"Government is a contrivance of human wisdom to provide for human wants. Men have a right that these wants should be provided for by this wisdom."
Edmund Burke, Reflections on the Revolution in France, 1790

"I think that the world has gotten to a point where conflict of interest is under the microscope now more than ever before. It is quite clear that the role of a trade association and the role of a regulator are distinctly different functions."
David Wilson, Former Chair of the Investment Dealers Association of Canada

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The National Association of Investment Professionals

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Sent by e-mail to rule-comments@sec.gov
On March 8, 2005

March 8, 2005

Jonothan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549

Re: File Number S7-40-04, Comments on the Self- Regulatory System for the U.S. Financial Services Industry

Dear Mr. Katz:

As recently as 1965, only 10.4 percent of American household owned stock either directly or through mutual funds. By 1997, that number had more than quadrupled to 43 percent. Increased ownership has helped jettison the market from a mere 1100 in 1983 to over ten times that number by March of 2000. One can see that the markets have become more complex, if for no other reason, than its sheer size.

The complexity and our concomitant concern over a well-regulated stock market increases as we see more proposals for privatizing some of the Social Security Trust Fund. NAIP feels that our regulatory system must be over-hauled before U.S. citizens are allowed to privatize any Social Security contributions. To not do so would be foolhardy and irresponsible.

Britain eliminated self-regulation in June of 2000 with the Financial Services and Markets Act. They assembled a group called the Wise Men to study the regulatory system of that country for several years before they re-structured their system of

regulation. Canada has assembled their own group of "Wise Men" to study the regulatory system in that country as well.

NAIP would encourage the SEC and the U.S. Congress to follow the lead of Britain and Canada in this regard. We would encourage the regulatory bodies to assemble their own "Wise Men" group to study the very important and complex subject of securities regulation. This study should take 3-5 years to thoroughly understand the questions outlined in SEC Release Number 34-50700, File No. S7-40-04. Some of NAIP's concerns our listed below in our replies to some of the questions in this Release.

In a fireside chat with the SEC Historical Society on February 26, 2004, Professor Seligman - a "wise-man" of U.S. securities regulation made the following comments:

> *"I think the challenge before the SEC at the moment is in a sort of post Enron period, in a period where there has been systematic dysfunction revealed in a number of different arenas, [the SEC has not] to look deeply enough. At some level I'm concerned with a very major change in style, which has occurred with the SEC over time. During the 30s, this was an agency that focused on learning the fundamental facts of an industry, publishing detailed reports, holding public hearings, trying to articulate alternative approaches to problems. It was a much more self-consciously engaged effort to look at whichever industry they were addressing in a fundamental way. In more recent decades, under SEC Chairs of both parties, there has been much more a sense of firefighting.* ***There's been more a sense, 'If the immediate issue is revenue sharing on the part of investment companies, we'll try to adopt a rule there.' But much less a sense of; 'How did we get to a point where this became the issue?'*** *What does it tell us more broadly about the way investment companies are regulated or the way in which oversight of investment companies is addressed by the SEC and the by the industry. And I think the lack of a willingness in recent years for the SEC to engage in the kind of study that was perhaps most effectively done in 1961 to 1963, in the famous Special Study of Securities Markets, is a very significant weakness. I would like— more than anything else— to take a tough hard look at issues such as market structure, market regulation, and issues like the oversight in the mutual fund industry, and issues such as the potential globalization of securities trading and its relationship to the Securities Act of 1933.* ***I think I'd like to, if you will, try to develop the facts before trying to propose solutions****.(Emphasis added.)*
>
> *And I think, one of the tough questions where we live in a world where the financial press is increasingly vigilant and more short term in their attention span, and Congress tends to be moved most by the type of scandals that are on the front page of the New York Times, for example, is, do we anymore have a political culture that can sustain and support the depth-full look that the SEC has historically taken at problems. I am absolutely convinced that when the*

Commission has taken this broader and more depth-full look, it's been at its most effective."

