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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-89739; File No. SR-NASDAQ-2020-028]

### **Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Amend IM-5101-1 (Use of Discretionary Authority) to Deny Listing or Continued Listing or to Apply Additional and More Stringent Criteria to an Applicant or Listed Company Based on Considerations Related to the Company's Auditor or When a Company's Business Is Principally Administered in a Jurisdiction That Is a Restrictive Market**

September 2, 2020.

#### I. Introduction

On May 19, 2020, The Nasdaq Stock Market LLC (“Nasdaq” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend IM-5101-1 (Use of Discretionary Authority) to deny listing or continued listing or to apply additional and more stringent criteria to an applicant or listed company based on considerations related to the company’s auditor or when a company’s business is principally administered in a jurisdiction that has secrecy laws, blocking statutes, national security laws, or other laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdiction. The proposed rule change was published for comment in the Federal

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

Register on June 8, 2020.<sup>3</sup> On July 20, 2020, pursuant to Section 19(b)(2) of the Act,<sup>4</sup> the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.<sup>5</sup> The Commission is publishing this order to solicit comments on the proposed rule change from interested persons and to institute proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>6</sup> to determine whether to approve or disapprove the proposed rule change.

## II. Exchange's Description of the Proposed Rule Change

The Exchange states that its listing rules include requirements to provide transparent disclosure to investors as well as corporate governance requirements for listed companies.<sup>7</sup> In addition to these requirements, the Exchange further states that Rule 5101 describes the Exchange's broad discretionary authority over the initial and continued listing of securities on the Exchange in order to maintain the quality of and public confidence in its market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. Pursuant to this rule, the Exchange states that it may use such discretion to deny initial listing, apply additional or more stringent criteria for the initial or continued listing of particular securities, or suspend or delist particular securities based

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<sup>3</sup> See Securities Exchange Act Release No. 88987 (June 2, 2020), 85 FR 34774. Comments on the proposed rule change can be found at: <https://www.sec.gov/comments/sr-nasdaq-2020-028/srnasdaq2020028.htm>.

<sup>4</sup> 15 U.S.C. 78s(b)(2).

<sup>5</sup> See Securities Exchange Act Release No. 89344, 85 FR 44951 (July 24, 2020). The Commission designated September 6, 2020 as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to approve or disapprove, the proposed rule change.

<sup>6</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>7</sup> See Notice, supra note 3, at 35134. See also Rule 5000 Series.

on any event, condition, or circumstance that exists or occurs that makes initial or continued listing of the securities on the Exchange inadvisable or unwarranted in the opinion of the Exchange, even though the securities meet all enumerated criteria for initial or continued listing on the Exchange.<sup>8</sup>

The Exchange further states that, under Exchange rules and federal securities laws, a company's financial statements included in its initial registration statement or annual report must be audited by an independent public accountant that is registered with the Public Company Accounting Oversight Board ("PCAOB").<sup>9</sup> According to the Exchange, company management is responsible for preparing the company's financial statements and for establishing and maintaining disclosure controls and procedures and internal control over financial reporting.<sup>10</sup> The Exchange states that the company's auditor, based on its independent audit of the evidence supporting the amounts and disclosures in the financial statements, expresses an opinion on whether the financial statements present fairly, in all material respects, the company's financial position, results of operations, and cash flows.<sup>11</sup> The Exchange further states that the auditor, in turn, is normally subject to inspection by the PCAOB, which assesses compliance with PCAOB and Commission rules and professional standards in connection with the auditor's performance

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<sup>8</sup> See id. See also Rule 5101.

<sup>9</sup> See Notice, supra note 3, at 35134 (citing Rules 5210(b) and 5250(c)(3), which reference Section 102 of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002)).

<sup>10</sup> See id.

<sup>11</sup> See id. (quoting PCAOB Auditing Standard 1101.03 – Audit Risk, available at <https://pcaobus.org/Standards/Auditing/Pages/AS1101.aspx> (“To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud.”)).

of audits.<sup>12</sup> According to the Exchange, it relies on the work of auditors to provide reasonable assurances that the financial statements provided by a company are free of material misstatements, and further relies on the PCAOB's role in overseeing the quality of the auditor's work.<sup>13</sup> The Exchange believes that accurate financial statement disclosure is critical for investors to make informed investment decisions and is concerned that constraints on the PCAOB's ability to inspect auditor work in countries with national barriers on access to information may weaken assurances that the disclosures and financial information of companies with operations in such countries are not misleading.<sup>14</sup>

