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OFFICE OF THE SECRETARY

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Ref: File #4-606

Dear Ms. Murphy:

These comments are submitted in response to the Commission's request for public comment in connection with the statutory mandate to study the obligations of brokers, dealers and investment advisors. These comments focus on the obligations applicable to dealers. They do not cover legal or regulatory standards with respect to other professionals in the securities business.

With the transition in the securities business from a broker oriented to a dealer oriented market, there have been enormous changes in the need for protection of retail investors. Dealers have become the central players in the securities business with brokers and investment advisors having a peripheral role to play in the buying or selling of securities.

Over the years the Commission's regulation of dealers has been minimal. Under NASD rules a dealer must assure himself that the security is "suitable" to the customer and markups or mark-downs must be reasonable. This regulatory scheme was developed many years ago and has not been changed despite the revolution in the markets over the years. The Goldman Sachs case represents the first major development in the regulation of dealers since that time. In this case, the Commission examined the selling practices of a major dealer and found that the dealer had failed in its obligations to disclose all relevant facts including the participation of a short seller in the selection of the sub-prime securities for a CDO. As part of its settlement with the S.E.C., Goldman stated that it was conducting an examination of all of its business practices in connection with the sale of securities.

In my view, this settlement deals only with the facts surrounding the Goldman case and it does not provide legal or regulatory standards for the entire securities business. It is vital in my view for the Commission to concentrate much of its effort in this study to standards applicable to dealers who now dominate our markets. These standards should cover such matters as disclosure of conflicts of interest that the dealer may have. This portion of the Commission's study should lay the ground work for recommendations on requirements imposed on dealers to protect retail customers.

I have appended to this memorandum comments on this issue written over the past year.

Ralph S. Saul

Attachments

This memorandum outlnes some Wall Street history that relates to the financial disaster which occurred over the past two years. We may find this history relevant to current deliberations about financial reform and we may find it useful for fashioning what should be done in the future.

In the 60's and early 70's, most Wall Street firms were organized as partnerships with their capital based on contributions from the partners. Capital could be withdrawn pursuant to notice from the partner. Most firms derived a significant share of their revenue from brokerage commissions which were fixed at the time. Only a few firms, such as Salomon and First Boston, depended upon dealer activities as a major source of revenues. Membership on the New York Stock Exchange became a primary objective for most firms that sought to deal with the public.

Under the Glass-Seagall Act, commercial banks could not participate in the securities markets.

With the tremendous surge in brokerage activity during the 1960's, some firms such as Donaldson, Lufkin and Jenrette (DLJ) saw the importance of broadening their market base, primarily by having access to public capital. DLJ observed that more than 90% of firm capital on Wall Street was owned by people over sixty and it was impermanent. The "go-go years" of the 60's and the back office crisis of the 70's stimulated a profound change on Wall Street by demonstrating that firms had to change their capital structures to have more permanent capital to meet the growing needs of investors for liquidity and service. The impending change away from fixed commissions alerted firms to the fact that commissions would decrease substantially. The back office crisis stimulated firms to see the overwhelming importance of technology to meet a growing volume of transactions. These developments laid the foundation for going public and for the shift away from agency markets to dealer markets.

Over the next 40 years firms saw dealer trading markets as a preferred way of employing their capital and offered themselves to the public no longer as brokerage firms but as dealer firms with massive capital bases and the ability to provide many new services to the public customer. This major change on Wall

Street had profound implications for Wall Street's role in the economy and how it now dealt with public investors, both individuals and institutions.

First, the emphasis on acting as dealers meant that firms became far more profitable then in their prior role as brokerage intermediaries as mark ups and mark downs as dealers produced spreads exceeding what unfixed brokerage commissions could produce. Even as these spreads declined, firms had the technical ability to make up the loss through higher volumes of activity. Compensation levels escalated far beyond levels during the old brokerage era. Moreover, acting as dealers intensified the interest of firms in exterior developments that could impact their positioning activity.

Second, capital generated from this new role provided the basis for recruiting new talent to the Street. Many of these talented individuals included "quants" with the ability to understand financial markets and to devise financial products and trading strategies to enhance the profitability of their firms. Academia observed this development and began to orient their curricula to satisfy the demand of the Street for academically trained talent.

Third, the unusual profitability of dealer operations penetrated into the ranks of other financial institutions. With the repeal of the Glass-Steagall Act, banks saw trading activity as a major new source of profits and began to recruit traders to man their new trading floors. The profitability of trading focused banks as well as other firms on proprietary trading. Many blindly became dealers for a variety of financial products without fully understanding the risks entailed. But many could not recruit into their ranks qualified professional traders leaving them highly exposed to dramatic changes in the markets.

