



VIA ELECTRONIC MAIL

March 8, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Concept Release Concerning Self-Regulation - File No. S7-40-04/Release No. 34-50700

Dear Mr. Katz:

The Financial Services Institute¹ (Institute) appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to evaluate and possibly overhaul the system of self-regulation that has existed for nearly 70 years (Concept Release). We applaud the SEC's efforts to carefully and thoroughly analyze the system of self-regulation, provide an unbiased evaluation of its inherent strengths and weaknesses and present creative alternatives to the present system. In the current business and regulatory environment it would be easy (and likely popular among some) to merely move forward to dismantle a system that, as is stated in the Concept Release, "has functioned effectively and has served government, industry, and investors well."

A. Background of Institute Members

The Institute was conceived in 2003 and launched in 2004 as an advocacy voice for independent broker-dealers. Our members, for the most part, have a number of similar business characteristics. They generally clear their securities business on a fully disclosed basis; are primarily regulated by the NASD; take a comprehensive approach to their client's financial goals and objectives; offer primarily packaged products such as mutual funds and fixed and variable insurance products; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Our members' registered representatives are also independent contractors, rather than being employees of a broker-dealer. These registered representatives are typically located in communities where they know their clients personally and

¹ The Financial Services Institute, Voice of the Independent Contractor Broker-Dealer, was formed on January 1, 2004. Our members are broker-dealers and registered investment adviser firms that serve representatives who are independent contractors. The Institute has 107 member firms, with more than 122,000 registered representatives and over \$7.8 billion in Total Revenues.

provide investment advice to their clients on a face-to-face basis. Our members, for the most part, do not concentrate their retail business on the sale of individual stocks and bonds; engage in active trading of individual securities; make markets; carry inventories; engage in investment banking services; or prepare and issue research to retail customers. Because our members take a comprehensive, holistic approach to their client's financial needs and objectives, they have a strong incentive to keep their client's interests paramount. Therefore, the Institute and its members are primarily concerned that, at the end of the day, the SEC maintain a system of self-regulation that continues to protect investors and ensure market integrity but also provides a regulatory framework that fosters member involvement and brings a thoughtful, practical approach to rulemaking so that SRO rules are rationally related to our members' business model and not merely fashioned on the theory that "one size fits all."

B. Summary Comments

We have carefully reviewed and analyzed the Concept Release. Following are summaries of our comments, each of which will be discussed in more detail below, to the proposals that we believe have the most direct impact on our members:

1. Inherent Conflicts With Members and Market Operations.

NASD is the primary regulator of the Institute's member broker-dealers. As we discussed in detail in our response to Exchange Act Release No. 34-50699 (Release), we believe that many of the SEC's concerns about various conflicts discussed in the Concept Release will be resolved with respect to NASD when the SEC approves Nasdaq's application to register as an exchange. This includes conflicts related to NASD's funding and those involving its regulatory and market operation functions. It will not, however, resolve the present, substantial member conflicts that arise in the SRO governance context between large and small NASD members. FSI's members are likely the largest constituency represented in the category referred to as "other broker-dealers" by the SEC in the Concept Release. In fact, our members are not represented on NASD's Board of Governors. We believe the SEC is correct when it suggests that SROs (including NASD) have traditionally failed to enforce rules as aggressively against larger, more influential firms. This is blatantly evident even through a cursory review of NASD's press releases for 2003 and 2004 regarding settled enforcement actions. For example, over a two year period NASD sanctioned a major wirehouse firm for municipal bond disclosure violations, late reporting on forms U-4/U-5, giving preferential treatment to certain mutual funds in exchange for brokerage commission payments, municipal securities pricing violations and prohibited sales contests. Although that firm agreed to pay over \$50 million in the aggregate to resolve these proceedings,

not once did NASD seek to suspend that firm or any of its principals. This seems strange in light of the fact that the cumulative effect of that firm's actions appears extremely serious and indicates a recidivist, unrepentant mentality. We believe the only way to prevent this type of preferential treatment is to ensure that all NASD members are equally represented in the governance process.

2. Inherent Conflicts With Market Operations.

As we will discuss in more detail in our comments to the Release, we believe that NASD's conflicts between its primary role as a self-regulatory organization and its market operations will be resolved when the SEC permits the registration of Nasdaq as an exchange.