NAIP wishes to thank the Commission for opening the first round of debates on self-regulation in the securities industry. Our hope is that this is just the beginning and not the end of the discussion on this very important issue.

NAIP and its related entity – The Financial Services Policy Institute – will continue this SRO discussion on our websites at www.naip.com and www.fspi.us . We will attempt to work for change in the current regulatory system so it is both fair to those working in it and at the same time protects the investors that our members strive to serve.

Sincerely,
Thomas S. O'Keefe
President
Email: tokeefe@naip.com

NAIP Official Comment on Self- Regulatory System For the U.S. Financial Services Industry

A. General Comments on SEC Concept Release

The current problems associated with stock market regulation are not new. In fact, there are many similarities between the events subsequent to the 1929 Crash, and subsequent inadequate regulation, and what has unfolded in our markets since the turn of the millennium.

To ameliorate these problems associated with recent financial scandals, it is important to determine their causes and some possible solutions. The following text offers both.

In John Kenneth Galbraith's "The Great Crash" (Published in 1954). He said the following:

> *"...The sense of responsibility in the financial community for the community as a whole is not small. It is nearly nil. Perhaps this is inherent. In a community where the primary concern is making money, one of the necessary rules is to live and let live. To speak out against madness may be to ruin those who have succumbed to it. So the wise in Wall Street are nearly always silent. The foolish thus have the field to themselves. None rebukes them. There is always the fear, moreover, that even needful self-criticism may be an excuse for government intervention. That is the ultimate horror.*[1]

So someday, no one can tell when, there will be another speculative climax and crash. There is no chance that, as the market moves to the brink, those involved will see the nature of their illusion and so protect themselves and the system..."

People in our industry hate speaking out for better regulation because they think it will infringe on their ability to make money. The greed motivation far out-weighs the desire to do what is better for the common good. There were some enlightened individuals working in the industry as there were in the 1930's, who realized the industry needed better regulation. In fact, the "founding fathers" of securities regulation confronted an industry that was very similar to conditions of today according to Thomas K. McCraw in his Prophets of Regulation:

"*Here was an industry that seemed hopelessly divided among warring groups of practitioners: investment bankers on the one hand and speculators on the other; the exchanges, dominated the New York Stock Exchange, of which all the smaller regional exchanges traditionally were jealous; an over-the-counter, with its diffuse hordes of brokers and dealers held together only by telephone lines and a loose set of unenforceable rules. And everywhere in the securities industry, <u>there prevailed a tradition of nondisclosure and nonstandard accounting practice.</u>* (Emphasis added.)"

But author McCraw went on to state that:

"Despite such obstacles, Landis(an early SEC Chairman), and his cohorts had some powerful ad hoc allies. These included the most progressive elements among broker and dealers within the stock exchanges and a larger number of professional accountants, who found good reasons to cooperate with the government. Already accountants had benefited more from government regulations that from any source of support among business groups."

These "progressives" discovered early on that they may have to change professions very quickly if confidence wasn't restored in the service they provided the public. The same should apply to brokers, advisors and accountants working in this era. Unfortunately entrenched political beliefs may handcuff them from doing so.

There have been those few who have wisely spoken out against the madness since the '29 Crash. One of these is Dr. Joel Seligman, law professor and author of the "bible" of securities regulation - "The Transformation of Wall Street", made the following observation of the SEC during the 1960 to 1970 period which is so applicable to the current Enron/Arthur Andersen problem:

"Historically, the breadth of the SEC's jurisdiction and the vagueness of pivotal provisions of the Commission's enabling statutes have contributed

> *to the SEC's relative inattention to accounting and corporate governance...Lack of commissioner expertise has contributed to the SEC's passivity in such fields as accounting. Lacking commissioners with training or interest in the accounting field, the SEC's Office of Chief Accountant, consistently under funded and understaffed, has not made studies of leading accounting problems, and has rarely proved able to attract outstanding theorist.*
>
> *The SEC's history suggests that the breadth of the Commission's jurisdiction also has been disabling for political reasons. An agency like the SEC can sponsor only a few initiatives at one time. Securing Executive and Legislative Branch support, conduction empirical studies, presenting hearings, and negotiating with or confronting and industry are time-consuming and expensive activities. The very corporate governance has afforded the Commission a justification to relegate these issues to a low priority and concentrate its political energies elsewhere.*" (Emphasis added.)

