United States General Accounting Office

GAO

Report to Congressional Requesters

May 1994

# AMERICAN STOCK EXCHANGE

## More Changes Needed in Screening Emerging Companies for the Marketplace

**RESTRICTED--Not to be released outside the General Accounting Office unless specifically approved by the Office of Congressional Relations.**

RELEASED

GAO/GGD-94-72

GAO

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

**General Government Division**

B-256792

May 25, 1994

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on Telecommunications
and Finance
Committee on Energy and Commerce
House of Representatives

In March 1992, the American Stock Exchange (Amex) began trading equity securities on its Emerging Companies Marketplace, which Amex developed for companies too small to qualify for a standard Amex listing. That same month, an Amex official questioned the Marketplace listing of a company whose majority stockholder had been barred from trading activities on Amex for violations of the exchange's trading rules. Shortly thereafter, media reports included allegations that individuals with histories of criminal and regulatory violations were associated with two other Marketplace-listed companies. In response to your concerns about Amex's procedures for screening companies for the Marketplace, we reviewed Amex's method for deciding whether to approve a company's securities for Marketplace listing and trading.

In accordance with your request, this report provides information on (1) Amex's screening procedures for assessing the reputation of the management and stockholders of companies seeking a Marketplace listing and (2) the extent to which Amex ensures that companies approved for Marketplace listing meet all criteria required for such approval.

## Background

Amex, one of the major U.S. exchanges for trading equity securities, created the Marketplace as an "incubator" for companies too small to qualify for its regular list. Amex believed that a listing on the Marketplace would provide increased liquidity[1] and visibility for companies and their securities. Amex submitted to the Securities and Exchange Commission (SEC) its proposal for the Marketplace in October 1991 and began screening companies for listing in December 1991. The first Marketplace

[1]Liquidity in the stock market refers to the ability of investors to buy or sell a given quantity of a stock quickly at the best trade price.

trades were made on March 18, 1992. As of April 1, 1994, 52 companies had been listed and traded on the Marketplace.

Amex's published rules prescribe a two-step screening process for the exchange's assessment of Marketplace eligibility.[2] First, to determine whether a company meets specific quantitative requirements, an Amex analyst is to review the company's total assets, capital and surplus, the market value of all its shares, total public shares, number of public shareholders, and market price per share. (App. I contains details on the quantitative requirements.) The analyst is then to consider the company's suitability for listing on the basis of five qualitative factors: (1) the reputation of the company's management, (2) the nature of its business, (3) its commercial prospects and future outlook, (4) its historical record and pattern of growth, and (5) its financial integrity. If the analyst is satisfied that the company has met or will meet the qualitative factors and all quantitative requirements before trading, a memorandum is to be forwarded to Amex's Special Committee on Listing. The committee, which is composed of Amex specialists,[3] brokers (inside members), and investment experts (outside members), is to consider qualitative factors for each company. If the committee approves the company for listing, a resumé is to be prepared documenting that the company has or will meet all quantitative requirements before trading. The resumé, when signed by the Amex analyst and senior Amex officials, documents final approval of the company for trading on the Marketplace.

Not all companies approved by the committee were listed and traded; some withdrew their applications, and others were rejected by Amex officials because of additional information received regarding compliance with Marketplace quantitative or qualitative requirements.

## Results in Brief

Following the allegations that individuals with questionable reputations were associated with three Marketplace-listed companies, Amex improved its assessments of the reputation of the management of companies seeking a Marketplace listing. Before the allegations, Amex obtained information mainly from annual reports, proxy statements, and other documents required by the SEC. However, such documents do not always list everyone

[2]These rules were published in the Federal Register at the time they were proposed and again at the time of their approval by the SEC. They also appear in Amex's rule book and Marketplace marketing literature.

[3]A specialist is an exchange member designated to handle transactions of a particular company on the trading floor and maintains an orderly market for the trading.

in a position to influence Marketplace companies or provide information on their criminal histories. Amex expanded its information sources to include additional data from the SEC, internal Amex sources, an automated system operated by the National Association of Securities Dealers (NASD), and two commercially available automated systems. Amex also expanded the scope of its assessments to include major stockholders and other individuals in a position to influence the company. In addition, Amex revised the committee's assessment procedures. For example, Amex disallowed voting by absentee ballot to encourage a wider exchange of views among committee members before the decision to approve or disapprove a company for Marketplace listing.

We found weaknesses in Amex's practices of assessing companies' qualifications for Marketplace listings. Although Amex's rules did not indicate that any of the qualitative factors considered were more important than others, Marketplace listing decisions emphasized two factors over others: (1) the company's commercial prospects and future outlook and (2) the reputation of its management. The three other qualitative factors—(1) the nature of the company's business, (2) its historical record and pattern of growth, and (3) its financial integrity—were given less emphasis. In fact, 13 of the 18 Marketplace-traded companies in our sample had no revenues and earnings, declining revenues and earnings, or negative cash flows, according to information in Amex's screening files. We believe that Amex's failure to disclose the relative importance of the qualitative factors could mislead investors regarding Marketplace eligibility standards. Finally, Amex did not always properly document that Marketplace-listed companies met all quantitative requirements before being traded. Without such documentation, Amex cannot assure the SEC and others of the soundness of the Amex analysts' and committee's decisions to approve companies for Marketplace listing.