3. Inefficiencies of Multiple SROs.

Although our members are not as directly impacted by the existence of duplicative and inconsistent regulation as are firms with more traditional business models, our members believe that it is in the best interest of all market participants to ensure that markets are fair and efficient. Market participants must be able to expect, at a minimum, a level playing field where they are not required to continue expending financial and human resources to comply with duplicative and inconsistent SRO rules and to implement multiple SRO-specific data systems in order to ensure access to all relevant market information. The Institute believes the best way to accomplish this result is for the SEC to lay down a foundational concept for the regulation of all markets and then allow competition and innovation by and among markets to facilitate fair and efficient markets at the lowest possible cost to market participants and investors. This assumes continuing SEC oversight of the process to ensure fairness to member firms, efficient markets and investor protection.

4. Funding.

It is virtually impossible to make an informed comment about funding for SRO regulatory operations because SRO revenues and costs of providing regulatory services are not currently transparent. We look forward to the adoption of the enhanced financial disclosures proposed by the SEC in the Release. We believe the implementation of these disclosures will enable the SEC to accurately determine the actual costs incurred by SROs to fulfill their statutory mandate to provide effective regulatory programs. Once this occurs, we believe SEC will be in the best position to determine the level of revenues necessary to adequately fund regulatory programs at a level and allocated in a manner that is fair to all SROs and market participants.

Ultimately, we believe that divesting NASD of Nasdaq will ensure that current funding arrangements for NASD's self-regulatory activities will be adequate and equitable to NASD members.

5. Alternative Regulatory Approaches.

The Institute and its members support the Hybrid Model, with certain modifications. We envision that NASD, after divesting itself of Nasdaq, will serve as the market neutral single self-regulatory organization (Single Member SRO). Given NASD's current structure, systems and staffing, it is the only SRO that is immediately capable without substantial system restructuring to be solely responsible for regulating all current SRO members with respect to membership rules, including rules governing members' financial condition, margin practice, handling of customer accounts, registered representative registration, branch office supervision, sales practices and a plethora of other functions not mentioned in the Concept Release but necessary for an effective system of self-regulation, including taking enforcement actions against its members. We believe that, subject to the SEC's evaluation of data obtained as a result of the adoption of the transparency proposals in the Release, NASD's current system of funding will provide the funding necessary to support the regulatory services detailed by the SEC in the Concept Release. This model will eliminate regulatory arbitrage across markets and provide consistent surveillance and examination functions and fairly distributed costs for all members.

While our members are not as directly impacted by market regulation as firms with more traditional business models, we appreciate the fact that the SEC has the authority to review and approve SRO rule proposals and oversee their regulatory programs. We believe the SEC should engage current market participants, SROs and automated market facilities in a dialogue through which the SEC will create a foundation for the establishment and operation of what it refers to in the Concept Release as Market SROs. The Market SRO's will then build through innovation and competition the framework on the foundation laid by the cooperative efforts of the primary stakeholders.

D. Detailed Comments On Alternative Regulatory Approaches

The issues presented in the SEC's 106 page Concept Release are complex. However, as discussed above and in the Institute's response to the Release we believe some of the solutions are quite simple. Fundamentally, the Institute and its members believe that the basic system of self-regulation has over the years ensured both fair and efficient markets and a reasonable, cost-effective system of regulation to protect those markets. We agree, however, that it is time to explore certain

modifications to this system in light of the rapidly changing market structure including the need to collect and distribute trading data over various market centers and new means of trading in and across markets driven by low-cost trading systems and less expensive, more powerful technology. Regardless of the regulatory approach eventually adopted by the SEC, we urge the SEC to ensure that the approach is grounded in free-market principals and is not based on a system of detailed, proscriptive rules promulgated by the SEC. The Institute recognizes that this evaluation of self-regulation provides an opportunity to carefully review one historical aspect of regulation and self-regulation that is often overlooked but, we believe, is critical to the success of the SEC's efforts to make self-regulation more effective. The responses by SEC and NASD to recent IPO, analyst, late trading and directed brokerage scandals provide ample evidence that the immediate regulatory response to market disasters in which investors are harmed in large numbers is always the same. Regulators immediately call for the adoption of additional, more complex rules that are often layered over existing rules, are proscriptive in nature and fail to consider that the wrong they are intended to correct is behind us and may never occur again in its prior form. We believe the better way to approach such behavior is to aggressively enforce existing rules. Therefore, we urge the SEC to consider in connection with any restructuring of the self-regulatory system a structure that works with the industry to apply principals of risk management prospectively to the compliance process and encourages the SROs to enforce existing rules aggressively when serious infractions occur.

