

GAO

Report to the Ranking Minority Member,
Committee on Commerce, House of
Representatives

February 1998

SECURITIES REGULATION

Oversight of SRO's Listing Procedures Could Be Improved



General Government Division

B-277217

February 6, 1998

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

This report responds to your request concerning the National Association of Securities Dealers' (NASD) Nasdaq SmallCap Stock Market and the events surrounding the listing of Comparator Systems Corporation stock. Comparator, whose stock was listed on the SmallCap Stock Market from February 1990 to June 1996, typically traded at prices between 3 and 6 cents per share. However, between May 3 and May 8, 1996, the price of a share of Comparator stock reached a high of nearly \$2, and the number of shares traded set Nasdaq records. Subsequently, the price plummeted to 56 cents a share. Because of this unusual price volatility and recordbreaking trading volumes, NASD halted trading in Comparator stock before the market opened on May 9, 1996. NASD began an investigation that raised immediate concerns about the validity of the company's financial statements, including the value of Comparator's assets. On May 14, the Securities and Exchange Commission (SEC) also suspended trading in Comparator stock.

On May 31, 1996, SEC brought charges of securities law violations against Comparator and three of its officers, alleging they fraudulently obtained at least \$2.9 million from buyers of Comparator stock. SEC alleged that the purpose of the Comparator officers' actions was to retain the stock's listing on the SmallCap Stock Market to make it easier to sell stock to the public. On that same day, the United States District Court for the Central District of California issued temporary restraining orders and other emergency relief for all defendants. NASD's investigation resulted in Comparator's delisting on June 12, 1996.

In September 1996, by mutual agreement of the parties, the court entered a final judgment against Comparator and two of its former officers and permanently barred these two individuals from serving as officers and directors of a public company. As of December 1997, the monetary penalties to be paid by these two officers had not been resolved, and SEC was still pursuing a third former officer of Comparator who now resides in Malaysia.

Comparator's trading and price run-up in May attracted public attention to the SmallCap Stock Market. Subsequent revelations that Comparator's assets had no value raised serious questions about how the company was able to meet the SmallCap Market's listing requirements.

We agreed with your staff that the key questions this report would address were as follows:

- What has SEC done to meet its oversight responsibilities regarding the Nasdaq SmallCap Market's listing requirements?
- Did Nasdaq follow its listing and maintenance requirements with respect to Comparator Systems Corporation?
- What actions has Nasdaq taken to improve its operations since the May 1996 run-up in trading of Comparator Systems Corporation stock?
- How does Nasdaq monitor the effectiveness of its policies on granting exceptions to its listing and maintenance requirements?

Background

National securities exchanges and registered securities associations, along with registered clearing agencies and the Municipal Securities Rulemaking Board, are collectively termed self-regulatory organizations (SROs) under Section 3(a)(26) of the Securities Exchange Act of 1934 (Exchange Act). NASD is the SRO of the securities industry responsible for regulating the over-the-counter (OTC) securities market and the products traded in it. NASD's responsibilities are contained in Section 15A of the Exchange Act, and it operates subject to SEC oversight. NASD has responsibility for ensuring that its members comply with federal securities laws and NASD rules. It is the largest SRO in the United States, with a membership that includes virtually every broker/dealer in the nation that does a securities business with the public.

Through its subsidiaries, NASD Regulation, Inc. (NASDR)¹ and the Nasdaq Stock Market, Inc. (Nasdaq), NASD develops rules and regulations, conducts regulatory reviews of members' business activities, and designs and operates marketplace services and facilities. NASD helps to establish and coordinate the policy agendas of its two subsidiaries and oversees their effectiveness. It has delegated to Nasdaq the obligation to develop,

¹NASDR began operations in 1996 as a separate, independent subsidiary of NASD. NASD created NASDR as part of a restructuring of NASD to separate the regulation of broker/dealers from the operation of Nasdaq. NASDR's mission is to regulate securities markets for the benefit and protection of the investor. It oversees the activities of more than 5,400 securities firms, more than 58,000 branch offices, and in excess of 505,000 registered securities professionals. It also regulates the markets operated by Nasdaq.

operate, and maintain systems, services, and products for the securities markets that NASD operates. It has also delegated to Nasdaq responsibility for formulating regulatory policies and listing criteria applicable to the markets it operates.

The Nasdaq Stock Market began operation in 1971 as the first electronic, screen-based stock market for nonexchange listed securities.² Nasdaq enables securities firms to execute transactions for investors and for themselves in an environment of real-time trade reporting and automated market surveillance. As of December 1997, more than 6,200 securities were traded on Nasdaq, representing approximately 5,500 companies.³ In addition to its screen-based operations, Nasdaq is distinguished from stock exchanges by its use of multiple market makers—-independent dealers who openly compete with one another for investors' orders in each Nasdaq security. Nasdaq has two tiers: the Nasdaq National Market, where approximately 4,200 of Nasdaq's larger companies are listed and traded; and the Nasdaq SmallCap Market, where approximately 1,300 smaller, emerging growth companies are traded.

Nasdaq Establishes Qualifications Requirements

Before a company's stock can be traded on the Nasdaq Stock Market, the company must be admitted to Nasdaq. Upon request, the company receives written notice of the applicable Nasdaq qualifications requirements. The company must then submit a listing application (together with supporting financial statements) in which it states that it (1) will abide by all applicable marketplace rules, (2) currently meets the applicable requirements for inclusion of its stock in Nasdaq, (3) will file with NASD copies of all reports or other information filed with SEC or other regulatory authorities, and (4) will pay the fees associated with inclusion in Nasdaq. As part of the new listing requirements, all companies listing on the Nasdaq Stock Market are required to sign and complete a listing agreement in addition to the listing application.

Nasdaq has authority over the initial and continued inclusion of securities in its markets in order to maintain the quality of and public confidence in its markets. Nasdaq may deny initial inclusion or delist securities even though the securities meet all criteria for initial or continued inclusion.

²NASD is an association of securities dealers, and its markets are dealers' markets—not organized exchanges. Therefore, stocks traded on Nasdaq are referred to as nonexchange listed.

³The Nasdaq system consists of more than 6,000 workstations throughout the United States connected to servers that link to a central processing complex in Trumbull, CT. A complete back-up facility is located in Rockville, MD.

