is circumvented when OTC quality stocks are listed as NMS stocks.[10]

To promote investor protection, we petition the SEC to engage in rulemaking implementing the following recommendations.

<u>Recommendation 1</u>: Require Exchanges to Adopt More Rigorous Initial Listing Standards to Prevent Listing of Risky Issuers

We believe the root of the problem is in the major exchanges' initial listing standards, which set the bar far too low to prevent the listing of risky issuers. Especially concerning is the dilutive capital structures that are a hallmark of many risky penny stock companies where

[10] We note that there are many reputable companies that are not exchange listed and are traded over-the-counter for a variety of reasons. OTC Markets Group ("OTC Markets") has proactively taken steps to help investors identify risker companies through the development of market tiers and labels that are intended to alert investors of those risks including, for example, that an issuer's securities are being touted. OTC Markets also sells data files and risk scoring analytics to the broker-dealer community who can use the files in a variety of ways including in their surveillance routines.

convertibility is a function of price such that the lower the price, the more stock the insiders can convert. This is highly dilutive and a red flag.

To address this, the Commission should direct the exchanges to adopt initial listing standards requiring that restricted common shares, and securities convertible into restricted common shares, cannot dilute public shareholders of common shares by greater than 5% within 180 days of listing.

Recommendation 2: Require Exchanges to Strengthen Continuing Listing Standards Applicable to Stocks Trading Under $1

We also believe that the exchanges' continuing listing standards should be strengthened. In particular, we recommend that the exchanges' rules related to the continued listing eligibility of stocks trading under $1 be revisited.

As noted above, all of the major stock exchanges have rules requiring listed companies to maintain a minimum share price of $1 or risk being delisted. However, under those listing rules, companies that dip below the $1 threshold can, and often do, remain listed for months despite their "penny stock" status, thus remaining accessible to retail investors despite the substantial risks associated with them. This problem has become especially acute on NASDAQ.

Here is our understanding of how NASDAQ's rule[11] works:

- If a company's stock trades below $1 for 30 consecutive business days, it is considered to have failed to meet NASDAQ's minimum bid price requirement.
- Upon such failure, companies have a period of 180 calendar days to achieve compliance.
- Compliance can be achieved by meeting the applicable standard for a minimum of 10 consecutive business days during the applicable compliance period.
- However, if after 180 days a company has not achieved compliance, under certain conditions it may be granted a second 180-day grace period to achieve compliance.[12]
- Accordingly, a company can trade below the $1 minimum bid requirement for over a year, yet remain listed on NASDAQ exchanges.

To address the significant investor protection concerns that flow from allowing penny stocks to remain listed on a National Securities Exchange, we recommend reducing the timeline thresholds that lead to a violation of the minimum bid requirement and delisting. Specifically, we recommend that a stock that trades below $1 for 15 consecutive days should be considered to have failed to meet the minimum bid requirement. Further, we recommend that the period for curing that deficiency should be reduced from 180 days to 60 days. Finally, we recommend eliminating the option for an issuer to get additional time to cure the deficiency.

[11] NASDAQ Rule 5810.
[12] Our understanding, based on our reading of the rule, is that a second 180-day grace period is available to issuers listed on NASDAQ's Capital Market tier under certain conditions.

<u>Recommendation 3</u>: Require Exchanges to Adopt Rules Limiting Excessive Reverse Stock Splits

We believe engaging in a reverse split simply to avoid delisting is an abusive practice that should be prohibited. While the exchanges have rules targeting the use of excessive reverse stock splits to avoid minimum bid requirement deficiencies, they are inadequate to prevent abuses except in the most extreme cases.

Take NASDAQ's Excessive Reverse Stock Split provision, for example:

> "iv) **Excessive Reverse Stock Splits**
>
> Notwithstanding the foregoing, if a Company's security fails to meet the continued listing requirement for minimum bid price and the Company has effected one or more reverse stock splits over the prior two-year period with a cumulative ratio of 250 shares or more to one, then the Company shall not be eligible for any compliance period specified in this Rule 5810(c)(3)(A) and the Listing Qualifications Department shall issue a Staff Delisting Determination under Rule 5810 with respect to that security."[13]

Under this provision, an issuer falling below the $1 threshold could repeatedly engage in reverse stock splits of a low magnitude to avoid delisting. NASDAQ's 250 to 1 limit for excessive reverse stock splits is, therefore, a toothless restriction that is not serving its purported objective.

We believe that the exchanges should be required to amend their listing rules to target excessive reverse stock splits used to avoid delisting due to violations of the minimum bid requirement. We recommend that these rules eliminate the grace period for curing a deficiency for any issuer that has engaged in one or more reverse stock splits over the prior three-year period with a cumulative ratio of 10-for-1 or greater.

As noted above, NASDAQ appears to recognize that some issuers are gaming the system by engaging in reverse stock splits to bring their stock price into compliance with the minimum bid requirement, as evidenced by a recent rule filing that would eliminate an extended compliance period where the reverse split results in violation of another listing requirement.[14] While this is a small step in the right direction, it does not go nearly far enough. Where a reverse stock split would not result in a violation of another rule, issuers can still engage in multiple reverse splits without violating the excessive reverse stock split provision or the restrictions in Nasdaq's proposed rule change.

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[13] NASDAQ Rule 5810.

[14] *Supra* n.9.

Recommendation 4: Require Exchanges to Monitor for Potentially Misleading and Manipulative Promotional Activity

Often, increases in trading activity and share price volatility in penny stocks are triggered by activity on social media outlets. OTC Markets has developed policies and procedures to monitor for potentially misleading, and manipulative promotional activity.[15] The Commission should require Exchanges to adopt similar policies and procedures.

Recommendation 5: Mandate Additional Disclosures Under Regulation S-K to Facilitate Assessment of the Hazards of Investing in High-Risk Penny Stocks

Finally, we recommend that the Commission adopt amendments to Regulation S-K that would require additional disclosure of information that would facilitate investors' assessment of the hazards of investing in issuers with attributes that are common in high-risk penny stocks. As described above, the highly dilutive corporate actions of many penny stock issuers present the most risk to uninformed investors. Accordingly, the Commission should amend Regulation S-K to require additional disclosures that would facilitate investors' analysis of the dilutive impact of an issuer's proposed corporate action.

Specifically, the Commission should require disclosure of the hypothetical impact on the issuer's share price if, within 180 days following the issuer's initial listing on an exchange, all restricted shares become unrestricted, all insider options are exercised, and all convertible securities are converted into common stock. Relatedly, the Commission should require issuers to disclose, based on foreseeable needs, how much additional common stock, or securities convertible into common stock the issuer projects it will need to issue within 180 days of initial listing.

We are concerned that retail shareholders may not be aware of how dilutive corporate actions can negatively impact a company's share price. Requiring issuers to affirmatively disclose their projected share issuances and conversions, and to include a hypothetical analysis that demonstrates the dilutionary effect of the conversion of restricted and/or convertible shares and insider options, would better inform investors about the potential risks of investing.

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[15] *OTC Markets Group Policy on Stock Promotion*, available at https://www.otcmarkets.com/files/OTC_Markets_Group_Policy_on_Stock_Promotion.pdf.

Virtu appreciates the Commission's attention to this Petition for Rulemaking. The bottom line is that current SEC rules that allow high-risk penny stocks to be listed on major stock exchanges present serious investor protection concerns. We believe that it is long past due for the Commission to take a fresh look at its rules around the listing of such securities and ensure that investors are armed with the information they need to assess the investment risks.

Respectfully submitted,

Thomas H. Merritt
Deputy General Counsel

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime E. Lizarraga, Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets