

the "Staff Warning Letter" described in the proposed amendments to paragraph (e)(2) of NASD Rule 4450 and to make other minor, technical revisions.

III. Discussion

A. Approval of Revised Pilot Program

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the regulations thereunder applicable to the NASD.²³ In particular, the Commission believes that the proposal is consistent with Section 15A(b)(6) of the Act.²⁴ Section 15A(b)(6) requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general, to protect investors and the public interest.

During the 1980s, there was widespread concern about the occurrence of so-called penny stock fraud which prompted Congress to enact the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.²⁵ This legislation provided the Commission with expanded authority to regulate the market in securities with a low bid price. In light of these developments and that fact that the provisions of the Penny Stock Reform Act do not apply to any security listed on Nasdaq, the Commission in January 1990 wrote the NASD urging it to carefully scrutinize Nasdaq listing applications to ensure that low-priced securities fully complied with all applicable standards.²⁶ Nasdaq responded with a proposal to raise its listing standards by, among other things, adopting for the first time a requirement that an issuer maintain a minimum bid price. In its September 1991 approval order for that proposal, the Commission noted that there were two competing interests present. First, small, thinly capitalized companies had an interest in listing on Nasdaq to further their efforts to raise capital and grow their businesses. Second, Nasdaq had an interest in preventing suspect issuers from evading the Penny Stock Reform

Act by allowing them to list on Nasdaq.²⁷ More broadly, Nasdaq has an interest in establishing and maintaining investor confidence in the quality of securities that it allows to trade on its market. Nasdaq's listing regime is an ongoing effort to balance these two considerations, particularly with respect to the SmallCap Market, which is designed to allow smaller companies access to the capital markets.

Nasdaq's original bid price rules allowed a perpetual exemption from the \$1 bid price minimum if the issuer met heightened requirements for the market value of its public float and for the amount of capital and surplus.²⁸ In 1997, Nasdaq proposed to eliminate this alternative method of compliance, providing several reasons for doing so. First, Nasdaq believed that removing the exemption and enforcing a maintenance standard of a \$1 bid price for all Nasdaq issuers would "provide a safeguard against certain market activity associated with low-priced securities."²⁹ Second, Nasdaq pointed out that, when the exemption was adopted, it was intended to address "temporary adverse market conditions," not to create a permanent means of meeting the listing standards.³⁰ Third, Nasdaq believed that "a \$1 minimum bid price would serve to increase investor confidence and the credibility of its market commensurate with its increased prominence."³¹

Nasdaq's present proposal is in some ways a return to the alternate standard that was in effect from 1991 to 1997 since, under both regimes, an issuer can remain listed on Nasdaq if it meets heightened quantitative standards. Although the Commission found the alternate standard to be consistent with the Act in its 1991 approval order, the Commission now shares the concerns that prompted Nasdaq to rescind the alternative standard in 1997. An investor who purchases a security on the Nasdaq Stock Market should have reason to assume that the security has met all of the minimum standards to obtain a listing there, including the bid

price standard. Moreover, as Nasdaq observed in 1997, enforcing a minimum bid price helps deter abusive market activity sometimes associated with low-priced, thinly capitalized securities. The Commission agrees with the NASD's 1997 statement that the \$1 minimum bid price generally "serve[s] to increase investor confidence and the credibility of its market."³²

Furthermore, the Commission echoes Nasdaq's concern in rescinding the alternate standard that derogations from the bid price standard are meant to address "temporary adverse market conditions." The Commission agrees with Nasdaq that "at times companies experience temporary adverse market conditions that cause the share price of their security to fall below \$1 without having a serious impact on the health or viability of the company."³³ On that basis, the Commission was able to approve the alternate standard of compliance that allowed for the original, indefinite exemption from the bid price test. Nevertheless, an issuer should not be permitted to rely for an extended period of time on an exemption premised on "temporary adverse market conditions." The Commission is concerned that the length of the grace periods for bid price deficiency in this case raises concerns about investor protection. Transparency is one of the fundamental aspects of any set of listing standards. If a listing standard is suspended for too long, the standard is not transparent and the investor protection principles underlying the listing standards could be compromised.

Despite these concerns, the Commission does not presently have reason to believe that Nasdaq's proposal is inconsistent with the Act. The present proposal differs from the earlier alternative to the bid price test in that the grace periods now are only temporary (up to 2.0 years for the SmallCap Market and 1.5 years for the National Market), whereas under the old rules an issuer that met the heightened quantitative standards could keep its listing indefinitely despite a bid price below \$1. The present proposal also requires issuers that fail the bid price test to meet all of the initial listing criteria (except for the bid price test), whereas the old rules required issuers to meet just two heightened quantitative criteria (market value of the public float and amount of capital and surplus). These additional requirements that an issuer must meet to qualify for the grace periods should offer additional

²³ In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²⁴ 15 U.S.C. 78o-3(b)(6).

²⁵ Pub. L. 101-429, 104 Stat. 931 (October 15, 1990).

²⁶ See Securities Exchange Act Release No. 29638 (August 30, 1991), 56 FR 44108, 44109 (September 6, 1991) (approval of SR-NASD-90-18) ("1991 Approval").

²⁷ See 1991 Approval, 56 FR at 44111.

²⁸ See Securities Exchange Act Release No. 38469 (April 2, 1997), 62 FR 17262, 17262, 17268 (April 9, 1997) (proposing SR-NASD-97-16) ("1997 Proposal") (showing 1991 rules providing exemption from bid price maintenance standard). For the SmallCap Market, an issuer could use the exemption if the market value of its public float was at least \$1 million and it had capital and surplus of at least \$2 million. For the National Market, an issuer could use the exemption if the market value of its public float was at least \$3 million and it had capital and surplus of at least \$4 million.

²⁹ 1997 Proposal, 62 FR at 17269.

³⁰ *Id.*

³¹ *Id.*

³² 1997 Proposal, 62 FR at 17269.

³³ 1991 Approval, 56 FR at 44111.