## Objectives, Scope, and Methodology

To obtain information on Amex's procedures for assessing the reputation of management and others associated with companies seeking a Marketplace listing, we reviewed Amex's procedures for screening companies for the Marketplace. We discussed these procedures, as well as the changes made to them, with Amex officials responsible for reviewing and approving companies for the Marketplace. We also discussed these procedures with officials of a law firm retained by Amex to assess the Marketplace screening process and reviewed a report containing the results of the firm's work. In addition, we interviewed four members of the committee to obtain their views on the adequacy of information they receive from Amex to assess the merits of a company's listing application.

To determine whether Amex was applying its screening procedures, we judgmentally selected a sample of listing actions. Our sample consisted of 45 of the 212 companies Amex screened from December 1991 through December 31, 1992. Our sample included 18 companies that were approved and traded on the Marketplace, 8 that were approved but were not traded, and 19 that Amex disapproved. We selected our sample to provide a variety of listing decisions. Our sample included companies that Amex considered (1) before Marketplace trading began through March 1992; (2) from April through August 1992, a transition period during which Amex was revising its screening procedures; and (3) from September 1992 through December 1992, the period that Amex's revised procedures were in effect.

For each of the companies in our sample, we reviewed Amex's Marketplace screening files. Among the documents in these files were financial reports, proxy statements, market price per share data, the results of background investigations of company managers and other officials, minutes of committee meetings, and Amex assessment and approval documents. We used these documents to determine if each company in our sample satisfied Amex's quantitative requirements for total assets, capital and surplus, total public shares, total market value of its shares, number of public shareholders, and minimum market price per share. These documents also provided us information on the prior history, future prospects, and other qualitative attributes of each company as well as Amex's assessment of these qualitative factors. We also reviewed the minutes of the committee meetings at which these companies were discussed. Finally, we interviewed Amex staff and committee members to obtain their views on the significance they assign to each of the five qualitative factors.

To determine if Amex documented that all companies met the mandatory quantitative requirements before their securities were traded, we compared the data in the memorandum and resumé to the mandatory quantitative requirements for all of the 32 companies that had been approved and traded on the Marketplace as of December 31, 1992.

To gain a further understanding of the Marketplace screening process, we reviewed a report containing the results of an SEC inspection of the Marketplace listing procedures and interviewed the officials responsible for its preparation. The SEC's inspection was carried out in accordance with your July 1992 request. Since the contents of the report are confidential, they are only generally characterized in this report.

Our work was performed in New York, NY, and Washington, D.C., between November 1992 and September 1993 in accordance with generally accepted government auditing standards. We obtained written comments from SEC and Amex on a draft of this report. We have included their written comments in appendixes II and III and summarized and evaluated them at the end of this letter.

## Amex Expanded Its Assessments of Individuals Associated With Companies

Following the allegations, Amex took steps to improve its method of assessing the reputations of individuals associated with companies seeking Marketplace listing. Basically, Amex expanded the types of individuals to be assessed as well as the information sources to be used in the assessments. Amex also improved the decision-making procedures of the committee.

### Amex Expanded the Scope of Assessments and Information Sources

As a result of the allegations, Amex improved its procedures for assessing the reputation of the management of companies seeking a Marketplace listing. Before the allegations surfaced, Amex assessed the reputation of company management primarily on the basis of documents such as the company's annual report (Form 10-K) and proxy statement.[4] These documents, if completed in accordance with SEC requirements, contain biographical data on management, including any citations for violations of securities law in the most recent 5-year period. Amex also used these documents, and discussions with company officials, for its assessment of a company's business, history, future outlook, and other qualitative factors.

Around April and August 1992, Amex adopted revisions to its procedures partially on the basis of recommendations of the law firm it retained to analyze its screening process. These revisions required Amex to expand its assessments to include such individuals as major stockholders, underwriters, investment bankers, and others in a position to influence companies seeking a Marketplace listing. Amex is to develop a list of such

[4]The SEC requires that background information on officers and directors be contained in the Form 10-K, or that the Form 10-K refer the reader to other documents filed with the SEC where this information appears. The Form 10-K is an annual report containing financial statements and other company-related information; the proxy statement informs stockholders of matters to be voted on at a company's annual meeting and includes, among other things, information on the company's business and management.

persons from the annual reports and other information reviewed during the screening process. The revisions also required Amex to obtain assessment information from additional sources. These sources included SEC's Enforcement Division, Amex officials responsible for regulatory surveillance and compliance activities, and three automated systems of information. One such system, the Central Registration Depository, operated by NASD, contains, among other information, a database of individuals and organizations in the securities industry, including any violations of securities laws, regulations, and rules. SEC, U.S. stock exchanges, NASD, and state regulators of the securities industry contribute information to this system. Two other automated systems, which are privately owned and operated, contain databases with information from selected newspapers and magazines.

