United States General Accounting Office

GAO

Report to Congressional Requesters

April 2004

SECURITIES MARKETS

Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight

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GAO-04-75

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Highlights

Highlights of GAO-04-75, a report to congressional requesters

April 2004

SECURITIES MARKETS

Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight

Why GAO Did This Study

The equity listing standards of the three largest U.S. securities markets—the American Stock Exchange (Amex), the Nasdaq Stock Market, Inc. (NASDAQ), and the New York Stock Exchange (NYSE)—have received heightened attention as part of efforts to restore investor confidence following the 2001 terrorist attacks and the unexpected corporate failures beginning that year. GAO was asked to discuss (1) the status of the Securities and Exchange Commission's (SEC) recommendations to the three largest markets for improving their equity listing programs, (2) SEC's oversight of NASDAQ's moratorium on the enforcement of certain of its listing standards and the status of affected listed companies (issuers), and (3) actions the three largest markets have taken to strengthen corporate governance.

What GAO Recommends

This report includes 12 recommendations to SEC designed to enhance investor confidence in the markets, further strengthen the listing standards of the self-regulatory organizations (SRO) that oversee the markets, and improve SEC and SRO oversight of the markets' listing programs. SEC generally agreed with the recommendations; the SROs expressed concerns about those related to notifying the public of noncompliance with listing standards and enhancing board independence.

www.gao.gov/cgi-bin/getrpt?GAO-04-75.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Rick Hillman at (202) 512-8678 or hillmanr@gao.gov.

What GAO Found

The only significant open recommendation from SEC's inspections of the three largest U.S. markets' equity listing programs was a recommendation that these markets append a modifier to the stock symbol of issuers that do not meet their continued listing standards to provide the public early and ongoing notification of issuers' noncompliance with these standards. NYSE has taken steps to implement this recommendation for its quantitative standards by transmitting an indicator of an issuer's noncompliance with stock data to information vendors, but concerns remain about the further distribution of this information from the vendors to investors. NASDAQ has provided some ongoing notification of noncompliance with certain listing standards since before 1980. More recently, NASDAQ and Amex have proposed using indicators to address SEC's recommendation, but the indicators generally would not be transmitted early in the deficiency process. In the absence of voluntary action by the markets, further SEC action is warranted to ensure that the public receives early and ongoing notification of issuers' noncompliance with listing standards.

Following the market instability after September 11, 2001, SEC allowed a NASDAQ rule to remain in effect that imposed a 3-month moratorium on enforcing NASDAQ's bid-price related listing standards. While its full effect could not be determined, the moratorium met its objective of allowing noncompliant issuers more time to trade without facing the threat of delisting. According to NASDAQ, the moratorium provided relief to at least 509 issuers—about 11 percent of all its issuers. SEC subsequently approved another NASDAQ rule that allows some issuers to trade up to 2 years while noncompliant with the bid-price standard—a long time absent a means of providing the public with both early and ongoing notification of an issuer's listing status.

In response to a 2002 SEC request and rules implementing the Sarbanes-Oxley Act of 2002, the three largest U.S. markets have adopted changes to their corporate governance listing standards that when implemented should promote stronger board oversight and greater accountability. Increasing the role and authority of independent directors is central to these governance reforms. Consistent with the position of some market participants, GAO encourages SEC, in conjunction with the markets, to seriously consider using listing standards to further strengthen board independence by requiring a supermajority of independent directors and separating the positions of chief executive officer and board chairman. Also, to better ensure that they hold themselves accountable to standards consistent with those imposed on issuers, SEC asked the three largest markets to evaluate their own governance. SEC's timely review of both the markets' oversight of issuers' compliance with the new corporate governance standards and the markets' changes to their governance will be important to ensuring the effectiveness of issuers and markets' actions.

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Abbreviations

AFEP-AGREF	Association of French Private Sector Companies and Association of Major French Corporations
AFL-CIO	American Federation of Labor and Congress of Industrial Organizations
Amex	American Stock Exchange
CEO	Chief Executive Officer
CFTC	Commodity Futures Trading Commission
EDGAR	Electronic Data Gathering, Analysis, and Retrieval
IG	Inspector General
NASD	National Association of Securities Dealers, Inc.
NASDAQ	Nasdaq Stock Market, Inc.
NNM	NASDAQ National Market
NYSE	New York Stock Exchange
OCIE	Office of Compliance Inspections and Examinations
SEC	Securities and Exchange Commission
SCM	SmallCap Market
SRO	self-regulatory organization

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United States General Accounting Office
Washington, D.C. 20548

April 8, 2004

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

The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

The Honorable Paul E. Kanjorski
Ranking Minority Member
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

The equity listing standards of the three largest U.S. securities markets—the American Stock Exchange (Amex), Nasdaq Stock Market, Inc. (NASDAQ), and New York Stock Exchange (NYSE)—have received heightened attention as part of public and private efforts to restore investor confidence in the markets.[1] Listing standards have been the focus of attention because they govern which companies can be listed for trading on a particular market and are intended in part to maintain public confidence in the markets. In its role as a self-regulatory organization (SRO), each market establishes and enforces the standards that companies must meet to be listed for trading.[2] To oversee the effectiveness of the SROs' listing programs, the Securities and Exchange Commission (SEC), through its Office of Compliance Inspections and Examinations (OCIE), periodically

[1]Amex, NASDAQ, and NYSE are the three largest U.S. securities markets for equities trading based on the number of listed U.S. companies.

[2]The markets are regulated under a combination of self-regulation (subject to oversight by the Securities and Exchange Commission) and direct federal regulation. Except where the context otherwise requires, we use the term "SRO" to include NASDAQ, although as of March 10, 2004, NASDAQ's application for registration as a national securities exchange was pending at the Securities and Exchange Commission. Until its application is approved, NASDAQ is not an SRO. Instead, NASDAQ proposes its rules through the responsible SRO, the National Association of Securities Dealers, Inc.

inspects these programs and makes recommendations intended to improve them.

Your ongoing interest in learning how the three largest SROs have addressed OCIE's recommendations for improving their listing programs, particularly those related to protecting investors, has broadened as listing standards have increasingly become the focus of solutions to challenges facing the markets.[3] First, in response to the market turmoil resulting from the September 2001 terrorist attacks on the United States, NASDAQ, subject to SEC's oversight, implemented a rule that imposed a moratorium on enforcing its listing standards for bid price[4] and market value of publicly held shares[5] and subsequently implemented two additional rules that further relaxed its bid-price standard. These actions raised questions about how NASDAQ and SEC, in their regulatory roles, balanced the goal of market stability against that of investor protection. Second, the unexpected failures of several major corporations beginning in 2001 focused congressional and regulatory attention on improving issuers and SROs' corporate governance—that is, the way boards oversee management to ensure that organizations are well-run and shareholders are treated fairly.[6]

As agreed with your offices, we discuss the following in this report: (1) the status of OCIE's recommendations to the three largest SROs for improving their markets' equity listing programs, focusing on a recommendation intended to ensure early and ongoing public notification of issuers' noncompliance with continued listing standards; (2) the extent to which OCIE uses SROs' internal review reports in its inspection process;[7] (3) SEC's oversight of NASDAQ's moratorium and subsequent bid-price rule changes and the listing status of the issuers directly affected by these

[3]The term "three largest SROs" is used in this report to refer to Amex, NASDAQ, and NYSE.

[4]NASDAQ defines bid price as the price a buyer is willing to pay for a security.

[5]Market value of publicly held shares is the bid price multiplied by the number of outstanding shares held by investors that are not officers, directors, or 10 percent or greater shareholders.

[6]Issuers are organizations such as corporations that are selling or have sold their securities to the public.

[7]The term "internal review reports," as used in this report, includes internal audit reports, management review reports, and internal reports prepared by outside consultants or auditors.

changes; and (4) actions the three largest SROs have taken to strengthen corporate governance for issuers and themselves.

To report on the status of OCIE's recommendations to the three largest SROs for improving their markets' equity listing programs, we reviewed OCIE's inspection reports and related workpapers and obtained available information from OCIE, Amex, NASDAQ, and NYSE officials on OCIE's recommendations and the SROs' efforts to address them. In addition to these steps, in reviewing actions to address OCIE's recommendation intended to ensure early and ongoing public notification of issuers' noncompliance with continued listing standards, we contacted 11 information vendors, visited their Web sites, or both, to determine whether they were distributing the information on issuers' noncompliance with NYSE's quantitative continued listing standards.[8] To report on the extent to which OCIE uses SROs' internal review reports in its inspection process, we obtained and reviewed information from OCIE and other regulatory agencies on their policies for using these reports in planning and conducting inspections and examinations and reviewed authoritative standards and selected SRO internal review reports. To report on SEC's oversight of NASDAQ's moratorium and subsequent bid-price rule changes and the listing status of issuers directly affected by these changes, we reviewed relevant NASDAQ proposed and final rules and discussed their purposes with NASDAQ officials, obtained information from SEC officials on their review of the proposals, and analyzed data provided by NASDAQ. Finally, to report on the actions the three largest SROs have taken to strengthen corporate governance for issuers and themselves, we reviewed SROs' proposed and final (new) corporate governance rules for issuers and self-evaluations of their own governance. We obtained information from regulatory officials on the purpose of the new rules and their plans for ensuring compliance with them. We also obtained selected market participants' views of the adequacy of the SROs' new rules.[9] We performed our work from April 2002 through March 2004 in accordance with generally accepted government auditing standards. Appendix I provides a detailed discussion of our scope and methodology.

[8]Quantitative continued listing standards are the minimum financial requirements that issuers must meet to remain listed for trading on a market. See appendix II for Amex, NASDAQ, and NYSE's quantitative listing standards.

[9]See appendix IV for a list of the market participants that we contacted during this review.

Results in Brief

OCIE has concluded that the three largest SROs have addressed the recommendations that were unique to their markets from its inspections of their listing programs. The only significant, open recommendation applies to all three SROs—that they append a modifier to the stock symbols of issuers that do not meet their continued listing standards to provide the public early and ongoing notification of issuers' noncompliance with these standards. OCIE's recommendation addressed its concern that the SROs were allowing noncompliant issuers to remain listed for significant periods of time without providing adequate notification to investors. To avoid investor confusion caused by temporary changes to stock symbols, NYSE has implemented procedures for transmitting an indicator with the issuer's stock quotation data over the consolidated tape[10] to information vendors,[11] beginning 5 business days after NYSE notifies the issuer of its noncompliance with the market's quantitative continued listing standards. OCIE officials said that NYSE's response could meet the intent of OCIE's recommendation as it relates to quantitative listing standards, if concerns about distributing the information transmitted by the indicator from vendors to investors were resolved. A NASDAQ official told us that NASDAQ has used a symbol modifier since before 1980 to provide the public ongoing notification of some issuers' noncompliance with quantitative listing standards. In April 2003, NASDAQ tentatively proposed replacing the modifier with an indicator that would be used in a manner similar to NYSE's. However, as in the case of its symbol modifier, the indicator would not be transmitted early in the deficiency process. Amex has also proposed using an indicator that would not be transmitted early in the deficiency process. Complementing OCIE's efforts, SEC's Division of Corporation Finance (Corporation Finance) has proposed a rule that would require, among other things, that an issuer report on SEC's Form 8-K[12] the receipt of a notice of noncompliance with quantitative or qualitative

[10]The consolidated tape is a high-speed electronic system that continuously provides the last sales price and volume of securities transactions in listed Amex and NYSE stocks to information vendors. NASDAQ operates a similar, but separate, tape to transmit information on its stocks to information vendors.

[11]Information vendors supply quotation and market data for investors' use.

[12]Issuers use the Form 8-K to report significant specified corporate events as well as any other event or change that the issuers deem to be of importance to investors and that has not been previously reported. (Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, SEC Release No. 33-8106, June 17, 2002.)

continued listing standards,[13] along with an explanation of the facts surrounding the issuer's noncompliance, within 2 business days of receiving the notice.[14] If finalized, the revised filing requirement would provide investors the early notification that OCIE seeks as well as information that would allow them to better understand the issuer's noncompliant status. OCIE officials told us that further use could be made of modifiers or indicators to identify issuers that do not meet the markets' qualitative listings standards, which include corporate governance standards. For example, a NASDAQ official said that since before 1984, NASDAQ has appended a modifier to the stock symbols of issuers that do not comply with its qualitative listing standard that requires timely filing of SEC quarterly and annual financial reports and in doing so has provided investors early and ongoing notification that significant corporate information has not been made available. OCIE plans to report to the Commission on the SROs' progress in implementing its recommendation, and the Commission has authority under the Securities Exchange Act of 1934 (the Exchange Act) to resolve implementation issues or to take alternative actions to ensure that the public receives early and ongoing notification of issuers' noncompliant status.

OCIE officials told us that they do not routinely use SROs' internal review reports in planning and conducting inspections designed to assess the quality of SROs' oversight. These officials said that OCIE does not have a written policy that specifically addresses the use of internal review reports in inspections and that OCIE relies on the guidance provided in a policy memorandum addressing their use in examinations of broker-dealers, investment advisers, and investment companies. Under the policy, internal review reports would be used in inspections when OCIE believed specific problems existed at an SRO that warranted further investigation. According to OCIE officials, routine use of the reports would have a "chilling effect" on the flow of information between SRO internal review staff and other SRO employees, thereby reducing the effectiveness of the internal review function. Nonetheless, professional standards recommend the use of the reports for planning and conducting inspections, and officials of the Inspectors General (IG) offices for the Commodity Futures Trading Commission (CFTC) and the Department of the Treasury (Treasury) told us

[13]Qualitative continued listing standards are the market's minimum nonfinancial requirements that issuers must meet to remain listed for trading on a market.

[14]Corporation Finance officials told us that they are considering alternatives to the proposed 2-business-day filing requirement based on public comments.

that they routinely use the reports for these purposes. Also, our work showed that some of the SROs' reports addressed topics that OCIE has addressed in its listing program inspections, such as internal reviews of SROs' initial and continued listing programs, and that the reports could have been useful to OCIE in planning and conducting its inspections. However, according to OCIE officials, to the best of their knowledge, they have never requested an SRO internal review report as part of a listing program inspection.

In September 2001, SEC allowed a NASDAQ rule to remain in effect that imposed a 3-month moratorium on enforcing continued listing standards for bid price and market value of publicly held shares.[15] NASDAQ had concluded that the moratorium was necessary because of the increasing number of issuers that were falling below the applicable standards after September 11. NASDAQ officials expressed concern that delisting these issuers would, among other things, disadvantage investors who would be limited to trading the related securities in markets that were not subject to the same level of regulation and transparency as NASDAQ.[16] According to NASDAQ data, the moratorium provided relief from pending or potential delisting to at least 509 issuers, or about 11 percent of all NASDAQ issuers.[17] After the moratorium expired, SEC allowed another NASDAQ rule to remain in effect establishing a pilot program that (1) extended from 90 days[18] to almost 1 year the period that SmallCap Market (SCM) issuers that were noncompliant with the market's bid-price continued listing standard could remain listed and (2) established procedures that allowed NASDAQ National Market (NNM) issuers that remained noncompliant with the bid-price standard to transfer to the SCM.[19] As of February 28, 2003, 246

[15]NASDAQ proposed the moratorium in a filing with SEC under procedures contained in federal securities law and SEC regulations that allowed the proposal to become effective upon filing, subject to a waiting period that SEC waived.

[16]Transparency is, among other things, the degree to which trade and quotation information is available to the public.

[17]NASDAQ stopped tracking individual issuers' compliance with the bid-price and market value of publicly held shares standards during the moratorium; therefore, the total number of issuers affected by the moratorium could not be determined.

[18]Unless otherwise indicated, all days in this report are calendar days.

[19]NASDAQ is a two-tier market, consisting of the SCM, which as of December 31, 2003, listed 685 smaller companies, and the NNM, which as of December 31, 2003, listed 2,648 larger companies. Quantitative listing standards are generally lower for the SCM than the NNM.

of the 509 issuers receiving relief through the moratorium (48 percent) continued to trade on NASDAQ.[20] Of these, 132 took advantage of the extended compliance period. The remaining 263 of the 509 issuers (52 percent) were delisted because they did not comply with one or more continued listing standards or for other reasons, such as a merger with or acquisition by another company. On December 23, 2003, SEC approved, also as a pilot program, a NASDAQ rule that, subject to requirements intended to protect investors, further extended the SCM and NNM bid-price compliance periods for up to 2 years and almost 1 year, respectively.

The collapse of several major U.S. corporations beginning in 2001 motivated efforts to strengthen the oversight of boards of directors through revisions to the markets' corporate governance listing standards. In response to a 2002 SEC request as well as rules implementing the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), the three largest SROs adopted rules intended to significantly strengthen these standards. Among other things, the new standards increase the role and authority of independent directors and corporate governance disclosures. However, unlike NASDAQ and NYSE's standards, Amex's standards do not currently require issuers to disclose the names of the directors they have designated as independent, hampering regulators and investors' ability to assess the independence of boards. Market participants told us that they support the SROs' new standards, although they held differing views on the need for further enhancements. Consistent with the position of some market participants, we have expressed the view in prior work that SEC, in conjunction with the SROs, should consider using listing standards to further strengthen board independence by requiring a supermajority of independent directors and separating the positions of chief executive officer (CEO) and board chairman.[21] SRO officials told us that they are taking steps to enhance their ability to assess compliance with their new corporate governance standards, and OCIE officials told us that they will work with the SROs to

[20]We determined the listing status of the 509 issuers as of February 28, 2003, approximately 1 year after NASDAQ implemented its postmoratorium rule change—because by this date issuers that were affected by the moratorium would have had an opportunity to go through NASDAQ's deficiency process. Examining this period also allowed us to determine the listing status of issuers affected by the first postmoratorium bid-price rule change.

[21]U.S. General Accounting Office, *Protecting the Public's Interest: Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues*, GAO-02-601T (Washington, D.C.: Apr. 9, 2002); and *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges*, GAO-03-138 (Washington, D.C.: Oct. 4, 2002).

ensure effective processes are in place to more thoroughly assess compliance with these standards. Complementing the SROs' enhancements to listing standards, SEC has proposed rule changes that address longstanding investor interest in gaining greater access to the director nomination process and approved rules increasing disclosures of that process. Also, Corporation Finance officials told us that in response to a market participant's request, they plan to review SEC requirements governing disclosures of potential director and director nominees' conflicts of interest. Further, to better ensure that the SROs hold themselves to standards of governance that are consistent with those imposed on issuers, SEC has asked the SROs to evaluate their own governance, including board structures, policies, and practices. Although SEC's Division of Market Regulation (Market Regulation) has not completed its review of the SROs' self-evaluations, as a result of this process, both NASDAQ and NYSE have separated the positions of CEO and chairman, and NYSE has made other significant changes to its governance structure.

This report makes 12 recommendations to the SEC Chairman that should help restore investor confidence in the markets, further strengthen the listing standards of the SROs, and improve SEC listing program oversight. We recommend, among other things, that the Chairman take actions, working with the SROs as necessary, to ensure that the public receives early and ongoing notification of issuers' noncompliance with the markets' continued listing standards; SRO internal review reports are used in planning and conducting OCIE inspections of SROs; Amex issuers are required to disclose the names of their independent directors; serious consideration is given to requiring issuers to establish a supermajority of independent directors and separate the positions of CEO and chairman through revisions to listing standards; OCIE conducts timely inspections to assess SRO oversight of issuers' compliance with new corporate governance listing standards; and Market Regulation places a high priority on completing reviews of the SROs' self-evaluations of their governance practices.

We received comments on a draft of this report from SEC, Amex, NASDAQ, and NYSE, which are included in appendixes V-VIII. SEC generally agreed with our findings and recommendations and is taking or plans to take actions to address them. The SROs expressed concerns about the recommendations related to notifying the public of noncompliance with listing standards, giving serious consideration to requiring a supermajority of independent directors, and separating the positions of CEO and chairman. Recognizing their concerns, we nonetheless continue to believe that further SEC and SRO actions are needed to address our recommendations. The comments are discussed in greater detail at the end of this letter.

Background

The Exchange Act established the regulatory structure of the U.S. securities markets. These markets are regulated under a combination of self-regulation (subject to SEC oversight) and direct SEC regulation. This regulatory structure was intended to give SROs responsibility for administering their own operations, including most of the daily oversight of the securities markets and their participants. One of the SROs—the National Association of Securities Dealers, Inc. (NASD)—is a national securities association that regulates registered securities firms, professionals, and NASDAQ.[22] Other SROs include national securities exchanges that operate the markets where securities are traded.[23] These SROs are primarily responsible for establishing the standards under which their members conduct business; monitoring the way that business is conducted; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC's rules, and their own rules. SEC oversees the SROs by inspecting their operations and reviewing their rule proposals and appeals of final disciplinary proceedings.

Each SRO proposes the rules that establish its listing standards. To be eligible for listing, issuers must comply with initial quantitative and

[22]NASD is registered as a national securities association under section 15A, 15 U.S.C. § 78o-3 and is considered an SRO pursuant to section 3(a)(26), 15 U.S.C. § 78c(a)(26). NASD develops rules and regulations governing the business and sales practices of NASD members, conducts regulatory reviews of members' business activities, and disciplines those members that fail to comply with its rules and regulations. NASDAQ and Amex are subsidiaries of NASD. NASD has delegated to NASDAQ the responsibility for operating NASDAQ as well as for developing, adopting, and administering rules governing listing standards for NASDAQ issuers. In April 2000, NASD members voted to restructure NASD and sell a substantial part of NASD's ownership in NASDAQ in part to minimize the potential for conflicts of interest associated with NASD's responsibility for both the business operations and regulation of NASDAQ. Unlike NASDAQ, Amex is a registered SRO. On November 3, 2003, NASD and Amex announced an agreement to make Amex an independent entity and transfer control of Amex to the Amex Membership Corporation. The agreement is subject to approval by Amex, Amex Membership Corporation, Amex and NASD's Boards of Governors, Amex seat holders, and SEC.

[23]The national securities exchanges are Amex, the Boston Stock Exchange, the Chicago Board Options Exchange, the Chicago Stock Exchange, the International Securities Exchange, the National Stock Exchange, NYSE, NQLX, OneChicago, the Pacific Exchange, and the Philadelphia Stock Exchange.

qualitative listing standards. Quantitative listing standards are minimum financial requirements addressing such areas as the issuer's total revenues, distribution, and market capitalization.[24] Qualitative listing standards, which include corporate governance standards, are nonfinancial requirements addressing such matters as the definition of director independence, the number of independent directors on the board of directors and audit committee, and provisions for annual stockholder meetings and shareholder approval of certain corporate actions. In addition, to remain listed, issuers must maintain compliance with the market's continued listing requirements. For quantitative listing standards, these are generally lower than initial listing standards, while for qualitative standards they are the same.

In general, a company applies to have its securities listed for trading on a specific market, subject to that market's rules. This process includes submitting an application for review, together with supporting information such as financial statements, a prospectus, and relevant share distribution information. The market's equity listing department reviews these submissions for compliance with its initial listing standards and conducts background checks of company officers and other insiders. This department or a committee of the exchange makes the listing decision. The equity listing department also monitors listed companies for compliance with the market's continued listing standards and, in accordance with the market's rules, is expected to take action when these standards are not met.

Amex, NASDAQ, and NYSE are the three largest U.S. securities markets for equities trading based on the number of listed U.S. companies. According to Amex, as of the end of the third quarter 2003, it listed 735 issuers with a total market capitalization of approximately $282 billion.[25] For this same period, NASDAQ said it listed 3,367 issuers with a total market capitalization of approximately $2.99 trillion for the SCM and the NNM

[24]Market capitalization is the price of a stock multiplied by the total number of shares outstanding and represents the market's total valuation of a public company.

[25]According to Amex and NASDAQ, their total market capitalization includes the value of shares and American Depository Receipts in the United States. The receipts are issued by a U.S. depository bank and represent shares of a foreign corporation held by the bank.

combined. Finally, for this period, NYSE told us that it listed approximately 2,800 issuers with a total market capitalization of approximately $14.8 trillion.[26]

The Exchange Act created SEC as an independent agency to oversee the securities markets and their participants. SEC has a five-member Commission headed by a chairman who is appointed by the President of the United States for a 5-year term. In overseeing the SROs' implementation and enforcement of rules, SEC may use its statutory authority to, among other things, review and approve SRO-proposed rule changes and abrogate (annul) SRO rules. Section 19(b) of the Exchange Act governs the process by which SROs can change their rules. Section 19(b)(1) requires an SRO to file a proposed rule or amendment to an existing rule with SEC for publication and solicitation of comments. Under section 19(b)(2), SEC may approve the rule change by order or conduct proceedings to determine whether it must be disapproved. SEC must approve a proposal if it finds that it is consistent with Exchange Act requirements; otherwise, it must institute disapproval proceedings. However, if the rule change proposed by the SRO does not comply with the filing requirements promulgated under section 19(b) of the Exchange Act, SEC may deem the submission as not properly filed and reject it.

In addition, section 19(c) gives SEC power by rule to abrogate, add to, or delete from the rules of an SRO, subject to specified procedures. SEC officials said that SEC rarely uses this authority to amend SRO rules, because, among other things, a number of procedural steps must be satisfied, potentially making a section 19(c) ruling time-consuming. SEC officials said that, in view of the procedural steps that would need to be followed under section 19(c) to amend rules related to listing standards and the need to consider any such proceeding in light of *Business Roundtable v. SEC*, in which the D.C. Court of Appeals vacated a listing standard that SEC had adopted using section 19(c) authority, SEC prefers to rely on its powers of persuasion to convince the SROs to enhance their corporate governance listing standards.[27]

[26]According to NYSE, its total market capitalization includes the global market value of all listed companies.

[27]*Business Roundtable v. SEC*, 905 F. 2d 406 (D.C. Cir. 1990).

SEC's Market Regulation division is responsible for the administration and execution of SEC's programs under the Exchange Act relating to the structure and operation of the securities markets, which includes oversight of the SROs and review of their proposed rule changes. SEC has delegated authority to Market Regulation with respect to other aspects of SRO rulemaking as well, including the authority to publish notices of proposed rule changes and to approve such proposed rule changes.

In addition to granting authority to approve SRO-proposed rules, the Exchange Act authorizes SEC to conduct reasonable, periodic, special, or other examinations of all records that the SROs are required to maintain.[28] Under the Exchange Act, the national securities exchanges, national securities associations, members of these exchanges and associations, brokers, and dealers are required by SEC to preserve certain books and records and keep them available for inspection.[29] The Exchange Act, in conjunction with relevant rules, gives SEC the authority to request and review such records as part of its inspections and examinations. These examinations may be conducted at any time, or from time to time, as SEC deems necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.

OCIE, the SEC office responsible for conducting inspections and examinations, is divided into three primary units—the Office of Broker-Dealer and SRO Examinations, the Office of Market Oversight, and the Office of Investment Advisor/Investment Company Examinations.[30] The Office of Broker-Dealer and SRO Examinations and the Office of Market Oversight are responsible for conducting examinations of broker-dealers and inspections of SROs pursuant to the Exchange Act. According to OCIE officials, the inspections conducted by the Office of Broker-Dealer and SRO Examinations generally focus on a program area such as the listing program, with the objective of evaluating whether the SROs' programs and procedures are adequate and whether these programs and procedures as well as recommendations from previous inspections are effectively implemented. OCIE officials also told us that Office of Market Oversight inspections primarily focus on issues related to trading securities and that

[28]Section 17(b) of the Exchange Act; 15 U.S.C. § 78q(b).

[29]Section 17(a) of the Exchange Act; 15 U.S.C. § 78q(a).

[30]SEC generally refers to its reviews of SROs as "inspections" and its reviews of broker-dealers, investment companies, and investment advisers as "examinations."

the Office of Investment Advisor/Investment Company Examinations is responsible for examinations conducted pursuant to the Investment Company and Investment Advisers Acts of 1940.

Under the Securities Act of 1933 and the Exchange Act, publicly traded companies are required to file disclosures with SEC concerning their business and financial affairs, both when securities are initially offered and sold and on a periodic basis thereafter. Corporation Finance reviews these disclosures, which include annual reports to shareholders and proxy statements.[31] Corporation Finance also provides companies with assistance in interpreting SEC rules and recommends to the Commission new rules for its approval.

The SROs Have Addressed All OCIE Recommendations, Except One to Use Stock Symbol Modifiers

OCIE has concluded that the three largest SROs have addressed the recommendations that were unique to their markets from its inspections of their listing programs. OCIE officials said that the only significant, open recommendation was for the three SROs to use stock symbol modifiers to provide the public early and ongoing notification of issuers that do not meet their continued listing standards.

[31]A proxy statement contains material information that SEC regulations require issuers to provide their shareholders as a prerequisite to soliciting votes, including biographical information on directors and director nominees and information on their financial and business relationships with the issuer and its executive officers.

The SROs Have Addressed OCIE Recommendations That Were Unique to Their Markets

According to OCIE officials, Amex, NASDAQ, and NYSE have addressed the recommendations that were unique to these markets' listing programs from OCIE's recent inspection reports and have improved the structure and operations of their programs in doing so. OCIE officials told us that Amex's recent listing standards revisions met the intent of OCIE's 2001 inspection report recommendations.[32] For example, in response to these recommendations, Amex converted its discretionary listing guidelines into mandatory listing standards to provide more certainty to investors about the eligibility of issuers to trade on Amex. In addition, Amex set firm time limits within which issuers that are not compliant with its continued listing standards must regain compliance.

