

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 230

[Release No. 33-8754; File No. S7-18-06]

RIN 3235-AJ73

### Covered Securities Pursuant to Section 18 of the Securities Act of 1933

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("SEC" or "Commission") proposes for comment an amendment to a Rule under Section 18 of the Securities Act of 1933 ("Securities Act"), as amended, to designate certain securities listed on The NASDAQ Stock Market LLC ("Nasdaq") as covered securities for purposes of Section 18 of the Securities Act. Covered securities under Section 18 of the Securities Act are exempt from state law registration requirements.

**DATES:** Comments should be received on or before December 22, 2006.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-18-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-18-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You

should submit only information that you wish to make available publicly.

#### **FOR FURTHER INFORMATION CONTACT:**

Heather Seidel, Senior Special Counsel, (202) 551-5608, Hong-anh Tran, Special Counsel, (202) 551-5637 or Michou Nguyen, Special Counsel, (202) 551-5634, Division of Market Regulation ("Division"), Commission, 100 F Street, NE., Washington, DC 20549-6628.

#### **SUPPLEMENTARY INFORMATION:**

#### **I. Introduction**

In 1996, Congress amended Section 18 of the Securities Act to exempt from state registration requirements securities listed, or authorized for listing, on the New York Stock Exchange LLC ("NYSE"), the American Stock Exchange LLC ("Amex"), or the National Market System of The NASDAQ Stock Market LLC ("Nasdaq/NGM")<sup>1</sup> (collectively, the "Named Markets"), or any national securities exchange designated by the Commission to have substantially similar listing standards to those markets.<sup>2</sup> More specifically, Section 18(a) of the Securities Act provides that "no law, rule, regulation, or order, or other administrative action of any State \* \* \* requiring, or with respect to, registration or qualification of securities \* \* \* shall directly or indirectly apply to a security that—(A) is a covered security."<sup>3</sup> Covered securities are defined in Section 18(b)(1) of the Securities Act to include those securities listed, or authorized for listing, on the Named Markets, or securities listed, or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule are "substantially similar" to the Named Markets.<sup>4</sup>

Pursuant to Section 18(b)(1)(B) of the Securities Act, the Commission adopted Rule 146.<sup>5</sup> Rule 146(b) lists those national securities exchanges, or segments or tiers thereof, that the

Commission has determined to have listing standards substantially similar to those of the Named Markets and thus securities listed on such exchanges are deemed covered securities.<sup>6</sup> Nasdaq has petitioned the Commission to amend Rule 146(b) to determine that its listing standards for securities listed on the Nasdaq Capital Market ("NCM")<sup>7</sup> are substantially similar to those of the Named Markets and, accordingly, that securities listed pursuant to such listing standards are covered securities for purposes of Section 18(b) of the Securities Act.<sup>8</sup> If the Commission makes this determination, then securities listed on the NCM would be exempt from state law registration requirements.<sup>9</sup>

#### **II. Background**

In 1998, the Chicago Board Options Exchange, Incorporated ("CBOE"), Pacific Exchange, Inc. ("PCX") (now known as NYSE Arca, Inc.), the Philadelphia Stock Exchange, Inc. ("Phlx"), and the Chicago Stock Exchange ("CHX") petitioned the Commission to adopt a rule determining that specified portions of the exchanges' listing standards were substantially similar to the listing standards of the Named Markets.<sup>10</sup> In response to the petitions, and after extensive review of the petitioners' listing standards, the Commission adopted Rule 146(b), determining that the listing standards of the CBOE, Tier 1 of the PCX, and Tier 1 of the Phlx were substantially similar to those of the Named Markets and that securities listed pursuant to those standards would be deemed covered securities for purposes of Section 18 of the Securities Act.<sup>11</sup> Further, in 2004, the International Stock Exchange, Inc. ("ISE") petitioned the Commission to amend Rule 146(b) to determine that its listing standards for securities listed on ISE are substantially similar to those of the Named Markets and, accordingly,

<sup>6</sup> 17 CFR 230.146(b).

<sup>7</sup> The Nasdaq Capital Market was previously named the Nasdaq SmallCap Market.

<sup>8</sup> See letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Nancy M. Morris, Secretary, Commission, dated March 1, 2006 (File No. 4-513).

<sup>9</sup> 15 U.S.C. 77r.

<sup>10</sup> See letter from David P. Semak, Vice President, Regulation, PCX, to Arthur Levitt, Jr., Chairman, Commission, dated November 15, 1996; letter from Alger B. Chapman, Chairman, CBOE, to Jonathan G. Katz, Secretary, Commission, dated November 18, 1996; letter from J. Craig Long, Esq., Foley & Lardner, Counsel to CHX, to Jonathan G. Katz, Secretary, Commission, dated February 4, 1997 ("CHX Petition"); and letter from Michele R. Weisbaum, Vice President and Associate General Counsel, Phlx, to Jonathan G. Katz, Secretary, Commission, dated March 31, 1997.

<sup>11</sup> Securities Exchange Act Release No. 39542, *supra* note 5.

<sup>1</sup> As of July 1, 2006, the National Market System of The NASDAQ Stock Market LLC is known as the National Global Market. See Securities Exchange Act Release Nos. 53799 (May 12, 2006), 71 FR 29195 (May 19, 2006) and 54071 (June 29, 2006), 71 FR 38922 (July 10, 2006).