These improved procedures provided information that contributed to Amex's decision to reject some companies' applications for Marketplace listing. Of the 45 company listing actions we reviewed, 27 occurred under the new procedures and involved database searches. The remaining 18 companies were not subject to database searches because they were reviewed before implementation of the revised procedures or they were rejected before a search was conducted. Of the 27 cases, the database searches identified 19 companies associated with persons or companies disciplined for securities violations. Of these 19 companies

- 6 were rejected for listing partially on the basis of the negative information;
- 8 were listed because Amex determined that the violations were minor, occurred in the distant past, or involved individuals not associated with the company seeking Marketplace listing;
- 3 withdrew their applications for listing; and
- 2 were being analyzed for listing at the time of our review.

## Amex Revised the Committee Decision-Making Procedures

In March and September 1992, Amex revised committee procedures to address weaknesses identified by Amex, the law firm Amex retained to review Marketplace listing procedures, and SEC. Under the old procedures, committee members were allowed to vote on a company's listing even if they were not present to discuss the company's compliance with Marketplace requirements. Before the March revision, the committee approved 16 companies entirely by absentee balloting and without discussion among committee members. The revised procedures limit voting to members attending the discussion or participating by teleconference. Committee members told us that the revised voting procedures have increased information shared among members and promoted more comprehensive discussions of companies' history, prospects, reputation of management, and other qualitative factors.

In addition, in September 1992 Amex instituted procedures that preclude a committee member with a financial interest in a company under review from influencing the committee's decision about that company. More specifically, the procedures prohibit committee members from participating in discussions and voting if they are associated with the subject company's underwriter or have expressed an interest in becoming the Amex specialist for the company. These members are also to be barred from receiving confidential information, such as the company's future marketing plans, obtained by Amex during the screening process.

## Differences Existed Between Amex's Eligibility Rules and Practices

Differences existed between Amex's published rules for assessing companies' qualifications and those we found in practice. The first difference involves a discrepancy between the rules for assessing qualitative attributes of companies and Amex's assessment practices. The second difference relates to Amex's inadequate documentation of Marketplace companies' compliance with all quantitative listing requirements. These observations are similar to those made by SEC in its inspection of Marketplace screening practices.

### Amex Assessment Practice Differed From Assessment Rules

As discussed in the background section of this report, Amex's published rules set forth five qualitative factors to be considered in the determination of a company's eligibility for Marketplace listing. Although Amex's rules did not indicate that any of the qualitative factors are to be considered as more important than others, Amex's Marketplace listing decisions emphasized two of the five factors: (1) the company's commercial prospects and future outlook and (2) the reputation of its management. Amex officials and committee members told us that for some emerging companies it is appropriate to place more importance on their judgments of these factors and less on the others—the nature of the company's business, historical record and pattern of growth, and financial integrity. Amex officials explained that the emphasis placed on each qualitative factor varies with the company's maturity and the commercial acceptance of its products.

According to the information contained in the memoranda prepared for the committee, 13 of the 18 traded companies in our sample had 1 or more negative financial indicators. For example:

- nine had no earnings or declining earnings,
- four had no revenues or declining revenues,
- nine had negative cash flows, and
- five had outside auditor opinions that questioned their ability to function as going concerns.[5]

Amex officials and committee members told us that the companies with no earnings, no revenues, or negative cash flows were considered suitable for listing and trading because the companies were judged capable of improving their finances in the future. In addition, Amex officials said that Marketplace rules do not require a company to have increasing revenues or positive earnings and cash flow at the time the companies are listed. In commenting on a draft of this report Amex also said that it believes a going concern auditing opinion is a cautionary sign that should be scrutinized but by itself should not render a company ineligible for listing.

We are not questioning Amex's decision to list these companies. Rather, we are concerned that the discrepancy between Amex's practice and the published rules setting forth the qualitative requirements may mislead investors. In our view, a reasonable investor might well assume from reading the rules that Amex would be unlikely to approve for Marketplace listing companies with no earnings, no revenues, or negative cash flows because the rules state that the factors considered in listing decisions include the historical record and pattern of growth of the company and the company's financial integrity.

We share SEC's view that an exchange's rules for the listing of companies is of critical importance to the investing public. An incomplete description of the weight given to factors or the absence of a disclosure of the conditions under which companies with poor financial histories may be listed may leave investors with an incomplete impression of the risk they may be assuming by investing in a listed company. While Amex's Marketplace rules inform investors that a company's historical record and financial integrity are screening factors, they do not disclose the conditions under which companies with poor financial histories may be listed. We should note that another exchange discloses in its rules that companies in poor

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

financial condition may be approved for listing, but they may have to undergo a more stringent screening review.