According to OCIE's June 2002 inspection report on NASDAQ's listing program, the SRO had addressed the recommendations from prior reports, issued in 1997 and 1999, and the listing program was operating according to NASDAQ's policies and procedures. OCIE found that the SRO was generally thorough in its financial and regulatory reviews of companies and complied with its obligation to compile periodic management reports containing statistical data on issuers. While the 2002 report identified some new areas where the SRO could enhance listing program operations, according to OCIE officials, NASDAQ addressed the related recommendations.

OCIE's March 2003 inspection report on NYSE's listing program concluded that the SRO had substantially improved its listing program since OCIE's initial report, issued in 1998, and was generally adhering to SRO listing rules and procedures. For example, OCIE found that NYSE had enhanced its systems for detecting issuers that were out of compliance with its continued listing standards and prepared quarterly management reports to assist in monitoring the status of listed companies. The 2003 report made some new recommendations that OCIE officials said NYSE addressed.

[32] We also addressed the need for Amex to improve its listing standards in a November 2001 report. See U.S. General Accounting Office, *Securities Regulation: Improvements Needed in the Amex Listing Program*, GAO-02-18 (Washington, D.C.: Nov. 27, 2001).

The Intent of the Recommendation to Use Stock Symbol Modifiers Has Not Been Fully Addressed

OCIE recommended that the SROs append a modifier to the stock symbols of issuers that do not meet their continued listing standards to provide the public early and ongoing notification of issuers' noncompliance with these standards—a recommendation that Market Regulation also made. NYSE has begun transmitting an indicator over the consolidated tape to information vendors, which OCIE officials said could address the intent of OCIE's recommendation as it relates to NYSE's quantitative listing standards, if concerns about vendor distribution of the information transmitted by the indicator are addressed. NASDAQ and Amex have reservations about modifiers and their proposals for implementing them would not provide early public notification. Complementing OCIE's efforts, Corporation Finance proposed changes to SEC's Form 8-K, which, if finalized, would provide investors with early notification of an issuer's noncompliance with qualitative and quantitative listing standards and additional information on the issuer's noncompliant status. OCIE officials told us that further use could be made of modifiers or indicators to identify issuers that do not meet the markets' qualitative listings standards. OCIE plans to report to the Commission on the SROs' progress in implementing its recommendation, and the Commission has authority to resolve implementation issues or to take alternative actions to ensure that the public receives early and ongoing notification of issuers' noncompliance with the SROs' continued listing standards.

OCIE and Market Regulation Recommended the Use of Symbol Modifiers to Provide Early and Ongoing Notification of Issuers' Noncompliance

In its most recent reports on Amex, NASDAQ, and NYSE's listing programs, OCIE recommended that the three largest SROs use stock symbol modifiers to provide the public early and ongoing notification of issuers' noncompliance with their continued listing standards. [33] OCIE's recommendation would have extended NASDAQ's practice of modifying the stock symbols of certain noncompliant SCM issuers. Market Regulation concurred with the recommendation and also requested that the three largest SROs append the modifier.[34] The recommendation addressed OCIE's concern, which surfaced during its listing program inspections, that the SROs were allowing deficient issuers to remain listed for significant

[33]In our November 2001 report on Amex's listing program, we also addressed the need for ongoing notification of issuers' listing status and recommended that the SEC Chairman direct Amex to implement mandatory equity listing requirements or provide ongoing public disclosure of the noncompliant status of companies.

[34]Market Regulation asked the three SROs in a May 1, 2002, letter to consider whether it would be feasible and advisable to use symbol modifiers to disclose issuers' noncompliance with continued listing standards.

periods of time without adequately notifying investors. For example, an OCIE report on the listing program of one SRO identified several instances in which the SRO granted issuers excessive delisting deferrals or did not commence delisting proceedings in a timely manner. The report cited one instance of an issuer being allowed to remain listed for approximately 2 years while out of compliance with the market's continued listing standards. An OCIE report on another SRO found that two issuers had been listed for at least 3 years without meeting the SRO's continued listing standards.[35]

According to OCIE and Market Regulation officials, modifiers would make the listing status of an issuer more transparent to investors and reduce the misleading perception that because an issuer is listed it meets a market's continued listing standards. Investors currently receive information on an issuer's noncompliance with these standards through issuer press releases that are required by Amex, NASDAQ, and NYSE rules. However, these rules do not provide for early public investor notification of an issuer's noncompliance. For example, while Amex's rules require it to send an issuer a deficiency notice within 10 business days of identifying the issuer's noncompliance with continued listing standards, by applying the various rules in Amex's deficiency process, the issuer would not have to issue a press release for up to 80 days after receiving the notice.[36] NASDAQ's rules require it to send a similar deficiency notice within 5 days, but an issuer is not required to issue a press release for approximately 35–97 days (up to 730 days in the case of bid-price deficiencies) after receiving the notice, depending on the listing standard. Under NYSE's rules, the SRO also sends its deficiency notice within 10 business days after detecting the noncompliance, but issuers are not required to issue a press release until 45 days after receiving a deficiency notice. Further, OCIE and Market Regulation officials said that symbol modifiers provide continuous disclosure that an issuer is not meeting continued listing standards, unlike a press release, which is a one-time event. Also, according to OCIE and Market Regulation officials, information vendors may not distribute the press releases of smaller companies, and vendors may not be consistent in

[35]In response to the OCIE report, the SRO said that under its policy, these issuers were considered compliant with its continued listing standards. OCIE responded that the SRO's application of such a policy was improper and that such issuers should be considered to be noncompliant.

[36]See appendix III for a description of the deficiency and hearing processes of the three largest SROs.

the amount of time that they make the press releases available to the public—factors that could affect the usefulness of the releases for making investment decisions.

The effect of implementing OCIE and Market Regulation's recommendation on issuers that were noncompliant with quantitative listing standards in 2003 is illustrated by table 1.[37] The table shows that a low of 1 percent of issuers (NASDAQ and NYSE) were trading noncompliant with the market's quantitative continued listing standards during calendar year 2003, meaning that as few as 1 percent of the issuers on these markets would have been identified with a symbol modifier or comparable identifier had OCIE's recommendation been implemented. Similarly, a high of 10 percent of issuers (NASDAQ) traded noncompliant with their market's quantitative continued listing standards, meaning that at most 10 percent of the issuers on any of the markets would have been identified with a modifier or comparable identifier during that year.

[37]We did not provide data on the number of qualitative deficiencies at each SRO because differences exist in how they address these deficiencies. While officials from all three SROs told us they send deficiency notices to issuers upon detecting noncompliance with quantitative listing standards, they do not use similar notices in all instances of noncompliance with qualitative listing standards. Officials of two SROs told us that because some qualitative deficiencies were more serious than others and because it was not always possible to make an objective assessment of compliance with these standards, they use their discretion in determining whether to send an issuer a deficiency notice, which would trigger the deficiency and delisting process, or whether to work informally with an issuer to address the deficiency.

Table 1: Lowest and Highest Numbers of Issuers Trading Noncompliant with Quantitative Continued Listing Standards in Calendar Year 2003, by SRO

SRO	Lowest number of noncompliant issuers trading (percent)	Highest number of noncompliant issuers trading (percent)
Amex	32 (4%)[a]	51 (7%)[a]
NASDAQ	45 (1%)[b]	351(10%)[b]
NYSE	15 (1%)[c]	48 (2%)[c]

Sources: Amex, NASDAQ, and NYSE.

Notes:

[a]For Amex, the percentages for the lowest and highest number of noncompliant issuers are based on the month-end numbers and the 738 listed issuers trading on both December 31, 2003, and June 30, 2003.

[b]For NASDAQ, the percentages for the lowest and highest number of noncompliant issuers are based on the month-end numbers and the 3,333 listed issuers trading on December 31, 2003, and the 3,620 listed issuers trading on January 31, 2003, respectively.

[c]For NYSE, the percentages for the lowest and highest number of noncompliant issuers are based on the month-end numbers and the 2,938 listed issuers trading on December 31, 2003, and the 2,959 listed issuers trading on December 31, 2002, respectively.

The total numbers of issuers identified with a symbol modifier or its equivalent would have been greater for each market than the numbers shown in the table, because not all issuers were noncompliant with the quantitative listing standards at the same time. As shown in table 2, the total number of issuers that traded while noncompliant with their markets' quantitative standards at any time during calendar year 2003 ranged from 68 (NYSE) to 617 (NASDAQ). Of these issuers, some regained compliance with continued listing standards by December 31, 2003, while others continued to trade noncompliant or were delisted as of that date.

Table 2: Total Number of Issuers Trading Noncompliant with Quantitative Continued Listing Standards in Calendar Year 2003 and Their Listing Status on December 31, 2003, by SRO

SRO	Total number of noncompliant issuers in 2003 (percent)	Their Listing status on December 31, 2003: Number compliant (percent)	Number noncompliant (percent)	Number delisted (percent)
Amex	94 (100%)	22 (23%)	32 (34%)	40 (43%)
NASDAQ	617[a] (100%)	381 (62%)	45 (7%)	191 (31%)
NYSE	68 (100%)	13 (19%)	15 (22%)	40 (59%)

Sources: Amex, NASDAQ, and NYSE.

Note:

[a]According to NASDAQ, 486 of the 617 noncompliant issuers (79 percent) were noncompliant with standards related to bid price.

NYSE's Transmittal of Indicators Could Address the Intent of OCIE's Recommendation If Vendor Distribution Concerns Are Addressed

To avoid investor confusion caused by temporary changes to stock symbols, on July 1, 2003, NYSE began transmitting an indicator that reflects an issuer's noncompliance with its quantitative continued listing standards.[38] Under its procedures, NYSE transmits the indicator over the consolidated tape with the issuer's quotation data beginning 5 business days after it notifies an issuer of its noncompliant status and continuing until the issuer regains compliance with the listing standard or is delisted. According to NYSE officials, the 5-business-day period provides the issuer an opportunity to bring to NYSE's attention any inaccuracy in NYSE's noncompliance determination, as well as an opportunity to release a statement to the public. Further distribution of the information transmitted by NYSE's indicator from the consolidated tape to investors is at the discretion of information vendors. NYSE officials told us that NYSE has notified all vendors by e-mail of the availability of the indicator and followed up with some of the major vendors to further discuss its distribution, but NYSE has not formally notified the public of the indicator's availability. However, NYSE displays the indicator and a list of companies that do not meet its continued listing standards on its Web site.

[38]In May 2000, Market Regulation approved an amendment to NYSE's procedures for delisting securities, which, if implemented, would have required that a modifier be attached to the stock symbol of an issuer that no longer met the quantitative continued listing standards of the exchange. Upon further analysis, NYSE determined that because attaching the modifier would change the stock symbol of an issuer, investors would be required to know the modified stock symbol, for example, to retrieve information on a noncompliant issuer through the Internet. As a result, NYSE filed a rule in December 2000 withdrawing its May 2000 rule. Unlike the modifier, NYSE's indicator does not change an issuer's stock symbol.

According to NYSE officials, the list included 15 issuers on December 31, 2003.

The Associated Press, which according to a company representative, provides quotation information to all major U.S. daily newspapers except *The Wall Street Journal*, began distributing the information transmitted by the NYSE indicator in September 2003.[39] It does so by appending an "h" to an issuer's stock symbol to identify NYSE-listed securities that do not meet the market's continued listing standards. A representative of Dow Jones & Company told us that the organization plans to distribute the information transmitted by NYSE's indicator to investors through print media such as *The Wall Street Journal* and over the Internet through www.WSJ.com, and that it would begin doing so when technical difficulties are resolved.[40] A representative of Ameritrade Holding Company told us that the broker-dealer is considering publicizing the information transmitted by NYSE's symbol indicator during calendar year 2004.[41]

Of the five other information vendors we contacted that provide quotation information to investors over the Internet, none planned to distribute the information transmitted by NYSE's symbol indicator. These vendors, including two broker-dealers, provide market data on their own Web sites or to third-party vendors, including many financial Web sites such as www.cbs.marketwatch.com, www.cnnfn.com, www.finance.yahoo.com, www.moneycentral.msn.com, and www.smartmoney.com.[42] In addition, none of three additional broker-dealers whose Web sites we visited were distributing the information transmitted by the indicator. Among the reasons vendors gave for not distributing this information were a lack of client demand and reluctance to divert resources from more important initiatives.

[39]For example, The Associated Press provides quotation information to such newspapers as *The Boston Globe*, *The Chicago Tribune*, *The Los Angeles Times*, *The New York Times*, *USA Today*, and *The Washington Post*.

[40]Dow Jones & Company provides quotation information to the public through *The Wall Street Journal* and *Barron's*—financial print media—and through www.WSJ.com.

[41]Ameritrade Holding Corporation provides electronic brokerage services to investors, primarily through the Internet.

[42]Third-party vendors, such as Yahoo, have a contract to receive consolidated tape information from another information vendor, rather than the Consolidated Tape Association.

OCIE and Market Regulation officials said that NYSE can and should do more to actively encourage information vendors to implement and distribute the information transmitted by its indicator. For example, OCIE officials said that NYSE could consider adding provisions to its contracts with information vendors requiring them to distribute and display the indicator. NYSE officials said that this option is not practical, in part because information vendors are NYSE customers. NYSE officials said that SEC has the authority to implement rules requiring information vendors to distribute and display indicators, and it would be appropriate for them to do so. Officials of all three SROs stressed the desirability of having a marketwide solution to the information distribution issue.

OCIE officials also said that although NYSE displays the indicator with the stock symbol of issuers and a list of companies that do not meet its continued listing standards on its Web site, NYSE could do more to make this information readily accessible to investors. To determine whether a Web site visitor could locate the indicator and the list of noncompliant NYSE issuers, we visited the NYSE Web site and inputted the stock symbol of a noncompliant issuer in the “Quick Quote” search box located on the top right corner of NYSE’s home page. In response, we received quotation information that included the indicator with a footnote explaining that the issuer did not meet NYSE’s continued listing standards. However, the indicator was not readily identifiable because it did not visually stand out from all of the other information presented on the page. Also, the information explaining the meaning of the indicator was located at the very bottom of the page, separate from the indicator itself and mingled with press releases and information vendor logos. In addition, NYSE did not provide a link to its list of noncompliant issuers on its home page, limiting its accessibility to investors who do not already know of its existence. OCIE officials told us that NYSE’s approach to implementing symbol modifiers could meet the intent of its recommendation to provide early and ongoing notification to investors as it relates to quantitative listing standards, provided that issues related to the distribution of the indicator from vendors to investors were resolved.

NASDAQ and Amex Have Reservations about Symbol Modifiers, and Their Proposals Would Not Provide Early Public Notification

NASDAQ and Amex have both expressed reservations to OCIE and Market Regulation about the effectiveness and fairness of using symbol modifiers to communicate information about issuers’ noncompliance with continued listing standards to the public. In commenting on the value of modifiers, they both stated that investors would view a modifier as a warning not to invest in a company, which could have other negative consequences for the issuer, including impeding its ability to raise capital and regain compliance with the market's continued listing standards.

A NASDAQ official told us that since before 1980 NASDAQ has appended a modifier—the character "C"—to the stock symbol of an SCM issuer if the NASDAQ Hearing Panel determined that the issuer was noncompliant with quantitative continued listing standards and granted the issuer a conditional listing, termed an "exception." According to NASDAQ, 32 noncompliant SCM issuers received a NASDAQ Hearing Panel exception in 2003 and had the modifier appended to their stock symbol. NASDAQ has not appended the modifier to the stock symbols of NNM issuers because, according to market officials, doing so would have put the NNM at a competitive disadvantage to NYSE, which until 2003 did not identify noncompliant issuers with either a symbol modifier or indicator. NASDAQ said that its use of modifiers to identify SCM issuers that are listed under an exception to its listing standards has raised concerns among these issuers. NASDAQ officials told us that issuers have complained that the modifier has a depressive effect on their stock price, frustrating their efforts to regain compliance with listing standards related to bid price. In addition, they said that issuers have indicated that a modifier may make it more difficult to attract investors for a private placement or complete other transactions that may address a deficiency with a listing standard, such as the shareholder equity requirement. In contrast, NYSE officials told us that while the few affected companies have not been pleased by the presence of the indicator, these companies have generally not found it to have an adverse affect on their ability to raise capital. However, NYSE's experience with the indicator has been limited, due to the small number of companies that have been out of compliance with its quantitative listing standards since the implementation of the indicator. Amex said it does not believe that anyone has attempted to evaluate the collateral consequences of symbol modifiers, especially for small and middle market companies—the types of companies that are generally listed on Amex.

NASDAQ and Amex also said that symbol modifiers oversimplify each issuer's unique situation by lumping together dissimilar deficiencies under one type of notification, regardless of the seriousness of the deficiency and the likelihood that it will be corrected. They also said that other issues that might affect the continued listing status of an issuer would not be disclosed to the public with a symbol modifier—for example, a going concern opinion from an issuer's auditors, major litigation, the initiation of a regulatory investigation, or notice that security holders should no longer rely on previously issued financial statements or a related audit report.

Nonetheless, the use of a modifier or indicator to alert the public to an issuer's noncompliance with continued listing standards would not preclude using different modifiers or indicators to identify different types of deficiencies or significant events that are unrelated to listing standards. For example, while NASDAQ uses the symbol modifier "C" for SCM issuers that receive an exception to the certain continued quantitative listing standards of that market, it uses the symbol modifiers "Q" and "E" for both SCM and NNM issuers that have filed for bankruptcy or have not filed required SEC reports, respectively.[43] Also, these required reports would generally contain the information affecting the continued listing status of issuers that is cited in NASDAQ and Amex's example above.

Additionally, Amex and NASDAQ stated that a significant number of issuers are able to regain compliance with continued listing standards within the time frames allowed under SRO rules. According to Amex officials, during calendar year 2003, 26 (25 percent) of 104 issuers deficient with both quantitative and qualitative listing standards regained compliance with the standards before the expiration of the compliance period, 31 (30 percent) were still trading within their compliance period, and 47 (45 percent) had been delisted or were in the delisting process by the end of the year.[44] According to NASDAQ officials, during calendar year 2003, 150 (75 percent) of 200 issuers deficient in those quantitative NASDAQ listing standards that specify compliance periods regained compliance before the compliance periods expired.[45] The remaining 50 (25 percent) were either delisted, achieved compliance after the compliance period expired, or were in the hearings process as of December 31, 2003.

[43]NYSE also uses an indicator to identify issuers that file for bankruptcy.

[44]For purposes of this discussion, Amex provided us with data on the number of issuers that were noncompliant with both qualitative and quantitative standards in 2003. In contrast, the data in tables 1 and 2 reflect issuers with only quantitative deficiencies. Also, the 47 issuers that Amex identified as either in the delisting process or already delisted by December 31, 2003, could include some of those Amex issuers identified in table 2 as remaining noncompliant at the end of the year, because that category comprises both issuers that were trading within their compliance period and issuers that were in the delisting process.

[45]The 200 deficient issuers include only those issuers that NASDAQ identified in 2003 as noncompliant with quantitative listing standards for which NASDAQ's rules specify a compliance period. These include NASDAQ's bid price, market value of publicly held securities, market capitalization, and market maker standards. In contrast, the data NASDAQ provided in tables 1 and 2 reflect deficiencies with all of NASDAQ's quantitative standards and include issuers that were identified as noncompliant in 2002, but continued to trade noncompliant into 2003, and issuers that were identified as noncompliant in 2003.

Further, the two SROs said that investors have access to timely and comprehensive notice of an issuer's listing status through press releases, thus obviating the need for symbol modifiers. Also, they both stated that the information on listed companies available to investors through the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system—a searchable database on SEC's Web site—and media such as the Internet are sufficient for investors to make informed investment decisions. However, as previously discussed, issuers are not required to issue press releases early in the deficiency process, and press releases do not provide ongoing public notification of an issuer's listing status.

OCIE did not formally respond to the markets' individual concerns. However, according to OCIE and Market Regulation officials, using the symbol modifier to provide investors early and ongoing notification of noncompliance with continued listing standards would strike an appropriate balance between investor and issuer needs. These officials said that modifiers would provide investors with adequate, timely, and continuous notice of the listing status of affected issuers and also allow these issuers to remain listed on the markets as they address deficiencies.

OCIE officials told us that NASDAQ's proposal for addressing OCIE's recommendation does not provide for early notification of issuer's noncompliance. In an April 22, 2003, letter to OCIE, NASDAQ tentatively proposed replacing all its symbol modifiers with indicators, which would be used in a manner similar to the NYSE indicator. NASDAQ said that one advantage of using an indicator is that it would minimize the potential for investor confusion that may result from symbol modifications.[46] As part of its proposal, NASDAQ would discontinue use of the "C" modifier on the SCM and instead transmit an indicator to the consolidated tape whenever the NASDAQ Hearing Panel determined that an SCM or NNM issuer was noncompliant with NASDAQ's quantitative continued listing standards and received an exception, just as it does now with the "C" modifier. Under NASDAQ's tentative proposal, an issuer that is deficient with applicable listing standards could be listed on NASDAQ for up to 145 days before the indicator would be transmitted. However, NASDAQ would not initially transmit an indicator with the symbols of issuers that were deficient with standards for which its rules specify a time period to regain compliance,

[46]NASDAQ said that when a symbol is changed by appending a symbol modifier, an investor that is trying to get a quote using the original symbol will sometimes receive a message that says "security not in NASDAQ" or "security not found."

such as its bid-price standard. Instead, NASDAQ said it would transmit an indicator for these issuers, if, after the expiration of the compliance period, the issuer requested a hearing and the NASDAQ Hearing Panel allowed the issuer to remain listed pursuant to an exception. NASDAQ officials said that they do not consider it appropriate to transmit the indicator earlier in the deficiency process, because doing so would deny deficient issuers their due process. OCIE officials said that NASDAQ should transmit the indicator early in the deficiency process so that investors are fully informed that an issuer is not in compliance with listing standards. Further, they said NASDAQ should more fully address instances of noncompliance with listing standards.

OCIE officials also told us that Amex has not addressed the intent of OCIE's recommendation and that its proposals would not meet the goal of providing early notification of issuers' noncompliance with continued listing standards. In a May 21, 2003, letter to OCIE, Amex proposed transmitting an indicator over the consolidated tape in a manner similar to that used by NYSE. However, unlike at NYSE, under this Amex proposal, an indicator would not be transmitted until the issuer received notice that Amex was initiating delisting proceedings. As a result, a noncompliant issuer could be listed for up to 18 months before the indicator was transmitted.[47] Amex officials told us that they expected the SRO to begin using indicators during the third quarter of 2004. They also said that they plan to discuss a second proposal with the Amex Board of Governors at its April 2004 meeting. Under this proposal, an indicator would be transmitted when a noncompliant issuer was granted an extension pursuant to an accepted compliance plan, which would reduce the time that a noncompliant issuer could be listed without an indicator from 18 months to up to 75 days.[48] According to OCIE officials, Amex should transmit its indicator when it first notifies an issuer that it is deficient with one or more of its standards.

[47]Amex does not have a minimum bid-price listing standard, but instead uses its discretion in delisting issuers with a low bid price by evaluating bid price in the context of an issuer's trading, financial, and operational circumstances. As a result, Amex officials said that Amex would not use an indicator in association with a low bid price. They also noted that low price is readily apparent to investors.

[48]A compliance plan describes the steps the issuer has committed to taking in order to return to compliance with the market's listing standards.

Proposed Changes to SEC's Form 8-K Would Provide Early Notification of Noncompliance

In June 2002, Corporation Finance proposed a rule that would require, among other things, that issuers report on SEC's Form 8-K the receipt of either a notice of noncompliance with quantitative and qualitative continued listing standards or a notice of delisting within 2 business days of receiving either notice.[49] The proposed changes would also require the issuer to discuss its planned response to either notice and give an explanation of the facts surrounding the issuer's noncompliance. OCIE officials said that the Form 8-K revisions, if finalized, would complement the symbol modifier or its equivalent; that is, the symbol modifier or indicator could be a trigger for investors to do further research on an issuer, for example, by retrieving an issuer's Form 8-K from the EDGAR system to learn more about the nature of an issuer's noncompliance with listing standards and the issuer's plans to take corrective action.

According to OCIE officials, public disclosure through the Form 8-K is preferable to existing disclosures provided through press releases because issuers will be required to file the form earlier in the deficiency process. In addition, unlike press releases, Form 8-K filings would be available to investors through the EDGAR system. However, agency officials said that the filings would not provide the ongoing notification OCIE seeks through the modifier because they reflect the company's status at the time the Form 8-K is filed and, as a result, would not provide information about the ongoing listing status of issuers. OCIE officials also said that investors would have to know that they could search for an issuer's Form 8-K. Corporation Finance officials said they expect the Commission to consider whether to approve the final Form 8-K revisions in March 2004.

OCIE Said that Modifiers or Indicators Could Be Used to Further Identify Noncompliance with Qualitative Listing Standards

OCIE officials told us that their discussions with the SROs have focused on using modifiers or indicators when issuers do not meet their market's quantitative listings standards but that they could also be useful in further alerting the public to issuers' noncompliance with qualitative listing standards, which include corporate governance standards. The three largest SROs have already taken a step in this direction. For example, Amex and NASDAQ have qualitative standards addressing the timely filing of required SEC reports. According to a NASDAQ official, since before 1984, NASDAQ has appended a modifier to the stock symbols of all issuers within 2 business days of detecting that they have not met time frames for filing required SEC quarterly and annual financial reports and in doing so

[49]As previously discussed, Corporation Finance officials said that they are considering alternatives to the proposed 2-business-day filing requirement based on public comments.

has provided investors early and ongoing notification that significant corporate information has not been made available. The required reports contain financial statements and other information that NASDAQ officials described as being critical for investors' decision making and for regulators' assessment of issuers' compliance with listing standards. According to Amex officials, the SRO expects to begin transmitting an indicator identifying listed companies that have not filed required reports during the third quarter of 2004, although it has not yet determined if it will use the indicator for nonfiling of annual reports alone or for both quarterly and annual reports. NYSE officials told us that the SRO will also begin transmitting indicators for issuers that have not filed required annual reports at the end of the first quarter of 2004.[50]

OCIE officials said that they are exploring the feasibility of requiring the SROs to implement symbol modifiers to disclose issuers' noncompliance with other qualitative standards, such as corporate governance standards. For example, all three SROs require a majority of directors on issuer boards to meet their respective definition of director independence. A modifier could potentially be used to indicate when an issuer does not have the requisite number of independent directors.

OCIE Plans to Report SRO Progress to the Commission, Which Has Authority to Ensure Early and Ongoing Notification of Noncompliant Issuers

OCIE officials told us that they are in the process of drafting a report to the Commission that details the progress the SROs have made in addressing its symbol modifier recommendation. According to OCIE officials, the report will discuss the implementation issues that OCIE has encountered—including early public notification and information distribution. The report will also recommend how these problems could be resolved. OCIE officials told us that their goal was for the public to get the same type of information from each of the SROs on issuers' noncompliance with continued listing standards, even if small differences existed in how each SRO provides the information. The Commission has authority under the Exchange Act to address obstacles to implementing symbol modifiers or indicators, or to take alternative actions to meet the goal of early and ongoing public notification. For example, the Commission could approve Corporation Finance's proposed revisions to the Form 8-K to address early notification issues. Also, according to an OCIE official, SEC could require the SROs to implement symbol modifiers or indicators and prohibit the SROs through

[50]Instead of requiring timely filing of SEC reports, NYSE's rules require issuers to notify NYSE if they do not file the required reports on time.

rulemaking from entering into a contract with an information vendor that refuses to display a modifier or indicator.[51]

OCIE Does Not Routinely Use SRO Internal Review Reports in Planning and Conducting Inspections

OCIE officials told us that they do not routinely use SROs' internal review reports in planning and conducting inspections designed to assess the quality of SROs' oversight, nor does the guidance on which they rely specifically address the use of these reports in SRO inspections. Nonetheless, professional standards recommend that internal review staff use the reports prepared by or on behalf of the organizations they are reviewing for these purposes, and other organizations that have an oversight role similar to OCIE's told us that they do so. Our work showed that many of the topics and findings in the SROs' internal review reports were similar to those covered in OCIE's listing program inspections, and the reports could be useful to OCIE in planning and conducting inspections.

OCIE Does Not Routinely Use SRO Internal Review Reports, Nor Does the Guidance Upon Which It Relies Specifically Address Their Use

OCIE officials said that they do not routinely use SROs' internal review reports in planning and conducting inspections designed to assess the quality of SRO oversight. Although OCIE does not have a written policy that specifically addresses the routine use of internal review reports in SRO inspections, OCIE officials said that they rely on guidance provided in a policy memorandum that addresses the use of these reports in examinations of broker-dealers, investment advisers, and investment companies. The policy directs OCIE staff to request internal review reports when they believe specific problems exist at an SRO.[52] OCIE officials said that, using their discretion, they might review a sample of internal review reports to determine whether a broker-dealer, investment adviser, investment company, or SRO had identified problems being reviewed by OCIE and, if so, how the problems were addressed. For example, OCIE

[51]In order to require the SROs to take actions to resolve implementation issues associated with symbol modifiers, the Commission would have to use its section 19(c) rule-making authority, subject to specified procedures. As previously discussed, SEC rarely uses this authority.

[52]The policy also directs OCIE staff to request internal review reports as part of a review of internal controls or supervisory systems of broker-dealers, investment advisers, and investment companies. OCIE officials said that they have not conducted these types of reviews at the SROs; therefore, the use of internal audit reports would not be applicable in this context.

officials told us that they requested copies of NYSE's internal review reports when investigating alleged violations by floor brokers at NYSE that resulted in a 1999 report, which concluded that NYSE failed to dedicate sufficient resources to allow regulatory staff to perform required random and for-cause examinations of floor-broker activity.[53] OCIE officials said that, to the best of their knowledge, they have never requested an SRO internal review report as part of a listing program inspection.