<sup>2</sup> See National Securities Markets Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (October 11, 1996).

<sup>3</sup> 15 U.S.C. 77r(a).

<sup>4</sup> 15 U.S.C. 77r(b)(1)(A) and (B). In addition, securities of the same issuer that are equal in seniority or senior to a security listed on a Named Market or national securities exchange designated by the Commission as having substantially similar listing standards to a Named Market are covered securities for purposes of Section 18 of the Securities Act. 15 U.S.C. 77r(b)(1)(C).

<sup>5</sup> Securities Exchange Act Release No. 39542 (January 13, 1998), 63 FR 3032 (January 21, 1998).

that securities listed pursuant to such listing standards are covered securities for purposes of Section 18(b) of the Securities Act.<sup>12</sup> The Commission subsequently amended Rule 146(b) to designate options listed on ISE as covered securities.<sup>13</sup>

Nasdaq has petitioned the Commission to amend Rule 146(b) with a determination that its listing standards for securities listed on the NCM are substantially similar to those of the Named Markets, and that NCM securities are “covered securities” under Section 18(b) of the Securities Act.

### III. Discussion

Under Section 18(b)(1)(A) of the Securities Act,<sup>14</sup> the Commission has the authority to compare the listing standards of a petitioner with those of either the NYSE, Amex, or Nasdaq/NGM. The Commission initially has compared Nasdaq’s listing standards for all NCM securities with only one of the Named Markets. If the listing standards in a particular category did not meet the standards of that market, the Commission compared the standards to the other two markets.<sup>15</sup> In addition, the Commission has interpreted the “substantially similar” standard to require listing standards at least as comprehensive as those of the Named Markets.<sup>16</sup> If a petitioner’s listing standards are higher than the Named Markets, then the Commission may still determine that the petitioner’s listing standards are substantially similar to the Named Markets. Finally, the Commission notes that differences in language or approach would not necessarily lead to a determination that the listing standards of the petitioner are not substantially similar to those of a Named Market.

The Commission has reviewed listing standards for securities traded on NCM<sup>17</sup> and, for the reasons discussed below, preliminarily believes that the standards overall are not substantially similar to those of a Named Market. However, Nasdaq has filed a proposed rule change to amend its quantitative

listing standards for NCM securities.<sup>18</sup> In view of Nasdaq’s proposed rule change, the Commission preliminarily believes that it could make a finding that the NCM’s listing standards are substantially similar to those of a Named Market, and thus amend Rule 146(b) to include securities listed on the NCM. The Commission also notes that Nasdaq’s qualitative listing standards for NCM securities are identical to the qualitative listing standards for Nasdaq/NGM securities.<sup>19</sup>

#### A. Common Stock

As discussed below, the Commission preliminarily believes that some, but not all, of the requirements in Nasdaq’s quantitative initial listing standards for common stock listing on the NCM are substantially similar to those of Amex’s common stock listing standards. The Commission therefore preliminarily believes that the NCM common stock initial listing standards are not currently substantially similar to those of Amex’s common stock listing standards.

Specifically the Commission preliminarily believes that the NCM listing requirements are substantially similar to Amex Standard 1 through 3 requirements relating to operating history, bid price, round lot holders,<sup>20</sup> and shares held by the public.<sup>21</sup> However, under the NCM standards, an issuer may qualify for listing by satisfying either a shareholder equity requirement (at least \$5 million),<sup>22</sup> a market value of listed securities test (at least \$50 million),<sup>23</sup> or an income test (at least \$750,000 in after tax net income

from continuing operations in the last fiscal year or two out of the last three fiscal years).<sup>24</sup> Amex’s common stock listing Standards 1 and 3 not only require the satisfaction of an equity test, but Standard 1 also requires the satisfaction of an income test (at least \$750,000 in pre-tax income from continuing operations in the last fiscal year or two of the last three fiscal years),<sup>25</sup> and Standard 3 also requires the satisfaction of a market value test (at least \$50 million).<sup>26</sup> Amex Standard 2 does not require an income test or a market value test but does require an operating history of two years<sup>27</sup> as compared to the NCM, which requires only one year.<sup>28</sup> An additional difference is that Amex Standards 2 and 3 require the aggregate market value of publicly held shares to be \$15 million, whereas Nasdaq’s requirement is \$5 million.<sup>29</sup> The Commission preliminarily believes that these differences preclude the Commission from making a determination that the NCM common stock initial listing standards are substantially similar to those of the Amex.

Nasdaq has filed a proposed rule change under Section 19 of the Exchange Act<sup>30</sup> to modify its NCM initial listing standards for common stock. Specifically, Nasdaq’s proposal would require an issuer to have: (i) Shareholder’s equity of \$4 million and net income from continuing operations of \$750,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years; (ii) shareholder’s equity of \$4 million and a market value of listed securities of \$50 million; or (iii) shareholder’s equity of \$5 million and a two-year operating history.<sup>31</sup> Moreover, Nasdaq’s proposal also would increase the aggregate market value of publicly held shares from \$5 million to \$15

<sup>18</sup> See Securities Exchange Act Release No. 54378 (August 28, 2006), 71 FR 52351 (September 5, 2006) (“Nasdaq Proposed Rule Change”); see also letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Heather Seidel, Senior Special Counsel, Division of Market Regulation (“Division”), Commission, dated August 11, 2006 (“Nasdaq Letter”).