In light of the foregoing, the Exchange now proposes to amend IM-5101-1 to add a new subparagraph (b) to state that the Exchange may rely upon Rule 5101 to deny initial or continued listing or to apply additional and more stringent criteria to an applicant or listed company based on the following factors related to the qualifications of the company's auditor:

- (1) whether the auditor has been subject to a PCAOB inspection, such as where the auditor is newly formed and has therefore not yet undergone a PCAOB inspection or where the auditor, or an accounting firm engaged to assist with the audit, is located in a jurisdiction that limits the PCAOB's ability to inspect the auditor;
- (2) if the company's auditor has been inspected by the PCAOB, whether the results of that inspection indicate that the auditor has failed to respond to any requests by the PCAOB or that the inspection has uncovered significant deficiencies in the auditor's conduct in other audits or in its system of quality controls;

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<sup>12</sup> See id.

<sup>13</sup> See id. at 35135.

<sup>14</sup> See id.

- (3) whether the auditor can demonstrate that it has adequate personnel in the offices participating in the audit with expertise in applying U.S. GAAP, GAAS, or IFRS, as applicable, in the company's industry;
- (4) whether the auditor's training program for personnel participating in the company's audit is adequate;
- (5) for non-U.S. auditors, whether the auditor is part of a global network or other affiliation of individual auditors where the auditors draw on globally common technologies, tools, methodologies, training, and quality assurance monitoring; and
- (6) whether the auditor can demonstrate to the Exchange sufficient resources, geographic reach, or experience as it relates to the company's audit.<sup>15</sup>

The Exchange states that it would consider these factors holistically and may be satisfied with an auditor's qualifications notwithstanding the fact that the auditor raises concerns with respect to some of the factors set forth above.<sup>16</sup> The proposed rule further provides examples of additional and more stringent criteria that the Exchange may apply to an applicant or a listed company to obtain comfort that the company satisfies the financial listing requirements and is suitable for

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<sup>15</sup> The Exchange also proposes to identify certain existing paragraphs within IM-5101-1 as subparagraphs (a), (d), and (e); add descriptive headings to the subparagraphs within IM-5101-1; and relocate existing text describing the Exchange's review process to subparagraph (e). The Exchange also proposes to revise the term "listing qualifications panel" in subparagraph (e) to "Hearings Panel (as defined in Rule 5805(d))" for consistency within the rulebook.

<sup>16</sup> See Notice, supra note 3, at 35135. For example, the Exchange states that it may be satisfied that an auditor that is not subject to PCAOB inspection has mitigated the risk that it may have significant undetected deficiencies in its system of quality controls by being a part of a global network where the auditors draw on globally common technologies, tools, methodologies, training, and quality assurance monitoring. See id.

listing.<sup>17</sup> These criteria may include requiring: (i) higher equity, assets, earnings, or liquidity measures than otherwise required under the Rule 5000 Series; (ii) that any offering be underwritten on a firm commitment basis, which typically involves more due diligence by the broker-dealer than would be done in connection with a best-efforts offering; or (iii) companies to impose lock-up restrictions on officers and directors to allow market mechanisms to determine an appropriate price for the company before such insiders can sell shares.<sup>18</sup> The Exchange states that it may impose each of these additional requirements separately or in combination, or may determine that listing is not appropriate and deny initial or continued listing to a company.<sup>19</sup>

The Exchange further states that risks to U.S. investors related to the accuracy of disclosures, accountability, and access to information are heightened when a company's business

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<sup>17</sup> The Exchange states that if a company's auditor does not satisfy the proposed criteria in IM-5101-1(b), the Exchange may still obtain comfort that the company truly satisfies the financial listing criteria by imposing a higher standard on such company. See id. at 35136.

<sup>18</sup> See proposed IM-5101-1(b). The Exchange states that it may also have concerns that a company listing on the Exchange through an initial public offering, business combination, direct listing, or issuing securities previously trading over-the-counter may not develop sufficient public float, investor base, and trading interest to provide the depth and liquidity necessary to promote fair and orderly trading, resulting in a security that is illiquid. See Notice, supra note 3, at 35136. In such cases, the Exchange states that it may impose additional liquidity measures on the company, such as requiring a higher public float percentage, market value of unrestricted publicly held shares, or average over-the-counter trading volume. See id. The Exchange further states that it may obtain additional comfort regarding the quality of a company's financial statements by requiring the offering to be underwritten, which the Exchange believes would help to ensure that third parties other than the auditor are conducting significant due diligence on the company, its registration statement, and its financial statements. See id. The Exchange also believes that, if material misstatements are detected by the company's auditors and have not been disclosed to investors, it may be appropriate to impose lock-up restrictions on officers and directors to allow market mechanisms to determine an appropriate price for the company before such insiders can sell shares. See id.