OCIE officials told us that routine use of SRO internal review reports would have a "chilling effect" on the flow of information between SRO internal review staff and other SRO employees. They said that routine use would make employees less forthcoming in disclosing information to SRO internal review staff for fear that the information would be provided to government regulators and through them be made public. They concluded that the consequences might outweigh the benefit of reviewing the reports. Officials at one SRO said that they believe OCIE would attempt to keep the SRO's internal review reports confidential, but that there was no assurance that OCIE could do so. Officials at each of the three largest SROs told us that they have provided and would continue to provide OCIE with copies of their internal review reports if OCIE requested them.

Professional Standards Recommend Using Internal Review Reports and Other Organizations with an Oversight Function Said That They Do So

The Government Auditing Standards, also called the Yellow Book, recommend the use of internal review reports in conducting performance and other types of reviews.[54] The Yellow Book defines performance reviews to include reviews that assess the extent to which legislative, regulatory, or organizational goals and objectives are being achieved. OCIE's SRO inspections share many of the attributes of performance reviews, including their objectives. Although OCIE is not required to follow the Yellow Book standards in inspecting SROs, OCIE inspections may benefit from adopting

[53]Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Ordering Compliance with Undertakings, SEC Release No. 34-41574 (June 29, 1999); and Inspection of the New York Stock Exchange's Undertakings Regarding the Surveillance, Examination, Investigatory, and Disciplinary Programs for Independent Floor Brokers, (Aug. 23, 2001). The 2001 report followed up on actions NYSE took to improve its regulation of independent floor brokers as a result of the 1999 findings.

[54]The Yellow Book refers to reviews as "audits."

some of the standards applicable to performance reviews.[55] The Yellow Book standards recognize that previous reports can be a useful source of information for planning and conducting reviews and can impact the areas on which subsequent reviewers focus. The Yellow Book states that those conducting reviews should determine if internal review staff have previously done, or are doing, reviews of the program or the entity being examined. It suggests that these staff review previous internal review reports or other studies to consider how areas identified as warranting further study might affect the selection of their review objectives and that internal review staff follow up to assess the actions taken to address significant report findings and recommendations related to the objectives of the current review.

CFTC and Treasury IG officials told us that, consistent with Yellow Book requirements, they routinely request internal review reports in doing their work. According to CFTC IG officials, the agency's policy is to request copies of all relevant audits, management reviews, consultant reports, and other related materials so that they can familiarize themselves with the program they are reviewing. They said that this information provides them with useful background on the program under review and helps them to determine the objectives and scope of the current review.[56] They also said that they use internal review reports to follow up on the agency's implementation of prior IG recommendations. Finally, Treasury IG guidance requires the review of prior IG reports, GAO reports, management reviews, studies, and consulting reports on the function or activity that is being reviewed as a means of understanding the agency and its operations. Treasury IG officials also told us that they refer to these reports in establishing the objectives and scope of reviews and in following up on actions to address previous recommendations.

[55]Generally accepted government auditing standards (also known as "GAGAS" and outlined in the Yellow Book) apply to audits and attestation engagements of government entities, programs, activities, and functions.

[56]Bank examiners may request the internal review reports of the banks they are reviewing. However, while Treasury and CFTC IG officials use internal review reports in determining the objectives and scope of their reviews, bank examiners use them in testing the bank's internal audit or loan review function. An OCIE official told us that in reviews of broker-dealers, investment companies, and investment advisors, OCIE also uses the internal review reports of these entities in testing internal controls.

Topics and Findings in SRO Internal Reviews and OCIE Listing Program Inspections Were Similar, and the Reports Could be Useful to OCIE in Planning and Conducting Inspections

Our review of selected internal review reports of two SROs and conversations with one other about its reports revealed that the SROs' internal review functions have examined or were in the process of examining aspects of their listing programs that OCIE covered in its most recent inspections.[57] Consistent with OCIE's inspection objective related to evaluating the effectiveness of the SROs in implementing rules and procedures applicable to listing issuers, all three SROs conducted internal reviews of their initial and continued listing programs and hearings and appeals processes for issuers that received delisting notices. Also, one SRO addressed policies, procedures, and systems for reviewing issuer information as part of the initial listing process. Consistent with OCIE's inspection objective related to determining whether the SROs have implemented recommendations from previous OCIE inspections, officials of one SRO told us that as part of their internal reviews, they follow up on OCIE's recommendations to ensure that the corrective actions taken were consistent with the intent of OCIE's recommendations. Finally, all three SROs told us that they follow up on all recommendations made as a part of their own internal reviews.

Moreover, SEC has recognized that a strong internal review function is important to the effectiveness of the SROs in fulfilling their regulatory responsibilities by recommending on at least two occasions that the SROs strengthen this function to improve their oversight. First, an investigation SEC began in 1994 into the operations and activities of NASD and the market making activities of NASDAQ found that NASD failed over a period of time to conduct an appropriate inquiry into anticompetitive actions among NASDAQ market makers.[58] In responding to SEC's resulting recommendations, NASD agreed to, among other things, ensure the existence of a "substantial," independent internal review staff reporting directly to NASDAQ's Board of Governors.[59] Second, as discussed, SEC reported in 1999 that its investigation of the activity of NYSE floor brokers

[57]NASD is responsible for conducting oversight inspections of Amex.

[58]Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and NASDAQ Market, SEC Release No. 34-37542 (Aug. 8, 1996).

[59]More recently, NASDAQ has taken steps to further bolster the independence of its internal review function by providing that its internal review department report directly to the audit committee, which consists solely of independent directors, and mandating that its internal review department have free and open access to information deemed necessary by the department to perform its reviews.

found that NYSE failed to dedicate sufficient resources to allow regulatory staff to perform certain required examinations of floor-broker activity. To address SEC's resulting recommendation, NYSE agreed to maintain its Regulatory Quality Review Department as a "substantial," independent internal review staff with adequate resources to regularly review all aspects of NYSE.

The NASDAQ Moratorium and Subsequent Rule Changes Allowed Issuers to Remain Listed Longer

Following September 11, 2001, SEC allowed a NASDAQ rule to remain in effect that implemented a moratorium on enforcing its continued listing standards for bid price and market value of publicly held shares. After the moratorium ended, SEC allowed a separate NASDAQ rule to remain in effect that established a pilot program extending the bid-price compliance period for SCM issuers from 90 days to almost 1 year and allowing NNM issuers that were noncompliant with the bid-price standard to transfer to the SCM at the end of the compliance period, rather than enter the delisting process. On December 23, 2003, SEC approved another NASDAQ rule proposal that further extended the time noncompliant issuers could remain listed, also under a pilot program.

SEC Allowed NASDAQ's Rule Implementing a Moratorium on Enforcing Bid-Price and Market Value of Publicly Held Shares Continued Listing Standards to Remain in Effect

In response to market conditions after September 11, SEC allowed a NASDAQ rule to remain in effect that implemented a 3-month moratorium on enforcing its continued listing standards for bid price and market value of publicly held shares. According to NASDAQ officials, NASDAQ's Listing and Hearing Review Council began to study the possible effects of modifications to the bid-price standard about 1 year before the moratorium. These officials said that as the market was already experiencing a downturn in the months before September 11, 2001, many NASDAQ-listed companies saw their stock price fall below the minimum bid-price standard. According to NASDAQ officials, after this date, market conditions worsened considerably and the bid price of more issuers fell below the standard. NASDAQ expressed concern that, in the absence of the moratorium, a large number of otherwise financially sound companies would have to be delisted. According to NASDAQ officials, delisting these issuers would, among other things, disadvantage investors who would be limited to trading the related securities in markets that were not subject to the same level of regulation and transparency as NASDAQ. To give the markets time to stabilize and to provide issuers that were noncompliant with only these standards time to return to compliance, NASDAQ proposed the rule that implemented the moratorium. The rule became operative on September 27, 2001, and the moratorium expired on January 2, 2002.[60]

NASDAQ filed its proposal with SEC in accordance with a procedure set forth in the Exchange Act and SEC regulations that allows a rule proposed by an SRO to take effect upon filing without any action being taken by SEC. A proposed rule change can become immediately effective without SEC action if it is properly designated by the SRO as effecting a change that (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) by its terms does not become operative for 30 days after the date of the filing, or such shorter time as SEC may designate if consistent with the protection of investors and the public interest.[61] SEC, within 60 days of the date of filing, may summarily abrogate the rule change if it appears to SEC that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.[62]

[60]Self-Regulatory Organizations: Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Provide Nasdaq Issuers Temporary Relief from Listing Requirements Relating to the Bid Price for Continued Inclusion and the Market Value of the Public Float, SEC Release No. 34-44857 (Sept. 27, 2001). After the date of this release, NASDAQ changed the name of the market value of public float listing standard to market value of publicly held shares.

[61]These criteria are found in SEC Rule 19b-4(f)(6), 17 C.F.R. 240.19b-4(f)(6), which implements section 19(b)(3)(A) of the Exchange Act, 15 U.S.C. § 78s(b)(3)(A). SEC Rule 19b-4(f)(6) also requires that, for a rule change to take effect immediately upon filing with SEC, the SRO must give SEC written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least 5 business days before the date of filing of the proposed rule change, or such shorter time as designated by SEC. This 5-day period allows SEC staff to offer its opinion to the SRO regarding whether the proposal meets the criteria for filing under Rule 19b-4(f)(6).

[62]Section 19(b)(3)(C) of the Exchange Act, 15 U.S.C. § 78s(b)(3)(C).

SEC did not abrogate NASDAQ's proposed rule change implementing the moratorium. Moreover, to provide issuers immediate relief, SEC waived the 30-day waiting period and allowed the rule to become operative immediately.[63] In the notice of this proposal, SEC stated that the rule's potential benefits could have been lost without accelerating the operative date, because NASDAQ might otherwise have been required to begin delisting proceedings against issuers that did not meet the bid-price and market value of publicly held shares standards.

The moratorium provided relief to at least 509[64] issuers that were noncompliant or approaching noncompliance with the bid-price or market value of publicly held shares continued listing standards.[65] During the moratorium, NASDAQ stopped enforcing these standards, which meant that noncompliant issuers were no longer subject to NASDAQ's deficiency process, thereby relieving those that were in the process from potential delisting. NASDAQ also stopped tracking individual issuers' compliance with these standards so that issuers approaching noncompliance that might otherwise have entered the deficiency process did not do so. Because NASDAQ stopped tracking individual issuers' compliance with the bid-price and market value of publicly held shares standards during the moratorium, it could not determine the total number of issuers that might have become noncompliant in the absence of the moratorium and, therefore, benefited from it. Neither could NASDAQ determine the number of noncompliant issuers that would have returned to compliance in the absence of the moratorium.

[63]Without SEC action, a rule filed under this procedure would become "effective" immediately but not "operative" until 30 days later. The net result would be a 30-day delay before the SRO could enforce the proposed rule. However, if SEC waives the 30-day period, the proposed rule can become "effective" and "operative" at the same time. According to SEC staff, the 30-day "preoperative" waiting period gives affected parties, such as issuers and investors, time to adjust to the new rule. The period also serves to give SEC time during which it can evaluate the rule and, if warranted, abrogate it without significantly disrupting SRO operations. In waiving the 30-day waiting period, SEC is to consider the proposed rule's impact on efficiency, competition, and capital formation, as required by 15 U.S.C. § 78c(f).

[64]Of these 509 issuers—about 11 percent of the issuers listed on NASDAQ—152 traded on the SCM and 357 traded on the NNM.

[65]Before the moratorium, if bid price or market value of publicly held shares fell below the continued listing standards for 30 consecutive trading days, the issuer was classified as noncompliant and had 90 days to return to compliance.

At the end of the moratorium, 447 of the 509 issuers that could be identified as having received temporary relief remained listed. The remaining 62 were no longer listed at the time the moratorium expired on January 2, 2002. Of these, 47 were delisted for deficiencies in listing standards not related to bid price and 15 were delisted for other reasons, such as merger with or acquisition by another company.

SEC Subsequently Allowed a NASDAQ Rule to Remain in Effect That Allowed Noncompliant SCM Issuers Almost 1 Year to Comply with the Bid-Price Standard and NNM Issuers to Transfer to the SCM

In February 2002, shortly after the moratorium ended, SEC allowed a NASDAQ rule to remain in effect that extended the bid-price compliance period from 90 days to almost 1 year for SCM issuers and allowed noncompliant NNM issuers to transfer to the SCM at the end of the NNM bid-price compliance period, rather than enter the delisting process.[66] The rule implemented these changes on a 2-year pilot basis, and NASDAQ agreed to evaluate the rule's impact on the market at the end of the 2-year period. First, the new rule extended the initial SCM bid-price compliance period from 90 days to 180 days. Second, at the expiration of the 180 days, SCM issuers that had not regained compliance with the bid-price standard were allowed an additional 180 days to regain compliance if they met one of three initial SCM listing standards.[67] The net result was that noncompliant SCM issuers that met these higher initial listing standards had almost 1 year to regain compliance before entering the delisting process. The rule also established procedures for noncompliant NNM issuers to transfer to the SCM at the end of the 90-day NNM bid-price compliance period. Under these procedures, NNM issuers that did not comply with the bid-price standard at the end of the 90-day NNM compliance period could, in lieu of entering the delisting process, elect to transfer to the SCM, if they (1) met all but the SCM's bid-price continued listing standards, (2) filed an application, and (3) paid the applicable listing fee. Under rules applicable to SCM issuers, noncompliant NNM issuers that transferred to the SCM could trade for as much as an additional 270 days

[66]Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Bid Price Criteria of Nasdaq Listing Standards, 67 Fed. Reg. 6306 (Feb. 11, 2002).

[67]The three SCM initial listing standards were a minimum of (1) $5,000,000 in shareholders' equity, (2) $50,000,000 in market capitalization, or (3) $750,000 in net income from continued operations in the most recent fiscal year or in 2 of the last 3 most recent fiscal years. Issuers are required to meet at least one of these three standards to be eligible for initial listing. SCM initial listing standards for shareholders' equity, market capitalization, and net income are higher than for continued listing.

(the remaining 90 days of the first 180-day SCM compliance period and the entire second 180-day compliance period).

According to NASDAQ, the rule was proposed in order to provide noncompliant NNM issuers more time to develop and implement strategies for regaining compliance with the bid-price standard. Until the rule change, the bid-price continued listing standards for the SCM and NNM were the same. As a result, NNM issuers failing to meet the bid-price standard after the expiration of the compliance period were not eligible to trade on the SCM and, if delisted by NASDAQ, would be forced to trade in another over-the-counter market. NASDAQ filed this rule change under the same procedure as the rule change implementing the moratorium. As with the moratorium rule, SEC took no action to abrogate the proposed rule and also waived the 30-day waiting period, allowing NASDAQ to enforce it immediately. In waiving the 30-day waiting period, SEC stated that no purpose would be served by having 30 days pass before the rule became operative because, during the intervening period, issuers and investors could become confused about which compliance period applied.[68]

The February 2002 rule change affected the listing status of issuers that were provided relief from pending or potential delisting by the moratorium (moratorium issuers) and other issuers that were not identified as receiving such relief (nonmoratorium issuers). As previously discussed, 447 (88 percent) of the 509 moratorium issuers continued to trade when the moratorium expired on January 2, 2002. By February 28, 2003, approximately 1 year after NASDAQ implemented its February 2002 rule change, the number of issuers trading had dropped to 246 (48 percent of the 509 moratorium issuers).[69] This drop reflects 201 additional delistings, increasing the total number of moratorium issuers delisted from 62 to 263 (52 percent of the 509 moratorium issuers).[70]

[68]According to a Market Regulation official, if SEC had not granted NASDAQ's request to waive the 30-day waiting period, different SCM issuers could have been subject to different compliance periods, depending on which rule applied at the time they became deficient.

[69]The 246 moratorium issuers trading on February 28, 2003, included issuers that were in full compliance with the continued listing standards as well as issuers that were noncompliant with bid-price or other continued listing standards.

[70]Of the 201 moratorium issuers that were delisted between January 2, 2002, the day the moratorium expired, and February 28, 2003, 70 were delisted for noncompliance with the bid-price standard alone or noncompliance with the bid-price and other listing standards; 95 were delisted for noncompliance with listing standards not related to bid price; and 36 were delisted for other reasons, such as merger with or acquisition by another company.

Of the 246 issuers that continued to trade as of February 28, 2003, 132 issuers were listed on the SCM and were trading under the extended compliance period or had traded in an extended compliance period and regained compliance with the bid-price standard, including 87 that had transferred from the NNM. Under the premoratorium bid-price rule, all of the 132 issuers would have entered the delisting process. Also, as of February 28, 2003, 150 nonmoratorium issuers had traded or were trading on the SCM under the extended bid-price compliance period, including 89 issuers that transferred from the NNM. These 150 issuers also would have entered the delisting process under the premoratorium bid-price rule.

SEC Approved a Rule That Further Extended the Bid-Price Compliance Periods

In January 2003, the NASDAQ and NASD boards of directors approved NASDAQ's plans to propose to SEC a rule change that would further extend the SCM and NNM bid-price compliance periods up to 2 years and almost 1 year, respectively, under a pilot program. Market Regulation subsequently asked NASDAQ to modify its request to submit the proposal under provisions that would allow the rule to be applied immediately upon filing. Market Regulation officials said that they wanted to assess whether the public perceived any negative consequences for investors in allowing SCM issuers to trade while noncompliant for up to 2 years. After ongoing discussions with Market Regulation officials, NASDAQ divided its proposal into two rule filings—one that would partially implement the extended compliance periods and become immediately effective upon filing, and the other that would subject the remainder of the proposal to public notice and comment before final SEC action.

Accordingly, in March 2003, NASDAQ submitted to SEC a proposal to extend the bid-price compliance periods on both the SCM and NNM by 90 days.[71] SEC took no action to abrogate the rule and waived the 30-day waiting period, allowing NASDAQ to enforce the rule immediately. The rule allowed noncompliant SCM issuers that met one of three initial SCM listing standards another 90-day compliance period extension, increasing the SCM

[71]Self-Regulatory Organizations: Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Bid Price Test in Nasdaq Listing Standards, 68 Fed. Reg. 12729 (Mar. 17, 2003).

compliance period to a potential total of 450 days.[72] The rule also extended the NNM's initial bid-price compliance period from 90 days to 180 days. At the end of the 180-day compliance period an NNM issuer could apply to transfer to the SCM, provided it (1) met all but the SCM bid-price continued listing standards, (2) filed an application, and (3) paid the applicable listing fee. In addition, the rule extended the pilot program established under the February 2002 rule change until December 31, 2004, by which time NASDAQ is expected to evaluate the rule's impact on the market.

NASDAQ proposed the remainder of its plan to extend the SCM bid-price compliance period up to 2 years and the NNM bid-price compliance period to almost 1 year, using a different procedure that requires affirmative SEC approval of the proposed rule change. This procedure allows SEC to review comments submitted by the public before the rule becomes effective. However, no public comments were submitted. SEC approved the rule on December 23, 2003.[73] The new rule amended the March 2003 rule to extend the SCM bid-price compliance period up to 2 years and the NNM bid-price compliance period to almost 1 year under the pilot program. The new rule allows NASDAQ to continue to grant a noncompliant SCM issuer a second 180-day compliance period extension; however, NASDAQ now requires the issuer to meet all SCM initial listing standards, except for bid price, rather than only one of three initial listing standards as specified in the February 2002 and March 2003 rule changes.[74] NASDAQ officials told us that this new requirement was intended to protect investors by preventing financially weak companies from taking advantage of the compliance period extensions.

[72]The three SCM initial listing standards were a minimum of (1) $5,000,000 in shareholders' equity, (2) $50,000,000 in market value of listed securities, or (3) $750,000 in net income from continued operations in the most recent fiscal year or in 2 of the last 3 most recent fiscal years.

[73]Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto by the National Association of Securities Dealers, Inc. to Modify an Existing Pilot Program Relating to the Bid Price Test of the Nasdaq Maintenance Listing Standards, 68 Fed. Reg. 75677 (Dec. 31, 2003). Also, see SEC's correction to the text of the rule: Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto by the National Association of Securities Dealers, Inc. to Modify an Existing Pilot Program Relating to the Bid Price Test of the Nasdaq Maintenance Listing Standards, 69 Fed. Reg. 6707 (Feb. 11, 2004).

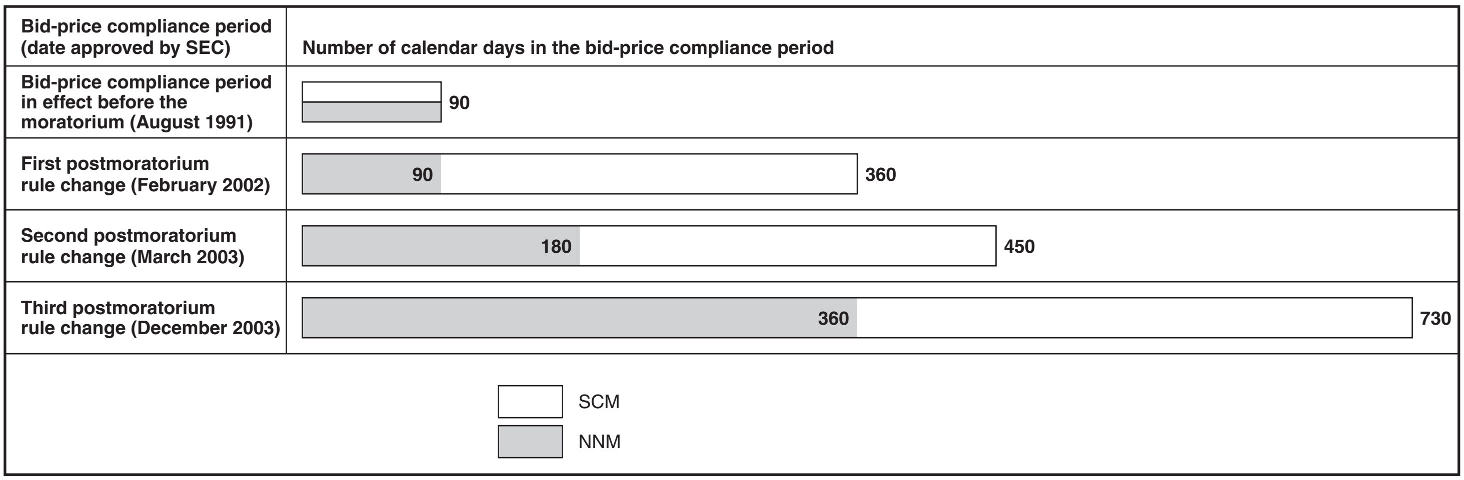
[74]See appendix III, figure 7, for NASDAQ's current bid-price deficiency process.

An SCM issuer that is still noncompliant with the bid-price standard at the end of the 180-day extension but that meets all other SCM initial listing standards can receive a further compliance period extension, up to the time of its next scheduled shareholders' meeting, if the issuer agrees to seek shareholder approval for a reverse stock split at that meeting and implement it promptly afterward.[75] The new rule allows NASDAQ to grant this compliance period only if the next shareholders' meeting is scheduled to occur within 2 years of the date on which NASDAQ initially notified the issuer of its noncompliance, thus limiting the time a noncompliant issuer can remain trading to 2 years. Under the new rule, NASDAQ must immediately begin delisting proceedings if the issuer does not propose, obtain approval for, or promptly execute the reverse stock split.

The new rule also permits NASDAQ to grant a noncompliant NNM issuer a second 180-day compliance period extension, if the issuer meets all NNM initial listing standards except bid price. An issuer may elect to transfer to the SCM at the end of either the first or second compliance period, provided it (1) meets all of the SCM continued listing standards except bid price, (2) files an application, and (3) pays the applicable listing fee. Thus, under the new rule, noncompliant NNM issuers can remain listed for almost 1 year on the NNM and for up to 2 years if they transfer to the SCM instead of entering the delisting process. Figure 1 shows how NASDAQ has lengthened the SCM and NNM bid-price compliance periods from the premoratorium standards through the December 2003 rule.

[75]A reverse stock split is the reduction of the total number of shares outstanding. The total number of shares will have the same market value immediately after the reverse split as before it, but each share will be worth more. For example, if a firm with 10 million outstanding shares selling at $10 a share executes a reverse 1 for 10 split, the firm will end up with 1 million shares selling for $100 each.

Figure 1: Maximum Number of Calendar Days in NASDAQ Bid-Price Compliance Periods from August 1991 (Premoratorium) through December 2003 (Latest Rule Change)



Source: NASDAQ.

In its approval order, SEC said that the length of the extended compliance periods under the new rule raises investor protection concerns. According to SEC, if a listing standard is suspended for too long, the standard is not transparent and the investor protection principles underlying the premise of listing standards could be compromised. SEC said that the heightened requirements that NASDAQ issuers must meet under the rule to be eligible for the extended compliance periods should offer reassurance to investors that the issuer remains a viable business despite its low bid price. SEC further noted that if NASDAQ seeks permanent approval for the new rule, the results of NASDAQ's study on the effects of the rule under the pilot program would be essential in analyzing whether the length of the extended compliance periods undermines investor protection.

Listing Standards Have Been Used as a Vehicle for Improving Corporate Governance

Responding to the unexpected collapse of several major corporations, SEC requested in 2002 that the SROs strengthen their corporate governance standards. In addition, Congress passed Sarbanes-Oxley, which mandated that the SROs adopt rules governing audit committees of listed issuers. The three largest SROs responded by adopting rules that amended their corporate governance standards for listed companies, by among other things, increasing the role and authority of independent directors. Additionally, in response to an SEC request in 2003, the three largest SROs began evaluating their own governance against the standards proposed for their issuers. Finally, we reviewed the actions taken by public and private institutions in four other countries related to the role and authority of independent directors of issuers in those markets.

Corporate Collapses Led to SEC and Congressional Efforts to Strengthen Corporate Governance through Listing Standards

The collapse of major U.S. corporations, such as the Enron Corporation, Inc., and WorldCom, Inc., beginning in 2001 raised congressional, SEC, and market participant concerns about the quality of corporate governance at publicly traded companies. One area of concern focused on the ability of directors to provide active and independent oversight of management. For example, various congressional committees, including the Senate Permanent Subcommittee on Investigations, held hearings as part of their examination of the collapse of Enron.[76] The subcommittee's final report on the role of the board of directors in Enron's collapse raised concerns about the failure of the Enron board to safeguard the interests of shareholders by allegedly allowing management to engage in, among other things, inappropriate conflict-of-interest transactions.[77] The report alleged that financial ties existed between the company and certain board members that likely compromised their independence. Also, at companies such as Enron and WorldCom, allegedly conflicted boards approved excessive compensation for their chief executives. Similarly, hearings by Congress as well as an investigation mandated by a U.S. district court into the 2002 collapse of WorldCom questioned the effectiveness of the board's oversight of the CEO. According to the court-mandated report, the CEO appeared to have dominated the course of the company's growth, as well as the agenda, discussions, and decisions of the board.[78]

Consistent with the court's decision in *Business Roundtable v. SEC*, SEC did not mandate changes to the SROs' listing standards to address these

[76]Other congressional committees holding hearings on the collapse of Enron included the Senate Committee on Banking, Housing, and Urban Affairs; the Senate Committee on Commerce, Science, and Transportation; the House Committee on Energy and Commerce, Subcommittee on Oversight and Investigations; and the House Committee on Financial Services and its Subcommitee on Capital Markets, Insurance, and Government Sponsored Enterprises.

[77]U.S. Senate Permanent Subcommittee on Investigations, *The Role of the Board of Directors in Enron's Collapse*, 107th Cong., 2nd sess., 2002, S. Rept. 107-70.

[78]Dick Thornburgh, *First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner* (November 2002).

lapses in corporate governance. Instead, the former SEC Chairman asked NASDAQ and NYSE in a February 2002 letter to review ways in which they could strengthen corporate governance through their listing standards.[79] He suggested several issues for the SROs to consider, including whether public companies should be required to adopt codes of conduct for their officers and directors, take steps to ensure directors are qualified for board service, and further strengthen audit committee requirements. SEC staff sent Amex a similar letter in June 2002.[80]

Also, responding to the corporate collapses, Congress mandated, with the passage of Sarbanes-Oxley in July 2002, that listing standards be used as a vehicle for improving corporate governance. Section 301 of Sarbanes-Oxley sought to improve the effectiveness of issuer audit committees by imposing requirements designed to enhance their independence, authority, and responsibility. Sarbanes-Oxley required SEC to direct the SROs through rulemaking to prohibit the listing of issuers that do not meet these requirements. SEC issued its final rules in April 2003.[81]

[79] SEC's 2002 request was preceded by a 1998 request that resulted in NASD and NYSE convening the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon Committee) to make recommendations for strengthening audit committee oversight. Amex, NASDAQ, and NYSE adopted many of the resulting recommendations in 1999 as listing standards. Among other things, they required issuers to establish audit committees comprising directors that meet specific independence and financial literacy requirements and required audit committees to adopt written charters detailing their responsibilities. SEC also followed a Blue Ribbon Committee recommendation by requiring issuers to disclose these charters as an appendix to the proxy statement at least once every 3 years.

[80] SEC also sent letters to other securities exchanges requesting that they review their corporate governance listing standards.

[81] Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18788 (Apr. 16, 2003). SEC's final rules require most issuers to comply with the new audit committee requirements by their first annual shareholders' meeting after January 15, 2004, or by October 31, 2004, whichever is earlier.