<sup>19</sup> Such qualitative listing standards relate to, among other things, the number of independent directors required, conflicts of interest, composition of the audit committee, executive compensation, shareholder meeting requirements, voting rights, quorum, code of conduct, proxies, shareholder approval of certain corporate actions, and the annual and interim reports requirements. See Nasdaq Rule 4350.

<sup>20</sup> The Commission notes that the NCM listing standards require at least 300 round lot holders, while Amex’s listing standards require 400 or 800 (depending upon the number of shares held by the public), or 300 or 600 for its alternate listing standards. The Commission preliminarily does not believe this difference precludes a determination of substantial similarity between the standards.

<sup>21</sup> See generally Section 101 of the Amex Company Guide and Nasdaq Rule 4310.

<sup>22</sup> Nasdaq Rule 4310(c)(2)(A)(i).

<sup>23</sup> Nasdaq Rule 4310(c)(2)(A)(ii). The market value of listed securities refers to the closing bid price multiplied by the number of securities listed on Nasdaq or listed on another self-regulatory organization (“SRO”). See Nasdaq Rule 4200.

<sup>24</sup> Nasdaq Rule 4310(c)(2)(A)(iii).

<sup>25</sup> See Amex Rule 101(a)(1)–(2).

<sup>26</sup> See Amex Rule 101(c)(1)–(2).

<sup>27</sup> See Amex Rule 101(b)(1).

<sup>28</sup> See Nasdaq Rule 4310(c)(3).

<sup>29</sup> Specifically, Amex Standard 3, which allows an issuer to meet a requirement for the market value of listed securities of \$50 million (rather than an income test), requires an aggregate market value of publicly held shares of \$15 million (Amex Standard 2, which requires a two-year operating history, also requires an aggregate market value of publicly held shares of \$15 million). The NCM standard, which permits an issuer to meet either a market value of listed securities test or an income test, in either instance only requires an aggregate market value of publicly held shares of \$5 million. See Sections 101(b)(4) and (c)(3) of the Amex Company Guide and Nasdaq Rule 4310(c)(7)(A).

<sup>30</sup> 15 U.S.C. 78s.

<sup>31</sup> See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>12</sup> See letter from Michael Simon, Senior Vice President and General Counsel, ISE, to Jonathan G. Katz, Secretary, Commission, dated October 9, 2003.

<sup>13</sup> Securities Act Release No. 8442 (July 14, 2004), 69 FR 43295 (July 20, 2004).

<sup>14</sup> 15 U.S.C. 77r(b)(1)(A).

<sup>15</sup> This approach is consistent with the approach that the Commission has previously taken. See Securities Act Release Nos. 7422 (June 9, 1997), 62 FR 32705 (June 17, 1997) and 7494 (January 13, 1998), 63 FR 3032 (January 21, 1998).

<sup>16</sup> Securities Act Release No. 7422, *supra* note 15.

<sup>17</sup> See generally Nasdaq Rules 4310, 4320, and 4350.

million in scenario (ii) and (iii) above.<sup>32</sup> If these rule changes were approved prior to Commission action on this rule proposal, the Commission preliminarily believes it could find the NCM listing standards for common stock to be substantially similar to those of Amex.

The Commission preliminarily believes that the continued listing requirements for common stock listed on the NCM, while not identical, are substantially similar to those of Amex. Amex's delisting criteria are triggered by poor financial conditions or operating results of the issuer.<sup>33</sup> Specifically, Amex will consider delisting an equity issue if: (i) Stockholders' equity is less than \$2 million and such issuer has sustained losses from continuing operations and/or net losses in two of its three most recent fiscal years; (ii) stockholders' equity is less than \$4 million and such issuer has sustained losses from continuing operations and/or net losses in three of its four most recent fiscal years; (iii) stockholders' equity is less than \$6 million if such issuer has sustained losses from continuing operations and/or net losses in its five most recent fiscal years; or (iv) the issuer has sustained losses which are so substantial in relation to its overall operations or its existing financial resources, or its financial condition has become so impaired that it appears questionable, in the opinion of the Exchange, as to whether such company will be able to continue operations and/or meet its obligations as they mature.<sup>34</sup>

Although the NCM does not have the same continued listing provisions, Nasdaq also looks at the financial condition and operating results of the issuer. Specifically, for continued inclusion, Nasdaq requires shareholder's equity of at least \$2.5 million, market value of listed securities of at least \$35 million, or net income of \$500,000 from continuing operations in the past fiscal year or two out of three past fiscal years.<sup>35</sup> Further, Nasdaq requires a minimum bid price for

continued listing of \$1 per share.<sup>36</sup> In addition, for continued listing, Nasdaq requires an issuer to have a minimum number of publicly held shares of at least 500,000 shares with a market value of at least \$1 million.<sup>37</sup>

The Commission preliminarily believes that the differences in the maintenance criteria for common stock listed on Amex and on the NCM are not material and that, taken as a whole, the criteria are substantially similar.<sup>38</sup>

The Commission requests comment on whether the NCM's common stock listing rules are "substantially similar" to Amex's rules.

