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FINANCIAL SERVICES INSTITUTE
VOICE OF THE INDEPENDENT CONTRACTOR BROKER-DEALER

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VIA ELECTRONIC MAIL

March 8, 2005

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

Re: Fair Administration and Governance of Self-Regulatory Organizations – Release 34-50699/File No. S7-39-04

Dear Mr. Katz:

The Financial Services Institute[1] (Institute) appreciates the opportunity to comment on the Securities and Exchange Commission's (SEC) rule proposals dealing with SRO administration, governance, ownership and transparency embodied in Release 34-50699 (Release) under the Securities Exchange Act of 1934 (Exchange Act). The Institute commends the SEC for providing such a thorough and thoughtful analysis of the ownership, governance, operation and mission of our national securities exchanges and registered securities associations (sometimes collectively referred to in this letter as SRO's). We share the SEC's concerns that, while the legislative mandate for SRO's has changed little since the 1930's, the structure, perceived mission, sources of revenues and business direction of SRO's has changed dramatically. The Institute cautions, however, that radical changes to a system that has for the most part served well market participants, protected investors and ensured the integrity of the US securities markets for almost 70 years should not be made precipitously. We question whether many of the SEC's concerns about governance and conflicts of interest arise more from what might be called "SRO mission creep" than from a weakness of or flaw inherent in the system of self-regulation created by the Exchange Act. Rather than attempt to superimpose governance and structural principals that were created for the governance of public companies, on not-for-profit SRO's we believe the SEC should determine the specific mission for the various exchanges and associations and then work with Congress to refine the provisions of the Exchange Act and rules promulgated thereunder to ensure that SRO's have the appropriate regulatory framework to structure themselves in a manner that

[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.

will enable them to carry out the specific mission assigned by the SEC. We emphasize that our comments are directed only to the application of the proposals to NASD, since it is the primary self-regulator designated for our members. Finally, we recognize that the SEC published notice of Nasdaq's Form 1 application to register as a national securities exchange under Section 6 of the Exchange Act on June 7, 2001. The Institute's comments to the SEC's proposals in the Release presuppose that the SEC will act on Nasdaq's application at some point in the near future, especially in light of the proposals in the companion Concept Release (Release No. 34-50700).

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. Our members' registered representatives are also independent, rather than being employees of the broker-dealer. 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 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

The Institute and its members have carefully reviewed and analyzed the 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. <u>Proposed Rules 6a-5 and 15aA-3</u>

   <u>Independent Directors, Standing Committees, etc.</u> – The Institute opposes the proposed rules with respect to independent directors, standing committees and other governance changes as they apply to NASD. This is not to say that the Institute is satisfied with the current

NASD governance structure. We believe the NASD should provide for more representation on its Board of Governors, Committees and Standing Committees by our members and other broker-dealers that do not embrace the traditional wirehouse business model. Nevertheless, we believe NASD By-Laws already provide for sufficient Non-Industry and Public Directors and Governors by mandating that the number of Non-Industry Governors will exceed the number of Industry Governors and increasing the number of Public Governors that must be appointed as the total of Non-Industry and Industry Governors increase. While the Institute appreciates the SEC's proposal for certain specific Standing Committees, we believe this will be better achieved by each SRO evaluating its self-regulatory mission and adopting additional or different standing committees as are necessary to more effectively carry out their mission.

Separation of Regulatory and Market Operations - The Institute supports the SEC's proposals to separate a SRO's regulatory and market operations, including providing for independence of regulatory programs, use of regulatory fees, fines and penalties and protection of regulatory confidential information. However, we remind the SEC that NASD has gone further than the SEC's proposals in separating its regulatory functions and market operations. NASD has divested itself of AMEX and, as we understand it, is awaiting SEC approval to completely divest itself of any ownership interest in or control over Nasdaq. Based on this action we do not believe the proposals for the establishment of a Regulatory Oversight Committee and appointment of a Chief Regulatory Officer are applicable to NASD.

Member Voting and Ownership Limitations - The SEC appears to base its ownership proposal on the assumption that SRO's are all owned and controlled by stockholders or will shortly become so through demutualization. The SEC is apparently concerned that one or more broker-dealers will then gain control of the SRO and direct its regulatory operations and/or trading facility. This seems unlikely with respect to NASD. It is a member owned association that is in the process of divesting itself of its trading facility (Nasdaq). Therefore, it has no incentive to demutualize. We can see no legitimate reason why the proposals pertaining to member voting and ownership limitations should apply to a member owned SRO that does not own or operate a trading facility.

Adoption of Code of Conduct and Ethics - The Institute supports the adoption of a code of conduct and ethics and governance guidelines as proposed.

2. Proposed Revisions to Form 1 and New Form 2

The Institute supports specifically the SEC proposals to require SRO's to disclose detailed information about

various aspects of their operations on Forms 1 and 2 filed with the SEC.