As to why the regulators didn't see Enron coming, or couldn't do anything about it, I turn to Professor Joel Seligman. He made the following comment regarding a well-run SEC in his book "The Transformation of Wall Street":

> *"...the greatest weakness in SEC 'self-regulation' of the over-the counter market was the risk that during periods when the Commission was led by less activist chairmen than Douglas (A greatly-respected former SEC Chairman and Supreme Court Chief Justice.), or hamstrung by budget stringency, the SEC would cease to prod NASD to discipline its members vigilantly."*

The question that the SEC must answer is: How does the organization constantly revitalize itself with "activists" members and staff? How can it formulize the regulatory successes that some State regulators have had against some corrupt forces in our industry? Hopefully you will receive your answers in the responses you have requested on this matter. But more likely it should be researched and debated by our countries "wise men" to come up with the answers so that investors don't face the same kind of losses they experiences in the last market melt-down.

B. Response by question listed in SEC Release 34-50700:

***Question 4*: To what extent do conflicts exist between SRO regulatory and market operations functions? Has increased inter-market competition exacerbated this potential conflict? Are markets today attempting to use "lax regulation" as a means to attract business? Are they attempting to use "aggressive regulation" as a weapon against competitors? Is it unrealistic to expect a "cost center," such as regulation, to**

resist pressure from a function that generates business revenue in a modern business enterprise?

NAIP Response: I believe there are serious anti-trust problem developing in the industry as a result of de-facto rule making, and other recent decisions by the NASD that I believe inhibits mobility in the industry. In a recent letter to the NASD I highlighted some of these concerns. Here is an excerpt of that letter addressed to Barbara Sweeney of the NASD:

> ***Subject: NASD Requests For Comment on Proposed Amendments to Rule 3010 to Require Heightened Supervision Plans for Associated Persons with a Specified Threshold of Industry/Regulatory-Related Events.*** **Notice to Members 03-49.**
>
> *Dear Ms. Sweeney:*
>
> *In an NASD Notice to Members dated September, 2003, the NASD requested comments from members on proposed amendments to NASD Rule 3010 which addresses "how persons who have engaged in certain types of serious misconduct become subject to statutory disqualification under the federal securities laws and NASD rules."*
>
> *Even though the proposed amendments to Rule 3010 have not been approved many member firms are adopting "heightened supervision plans" for representatives who have three customer complaints on their CRD. NAIP has concerns and questions about the implementation of these policies by your members.*
>
> *Specifically, NASD Notice to Members # 03-49 sought comments on the adoption of rule amendments to require persons who meet or exceed threshold number of industry/regulatory-related incidents. This "threshold" as we understand it, is <u>just three customer complaints, arbitration proceedings, termination for cause, and disciplinary action.</u>*
>
> *<u>Our questions and concerns are as follows</u>:*
>
> *1. What is the status of the aforementioned Notice? It has been one and one-half years since the comment period closed on 03-49 and apparently there is still no decision from the NASD. Will NASD be issuing a formal decision on this Notice and if not - why?*
> *2. Is NASD aware that member firms are instituting these "three-strike" in-house compliance policies for their registered representatives?*
> *3. According to NASD figures approximately 29,500 reps have at least one complaint on their record. NAIP feels this represents a large percent of the active, producing reps in the industry which number closer to 300,000, not the percent of the total number of registered people in the industry of 660,000.*
> *4. NAIP also has a concern with the dramatic increase in problematic U-5 filings. NASD states that <u>terminations for cause</u>, which are triggered by the number of negative comments on a reps CRD <u>rose over 90% to 12,404 last year from 6,510 in year 2003</u>.*
> *5. We are receiving reports that reps are suddenly faced with charges on their CRD that weren't formerly on their records that appear on the CRD after they try to make a move to another firm. We are also hearing that because brokerage firms are*

afraid of being fined by NASD they are putting petty infractions on CRD records that they in times past would not have. (See On Wall Street Magazine, February, 2005, "The U-5 Nightmare", by Editor-at-Large, Dan Jamieson)