#### *B. Secondary Classes of Common Stock and Preferred Stocks*

The Commission notes that only Nasdaq has listing standards for the trading of a secondary class of common stock. A secondary class of common stock is a class of common stock of an issuer that has another class of common stock listed on an exchange. The Commission compared the secondary classes of common stock listing standards of the NCM with the listing standards of the Nasdaq/NGM. The Commission also compared the NCM listing standards for preferred stocks with those of Nasdaq's NGM.

With respect to the number of round lot holders,<sup>39</sup> bid price,<sup>40</sup> and number of

publicly held shares<sup>41</sup> requirements,<sup>42</sup> the Commission preliminarily believes that Nasdaq's initial and continued listing requirements for secondary classes of common stock and preferred stocks listing on the NCM are substantially similar to the listing standards for the Nasdaq/NGM. The Commission preliminarily believes, however, that the initial and continued listing requirements for market value of publicly held shares for NCM are not substantially similar to Nasdaq/NGM standards. In particular, the NCM listing standards require that there be at least 200,000 publicly held shares having a market value of at least \$2 million for initial listing and 100,000 publicly held shares having a market value of \$500,000 for continued listing.<sup>43</sup> The Nasdaq/NGM standards require that there shall be at least 200,000 publicly held shares having a market value of at least \$4 million for initial listing and 100,000 publicly held shares having a market value of \$1 million for continued listing.<sup>44</sup>

Nasdaq has filed a proposed rule change to increase the requirements for its NCM listing standards for both preferred and secondary classes of common stock for the market value of publicly held shares to \$3.5 million for initial listing and \$1 million for continued listing.<sup>45</sup> Nasdaq also has proposed to amend its initial and continued NCM listing rules for secondary classes of common stock and preferred stock to require that the common stock or common stock equivalent of the issuer either be listed on Nasdaq or be a covered security as defined in Rule 146(b).<sup>46</sup> Given these proposed revisions to the NCM's initial and continued listing standards for secondary classes of common stock and preferred stocks, the Commission preliminarily believes it could find that

<sup>36</sup> Nasdaq Rule 4310(c)(4). Amex will consider delisting if the price per share is "low." See Amex Rule 1003(f)(v).

<sup>37</sup> Nasdaq Rule 4310(c)(7)(A). Amex will consider delisting the common stock of an issuer if the aggregate market value of such publicly held shares is less than \$1 million for more than 90 consecutive days, the number of publicly held shares is less than 200,000 shares, or the number of its public stockholders is less than 300. See Section 1003(b) of the Amex Company Guide.

<sup>38</sup> As noted above, the Commission has interpreted the substantially similar standard to require listing standards at least as comprehensive as those of the Named Markets, and differences in language or approach of the listing standards are not dispositive.

<sup>39</sup> Both Nasdaq NCM and NGM require 100 round lot holders. See NASD Rules 4310(c)(6)(B) and 4420(k)(4). Nasdaq/NGM also requires 100 round lot holders for continued listing. Although the NCM requirements do not explicitly require a continuing number of round lot holders, Nasdaq has filed a proposed rule change to clarify that the 100 round lot holders requirement also will apply as a continued listing requirement for the NCM preferred and secondary classes of common stock standards. See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>40</sup> While the NCM bid price requirement for initial listing is \$4 and the Nasdaq/NGM requirement is \$5, the Commission preliminarily does not believe this difference is material. Both NGM and NCM require a \$1 bid price for continued listing. See Nasdaq Rules 4310(c)(4), 4420(k)(3), and 4450(h)(3).

<sup>41</sup> Both Nasdaq NCM and NGM require 200,000 publicly held shares for initial listing, and 100,000 publicly held shares for continued listing. See Nasdaq Rules 4310(c)(7)(B), 4420(k)(1), and 4450(h)(1).

<sup>42</sup> The Commission notes that these requirements apply to instances when the common stock or common stock equivalent security of the issuer is listed on Nasdaq/NGM, NCM, Global Select Market ("GSM") (the GSM is a segment of the NGM, see Securities Exchange Act Release Nos. 53799 and 54071, *supra* note 1), or another national securities exchange. If the common stock or common stock equivalent is not listed on one of these markets then the security must meet the common stock listing requirements for the relevant market (either Nasdaq/NGM or NCM). See generally NASD Rules 4310(c)(6)(B) and 4420(k).

<sup>43</sup> See Nasdaq Rules 4310(c)(7)(B).

<sup>44</sup> See NASD Rules 4420(k)(1)–(2) and 4450(h)(1)–(2).

<sup>45</sup> See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>46</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> See generally Sections 1001 through 1006 of the Amex Company Guide.

<sup>34</sup> See Section 1003(a) of the Amex Company Guide. Amex also will consider delisting if: (i) an issuer has sold or otherwise disposed of its principal operating assets or has ceased to be an operating company or has discontinued a substantial portion of its operations or business; (ii) if substantial liquidation of the issuer has been made; or (iii) if advice has been received, deemed by the Exchange to be authoritative, that the security is without value, or in the case of a common stock, such stock has been selling for a substantial period of time at a low price. See Section 1003(c) and (f)(v) of the Amex Company Guide.

<sup>35</sup> Nasdaq Rule 4310(c)(2)(B)(i)–(iii).

such standards are substantially similar to those of Nasdaq's NGM.