Fourth, and perhaps most important, the shift to dealer markets fundamentally changed the relationship between firms and their customers. Public investors no longer could rely upon the firm to protect their interest in executing their orders. Instead they had become counterparties where customers had to protect their own interests. It took some time for this change to sink in and for customers, both individual and institutional, to realize that they had to deal with firms as counterparties, not as fiduciaries.

The current financial collapse has and will produce enormous changes in the dealer markets. Numerous firms have exited the scene and those remaining have become much more cautious in how they approach this activity. The enormous profitability of Goldman Sachs illustrates what can happen when competition among dealers is severely constrained and a single dealer with a large capital base dominates the market. It's likely that as financial conditions improve, more dealers will emerge and the monopoly profits of a single dealer will erode. Recent improvements in the markets have attracted many back into proprietary trading which will continue to dominate our markets.

It strikes me in light of these developments that the Securities and Exchange Commission might want to consider ways to control dealer markets to protect investors. Unlike floor trading on the old New York Stock Exchange, proprietary trading has lacked public visibility. It may want to consider, for example, imposing higher capital requirements and leverage limitations upon firms engaged in proprietary trading. Not only should the Commission study the role of "dark pools" but also the larger issue of how our securities markets can become more "public" and "fair and orderly". Moreover, the bank regulatory agencies need to understand and deal with the risks of proprietary trading by banks – an activity far removed from their basic function of lending.

Ralph S. Saul
September 21, 2009

Proprietary Trading

Financial reform remains in flux as the Congress wrestles with some of the issues posed by the Secretary of the Treasury in his proposals. However, we need to focus on a basis issue before the reform debate concludes with a legislative package. That issue is: What accounts for the unusual growth in the size and complexity of the financial sector of the U.S. economy over the past 30 years? This memorandum seeks to provide one answer to that question. Understanding that answer remains at the heart of the debate on financial reform.

Several factors in the history of Wall Street help to explain its importance:

The first occurred when the NYSE allowed its members to go public. In the sixties and seventies most Wall Street firms were organized as partnerships with capital based on contributions from partners. That capital could be withdrawn pursuant to notice. Most firms derived a significant share of their revenue from brokerage commissions which were fixed at the time with only a few firms dependent upon dealer activities as a major source of revenue. Partners limited the amount of their capital that could be used for risky dealer activities. But the "Go-Go" years of the sixties and the back office crisis of the seventies demonstrated that firms had to have permanent capital to meet the growing needs of investors for liquidity and service. However, by permitting securities firms to have public capital, the NYSE (a broker oriented market) blindly sealed its own fate as firms saw that off board dealer activity could be far more profitable than acting as agents for customers.

The second major change allowed banks to enter the securities business. Repeal of the Glass-Steagall Act permitted banks to engage in investment banking and buying and selling securities for their own account. Buoyed by active securities markets, some banks entered the securities business with gusto acquitting investment bankers and traders or by acquiring entire securities firms and forming bank holding companies to manage the new array of businesses. Increasing sophistication in the art of trading lead major banks to promote proprietary trading and related dealer activities such as hedge funds and private equity as a major source of profit. That profitability has now grown to a point where it is something of an embarrassment.

In the 1990's when the Congress repealed the Glass-Steagall Act, proponents heralded a new era with the combination of commercial and investment banking that would produce far reaching benefits for clients and investors. What was not understood was that repeal would result in major changes in the strategies of financial firms on the Street by permitting them to evolve in ways not foreseen at the time. For example, the enormous increase in firm profitability permitted them to hire the top tier of qualified young people.

The third event relates to the impact of professional dealer activity upon the public. Many sought to copy what the professionals did. They became ensnared in the rage for trading without the advantages of time and information held by professionals. Over the long run many of these public traders will find that they have entered a "zero sum" game.

Fourth, and perhaps most important, the shift to dealer markets fundamentally changed the relationship between firms and their customers. Public investors no longer could rely upon the firm to protect their interest in executing their orders. Instead they had become counterparties where customers had to protect their own interest in their relationships with dealers. It took some time for this change to sink in and for customers, both individual and institutional, to realize that they had to deal with firms as counterparties, not as fiduciaries.

In thinking about how we remedy this situation there are a number of options, some more drastic than others. However, we have reached a point where something has to be done to bring the financial sector into a better relationship with our economy and to get that sector back to its original purpose of acting primarily as intermediaries for clients and investors rather then as businesses devoted to serving their own interests.