We also found some discrepancies between quantitative requirements as contained in the published rules and those used in practice. For example, Amex approved the warrants[6] of three companies for listing and trading even though they failed to meet minimum Marketplace market price or aggregate market value requirement. Amex officials explained that they never intended to apply market price and aggregate market value requirements to warrants. But they acknowledged that this is not clear in their published rules. Amex officials told us they plan to revise the rules.

Amex also approved for listing a company's units[7], each of which is composed of two shares of stock and three warrants, even though Marketplace rules contain no provision for listing and trading this type of security. Amex said that since trading in both stocks and warrants is authorized under its existing Marketplace rules, trading in units is likewise authorized. However, according to an SEC official, trading in units is inconsistent with Marketplace rules because these rules do not specifically mention them. Amex officials informed us that they plan to clarify their rules regarding the eligibility of units to be traded on the Marketplace.

## Amex Did Not Always Adequately Document Companies' Compliance With Quantitative Requirements

Amex's practices for assessing companies' compliance with Marketplace quantitative requirements did not ensure adequate documentation that all requirements had been met. Amex analysts prepare two screening documents used in assessing whether a company meets mandatory quantitative requirements. The first document, a memorandum prepared by Amex staff before the committee's evaluation of a company, compares the company's financial and trading statistics to the quantitative requirements. The second, called a resumé, is prepared by Amex staff after the committee approves a company's listing eligibility but before trading begins. Good internal control procedures require that eligibility assessment documents incorporate evidence that mandatory requirements have been met. While the memorandum and the resumé provided two opportunities to document compliance with these requirements, neither served this purpose in all cases.

[6]A warrant is a corporate instrument that gives the holder the right to purchase the corporation's stock at a stated price either before a stipulated date or at any future time.

[7]A unit is a combination of two or more component securities. For example, a unit may be composed of one share of common stock combined with one warrant.

According to the memoranda we reviewed for the 32 companies traded on the Marketplace as of December 31, 1992, 13 companies did not satisfy 1 or more of the quantitative requirements before the committee's evaluation. Amex officials told us that the application files of companies that do not meet all quantitative requirements may still be submitted to the committee if the analyst believes the company will be able to remedy all deficiencies before being traded. These officials said that a company may be willing, for example, to increase the price of its common stock to the minimum Marketplace requirement[8] but only if the committee approves its application.

In addition to the memorandum, Amex also prepares a resumé for each traded company. The resumé, when signed by the analyst and senior Amex officials, indicates that the company has met all quantitative requirements and represents final approval of the application. We found that the resumés for 4 of the 32 companies traded on the Marketplace as of December 1992 indicated that these companies did not satisfy 1 or more of the 6 quantitative requirements. For example:

- one company's stock was priced below the Marketplace minimum market price per share requirement,
- the number of publicly held shares for one company's stock was not indicated,
- the number of public shareholders of one company's stock was not indicated, and
- the number of public shareholders for one company's warrants was below the Marketplace requirement.

For each of these instances, Amex provided us with other documentation, not reflected on the resumé, indicating that the companies had fully met the Marketplace quantitative requirements before trading.

We also found that for 16 of the 18 traded companies in our sample, Amex did not retain documentation supporting its calculation of the number of publicly held shares. SEC requires that these types of records be maintained for at least 5 years. Amex officials told us that they now document these calculations on a worksheet that will be maintained in the files.

[8]This is often accomplished through a reverse stock split, which increases the price by reducing the number of shares outstanding.

Adequate documentation of companies' compliance with listing requirements is important because without it Amex cannot assure SEC and others of the soundness of the Amex analysts' and committee's decisions to approve companies for Marketplace listing.

## SEC Questioned Some Amex Marketplace Eligibility Screening Practices

SEC reported in April 1993 on its inspection of Amex's Marketplace listing procedures. The inspection included the 45 companies approved for listing by the committee through August 14, 1992. SEC's overall conclusion was that Amex's procedures for approving securities for trading on the Marketplace were satisfactory. Nevertheless, SEC questioned some of Amex's practices for assessing companies' compliance with Marketplace criteria. In general, the practices questioned by SEC are similar to those discussed in this report. Amex agreed to adopt in principle many of SEC's suggestions. However, Amex has not yet made changes that involve a revision of its Marketplace rules. Amex plans to make one change that will incorporate both SEC's and our suggested revisions. For example, on the basis of SEC's and our report, Amex plans to clarify its rules regarding the applicability of market price and aggregate market value requirements to warrants and the eligibility of units for trading on the Marketplace.