The Commission requests comment on whether the NCM secondary classes of common stock and preferred stock rules are "substantially similar" to Nasdaq/NGM's rules.

### C. Convertible Debt

The Commission has compared the NCM listing standards for convertible debt to Amex's listing standards for debt.<sup>47</sup> The Commission preliminarily does not believe that Nasdaq's standards are substantially similar to Amex's standards. Although the NCM's initial listing standards require a higher level of principal amount outstanding (the NCM standards require \$10 million versus \$5 million for Amex), Amex also requires that either (i) the issuer of the debt security (or an issuer that controls or is under common control with such issuer or that has guaranteed such issuer's debt) have equity securities listed on Amex, the NYSE, or Nasdaq/NGM, or (ii) that the debt security have a certain level of rating.<sup>48</sup>

Specifically, Amex will not list a debt security unless one of the following conditions is met: (i) The issuer of the debt security also has equity securities listed on Amex, the NYSE, or Nasdaq/NGM; (ii) an issuer of equity securities listed on Amex, the NYSE, or Nasdaq/NGM directly or indirectly owns a majority interest in, or is under common control with, the issuer of the debt security; (iii) an issuer of equity securities listed on Amex, the NYSE, or Nasdaq/NGM has guaranteed the debt security; (iv) a nationally recognized securities rating organization (an "NRSRO") has assigned a current rating to the debt security that is no lower than an S&P Corporation "B" rating or equivalent rating by another NRSRO; or (v) if no NRSRO has assigned a rating to the issue, an NRSRO has currently assigned an investment grade rating to

an immediately senior issue or a rating that is no lower than an S&P Corporation "B" rating, or an equivalent rating by another NRSRO, to a *pari passu* or junior issue.<sup>49</sup> This requirement is designed to ensure that the issuer (or guarantor) of a debt security listed on Amex is in reasonably sound financial condition, while also providing Amex with considerable flexibility in determining which debt issues qualify for listing on the Exchange.<sup>50</sup> The Commission preliminarily believes that the absence of these provisions would make the NCM's initial listing standards for debt securities not substantially similar to those of Amex.

Nasdaq has filed a proposed rule change to adopt a debt rating provision similar to Amex's provision to make its NCM initial listing standards more comparable to Amex's initial listing standards.<sup>51</sup> In light of this proposal, the Commission preliminarily believes it could find that the NCM's listing standards for convertible debt are substantially similar to those of Amex.

The Commission preliminarily believes that the continued listing requirements for convertible debt securities listed on the NCM are substantially similar to the Amex requirements. The NCM requires that the principal amount outstanding be maintained at \$5 million.<sup>52</sup> Amex generally will delist a bond if the aggregate market value or the principal amount of the bond publicly held is less than \$400,000, or if the issuer is not able to meet its obligations on the listed debt.<sup>53</sup> Although not identical, the Commission preliminarily believes that both standards are designed to ensure the continued liquidity of the debt security, and are substantially similar.

The Commission requests comment on whether the NCM convertible debt listing rules are "substantially similar" to Amex's listing standards for debt securities.

### D. Warrants

The Commission has compared the NCM's standards for warrants to

Nasdaq's NGM standards, and preliminarily believes that the NCM standards are not substantially similar to the Nasdaq/NGM standards. The NCM initial listing standards require that 100,000 warrants be outstanding for initial listing, whereas Nasdaq/NGM requires that there be 450,000 warrants outstanding.<sup>54</sup> Further, the NCM standards require the issuer's underlying security to be traded on Nasdaq/NGM, NCM, GSM or any national securities exchange.<sup>55</sup> Nasdaq therefore allows the underlying security to be traded on markets that the Commission has not determined to be substantially similar to Amex, the NYSE, or Nasdaq/NGM under Rule 146(b).<sup>56</sup> In addition, the NCM does not have any continuing maintenance standards for warrants whereas Nasdaq/NGM requires that the underlying security of the issuer must continue to be listed on Nasdaq/NGM.<sup>57</sup>

Nasdaq has filed a proposed rule change with the Commission to increase the required number of warrants outstanding for initial listing on the NCM from 100,000 to 400,000.<sup>58</sup> Nasdaq's proposal also would require for initial listing that the security underlying the warrant that is to be listed on the NCM be a covered security as defined in Rule 146(b) (if it is listed on a market other than Nasdaq).<sup>59</sup> Further, Nasdaq would require that the security of the issuer underlying the warrant continue to be listed on Nasdaq or be a covered security as defined in Rule 146(b).<sup>60</sup> Given these proposed revisions to the NCM's warrant listing standards, the Commission preliminarily believes it could find the NCM's listing standards for warrants to be substantially similar to those of Nasdaq/NGM.

The Commission requests comment on whether the NCM's listing rules for warrants are "substantially similar" to Nasdaq/NGM's listing rules.

### E. Index Warrants

For index warrants traded on the NCM, Nasdaq has adopted the same standards (both initial and continuing) that it applies to index warrants traded

<sup>47</sup> See generally Nasdaq Rule 4310(c)(5) and Sections 104 and 1003 of the Amex Company Guide.

