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NASDAQ®

March 18, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington D.C. 20549-0609

Re: Proposed Amendments to the Penny Stock Rules File No. S7-02-04

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("NASDAQ") welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed amendments to the penny stock rules. We applaud the Commission's goal of protecting investors from fraudulent or abusive sales and trading practices. To further this goal, NASDAQ has, among other things, separated the market operations from its regulator, the NASD, and paid the NASD over $61 million for market regulation in 2003.

However, we are concerned that the Commission's attempt to limit possible trading abuses in certain small, illiquid stocks by freezing in time the listing standards of all stock markets could hurt rather than help investors. Furthermore, to the extent that the Commission believes a standard must be set across all markets, fairness dictates that the same standard be applied to all markets. The proposal, as written, fails this test. It risks regulatory arbitrage and could impede the ability of established markets to deal with sudden economic and geopolitical events. This undermines a stated goal of the Commission: "we do not intend to create impediments to small companies' access to the capital markets or eliminate a viable secondary market for their securities."

It appears that by universally adopting the SmallCap Market listing standards as of January 8, 2004 as the baseline penny stock exempting standards and by "grandfathering" national exchanges registered since April 20, 1992, the Commission is laboring under the false assumption that the standards of all markets are substantially the same. Clearly this is not the case. For instance, NASDAQ notes that the American Stock Exchange's ("Amex") initial listing standard for price is $3.00 per share,[1] whereas the NASDAQ SmallCap Market standard is $4.00 per share.[2] Thus, in certain material respects, the SmallCap Market initial listing standards are more stringent than the initial standards of the Amex, which would be grandfathered by the proposed definition of a "penny stock."

This disparity between initial listing standards is presumably the opposite of what the Commission intends. It creates the opportunity for an issuer to choose a listing venue with laxer standards to secure an exemption from the penny stock rules rather than choosing the venue that provides a more transparent, more liquid, and better regulated market for investors. The proposal also may inadvertently thwart the stated goals of Congress and the Commission to foster competition since some markets would have a built in advantage memorialized in Commission regulation.[3] At a minimum, NASDAQ requests that the proposal be amended to apply truly uniform standards across all markets and exchanges impacted by the change.

On a broader level, an attempt to freeze listing standards seems contrary to the reality that change is an integral component of market evolution. The Commission has long recognized the value and importance of experimentation with new listing standards as exhibited, for example, by its willingness to review and approve certain proposed listing standards on a pilot basis. Such proposals and resulting pilot programs often stem from the unpredictable evolution of capital markets, the genesis of which typically touches small companies in emerging industries.

For example, in the fall of 2001, NASDAQ proposed and the Commission approved certain changes to the SmallCap Market continued listing standards in response to the terrorist attacks of September 11, 2001.

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[1] In fact, under certain listing alternatives the Amex will list a stocks regardless of their market price. *See gen.* Amex Company Guide, Section 101(c).
[2] *See* NASDAQ Marketplace Rule 4310(c)(4).
[3] *See e.g.*, Section 11A(a)(1)(C) of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. Section 78k-1(a)(1)(C)] (Congress finds that "[i]t is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—...fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets").

History has taught us that there are countless other unforeseeable scenarios in which it may be necessary to modify listing standards, perhaps including initial listing standards, to coincide with attendant outside forces, market forces and the evolution of capital formation. NASDAQ is concerned that the current proposal does not provide for such flexibility.

NASDAQ believes that the current overall regulatory structure encourages flexibility while ensuring the Commission's absolute oversight of listing standards to avoid potential penny stock-type abuses in listed securities. Under this system, the Commission has the authority to refuse any proposal or amendment it deems inconsistent with the federal securities laws, and could require that the application of certain amendments be limited to a separate "junior tier" of the market that would be subject to the penny stock rules. We believe that the current system meets the needs of investors better than a rigid, time-based freeze on listing standards.[4]

In sum, NASDAQ agrees with the Commission's efforts to improve the information available to investors in stocks covered by the penny stock rules. However, we believe that efforts to freeze listing standards are counterproductive—even if the baseline used is NASDAQ's current standards. Therefore, NASDAQ respectfully requests that the Commission recognize the value of a flexible model to investors when it adopts final rules. At a minimum, any standards adopted must be truly uniform across all affected markets.

NASDAQ appreciates the opportunity to comment on the penny stock proposals and would welcome the opportunity to discuss its concerns in more detail.

Sincerely,

Edward S Knight

Edward S. Knight

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[4] Of course, the Commission could grant waivers or exemptions on a case-by-case basis even under a rigid system. But this risks the development of regulation by exemption, eventually gutting the whole purpose of a uniform system. We believe it is better to begin with a more flexible model.