SROS have broad latitude in making judgments about whether dealings in a company's securities are inappropriate. Also, SEC has stated that:

“. . . the NASD's role in Nasdaq is the same as that of the organized exchanges with respect to the lists of securities traded on them. . . . primary emphasis must be placed on the interests of prospective future investors. The latter group is entitled to assume that the securities in the system meet the system's standards. Hence, the presence in Nasdaq of non-complying securities could have a serious deceptive effect.”⁴

SEC's Statutory Oversight Responsibilities

SEC's statutory oversight responsibilities regarding Nasdaq's listing requirements include its authority to (1) review and approve or deny SRO-proposed rule changes, (2) inspect SROS, and (3) review listing decisions either on appeal or by its own initiative. SRO rules and proposed rule changes may cover such activities as organization and administration, financial products traded, business conduct, and discipline. SRO rules also include listing requirements for traded companies. Nasdaq's listing requirements are embodied in its marketplace rules.⁵ SEC reviews SRO-proposed rules to ensure that they are consistent with the requirements of the Exchange Act and subsequent regulations.⁶ If SEC cannot make such a finding, it must disapprove the proposed rule change. On February 28, 1997, NASD filed a proposed rule change with SEC to make listing requirements for issuers listed on Nasdaq more stringent.⁷ SEC approved the rule change on August 22, 1997.

In addition to its authority to approve SRO-proposed rules, the Exchange Act authorizes the Commission to conduct “reasonable periodic, special, or other examinations” of “[a]ll records” maintained by SROS.⁸ These examinations, or inspections, may be conducted “at any time, or from time to time,” as the Commission “deems necessary and appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.” The SEC office responsible for conducting these inspections is the Office of Compliance Inspections and

⁴In the Matter of Tassaway, Inc., Securities Exchange Act Release No. 11291, March 13, 1975.

⁵National Association of Securities Dealers, Inc., Manual, Marketplace Rules, Rule 4300 - Qualification Requirements for Nasdaq Stock Market Securities; and Rule 4400 Nasdaq National Market - Issuer Designation Requirements, July 1996.

⁶Section 19(b) of the Exchange Act gives SEC broad statutory authority to review and approve or deny any SRO-proposed rule changes.

⁷Form 19b-4 Proposed Rule Change by National Association of Securities Dealers, Inc., File No. SR-NASD-97-16.

⁸Section 17(b) of the Exchange Act, 15 U.S.C. §78q(b).

Examinations (OCIE). The Commission created OCIE in 1995 to streamline and improve the inspection process. Previously, the responsibility for inspections was divided between the Divisions of Market Regulation and Investment Management. OCIE's stated mission is to protect investors, foster compliance with the securities laws, and deter violative conduct through effective inspections of regulated entities.

Among the types of inspections OCIE conducts are routine oversight inspections of programs administered by securities industry SROs to monitor the effectiveness with which these organizations fulfill their statutory responsibilities under the federal securities laws.⁹ These inspections test SROs' compliance with their regulatory and other duties, and they are to be routinely conducted on a cyclical basis. OCIE does not inspect an entire SRO, focusing instead on particular program areas. OCIE has inspected several programs in each SRO annually. Its inspection goals are based on such criteria as an established inspection cycle, length of time since last visit, known problems, or recent program developments.¹⁰ Inspection reports are to be reviewed internally by senior management within OCIE as well as by the Commissioners, where appropriate.

Results in Brief

SEC has taken actions to meet its oversight responsibilities with respect to the Nasdaq Stock Market Listing Qualifications Department (Listing Department) by approving two Nasdaq requests for rule changes to tighten listing standards in 1991 and 1997 and by inspecting the Department's operations in 1979, 1983, 1986, and 1997. However, it did not follow up on its 1986 recommendations to improve Listing Department operations until 1997, 11 years later. Such follow-up actions are essential to ensure that operating deficiencies are corrected properly and in a timely manner. When it did follow up in 1997, SEC reported that some of the same deficiencies it had found in 1986 still existed, and it found additional deficiencies as well. Nasdaq disagreed and stated that it had responded to SEC's 1986 inspection report and that for 11 years it believed it had addressed the issues SEC raised.

Before OCIE established new procedures, SEC used subsequent and follow-up inspections as its primary method for ensuring that its recommendations were implemented. However, this did not provide

⁹OCIE also may conduct special or "cause" inspections when it believes something may be wrong at an SRO.

¹⁰A description of OCIE's inspection program accomplishments is included each year in SEC's annual report, as required by Section 23 of the Exchange Act.

systematic recommendation follow-up when constraints such as limited resources or changing priorities caused long periods of time between inspections, as occurred for the Nasdaq Listing Department. OCIE has instituted a number of procedures to provide more systematic recommendation follow-up, but these procedures do not involve SEC's Commissioners, who have the authority to require SROS to comply with OCIE's recommendations.

The Listing Department followed its listing and maintenance requirements for Comparator and had never granted the company any exceptions to those requirements. However, SEC criticized Nasdaq's handling of Comparator because the Department had failed to investigate assets that appeared questionable on the company's financial statements. SEC subsequently proved that Comparator officials had inflated those assets to continue the company's Nasdaq listing and facilitate the sale of its stock. SEC made several recommendations to improve Nasdaq's Listing Department operations, which Nasdaq has begun to implement.

Since the May 1996 run-up in trading of Comparator, Nasdaq has improved its Listing Department operations in response to its own inquiry as well as SEC's. These improvements included staffing increases to allow the Department to focus greater attention on each listed company, formation of a special investigative unit to focus on listed companies with high-risk attributes, development of an automated risk-scoring system to identify companies with profiles that suggest the need for additional scrutiny, and more stringent listing and maintenance requirements to strengthen the financial stability of listed companies. SEC acknowledged that many of the changes Nasdaq has made meet the intent of SEC's recommended Listing Department improvements. However, not all of the changes have been completely implemented, and others have not been in place long enough to adequately assess their effectiveness.

Nasdaq monitors individual company requests for exceptions to its listing and maintenance requirements through reviews and approvals by the Nasdaq and NASD boards of directors and through information collected by Listing Department staff. Nasdaq officials told us that this process provides sufficient monitoring of Nasdaq's exceptions-granting policies. However, Nasdaq does not routinely aggregate and analyze overall statistics to measure Listing Department results, such as the number of exceptions granted or denied over time or the outcomes (came back into compliance or delisted) of companies granted exceptions. As a consequence, Nasdaq cannot readily identify performance gaps or align its

activities, core processes, and resources. Leading organizations have shown that such approaches to measuring results can become a driving force in improving the efficiency and effectiveness of program operations.

Scope and Methodology

This review focuses on Nasdaq's Listing Department and SEC's Office of Compliance Inspections and Examinations, the office responsible for oversight of SROs. To determine how SEC met its oversight responsibilities regarding SRO listing programs, we reviewed SEC inspection reports, inspection workpapers, annual reports, and other SEC internal documents. We also interviewed SEC officials. To determine whether Nasdaq followed its listing and maintenance requirements with regard to Comparator, we reviewed NASD and Nasdaq manuals; Nasdaq, NASDR, and SEC documents and court papers; and SEC filings. We also interviewed Nasdaq and SEC officials. To identify the actions Nasdaq has taken since May 1996, we reviewed Nasdaq documents and SEC filings. To determine how Nasdaq monitors exceptions to its listing and maintenance requirements, we interviewed Nasdaq officials and reviewed NASD and Nasdaq manuals.