The SROs Adopted Rules That, Among Other Things, Increase the Role and Authority of Independent Directors

Addressing the SEC request and Sarbanes-Oxley mandates, the three largest SROs adopted rules that, according to SEC, should foster greater board accountability to shareholders.[82] Market participants supported the rules but held differing views on the need for further enhancements to board independence. OCIE officials said that they will work with the SROs to ensure processes are developed to more thoroughly assess compliance with the new standards. SEC has also taken steps to further strengthen director accountability to shareholders, including addressing longstanding investor interest in gaining increased access to the director nomination process and planning a review of SEC requirements governing disclosures of qualitative corporate information.

SEC Stated That the SROs' Rules Should Foster Board Accountability

The SROs submitted rules that SEC stated should foster greater accountability, transparency, and objectivity in board oversight.[83] Among other things, these rules increase the role of independent directors, extend corporate governance disclosures, and expand shareholder oversight of equity compensation plans.[84] SEC completed its review and approval of these rules for Amex, NASDAQ, and NYSE between June 2002 and December 2003.[85] According to Corporation Finance and Market Regulation officials, although they worked with the markets to harmonize their listing standards in some key areas, they did not push the SROs to have identical standards because some differences were warranted, such as those related to the size of issuers.

[82] NASDAQ officials said that NASDAQ's Listing and Hearing Review Council, a standing independent advisory committee on listing and corporate governance issues, began an evaluation of potential actions to strengthen corporate governance listing standards before NASDAQ received the SEC Chairman's February 2002 letter.

[83] Amex submitted its initial rule proposals in separate filings to SEC on May 6 and June 23, 2003. NASDAQ submitted its initial rule proposals in separate filings on June 11 and October 9, 2002. NYSE submitted its initial rule proposals on August 16, 2002.

[84] An equity compensation plan is a plan or other arrangement under which the equity securities of the issuer are used to compensate such persons as officers, directors, or employees for services rendered.

[85] The SROs submitted revised rule filings during this period in response to ongoing discussions with SEC officials and SEC's April 2003 rules implementing Sarbanes-Oxley audit committee requirements.

New Rules Increased the Role of Independent Directors

Amex, NASDAQ, and NYSE's new rules increase the role of independent directors by (1) requiring that in most circumstances issuers have a majority of independent directors on their boards and that they meet regularly in executive sessions,[86] (2) tightening the definition of independence that applies to directors, (3) strengthening independent directors' oversight of financial reporting, and (4) increasing independent directors' authority over CEO compensation and director nominations.[87] First, according to Amex and NYSE, requiring that a majority of directors be independent, with limited exceptions, and free from relationships with the issuer or its management that might compromise their independence, will promote board decision making that is aligned with shareholders' interests and thereby enhance board accountability. NASDAQ similarly stated that such a requirement empowers independent directors to more effectively carry out their oversight responsibilities. Further, according to Amex and NASDAQ, requiring that independent directors regularly meet without management present, as specified in these SROs' rules, is designed to encourage open discussion among independent directors. NYSE's rules include a similar requirement for independent directors and other directors who are not company officers. NYSE's rules further require issuers to disclose either the name of the director chosen to preside at the executive sessions or the procedure by which a presiding director is selected for each executive session. The issuers must also disclose a method interested parties can use to communicate any concerns directly to the presiding director or nonmanagement directors as a group.

[86]Amex, NASDAQ, and NYSE's new rules apply in full to all domestic issuers listing common equity securities, with limited exceptions. For example, all three SROs exempt from the "majority of independent directors" standard those issuers for which an individual, a group, or another company holds more than 50 percent of the voting power. In addition, Amex exempts small business issuers from this standard, requiring instead that their boards of directors consist of at least 50 percent independent directors. Small business issuers, based on SEC's definition, are those issuers that, among other things, have less than $25 million in revenues and market capitalization.

[87]Self Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes Relating to Corporate Governance, 68 Fed. Reg. 64154 (Nov. 12, 2003); Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change by the American Stock Exchange LLC and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, 68 Fed. Reg. 68432 (Dec. 8, 2003).

Second, the three SROs' new rules tighten the definition of director independence by specifying additional bright-line criteria that boards must apply when making independence determinations. The three SROs specify, among other things, additional financial and employment relationships for directors and immediate family members that would preclude an independence determination. For example, Amex and NASDAQ's new rules maintain a test of financial independence that prohibits independent directors from receiving compensation from the issuer in excess of $60,000, subject to limited exceptions such as compensation for board service, but expand the specific types of compensation prohibited to include other types of payments and apply this financial test to the directors' immediate family. For example, NASDAQ's new rules would prohibit payments such as political contributions. NYSE's new definition of director independence also includes a test of financial independence similar to that of Amex and NASDAQ with a compensation ceiling of $100,000, unless this compensation is related to board service.

In addition to providing bright-line criteria to aid boards in making these independence determinations, NYSE's rules also recommend that boards broadly consider other material relationships that might impair a director's independence.[88] Boards must disclose any additional standards they adopt and explain to investors any determination of independence for a director who does not meet these standards.

Of the three SROs, NASDAQ and NYSE currently require issuers to disclose which directors they have designated as independent. Some market participants expressed concern that without this information they would have difficulty assessing the independence of issuers' boards. Likewise, regulators might face the same difficulty. Amex officials said that they would consider providing this added disclosure.

[88]According to NYSE, material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships.

Third, the three SROs' new rules strengthen the role of independent directors on audit committees and audit committee oversight of the financial reporting process.[89] Implementing SEC's final rules related to Sarbanes-Oxley section 301 requirements, the SROs further tightened the definition of independence that will apply to audit committee members by prohibiting them from accepting any consulting, advisory, or other compensatory fees, unless this compensation is related to board service. Also, responding to SEC's final rules, the SROs new rules mandate that audit committee charters require the committees to have direct responsibility for the retention, oversight, and compensation of the independent auditor, have access to and funding for any other independent advisers they need to complete their work, and establish procedures for treating accounting-related complaints and the anonymous submission of these complaints by employees.[90] In addition to addressing the Sarbanes-Oxley requirements, Amex, NASDAQ, and NYSE adopted other listing standards for audit committees. For example, NASDAQ's rules require audit committees to approve all related-party transactions.[91] Amex's rules require that the audit committee exercise appropriate review and oversight

[89]Amex, NASDAQ, and NYSE's new rules retain a previous requirement that issuers have audit committees of at least three members and consist solely of independent directors. The new rules also continue to require that each audit committee member be "financially literate" and that at least one have "financial expertise," although Amex uses the term "financial sophistication." Amex and NASDAQ define financial literacy as the ability to read and understand financial statements. NASDAQ defines financial expertise as having past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience. Amex defines financial sophistication in a similar manner. NYSE delegates the responsibility for defining financial literacy to issuers' boards. NYSE specifies that the financial expert must have accounting or related financial management expertise, although it delegates the responsibility to boards to further define this expertise. Pursuant to Sarbanes-Oxley section 407, issuers are required to disclose whether their audit committees have at least one financial expert meeting the definition of financial expert provided in SEC's rulemaking that implements section 407. Although none of the SROs' definitions of financial expert meet SEC's stricter definition, Corporation Finance officials stated that they expect most issuers will seek audit committee experts that meet SEC's definition, rather than disclose to investors that they do not have such an expert. Issuers other than small business issuers must comply with this disclosure requirement in their annual reports for fiscal years ending on or after July 15, 2003, and for small business issuers, December 15, 2003.

[90]Amex, NASDAQ, and NYSE's new rules retain the requirement that audit committees have charters that include descriptions of the committee's scope of responsibilities and the way in which the committee will carry them out.

[91]Related-party transactions refer to financial transactions between the issuer and a director, director nominee, officer, significant shareholders, or the immediate family members of any of these.

of these transactions. NYSE's rules include a requirement that the audit committee meet separately with management, internal auditors, and outside auditors.

Finally, the three SROs' new rules increase independent directors' authority over CEO compensation and the selection of new director nominees. Amex and NASDAQ's rules allow boards to establish independent compensation and nominating committees or require that a majority of their independent directors fulfill these responsibilities.[92] In contrast, NYSE's rules require boards to establish independent compensation and nominating committees.[93] According to Amex and NYSE, requiring independent directors to set CEO compensation will promote an objective evaluation of CEO performance and the design of a compensation package that fairly reflects that performance and includes appropriate incentives. NASDAQ stated that such a requirement helps to ensure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. Similarly, the three SROs stated that giving independent directors responsibility for nominating new directors will help ensure the quality and independence of nominees.

Amex issuers must comply with the new rules increasing the role of independent directors by their first annual shareholders' meeting after March 15, 2004, or by October 31, 2004, whichever is earlier.[94] NASDAQ and NYSE issuers have until their first annual shareholders' meeting after January 15, 2004, or October 31, 2004, whichever is earlier.[95] However,

[92]Amex's rules require the independent compensation committee or a majority of independent directors to determine, or recommend to the board for determination, the compensation of the CEO. NASDAQ has a similar requirement for determining the compensation of the CEO and all other executives.

[93]NYSE's rules require the independent compensation committee to determine and approve the CEO's compensation either alone or with the rest of the independent directors.

[94]Certain types of Amex issuers have different implementation schedules for the new listing standards. For example, Amex foreign private issuers and small business issuers have until July 31, 2005, to comply with the rules increasing the role of independent directors.

[95]As with Amex issuers, certain types of NASDAQ and NYSE issuers also have different implementation schedules for the new listing standards. For example, NASDAQ foreign private issuers and small business issuers (issuers that, among other things, generate less than $25,000,000 in revenues) have until July 31, 2005, to comply with the rules increasing the role of independent directors. NYSE foreign private issuers have until July 31, 2005, to comply with Sarbanes-Oxley-related audit committee listing standards.

NASDAQ issuers had until January 15, 2004, to comply with NASDAQ's new rule related to audit committee approval of related-party transactions.

New Rules Extended Corporate Governance Disclosures

Amex, NASDAQ, and NYSE's new rules require issuers to adopt a code of conduct and ethics that is applicable to all directors, officers, and employees.[96] Amex and NASDAQ require that these codes address conflicts of interest, compliance with laws and regulations, and enforcement of the codes. NYSE's rules recommend that the codes address these and other topics. All three SROs require issuers to disclose their codes and any waivers granted to officers and directors.[97] NYSE's rules further require boards to adopt and disclose corporate governance guidelines addressing such topics as director qualifications and responsibilities, management succession, and annual performance evaluations. According to NYSE, increased corporate governance disclosures should enhance investors' understanding of issuers' corporate governance policies and procedures and promote adherence to them by directors and management. In addition, NYSE's rules require audit committees to disclose their charters and nominating and compensation committees to adopt and disclose charters that address their purpose and responsibilities, among other things. The three SROs also adopted rules implementing disclosure requirements for foreign private issuers (foreign issuers) listed on their markets.[98] Amex and NYSE's rules require that foreign issuers disclose significant differences between their corporate governance practices and those required by the

[96]NASDAQ uses the term "code of conduct" instead of "code of conduct and ethics."

[97]SEC enacted a rule pursuant to Sarbanes-Oxley section 406 that requires disclosure of (1) whether issuers have adopted a code of ethics that applies to the company's principal executive, financial, and accounting officers or other persons performing such functions and, if not, the reasons why not; (2) any code that is adopted; and (3) waivers from the code granted to any of the aforementioned officers. Issuers must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003.

[98]While Sarbanes-Oxley applies generally to both U.S. and foreign issuers, SEC's section 301 rules are flexible and include various exemptions. In particular, foreign issuers may, in specified circumstances, be exempt from section 301's independence requirements for, and specified duties of, audit committees.

SROs.[99] NASDAQ requires foreign issuers to disclose any exemptions granted by NASDAQ to its corporate governance rules and describe any alternative measures taken by the issuer.[100]

Amex issuers have until June 1, 2004, to adopt and disclose a code of conduct and ethics, and NASDAQ issuers have until May 4, 2004, to do so. Foreign issuers listed on Amex or NASDAQ must begin disclosing any differences between their corporate governance practices and those required by the SRO beginning on or after January 1, 2004, respectively. NYSE issuers must comply with the new disclosure requirements by their first annual meeting after January 15, 2004, or by October 31, 2004, whichever is earlier.

New Rules Expand Shareholder Oversight of Equity Compensation Plans

Finally, the three SROs have implemented rules expanding requirements that issuers obtain shareholder approval of certain equity compensation plans.[101] In addition to maintaining previous requirements that shareholders approve equity compensation plans involving directors and

[99]Amex's new rules state that foreign issuers seeking relief from its corporate governance rules should provide written certification from independent counsel of the issuer's home country stating that the issuer's corporate governance practices are not prohibited by home country law. NYSE requires a written certification stating that the issuer's corporate governance practices comply with home country law and the rules of the principal securities market for the issuer's stock.

[100]NASDAQ's rules permit foreign issuers to request an exemption from NASDAQ's corporate governance rules if the NASDAQ rule is contrary to a law, rule, or regulation in their home country or is contrary to generally accepted business practices in that country.

[101]SEC approved NASDAQ and NYSE's proposals related to shareholder approval of equity-based compensation plans on June 30, 2003. (Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and NASDAQ Proposed Rule Changes and NASDAQ Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments Nos. 1 and 2 and NASDAQ Amendments Nos. 2 and 3 Thereto Relating to Equity Compensation Plans, 68 Fed. Reg. 39995 (July 3, 2003).) SEC approved Amex's related proposals on October 9, 2003. (Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change Amendment Nos. 1, 2, and 3 Thereto by the American Stock Exchange LLC Relating to Shareholder Approval of Stock Option Plans and Other Equity Compensation Arrangements, 68 Fed. Reg. 59650, (Oct. 16, 2003).) SEC approved an amendment to Amex's new rules on December 3, 2003. (Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change and Amendment No. 1. Thereto by the American Stock Exchange LLC Relating to Broker Voting on Equity Compensation Plans, 68 Fed. Reg. 69092 (Dec. 11, 2003).)

officers, the new rules include requirements that shareholders approve plans offered to employees and material modifications to all plans subject to shareholder approval.[102] According to NASDAQ, while the use of equity compensation plans can align director, officer, and employee interests with those of shareholders and assist in recruiting and retaining employees, they can also dilute the value of existing shares. For example, many equity compensation plans award an employee (or director or officer) stock options, or the rights to purchase a certain number of shares of the issuer's stock at a predetermined price for a fixed period. If the market value of the stock rises above the predetermined price, the option holders can profit by exercising their options to buy the stock at the predetermined price and then selling the stock at the higher market price.[103] As option holders exercise their options, the issuers would deliver to them newly issued stock or previously issued treasury stock, thus increasing the supply of outstanding shares.[104] Any company earnings would then be spread among the existing and the new shareholders, thereby reducing the earnings of existing shareholders. According to NYSE, broadening the approval requirements for equity compensation plans provides shareholders a means of protecting their economic interests. NASDAQ stated that the new rules provide shareholders a greater voice in the use of equity compensation.

Amex and NYSE's new rules also preclude their broker-dealer members from voting on behalf of shareholders when the issuers seek shareholder approval of equity compensation plans, unless the shareholders have first given the broker-dealer voting instructions. Amex required issuers to seek shareholder approval in accordance with these rules after October 9, 2003, and NASDAQ and NYSE began doing so after June 30, 2003.

[102]The three SROs do not require shareholder approval of inducement awards to new employees; certain grants, plans, and amendments related to mergers and acquisitions; and certain specific types of plans, such as those that are already regulated under Internal Revenue Code and Treasury regulations. All three SROs require that the independent compensation committee or a majority of the independent directors approve the use of an inducement exemption and promptly disclose it thereafter. Amex and NASDAQ further exempt warrants or rights issued generally to all shareholders or stock purchase plans available on equal terms to all shareholders.

[103]If the market value of the stock falls below the predetermined price specified in the equity compensation plan, the stock options could expire worthless.

[104]Treasury stock is stock that has been bought back by the issuer and is available for retirement or resale; the stock is issued but not outstanding.

Market Participants Supported the SROs' Efforts but Had Differing Views on Whether Board Independence Should Be Further Enhanced

Market participants expressed support for Amex, NASDAQ, and NYSE's efforts to improve corporate governance through listing standards. However, some said that more could be done to further enhance corporate governance, particularly board independence. Of these market participants, several told us that boards should be required through listing standards to adhere to higher standards of independence; others said that boards should be encouraged to voluntarily adopt stricter standards. According to one market participant, more time was needed to fully implement and assess the impact of the SROs' many new corporate governance standards before determining whether further changes were warranted.

First, several market participants said that stricter standards of independence should be applied to independent directors than are included in Amex, NASDAQ, and NYSE's new rules. For example, these rules leave in place standards that preclude an independence finding when a board interlock involves the compensation committee.[105] Some market participants would go further and preclude an independence finding when any interlocking board relationship exists, reasoning that any relationship directors have with the CEO on another board could impair their independence. Others said that the definitions adopted by the three SROs do not sufficiently address financial conflicts of interest for independent directors who are not audit committee members. They said that, similar to the Sarbanes-Oxley requirements for audit committee members, boards should not be able to designate directors as independent if they receive any compensation from the issuer that is not related to board service. One market participant told us that the definition of director independence should also prohibit financial relationships between the director and any executive officer.[106] However, others noted limitations to defining director independence through bright-line criteria. Three market participants said that bright-line criteria may impede independently minded individuals from serving on boards. For example, one market participant said that an independently minded person who has a financial relationship valued at

[105]Board interlocks occur when an issuer's director is employed as an executive officer of another company and that second company's board employs as a director any of the issuer's current executive officers. For example, a compensation committee interlock occurs when an issuer's director is employed as an executive officer of another company and that company's compensation committee employs any of the issuer's current executive officers.

[106]For example, under this approach, a director that provided legal services to the CEO for personal matters would not be considered independent.

$61,000—$1,000 over the compensation limit NASDAQ has established—would not be able to serve as an independent director. Another market participant told us that no independence definition could be structured to control all possible conflict-of-interest scenarios, particularly indirect relationships. This market participant said that indirect relationships, which include social relationships, can compromise a director's independence as much as direct financial relationships with issuers. Amex, NASDAQ, and NYSE officials told us that it was difficult to establish bright-line criteria that might signal conflicts of interest for all directors. NYSE officials said that for this reason, they decided to require issuers to disclose more information on their independence determinations and thus allow investors to make their own assessments of a board's independence.

Second, some market participants stated that boards should comprise a supermajority (two-thirds or three-fourths) of independent directors, rather than the simple majority that the three SROs' new rules require. According to one market participant, having a supermajority of independent directors would reassure investors that the board was independent and represented their interests. Several market participants said, however, that smaller issuers are having a harder time recruiting enough qualified independent directors to meet the majority independent director requirement because of the costs involved in searching for and retaining them. Amex officials said that for this reason, their SRO did not propose requiring a supermajority of independent directors. Two market participants told us that many boards continued to look for independent directors among CEOs. According to them, many qualified, willing, and less costly candidates are available for independent director positions among the ranks of professionals just below CEO, such as chief financial officers and chief operating officers. Officials from the American Institute of Certified Public Accountants told us that they have compiled a database with contact information on financial and other business professionals who are interested in serving as independent directors. NASDAQ officials said that they have not seen any evidence that supports requiring a supermajority of independent directors through a listing standard and that their goal of independent board decision making is achieved through their standard requiring a majority of independent directors. NYSE officials told us that they debated a supermajority of independent directors requirement, but said that a consensus did not exist in its favor. According to these officials, time is needed to first implement and evaluate the effect of the majority independent director requirement before assessing whether a supermajority of independent directors is needed.

Finally, several market participants recommended separating the positions of CEO and chairman. In the United States, many companies are under the leadership of a combined CEO/chairman, in contrast to companies in other countries where these roles tend to be separated, such as in the United Kingdom.[107] However, market participants expressed concern that this combined role can provide the potential for conflict, because CEOs are part of the management team that the board oversees. According to a January 2003 report by The Commission on Public Trust and Private Enterprise, a 12-member body sponsored by The Conference Board and comprising leaders from business, finance, and academia, in many of the corporate scandals of the recent past strong CEOs appeared to have exerted a dominant influence over their boards, often stifling the efforts of directors to perform the oversight needed to ensure a healthy system of corporate governance. The report further stated that boards have often lacked the structure and information needed to perform their roles properly or have abdicated their responsibility to provide the oversight required of them, and that, in such circumstances, boards cannot properly oversee the CEO's performance. Several market participants agreed with the Commission's recommendation for strengthening board independence and leadership by separating the role of CEO and chairman and providing that the chairman be independent or, as an alternative, providing for leadership of the independent directors by establishing an independent lead or presiding director.[108] According to one market participant, it is important that an independent director, whether an independent chairman, lead director, or presiding director, lead board meetings and have control over meeting agendas, meetings schedules, and the flow of information

[107]UK issuers listed on the London Stock Exchange are required to disclose the extent to which they comply with the Combined Code on Corporate Governance, the United Kingdom's official corporate governance code, and the reasons for any noncompliance. The code recommends separating the roles of CEO and chairman. According to a 2002 study commissioned by the UK Department of Trade and Industry, over 90 percent of UK issuers disclosed compliance with this provision. See Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors*, January 2003.

[108]The report discussed three alternative structures from which boards could choose to balance the powers of the CEO and independent directors. Under the first alternative, the CEO and chairman positions are separated, with the chairman position filled by an independent director. Under the second alternative, the CEO and chairman positions are separated, but if the chairman is not an independent director, the position of lead independent director is established. Under the third alternative, if the CEO and chairman positions are combined, a presiding director is established. See The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations Part 2: Corporate Governance and Part 3: Audit and Accounting*, January 2003.

from management to the other independent directors. Two market participants said that NYSE's new rule requiring boards to disclose the name of or process for selecting a director to preside over executive sessions was a step toward encouraging this independent leadership, although the new rule did not assign this individual specific responsibilities.

Other market participants opposed separating the positions of CEO and chairman of the board. One market participant said that the SROs' rules requiring that independent directors meet regularly in executive session is adequate to ensure board independence. According to this market participant, CEOs are very responsive to directors because they view the board as their boss. Others said CEOs may lose authority if the position is too weakened. Amex, NASDAQ, and NYSE officials told us that they had considered requiring the separation of CEO and chairman in developing their corporate governance rule proposals, but that they determined it was not appropriate to require all issuers to have this particular leadership structure at all times. According to NASDAQ and NYSE officials, an issuer may benefit from having a combined CEO and chairman under some circumstances, such as when the company is undergoing a merger. These officials said that in the case of a merger, the combined CEO and chairman position could provide the company the strong, unified leadership needed to guide the company through a difficult transition period.

In prior work, we expressed the view that SEC, in conjunction with the SROs, should consider using listing standards to further strengthen board independence by requiring a supermajority of independent directors and separating the positions of CEO and chairman. Although such practices do not guarantee that boards will be well managed, greater board independence could promote board decision making that is aligned with shareholders' interests, thereby enhancing board accountability. While board independence does not require eliminating all nonindependent directors, we have taken the position in previous work that it should call for a supermajority of independent directors.[109] Our prior work also recognized that independent leadership of the board is preferable to ensure some degree of control over the flow of information from management to

[109]U.S. Comptroller General David M. Walker, *Integrity: Restoring Trust in American Business and the Accounting Profession*, (document based on author's speech to the American Institute of Certified Public Accountants), November 2002. See also U.S. General Accounting Office, *Mutual Funds: Assessment of Regulatory Reforms to Improve the Management and Sale of Mutual Funds*, GAO-04-533T (Washington, D.C.: Mar. 10, 2004).

the board, scheduling of meetings, setting of board agendas, and holding top management accountable. The board has a clear responsibility to hold the CEO accountable for results. However, this system of checks and balances can be undermined when the positions of CEO and chairman are combined. A chairman who is also the CEO can have a significant impact on the direction of the company as well as on the role and composition of the board. For example, such individuals can have undue influence over who is asked to join or leave the board. For these reasons, we have supported the separation of the positions of CEO and chairman.

OCIE Plans to Work with the SROs to Ensure That Processes Are Developed to More Thoroughly Assess Compliance with the New Standards

SRO officials told us that they are revising the processes they use for assessing issuers' compliance with corporate governance listing standards, including issuers' self-certifications and reviews of public information. According to SRO officials, self-certifications are a means of holding issuers accountable for complying with their corporate governance standards, recognizing that the SRO cannot independently verify compliance with each individual standard. For example, these officials said that it would be difficult to independently determine compliance with some standards, such as those requiring independent directors to meet in executive sessions, nominate other independent directors, and determine CEO compensation, unless they were actually in the boardroom.

SRO officials said that as part of their efforts to ensure compliance with corporate governance listing standards, they have extended their historical use of issuer self-certifications of compliance with audit committee requirements to many of the new standards.[110] NASDAQ, for example, has updated its self-certification form and now requires issuers to certify compliance with its new audit committee composition, audit committee charter, executive sessions, and code of conduct standards. According to NASDAQ officials, issuers are not required to certify compliance with standards for which NASDAQ can independently determine compliance, such as the standard requiring a majority of independent directors. Amex and NYSE's new self-certification forms address their new rules relating to the composition and responsibilities of the board and audit, nominating, and compensation committees and their new disclosure requirements. As part of its new rules, NYSE further requires that CEOs annually certify that they are not aware of any violations of NYSE's corporate governance standards and that issuers disclose these CEO certifications in their annual reports. According to NYSE, requiring CEO certifications will focus the

[110]NYSE calls its self-certification form a "written affirmation."

CEO and senior management's attention on the issuer's compliance with corporate governance listing standards. Amex and NASDAQ officials said that they did not consider requiring CEO certifications necessary to ensuring compliance with corporate governance listing standards.

In addition to requiring self-certifications of compliance with corporate governance standards, the three SROs require their issuers to notify them upon becoming noncompliant with corporate governance standards. Amex, NASDAQ, and NYSE have each used their corporate governance listing standards to implement SEC's new rule directing the SROs to require their issuers to promptly notify them when an executive officer becomes aware of any material noncompliance with the Sarbanes-Oxley-mandated audit committee requirements. All three SROs apply the notification requirement to all of their corporate governance listing standards, not just the Sarbanes-Oxley-related listing standards. NYSE designated the CEO responsible for this notification.

Officials from the three SROs said that they have expanded their current process of reviewing periodic SEC filings, such as proxy statements, to include information that might indicate an issuer is noncompliant with the new corporate governance standards. For example, NASDAQ officials said that they review the financial disclosures in proxy statements to determine whether directors designated as independent have prohibited relationships with the issuer. Also, NYSE officials said that they review proxy statements to determine whether members of the management team are listed as members of the audit committee, which would be a violation of NYSE's listing standards. Officials of all three SROs said that they conduct manual reviews of required SEC filings, including proxy statements. They also said that they have automated systems that flag potential corporate governance issues for review and that they are enhancing these systems to allow them to better assess compliance with their new corporate governance requirements. Additionally, they said that they will continue to monitor other public disclosures, such as press releases, and the financial press for information that could indicate noncompliance with corporate governance standards. For example, NASDAQ officials said that news that an audit committee member had retired would lead to an inquiry about whether the issuer had filled the position, if the retirement would cause the audit committee to become noncompliant with NASDAQ's rules, and whether the person filling the position met the SRO's independence standards.

OCIE officials said that they will work with the SROs to ensure that effective processes are in place to more thoroughly assess compliance with the new standards. These officials told us that while the SROs can use information available in public disclosures to assess whether issuers comply with some of the new standards, such as whether directors satisfy the definition of independence, these disclosures do not contain information that would help assess compliance with other standards. For example, the new rules require that audit committee charters address the audit committees' responsibility to hire, compensate, and oversee outside auditors. OCIE officials said that while the SROs are able to determine whether the audit committee members satisfied the new audit committee independence standards by reviewing public disclosures, they would not be able to determine whether audit committees were actually providing independent oversight of the outside auditors using the same information. They said that a similar challenge exists with respect to rules requiring that independent directors determine executive compensation and nominate new directors. According to OCIE officials, sources of information are available that the SROs could use in helping to assess compliance with their new standards. For example, they said that the SROs could consider reviewing board and committee meeting agendas and minutes to assess whether independent directors may have discussed matters pertaining to the outside auditor without management present. They said that while it would not be practical for SROs to conduct such detailed compliance reviews for all issuers, conducting them on a sample basis could further promote compliance with the listing standards.

In addition to issues related to assessing compliance with corporate governance standards, the SROs have considered what sanctions should be imposed on issuers that do not comply with these standards. Concerned about the range of options available, in December 2003 and November 2003, respectively, Amex and NYSE each adopted a rule under which they reserve the right to issue public reprimand letters to issuers that do not comply with their corporate governance standards.[111] Amex and NYSE officials said that the only sanction otherwise available is delisting the issuer, a step that they said could, in certain circumstances, be perceived as more harmful to investors than the issuer's noncompliance. NYSE officials said that their experience to date has been that companies genuinely wish to comply with corporate governance standards; however, some of the standards have subjective elements, and a company may dispute a view by NYSE that it failed to comply with the standards and extend negotiations longer than acceptable. According to these officials, potential public

[111]Amex calls its public reprimand letter a "public warning" letter.

announcement of noncompliance might be a useful tool in such circumstances. According to Amex and NYSE officials, the SROs would, if necessary, delist an issuer that did not, after receiving the public reprimand letter, return to compliance with the market's listing standards. In contrast, NASDAQ officials opposed the lesser sanction, stating that they did not want issuers to knowingly violate corporate governance rules with the expectation that the only consequence would be a letter of reprimand. They said that part of ensuring a fair and transparent marketplace is to consistently apply and enforce listing standards and that if a requirement is significant enough to be a listing standard, then issuers that do not comply with the standard should be subject to delisting. According to these officials, the penalty of delisting is a more effective means of achieving issuer compliance, and thereby protecting investors, than a lesser sanction.