# Conclusions

The development and enforcement of adequate criteria governing the listing of securities are important to an exchange and the investing public. Exchanges use listing standards to screen companies in deciding which ones should be granted trading status. The investing public relies on listing as an indicator that a company has met exchange requirements and is a legitimate company. While Marketplace rules provide that Amex consider five qualitative factors in evaluating a company for listing, Amex has not disclosed that it places greater emphasis on some factors. By not disclosing that it places greater importance on factors related to a company's future outlook than on a company's historical record, Amex may be giving investors an incomplete picture of the risks they are assuming by investing in companies traded on the Marketplace.

Amex has implemented corrective measures designed to strengthen its Marketplace screening process. However, at the time of our review, weaknesses remained in the Marketplace screening process because Amex had (1) waived, without SEC approval, some mandatory quantitative requirements for warrants; (2) approved units for trading without incorporating in its rules a provision allowing it to do so; and (3) failed to maintain adequate documentation ensuring that companies approved for listing on the Marketplace met all quantitative requirements. Without proper documentation, Amex cannot assure SEC and others of the soundness of the analysts' and committee's decisions to approve companies for Marketplace listing.

## Recommendations to the Chairman of SEC

We recommend that the Chairman of SEC require Amex to

- publish a more comprehensive statement of its qualitative listing factors, including the significance of each to the final listing decisions;
- modify Marketplace rules to define the quantitative requirements warrants have to meet for listing;
- establish Marketplace rules regarding the listing and trading of units; and
- ensure that the resumé for each company fully documents that all quantitative requirements have been met before a company is traded on the Marketplace.

## Agency Comments and Our Evaluation

We obtained written comments on a draft of this report from SEC and Amex. The written comments are shown in appendixes II and III.

In its comments, SEC noted that we had reached conclusions consistent with those it reached in its report on Amex's practices for approving companies for the Marketplace. SEC added that it concurs with our recommendations and has begun a dialogue with Amex about the need to amend Marketplace rules.

In its comments, Amex disagreed with our characterization that it emphasizes certain of the five qualitative listing standards over others as a matter of policy. Amex acknowledged that certain of the five qualitative factors may be given greater significance than others in its assessment of particular Marketplace candidates' eligibility. Furthermore, Amex said that the qualitative standards enumerated in its guidelines are not exclusive and are applied on a case-by-case basis.

Our concern is not whether Amex's practice of assigning more emphasis to some qualitative factors is applied to all companies under consideration for the Marketplace or to individual companies on a case-by-case basis. Rather, we are concerned that investors familiar with the qualitative standards in Amex's published rules, but unfamiliar with Amex's practices in applying these standards, would be under the impression that companies with poor historical track records would be ineligible for

Marketplace listing. Our recommendation is for Amex to inform investors of its practices by publishing a revision to its rules that contains a more comprehensive statement of the qualitative factors and the significance of each to listing decisions.

Amex also questioned our use of revenues, earnings, and cash flows to analyze how the exchange applied these qualitative standards, since these financial indicators do not appear in their listing guidelines or in the guidelines of another market that trades similar types of securities. We agree that these elements are not mentioned in guidelines for either the Marketplace or the other market. However, we used these elements because our analysis of Marketplace screening files disclosed that these elements were among the factors considered by Amex analysts in making listing decisions.

Amex believed it was inappropriate for us to conclude that investors assume increased risk because of the manner in which Amex applies its qualitative listing factors. As discussed previously, we concluded that investors may be unaware that Amex has approved for the Marketplace some companies with poor historical track records. By not disclosing this practice, we believe Amex may be giving investors an incomplete picture of the risks they assume by investing in companies traded on the Marketplace.

Amex also said that all of the qualitative factors are highly subjective and cannot be precisely defined. We agree but believe that Amex's practices should not vary from the description of the qualitative factors in Amex's rules.

Amex acknowledged that certain older resumés did not demonstrate that each of the mandatory quantitative criteria had been satisfied. Amex noted that it has taken steps to prevent this from occurring in the future.

Amex disagreed with our conclusion that it listed warrants that failed to meet minimum Marketplace quantitative requirements. According to Amex, the exchange never applied market price and aggregate market value criteria to warrants. Amex acknowledged that a table in its rules could create the impression that Marketplace market price and aggregate market value criteria apply to warrants. Amex said it intends to correct this impression by amending the table in a revision to its rules.

Amex also explained that, before SEC's inspection, it did not view as necessary the adoption of separate listing guidelines for units. Since each unit represents two or more securities, Amex evaluated each component's eligibility separately. However, in light of SEC's and our comments, Amex intends to revise its rules to clarify this practice.

As agreed with the Subcommittees, unless you publicly announce its contents earlier, we plan no further distribution of this report for 30 days. At that time, we will provide copies to other appropriate congressional committees, interested Members of Congress, the Chairman of SEC, and the Chief Executive Officer of Amex. We will also make copies available to others upon request.

Please call me at (202) 512-8678 or Bernard Rashes, Assistant Director, at (212) 264-0737, if you have any questions concerning this report. The major contributors to this report are listed in appendix IV.