We obtained written comments on a draft of this report from SEC (see app. I) and Nasdaq (see app. II), and their comments are discussed at the end of this letter. We did our work in Washington, D.C., between February and September 1997 in accordance with generally accepted government auditing standards.

SEC Took Oversight Actions Related to Nasdaq's Listing Department

SEC oversight actions related to Nasdaq's Listing Department included approving two rule changes NASD proposed to make its Smallcap listing requirements more restrictive. In 1997, SEC also inspected Nasdaq's Listing Department for the first time since 1986.

SEC Approved Two Nasdaq Rule Changes

In 1991, and again in 1997, NASD proposed, and SEC approved, rule changes that made listing and maintenance requirements more restrictive for the SmallCap Market. For example, the 1991 change doubled from \$2 million to \$4 million the assets NASD required of companies applying for listing. The 1997 change tightened this asset requirement from total assets of \$4 million to net tangible assets of \$4 million. Net tangible assets are total assets minus total liabilities and goodwill. The 1997 rule change retained the \$1 minimum bid price for common and preferred stock for continued listing. However, the 1997 rule change removes an alternative available

under the 1991 rule allowing a company to maintain its listing when its bid price falls below \$1, as long as its capital and surplus exceed \$2 million and the market value of its public float exceeds \$1 million.¹¹ NASD's rationale for this requirement was that it provided a safeguard against certain market activity associated with low-priced securities.¹² Nasdaq officials said the new quantitative listing and maintenance requirements would further protect investors and enhance the quality and credibility of the Nasdaq Smallcap Market.

In addition to the quantitative requirements, NASD's 1997 rule change also included a peer review requirement for independent auditors of Nasdaq SmallCap listed companies. To meet this requirement, these companies must be audited by an independent auditor that has received or is enrolled in a peer review program that meets acceptable guidelines and is subject to oversight by an independent body. To qualify, such a peer review program must provide that an accounting firm's quality control system is to be externally peer reviewed every 3 years. Nasdaq officials believe that this requirement will improve the quality and stability of Nasdaq companies.

When the 1997 rule change was adopted, Nasdaq officials estimated that about 30 percent of companies listed on the SmallCap Market would no longer be eligible for continued listing. Companies currently listed have 6 months to meet the new maintenance requirements (until February 22, 1998). The 6-month period is intended to give currently listed companies adequate time to complete appropriate corporate action to achieve full compliance. Tables 1 and 2 summarize and compare Nasdaq's quantitative SmallCap listing and maintenance requirements.

¹¹Public float is the number of shares of a corporation that are outstanding and available for trading by the public.

¹²See Penny Stocks: Regulatory Actions to Reduce Potential for Fraud and Abuse (GAO/GGD-93-59, Feb. 1993).

Table 1: Comparison of Quantitative Listing Requirements for the Nasdaq SmallCap Market

	SmallCap market listing requirements			
	Current	1991-1997	1982-1991	Pre-1982
Net tangible assets ^a	\$4,000,000 ^b	N/A	N/A	N/A
Market capitalization	\$50,000,000			
Net income (2 of last 3 years)	\$750,000			
Total assets	N/A	\$4,000,000	\$2,000,000	\$1,000,000
Total equity	N/A	\$2,000,000	N/A	N/A
Capital/surplus	N/A	N/A	\$1,000,000	\$500,000
Public float (shares)	1,000,000	100,000	100,000	100,000
Market value of public float	\$5,000,000	\$1,000,000	N/A	N/A
Minimum bid price	\$4.00	\$3.00	N/A	N/A
Market makers	3	2	2	2
Shareholders	300	300	300	300
Operating history (years)	1 ^c or	N/A	N/A	N/A
Market capitalization	\$50,000,000			

^aNet tangible assets equals total assets less total liabilities and goodwill.

^bCurrent requirements are \$4 million in net tangible assets or \$750,000 in net income in 2 of the last 3 years, or market capitalization of at least \$50 million.

^cMarket capitalization must be at least \$50 million if operating history is less than 1 year.

Source: NASD, Nasdaq.

Table 2: Comparison of Quantitative Maintenance Requirements for the Nasdaq SmallCap Market

	SmallCap market maintenance requirements			
	Current	1991-1997	1982-1991	Pre-1982
Net tangible assets ^a	\$2,000,000 ^b	N/A	N/A	N/A
Market capitalization	\$35,000,000			
Net income (2 of last 3 years)	\$500,000			
Total assets	N/A	\$2,000,000	\$750,000	\$500,000
Total equity	N/A	\$1,000,000	N/A	N/A
Capital/surplus	N/A	N/A	\$375,000	\$250,000
Public float (shares)	500,000	100,000	100,000	100,000
Market value of public float	\$1,000,000	\$200,000	N/A	N/A
Bid price	\$1.00	\$1.00 ^c	N/A	N/A
Market makers	2	2	1	1
Shareholders	300	300	300	300
Operating history (years)	N/A	N/A	N/A	N/A
Market capitalization				

^aNet tangible assets equals total assets less total liabilities and goodwill.

^bCurrent requirements require net tangible assets of \$2 million or net income of \$500,000 in 2 of the last 3 years or market capitalization of at least \$35 million.

^cIf a company's bid price falls below \$1, but its capital and surplus exceed \$2,000,000 and the market value of its public float exceeds \$1,000,000, the company can maintain its listing.

Source: NASD, Nasdaq.

SEC's Lack of Follow-Up Allowed Inspection Deficiencies to Continue

When SEC identifies deficiencies in the operations of SROs, improvements in these operations can occur only if the deficiencies are effectively resolved. Without ongoing, systematic follow-up, SEC cannot ensure that its recommendations to correct these deficiencies are implemented properly in a timely manner. Before OCIE established new procedures, SEC depended primarily on subsequent inspections to follow up on its inspection recommendations.

SEC provided us with information on the listing department inspections it had performed since 1986, and this information is presented in table 3.

Table 3: SRO Listing Department Inspections From 1986 Through August 1997

Self-regulatory organization	Most recent inspection	Prior inspections
American Stock Exchange	1997	1995, 1993, 1992
Boston Stock Exchange	1997	1992
Chicago Stock Exchange	1997	1995, 1991, 1986
Nasdaq	1997	1986
New York Stock Exchange	1997 ^a	None ^b
Pacific Stock Exchange	1997	1991
Philadelphia Stock Exchange	1997	1991

^aInspection started in August 1997.

^bSEC officials told us they had never inspected the New York Stock Exchange (NYSE) Listing Department because they consider NYSE listed companies among the largest, most financially stable in the world, and these companies are audited by the largest independent accounting firms. They also told us SEC conducted 37 inspections of 16 programs at NYSE from 1986 through 1997.

Source: Compiled from information provided by SEC.