SEC Has Taken Steps to Further Increase Director Accountability

SEC has taken steps to revise regulations that have allowed issuers to exclude disclosures regarding shareholder director nominees in the issuer's proxy statement. For at least 60 years, shareholders have sought greater access to the issuer's proxy as a means of replacing ineffective or unresponsive directors and improving board accountability to shareholders.[112] In April 2003, the Commission directed Corporation Finance to formulate possible changes in the rules and regulations governing director elections, including SEC's Rule 14a-8, which addresses shareholder access to the proxy statement.[113] Responding to Corporation Finance's recommendations,[114] SEC proposed a rule in October 2003 that creates a mechanism for including, in issuer proxy material, disclosures of

[112]For example, SEC held hearings on shareholders' access to the director nominating process in 1943. See Securities and Exchange Commission Proxy Rules: Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 Before the House Committee on Interstate and Foreign Commerce, 78th Cong., 1st Sess., at 17-19 (1943); testimony of Chairman Ganson Purcell.

[113]SEC's Rule 14a-8 governs shareholder access to the issuer's proxy statement for the inclusion of shareholder proposals. Shareholders can conduct their own proxy contest, sending out proxy materials to other shareholders in accordance with applicable rules and regulations. According to market participants, proxy contests are prohibitively expensive for shareholders as they must prepare and pay for the dissemination of proxy materials at a potential cost of hundreds of thousands or even millions of dollars. Shareholders can nominate directors at the annual shareholder meeting, but because most shareholders vote through a proxy before the meeting, such nominees have little chance of being elected. According to market participants, other alternatives available to shareholders seeking to replace directors, such as shareholder litigation, are also costly and conflict-intensive.

[114]SEC Division of Corporation Finance, *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors* (July 2003).

director nominees made by long-term shareholders, or groups of long-term shareholders, with significant holdings.[115] Specifically, the proposed rule includes triggers that, when activated, require disclosure in an issuer's proxy materials of shareholder director nominees. For example, under one proposed trigger, this disclosure would be required when more than 35 percent of the shareholders who cast votes at the annual shareholders' meeting oppose at least one of the issuer's director nominees. The issuer is then required to include disclosure regarding shareholder director nominees in the proxy materials within the next two annual shareholders' meetings provided, among other things, that the nominees meet all applicable independence and eligibility requirements. Also, in response to the staff report, SEC adopted rules that strengthen disclosure requirements related to an issuer's nomination of directors and to shareholders' communication with directors.[116] According to SEC, the enhanced disclosures are intended in part to provide shareholders with additional information for use in evaluating the board of directors and nominating committees of the companies in which they invest.

SEC officials told us that they plan to review disclosure requirements regarding potential director and director nominees' conflicts of interest. Items 401 and 404 of SEC's Regulation S-K describe certain background information that an issuer must disclose in its proxy statement about its executive officers, directors, and director nominees, as well as certain relationships and transactions between the issuers and these individuals. These disclosure requirements focus on employment, family, and business relationships between the director or director nominees and the issuer or executive officers. In December 2001, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) filed a petition with SEC requesting that it consider a rulemaking to amend Regulation S-K to require additional conflict-of-interest disclosures. In its rule-making petition, the AFL-CIO stated that it discovered after Enron's collapse that several directors considered independent by the Enron board, including two who served on the audit committee, had relationships with Enron or its senior executives that could have interfered with their ability to exercise independent judgment. One, for example, was president of a not-for-profit

[115]Proposed Rule: Security Holder Director Nominations, SEC Release Nos. 34-48626 and IC-26206, File No. S7-19-03 (Oct. 14, 2003).

[116]Final Rule: Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, SEC Release Nos. 33-8340 and IC-26262, File No. S7-14-03 (Nov. 24, 2003).

organization that received contributions from Enron. Regulation S-K does not currently require disclosure of this relationship. The AFL-CIO and other market participants who shared its views said that increased disclosure of conflicts of interest would allow investors to better assess the independence of a board. Other market participants, however, told us that the current disclosure requirements in Regulation S-K were adequate for investors and that further requirements would only make the proxy statement bulkier and harder to read. Corporation Finance officials told us that they plan to review Regulation S-K disclosure requirements under items 401 and 404.

At SEC's Request, the Three Largest SROs Began Evaluating Their Own Corporate Governance

In a March 2003 letter, the SEC Chairman asked Amex, NASDAQ, and NYSE to review their governance, including board structures, policies, and practices, to ensure that it serves the public well. In these letters, the Chairman asked the SROs to discuss how their governance practices compare with the standards for issuers they proposed in the rules submitted to SEC. According to the Chairman, the SROs should serve as models of good governance. As such, he said they should adhere to the same high standards of governance they were requiring of the issuers listed on their markets. The three SROs provided reports to SEC in May 2003 that include varying amounts of information.

Amex reported that its board's governance structure and practices were consistent with the listing standards in effect before its new standards were implemented. The report did not discuss the extent to which Amex's governance conformed with its new listing standards, such as those requiring a majority of independent directors, or whether Amex would consider imposing higher standards on itself than it had on issuers, for example, by separating the positions of CEO and chairman as NASDAQ and NYSE have done (discussed below). The report stated that as Amex's corporate governance listing standards for issuers evolve, Amex would assess whether changes to its governance structure and practices were warranted. Amex officials told us that because NASD and Amex have recently agreed that Amex would become an independent entity, Amex planned to delay assessing and making changes to its governance structure until its separation from NASD was complete.

NASDAQ's May 2003 report stated that its board met NASDAQ's new corporate governance listing standards to the fullest extent permissible under NASDAQ's by laws.[117] Although NASDAQ's new listing standards require issuers to establish either a nominating committee composed entirely of independent directors to nominate new directors or provide that a majority of the independent directors carry out this function, NASDAQ's by laws prevent it from complying with this listing standard. That is, NASDAQ's by laws require its nominating committee to include individuals who are not NASDAQ directors. As a result, NASDAQ's nominating committee currently consists entirely of individuals who are not serving on the board, although they meet NASDAQ's definition of director independence. NASDAQ reported that it could revise its by laws so that a new committee of the board consisting of independent directors nominates directors and that it will discuss this change with SEC. Under NASDAQ's by laws, the board can choose whether to combine or separate the positions of CEO and chairman. NASDAQ reported that it was in the process of separating these positions—a separation that was completed later that month. NASDAQ officials said that this action complimented larger structural changes to NASDAQ's governance that took place in April 2000, when NASD members voted to sell a substantial part of NASD's ownership in NASDAQ. One of the goals of this restructuring was to minimize the potential for conflicts of interest associated with NASD's responsibility for both the business operations and regulation of NASDAQ.

Concurrent with the submission of its May 2003 report to SEC describing its governance structure, NYSE announced that its board had appointed a committee, called the Special Committee on Governance, to review and develop recommendations for improving NYSE's governance. On June 5, 2003, the NYSE board adopted the initial recommendations of the committee, including those allowing only nonindustry directors to serve as audit committee and compensation committee members and requiring, to the extent feasible, that the NYSE audit committee comply with applicable standards prescribed by NYSE for issuer audit committees.[118] NYSE also implemented a recommendation prohibiting all its employees from serving on the boards of business corporations. According to NYSE, following the adoption of the recommendation, the NYSE chairman and other senior executives agreed to resign from directorships on issuers' boards, effective

[117]By laws are the rules and practices governing the management of an organization. Pursuant to section 19(b)(1) of the Exchange Act, SROs must file a proposed rule change with SEC for any changes to their by laws.

[118]Nonindustry directors, as defined in the NYSE constitution, represented listed companies or the investing public. Industry directors represented NYSE members.

at the respective companies' next annual shareholder meeting, unless the companies could find directors to replace them sooner.

The NYSE board also adopted recommendations that would result in disclosures consistent with those included in NYSE's new corporate governance listing standards, including disclosures of compensation for the chairman, directors, and executive officers. In August 2003, the NYSE board disclosed that the compensation package of the CEO, also chairman of the board, was worth $139.5 million, including accrued savings and incentives. In a September letter to the chairman of NYSE's governance and compensation committees, the SEC Chairman stated that approval of the CEO compensation package raised serious questions regarding the effectiveness of NYSE's governance structure and called for further information about the procedures and considerations that governed the award of the pay package. The controversy prompted the September 2003 resignation of the CEO/chairman. According to NYSE, shortly thereafter, two directors who served on the committee that approved the compensation package resigned.

In December 2003, SEC approved a NYSE rule proposal that is intended to enhance NYSE's governance structure.[119] The new rule amends NYSE's constitution, creating an independent board of directors and a board of executives as an advisory body. The new board of directors consists of individuals who are independent from NYSE management, members, member organizations, and listed companies (with the exception of the CEO); and the board has responsibility for corporate governance, executive compensation, internal controls, and regulatory supervision.[120] Although the board of directors can choose whether to combine or separate the positions of CEO and chairman, NYSE decided to separate them after consultations with SEC.[121] The board of executives includes representatives of broker-dealers, institutional investors, large public funds, and listed companies. Although SEC has approved NYSE's proposal, public debate has continued as to the adequacy of its governance reforms.

[119]NYSE Rulemaking: Order Approving Proposed Rule Change Relating to the Amendment and Restatement of the Constitution of the Exchange to Reform the Governance and Management Architecture of the Exchange, 68 Fed. Reg. 74678 (Dec. 24, 2003).

[120]NYSE's revised constitution also created the position of chief regulatory officer, who is responsible for the management and administration of regulatory functions and reports directly to the board's Regulatory and Oversight Committee.

[121]In December 2003, NYSE's board of directors announced the appointment of a new CEO.

The SEC Chairman and Market Regulation also sent letters to other SROs requesting that they review their governance, and, according to Market Regulation officials, they have received written responses from each SRO.[122] Market Regulation officials said that the Chairman's letters to the SROs and their written responses were the first steps of a comprehensive review by SEC of SRO governance. These officials said that the recently approved changes to NYSE's governance structure could be instructive as they continue their review of Amex, NASDAQ, and the other SROs' governance. Further, these officials said that the new governance standards in place at Amex, NASDAQ, and NYSE for listed issuers could serve as a benchmark for SRO governance.

Other Countries Also Have Taken Steps to Enhance Board Independence

Private or public institutions in the United Kingdom, France, Germany, and Japan reviewed the corporate governance practices of issuers in 2002 and 2003. Although differences exist between the roles, responsibilities, and characteristics of managers, directors, and shareholders and the regulation of corporate governance in these countries, their issuers were encouraged to increase the role and authority of independent directors on their boards of directors. The United Kingdom, Germany, and France have promoted sound corporate governance by encouraging issuers to disclose in their annual reports the extent of their compliance with codes of corporate governance, explaining to investors the reasons for any areas of noncompliance. These codes include provisions encouraging greater board independence. Recent changes to Japan's corporate law allows issuers to choose a governance structure similar to that found in the United States by placing independent directors in key roles on boards.

The United Kingdom

UK issuers are required by the listing rules of the Financial Services Authority to describe in a narrative statement in their annual reports how they apply the principles set out in the Combined Code on Corporate

[122]The SEC Chairman sent letters to the other eight securities exchanges in March 2003 asking them to review their governance. Market Regulation officials told us that in May 2003 they sent a similar letter to the following eight securities industry SROs that operate clearinghouses: the Boston Stock Exchange Clearing Corporation, Depository Trust Company, Emerging Market Clearing Corporation, Fixed Income Clearing Corporation, National Securities Clearing Corporation, Options Clearing Corporation, Pacific Clearing Corporation/Pacific Stock Exchange, and the Stock Clearing Corporation/Philadelphia Stock Exchange. A clearinghouse is an organization that handles the clearance and settlement of transactions. Clearance and settlement in the securities markets involves comparing the details of the transaction between buyer and seller (or their brokers) and exchanging the securities for cash payment.

Governance (Combined Code) and explain any deviations from them. According to the Secretary of State for Trade and Industry, the merit of the "comply or explain" approach is that it recognizes that circumstances exist in which it is not sensible or appropriate for a company, especially a smaller one, to meet every Combined Code principle, but it requires issuers to explain the reason for any noncompliance to shareholders.

In 2002, the Secretary of State for Trade and Industry and the Chancellor of the Exchequer commissioned a review of the role and effectiveness of nonexecutive directors,[123] and the Coordinating Group on Accounting and Audit commissioned a simliar review of audit committees.[124] As a result of these reviews, the Combined Code was revised to include provisions recommending, among other things, that half of the issuer's board—including the chairman, all of the members of the audit and compensation committees, and a majority of the members of the nominating committee—meet a tightened definition of independence. In addition, the Combined Code's new provisions address the qualifications of audit committee members and the committee's authority over the outside auditor. Before these revisions, the code generally called for fewer independent directors on these committees and the board.

Germany

In September 2001, the German Federal Minister of Justice appointed the Government Commission on the German Corporate Governance Code to develop an official corporate governance code for Germany, which it completed in February 2002. The German code includes corporate governance-related statutes that were already in effect at the time the code was published and with which issuers must comply as well as corporate governance practices that are recommended but not required. A requirement that issuers annually disclose their reasons for deviating from the code's recommendations was enacted in July 2002.

According to the commission, unlike boards in the United Kingdom and United States, German issuers have a two-tier board structure, consisting of a management board that is responsible for managing the issuer and a supervisory board that appoints, supervises, and advises the members of the management board. The new German code recommends, among other

[123]Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors*, January 2003.

[124]Sir Robert Smith, *Audit Commitees Combined Code Guidance*, January 2003.

things, that the supervisory board establish an audit committee and that the committee chairman not be a former member of the management board. Further, the code recommends charging the audit committee with hiring and compensating the outside auditor as well as ensuring the auditor's independence.

France

In 2002, the Association of French Private Sector Companies and Association of Major French Corporations (in French, AFEP-AGREF) and the French Business Confederation,[125] convened a private working group to produce a code of corporate governance known as the Bouton report.[126] French issuers are not required by law to disclose compliance with the corporate governance principles outlined in this report; however, the report recommends that issuers include a discussion of the extent to which they have complied with the report's recommendations in their annual reports. Among other things, the Bouton report recommends that at least half of the issuer's board consist of independent directors, an increase from the one-third recommended by a similar report previously published by AFEP-AGREF and the French Business Confederation. Further, the Bouton report recommends that two-thirds of the audit committee consist of independent directors, also an increase from the one-third previously recommended.

Japan

According to the Japanese Association of Corporate Directors, in Japan, corporate governance structures more closely resembling those of the United States were introduced in May 2002 under laws that made sweeping revisions to the country's Commercial Code. Before these revisions, boards of directors managed issuers through a member vested with the authority to carry out the board's directives, and shareholders were required to elect outside auditors to monitor the boards' management. Revisions to the Commercial Code in 2001 strengthened the statutory auditor system by, among other things, requiring outside auditors to be independent.

According to the Japanese association, under the 2002 revisions to the Commercial Code, large Japanese issuers can choose from among three corporate governance structures—the traditional structure described

[125]AFEP-AGREF and the French Business Confederation are two leading French business associations.

[126]Daniel Bouton, *Promoting Better Corporate Governance in Listed Companies*, September 2002.

above and two other structures under which independent directors are involved in overseeing management. Under one of the two new options, boards would appoint a CEO who, similar to CEOs in the United States, would be responsible for managing the company's business operations, and a separate board of directors that would oversee the CEO and hold the CEO accountable to shareholders. Issuers that choose this structure must establish audit, nominating, and compensation committees consisting of a majority of independent directors. Under the other new option, an asset committee would be established within the board. This committee would have the authority to make decisions related to the transfer and disposal of major company assets and to make other management decisions. The board would oversee the asset committee and would have at least one independent director.

Conclusions

Investors need timely and ongoing information on the listing status of issuers for use in making investment decisions. In the absence of such information, they might logically but incorrectly assume that all issuers comply with the listing standards of their markets. Although NYSE has taken steps to address OCIE's recommendation to provide early and ongoing public notification of issuers' noncompliance with quantitative continued listing standards by introducing symbol indicators, investors may be unaware of the availability of the information transmitted by the indicators. Existing plans for distributing the information to the print media have not been fully implemented and distribution to investors through the Internet is limited. Further, although the indicator is displayed on NYSE's Web site with the stock symbol, the indicator is not sufficiently visible to investors. As a result, investors that do not independently learn of the indicator's availability may not become aware of its existence when they visit the Web site.

Although NASDAQ and Amex have discussed transmitting an indicator in a manner similar to NYSE for noncompliance with their quantitative continued listing standards, we are concerned about the hesitancy of both SROs to voluntarily provide the public early notification of an issuer's noncompliant status. We are also concerned that the distribution issues affecting the NYSE indicator would be applicable to the NASDAQ and Amex indicators. Corporation Finance's proposed revisions to SEC's Form 8-K would, if approved, ensure that investors receive early notification of issuers' noncompliance with quantitative and qualitative continued listing standards. Also, finalizing the revised filing requirement would complement OCIE and Market Regulation's efforts by providing investors a source of information on the facts surrounding an issuer's noncompliant status. Further extension of OCIE's recommendation to qualitative listing standards, including corporate governance standards, could be valuable to investors and is an objective worthy of further OCIE and Market Regulation exploration with the SROs. In the absence of voluntary action by the SROs, further SEC action is warranted to ensure that the public receives early and ongoing notice of an issuer's noncompliance with its market's listing standards.

OCIE's reluctance to routinely use SROs' internal review reports in planning and conducting inspections is inconsistent with the standards of organizations with functions similar to OCIE's. The development of a comprehensive policy regarding the use of SROs' internal review reports as part of SRO inspections would be valuable because these reports could aid OCIE in determining the objectives and scope of inspections designed to assess the SROs' effectiveness in fulfilling their oversight responsibilities. SEC recognized the importance of the internal review function to the quality of SRO oversight when it recommended that NASDAQ and NYSE strengthen this function to address weaknesses SEC identified. Reviewing, among other things, internal review objectives, scope, findings, recommendations, and resulting corrective actions would provide SEC insights into the quality of the function and at least one indicator of the effectiveness of the SROs.

SEC acted within its authority and followed its applicable regulations in allowing rules to remain in effect that implemented a 3-month enforcement moratorium on NASDAQ's continued listing standards for bid-price and market value of publicly held shares as well as subsequent changes to NASDAQ's bid-price standard. While data are not available from which to determine the full effect of the moratorium and subsequent rule changes on the listing status of NASDAQ issuers, the rules met their objective of allowing noncompliant issuers more time to trade. SEC also acted within its authority and followed applicable regulations in approving another NASDAQ rule that allowed SCM issuers to continue trading up to 2 years while noncompliant with the bid-price standard as part of a pilot program. NASDAQ's study on the effects of the pilot program will provide essential information to the Commission for use in evaluating whether the rule should be allowed to become permanent. However, 2 years is a long time to allow a noncompliant issuer to continue trading in the absence of a means of providing the public early and ongoing notification of the issuer's listing status.

Amex, NASDAQ, and NYSE have adopted changes to their corporate governance standards that when implemented should promote stronger board oversight and greater accountability. Independent directors play a key role in these governance reforms; however, of the three largest SROs only Amex does not require that issuers disclose the names of all their independent directors, hampering the ability of investors and regulators to assess the independence of these directors. While the SROs have strengthened their corporate governance listing standards, opportunities exist to further strengthen board independence by revising listing standards to require a supermajority of independent directors and the separation of the positions of CEO and chairman. We recognize that issuers would require a reasonable amount of time to implement any such reforms; for example, a 2-year implementation period would not be unrealistic.

OCIE's plans to work with the SROs to ensure that they have effective processes in place for evaluating issuers' compliance with their new corporate governance standards could be central to ensuring compliance with the standards and merit prompt action. Also, through its inspection process, OCIE could assess the SROs' oversight of issuers' compliance with the new standards and ensure that the standards are meeting their intended purpose. Corporation Finance's proposed changes to rules governing shareholders' access to the director nomination process and its plans to review issuers' disclosures of conflicts of interest in the proxy statement complement the SROs' efforts to improve their corporate governance standards and could result in further enhancements to board accountability to shareholders. As a result, they deserve timely attention.

Finally, given the SROs' role as standard setters for corporate issuers, the public has the right to expect the SROs to serve as models of strong governance. Market Regulation continues to assess the self-evaluations of corporate governance that the three largest SROs prepared, as well as the practices of 16 other SROs, including 8 securities exchanges and 8 clearinghouses. These reviews have resulted in actions by NASDAQ and NYSE to improve board independence and transparency of decision making and could result in additional changes when Market Regulation completes its assessment. Although SEC will need to consider the applicability of the changes made at NASDAQ and NYSE to the other SROs, action by NASDAQ and NYSE to split the position of CEO and chairman is one that could, where appropriate, enhance the governance of other SROs. Further, once any changes are in effect, OCIE, through its inspection process, could also ensure that the SROs have implemented proposed changes to their own corporate governance, determine that these changes are having their intended effect, and identify other appropriate changes.

Recommendations for Executive Action

To restore investor confidence in the markets, further strengthen the listing standards of the SROs, and improve SEC listing program oversight, we recommend that the Chairman, SEC, take the following 12 actions:

- work with NYSE to ensure the distribution of NYSE's indicator through the print media and the Internet and improve the visibility of the indicator on the NYSE Web site;
- work with NASDAQ and Amex to ensure that the public receives early and ongoing notification of issuers' noncompliance with their markets' quantitative continued listing standards—using issuer's receipt of the initial deficiency notice as the reference point for determining when public notification should begin or, if approved in a manner consistent with our following recommendation, the filing of the revised Form 8-K;
- ensure that the Commission expeditiously finalizes the rule requiring that issuers file the Form 8-K after receiving notice of being deficient with their market's listing standards and include a time frame for doing so that, consistent with its initial proposal, ensures early public notification of issuers' noncompliant status;
- work with Amex, NASDAQ, and NYSE to assess the feasibility of providing early and ongoing public notification of issuers' noncompliance with qualitative listing standards;
- ensure the development and implementation of a policy requiring OCIE staff to routinely use SRO internal review reports in planning and conducting SRO inspections;
- work with Amex to ensure that issuers disclose the names of those directors that they have designated as independent;
- work with the SROs to further enhance board independence by giving serious consideration to requiring issuers, through listing standards, to establish a supermajority of independent directors and to separate the positions of CEO and chairman, recognizing that a reasonable period of time would be needed to make such changes effective;

- work with the SROs to ensure that they have established effective processes for ensuring issuers' compliance with corporate governance listing standards;
- ensure that OCIE conducts timely inspections of the three largest SROs to assess their oversight of issuers' compliance with corporate governance standards;
- ensure that Corporation Finance places a high priority on establishing and meeting time frames for completing its rulemaking related to shareholder access to the director nomination process and reviewing issuers' qualitative disclosure requirements related to potential director and director nominee conflicts of interest;
- ensure that Market Regulation places a high priority on establishing and meeting time frames for completing its reviews of the SROs' self-evaluations of their governance, and works with Amex and, as appropriate, the other 16 SROs under review, to further enhance their own board independence by giving serious consideration to separating the positions of CEO and chairman; and
- ensure that OCIE conducts timely inspections of the three largest SROs to ensure that steps are taken to address any weaknesses identified in their self-evaluations and that new requirements governing SRO boards are effectively implemented.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from SEC, Amex, NASDAQ, and NYSE that are reprinted in appendixes V-VIII, respectively. As discussed below, SEC generally agreed with our recommendations and is taking or plans to take actions to address them. Also as discussed below, Amex and NYSE expressed concerns about our recommendations related to providing the public early and ongoing notification of issuers' noncompliance with their markets' listing standards, and Amex and NASDAQ discussed their concerns about our recommendation related to enhancing board independence by giving serious consideration to requiring issuers, through listing standards, to establish a supermajority of independent directors and to separate the positions of CEO and chairman. SEC and the three SROs also provided technical comments that have been incorporated into the report where appropriate.

SEC commented that it will continue working with the SROs to ensure that the goal of providing investors early and ongoing notice of issuers' noncompliance with their markets' listing standards is met. NYSE responded that it has fully addressed OCIE's related recommendation as is pertains to quantitative listing standards and that SEC would need to impose any additional requirements related to the dissemination of indicators on information vendors. Our view, consistent with OCIE's, continues to be that until the dissemination issue is resolved, NYSE's use of indicators does not meet the intent of OCIE's recommendation. For this reason and because the satisfactory resolution of the distribution issue is pivotal to the acceptability of using indicators to address OCIE's recommendation, SEC and NYSE have a mutual interest in working together and with information vendors to resolve the issue. Also, a joint SEC and NYSE effort could enhance the likelihood of voluntary action by information vendors. Finally, if Amex and NASDAQ should provide OCIE with proposals for using indicators that are otherwise acceptable, SEC may wish to involve them in resolving the information distribution issue.

NASDAQ expressed a willingness to change its procedures for notifying the public of issuers' noncompliance with the market's listing standards and to work with OCIE to implement its recommendation. Amex affirmed that transparency with respect to an issuer's compliance with listing standards is important but reiterated reservations expressed in the report that neither the indicator nor the symbol modifier is an appropriate or necessary method for providing such transparency. Amex also said that, notwithstanding its views, issues related to the use of indicators will be re-examined by the Amex Board of Governors at its April 2004 meeting. Consistent with SEC's view, we continue to believe that achieving early and ongoing public notification of issuers' noncompliance with listing standards is important to investors' decision making. Accordingly, we support SEC's commitment to working with the SROs to achieve this goal, whether through implementation of modifiers, indicators, or another alternative.

Although SEC, NASDAQ, and Amex did not specifically comment on how early notification of noncompliance with issuers' listing standards would be achieved in conjunction with symbol modifiers or indicators, SEC said that Corporation Finance's proposed revisions to the Form 8-K were to ensure early public notice of an issuer's noncompliant status. Consistent with our recommendation, the Commission has approved Corporation Finance's proposed revisions, as modified based on public comment. The final rule, approved on March 11, 2004, requires issuers to file the Form 8-K within 4 business days of being notified by the SRO of their noncompliance with either a quantitative or qualitative listing standard. Because the approved rule addresses our recommendation that the Form 8-K filing provide for early public notification, we believe that using the filing as the trigger for transmitting the indicator is warranted. Doing so would provide consistency across the markets and enhance the complementary relationship between the indicator as a mechanism for providing ongoing public notification and the Form 8-K as a source of more detailed information on the nature of the issuer's deficient status.

SEC also commented that the SROs should provide investors timely notification not only when issuers are noncompliant with financial listing standards, but also when they are noncompliant with corporate governance standards. Accordingly, SEC said that it would discuss with the SROs the feasibility of appending a modifier to or transmitting an indicator with the symbol of an issuer that is noncompliant with corporate governance standards. NYSE expressed concern about extending the use of indicators to qualitative listing standards, such as corporate governance standards, elaborating that the indicator is not an appropriate or effective method of conveying more complex, "less binary" information. NYSE explained that a large number of qualitative standards exist, with some situations of noncompliance being more serious than others and some matters being potentially easier to correct than others. NYSE said that using an indicator for all the standards would "homogenize" the information, which could lead the public to ignore the indicator as a conveyor of useful information. NYSE also noted that the present dissemination mechanism is limited as to the number of different indicators that can be used, so that the cost of employing additional indicators would likely be significant. Amex also expressed concern about the feasibility of addressing all "significant factors" with an indicator, stating that many are inherently subjective and not susceptible to an objective determination of whether the "triggering event" has occurred. Amex also said that using many different types of indicators would be confusing to investors and the marketplace. Nonetheless, the use of indicators for noncompliance with qualitative standards is among the topics that Amex expects to address at its April 2004 Board of Governors meeting. We agree that use of modifiers or indicators may not be appropriate for noncompliance with all qualitative listings standards. However, as NASDAQ has demonstrated through its use of a symbol modifier for issuers that have not filed required SEC reports and as we have recommended, early and ongoing public notification of noncompliance with additional qualitative standards may be appropriate and should be explored further.

SEC commented that it recognizes that SRO internal audit reports may be a useful tool in the inspection process. In response to our recommendation, SEC said that it will implement a formal written policy concerning the selection and review of SRO internal audit reports during inspections.

Regarding our recommendation that Amex ensure that issuers disclose the names of those directors that they have designated as independent, SEC noted that Amex responded on February 23, 2004, by filing a rule change that requires this disclosure and that the rule change became effective on filing. Amex also cited the rule change in its comments.

Amex said that while our recommendation related to requiring issuers, through listing standards, to establish a supermajority of independent directors and separate the positions of CEO and chairman, warrants further consideration, issuers, the markets, and SEC need more time to adjust to the various new requirements that have already been imposed on the markets and assess their impact. NASDAQ similarly commented that time is needed for the numerous new governance changes to take effect and their results assessed. NASDAQ said that mandating a supermajority of independent directors might prove unduly burdensome, particularly for smaller issuers, and that insufficient information is available to determine if it would provide greater benefits than a simple majority. NASDAQ also said that separating the positions of CEO and chairman might enhance the governance of some companies but that concerns exist that mandating the separation could make boards more inefficient and lead to unnecessary conflict. NASDAQ also said that insufficient information is available to justify taking the step at this time and that other steps it has taken, such as requiring a majority of independent directors, will significantly reduce the concerns associated with a combined CEO/chairman. NYSE commented that it is not opposed to companies adopting requirements for a separate CEO and chairman or a supermajority of independent directors, if they choose to do so.