James L. Bothwell

James L. Bothwell
Director, Financial Institutions
and Markets Issues

# Contents



**Abbreviations**

| | |
|---|---|
| NASD | National Association of Securities Dealers |
| SEC | Securities and Exchange Commission |

# Emerging Company Marketplace Quantitative Listing Requirements

| Requirement[a] | Nasdaq-traded stocks Regular | Nasdaq-traded stocks Alternate | Other stocks Regular | Other stocks Alternate |
|---|---|---|---|---|
| Total assets[b] | $2.0 | $2.0 | $4.0 | $3.0 |
| Capital and surplus[b] | $1.0 | $2.0 | $2.0 | $2.0 |
| Aggregate market value[b] | $2.5 | $2.5 | $2.5 | Over $10.0 |
| Publicly held shares | 250,000 | 250,000 | 250,000 | 400,000 |
| Public shareholders | 300 | 300 | 300 | 300 |
| Minimum market price per share | $1 | Under $1 | $3 | $2 |

[a]The Marketplace has two groups of quantitative requirements: one group for companies traded on NASD's Nasdaq market and a second group for other companies. A company that fails to meet the regular requirements may still qualify for listing if it meets the alternate requirements.

[b]Dollars in millions.

Source: Amex Company Guide.

# Comments From SEC

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

DIVISION OF
MARKET REGULATION

February 18, 1994

Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Re: **American Stock Exchange: Improvements Needed in Screening Securities for Listing on the Emerging Company Marketplace**

Dear Mr. Fogel:

The Division appreciates the opportunity to review and comment on the General Accounting Office's ("GAO") draft report entitled **American Stock Exchange: Improvements Needed in Screening Securities for Listing on the Emerging Company Marketplace**. Your draft report indicates that The Honorable John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, and The Honorable Edward J. Markey, Chairman Subcommittee on Telecommunications, requested that the GAO examine the American Stock Exchange's ("Amex") screening procedures for approving a company's securities for listing and trading on its Emerging Company Marketplace ("ECM" or "Marketplace"). The Division shares the concerns of Congressmen Dingell and Markey that led them to request this study and report. The Division is committed to ensuring that the quantitative listing standards of securities markets adequately protect investors.

The draft report indicates that the GAO found that Amex already has taken steps to improve its assessment of the reputation of the management of companies seeking an ECM listing for their securities. In addition, the GAO learned that the Amex has certain policies, practices, and procedures regarding ECM that are not fairly derived from the rules Amex now has in place. In particular, the Amex is placing different emphasis on the five qualitative factors used by the Amex staff when making subjective assessments about the future success of ECM candidates; and Amex is permitting certain types of securities (warrants and units consisting of warrants and common stock) to trade on ECM without the necessary listing criteria being in place. Finally, the GAO discovered that the securities of a number of ECM companies began trading without each of the six quantitative criteria being clearly indicated on documents prepared by the Amex, i.e., the Preliminary Listing Eligibility Opinion or the Resume of the ECM Company.

As the GAO acknowledges in the draft report, its findings are consistent with the findings of a prior inspection done by

Richard L. Fogel
General Accounting Office
February 18, 1994
Page 2

the Division of the Amex's screening process for ECM listing candidates, the report for which was made available to the GAO pursuant to its request. For this reason, the Division concurs with the GAO's findings which represent a subset of the findings made in our inspection report.

From its findings, the GAO intends to recommend that the Commission require Amex to:

1) provide a more comprehensive statement of its qualitative listing factors, including the significance of each, to the final listing decisions;

2) modify Marketplace rules to define the quantitative listing requirements for warrants;

3) establish Marketplace rules regarding the listing and trading of units; and

4) ensure that the resume for each company fully documents that all qualitative requirements have been met before the company is traded on the Marketplace.

As with the findings of the GAO, these four recommendations are similar to those made by the Division to the Amex in the Division's ECM inspection report. Accordingly, the Division concurs with the recommendations that the GAO intends to make. Moreover, the Division has begun a dialogue with the Amex about its need to amend formally the Amex rules pertaining to ECM.[1]

Thank you again for this opportunity to assist the GAO as it prepares its final draft of the report. I respectfully request that this letter be appended to the final report delivered to Congress.

Sincerely yours,

Brandon Becker
Director

---

[1] **See generally** Section 19(b) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder (requiring that all rules and rule changes of the various self-regulatory organizations be filed with the Commission in accordance with such rules as the Commission may prescribe).

# Comments From Amex

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

86 Trinity Place
New York, New York 10006-1881
212 306-1400

James F. Duffy
Senior Vice President
and General Counsel
Legal & Regulatory Policy Division

March 8, 1994

**American Stock Exchange**

Mr. James L. Bothwell
Director, Financial Institutions and
Market Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

This is in response to your letter of February 22, 1994 soliciting our comments on the GAO's draft report (the "Report") concerning its audit of the listing procedures of the Emerging Company Marketplace ("ECM").