6. Ironically, many of the complaints that are appearing on CRD records now are as a result of the problems created by analysts conflicts at the major wire-houses. I pointed this out in my October 17, 2003 Comment letter to NASD on Rule 3010 proposal amendments. (This is on the NAIP website at http://www.naip.com/CommentLettersAndTestimony). Now, after following the recommendations of their "star" analysts, financial advisors are again suffering the brunt of the penalties much in the way they did with the Prudential Limited Partnership scams.

7. NAIP feels that the NASD and large member firms are restraining trade by implying that members should institute a "three-strike" policy for registered persons as outlined in Notice 03-49. NAIP feels that large member firms would like to slow the "flood" of registered persons leaving large firms for the independent contractor and registered investment advisory firms.

Although NAIP arrived at this conclusion based on anecdotal evidence from attorneys who regularly practice in this field as well as feedback from brokers, we feel the reports we are receiving warrant further study of this serious issue in order to ensure that the tens of thousands of brokers affected are being treated fairly and in accordance with both the letter and spirit of the NASD rules. The NAIP would be happy to participate in such a study with the NASD and others.

Finally, NAIP feels that it is highly unusual though not unprecedented that the NASD requested formal comments on this matter in October of 2003 yet has made no decision on the suggestions for amending Rule 3010 nor has NASD even informed the public about the status of the Notice to Members 03-49.

Because NAIP is concerned with NASD lack of follow-up on this Notice, and because we are also concerned about the points outlined above, NAIP is sending a copy of this correspondence to Annette Nazareth, Director of Market Regulation at the Securities and Exchange Commission (SEC), with a requests to determine the status of the proposed amendments to Rule 3010 and to investigate the legality of member firms putting registered representative on these "heightened supervision plans", especially when it has not been proven in a legal forum if the accused financial advisor is guilty of a particular customer complaint or not.

***Question 5*: To what extent has internal SRO separation of these functions addressed these concerns? Has the restructuring of the NASD, and the recent governance changes of the NYSE and other SROs to enhance their independence, been effective in better insulating the regulatory function from the market function?**

NAIP Response: In the summer of 2003 I was invited to testify to the NYSE Governance Committee. I was to appear at this Committee's hearing on September 5, 2003. When I discovered the hearing was being conducted in secret (i.e. no one knew

who was testifying –even the other experts who were offering advice, and the transcripts of the testimony was not made public at that time.)[2]

In 2004 I was nominated to the NYSE's Board of executives and NYSE Advisory Committees.

In a letter to me from the NYSE dated August 24, 2004 I was informed of the following:

> *"The Nominating & Governance Committee of the NYSE Board has completed its initial review of 110 director candidates whose names were submitted in response to the NSYE's public solicitation for recommendation for the 2004 Annual Election. …."*
>
> *"After these initial evaluations, we are leased to inform you that you are one of forty individuals chosen by the committee for further consideration…"*

(A full copy of this the letter from the NYSE to me can be seen at the NAIP website at www.naip.com.)

It is important to note that I never heard again from the NYSE regarding this potential Board seat. In my opinion the NYSE was attempting to placate me on my insistence that the NYSE change their governance so that the regulatory operation was split from the trading/commercial operations of this entity. (I made these views known in interviews on CNBC, and CNNFN during the months of September and October 2003.)

Because of this one must call into question the sincerity of the NYSE to institute other governance and regulatory changes that have both been proposed and enacted.