Recognizing that a reasonable amount of time would need to be allowed for issuers to establish a supermajority of independent directors and separate the positions of CEO and chairman, we continue to believe that in the absence of voluntary action by issuers, SEC should, working with the SROs, seriously consider mandating such requirements through listing standards. SEC's January 2004 proposals that would require boards of mutual funds to comprise 75 percent (a supermajority) independent directors and have an independent board chairman are consistent with our recommendation. Although the conflicts of interest between the boards of directors and management of mutual funds may be more apparent than such conflicts at other publicly traded companies, we believe that the rationale behind SEC's proposals is equally applicable to publicly traded companies, regardless of whether they manage financial or physical assets. As SEC has noted, and we agree, with a supermajority of independent directors and an independent board chairman, independent directors will set the board agenda as well as have the power to control the outcome of board votes. Although SEC and we recognize that such actions do not guarantee effective management, we both agree that greater board independence could promote board decision making that is aligned with shareholders' interests, thereby enhancing board accountability. As SEC has stated, these proposals, along with others in its January 2004 rule-making package, would bolster the effectiveness of independent directors and enhance the role of the board as the primary advocate for shareholders. We acknowledge, however, that some issuers would not be in a position to immediately implement these best practices and that any improvements, therefore, would likely be best accomplished on an incremental basis. In this regard, we encourage SEC and the SROs, as industry leaders, to reach out to issuers and use their leverage to assist in the process of transitioning issuers' governance structures into models of corporate responsibility.

Regarding our recommendation related to ensuring that OCIE conducts timely inspections of the three SROs to assess their oversight of issuers' compliance with corporate governance standards, SEC said that it expects to continue to conduct timely inspections of the SROs' programs and procedures for ensuring that issuers comply with corporate governance requirements and to enhance its review to include the new corporate governance standards. We believe that OCIE's efforts will be important to ensuring the successful implementation of the new standards and enhancing SRO oversight of the markets, particularly if OCIE shares any best practices that it identifies with the SROs.

Regarding our recommendations related to reviewing the SROs' self-evaluations of their own corporate governance and following up with inspections of the SROs, SEC commented that it is currently conducting a comprehensive review of SRO governance that will take into consideration the new corporate governance standards. SEC also said that when appropriate and after any changes or new requirements are implemented at the SROs, it will inspect the SROs to determine whether they have effectively implemented their own enhanced governance standards. SEC's ongoing and proposed actions are consistent with our recommendations and should enhance the quality of SRO governance, particularly if, as noted above, the best practices identified are shared with all the SROs.

In response to our recommendation that Market Regulation work with Amex to further enhance its board independence by giving serious consideration to separating the position of CEO and chairman, Amex commented that draft changes to the Amex constitution are being considered in connection with NASD's proposed sale of its interest in Amex to the Amex Membership Corporation. Amex said that the proposed changes provide that if Amex's CEO is also the chairman of the Amex Board of Governors, a "lead governor"—designated by the Board of Governors from among the independent governors—would preside over executive sessions. Amex noted that the proposed changes are subject to various approvals, including by SEC and Amex members. Amex's proposals are consistent with NASDAQ's by laws and NYSE's constitution, which also retain the option of having the same person serve as CEO and chairman. However, we believe that the unique role of the SROs as standard setters suggests that absent compelling reasons to the contrary, SEC should ensure that Amex opts for separating these positions as NASDAQ and NYSE have done.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing, and Urban Affairs and its Subcommittee on Securities and Investment; the Chairman, House Committee on Energy and Commerce; the Chairmen of the House Committee on Financial Services and its Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises; and other interested congressional committees. We will send copies to the Chairmen of SEC, Amex, NASDAQ, and NYSE and to other interested parties. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site http://www.gao.gov.

If you have any further questions, please contact me at (202) 512-8678, hillmanr@gao.gov, or Cecile Trop at (312) 220-7600, tropc@gao.gov. Additional GAO contacts and staff acknowledgments are listed in appendix IX.

Richard J. Hillman
Director, Financial Markets and
Community Investment

Scope and Methodology

To report on the status of the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations' (OCIE) recommendations to the three largest self-regulatory organizations (SRO) for improving their markets' equity listing programs, we reviewed OCIE's inspection reports on the American Stock Exchange (Amex), Nasdaq Stock Market, Inc. (NASDAQ), and the New York Stock Exchange (NYSE) listing programs and related workpapers and correspondence. We also obtained information from OCIE, Amex, NASDAQ, and NYSE on OCIE's listing program inspection report findings and recommendations, and the SROs' efforts to address the recommendations. Further, we obtained data, in documentary form, from the three SROs on the number of noncompliant issuers trading during 2003 and their trading status as of December 31, 2003. In addition to these steps, in reviewing the effectiveness of NYSE's actions to address OCIE's recommendation intended to ensure early and ongoing notification of issuers' noncompliance with continued listing standards, we contacted a nonprobability (nonrandom) sample of 11 vendors. This sample included broker-dealers, vendors that supply information to the print media, and vendors that supply information through the Internet, either on their own Web sites or through third-party vendors, to determine whether they were distributing the information on issuers' noncompliance with NYSE's quantitative continued listing standards that NYSE transmits by its indicator. Our selection of the 11 vendors was based on a list from NYSE of the largest vendors of quotation data, a list from NYSE of recommended contacts, and our own research on vendors that supply quotation information over the Internet. Ultimately, we interviewed eight information vendors between August and November 2003 to determine whether they were publicizing the information and were successful in contacting six of these vendors in February and March 2004 for followup interviews. We also attempted to contact three additional vendors by telephone, but were unsuccessful. As a result, we visited their Web sites in September 2003 and again in February 2004 to determine whether they were publicizing the information transmitted by NYSE's indicator. Because we did not conduct a random sample of all vendors that receive quotation data from NYSE, our findings regarding the use of NYSE's indicator cannot be generalized to the entire population of vendors. To determine whether a Web site visitor could locate the indicator and the list of noncompliant NYSE issuers, we visited the NYSE Web site and independently searched for this information.

To report on the extent to which OCIE uses SROs' internal review reports in its inspection process, we obtained information from OCIE on its policy for reviewing internal review reports as part of its inspections and examinations, and information from Amex, NASDAQ, the National Association of Securities Dealers, Inc., and NYSE on the purpose and scope of their respective internal review functions. We reviewed the Government Auditing Standards, also called the Yellow Book, to identify best practices for using internal review reports in oversight inspections such as those conducted by OCIE. We also reviewed the examination policies of the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision to determine the extent to which bank and thrift examiners are required to use internal review reports as part of their examinations. In addition, we obtained information from officials representing the Inspectors General of the Commodity Futures Trading Commission and the Department of the Treasury on the extent to which they use internal review reports as part of their inspections and examinations. Further, we reviewed selected SRO internal review reports on their listing programs and discussed the contents of other reports with SRO officials. We did not review OCIE's entire inspection process because SEC was doing a review of the agency's operations during the time we did our work.

To report on SEC's oversight of NASDAQ's moratorium and subsequent bid-price rule changes and the listing status of the issuers directly affected by these changes, we reviewed relevant NASDAQ proposed and final rules and discussed their purposes with NASDAQ officials. We also obtained information from SEC officials on their review of these proposals. In addition to these steps, in reporting on the listing status of firms directly affected by the NASDAQ moratorium and subsequent rule changes, we analyzed data generated between September 26, 2001, and February 28, 2003, from NASDAQ's Web Issuer Support Services System, NASDAQ's primary source of data for monitoring compliance with NASDAQ's listing standards. Our data begin with September 26, 2001, rather than September 27, 2001, the date the moratorium was imposed, because NASDAQ stopped tracking compliance with the bid-price and market value of publicly held shares listing standards on the date the moratorium was imposed and, therefore, no data were available on September 27, 2001. Based on our analysis, we determined the listing status of the issuers NASDAQ identified as having received direct relief through the moratorium (moratorium issuers) as of January 2, 2002, the day the moratorium was lifted. We could not determine the number of issuers that might have received indirect relief, because, as previously discussed, NASDAQ stopped tracking individual issuers' compliance with the bid-price and market value of publicly held shares continued listing standards during the moratorium. As a result, we could not determine the total number of issuers that might have become noncompliant with these standards in the absence of the moratorium, the number of noncompliant issuers that would have returned to compliance in the absence of the moratorium, or the number of issuers approaching noncompliance that actually became noncompliant. We determined the listing status of the moratorium issuers as of February 28, 2003, approximately 1 year after NASDAQ implemented its postmoratorium rule change, because by this date issuers that were affected by the moratorium would have had an opportunity to go through NASDAQ's deficiency process. Examining this period also allowed us to determine the listing status of issuers affected by the first postmoratorium bid-price rule change. We discussed the results of our data analysis with NASDAQ officials. Although we did not independently verify the accuracy of the NASDAQ data, we performed internal checks to assess the data's reliability and concluded that they were reliable for the purposes of this report.

To report on the actions the three largest SROs have taken to strengthen corporate governance for issuers and themselves, we reviewed relevant legislation, GAO and other testimony to Congress, testimony to SROs, corporate governance studies, investigative reports on the collapse of major U.S. corporations, SEC's proposed and final rulemakings related to shareholder access to the director nomination process, and SEC's qualitative corporate disclosure requirements for issuers. We also reviewed the three SROs' proposed and final (new) corporate governance rules for issuers as well as the rules they have replaced. Additionally, we obtained information from SRO officials on the purpose of the new rules and the SROs' plans for ensuring compliance with them. We also obtained information from SEC on its review of these rules and its plans to review qualitative corporate disclosure requirements. Further, we obtained an assessment from a nonprobability sample of 14 market participants representing the investor, legal, business, and financial communities on the adequacy of the SROs' new rules and SEC's qualitative corporate disclosure requirements. Because we did not conduct a random sample of all market participants, the views expressed in this report on the corporate governance rules of the three SROs cannot be generalized to the entire population of market participants. In addition, we attended a forum that GAO sponsored on corporate governance and accountability issues and attended corporate governance conferences given by organizations in the public and private sectors. We also reviewed the three largest SROs' self-evaluations of their own corporate governance, including board structures, policies, and practices. Finally, we reviewed publicly available information to identify actions that private and public institutions took in the United

Kingdom, Germany, France, and Japan between January 2002 and June 2003 to strengthen corporate governance. This included a review of the new or revised corporate governance codes used in the United Kingdom, Germany, and France, and descriptions by Japanese corporate associations of recent revisions to Japanese corporate law. Due to limitations on the scope of our inquiry, we may not have identified all of the actions taken over this period. Also due to these limitations, we did not discuss in the report the corporate or regulatory structure of the countries or the respective roles, responsibilities, and characteristics of shareholders, corporate managers, and boards.

We did our work in accordance with generally accepted government auditing standards between April 2002 and March 2004. We performed our work in Chicago, Ill.; New York City, N.Y.; and Washington, D.C.

Quantitative Listing Standards for Domestic Issuers of the Three Largest Markets

Table 3: The American Stock Exchange's Quantitative Standards for Initial Listing of Domestic Issuers

	Minimum requirements[a]			
Standard	**Option 1**	**Option 2**	**Option 3**	**Option 4**
Stockholders' equity[b]	$4 million	$4 million	$4 million	N.A.[c]
Market capitalization[d]	N.A.	N.A.	$50 million	$75 million[e]
Pretax income[f]	$750,000	N.A.	N.A.	N.A.
Operating history	N.A.	2 years	N.A.	N.A.
Distribution	One of the following: 1. 800 public shareholders and 500,000 publicly held shares, 2. 400 public shareholders and 1 million publicly held shares, or 3. 400 public shareholders, 500,000 publicly held shares, and average daily trading volume of 2,000 shares in the previous 6 months.	One of the following: 1. 800 public shareholders and 500,000 publicly held shares, 2. 400 public shareholders and 1 million publicly held shares, or 3. 400 public shareholders, 500,000 publicly held shares, and average daily trading volume of 2,000 shares in the previous 6 months.	One of the following: 1. 800 public shareholders and 500,000 publicly held shares, 2. 400 public shareholders and 1 million publicly held shares, or 3. 400 public shareholders, 500,000 publicly held shares, and average daily trading volume of 2,000 shares in the previous 6 months.	One of the following: 1. 800 public shareholders and 500,000 publicly held shares, 2. 400 public shareholders and 1 million publicly held shares, or 3. 400 public shareholders, 500,000 publicly held shares, and average daily trading volume of 2,000 shares in the previous 6 months.
Price[g]	$3	$3	N.A.	$3
Market value of publicly held shares[h]	$3 million	$15 million	$15 million	$20 million

Source: The American Stock Exchange.

Notes:

While data provided in the table reflect information from the American Stock Exchange, the definitions provided in the following notes are from David L. Scott, *Wall Street Words* (1997).

[a]A company must meet all of the minimum requirements under option 1, 2, 3, or 4.

[b]Stockholders' equity is the stockholders' interest in the assets of a business. It includes the amount invested by the stockholders in the enterprise plus the profits (or minus the losses).

[c]Not applicable.

[d]Market capitalization is the total value of all of a firm's outstanding shares, calculated by multiplying the price of a stock by the total number of shares outstanding.

[e]A company may also meet the total market capitalization standard with $75 million each in total assets and total revenue in the most recent fiscal year or in 2 of the last 3 fiscal years.

[f]Companies can meet the pretax income requirement either in the last fiscal year or in 2 of the last 3 fiscal years.

[g]Price is the dollar amount at which a share of common stock trades. Amex's standards specify that a company must satisfy the share price requirement for a reasonable period of time but do not define "reasonable."

[h]According to the American Stock Exchange, market value of publicly held shares is the price of a stock multiplied by the number of outstanding shares held by investors that are not officers, directors, and 10 percent or greater shareholders.

Table 4: The American Stock Exchange's Quantitative Standards for Continued Listing of Domestic Issuers

Standard	Minimum requirements
Stockholders' equity	$2 million, $4 million, or $6 million[a]
One of the following:	
1. publicly held shares,	1. 200,000,
2. number of public shareholders, or	2. 300, or
3. market value of publicly held shares.	3. $1 million[b]

Source: The American Stock Exchange.

Notes:

[a]The stockholders' equity requirement is $2 million if the issuer has sustained losses from continuing operations or net losses in 2 of its 3 most recent fiscal years, $4 million if the issuer has sustained losses from continuing operations or net losses in 3 of its 4 most recent fiscal years, and $6 million if the issuer has sustained losses from continuing operations or net losses in 4 of its 5 most recent fiscal years.

[b]Delisting will be considered if the issuer does not meet the $1 million minimum requirement for market value of publicly held shares for more than 90 consecutive calendar days.

Table 5: The NASDAQ National Market's Quantitative Standards for Initial Listing of Domestic Issuers

	Minimum requirements[a]		
Standard	**Option 1**	**Option 2**	**Option 3**
Stockholders' equity	$15 million	$30 million	N.A.
One of the following:	N.A.	N.A.	
1. market value of listed securities[b] or			1. $75 million or
2. total assets and total revenue.			2. $75 million and $75 million.
Income from continuing operations before income taxes[c]	$1 million	N.A.	N.A.
Publicly held shares[d]	1.1 million	1.1 million	1.1 million
Market value of publicly held shares	$8 million	$18 million	$20 million
Bid price[e]	$5	$5	$5
Round-lot shareholders[f]	400	400	400
Market makers[g]	3	3	4
Operating history	N.A.	2 years	N.A.

Source: Nasdaq Stock Market, Inc.

Notes:

While data provided in the table reflect information from the Nasdaq Stock Market, Inc., the definitions provided in the following notes are from David L. Scott, *Wall Street Words* (1997), unless otherwise indicated.

[a]A company must meet all of the requirements under option 1, 2, or 3.

[b]According to the Nasdaq Stock Market, Inc., market value of listed securities is the price per share multiplied by the total number of shares outstanding held by the public, officers, directors, and beneficial owners.

[c]A company can meet the income from continuing operations requirement in either the latest fiscal year or in 2 of the last 3 fiscal years.

[d]According to the Nasdaq Stock Market, Inc., publicly held shares, also referred to as public float, are the total shares outstanding less any shares held by officers, directors, or beneficial owners of 10 percent or more.

[e]According to the Nasdaq Stock Market, Inc., bid price is the price a buyer is willing to pay for a security.

[f]Round-lot shareholders hold 100 shares or a multiple thereof.

[g]According to the Nadsaq Stock Market, Inc., market makers are firms or individuals that maintain a firm bid and offer price in a given security by standing ready to buy or sell at publicly quoted prices.

Table 6: The NASDAQ National Market's Quantitative Standards for Continued Listing of Domestic Issuers

	Minimum requirements[a]	
Standard	**Option 1**	**Option 2**
Stockholders' equity	$10 million	N.A.
One of the following:	N/A	
1. market value of listed securities or		1. $50 million or
2. total assets[b] and total revenue.[c]		2. $50 million and $50 million.
Publicly held shares	750,000	1.1 million
Market value of publicly held shares	$5 million	$15 million
Bid price	$1	$1
Round-lot shareholders	400	400
Market makers	2	4

Source: Nasdaq Stock Market, Inc.

Notes:

While data provided in the table reflect information from the Nasdaq Stock Market, Inc., the definitions provided in the following notes are from David L. Scott, *Wall Street Words* (1997).

[a]An issuer must meet the requirements under option 1 or 2.

[b]Total assets include all property and items of value owned by the company.

[c]Total revenue is the inflow of assets that results from the sales of goods and services and earnings from dividends, interest, and rent.

Table 7: The NASDAQ SmallCap Market's Quantitative Standards for Initial Listing of Domestic Issuers

Standard	Minimum requirements
One of the following: 1. stockholders' equity, 2. market value of listed securities, or 3. net income from continuing operations.	 1. $5 million, 2. $50 million, or 3. $750,000.
Publicly held shares	1 million
Market value of publicly held shares	$5 million
Bid price	$4
Round-lot shareholders	300
Market makers	3
One of the following: 1. operating history or 2. market value of listed securities.	 1. 1 year or 2. $50 million.

Source: Nasdaq Stock Market, Inc.

Table 8: The NASDAQ SmallCap Market's Quantitative Standards for Continued Listing of Domestic Issuers

Standard	Minimum requirements
One of the following: 1. stockholders' equity, 2. market value of listed securities, or 3. net income from continuing operations.	 1. $2.5 million, 2. $35 million, or 3. $500,000.
Publicly held shares	500,000
Market value of publicly held shares	$1 million
Bid price	$1
Round-lot shareholders	300
Market makers	2

Source: Nasdaq Stock Market, Inc.

Table 9: The New York Stock Exchange's Quantitative Standards for Initial Listing of Domestic Issuers

Standard	Minimum requirements
One of the following:	
1. round-lot shareholders,	2,000;
2. total stockholders and average monthly trading volume,[a, b]	2,200 and 100,000 shares, respectively;
3. total stockholders and average monthly trading volume,[c] or	500 and 1 million shares, respectively; or
4. publicly held shares.	1.1 million.
Market value of publicly held shares	$60 million or $100 million[d]
One of the following:	
1. aggregate pretax earnings,	1. $10 million,[e,f]
2. aggregate operating cash flow[g] and global market capitalization and revenue, or	2. $25 million,[h] $500 million, and $100 million, respectively; or
3. global market capitalization[i] and revenue.	3. $750 million[f] and $75 million,[f] respectively.

Source: The New York Stock Exchange.

Notes:

The New York Stock Exchange introduced a pilot program, effective January 29, 2004, through July 29, 2004, that amends certain of its minimum quantitative standards for initial listing. While data provided in the table reflect information from the New York Stock Exchange, the definitions provided in the following notes are from David L. Scott, *Wall Street Words* (1997), unless otherwise indicated.

[a]For this alternative standard and related requirements, the average monthly trading volume is calculated over the most recent 6 months.

[b]According to the New York Stock Exchange, volume is the number of shares or contracts traded in a security or an entire market during a given period and is normally considered on a daily basis, with a daily average being computed for longer periods.

[c]For this alternative standard and related requirement, the average monthly trading volume is calculated over the most recent 12 months.

[d]The $60 million minimum requirement applies to companies that listed through initial public offerings, as a result of spin-offs, or under the affiliated companies requirement. The minimum requirement is $100 million for other companies.

[e]A company must achieve the $10 million aggregate pretax earnings requirement for the last 3 fiscal years, with at least $2 million in each of the most recent 2 fiscal years, and being profitable in all 3 years.

[f]The New York Stock Exchange has revised this standard under the pilot program.

[g]Aggregate operating cash flow is the cash generated from the operations of a company. Generally, it is defined as net income adjusted for noncash charges and income.

[h]A company's 3-year total for aggregate operating cash flow must equal $25 million and the company must report a positive amount each year.

[i]According to NYSE, global market capitalization includes all domestic and foreign companies and all domestic and foreign shares.

Table 10: The New York Stock Exchange's Quantitative Standards for Continued Listing of Domestic Issuers

Standard	Minimum requirements
Price[a]	$1
Both of the following:	
1. total stockholders and	1. 400 and
2. total stockholders and trading volume.[b]	2. 1,200 and 100,000, respectively.
Publicly held shares	600,000
For those companies that listed pursuant to the aggregate pretax earnings standard:	
1. global market capitalization[c] and total stockholders' equity or	1. $75 million[d] and $75 million,[d] respectively, or
2. global market capitalization.	2. $25 million.[d]
For those companies that listed pursuant to the aggregate operating cash flow, and global market capitalization and revenue standards:	
1. global market capitalization and total revenues or	1. $250 million[e] and $20 million,[e] respectively, or
2. global market capitalization.	2. $75 million.[e]
For those companies that listed pursuant to the global market capitalization and revenue standard:	
1. global market capitalization and total revenues or	1. $375 million[d] and $15 million,[d] respectively, or
2. global market capitalization.	2. $100 million.[d]

Source: The New York Stock Exchange.

Notes:

The New York Stock Exchange introduced a pilot program, effective January 29, 2004, through July 29, 2004, that amends certain of its minimum quantitative standards for continued listing. While data provided in the table reflect information from the New York Stock Exchange, the definitions provided in the following notes are from David L. Scott, *Wall Street Words* (1997), unless otherwise indicated.

[a]An issuer is out of compliance with the price standard if the average price is below the minimum standard over a 30-consecutive-day trading period.

[b]An issuer is out of compliance with the trading volume standard if the average monthly trading volume is below the minimum requirement in the most recent 12-month period and total stockholders are less than 1,200.

[c]According to NYSE, global market capitalization includes all domestic and foreign companies and all domestic and foreign shares. An issuer is out of compliance with the global market capitalization standard if average global market capitalization is below the minimum standard for a 30-consecutive-trading-day period.

[d]The New York Stock Exchange has revised this standard under the pilot program.

[e]The New York Stock Exchange has added this standard under the pilot program.

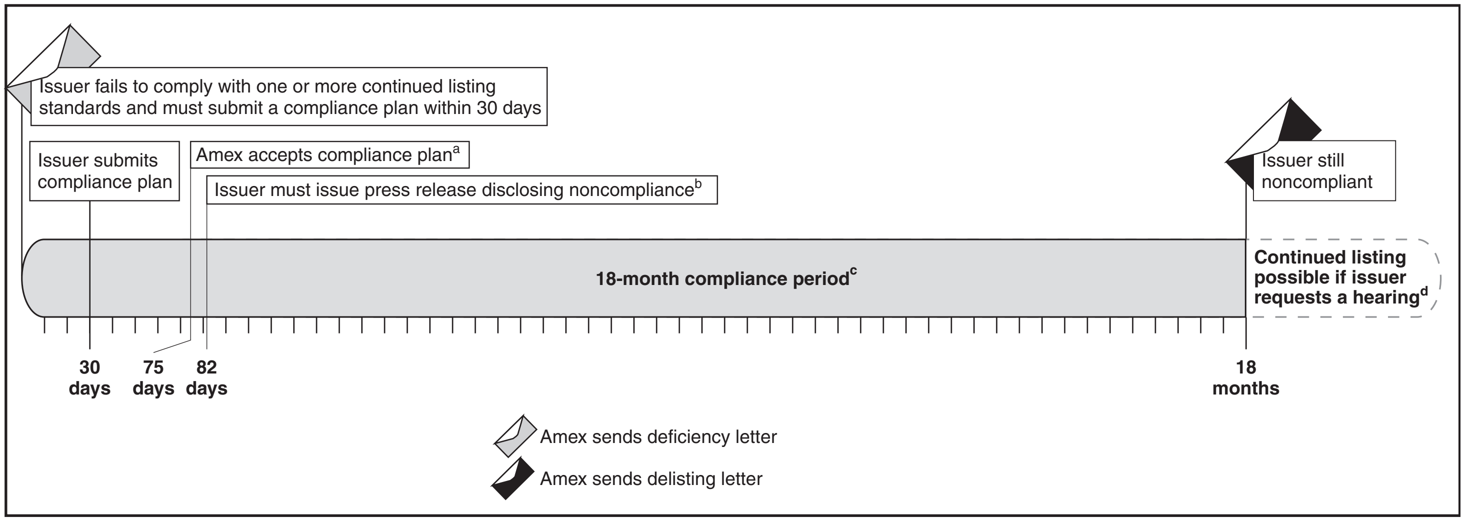
Deficiency and Hearing Processes for Domestic Issuers Listed on the Three Largest Markets

After a domestic company is listed on the American Stock Exchange (Amex), Nasdaq Stock Market, Inc. (NASDAQ), or the New York Stock Exchange (NYSE), it must comply with the market's quantitative continued listing standards (see app. II). If a domestic issuer does not maintain compliance with one or more of these standards, the SRO's rules generally require that its deficiency, or delisting, process begins. If an SRO decides to delist a noncompliant issuer, the issuer may request a review of the delisting decision through the SRO's hearings process. The deficiency and hearings processes for domestic issuers listed on Amex, NASDAQ, and NYSE are described below.

The Amex Deficiency and Hearing Processes for Domestic Issuers

Amex's procedures require the SRO to send an issuer a deficiency letter within 10 business days of determining that the issuer is deficient with one or more continued listing standards. The letter offers the issuer an opportunity to submit a compliance plan detailing definitive actions the issuer has taken or will take to return to compliance with Amex's continued listing standards. If Amex accepts the issuer's plan, the issuer will be granted a compliance period for up to 18 months, during which time it will have the opportunity to regain compliance with the continued listing standards (see fig. 2). The issuer must issue a press release within 5 business days disclosing that it does not meet Amex's continued listing standards and that its listing is being continued pursuant to an extension.

Figure 2: Key Points in Amex's Deficiency Process for Domestic Issuers



Source: Amex.

Notes:

All days are calendar days, unless otherwise indicated.

[a] Amex has 45 days to review an issuer's proposed compliance plan. If Amex rejects the plan, or if the issuer does not submit a plan within 30 days, Amex is to send the issuer a delisting letter.

[b]The issuer must issue a press release within 5 business days disclosing that it does not meet Amex's continued listing standards and that its listing is being continued pursuant to an extension; we have converted the 5 business days to 7 calendar days for purposes of this figure.

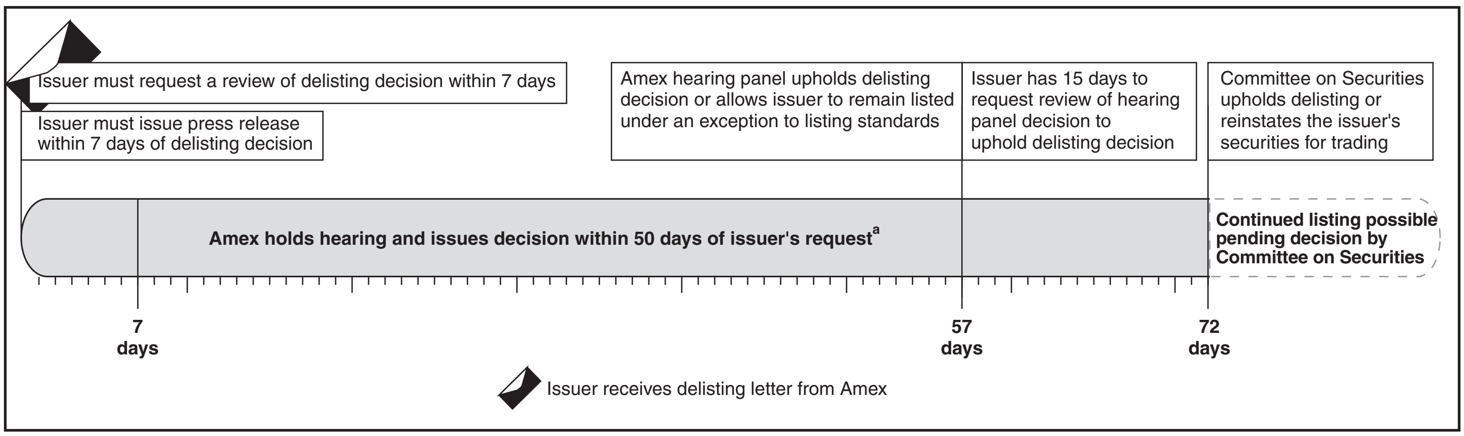
[c]The compliance period begins on the day that Amex sends an issuer a deficiency letter. Under its rules, Amex can grant issuers a compliance period of up to 18 months.

[d]See figure 3.

Under Amex procedures, the SRO is to send an issuer a delisting letter if it does not regain compliance within the compliance period granted, Amex rejects its proposed compliance plan, or it does not submit a plan within 30 calendar days. The delisting letter explains the basis for Amex's decision to begin delisting proceedings against an issuer and informs the issuer of its right to a hearing (see fig. 3). The issuer must issue a press release announcing the initiation of delisting proceedings and the basis for the delisting decision within 7 calendar days of receiving the delisting letter. The Amex hearing panel may decide to uphold the delisting decision or allow the issuer to remain listed if it determines that the delisting decision was erroneous. Normally, trading in an issuer's securities will continue pending a decision by the Amex hearing panel. If the hearing panel upholds the delisting decision, trading in the issuer's securities will be suspended.

The issuer may request a review by the Committee on Securities, appointed by the Amex Board of Directors, which can uphold the delisting decision or reinstate the issuer's securities for trading.

Figure 3: Key Points in Amex's Hearing Process for Domestic Issuers



Source: Amex.