In its 1983 and 1986 inspections of Nasdaq's Listing Department, SEC had followed up on recommendations it had made in prior inspections, finding that deficiencies had been corrected. The 1983 report refers to an inspection conducted in 1979 and concludes that Nasdaq complied with recommendations made in the 1979 report. Similarly, the 1986 report refers to the 1983 inspection and concludes that Nasdaq complied with recommendations made in the 1983 report.

By contrast, the 1997 report refers to the 1986 report and concludes that Nasdaq ignored the recommendations SEC made 11 years earlier. SEC stated that failure by Nasdaq to enforce its listing and maintenance standards could have the effect of misleading investors who are entitled to assume that Nasdaq-listed securities meet its published requirements. However, in 1986, Nasdaq's written response to SEC's inspection report disagreed with SEC's findings. Nasdaq cited alternative means to address one recommendation it declined to implement and stated that its practices regarding issuers making delinquent filings met the intent of SEC's second recommendation. Because SEC had not followed up on its 1986 recommendations until 1997, this disagreement continued for 11 years, and Nasdaq believed it had addressed the issues SEC raised. Disagreements like this could be avoided if recommendations were followed up systematically and not dependent solely on subsequent inspections.

OCIE officials told us that the reason the Nasdaq Listing Department had not been inspected since 1986 was because SEC must inspect a wide range of exchange programs with limited resources, and SEC had no inspection cycle for listing departments until 1996.¹³ OCIE officials told us that they began to reevaluate the cycles and coverage of SEC's inspection program when OCIE was created in 1995. They said they made a number of changes to the program, including establishing inspection cycles for listing departments. As additional resources became available, OCIE shortened its inspection cycles. In November 1996, the OCIE Director placed regional SRO listing departments on a regular 3-year cycle of inspections; and the American Stock Exchange, Nasdaq, and the New York Stock Exchange were to be inspected, at least in part, on a 2-year cycle. OCIE inspected equity listing programs at all the exchanges in 1997. An SEC document states that the length of time since the last visit and known problems are criteria to be considered when OCIE sets its inspection goals.

OCIE officials also told us they have instituted a number of procedures in addition to subsequent inspections to ensure that SEC's recommendations are addressed. First, the recommendations are to be included in a report sent to the SRO, and the SRO is requested to respond in writing to the recommendations within 60 days, outlining remedial actions it intends to take. SEC is to ask the SRO to provide a specific timetable for the actions, and the SRO must send SEC written confirmation at the completion of each action. Second, in cases where the findings and recommendations are more significant, the SRO may be required to report the findings and intended remedial actions to its board of directors. Senior officials of the SRO may be required to meet with OCIE to discuss the report; and in the most egregious cases, OCIE may refer the matter to SEC's Enforcement Division. Third, OCIE is to analyze the written SRO responses to ensure that (1) each recommendation has been adequately addressed, (2) the results have been reported to senior management, and (3) any outstanding issues are being monitored. When OCIE makes a large number of recommendations, it is to prepare spreadsheets to monitor the progress of remedial actions. Fourth, OCIE may conduct a follow-up inspection that focuses on the remedial actions taken to ensure that the SRO has properly implemented OCIE's recommendations. OCIE staff also are to review the remedial actions in its next cyclical inspection of the program. OCIE officials told us that these procedures are intended to ensure that problems found during an inspection do not persist and that immediate remedial action is properly implemented.

¹³Although SEC did not inspect the Listing Department during the 11-year period, SEC inspected other NASD programs. OCIE officials told us that SEC conducted 24 inspections of 16 programs at NASD and NASDR from 1986 through 1997.

These new OCIE procedures should significantly improve recommendation follow-up. However, these procedures do not involve Commissioners, the agency's highest authorities. Involving the Commissioners in following up on recommendations would provide them information on the status of corrective actions deemed significant by SEC staff and would provide an additional incentive for SROs to comply. One way to accomplish this would be for SEC staff to periodically report all open, significant recommendations to the Commission. Involving the Commission would be analogous to OCIE's policy of involving an SRO's board of directors when OCIE deems its findings significant enough to merit board involvement. As SEC staff determine that SROs comply with recommendations, those recommendations could be closed.

Nasdaq Followed Its Listing Requirements for Comparator, but SEC Found the Continued Listing Inappropriate

Although Comparator occasionally had problems complying with Nasdaq's listing and maintenance requirements, Nasdaq never granted Comparator any exceptions. However, SEC found that Comparator's continued listing was inappropriate because, among other deficiencies, Nasdaq failed to investigate the value of Comparator's assets.

Comparator's Compliance With Listing and Maintenance Requirements

Nasdaq records show that Comparator had never received an exception, either to listing or maintenance requirements. Nasdaq officials provided us copies of excerpts from Comparator's SEC filings for the period from June 1989 through March 1996, along with selected trading and market information for the same time period. This information showed that Comparator complied with all initial listing requirements and, except as discussed below, also complied with all maintenance requirements.

Comparator was most recently listed on the Nasdaq SmallCap Market from February 28, 1990, through June 12, 1996.¹⁴ Nasdaq cited the company for late filings in 1991 and again in 1992. In both instances Comparator corrected the deficiencies before the conclusion of compliance procedures initiated by Nasdaq staff and received no exceptions at any time.

¹⁴Comparator had been listed on the Nasdaq Stock Market from June 1979 through July 1984. During this 5-year period, Comparator was cited for late filings three times and was also cited for capital and surplus or asset deficiencies four times. In each instance the company corrected these deficiencies before the conclusion of compliance procedures initiated by Nasdaq staff and received no exceptions. Comparator was delisted in 1984 for failing to maintain the required number of active market makers.

Although Comparator's bid price was typically less than \$1, Comparator complied with Nasdaq's \$1 minimum bid price requirement by meeting the capital and surplus alternative and under that option maintained its listing.¹⁵ However, in 1993 Comparator failed to meet the alternative \$2 million capital and surplus requirement. The company corrected this deficiency in its next public filing. In 1995, Comparator was not current in its annual listing fees but corrected this deficiency when notified by Nasdaq staff. In May 1996, Nasdaq staff notified the company it was not current in its filings. Nasdaq staff asked Comparator for updated filings and payment of fees. Nasdaq officials informed us that at all other times Comparator's public filings demonstrated compliance with Nasdaq maintenance requirements, and the company received no exceptions at any time.

SEC Criticized Nasdaq's Handling of Comparator

After its 1997 inspection of Nasdaq's Listing Department, SEC criticized Nasdaq's handling of Comparator. SEC staff said Nasdaq's Listing Department should have looked more closely at Comparator's balance sheet, particularly its assets. SEC staff noted that in Comparator's 1994 annual report, more than 50 percent of its assets consisted of patents and licenses related to obscure technologies. This made it relatively easy for Comparator to inflate their values. Because Nasdaq failed to verify the value of Comparator's assets, SEC claimed that Comparator continued to be listed inappropriately. SEC recommended that when asset valuation is an issue, Nasdaq staff should obtain additional information that would allow a Nasdaq analyst to verify, to the extent reasonably necessary, the validity and value of the asset.