<sup>48</sup> See Section 104 of the Amex Company Guide and Nasdaq Rule 4310(c)(5). Amex also will generally not list a convertible bond or debenture unless current last sale information is available in the United States, with respect to the underlying security into which the bond or debenture is convertible. Further, Amex will not list a convertible debt issue containing a provision permitting an issuer discretion to reduce the conversion price unless the issuer establishes a minimum 10-day period within which such price reduction will be in effect. See Section 104 of the Amex Company Guide. The Commission preliminarily believes that these provisions are not material to its determination. See Securities Act Releases No. 7494, *supra* note 15 (the Commission found PCX listing standards to be substantially similar to Amex even with the absence of these provisions).

<sup>49</sup> See Section 104 of the Amex Company Guide.

<sup>50</sup> See Securities Exchange Act Release No. 7422, *supra* note 15.

<sup>51</sup> See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>52</sup> See Nasdaq Rule 4310(c)(5).

<sup>53</sup> See Section 1003(b)(iv) of the Amex Company Guide. Section 1003(e) of the Amex Company Guide states that convertible bonds will be reviewed when the underlying security is delisted and will be delisted when the underlying security is no longer the subject of real-time reporting in the United States. The Commission does not believe that this is material because although Nasdaq does not have an identical rule, it does have the discretion to delist beyond its standards.

<sup>54</sup> See Nasdaq Rules 4310(c)(9)(A)-(B) and 4420(d).

<sup>55</sup> See Nasdaq Rule 4310(c)(9)(A)-(B).

<sup>56</sup> In contrast, Nasdaq's NGM standards require the issuer of the warrant to meet its common stock "price and earnings" listing requirements. See Nasdaq Rule 4420(d).

<sup>57</sup> See Nasdaq Rule 4450(d).

<sup>58</sup> See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

on the Nasdaq/NGM market.<sup>61</sup> Therefore, the Commission preliminarily believes that the listing standards for index warrants traded on the NCM are substantially similar to the standards applicable to index warrants traded on the Nasdaq/NGM market.

#### F. Units

The NCM, Amex, and Nasdaq/NGM all evaluate the initial and continued listing of a unit by looking to its components.<sup>62</sup> If all of the components of a unit individually meet the standards for listing, then the unit would meet the standards for listing.<sup>63</sup> The Commission preliminarily believes that it would be able to make a finding that the NCM listing standards for units are substantially similar to a Named Market in light of Nasdaq's proposed revisions to its NCM's listing standards for the different categories of securities that could make up the components of a unit, as discussed above.<sup>64</sup>

#### G. Other Changes

Sections (b)(1) and (b)(2) of Rule 146 use the term "Nasdaq/NMS" to refer to the National Market System of The NASDAQ Stock Market LLC. In addition, Rule 146(b)(1)(i) refers to the Pacific Exchange Incorporated, Rule 146(b)(1)(ii) refers to the Philadelphia Stock Exchange, Incorporated, and Rule 146(b)(1)(iv) refers to the International Securities Exchange, Incorporated. As noted above, on July 1, 2006, what was the National Market System of The NASDAQ Stock Market LLC became known as the Nasdaq Global Market.<sup>65</sup> Further, in April 2006, the Pacific Exchange, Incorporated was renamed NYSE Arca, Inc.,<sup>66</sup> and in September 2006, the International Securities Exchange, Incorporated was renamed the International Securities Exchange, LLC. The proposed rule change includes changes to Rule 146(b) to account for these name changes. Finally, the proposal includes a change to reflect the

legal name of the Philadelphia Stock Exchange, Inc.

#### H. Comments

The Commission has received three comment letters on Nasdaq's petition.<sup>67</sup> The State Regulation of Securities Committee of the American Bar Association Section of Business Law ("ABA Committee") expressed support of the petition, assuming that Nasdaq's representation of the data and analysis contained in the petition is accurate.<sup>68</sup> The North American Securities Administrator's Association ("NASAA"), stated that it does not oppose the Nasdaq petition but is concerned generally about what it perceives to be deficiencies in listing standards at several of the Named Markets and encourages the Commission to undertake an SRO oversight initiative to set uniform principles for these Named Markets.<sup>69</sup>

#### IV. Solicitation of Comments

The Commission seeks comment generally on the desirability of amending Rule 146(b) to include securities of the NCM. As discussed above, based on its review of Nasdaq's listing rules for its NCM, the Commission preliminarily believes that the current original and continued listing standards for the NCM are not substantially similar to those of the Amex, the NYSE, or Nasdaq/NGM. The Commission seeks comments on its preliminary analysis. The Commission also seeks comments on whether the proposed changes to its NCM standards that Nasdaq has filed would make the NCM's initial listing and continued listing standards substantially similar to those of a Named Market.

In addition, if the NCM securities are designated as covered securities under Rule 146(b)(1), then the NCM's listing standards would be subject to Rule 146(b)(2) under the Securities Act. Rule 146(b)(2) conditions the designation of securities as "covered securities" under Rule 146(b)(1) on the identified

exchange's listing standards continuing to be substantially similar to those of the Named Markets. Thus, under Rule 146(b)(2), the designation of certain securities as covered securities would be conditioned on Nasdaq maintaining listing standards for NCM securities that were found to be substantially similar to those of the Named Markets. Commenters may wish to address the application and effect of Rule 146(b)(2) on the proposal.