***Question 21*: How has the trend of decreasing transaction fees impacted the SROs' ability to fulfill their statutory obligations?**

NAIP Response: Section 31 fees use to be 1/300th of 1%. (On a $30,000 trade this would be $1.00.) This brought in $2 billion in total fees in 2001. Yes, this went into the general revenues, but I'm sure that Congress could set up a mechanism in which these fees would fund the SEC and only the SEC. The SRO's should be eliminated – their conflicts of interest don't serve the public and having multiple SRO's is inefficient.) And the new SEC should have a budget that equaled the Section 31 fees in year 2000 ($2 billion). Any fees above the SEC's current budget could be shared with the States much like Medicare payments.

Medicaid is a partnership between the Federal Government and the states. While the Federal Government provides financial matching payments to the states and is responsible for overseeing the Medicaid program, each state essentially designs and runs

its own program. States have great flexibility in administering their programs, and the Federal Government pays the states a portion of their costs by matching certain spending levels, with statutorily determined matching rates, currently ranging between 50 and 77 percent. This creates a natural tension in which states strive to maximize Federal matching dollars.

The revenue brought in by the SEC from increased fees and penalties could be used for this Federal matching program for State regulators much in the same way that the Federal governments shares this revenue with the States to take care of the elderly.

It is, after all, state regulators like Elliot Spitzer who have been on the vanguard of protecting investors the last five years – not the SEC and surely not the NASD. The problem all State Securities Regulators face however, is lack of sufficient funding. This kind of revenue sharing would ameliorate this problem. And, the State regulators do not have the same conflict of interests problems that the SRO's have.

***Question 38*: To what extent would the changes proposed in the SRO Governance and Transparency Proposal continue to provide the benefits of the current SRO system (*e.g.*, largely self-funded system with market specific expertise of SRO regulatory staff enhancing rule promulgation and enforcement)?**

The following is an example of SRO rule making that the new Regulatory System should avoid. A well-funded system, that has the SEC in control at the Federal level and working closely with a well-funded network of State regulators should avoid this following real life Rule Making problem that registered representatives experiences with the NASD in the mid-1990's.

> *In 1997, with a very select committee, the NASD formulated Rule 1150 . Rule 1150, if it would have been passed by the SEC, would have given brokerage firms qualified immunity for remarks put on a brokers U-5 (license) when they leave one firm to join another. The firms claimed they needed qualified immunity because they were being hurt financially by a large number of defamation suits from departing brokers who were Ablackballed@ on their U-5's. They also claimed that they were afraid to put the Atruth@ on U-5's because of fear of being sued. They have claimed this fear as their excuse for the large numbers of Arogue brokers@ after the SEC=s Large Firm Report came out in 1994 documenting the growing problem of rogue brokers.*
>
> *Under the proposed Rule, culpability for defamation on your U-5 would have to be proven by Aclear and convincing evidence, that the brokerage firm either knew or was reckless in not knowing that the statement was materially false at the time it was made.@ This standard is used most often in criminal cases, not civil. Many plaintiffs lawyers tried to replace this harder to prove standard with one that is normally used in civil cases - the Apreponderance of evidence@ standard.*

But the NASD felt it was compromising with the Securities Industry Association (SIA) who desperately wanted Absolute Immunity for remarks put on ones U-5. It is important to note that judges are the only ones who now have absolute immunity involving their decisions in court. If broker/dealers were given absolute immunity, they could make any comment on your U-5, and never be liable, even if the comments were utterly and completely false.