SEC reported that Comparator had numerous problems that should have been tracked on a watch list system. In addition to the questionable assets just mentioned, SEC concluded that Comparator's termination of its corporate secretary for improper issuance of stock and stealing from the company, in addition to the 27 unsatisfied final judgments against it, should have foreshadowed the noncompliance that ultimately led to Comparator's removal from the SmallCap Market on June 12, 1996. SEC recommended that Nasdaq institute a watch list tracking system to identify

¹⁵Nasdaq's maintenance requirements from 1991 to 1997 permitted an alternative way to meet the \$1 minimum bid requirement. If a company's bid price was below \$1, but its capital and surplus were in excess of \$2 million and \$1 million in market value of public float, the company was allowed to maintain its listing. Effective February 22, 1998, with the implementation of Nasdaq's new listing requirements, Nasdaq Marketplace Rule 4310(c)(4) requires that common and preferred stock have a minimum bid price of \$1 per share for continued inclusion. Companies can no longer remain listed by satisfying alternative criteria.

and monitor companies experiencing difficulties that might be an indicator of future noncompliance.

SEC stated that Comparator had issued press releases announcing (1) the acquisition of a company engaged in real estate development in China, (2) its entry into a contract to produce the world's first biometrically protected national identification card, and (3) the introduction of its new identification verification system. SEC found that none of the claims made in these press releases were true. SEC recommended that Nasdaq require analysts to review Nasdaq companies' press releases.

SEC noted that on Comparator's 1993, 1994, and 1995 financial statements, the independent auditor's opinions expressed doubts about whether Comparator could continue as a "going concern."¹⁶ SEC noted no indication of concern by Nasdaq. SEC recommended that Nasdaq revise its procedures to require that companies receiving a going-concern opinion on their financial statements be required to file a business plan with Nasdaq demonstrating the company's ability to continue to operate in compliance with Nasdaq's maintenance requirements.¹⁷

SEC Also Generally Criticized Nasdaq's Listing Department

SEC's primary criticism was that Nasdaq did not adequately review companies for initial and continued listing. SEC reported that this condition existed mainly because Nasdaq failed to devote sufficient resources to the Listings Department.

SEC also noted other deficiencies in Nasdaq's Listing Department. In one case, SEC noted that Nasdaq failed to follow up on or refer for further investigation possible securities law violations it discovered in its review process, and SEC recommended that this be corrected. SEC expressed its concern that investors did not fully appreciate the difference between the National Market and the SmallCap Market. It recommended that Nasdaq highlight the differences between companies trading in these two markets and the attendant risks of investing in either market. SEC criticized the organizational structure of the Listing Department, noting that the senior official in charge of the Department also had marketing responsibilities.

¹⁶If an auditor concludes that there is substantial doubt about a company's ability to continue operations as a going concern, the audit report should reflect that conclusion. American Institute of Certified Public Accountants, Statement on Auditing Standards 59.

¹⁷SEC staff also recommended that Nasdaq analysts reviewing troubled companies for continued listing be required to prepare calculations estimating the company's ability, based on current expenses and income, to remain in compliance with Nasdaq's maintenance requirements. SEC staff noted that Comparator, as a company with negative earnings trends, would have qualified for such a review.

SEC observed that Nasdaq had generally failed to enforce filing deadlines and recommended that such deadlines be enforced. SEC also observed that Nasdaq had difficulty producing files in a timely manner and recommended that Nasdaq review and revise its filing system.

Finally, SEC noted that Nasdaq's Review Committee is dominated by members of the securities industry, and about 70 percent of its pool of hearing panel members are employed by market makers. SEC recommended that the Review Committee contain a strong representation of nonindustry representatives.

SEC recognized that Nasdaq has taken significant steps to address several of its recommendations to improve the Listing Department and the SmallCap Market. SEC believes that these developments reflect a commitment by Nasdaq towards improving the SmallCap Market.

Nasdaq Has Taken Actions to Improve Its Listing Department

Nasdaq officials disagreed with some of SEC's findings, but they generally recognized the merits of SEC's recommendations and stated their commitment to respond and continue to improve the quality of the SmallCap Market. They disagreed with SEC's findings that as a general matter, Nasdaq staff reviews of company filings were cursory or that Nasdaq had failed to satisfy its regulatory responsibilities to preserve and strengthen the quality of, and public confidence in, the SmallCap Market. As previously discussed, Nasdaq officials also disagreed that they had ignored recommendations SEC made in its 1986 inspection report. Nasdaq officials noted that although the SmallCap Market represented only about 3 percent of the Nasdaq Stock Market's total market value, they devoted significant resources to that market. Nasdaq statistics indicate that in 1996 the Department reviewed 374 applications for listing on the SmallCap Market and denied 132 of them, about 35 percent. During the same period the Department identified 972 deficiencies in 640 SmallCap companies. Of the 640 companies receiving deficiency notices, 548, about 86 percent, achieved compliance.

Nasdaq took several actions to address OCIE's criticism that Nasdaq failed to verify Comparator's assets or track its problems on a watch list. These actions also responded to OCIE's general criticism of inadequate review of filings due to insufficient resources. To complement its review procedures for listed companies, Nasdaq increased the staffing of its Listing Department by 11 positions to 44. In the SmallCap Market area, Nasdaq increased its review staff by 80 percent, from five to nine. Nasdaq's new

requirement that independent auditors of Nasdaq companies be subject to peer review is intended to help ensure a firmer basis for the reliance Nasdaq places upon audited financial statements, including asset valuation.

To identify and track high-risk companies, Nasdaq has developed an automated risk scoring system. This system was designed to identify companies with profiles that suggest the need for additional scrutiny, including scrutiny of asset valuations. These profiles are to be based on quantitative, qualitative, and trading attributes. Nasdaq also created a new special investigative unit of five experienced staff with financial and accounting expertise. It subsequently increased authorized staffing to a total of seven positions. This unit is intended to complement the listing qualifications program and to allow Nasdaq to watch and track high-risk issuers with more specialized focus. Such issuers might include those whose management, large shareholders, consultants, or underwriters had a disciplinary history. From its inception in December 1996 through April 1997, the unit has delisted five SmallCap issuers and investigated and closed two other matters.

In response to OCIE's criticism that it failed to review Comparator's press releases, Nasdaq stated that the review of Nasdaq companies' press releases is the primary responsibility of Nasdaq's Market Watch staff. Nasdaq-listed companies are required to notify Market Watch of the release of any significant information before its public release. Market Watch is to assess the information and, when appropriate, may implement temporary trading halts. Market Watch is also to notify the Listing Department and NASDR when there appears to be a pattern of misleading press releases. Upon such notification by Market Watch, the Listing Department is to evaluate the press release and follow up on any concerns the Department may have with the company. Nasdaq stated that a separate review of all press releases by its Listing Department is not warranted and would not be an appropriate allocation of resources.