The Commission also invites commenters to provide views and data as to the costs, benefits, and effects associated with the proposed amendments. In addition to the questions posed above, commenters are welcome to offer their views on any other matter raised by the proposed amendment to Rule 146(b). Finally, the Commission requests comment on whether it could use a different methodology to determine whether the NCM's listing standards are "substantially similar" to the Named Markets.

#### V. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 does not apply because the proposed amendment to Rule 146(b) does not impose recordkeeping or information collection requirements or other collection of information, which require the approval of the Office of Management and Budget under 44 U.S.C. 3501 *et seq.*

#### VI. Cost and Benefits of Proposed Rulemaking

Congress amended Section 18 of the Securities Act to exempt covered securities from state registration requirements. These securities are listed on the Named Markets or any other national securities exchange determined by the Commission to have substantially similar listing standards to the Named Markets.<sup>70</sup> Consistent with statutory authority, the Commission proposes to determine (if the Commission were to approve the rule changes that Nasdaq has filed) that the listing standards for securities listed on the NCM are substantially similar to those of either Amex, the NYSE, or Nasdaq/NGM. Securities listed on the NCM therefore would be covered securities subject only to federal regulation.

By exempting securities listed on the NCM from state law registration requirements, the Commission expects that the listing process for those securities would become easier as one layer of regulation is eliminated. Moreover, the Commission also expects

<sup>61</sup> See generally Nasdaq Rule 4310(c)(9)(C).

<sup>62</sup> A unit is a type of security consisting of two or more different types of securities (e.g., a combination of common stocks and warrants). See Securities Exchange Act Release No. 48464 (September 9, 2003), 68 FR 54250 (September 16, 2003).

<sup>63</sup> See generally Section 101(g) of the Amex Company Guide and Nasdaq Rules 4310(c)(10) and 4420(h)(1)(a)-(c).

<sup>64</sup> See Nasdaq Proposed Rule Change, *supra* note 18.

<sup>65</sup> The NGM includes a new segment known as the Nasdaq Global Select Market. See Securities Exchange Act Release Nos. 53799 and 54071, *supra* note 1.

<sup>66</sup> See Securities Exchange Act Release No. 53615 (April 7, 2006), 71 FR 19226 (April 13, 2006).

<sup>67</sup> See File No. 4-513, *supra* note 8.

<sup>68</sup> See letter to Nancy M. Morris, Secretary, Commission, from Alan M. Parness, Vice Chair, ABA Committee, dated April 3, 2006.

<sup>69</sup> See letter to Nancy M. Morris, Secretary, Commission, from Patricia D. Struck, NASAA President and Wisconsin Securities Administrator, dated March 29, 2006; and electronic mail to Robert L.D. Colby, Acting Director, Division Commission, from Randall Schumann, Legal Counsel, Wisconsin DFI-Division of Securities, NASAA Corporation Finance Section Member, dated June 1, 2006. In addition, the Commission's Advisory Committee on Smaller Public Companies recommended on April 23, 2006 that the Commission make NCM stocks "covered securities." SEC Advisory Committee on Smaller Public Companies, Final Report, at 97-100 (2006).

<sup>70</sup> 15 U.S.C. 77r(b)(1)(B).

adoption of the rule would reduce the administrative burden the issuers of covered securities face inasmuch as compliance with state blue sky law requirements would be preempted.<sup>71</sup>

The Commission also preliminarily believes that the proposed amendment to Rule 146(b) should permit Nasdaq to compete with other markets whose listed securities are exempt from state law registration requirements for new securities products and listings. This result would likely enhance competition and, potentially, liquidity, thus benefiting market participants and the public. The proposed amendment would eliminate state registration of securities listed on the NCM. There may be a cost to investors through the loss of benefits of state registration and oversight, although the cost is difficult to quantify. The Commission believes that Congress contemplated these costs in relation to the economic benefits of exempting covered securities from state regulation. The Commission, however, is considering the costs and benefits of the proposed amendment to Rule 146(b) and requests commenters to provide views and supporting information as to the costs and benefits associated with this proposal.

#### VII. Consideration of Promotion of Efficiency, Competition, and Capital Formation

As required under the Securities Act,<sup>72</sup> the Commission has preliminarily considered the proposed rule's impact on efficiency, competition, and capital formation. National securities exchanges compete for the listing of securities. Thus, the Commission preliminarily believes that amending Rule 146(b) to designate securities traded on the NCM as covered securities (if the Commission were to approve the rule changes that Nasdaq has filed) would offer potential benefits for investors because it would facilitate the ability of Nasdaq to compete for listings, which should increase competition and enhance the overall liquidity, and thus the efficiency of the U.S. securities markets. The Commission also preliminarily believes that the proposed rule would serve to reduce the cost of raising capital because it would streamline the registration process for issuers listing on

the NCM. In addition, the Commission believes that the proposed rule amendment, consistent with Congressional action, is designed to promote efficiency by removing a layer of duplicative regulation. The Commission also preliminarily believes that the proposed amendment to Rule 146(b) should permit Nasdaq to compete with other markets whose securities are exempt from state law registration requirements for new securities products and listings. Finally, the proposed amendment to Rule 146(b) should not impair efficiency, competition, and capital formation because it would impose no recordkeeping or compliance burdens, but would provide a limited purpose exemption under the federal securities laws.

Thus, the Commission preliminarily believes that the proposed amendment to Rule 146(b) would promote efficiency, competition, and capital formation. Commenters should consider the proposed amendment's effect on efficiency, competition, and capital formation.