Notes:

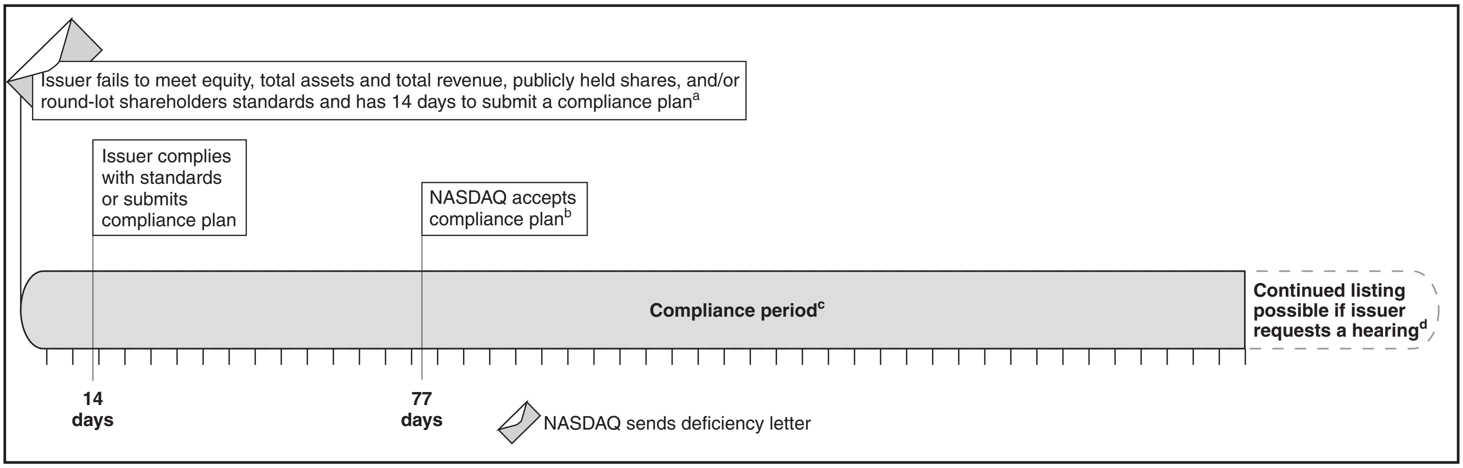
All days are calendar days, unless otherwise indicated.

[a]The Amex hearing panel must hold a hearing within 45 days of receiving an issuer's request to review the delisting decision. According to an Amex official, the Amex hearing panel issues a decision within 5 calendar days of holding the hearing.

The NASDAQ Deficiency and Hearing Processes for Domestic Issuers

NASDAQ's procedures require the SRO to send a deficiency letter when an issuer becomes deficient in one or more of its continued listing standards. The deficiency process differs depending on the listing standard. An issuer with a deficiency in the equity, total assets and total revenue, publicly held shares, and/or round-lot shareholders standards has 10 business days from the date of the letter to comply with the applicable standard or submit a compliance plan (see fig. 4).

Figure 4: Key Points in NASDAQ's Equity, Total Assets and Total Revenue, Publicly Held Shares, and/or Round-Lot Shareholders Deficiency Process for Domestic Issuers



Source: NASDAQ.

Notes:

All days are calendar days, unless otherwise indicated.

[a] An issuer with a deficiency in the equity, total assets and total revenue, publicly held shares, and/or round-lot shareholders standards has 10 business days from the date of the letter to comply with the applicable standards or submit a compliance plan; we have converted the 10 business days to 14 calendar days for purposes of this figure.

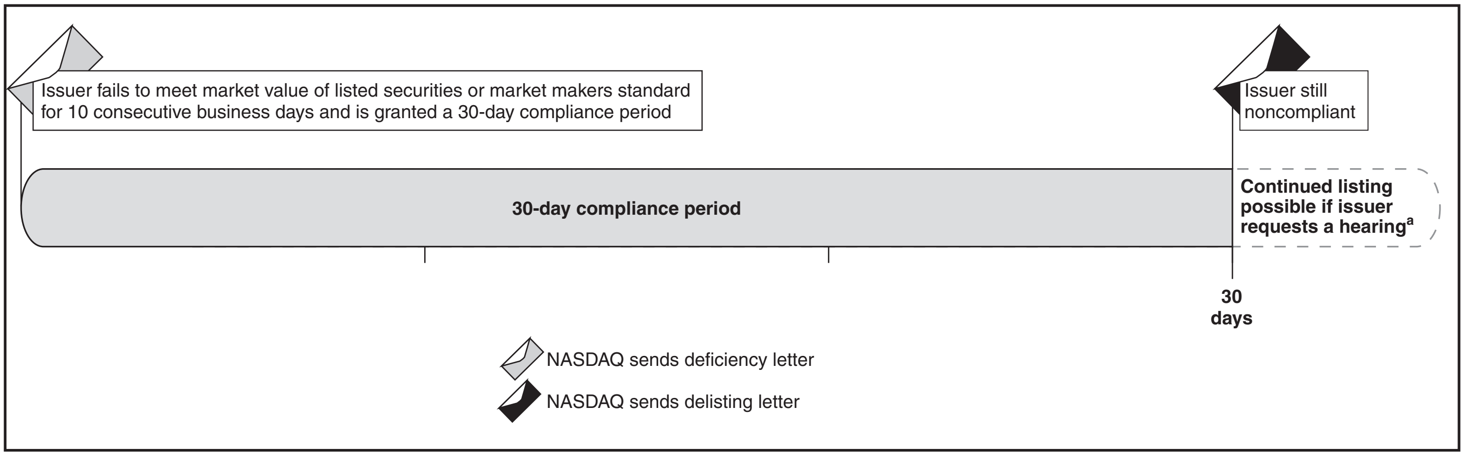
[b]NASDAQ takes up to 63 calendar days to review an issuer's compliance plan. If NASDAQ rejects the plan, the issuer does not submit a plan within 10 business days, or the issuer does not regain compliance within the compliance period, NASDAQ is to send the issuer a delisting letter.

[c]NASDAQ procedures allow the SRO to accept an issuer's compliance plan and grant a short extension period during which the issuer must meet certain milestones to regain compliance. Upon receipt of a delisting letter, an issuer may request a hearing to remain listed under a short-term exception to the listing standards.

[d]See figure 8.

Issuers that fail to meet the market value of listed securities and market maker standards for 10 consecutive business days are granted an automatic compliance period during which they have the opportunity to regain compliance with the applicable standard (see fig. 5).

Figure 5: Key Points in NASDAQ's Market Value of Listed Securities and Market Makers Deficiency Process for Domestic Issuers



Source: NASDAQ.

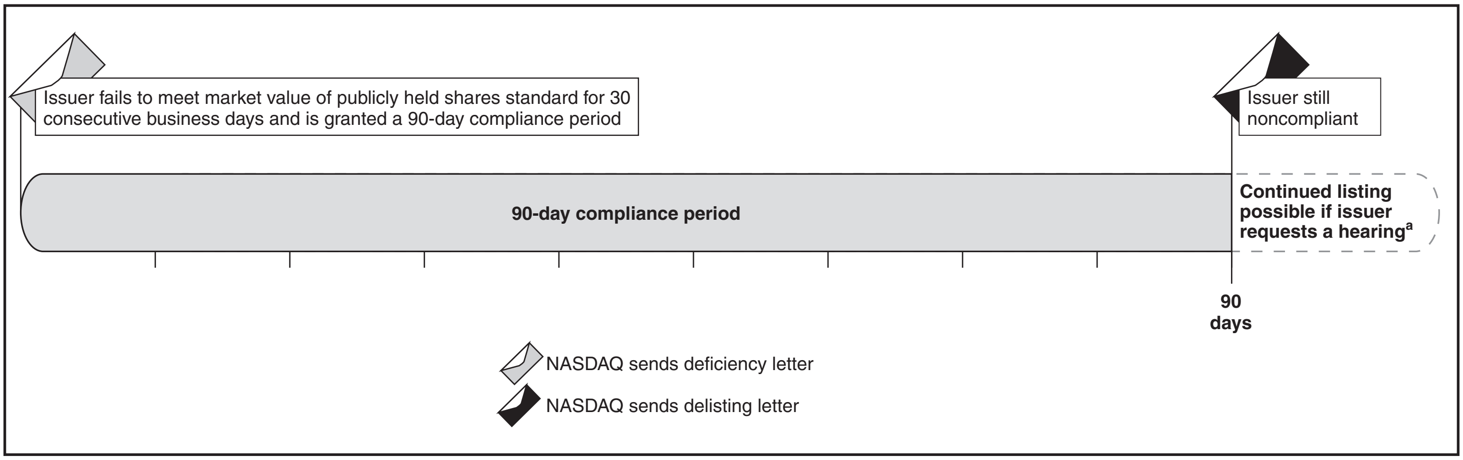
Notes:

All days are calendar days, unless otherwise indicated.

[a]See figure 8.

Issuers that do not meet the market value of publicly held shares and bid-price standards for 30 consecutive business days are granted automatic compliance periods during which they have the opportunity to regain compliance with the applicable standard. Figure 6 describes the key points in the deficiency process for issuers deficient in the market value of publicly held shares standard, and figure 7 describes the key points in the deficiency process for issuers deficient in the NASDAQ National Market (NNM) and SmallCap (SCM) bid-price standards.

Figure 6: Key Points in NASDAQ's Market Value of Publicly Held Shares Deficiency Process for Domestic Issuers



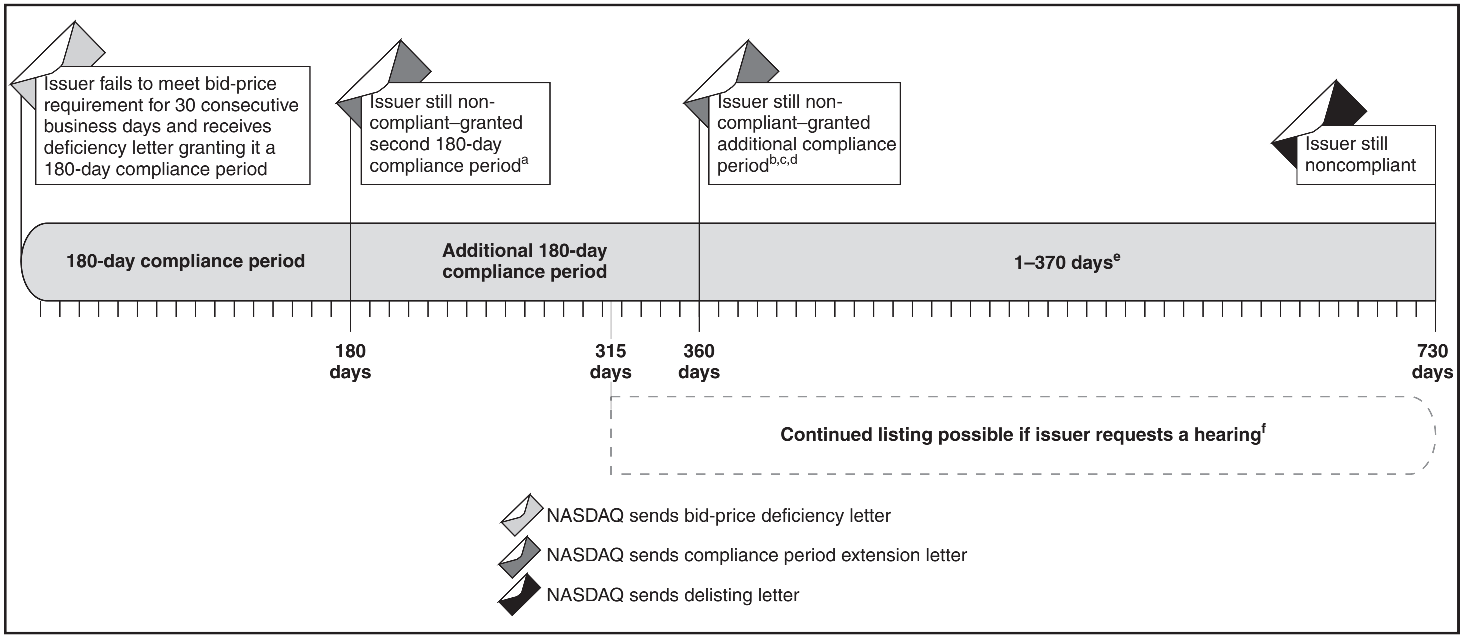
Source: NASDAQ.

Notes:

All days are calendar days, unless otherwise indicated.

[a]See figure 8.

Figure 7: Key Points in NASDAQ's SCM and NNM Bid-Price Deficiency Process for Domestic Issuers



Source: NASDAQ.

Notes:

All days are calendar days, unless otherwise indicated.

[a]An SCM or NNM issuer must meet all of its market's initial listing standards, except for bid price, to take advantage of the second 180-day bid-price compliance period; if the issuer does not meet these standards, NASDAQ is to send the issuer a delisting letter.

[b]If an NNM issuer has not regained compliance with the bid-price standard 45 days before the expiration of the second NNM 180-day compliance period, NASDAQ is to send a letter notifying the issuer of its noncompliance, the pending expiration of the compliance period, and its right to request a hearing.

[c]NNM issuers that do not regain compliance at the end of the second 180-day compliance period may elect to transfer to the SCM provided that they meet all of the SCM continued listing standards, except for bid price, and other requirements; if the issuer does not meet all the SCM continued standards and requirements or elects not to transfer to the SCM, NASDAQ is to send the issuer a delisting letter.

[d]An issuer must meet all initial SCM listing standards, except for bid price, to take advantage of the additional compliance period; if the issuer does not meet these standards, NASDAQ is to send the issuer a delisting letter.

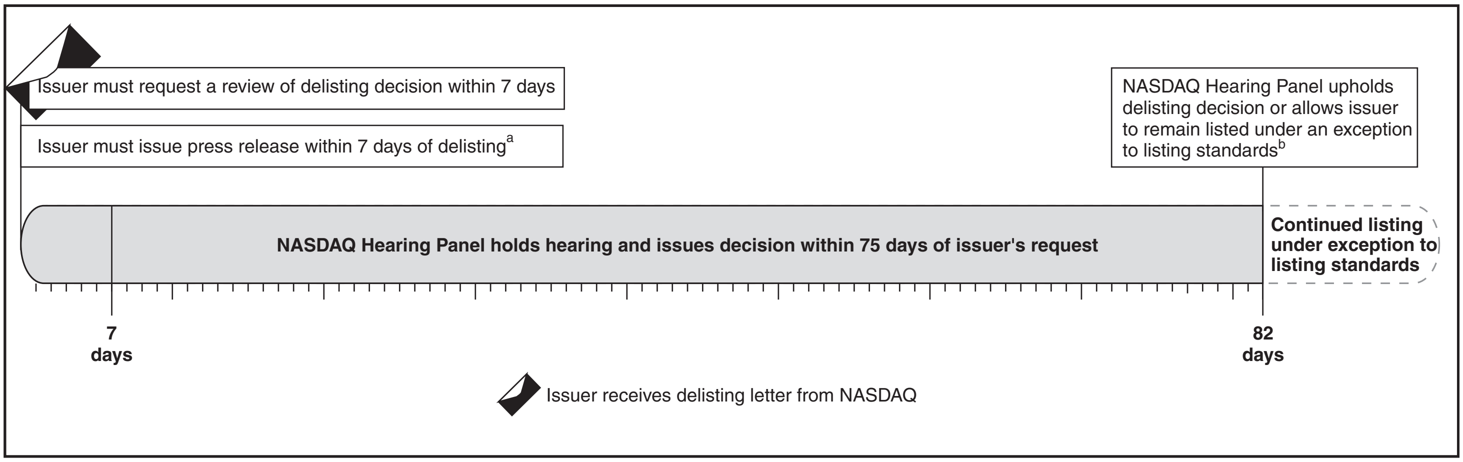
[e]If the issuer meets all initial SCM listing standards, except for bid price, it will be provided with an additional compliance period up to its next shareholder meeting scheduled to occur within the next 370 days, provided the issuer commits to seeking shareholder approval of a reverse stock split to address the bid-price deficiency at that meeting. If the issuer does not meet all the initial standards or fails to timely propose, obtain approval of, or promptly execute the reverse stock split, NASDAQ is to send the issuer a delisting letter.

[f]See figure 8.

If NASDAQ rejects an issuer's compliance plan, if the issuer does not submit a plan, or if an issuer does not regain compliance within the applicable compliance period, NASDAQ is to send the issuer a delisting letter. Upon receipt of a delisting letter, the issuer has 7 calendar days to issue a press release announcing receipt of the delisting letter and the basis for the delisting decision. It may also within this time frame request a hearing to remain listed under an exception to the listing standards (see fig. 8).[1] Before the hearing, issuers are asked to submit a compliance plan for the NASDAQ Hearing Panel's review. If the NASDAQ Hearing Panel determines that the issuer will be able to implement in the short term a plan of compliance that will likely enable the issuer to achieve and sustain long-term compliance, the NASDAQ Hearing Panel may allow the issuer to remain listed under a temporary exception to the listing standards. Normally, trading in an issuer's securities will continue pending a decision by the NASDAQ Hearing Panel. If the NASDAQ Hearing Panel determines that it is unlikely that the issuer will be able to achieve and sustain long-term compliance, the issuer's securities will be delisted. An issuer may appeal the NASDAQ Hearing Panel decision to the NASDAQ Listing and Hearing Review Council, which can uphold the delisting decision or reinstate the issuer's securities for trading.

[1]For all deficiencies, if an issuer chooses not to request a hearing following receipt of a delisting letter, the issuer is to be delisted in 7 calendar days. In addition, rather than request a hearing or delist, NNM issuers have the opportunity to transfer to the SCM, provided they meet all SCM continued listing standards, except for bid price. An issuer that wishes to transfer from NNM to SCM must submit an application, a copy of the SCM Listing Agreement, and pay the applicable entry fee.

Figure 8: Key Points in NASDAQ's Hearing Process for Domestic Issuers



Source: NASDAQ.

Notes:

All days are calendar days, unless otherwise indicated.

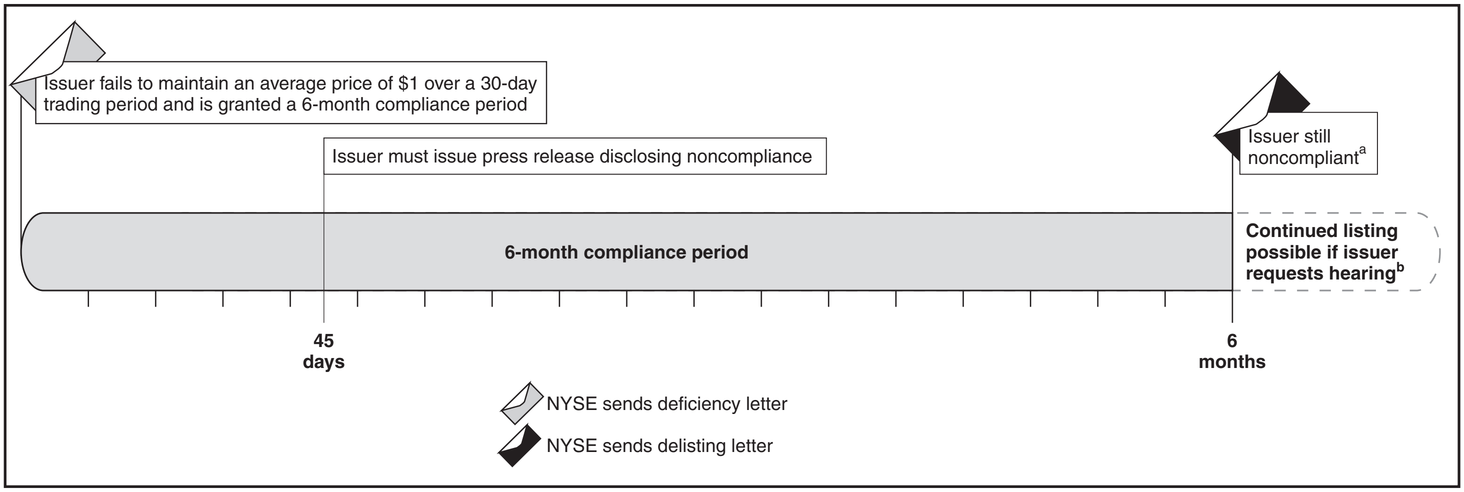
[a]The delisting letter at the end of the compliance period triggers the requirement for the press release.

[b]An issuer may appeal a delisting decision to the NASDAQ Listing and Hearing Review Council.

The NYSE Deficiency and Hearing Processes for Domestic Issuers

NYSE has different deficiency procedures for price and nonprice deficiencies. If an issuer's average closing price over a 30-day trading period is less than $1, NYSE must send a deficiency letter to the issuer within 10 business days, stating that the issuer has the later of 6 months or its next annual meeting of shareholders (should the company determine that its action to cure the price deficiency requires shareholder approval) to bring the share price and average share price back above $1 (see fig. 9). NYSE transmits an indicator on the consolidated tape 5 business days following notification to the issuer that it is below the $1 share-price requirement. In addition, the issuer is required to issue a press release within 45 calendar days of notification from NYSE that it is below the $1 share-price requirement. NYSE may initiate delisting proceedings before the expiration of the compliance period, by shortening the period, if it appears likely that the issuer will be unable to regain compliance due to an abnormally low price.

Figure 9: Key Points in NYSE's Price Deficiency Process for Domestic Issuers



Source: NYSE.

Notes:

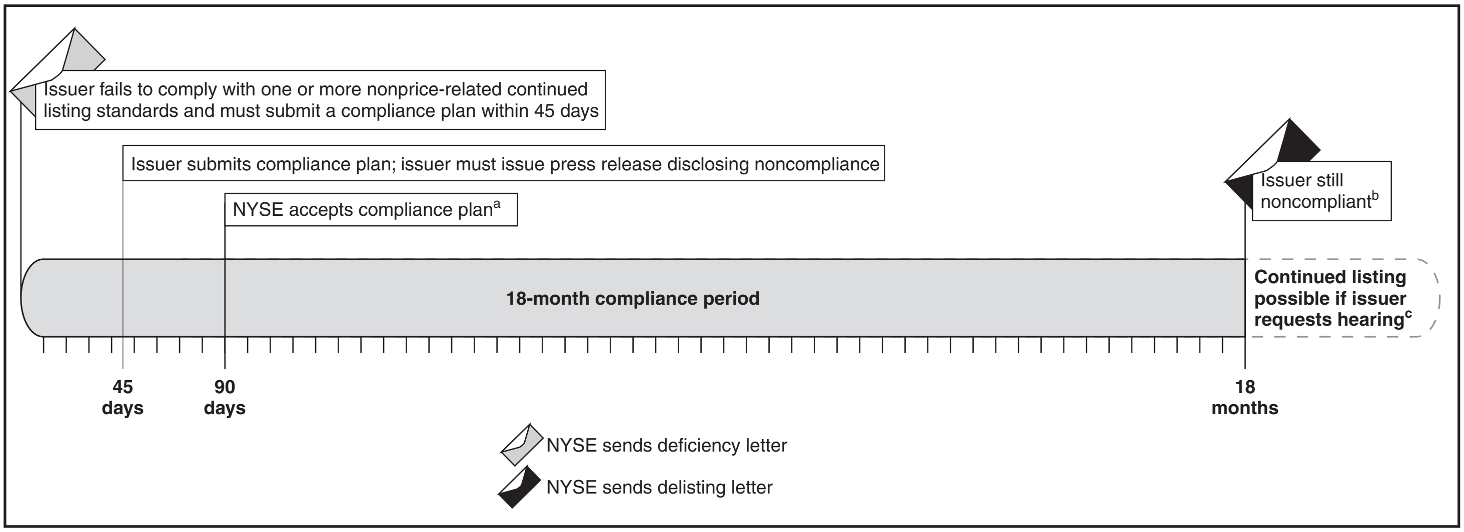
All days are calendar days, unless otherwise indicated.

[a]NYSE issues a press release disclosing the issuer's listing status and the basis for its delisting decision.

[b]According to NYSE officials, continued listing during a hearing is rare in cases of a price deficiency. See figure 11.

NYSE must send an issuer a deficiency letter within 10 business days of determining that the issuer is deficient with one or more nonprice continued listing standards. The letter provides the issuer an opportunity to submit a compliance plan to NYSE detailing definitive actions the issuer has taken or is taking to return to compliance with the continued listing standards. NYSE transmits an indicator on the consolidated tape 5 business days following notification to the issuer that it is not in compliance with NYSE nonprice continued listing standards. In addition, the issuer is required to issue a press release within 45 calendar days of notification from NYSE that it is not in compliance with NYSE nonprice continued listing standards (see fig. 10). If NYSE accepts the issuer's plan, the issuer will be granted a compliance period, during which time it will have an opportunity to regain compliance with the standards. This compliance period is subject to quarterly monitoring of the goals outlined in the issuer's plan, and NYSE may, subject to approval, initiate delisting proceedings before the expiration of the compliance period if the issuer fails to meet a goal or if it appears likely that the issuer will be unable to regain compliance.

Figure 10: Key Points in NYSE's Nonprice Deficiency Process for Domestic Issuers



Source: NYSE.

Notes:

All days are calendar days, unless otherwise indicated.

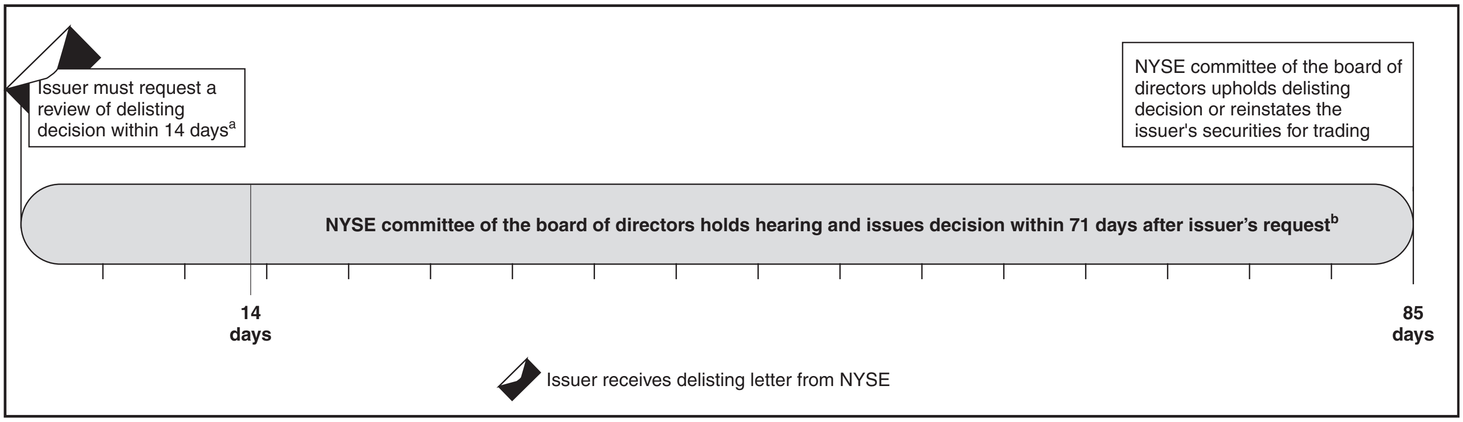
[a]NYSE has 45 days to review an issuer's proposed compliance plan. If NYSE rejects the plan, or if the issuer does not submit a plan within the 45-day time frame, NYSE is to send the issuer a delisting letter.

[b]NYSE issues a press release disclosing the issuer's listing status and the basis for its delisting decision.

[c]See figure 11.

Under NYSE procedures, the SRO is to issue a press release and send an issuer a delisting letter if the issuer does not regain compliance within the 6-month compliance period for price deficiencies or the 18-month compliance period for nonprice deficiencies, NYSE rejects the issuer's proposed compliance plan, the issuer does not submit a plan within the 45-calendar-day time frame, or the issuer fails to meet a quarterly milestone. The press release and the delisting letter explain the basis for NYSE's decision to begin delisting proceedings against an issuer and inform the issuer of its right to a hearing by a committee of the board of directors (see fig. 11). Generally, trading in an issuer's securities will continue pending a decision by the committee. The committee may decide to uphold the delisting decision or allow the issuer to remain listed.

Figure 11: Key Points in NYSE's Hearing Process for Domestic Issuers



Source: NYSE.

Notes:

All days are calendar days, unless otherwise indicated.

[a]The issuer must request a review of the delisting decision within 10 business days; we have converted the 10 business days to 14 calendar days for purposes of this figure.

[b]According to a NYSE official, a committee of the board of directors holds a hearing within 70 days of the issuer's request and issues a decision within 1 day of holding a hearing.

Market Participants Contacted During This Review

As part of our review of the actions the three largest SROs have taken to strengthen corporate governance for issuers and themselves, we interviewed market participants representing the following 14 investor, legal, business, and professional organizations:

American Federation of Labor and Congress of Industrial Organizations

American Institute of Certified Public Accountants

Association for Investment Management and Research

The Business Roundtable

California Public Employees' Retirement System

The Corporate Library

Council of Institutional Investors

Institute of Internal Auditors

Institutional Shareholder Services

Investment Company Institute

National Association of Corporate Directors

Securities Industry Association

Teachers Insurance and Annuity Association–College Retirement Equities Fund

Weil, Gotshal, & Manges LLP

Comments from the Securities and Exchange Commission

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

February 26, 2004

Richard J. Hillman
Director, Financial Markets
And Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the General Accounting Office's draft report entitled Securities Markets: SEC Has Opportunities to Enhance Investor Confidence and Improve Listing Program Oversight. In the draft report, GAO discusses issues related to the equity listing standards of the self-regulatory organizations. We agree that there are fundamental investor protection issues related to SRO listing standards and programs. As you recognize in your report, the Commission has significantly enhanced these areas during the period of your review. Your report details many of these enhancements.