In response to OCIE's criticism that Nasdaq was unconcerned about Comparator's going concern audit opinions, Nasdaq stated it does not believe that companies with going concern opinions should in each instance be required to file a business plan in order to maintain their listing. Nasdaq stated that it took this position because these plans focus on uncertain projections of future performance. Nasdaq agrees that a going concern opinion is a factor that the Listing Department should always consider. However, it believes that other factors, such as the

proceeds from the sale of stock, may counterbalance the opinion. In late 1996, Nasdaq added going concern audit opinions as a separate data element in its database of information about Nasdaq-listed companies. When Nasdaq staff review companies' filings, they are to note the presence of going concern opinions, and those companies are to be watched and tracked more closely.

Nasdaq also took actions that responded to OCIE's general criticisms of the Listing Department. Nasdaq implemented the use of a worksheet to be filled out when it reviews listed companies' SEC filings. To improve its referrals process, Nasdaq adopted a policy that referrals to NASDR Enforcement, SEC, and other law enforcement agencies should be in written form. Nasdaq officials met with SEC staff to establish the parameters of the referral program. As of November 21, 1997, Nasdaq staff had made three written referrals under the program.

Regarding OCIE's recommendation that Nasdaq highlight the differences between companies that trade in the National Market and companies that trade in the SmallCap Market, Nasdaq agrees with SEC's general policy that investors should be provided greater information about the securities they are buying. Nasdaq stated that it continues to make substantial investments in its public Internet Web site (Nasdaq.com), which includes a broad range of information for individual investors, such as current company and market information. The NASDR Web site (NASDR.com) also provides investors with a basic primer on how securities regulation works and how investors can avoid problems before they occur. The site also provides information on steps investors can take if they run into difficulty. In August 1996, NASD established the Office of Individual Investor Services to enhance investor education and outreach efforts and to establish a strong advocate for the individual investor within NASD. This office offers training on investment basics, provides guidance on working with a broker, publishes an investor newsletter, makes presentations, and provides information at investor forums.

To separate the compliance responsibilities of the Listing Department from its marketing responsibilities to obtain new listings, Nasdaq restructured its reporting lines so that the head of the Listing Department no longer reports to a Senior Vice President with direct marketing responsibilities. The Listing Department now reports to the Executive Vice President for Issuer, Investor, and International Services. To enhance its filing delinquency program, Nasdaq now provides its analysts with real-time access to periodic reports filed electronically with SEC. Nasdaq

anticipates this access will significantly reduce its delinquency discovery times and allow it to monitor listed companies' filing status on a daily basis.

To produce files in a timely manner when they are needed or requested, Nasdaq converted its issuer files from paper copies to electronic media for public filings and to an optical storage and retrieval system for issuers' proprietary material. To diversify the makeup of its Listing and Hearing Review Council, Nasdaq has agreed to change the makeup of the council. In 1998, the council is to comprise 11 members, with the majority being nonindustry representatives.

Nasdaq began designing and implementing these changes at different times after May 1996. Although SEC acknowledged that many of the changes Nasdaq made met the intent of SEC's recommendations, not all of the changes have been completely implemented, and others have not been in effect long enough to adequately assess their effectiveness. Further, SEC noted that the changes in Nasdaq's listing and maintenance requirements that it approved in August 1997 would not affect the need for Nasdaq to implement SEC's recommendations.

Nasdaq Monitors Exceptions Granted but Does Not Use Overall Program Statistics to Guide Its Operations

When Nasdaq staff make decisions to deny listing or to delist a company, the company can request a hearing before a Nasdaq listing qualifications panel. On the basis of its review, the panel may determine that an exception is warranted. Nasdaq staff maintain a database to monitor information about all companies that go through its hearings process. Nasdaq staff use the information in the database to gauge the day-to-day operations of the hearings process. However, the Listing Department does not aggregate or analyze the information over time to assess what happens to companies that request exceptions and their ultimate disposition. As a result, Nasdaq is missing opportunities for measuring the overall effectiveness of its operations.

Nasdaq Review Panels Grant Exceptions

As described earlier, issuers must apply to be listed on the Nasdaq SmallCap Market. If an application is denied, or if the company has fallen out of compliance with maintenance requirements, the company can request an exception to the denial or delisting decision made by Nasdaq staff. The exception must be requested in writing and a fee paid. The Nasdaq Listing Qualifications Panel (NLQP), a two-member panel composed of both securities industry and nonindustry professionals approved by the

NASD Board of Governors, reviews denial or delisting decisions made by Nasdaq staff. NLQP makes a decision that is immediately actionable, but the decision is subject to review at the request of the company or a member of the Nasdaq Listing and Hearing Review Committee (NLHRC).

NLHRC is an 11-member standing committee appointed by the Nasdaq Board of Directors. NLHRC receives all decisions made by NLQP and can affirm, reverse, modify, or remand any decisions it receives. Furthermore, all NLHRC decisions are provided to, and may be called for review by, the Nasdaq Board of Directors or the NASD Board of Governors. In addition to the levels of review described above, Nasdaq officials pointed out that decisions by NLHRC after Board consideration can be appealed to SEC, and SEC may call any NLHRC decision for review.

Nasdaq Collects Information on Companies That Go Through Its Hearings Process

Nasdaq maintains a database that includes information about a company's deficiencies as well as the outcomes of hearings (whether a company is approved or denied initial listing, granted an exception, or delisted from Nasdaq). Nasdaq staff use this database to document the terms of any exceptions granted and the company's final disposition with respect to the terms of the exception.

Nasdaq officials told us the Listing Department uses the information in its databases to generate a daily delinquency report that lists all companies that are delinquent in their filings. The Department also generates a weekly list of companies that do not comply with other maintenance requirements. According to Nasdaq officials, the databases that produce these reports will be replaced shortly by a new system that will consolidate in one database all information about a listed company, including its compliance record and a record of any deficiencies and exceptions granted.

Nasdaq Could More Effectively Use Overall Program Statistics

Currently, Nasdaq does not routinely use overall program statistics to evaluate and guide its Listing Department activities. For example, the Department produces no routine reports for senior management that present overall program statistics. By not routinely aggregating and analyzing overall program statistics over time, Nasdaq cannot demonstrate the effectiveness of its exceptions granting policies. Key indicators of effectiveness, such as the outcomes of companies granted exceptions, compared to those not granted exceptions as well as compared to program

goals, can help to demonstrate the effectiveness of Nasdaq's exceptions granting policies.

For example, Nasdaq officials provided statistics that showed they received 1,147 listing applications for the SmallCap Market between May 1994 and June 1997. Of that number 66 companies, or 5.8 percent, were listed with exceptions to listing requirements. During the same period, Nasdaq granted exceptions to maintenance requirements to 168 companies. On an annualized basis, the average number of companies granted an exception was 53, or 3.8 percent of the average number of companies (1,381) listed on the SmallCap market at any given time. These numbers have little meaning without some context. Collecting and analyzing the data over time, especially the outcomes for these companies (whether they remain on the SmallCap Market or list on another market), could provide Nasdaq a key indicator of the effectiveness of its exceptions granting process.