With the foregoing considerations in mind, the Institute and its members urge the SEC to adopt the Hybrid Model of self-regulation and designate NASD as the Single Member SRO. We believe NASD brings the ability to effectively provide a self-regulatory platform at the lowest possible costs to its members. NASD has served well as the primary regulator of its members since its formation. It has over the years continually updated and upgraded its technology and other surveillance systems. As with any complex, diversified business NASD is not without its operational challenges. We believe NASD needs to develop more effective district staff training so that examiners and others will take a more consistent approach to the interpretation and application of rules and policies among districts. This can be accomplished when NASD's main priority becomes promulgating, ensuring member compliance with and bringing enforcement actions against members for violations of what the SEC refers to as "member" rules. Assuming the SEC effectively focuses and guides the Single Member SRO's self-regulatory activities through the use of its rulemaking and oversight authority, we disagree that funding issues will arise.

We believe NASD's current funding model, once it divests itself of Nasdaq, will provide ample funding for its more concentrated activities. To the extent that the regulatory efforts of the Single Member SRO become more cost-based, the current environment in which NASD clearly gives certain preferential treatment to firms that are significant market participants and that adopt a more traditional business model can and should be eliminated. We believe strongly that the SEC should be the final arbiter of fair and appropriate funding for regulatory efforts and the manner in which the funding obligation is to be apportioned among members of the Single Member SRO. Nevertheless, we believe the SEC will be unable to make such determinations unless and until there is adequate transparency with respect to SRO revenues and costs. This should occur when the SEC adopts the transparency provisions proposed in the Release.

Our members are, for the most part, not direct market participants. Nevertheless, our members can be adversely affected by ineffective market regulation that fosters a perception that markets are neither fair nor efficient. For this reason we will make limited comments to the SEC's Hybrid Model proposal regarding what the SEC refers to as a "Market SRO."

To the extent that market participants can arbitrage regulation across markets then the SEC's proposal is appropriate. Obviously, all industry members should support fair and equal regulation across all markets. Similarly, all industry members must support the infrastructure necessary to capture market and trading data necessary to support regulatory surveillance efforts. We believe all industry members must support a system that enables investors to feel confident that their orders will be routed to the market in which they will receive the best available price and obtain execution timing that best suits their needs. Finally, we believe that there is no fair method of measuring and allocating the costs of operating the Model SROs at this time. However, we are confident that when such data is available the SEC is the appropriate body to analyze the data, determine appropriate and fair surveillance and enforcement costs and apportion them fairly across all markets. We urge the SEC to adopt the Model SRO concept. We believe this will be the most effective and efficient vehicle through which to regulate intermarket trading activity. We suggest that the SEC, in conjunction with industry participants, establish a general set of minimum regulatory obligations for the Model SROs. The Model SROs could then adopt specific rules within this general framework that coincide with the structure of the market overseen by each Model SRO. We do not believe this system will work if the SEC imposes one set of rigid, proscriptive rules on all Model SROs. Each SRO must be able to adopt rules best suited to the business model of the market they

regulate. Technology, market systems and execution services are evolving rapidly and, as a result, each Model SRO must have the flexibility to craft rules designed to meet their specific market structures. These rules must, however, also be consistent with the basic framework laid down by the SEC. The SEC, just as it does now, will have the ultimate oversight authority for the adoption of rules by the Model SROs. This leaves open the issue of who will conduct surveillance and enforce the rules adopted by the Model SROs. We believe that the Model SROs should be given the authority to conduct surveillance on their respective markets. However, the SEC should carefully monitor each Model SRO to ensure that the data they collect from their members is sufficient to support adequate member regulation. Where appropriate, we believe the SEC should mandate that the Model SROs will share data to ensure that no one Model SRO dominates data access and that Model SROs do not create unique data collection or dissemination in an effort to stifle competition. Finally, we believe that enforcement of market should be the primary responsibility of the SEC working in concert with each Model SRO. We do see any justification for placing this responsibility with the Model SROs. To do so would require each Model SRO to develop separate, duplicative enforcement staffs and systems. The cost would be prohibitive. We also cannot recommend placing the enforcement responsibilities with the Single Member SRO. We believe this will engender more of the same conflicts that prompted the SEC to issue the Concept Release. The SEC already supports a competent, sophisticated enforcement program and we believe that the SEC is suited to the task of evaluating and pursuing the types of complex enforcement issues that will likely arise in multiple creative, competitive and technology-driven markets.

We appreciate the opportunity to share the views of our members with the SEC on these timely and important issues. We and our members will be pleased to work with the SEC staff in crafting the final SRO structure that evolves through this comment process. Please feel free to contact me at 770 980-8487 with any questions or to discuss further any of our comments.

Respectfully submitted,



Dale E. Brown, CAE
Executive Director and CEO

pc: Honorable William H. Donaldson
Honorable Cynthia A. Glassman
Honorable Harvey J. Goldschmid
Honorable Paul S. Atkins

Honorable Roel C. Campos