Let me state at the outset how much we appreciate the opportunities to express our views given us by Mr. Rashes and his colleagues throughout the audit process, as well as this opportunity to comment on the Report. We are pleased that the Report has confirmed both the adequacy of the screening procedures in use today on the ECM and the fact that every company listed fully satisfied each and every one of our mandatory numerical criteria. Notwithstanding the title of your Report, we believe that today the ECM's screening procedures, particularly with respect to the reputation of management, controlling shareholders or other significant individuals, are more rigorous than those applied by any other marketplace. The other items cited in the Report concern issues of rule interpretation which, in most respects, already have been (or in an upcoming rule filing will be) addressed by the Exchange.

AMEX

See comment 1.



There is, however, one conclusion in the Report with which we are particularly concerned, namely, that the Exchange, as a matter of unstated policy, emphasizes certain of the five enumerated qualitative listing standards over the others. We must disagree with this characterization. The qualitative standards are applied to each applicant on a case-by-case basis.* While it is true that certain factors may well be of greater significance to a particular candidate, that is a function of the issuer's maturity and the relative level of commercial acceptance of its products.

To say then that investors assume "increased risk" because of the manner in which the ECM Committee weighs certain factors is inappropriate, and we are concerned that the Report is seeking to read into our guidelines elements which were never intended to be present. Neither the ECM nor Nasdaq Small Cap (which serves a similar corporate population) requires issuers to have positive or increased earnings, revenues or cash flows. The fact that the Exchange has reserved to itself a certain amount of subjective discretion in evaluating listing applicants should not be mistaken for a requirement that the Exchange or the ECM Committee must make a positive finding that the enumerated characteristics presently exist.

*In fact, the enumerated factors are not an exclusive list of what may be considered in evaluating applicants. As the guidelines state, ". . . in evaluating listing eligibility, the Exchange will consider such other factors as the nature of the company's business, its commercial prospects and future outlook, the reputation of its management, its historical record and pattern of growth and its financial integrity." [Emphasis added.]

AMEX

3

The ECM's qualitative listing standards were taken almost verbatim from the regular Amex guidelines. In the case of our regular list, those qualitative standards are applied solely by the Exchange staff. For the ECM, they provide a framework for review by both the staff and the Committee once the staff has determined that an applicant can meet the minimum quantitative guidelines. We have, over many years, applied the qualitative standards without difficulty to literally thousands of companies applying for our regular list. While each of the enumerated terms is commonly understood, they are all highly subjective. In fact, no two analysts view a company in exactly the same way, and the factors they utilize are not susceptible of precise definition.

In support of your staff's conclusion regarding the qualitative guidelines, the Report states that a number of companies were listed that had "one or more negative financial indicators", e.g., "no earnings or declining earnings". As noted above, listing on the ECM or Nasdaq does not require a present demonstration of positive earnings or cash flow. Due to the high cost of product development, etc., young companies are frequently without positive cash flow or earnings. In fact, companies with substantial earnings and other "positive" financial indicators are ordinarily eligible to list directly on the regular Amex list. We do wish to note, however, that to date sixteen ECM companies have graduated to the primary list, demonstrating that the ECM is working as it was intended, and that the gap between promise and performance is not nearly as great as the Report suggests.

AMEX

4

We do believe that a "going concern" auditing opinion is a cautionary sign which should be closely scrutinized, and we have, in fact, treated it as such. You should be aware that of the five companies referred to, two had their qualified opinions lifted shortly after listing (as we had confirmed with their auditors prior to listing), and a third had exhibited strong trends in revenue growth and a history of attracting significant institutional investors. In contrast, the other two companies turned out to be weaker candidates and were later delisted by the Exchange. Inevitably, over time, certain of the companies listed on the ECM will fail to meet continued listing requirements, as will certain companies listed on any market. This is true not just of "incubator" marketplaces, but of the nation's largest marketplaces as well. We do not believe, however, that the mere existence of a "going concern" opinion should by itself render a company ineligible for listing.*

Other Comments

The Report makes several comments regarding our documentation of compliance with certain of the ECM's quantitative requirements. As we noted at the beginning of this letter, these interpretative questions have already been addressed or will be the subject of an Exchange rule filing promptly following the

*We note that the Report states that "another exchange's rules disclose that companies in poor financial condition...may have to undergo a more stringent screening review". We are not certain what marketplace this refers to, although we are aware that the NASD's rules specifically provide a procedure for the waiver of any Nasdaq listing criteria. If this is what the Report refers to, then the suggestion that it is somehow superior to the ECM procedures is simply inappropriate. Companies in poor financial condition would fall below the Nasdaq's numerical criteria, but could be listed by Nasdaq as an exception. In contrast, compliance with each of the ECM's numerical listing criteria is mandatory and the Exchange is not permitted to grant exceptions.

AMEX

5

completion of your Report. Nonetheless, we believe it is important to make several observations regarding the Report's treatment of these matters.