Nasdaq officials also provided statistics for us that showed 562 companies dropped off the SmallCap Market from May 1, 1994, to May 30, 1997.¹⁸ Of that number, 409 were delisted as noncompliant, and 153 delisted voluntarily. On an annualized basis, the 562 companies that were no longer listed represent a turnover rate of about 182 companies, or 13.2 percent of the average number of companies (1,381) listed at any given time. Collected and analyzed over time, data on this turnover rate of companies listed on the Nasdaq SmallCap Market, including information on what happened to those companies, would provide Nasdaq, SEC, and investors a key indicator of the effectiveness of its listing and maintenance standards. Such data, when compared to program goals, can help demonstrate Listing Department results; identify performance gaps; and align activities, core processes, and resources. The experiences of leading organizations that use such information show that it can become a driving force in improving the effectiveness and efficiency of program operations.

Conclusions

Although SEC inspected all SRO listing departments in 1997, during the preceding 11 years it had inspected these departments infrequently or not at all. Before 1995, frequent and regular inspections were SEC's primary method of following up to ensure its recommendations were implemented. Our work at Nasdaq's Listing Department showed that infrequent inspections and the lack of an effective recommendation follow-up system

¹⁸These numbers do not include companies that switched, either from the Nasdaq National Market to the SmallCap Market, or vice versa.

allowed deficiencies that SEC identified to remain uncorrected for long periods. OCIE's action in 1996 to establish regular inspection cycles for SRO listing departments, if properly implemented, should help ensure that deficiencies in these departments do not remain uncorrected for long periods. More importantly, OCIE's new procedures provide a systematic process to follow up on the recommendations it makes in all of its SRO inspections. Including SEC Commissioners, who have the authority to require SROs to comply with OCIE's recommendations, in the process would provide an additional incentive for SROs to comply with OCIE recommendations.

We share SEC's concern that the deficiencies identified in Nasdaq's Listing Department operations could have had the effect of misleading investors who are entitled to assume that the stocks listed on the Nasdaq SmallCap Stock Market meet the listing and maintenance requirements of that marketplace. The Listing Department has made changes in its operations that, if implemented correctly, should improve the SmallCap Market and enhance investor protection. Not all of these changes have been completely implemented, and others have not been in effect long enough to adequately assess their effectiveness.

Our work also showed that Nasdaq's Listing Department does not routinely use overall program statistics to evaluate and guide its activities. Aggregating and analyzing such information could help Nasdaq ensure that its programs are results oriented, its goals are clearly established, and its strategies for achieving those goals are appropriate and reasonable. Such information could also help SEC conduct better regulatory oversight of SRO listing programs.

Recommendations

We recommend that the Chairman, SEC,

- require OCIE to periodically report the status of all open, significant recommendations to the Commissioners; and
- require NASD to develop management reports based on overall program statistics that demonstrate its Listing Department's operating results, such as the number of companies granted exceptions to listing and maintenance requirements along with their ultimate disposition, and to submit this data periodically to the Commissioners for review.

SEC's Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman, SEC. On December 19, 1997, the Director, Office of Compliance Inspections and Examinations for SEC, provided written comments. These comments are reprinted in appendix I. SEC also provided technical comments, which we incorporated where appropriate.

SEC agreed with the facts as stated in our report. It also agreed with our recommendation that OCIE periodically apprise the Commission of the status of all open, significant recommendations. Further, SEC stated that it intends to take steps to inform the Commission whenever an SRO submits a response to an SEC inspection report that indicates the SRO does not intend to take adequate corrective actions in response to SEC's recommendations.

NASD's Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman, NASD. On December 19, 1997, the President of the Nasdaq Stock Market, Inc., provided written comments. These comments are reprinted in appendix II.

Nasdaq Stock Market officials agreed with the conclusion reached in our report regarding the need for Nasdaq to make greater use of statistics to evaluate and guide its activities. They accepted our recommendations and stated they will provide senior management with statistical reports on the Listing Department's operations on a quarterly basis.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 14 days from its issue date. At that time, we will send copies of this report to the Majority and Minority Members of the House Commerce Committee and to other interested parties. We will also make copies available to others on request.

Major contributors to this review are listed in appendix III. Please contact me at (202) 512-8678 if you or your staff have any questions.

Sincerely yours,

A handwritten signature in black ink that reads "Thomas J. McCool". The signature is written in a cursive style with a large, looping "M" and "C".

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

Contents

Letter	1
Appendix I Comments From the Securities and Exchange Commission	28
Appendix II Comments From the NASDAQ Stock Market, Inc.	30
Appendix III Major Contributors to This Report	34
Tables	
Table 1: Comparison of Quantitative Listing Requirements for the Nasdaq SmallCap Market	9
Table 2: Comparison of Quantitative Maintenance Requirements for the Nasdaq SmallCap Market	10
Table 3: SRO Listing Department Inspections From 1986 Through August 1997	11

Abbreviations

NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation
NASDR	NASD Regulation, Inc.
NLHRC	Nasdaq Listing and Hearing Review Committee
NLQP	Nasdaq Listing Qualifications Panel
NYSE	New York Stock Exchange
OCIE	Office of Compliance Inspections and Examinations
OTC	over the counter
SEC	Securities and Exchange Commission
SRO	self-regulatory organization

Comments From the Securities and Exchange Commission



OFFICE OF COMPLIANCE
INSPECTIONS AND
EXAMINATIONS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 19, 1997

Mr. Thomas J. McCool
Director, Financial Institutions and
Market Issues
United States General Accounting Office
Washington, DC 20548

Re: GAO's Draft Report: Oversight of SROs Listings Departments
Could be Improved

Dear Mr. McCool:

Thank you for the opportunity to comment on the General Accounting Office's draft report and assessment of the oversight of the Nasdaq SmallCap Market by the National Association of Securities Dealers and the Securities and Exchange Commission (SEC). While your report focuses largely on events surrounding the Nasdaq's SmallCap listing of Comparator Systems Corporation, it highlights the need for self-regulatory organizations (SROs) to have in place systems and procedures to ensure that their listed companies are in compliance with all applicable listing standards, and the need for the SEC to provide adequate oversight over this important function.

As the Report notes, the SEC has taken steps to enhance its oversight of the SROs listing programs. With the addition of new staff in 1996, the Office of Compliance Inspections and Examinations was, for the first time, able to place SROs' listing programs on a routine inspection cycle. As you note in the Report, all equity listing programs have recently been inspected. We appreciate GAO's acknowledgment that these new cycles, and the other measures adopted by OCIE, "should significantly improve" the SEC's ability to follow-up on the recommendations we make in connection with our inspections of listings programs.