In your report, you discuss methods for ensuring that investors receive early and ongoing notice if an issuer listed on a particular market is not compliant with all of that market's listing standards. As outlined in your report, we believe that disclosing this information to investors in a timely, clear and ongoing manner is important so that investors understand that an issuer could be delisted. We will continue to work with the SROs to ensure that this goal is fully and adequately achieved. We also believe, as you do, that the SROs should timely notify investors not only when issuers are noncompliant with financial listing standards, but also when they are noncompliant with corporate governance standards. We will discuss with the SROs the feasibility of appending a modifier to or transmitting an indicator with the symbol of an issuer that is not in compliance with corporate governance standards.

In your report, you further recommend that the Commission expeditiously adopt a proposed rule requiring an issuer to file a Form 8-K within a specified timeframe after receiving notice from an SRO that the issuer is not in compliance with a continued listing standard. The rule was proposed to ensure early public notice of an issuer's noncompliant status. The Division of Corporation Finance expects the Commission to consider whether to approve this rule change in March 2004.

You also recommend that we routinely use internal review reports in planning and conducting SRO inspections. You note that internal audit reports can be helpful in assessing whether an

Mr. Richard Hillman
Page 2

SRO addressed prior inspection findings and recommendations and to learn background information regarding particular SRO program areas. We agree that internal audit reports are one source of information with respect to an SRO's performance and compliance. Their value depends on the thoroughness of the review and the content of the report. As you are aware, our SRO oversight inspections are generally more comprehensive than a review conducted by an SRO internal audit department. In addition, during our inspections, we consistently review whether an SRO has effectively implemented our recommendations from prior inspections. We also thoroughly review SRO policies and procedures to familiarize ourselves with a particular program area or department. As we have discussed with you, we recognize that SRO internal audit reports may be a useful tool in the inspection process. We currently selectively request and review SRO internal audit reports during inspections when we believe it is appropriate to follow-up on particular problems or issues at an SRO. In response to your recommendation, we will implement a formal written policy concerning the selection and review of SRO internal audit reports during inspections.

With regard to your recommendation that the Amex listing standards require companies to disclose the names of its directors that were designated as independent, we note that on February 23, 2004, Amex filed such a rule change. Amex's rule filing requires companies to disclose the names of directors that the company's board of directors has determined to be independent. This rule change became effective upon filing.

Additionally, in your report, you recommend that we conduct timely inspections of the SROs to assess their oversight of issuers' compliance with corporate governance standards. Reviewing corporate governance requirements is currently included in our listing inspection process. We expect to continue to conduct timely inspections of the SROs' programs and procedures for ensuring that issuers comply with corporate governance requirements and to enhance our review to include the new corporate governance requirements.

Also, you recommend that we place a high priority on completing our review of the governance self-evaluations of the three listed markets that are the focus of your report. SEC staff, through its Division of Market Regulation, currently is conducting a comprehensive review of SRO governance. This assessment will take into consideration the new corporate governance standards for listed issuers that are now in place at Amex, NYSE and Nasdaq. In many respects, these standards could serve as a benchmark for SRO governance. There are, however, additional factors to be considered when assessing SRO governance, including the Exchange Act's "fair representation" requirements. Moreover, the Commission in December approved significant revisions to the NYSE's governance structure, which also could be instructive as the Commission assesses SRO governance generally. We assure you that SRO governance remains a high priority for us as we continue to work on this important project. In addition, when appropriate and after any changes or new requirements are implemented at the SROs, we will inspect whether the SROs have effectively implemented their own enhanced governance standards.

Mr. Richard Hillman
Page 3

Thank you again for the opportunity to comment on the final draft report. We also thank you and your staff for the courtesy extended during this review.

Sincerely,

Annette L. Nazareth	Lori A. Richards	Martin P. Dunn
Director	Director	Deputy Director
Division of Market Regulation	Office of Compliance Inspections and Examinations	Division of Corporation Finance

Comments from the American Stock Exchange

AMERICAN STOCK EXCHANGE®
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February 26, 2004

Mr. Richard J. Hillman
Director
Financial Markets and Community Investment
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Hillman:

The American Stock Exchange ("Amex" or "Exchange") appreciates the opportunity to provide comments on the draft report of the United States General Accounting Office ("GAO") entitled *Securities Markets: SEC Has Opportunities to Enhance Investor Confidence and Improve Listing Program Oversight* ("Draft Report"). The Draft Report provides a comprehensive analysis of several important issues related to the equity listing programs of the three largest U.S. securities markets – Amex, the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq"). Our comments are addressed to certain of your specific conclusions and recommendations.

Symbol Modifiers

You note in the Draft Report that investors need timely and ongoing information about the listing status of issuers for use in making investment decisions. Although we agree that transparency with respect to an issuer's compliance with continued listing standards is important, we do not believe that an indicator or symbol modifier is an appropriate or necessary method of providing such transparency. As we have previously discussed with both the SEC and GAO staff, our views in this regard are based on several concerns.

First, use of an indicator or symbol modifier to identify a noncompliant company lumps all noncompliant issuers together, whether the noncompliance concerns a transient and correctable issue or a potentially unresolvable deficiency. By contrast, the press release currently required of noncompliant issuers (or a Form 8-K if required by pending SEC rule revisions) provides more meaningful and accurate information to the investing public.

Second, an issuer which has received notice that it is below continued listing standards is not necessarily in immediate jeopardy of being delisted in that issuers often regain compliance. All three markets provide a window of opportunity for a company that falls below continued listing standards to return to compliance. These processes are in place in recognition of the fact that many listed companies are able to return to compliance and that precipitous delisting action would harm the impacted issuer as well as its shareholders, employees and other stakeholders and could have a destabilizing effect on the capital markets in times of an economic downturn.

Richard J. Hillman
February 26, 2004
Page 2 of 3

Third, the use of a symbol modifier could jeopardize an issuer's ability to resolve a continued listing deficiency, by attaching the equivalent of a "scarlet letter" to the company, thus reducing its ability to negotiate effectively with investors and lenders. Indeed, as noted in the Draft Report, some companies listed on Nasdaq's SmallCap market have confirmed these concerns.

Finally, and perhaps most significantly, there are many factors other than compliance with continued listing standards which are potentially far more material to both current and prospective investors. These factors include: a "going concern" opinion from the company's auditors, major litigation, failure to obtain regulatory approval of a new product, material write-offs or restructuring charges, material impairment, termination of a business relationship with a significant customer, and initiation of a regulatory investigation. While the Draft Report suggests that other indicators could also be used, we are concerned about the feasibility of addressing all significant factors in this manner in that many are inherently subjective and not susceptible to an objective determination of whether the triggering event has occurred. Further, use of many different types of indicators would also be confusing to investors and the marketplace.

However, notwithstanding our views in this regard, as noted in the Draft Report, this issue will be re-examined by the Amex Board of Governors at its April 2004 meeting.

Corporate Governance

We agree with your conclusion that the significant changes to the Amex, NYSE and Nasdaq corporate governance standards applicable to listed issuers should promote stronger board oversight and greater accountability. With respect to your recommendation that Amex adopt a requirement that issuers disclose the names of those directors that they have designated as independent, we note that Amex rules were recently amended to incorporate this requirement.[1]

The Draft Report also concludes that further opportunities exist - and recommends that serious consideration be given - to strengthen board independence by revising listing standards to require a supermajority of independent directors and the separation of the positions of chief executive officer and chairman. In this regard, it is important to recognize that the new enhanced corporate governance requirements at all three marketplaces have only recently been adopted and are still in the process of implementation. While your recommendations warrant further consideration, we believe issuers, the markets and the SEC need more time to adjust to the new requirements and to assess the impact of these requirements on public companies and the capital raising process. However, the Amex monitors the need for revisions to its listing requirements generally on an ongoing basis and is committed to working closely with the SEC staff to ensure that the Amex corporate governance requirements promote the highest level of integrity and accountability by listed issuers.

With the implementation of the new enhanced corporate governance requirements, we have devoted considerable resources to assessing and enhancing our processes for

[1] *See* SR-Amex-2004-06.

evaluating listed issuer compliance. As noted in the Draft Report, these enhancements include expanded manual reviews of issuer SEC filings, improved automated monitoring systems and additional staffing. We look forward to the input from and the opportunity to work with the SEC's Office of Compliance Inspections and Examinations with respect to these processes.

We wholeheartedly agree with your conclusion that, given our role as standard setters, the public has the right to expect the marketplaces to serve as models of strong governance. As you note in the Draft Report, the Amex's corporate governance structure has been under review in the context of the separation of the Amex from the NASD. Draft changes to the Amex Constitution are now being considered in connection with the proposed sale by the NASD of its interest in the Amex to the Amex Membership Corporation. The proposed changes would provide, among other things, for a Board of Governors that consists of 15 governors, nine of whom would be "independent." The definition of "independent" excludes not only members of the Amex and employees or other affiliates of members and broker-dealers, but also directors, officers or employees of Amex-listed issuers. The proposed changes also provide that if the chief executive officer of the Amex is also the chairman of the Amex Board of Governors, the chairman will not participate in executive sessions of the Board. In that case, the "lead governor" – designated by the Board from among the independent governors – would preside over executive sessions. These changes are subject to various approvals, including by Amex members in a vote scheduled for March 2004 and by the SEC, before becoming effective.

* * * *

Thank you for the opportunity to provide comments on the Draft Report. We have separately provided several technical comments to your staff, and appreciate their hard work and thoughtful consideration of the issues addressed. If you have any questions, please contact me directly, Claudia Crowley, Vice President (212-306-2432, claudia.crowley@amex.com) or Ivonne Natal, Associate General Counsel (212-306-1397, ivonne.natal@amex.com).

Sincerely,

Michael J. Ryan Jr.

Comments from the Nasdaq Stock Market, Inc.

NASDAQ

Michael S. Emen
Senior Vice President
Listing Qualifications

February 25, 2004

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment
United States General Accounting Office
441 G Street, N.W.
Washington, DC, 20548

Dear Mr. Hillman:

This is in response to your February 11, 2004 letter to Robert Greifeld, President and Chief Executive Officer of the NASDAQ Stock Market, Inc. ("NASDAQ") enclosing the draft report, entitled *Securities Markets: SEC Has Opportunities to Enhance Investor Confidence and Improve Listing Program Oversight* (the "Draft Report"). We appreciate the opportunity to comment on this draft, as well as the professionalism shown by the staff of the General Accounting Office ("GAO") throughout their review. The Draft Report has three principal areas of discussion: the manner in which the three major markets, NASDAQ, the New York Stock Exchange, Inc. ("NYSE") and the American Stock Exchange, Inc. ("Amex"), have enforced their equity listing standards, as reflected by the oversight reports of the Office of Compliance Inspections and Examinations ("OCIE") of the Securities and Exchange Commission ("SEC"); the implementation and oversight of NASDAQ's bid price moratorium and the subsequent adoption by NASDAQ of a pilot program implementing modified bid price rules; and, the actions taken by the major markets to strengthen corporate governance for listed issuers and themselves. While the Draft Report is generally thorough and accurate, we believe that the discussion concerning ongoing notification of issuer noncompliance with equity listing standards requires further clarification, particularly with respect to NASDAQ's existing procedures to provide notice to investors, which are significantly more comprehensive and transparent than the comparable procedures in place today at the other markets, and NASDAQ's willingness to work with OCIE to implement further notification procedures consistent with our process.

1) OCIE Findings and Recommendations

NASDAQ is profoundly committed to adopting and enforcing significant listing standards. We have over 40 staff engaged in monitoring and enforcing issuer compliance. The backbone of our process is a state-of-the art electronic data storage and analysis system. As noted in the

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Draft Report, our commitment to regulatory excellence was recognized by OCIE, which found that NASDAQ is "generally thorough in its financial and regulatory reviews of companies."

As you know, following its last round of inspections, OCIE recommended that the three major markets implement a practice of identifying issuers which were not in compliance with their continued listing requirements. In response, the NYSE indicated that it would, for the first time, identify companies not in compliance with certain of its listing requirements.[1] It proposed to do this not through means of a symbol modifier, but by imbedding a message in data transmitted to vendors, with the expectation that these vendors would then find a means to display this information. We advised OCIE that we would be prepared to pursue a similar process for NASDAQ issuers, recognizing that NASDAQ's process is different.[2] While we have had preliminary discussions with OCIE subsequent to this, we have yet to resolve these issues. We have, however, made clear, both to OCIE and GAO staff that we are open to changing our existing procedures and are willing to work cooperatively with OCIE in the near term to implement an appropriate solution.

NASDAQ agrees that it is important for investors to understand how our rules operate and how they are being applied to specific issuers. Our commitment to transparency is evident both in the expanding content of our legal/compliance web site (see www.nasdaq.com/about/LegalCompliance.stm) and in various aspects of our existing rules. For instance, NASDAQ believes that nothing is more important to investors than the financial information contained within an issuer's periodic reports to the SEC. In the absence of such information, no market is able to determine whether the issuer is in compliance with its listing requirements and investors are unable to assess accurately the underlying listed enterprise. We believe that rigorous enforcement of SEC filing requirements should be consistent across all markets. NASDAQ has, for more than 20 years, followed the practice of immediately affixing an "E" modifier to the ticker symbol of an issuer which is delinquent in meeting any of its periodic SEC filing requirements, whether they be quarterly filings due on a Form 10-Q or annual filings. An issuer is considered delinquent if the filing is late or is missing certain information such as the certifications required by the Sarbanes Oxley Act of 2002 ("SOX"). At

[1] However, according to the Draft Report, the NYSE does not plan to take any action to identify issuers delinquent in satisfying their SEC interim (quarterly) filing obligations. In contrast, and as discussed below, NASDAQ has long affixed an "E" modifier to the symbol of such companies immediately upon the onset of the delinquency.

[2] As noted in the Draft Report, OCIE has not yet concluded at what point in the NASDAQ process it would be appropriate to append a symbol modifier or take equivalent action. This is because our process incorporates the use of non-discretionary compliance periods for certain deficiencies. Further, NASDAQ's delisting process, for those deficiencies without compliance grace periods, is generally much quicker than those of the exchanges. As noted in Figure 8 of Appendix VII of the Draft Report, the outside time frame for a NASDAQ Panel to hold a hearing and issue a decision is generally less than three months. In contrast, the process at the Amex and NYSE, depicted in Figures 2 and 10, can take at least 18 months. While the process reflected in NASDAQ's pilot rules for bid price deficiencies may take up to two years, it is important to distinguish these cases because such companies are NOT subject to being delisted until the expiration of the compliance grace period and, because the price itself is an early, obvious, and continuing sign to the investing public. Also, given the widespread availability of historical trading information on the internet, it is extremely simple to determine how long a particular issuer has been trading below $1. Further, NASDAQ believes that our practice in this area is well known to the investing public.

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the same time, a letter is sent to the issuer advising that it will be delisted unless it files an appeal. An issuer pursuing such an appeal is required, no later than seven calendar days after receiving the delisting notice, to issue a press release advising investors that it is subject to being delisted. This notice is required to include the basis for the delisting letter so that investors have specific notice of why the issuer's listing is at risk. Our practice in this most critical area provides early and ongoing notice to investors, operates extremely quickly and is unmatched by any other market. In addition to this, if an issuer listed on the NASDAQ SmallCap market pursues an appeal of any delisting notification and is granted a temporary exception by a Hearings Panel, NASDAQ affixes a "C" modifier to the ticker symbol so that investors know that the company is non-compliant, has received fair process, and continues to be listed as a result of that process.[3]

2) Bid Price Moratorium and Subsequent Rule Changes

NASDAQ's bid price moratorium was implemented in response to the extraordinary market conditions that followed the tragedy of September 11, 2001. Those events shocked financial markets and a national economy already in the throes of a significant downturn. In January 2002, the moratorium expired and was replaced by a pilot program to significantly extend the compliance grace periods in which SmallCap Market issuers could regain compliance with the bid price rules.[4] While the moratorium was applied to all issuers, eligibility for these new, longer compliance grace periods was principally limited to viable companies which, but for bid price, could still satisfy one of NASDAQ's initial listing standards. Our expectation was that these extended compliance grace periods would allow such companies to focus on reinvigorating their businesses without having to worry that they were about to be delisted, a prospect which could adversely affect their business dealings and would deprive their shareholders of the ability to participate in a transparent, liquid and well-regulated market environment.

The GAO's review confirmed that the moratorium and related rule changes worked as intended and benefited a considerable number of companies. This means shareholders, employees and other constituents of these companies benefited as well. The Draft Report also acknowledges that the SEC acted within its authority and followed its applicable regulations in approving the various rule changes.

Today, the total number of issuers trading below our minimum bid price requirement is minimal. This is further confirmation that the moratorium and pilot program have accomplished their objectives. As of the end of January 2004, only 28 issuers (4 on the National Market and 24 on the SmallCap Market) were trading below $1, compared with 611

[3] SmallCap issuers receiving exceptions are also required to issue a press release providing further notice and transparency to the application of the "C" modifier.
[4] NASDAQ subsequently proposed further changes to these rules, which included lengthening the compliance grace periods applicable to National Market issuers.

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NASDAQ issuers trading below $1 as of September 30, 2001, shortly after the moratorium was declared.

3) Corporate Governance Reforms

The Draft Report acknowledges that the recent rule changes adopted by the SRO's should promote stronger board oversight and greater accountability. The implementation of these rules is a significant step towards restoring investor confidence in the U.S. securities markets. The SRO's new governance rules, like SOX, are predicated on the important role that must be played by independent directors. Consistent with that, NASDAQ alone among the markets requires that independent directors approve of related party transactions.

While the rules of the SRO's are in many respects quite similar, in certain areas NASDAQ has avoided a one-size fits all approach. We also sought to avoid overly prescriptive rules. And, we believe it is critically important that our rules not impose such significant burdens on issuers that it would harm their ability to take risks and to innovate. It is in this context that we'd like to respond to the Draft Reports recommendation that the markets adopt additional rules mandating the separation of the Chairman and CEO roles and requiring that listed issuers have a supermajority of independent directors.

NASDAQ certainly considered whether to mandate the separation of the roles of the Chairman and CEO. We agree that this may enhance the governance of some companies. In fact, as the Draft Report notes, NASDAQ recently took this step for its own Board of Directors. However, many companies and others are concerned that mandating this separation could make corporate boards more inefficient and lead to unnecessary conflict. Moreover, we believe there is insufficient information available to justify taking such a potentially far-reaching step at this time. And, we also believe that other steps we have taken, such as requiring a majority of independent directors and an independent nominations and executive officer compensation process, will significantly reduce the concerns associated with a combined Chairman/CEO.

Similarly, we considered mandating that listed issuers have a supermajority of independent directors. We remain concerned that such a requirement would prove unduly burdensome, particularly for smaller issuers and believe there is insufficient information available to determine that a supermajority of independent directors would provide governance benefits above and beyond what can be achieved through a simple majority.

We also believe, in view of the numerous governance changes that listed companies have been asked to digest as a consequence of SOX, related SEC regulations and the new SRO rules, that it is important that we allow time for these new rules to take effect and then assess their results. We are committed to doing just that.

The Draft Report recommends that OCIE work with the SRO's to make sure that they establish effective procedures to ensure that listed issuers comply with the new corporate governance

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listing standards. We look forward to this, and have had preliminary discussions with OCIE in this regard. We believe strongly that the new rules must be rigorously enforced if we are ultimately to succeed in restoring investor confidence in our markets.

Finally, in terms of its internal governance, NASDAQ believes that it substantially complies with all of its new listing standards.[5] NASDAQ has, throughout the process of proposing and then adopting new corporate governance rules, sought to "eat our own cooking" by complying with those rules as if we too were a listed issuer.

* * * * *

We appreciate this opportunity to provide comments on the Draft Report and look forward to working constructively with OCIE to address the issues discussed above.

Sincerely,

[5] As noted in the Draft Report, NASDAQ's by-laws require it to have a nominations committee, which includes individuals who are not NASDAQ directors.

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Comments from the New York Stock Exchange

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February 27, 2004

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment
U.S. General Accounting Office
Washington, D.C. 20548

Re: GAO Report 04-75
Securities Markets: SEC Has Opportunities to Enhance Investor Confidence and Improve Listing Program Oversight

Dear Mr. Hillman:

The New York Stock Exchange (the "Exchange" or "NYSE") appreciates this opportunity to offer comments on certain matters discussed in the above-referenced GAO Report (the "Report"). The Exchange also wishes to compliment the professionalism and courtesy of the GAO staff that met with Exchange officials in the course of preparing their Report.

We would first like to underscore our appreciation of the role played by the staff of the SEC's Office of Compliance, Inspections and Examinations (OCIE) in the NYSE's oversight of its listing program, including the proper and diligent application by the Exchange of its rules and policies applicable to listed companies. Self-regulation in the securities industry is premised on active and knowledgeable oversight by the SEC of the self-regulatory organizations, and we firmly believe that our listing program has improved as a result of the inspections performed by OCIE and the comments that have emerged therefrom.

Accordingly, we support the GAO recommendations that would continue the SEC's active role in working with Exchange staff to ensure that our own oversight program is as effective as possible. We also support the position that SRO rules and standards should be transparent and that relevant information regarding a company should be readily available to investors. We do have concerns, however, about the details of some of the GAO's recommendations, and we would like to explain those concerns in this letter.

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Summary

We will address four separate matters. They are:

- The use of market data "indicators" to convey information regarding listed company status
- The GAO recommendations regarding supermajority board requirements and the separation of the role of chairman of the board and CEO
- The GAO recommendation contemplating that OCIE staff would routinely use SRO internal review reports in planning and conducting inspections of the SROS
- NYSE's preparations to oversee listed company compliance with the new corporate governance standards.

A. The use of market data "indicators" to convey information regarding listed company status.

The Report discusses in considerable detail NYSE's dissemination of an "indicator" over the consolidated tape with each quote or reported trade in the stock of an issuer that has been determined by the Exchange to be below NYSE financial continued listing criteria. It is worth noting as a general matter that the number of companies involved is a very small percentage of the listed company population, approximately one-half of one percent at year-end 2003. In addition, we would like to make the following points regarding this matter of ticker symbol "indicators":

- Contrary to the position noted in the Report, the NYSE believes that it has fully addressed the OCIE recommendation in this area, in that any vendor dissemination requirements would have to be imposed by the SEC.
- We have agreed to use ticker symbol indicators as one means of informing interested persons that a listed company is below compliance with financial continued listing standards, or is delayed in filing its annual report on Form 10-K. However, we continue to believe that a ticker symbol indicator is not an effective method for the dissemination of more complex information, and this should limit the purpose for which the device is used. We believe it is ill suited, for example, to convey information regarding a company's status vis-à-vis qualitative listing standards, such as the Exchange's recently expanded corporate governance standards.

We would like to briefly elaborate on each of these points:

1. The NYSE believes that it has fully addressed OCIE's recommendation regarding use of a ticker indicator for companies below NYSE financial continued listing standards.

The Report states that NYSE's transmittal of the ticker indicator over the consolidated tape will address the intent of OCIE's recommendation if distribution concerns are addressed. The Report goes on to explain that while the Associated Press has made the indicator available in the stock tables in supplies to newspapers, and the Wall Street Journal has indicated an intent to do so, none of the five electronic data vendors contacted by the GAO planned to distribute the symbol indicator. The GAO Report states that among the reasons vendors gave were a lack of client demand and reluctance to divert resources from more important initiatives.

The GAO Report states OCIE's position that NYSE can and should do more to actively encourage information vendors to implement and distribute the indicator information, specifically, that NYSE could amend its vendor contracts to require indicator display. NYSE respectfully disagrees that this is a realistic alternative. Rules dictating what market data must be displayed by vendors are properly the province of the SEC, and to date those rules have extended only to real time quote and trade information. Beyond that, market data is a service that responds to the needs and demands of subscribers, and the marketplace itself determines what ancillary information is made available over the screens of data vendors. If that is to change, it would be the province of the SEC to enact the additional requirements.

For this reason it is the position of the NYSE that it has responded in full to OCIE's recommendation regarding the use of an indicator for companies below financial continued listing standards.

2. <u>An indicator associated with a ticker symbol is not an effective method to convey complex information.</u>

Under the subheading "The Commission Has Authority to Ensure Early and Ongoing Notification of Noncompliant Issuers", the Report states that OCIE officials told the GAO staff that to date they had not explored with the SROs the possibility of using modifiers (or indicators) for noncompliance with qualitative listing standards, but that doing so "could be an important step in providing the public the information they need about issuers' noncompliance with these standards." One of the Report's recommendations then is that the SEC "work with [the SROs] to assess the feasibility of providing early and ongoing public notification of issuers' noncompliance with qualitative listing standards."

The NYSE has been responsive to suggestions that indicators be used as one mechanism to signal an issuer's noncompliance with financial continued listing status, or that the issuer is late in filing its annual report on Form 10-K. However, after much discussion and assessment of the types of actual situations that could arise, we are convinced that a ticker symbol indicator is not an appropriate or effective method to convey more complex, less binary, information. This would certainly be the case with respect to compliance with the various corporate governance standards of the SROs. There are a large number of such standards, and a variety of ways in which an issuer may be noncompliant. Some matters may be much more easily corrected than others; some situations may be considerably more serious than others. An attempt to use an indicator to convey a company's status with respect to these standards would homogenize the information, omitting content and color and making it difficult to assess the meaning of the indicator in any particular case. This, in turn, could lead people to ignore the indicator as a conveyor of useful information.

Separately, we think it is worth noting that the present mechanism through which the market data indicators are disseminated is technically limited in the number of different indicators that can be utilized, so that the cost to employ additional indicators would likely be significant – which would affect the cost/benefit analysis.

Of course, as the Report notes, this is not a matter that has yet been the subject of discussion between the SROs and the SEC. Nonetheless, in view of its discussion in the Report, we considered it worth giving our views.

B. The GAO recommendations regarding listed company supermajority board requirements and the separation of the role of chairman of the board and CEO.

The Report recommends that the SEC "work with the SROs to further enhance board independence by giving serious consideration to requiring issuers, through listing standards, to establish a supermajority of independent directors and to separate the positions of CEO and chairman."

The Report devotes a number of pages to discussing the opinions of various "market participants" regarding a number of corporate governance reforms, including the two mentioned above, and notes the divergent opinions that exist. The Report also accurately notes that we informed the GAO staff that our Corporate Accountability and Listing Standards Committee carefully considered both these issues and determined that they should not be among the recommendations for new standards. This does not mean that the NYSE considers these in any way inappropriate for companies that desire to adopt them, and many NYSE listed companies have boards with a supermajority of independent directors, and an increasing number of companies are separating the roles of chairman and CEO. The NYSE itself, in its new governance architecture, has a completely independent board but for the CEO, and has itself separated the roles of chairman and CEO. However, after careful consideration, and input from a variety of knowledgeable, experienced constituents, we did not consider either of these to be appropriate as a *requirement* for *all* listed companies at this time.

C. The GAO recommendation contemplating that OCIE staff would routinely use SRO internal review reports in planning and conducting inspections of the SROS.

The Report states that OCIE officials told the GAO staff that they do not routinely use SROs' internal review reports in planning and conducting inspections of the SROs, because OCIE is concerned that such routine use might make SRO employees less forthcoming in disclosing information to SRO internal review staff, and this chilling effect might outweigh the benefit to OCIE of reviewing the reports.

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The Report makes clear that this is not an access issue – that OCIE requests and is furnished such SRO reports when it considers it necessary. Nonetheless, the Report focuses on the fact that government auditing standards recommend the use of internal review reports, and accordingly the GAO has made the recommendation referred to above.

It is not a question of whether routinely reviewing the internal audit reports would be useful. Undoubtedly it would be, at least to a certain extent. The point, however, is its relative utility compared to the adverse effect it may have. Accordingly, we firmly support the position OCIE has taken on this issue.

D. NYSE's preparations to oversee listed company compliance with the new corporate governance standards.

The Report notes that OCIE plans to work with the SROs to ensure they have effective processes in place for evaluating issuers' compliance with the new corporate governance standards.

NYSE well understands that to be a part of OCIE's mission and expects to work closely with the SEC staff with respect to NYSE's oversight of the listed companies. We have already spent significant time and resources on our oversight plans, which are based on a combination of issuer self-certification, required public disclosure, and direct oversight. Our format will ask the issuers to specifically provide us with essential information, including pointing to precisely where required disclosures and discussion can be found in their proxy statements, web sites, and other relevant disclosure media. Our intent is to leverage the work we will require of our issuers to enable us to efficiently oversee their compliance with our requirements. We have already shared our program and plans with SEC officials, and we look forward to working with them to assure effective oversight.

The new corporate governance standards are a significant addition to the NYSE's requirements, and a significant addition to our oversight responsibility. We have as a result more than doubled the personnel, and made a significant investment in the technology, that we use to directly oversee company compliance. Our program will certainly evolve, but we have already spent considerable effort to expand our resources and build upon existing processes to create a thorough, effective and efficient program.

* * * *

I would like to again express the NYSE's appreciation for the opportunity to work with the GAO staff in their preparation of the Report, and for the opportunity to add our views by providing this letter. As always, if we can be of further assistance to GAO or to Congress, we would be pleased to do so.

Very truly yours,

GAO Contacts and Staff Acknowledgments

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Staff Acknowledgments

In addition to those named above, Rachel DeMarcus, Stefanie Jonkman, Marc Molino, Josephine Perez, Carl Ramirez, Barbara Roesmann, and Cory Roman made key contributions to this report.

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