The Exchange agrees that the "resume" is an important control document and should be the single document that demonstrates that the issuer has satisfied each of the mandatory listing criteria. We are aware that certain of the older resumes did not do this with respect to each and every guideline and we have taken steps to correct this. However, we believe it is crucial to emphasize that in each such case, as noted in your Report, the Exchange was able to provide your staff with written documentation to substantiate the fact that each company listed fully satisfied each and every one of our mandatory guidelines.

See comment 2.

We have several specific comments on the Report's characterization of certain of our listing guidelines. First is the issue of whether our price and market value guidelines apply to warrants on common stock. As we have discussed with your staff, in evaluating the listing of warrants on the regular Amex list, we have never taken into account the price or aggregate market value of the warrants. We acknowledge that the tabular presentation of the ECM guidelines could be read so that it appears that these guidelines would apply to warrants, and we have advised your staff that we intend to file with the SEC an amended table clarifying this issue. However, we note that warrants when first issued are typically worth only a fraction of the price of the stock, so that it would be impossible to have identical price and market value guidelines for both stock and the related warrants. We regret that our table may have been inartfully presented, but it is incorrect to

AMEX

6

conclude that we listed warrants which failed to meet minimum requirements. The requirements in question simply do not apply to warrants.

See comment 3.

We have a similar comment concerning the listing of units on the ECM. Prior to the SEC's inspection we did not consider it necessary to adopt separate listing guidelines for units, since they represent nothing more than a combination of two or more component securities, each one of which is separately evaluated under our existing guidelines. Indeed, we have for many years listed units on the Amex without having specific reference to units in our listing guidelines. However, in light of your comments and those from the SEC, we plan to file an ECM rule change clarifying this point as well. As we have noted to your staff, the Exchange has delayed making a clarifying filing while we awaited your Report and any final comments from the SEC staff.

See comment 4.

Finally, we disagree with the conclusion that we did not retain documentation which SEC rules required us to maintain for five years. The documents at issue are "scrap" papers, reflecting mathematical computations using numbers otherwise available in our permanent files. While we do not believe that the SEC's record retention requirements extend to such materials, we have nonetheless modified our procedures to retain these calculations.

* * *

AMEX

7

The Exchange believes that the principal purpose of your review was to assure that we were adequately screening listing candidates and that we were, in fact, listing only those companies which meet our guidelines. We are gratified to see that the Report confirms that we are achieving those objectives.

We hope that our views have been helpful and would be happy to respond to any further questions or comments you may have.

Very truly yours,

James F. Duffy

cc: Mr. Bernard Rashes
U.S. General Accounting Office
7 World Trade Center
New York, NY 10048

AMEX

Following are our comments on Amex's March 8, 1994, letter.

## GAO Comments

1. We concluded that Amex's emphasis on a company's commercial prospects and future outlook played a role in the approval of 13 of the 18 listed and traded companies in our sample. Furthermore, Amex staff and committee members told us that they believed it appropriate, when analyzing the eligibility of emerging companies, to place greater emphasis on its future prospects than on its history. The emphasis on companies' future prospects was also evident in Amex's comments on SEC's inspection report. A portion of those comments is quoted below.

"The ECM is, and always was, intended to be an incubator for small emerging companies. It is the prospects and future outlook of these companies which must lie at the heart of our analysis. It is not whether the company exhibits today the financial characteristics, e.g., earnings, or positive cash flow, which we would expect on our regular list, but whether the company has the potential to demonstrate those characteristics tomorrow."

Amex also commented that we had read into the Marketplace guidelines elements that it never intended to be present. Our concern was that investors would read into the guidelines the same elements. While we had the opportunity to hold detailed discussions with Amex officials to clarify this interpretation, investors may never have the opportunity. For this reason, we recommended that Amex publish a more comprehensive statement of these factors in its rules as a way to reduce the likelihood that the factors will be misinterpreted.

2. We acknowledge that in our discussions Amex officials told us that they never intended to, nor do they in practice, subject warrants to the Marketplace market price and aggregate market value criteria. Amex intends to amend the table to eliminate the variance between the published Marketplace rules and practices.

3. Amex's criteria for its regular list, while containing no specific provision for units, does contain a provision for any security not specifically mentioned elsewhere. Marketplace rules have no such provision. Amex intends to include a specific provision for units in a future revision to its rules to clarify the eligibility of units for Marketplace trading.

4. We are concerned about the retention of documentation containing computations of companies' publicly held shares. Amex could not provide us with such documentation. Retention of these computations is important

because they provide the only evidence that the publicly held shares used in assessing companies' compliance with the mandatory quantitative requirements was properly computed.

# Major Contributors to This Report

| | |
|---|---|
| General Government Division, Washington, D.C. | Bernard Rashes, Assistant Director |
| New York Regional Office | Garry Roemer, Evaluator-in-Charge<br>Michael Gipson, Evaluator<br>Kristen Harmeling, Evaluator |

## Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1000
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066.