#### VIII. Regulatory Flexibility Act Certification

Section 603(a) of the Regulatory Flexibility Act<sup>73</sup> requires the Commission to undertake an initial regulatory flexibility analysis of the proposed amendment to Rule 146 on small entities, unless the Commission certifies that the proposed amendment, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>74</sup> For purposes of Commission rulemaking in connection the Regulatory Flexibility Act, an issuer is a small business if its "total assets on the last day of its most recent fiscal year were \$5 million or less."<sup>75</sup> An exchange is a small business if it has been exempt from the reporting requirements of Rule 601<sup>76</sup> and it is not affiliated with any person other than a natural person that is not a small business.<sup>77</sup>

The Commission believes that the proposal to amend Rule 146(b) would not affect a substantial number of small entities because to list its securities on the NCM, an issuer's aggregate market value of publicly held shares must be at least \$5 million.<sup>78</sup> If an entity's market

value of publicly held shares is at least \$5 million, it is reasonable to believe that its assets are worth at least \$5 million. Therefore, an entity seeking to list securities on the NCM generally will have assets with a market value of at least equal to \$5 million and thus would not be considered a small entity. Further, Nasdaq itself is not a small entity for purposes of the RFA.<sup>79</sup>

Accordingly, the Commission hereby certifies, pursuant to Section 605(b) of the Regulatory Flexibility Act,<sup>80</sup> that amending Rule 146(b) as proposed would not have a significant economic impact on a substantial number of small entities. The Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed amendment to Rule 146(b) could have an effect that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

#### IX. Small Business Regulatory Enforcement Fairness Act of 1996

For purposes of the Small Business Enforcement Fairness Act of 1996, a rule is "major" if it results or is likely to result in:

- (i) An annual effect on the economy of \$100 million or more;
- (ii) A major increase in costs or prices for consumers or individual industries;
- or
- (iii) significant adverse effects on competition, investment, or innovation.<sup>81</sup>

The Commission requests comment regarding the potential impact of the proposed amendment on the economy on an annual basis. Commenters should provide empirical data to support their views to the extent possible.

#### X. Statutory Authority

The Commission is proposing an amendment to Rule 146 pursuant to the Securities Act of 1933,<sup>82</sup> particularly Sections 18(b)(1)(B) and 19(a).<sup>83</sup>

#### Text of the Proposed Rule

##### List of Subjects in 17 CFR Part 230

Securities.

For the reasons set forth in the preamble, Title 17, Chapter II of the *Code of Federal Regulations* is proposed to be amended as follows:

<sup>79</sup> 17 CFR 240.0–10(e).

<sup>80</sup> 5 U.S.C. 605(b).

<sup>81</sup> Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C., and as a note to 5 U.S.C. 601).

<sup>82</sup> 15 U.S.C. 77a *et seq.*

<sup>83</sup> 15 U.S.C. 77r(b)(1)(B) and 77s(a).

<sup>71</sup> A 1996 Report relating to Securities Market Reform: State Registration of Securities—Costs and Benefits stated that up to 1 percent of an issue's cost, which is generally covered by the offering's underwriter, could be apportioned to the legal/administrative costs of state level regulation. One benefit of this proposal would be to eliminate this type of legal/administrative cost with respect to NCM securities.

<sup>72</sup> 15 U.S.C. 77b(b).

<sup>73</sup> 5 U.S.C. 603(a).

<sup>74</sup> 5 U.S.C. 605(b).

<sup>75</sup> 17 CFR 230.157. *See also* 17 CFR 240.0–10(a).

<sup>76</sup> 17 CFR 242.601 (formerly Rule 11Aa3–1 under the Act).

<sup>77</sup> 17 CFR 240.0–10(e).

<sup>78</sup> As of June 30, 2006, the Division estimates that there were 557 listed issuers of securities on the NCM.

**PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933**

1. The general authority citation for Part 230 is revised to read as follows:

**Authority:** 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

\* \* \* \* \*

2. Section 230.146 is amended by revising paragraphs (b)(1) and (b)(2) to read as follows:

**§ 230.146 Rules under Section 18 of the Act.**

\* \* \* \* \*

(b) \* \* \*

(1) For purposes of Section 18(b) of the Act (15 U.S.C. 77r), the Commission finds that the following national securities exchanges, or segments or tiers thereof, have listing standards that are substantially similar to those of the New York Stock Exchange (“NYSE”), the American Stock Exchange (“Amex”), or the National Market System of the Nasdaq Stock Market (“Nasdaq/NGM”), and that securities listed on such exchanges shall be deemed covered securities:

- (i) Tier I of the NYSE Arca, Inc.;
- (ii) Tier I of the Philadelphia Stock Exchange, Inc.;
- (iii) The Chicago Board Options Exchange, Incorporated;

(iv) Options listed on the International Securities Exchange, LLC; and

(v) The Nasdaq National Capital Market.

(2) The designation of securities in paragraphs (b)(1)(i) through (v) of this section as covered securities is conditioned on such exchanges’ listing standards (or segments or tiers thereof) continuing to be substantially similar to those of the NYSE, Amex, or Nasdaq/NGM.

Dated: November 16, 2006.

By the Commission.

**Nancy M. Morris,**  
*Secretary.*

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