<sup>19</sup> See Notice, supra note 3, at 35136.

is principally administered in a jurisdiction that has secrecy laws, blocking statutes, national security laws, or other laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdiction.<sup>20</sup> Accordingly, the Exchange also proposes to amend IM-5101-1 to add a new subparagraph (c) to state that the Exchange may use its discretionary authority to impose additional or more stringent criteria, including the criteria set forth in proposed IM-5101-1(b), in other circumstances, including when a company’s business is principally administered in a jurisdiction that the Exchange determines to have secrecy laws, blocking statutes, national security laws, or other laws or regulations restricting access to information by regulators of U.S.-listed companies in such jurisdiction (a “Restrictive Market”). In determining whether a company’s business is principally administered in a Restrictive Market (“Restrictive Market Company”), proposed IM-5101-1(c)(4) provides that the Exchange may consider the geographic locations of the company’s: (a) principal business segments, operations, or assets; (b) board and shareholders’ meetings; (c) headquarters or principal executive offices; (d) senior management and employees; and (e) books and records.<sup>21</sup> The Exchange states that this definition would capture both foreign private issuers based in Restrictive Markets and companies based in the U.S. or another jurisdiction that principally administer their businesses in Restrictive Markets.<sup>22</sup>

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<sup>20</sup> See id.

<sup>21</sup> See proposed IM-5101-1(c)(4).

<sup>22</sup> See Notice, supra note 3, at 35136 n.11. The Exchange further provides the following example: a company’s headquarters could be located in Country A, while the majority of its senior management, employees, assets, operations, and books and records are located in Country B, which is a Restrictive Market. In this case, the Exchange would consider the company’s business to be principally administered in Country B, which is a Restrictive Market, and the Exchange may use its discretionary authority pursuant to proposed IM-5101-1(c) to apply additional or more stringent criteria to the company. See

The Exchange represents that, in the event it relies on its discretionary authority pursuant to the proposed rule changes and determines to deny the initial or continued listing of a company, it would issue a denial or delisting letter to the company that will inform the company of the factual basis for the Exchange's determination and the company's right for review of the decision pursuant to the Rule 5800 Series.<sup>23</sup> The proposed rule changes would apply to all companies listed and seeking to list on the Exchange.<sup>24</sup>

### III. Summary of the Comment Letters Received

One commenter stated that it supports the proposed rule change inasmuch as it seems reasonably tailored to help ensure full, complete, and transparent financial and other disclosure from Restrictive Market Companies.<sup>25</sup> Another commenter expressed its support for the proposed rule change and agreed with many of the concerns raised by the Exchange related to Restrictive Market Companies.<sup>26</sup> However, this commenter also suggested that the Exchange consider modifications to the proposed rule change, including narrowing the degree of discretion provided by the proposed rule change for situations where the applicant or listed company has an auditor or an accounting firm engaged to assist with the audit that is located in a jurisdiction that limits the PCAOB's ability to inspect the auditor, and where the applicant or listed company is a

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id. at 35136.

<sup>23</sup> See id. See also Rule 5815, which sets forth the review of staff determinations by a Hearings Panel, including the procedures for requesting and preparing for a hearing and the scope of the Hearing Panel's discretion.

<sup>24</sup> See id.

<sup>25</sup> See Letter from Annemarie Tierney, Founder and Principal, Liquid Advisors, Inc. (July 2, 2020), at 5.

<sup>26</sup> See Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors (June 18, 2020), at 5.

Restrictive Market Company.<sup>27</sup> Specifically, this commenter recommended that the Exchange modify the proposed rule change to replace proposed IM-5101-1(b)(1) and (c) with new rules that would require that applicants and listed companies from a Restrictive Market be prohibited from having an auditor or accounting firm engaged to assist with their company audit that is located in a jurisdiction that limits the PCAOB's ability to inspect the auditor.<sup>28</sup> This commenter further recommended that the Exchange also amend Rule 5810 to provide a Nasdaq Hearings Panel the discretion to grant a listed company an exception from such new rules for a period not to exceed 540 days from the date of the delisting letter issued by the Exchange.<sup>29</sup>

IV. Proceedings to Determine Whether to Approve or Disapprove SR-NASDAQ-2020-028 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>30</sup> to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described below, the Commission seeks and encourages interested persons to provide additional comment on the proposed rule change to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

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<sup>27</sup> See id. at 6.

<sup>28</sup> See id. at 6-7.

<sup>29</sup> See id. at 7.