One option is that some of these institutions have become "too big to fail" and must be broken up into smaller firms. This option has been suggested by Alan Greenspan. The problem with this option is that it does not deal with the fundamental issue of why these firms have grown to dominate the financial sector. By permitting proprietary trading and related dealer activities to remain acceptable, these firms will grow back in size and dominance.

Another option is to impose strict capital requirements upon firms engaged in proprietary trading. These requirements would have to be at a level which makes proprietary trading a far less profitable activity. There is little or no justification for this type of activity by institutions that are financial intermediaries and where trading for one's own account should be discouraged in a sector allegedly dedicated to the needs of clients and investors. Recently the Basel Committee announced a decision to increase capital requirements for trading activities but it remains to be seen whether these requirements will have a substantial impact.

A third option is to impose a transaction tax upon professional dealer activities in securities, commodities and currencies. While this option entails many complexities, it needs to be considered despite the heated opposition to it. That opposition will emphasize the loss of liquidity and its consequent impact upon the cost of capital.

Finally, there is the option of saying to Wall Street that trading for one's own account does not comport with the basic function of finance and proprietary trading should be prohibited. This is a far reaching proposal but it remains the most effective resolution of an issue that deeply troubles those concerned about the future of our financial sector. The Administration has taken an initial step by its proposal to prohibit proprietary trading by large banks and by proposing a tax on the liabilities of those banks. This issue has resonated over many decades and in fact was first raised in the 1930's when it was thought the securities laws should incorporate a total prohibition on dealer activity by exchange members. It ended with a compromise that dealer activity on an exchange floor should be limited to those engaged in maintaining a "fair and orderly market" and that "excessive trading" by members for their own accounts should be prohibited.

In any event, it appears that we are taking the first step towards returning an overblown financial sector to the basic principle that it serves the public as intermediaries and that it needs to subordinate its own interests to those of the public.

Ralph S. Saul
Former Chairman and CEO
of CIGNA Corporation,
Co-CEO of First Boston Corporation
and President of the American
Stock Exchange
January 25, 2010

A Market of Dealers

Wall Street has been transformed over the past quarter century by a tremendous infusion of talent and capital. Something significant triggered this change in the size and importance of this part of the American economy making it more attractive for the "best and brightest" of the current generation. That change occurred when Wall Street moved from a brokerage oriented market to a dealer market.

In the old broker oriented market, firms did not have access to public capital. Instead they relied upon the capital contributions of partners who in their self interest restricted risky dealer activities of their firms. This limitation provided an automatic check on the size of Wall Street and severely limited the risks taken by firms. When the NYSE permitted firms to have access to public capital, the Street entered into an age of expansion and importance for the American economy.

Over the years, the Congress and the SEC have wrestled with the combination of brokerage and dealer activities in the same firm including a study of segregation of these activities in the 1930's. The study decided against segregation but proposed a number of regulations to mitigate the conflict inherent in the combination of the two activities. In the 1930's we were still dealing with a brokerage oriented market limiting the immense number of conflicts which arose in the latter part of the 20th century.

The SEC had taken a number of steps to regulate dealer activity by limiting "unreasonable" mark-ups or marked downs and by seeking to insure that securities sold by dealers were "suitable" for their customers. But the SEC's regulation of dealers remained unusually light over the years and did little to restrain the growth and profitability of this activity.

The Goldman Sachs case illustrates how far we've come in the evolution of dealer markets. For Goldman and other dealers, clients are counterparties to whom they have no fiduciary obligations. Except for the obligation to charge "reasonable" mark-ups and to take steps to insure that the security is "suitable" for investors, they have no further obligation. Goldman could trade against the client and it could do so without disclosure.

It seems to me that the untrammeled growth of dealer markets-growth not only in size but in the complexity of its products -- has brought us to a point where the Congress as part of financial reform efforts needs to place limits on that growth for the protection of investors. The elimination of proprietary trading by bank holding companies is one step towards controlling these markets. But more needs to be done for investor protection. A new disclosure regime implemented by the SEC needs to be enacted which alerts investors to the conflicts involved in firms acting as dealers and these disclosures should not be boiler plate but highlight the conflicts in connection with each transaction. Investors should have an opportunity not to enter into a transaction if they feel these conflicts taint a trade.

In my view, the Congress cannot complete financial reform without enacting legislation along these lines.

R.S.S.

May 18, 2010