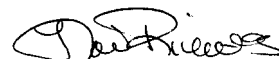
We agree with the GAO's recommendation that OCIE apprise the Commission periodically of the status of all open, significant recommendations. We intend to take steps to inform the Commission whenever an SRO submits a response to an SEC inspection report that indicates to us that it does not intend to take adequate corrective action to cure a material deficiency cited in an inspection report. We also intend to

Appendix I
Comments From the Securities and
Exchange Commission

Mr. Thomas J. McCool
December 19, 1997
Page 2

discuss with the Nasdaq your recommendation that Nasdaq develop management reports based on its overall listing program statistics. I understand that Nasdaq agrees with the recommendation and will be taking steps to implement it.

Very truly yours,



Lori A. Richards
Director

Comments From the NASDAQ Stock Market, Inc.

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE NASDAQ STOCK MARKET, INC.

NASDAQ

ALFRED R. BERKELEY, III
PRESIDENT

December 19, 1997

Thomas J. McCool
Director, Financial Institutions and
Market Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. McCool:

Thank you for the opportunity to review and comment on the General Accounting Office's ("GAO") draft report entitled SEC Could Improve Oversight of SROs' Listing Departments. We understand the report was prepared in response to a request from the Honorable John D. Dingell, Ranking Minority Member, Committee of Commerce, concerning the application of the Nasdaq SmallCap Market's entry and maintenance requirements and in particular, the events surrounding the listing of Comparator Systems Corporation. We are pleased at GAO's finding that Nasdaq's "Listing Department followed its listing and maintenance requirements for Comparator and had never granted the company any exceptions to those requirements."

Nasdaq and the NASD are committed to the highest quality listing qualifications program to ensure the integrity of The Nasdaq Stock Market. We believe it is our obligation to the investor community to ensure that all Nasdaq companies are in compliance with our qualitative and quantitative listing requirements. Although the Nasdaq SmallCap Market represents only 3.1 percent of the Nasdaq Stock Market's total market value, we devote significant resources to our SmallCap qualifications program.

In that regard, over the last 18 months, we have made significant commitments to strengthen our qualifications program which have been acknowledged by both GAO and SEC. These improvements include, among other things: the addition of 12 analyst positions, representing a 36 percent increase in Listing Qualifications staff, as well as the formation of a seven person Listings Investigations Department dedicated to scrutinizing high-risk issuers; the development of an automated risk scoring system to identify issuers that may warrant additional examination; the establishment of a direct link with SEC's Edgar database to expedite the identification and processing of filing delinquent issuers (resulting in the reduction of detection time from 15 to 2 days, an 87 percent decrease); the implementation of a filing review form to establish a more formal audit trail of staff periodic filing review; and formalization of a referral process regarding possible violations of the securities laws to NASD Regulation, SEC, and other regulatory

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**Appendix II
Comments From the NASDAQ Stock
Market, Inc.**

Thomas J. McCool
December 19, 1997
Page 2

authorities. Finally, we recently obtained SEC approval for a rule that significantly increases the listing standards for the SmallCap Market. These new standards substantially raise the quantitative requirements, institute independent director, audit committee, and shareholder approval requirements, and impose peer review requirements for independent auditors. We believe these standards should meaningfully improve investor protection in the SmallCap Market. In all, these improvements reflect Nasdaq's strong commitment to maintain and enhance the integrity of its SmallCap Market, and they should address any issues arising in the context of SEC's inspection of the listing program as it existed from April 1994 through April 1996.

In addition, we agree with GAO that all markets could benefit from more frequent inspections, program assessments, and the critical self-analysis they engender. Indeed, many of Nasdaq's listing qualifications initiatives over the years, as well as those discussed above, were prompted by the introspection that independent oversight affords. That said, we would like to clarify a point relating to GAO's statement that SEC's infrequent inspections allowed deficiencies that SEC previously identified to remain uncorrected for long periods. We believe it is important to note that the two areas that SEC identified as not being satisfactorily addressed related to SEC's recommendations that "1) Nasdaq adopt a special procedure to scrutinize the financial status of a company with a pattern of delinquent filings; and 2) that Nasdaq consider modifying its qualification requirements to provide for deletion of a security after a specified number of delinquent filings by the issuer." In fact, Nasdaq responded to both recommendations to in its reply to the 1986 inspection report. With respect to the first point, Nasdaq's records and its response to the inspection referenced its already existing practice of scrutinizing chronic delinquent filing issuers through its hearings process. With respect to the second point, following the 1986 inspection and again in 1997, Nasdaq indicated that it would decline to implement the recommendation. In 1986, Nasdaq noted that it had in place alternative means to address the issue. In 1997, Nasdaq also expressed concern that a rule providing for the deletion of a security after a specified number of delinquencies might imply a safe harbor for issuers whose delinquencies fall below the specified number. Accordingly, until 1997, Nasdaq believed it had addressed the issues raised in the SEC inspection report. There should be no impression left that Nasdaq ignored earlier recommendations or that the integrity of the market was harmed. Notwithstanding this, we concur with GAO's observation that greater oversight and interaction between SEC and SROs is beneficial.

GAO's suggestion that Nasdaq should make greater use of statistics to evaluate and guide its activities further illustrates the benefits of independent oversight. We have fully embraced your suggestions, and will provide senior management with the resulting statistical reports on a quarterly basis. You may be interested to know that, our statistical analysis of the effectiveness of our exceptions granting process reflects that only 18.8% of Nasdaq SmallCap issuers attending a hearing to request an exception had previously attended a hearing within the past three years. Of this 18.8%, 67% were ultimately delisted. We believe that this statistical analysis reflects

**Appendix II
Comments From the NASDAQ Stock
Market, Inc.**

Thomas J. McCool
December 19, 1997
Page 3

favorably on our program, and corroborates our strong impression based upon our case by case evaluation that there is a low recidivism rate among issuers receiving exceptions, and further, that issuers with a history of non-compliance are unlikely to receive an exception to our listing standards.

In closing, we would like to express our appreciation for the opportunity to have an open dialogue and the high level of professionalism of GAO staff in its interaction with Nasdaq staff, as well as the GAO's helpful recommendations regarding the use of statistics. We value the commitment of both the GAO and SEC to improve the quality of the SmallCap Market, and we appreciate the significant thought and effort that went into the respective contributions to the improvement of our market for the benefit of investors.

Very truly yours,



cc: Frank Zarb
Rick Ketchum
Mary Schapiro
Perry Peregoy

Appendix II
Comments From the NASDAQ Stock
Market, Inc.

The following is GAO's comment on the Nasdaq Stock Market, Inc.'s, December 19, 1997, letter.

GAO Comment

1. We added text on pages 11 and 16-19 that indicates that (1) Nasdaq officials disagreed with SEC that they had ignored recommendations SEC made in its 1986 inspection report; and (2) Nasdaq officials, until 1997, believed they had addressed the issues raised in SEC's 1986 inspection.

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