<sup>30</sup> 15 U.S.C. 78s(b)(2)(B).

Pursuant to Section 19(b)(2)(B) of the Act,<sup>31</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change's consistency with Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and to protect investors and the public interest, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>32</sup>

The Exchange is proposing to adopt new rule text to specifically permit it to utilize its broad discretionary authority to deny initial or continued listing or to apply additional and more stringent criteria to an applicant or listed company based on certain factors, as described in more detail above, related to the qualifications of the company's auditor. However, the Exchange does not state how these broad factors would be considered in its determination of whether an applicant or listed company will be denied initial or continued listing, or subject to additional and more stringent criteria, other than to note that the factors will be considered "holistically." In addition, the Exchange states that it may also find a particular auditor's qualifications sufficient despite the fact that the auditor raises concerns with respect to some of the specified factors. Further, the Exchange does not state what specific additional or more stringent criteria it would impose, if it decided to impose additional or more stringent criteria. Whether an applicant or

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<sup>31</sup> Id.

<sup>32</sup> 15 U.S.C. 78f(b)(5).

listed company is denied listing or subject to additional criteria and what that additional criteria is, however determined, appears to be subject to wide discretion under the proposed rule.

Similarly, under the proposed rule, the Exchange may also use its broad discretionary authority to impose similar additional or more stringent criteria on a Restrictive Market Company. The Exchange does not provide any information in its filing regarding when it generally will or will not use its authority to subject a Restrictive Market Company to such additional criteria, but rather just provides that a Restrictive Market Company “may” be subject to additional or more stringent criteria. In addition, the Exchange does not state what specific additional or more stringent criteria it would impose, if it decided to impose additional or more stringent criteria. These provisions appear to be subject to wide discretion by the Exchange.

The Exchange stated that its proposal is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers because the Exchange has identified additional concerns around companies with auditors that do not have sufficient PCAOB inspection history, quality controls, resources, geographic reach, and experience to adequately perform the company’s audit and Restrictive Market Companies, and because applying additional and more stringent criteria may not be appropriate in all circumstances.<sup>33</sup> As discussed above, however, the Exchange’s proposal provides it wide discretion to determine: (1) whether to deny initial or continued listing or to apply additional and more stringent criteria to an applicant or listed company based on factors related to the qualifications of the company’s auditor, and what specific additional or more stringent criteria it would impose, if it decided to impose additional or more stringent criteria; and (2) whether to apply additional or more stringent criteria to a

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<sup>33</sup> See Notice, supra note 3, at 35137-38.

Restrictive Market Company, and what specific additional or more stringent criteria it would impose, if it decided to impose additional or more stringent criteria. Accordingly, the Commission believes there are questions as to whether the proposal is consistent with Section 6(b)(5) of the Act and its requirement, among other things, that the rules of a national securities exchange not be designed to permit unfair discrimination.

Under the Commission’s Rules of Practice, the “burden to demonstrate that a proposed rule change is consistent with the [Act] and the rules and regulations issued thereunder . . . is on the self-regulatory organization that proposed the rule change.”<sup>34</sup> The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding,<sup>35</sup> and any failure of a self-regulatory organization to provide this information may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Act and the applicable rules and regulations.<sup>36</sup>

The Commission is instituting proceedings to allow for additional consideration and comment on the issues raised herein, including as to whether the proposal is consistent with the Act.

#### V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other

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<sup>34</sup> 17 CFR 201.700(b)(3).

<sup>35</sup> See id.

<sup>36</sup> See id.

concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5)<sup>37</sup> of the Act or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4 under the Act,<sup>38</sup> any request for an opportunity to make an oral presentation.<sup>39</sup>

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register]. The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal, which are set forth in the Notice,<sup>40</sup> in addition to any other comments they may wish to submit about the proposed rule change.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

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<sup>37</sup> 15 U.S.C. 78f(b)(5).

<sup>38</sup> 17 CFR 240.19b-4.

<sup>39</sup> Section 19(b)(2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

<sup>40</sup> See Notice, supra note 3.

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2020-028 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-NASDAQ-2020-028. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to

make available publicly. All submissions should refer to File Number SR-NASDAQ-2020-028 and should be submitted by **[INSERT DATE 21 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Rebuttal comments should be submitted by **[INSERT DATE 35 DAYS FROM DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>41</sup>

**J. Matthew DeLesDernier,**

*Assistant Secretary.*

[FR Doc. 2020-19841 Filed: 9/8/2020 8:45 am; Publication Date: 9/9/2020]

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<sup>41</sup> 17 CFR 200.30-3(a)(57).