Attorney=s who represent brokers are aghast at the boldness of the NASD in even putting the Aclear and convincing evidence standard@ in the proposed Rule. Leslie Corwin a plaintiff=s lawyer in New York, was quoted in the Wall Street Journal last year that the clear and convincing evidence standard Araises a virtual insurmountable obstacle because a terminated employee suing for U-5 defamation would have to show the state of mind of the member firm without significant access to its books and records.@

NAIP thought it was important to take a stand against the passage of Rule 1150 in our Comment Letter to the SEC dated June 18, 1998, for the following reasons (Go to our web-site at naip.com for further explanation):

1. *It would <u>not</u> achieve the SEC=s objective of ridding the industry of rogue brokers.*

2. *There is no evidence that member firms face a problem with U-5 defamation claims, which is the justification given for this proposed rule.(NAIP thoroughly researched the data that the Securities Arbitration Commentator has on defamation cases)*

3. *Neither SROs nor the SEC have authority to ignore existing state law, as this proposal would do with its uniform Aclear and convincing@ evidence standard, as well as other proposed legal standards for defamation.(possibly unconstitutional)*

4. *The rule will significantly restrain trade.*

5. *It will significantly reduce whistle-blowing activity by brokers, which will hurt the public.*

6. *The NASD=s rule making process has been flawed and biased. (no brokers were involved in its initial formulation)*

Furthermore, this proposed rule change is inconsistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the NASD=s rules must be designed to <u>prevent</u> fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general, to <u>protect investors and the public interest</u>. The NAIP believes this rule will not

encourage fuller disclosure but will instead encourage firms to create inaccurate Forms U-5 and to defame parting brokers.

ANo one should have the right to effectively use an information notice such as the U-5 for the purpose of hamstringing a former employee. And that's what the U-5 has all too often been used for: vendetta. There is virtually no firm where some supervisor hasn't thought about using the U-5 to get even with some subordinate at some time,@ says respected plaintiffs attorney Bill Singer.

Normally a proposed Rule is approved by the SEC within ninety days of the comment period closing. Rule 1150's comment period has been closed now for over seven months. Why was this proposed Rule never approved or even proposed again at the SEC? Perhaps the SEC hadecond thoughts about the validity of the NASD member firms claims about problem defamation suits, and their own reasoning for this Rule to eradicate rouge brokers.

During the SEC comment period in June of 1998, NAIP was instrumental in creating these doubts with our well researched and written comment letter to the SEC (which is on our Web-site). We also initiated a letter writing campaign from our members to both the SEC and members of Congress. NAIP member letters stating that Rule 1150 should not be passed, far out numbered those from the member firms who wanted qualified immunity.

H. Other Models

Alternative models of regulation exist that were not specifically explored in this release. Such approaches may be variations of the above alternatives or completely different models. The Commission specifically seeks public comment on the following question:

***Question 73*: Are there any other approaches to regulation of the securities industry that are worthy of consideration whether discussed herein or not? Should the current model remain unaltered?**

Yes. See the British model. For information on this see:

http://www.fsa.gov.uk/pubs/other/fsarevisited.pdf

Also see proposals made for Canadian securities regulation at: http://regulators.itgo.com/

Notes

[1] Indeed there are many stories about the large amount of money and energy Wall Street spent on defeating the Securities legislation from the Roosevelt Administration. Some conspiracy theorist also point out that Marine General Smedley Butler testified to Congress in 1934 that there was a planned coup d'etat by Wall Street Investment Bankers against the Presidential Administration of Franklin D. Roosevelt because they were angry over the securities reforms proposed in the Securities Act of 1933. See http://home.iprimus.com.au/korob/fdtcards/Butler.html. Also see U.S. House of Representatives, *Special Committee on Un-American Activities, Investigation of Nazi Propaganda Activities and Investigation of Certain Other Propaganda Activities*, Hearings 73-D.C.-6, Part 1, 73rd Cong., 2nd sess., (Washington, D.C.: Government Printing Office, 1935.

U.S. House of Representatives, *Special Committee on Un-American Activities, Public Statement*, 73rd Cong., 2nd sess., (Washington, D.C.: Government Printing Office, 1934).

[2] It was not until the Richard Grasso compensation problem at the NYSE became public knowledge in the media that the transcripts of these hearings were made public in October of 2004. Because of the constant vigilance and investigations by reporters like David Weidner at www.marketwatch.com much of the NYSE information on the Grasso compensation packages became public.