3. Proposed Rule 17a-26

The Institute supports the adoption of proposed Rule 17a-26, as we believe that these reports will provide statistics not currently available that will enable the SEC to easily discern the types of broker-dealers that are the primary sources of and the products that are the subject of a majority of complaints and significant disciplinary actions. However, the Institute opposes the SEC's confidential treatment under FOIA of "any report or other information" filed with the SEC pursuant to proposed Rule 17a-26.

C. Detailed Comments

The Institute and its members share the SEC's objectives to strengthen SRO governance, foster a greater degree of objectivity and impartially in important SRO governance processes and ensure independence in the application of SRO regulatory and disciplinary programs. The ultimate goal of all participants in this process must be to foster investor protection, market integrity and equal regulation of all market participants. However, as we discussed above, most of the Institute's members are primarily regulated by NASD. Although our members are interested in ensuring fair, orderly and efficient markets, fairly priced market data and the creation of technically advanced trading facilities, we are confident that these issues will be expertly and thoroughly addressed by the Securities Industry Association. The Institute and its members are focused more directly on the scale of the structural changes to SRO governance proposed by the SEC and the attendant costs associated with building the structure to support the implementation of the proposed changes. As always, the cost will be allocated to member broker-dealers and ultimately bourn by investors. The genesis for the SEC's proposals is the Sarbanes-Oxley Act of 2000 (Sarbanes-Oxley Act) and recent settlements of SEC enforcement proceedings against certain exchanges, principally the NYSE and CHX. Clearly, the jury is still out on the financial and other impacts the Sarbanes-Oxley Act will have on public companies. While we acknowledge that there likely have been certain general governance improvements at public companies, principally more "engaged" audit committees, we are also mindful that the Sarbanes-Oxley Act has substantially increased audit fees and D&O liability insurance premiums. The SEC has recently agreed to extend the deadline for public companies with market capitalizations of $75 to $700 million to come into full compliance with its rules implementing Section 404. Clearly, the SEC recognized that compliance with the provisions of Section 404 were more rigorous and costly than first anticipated. We believe this is an appropriate time to step back and evaluate these proposals in light of the potential gains in investor protection weighed against the potential ultimate costs of these proposals to broker-

dealers, especially those like most of our members that are small, entrepreneurial companies. It is with these cautionary thoughts about unintended consequences that we make the following specific comments to the SEC's proposals:

1. Proposed Rules 6a-5 and 15aA-3

The Institute opposes much of proposed Rule 15Aa-3 as it applies to the NASD. For purposes of our comments we recognize that Section 15A(b)(11) of the Exchange Act specifically directs the NASD, as the only registered national securities association, to develop rules and promote orderly procedures for "collecting, distributing and publishing quotations." We also appreciate that this obligation has been one of the obstacles to the final divestiture by NASD of Nasdaq. Nevertheless, we feel confident that the SEC will ultimately approve the Nasdaq's application to register as an exchange. As we discussed above, our comments are premised on the fact that NASD will ultimately separate its regulatory functions from its operation and ownership of Nasdaq to become only a self-regulatory organization. With this prospect in the forefront of our analysis we make the following comments to proposed Rule 15Aa-3:

The Proposal For Independent Directors And Standing Committees As Applied To NASD Should Not Be Adopted - The Institute does not believe that the series of proposed substantive requirements with respect to the composition of the NASD Board will do more than its present structure to enhance governance and protect investors. While no system of corporate governance is perfect and ultimately depends on the honesty and integrity of those responsible for day-to-day operations, we believe the current NASD corporate structure best serves the industry, the markets and investors. The Institute and its members believe strongly that the concept of self-regulation remains viable so long as industry members have a substantial voice in the creation and application of the rules and policies that govern the industry. We are not alone in this view of self-regulation. In his capacity as Senior Vice President and Deputy Member Regulation NASDR Regulation Inc., Daniel Sibears testified on May 23, 2002 before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Investigation and Oversight. Mr. Sibears testified that, "The co-existence of strong self-regulation and investor participation in the markets is no mere coincidence. Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives not readily available to governments. It fosters investor protection and member involvement by promoting high standards that go beyond simply obeying the law. And it has helped make the U.S. markets the most

successful in the world. Self-regulation works because the brokerage industry understands that market integrity leads to investor confidence, which is good for business. The overwhelming majority of NASD members comply with the letter and spirit of the rules and the law. They view their own reputation for fair dealing and high standards as an asset in a competitive industry." Mary Shrapiro echoed Mr. Sibears sentiments in remarks on November 13, 2001 before the A.A. Sommer Lecture at Fordham Law School when she stated, "Self-regulation brings to bear a keen practical understanding of the industry. It taps resources and perspectives that are not as readily available to governments (and she should have included members of the public). It fosters investor protection as well as member involvement. At its best, it is a nimble, responsive test-bed for regulatory innovation. And it promotes high standards that go well beyond simply obeying the law. That is why self-regulation is so well suited to help usher in the new normal in the securities industry. Because no one has a stronger incentive than our member firms to ensure that their disaster recovery and business continuity plans - to take just one big example - are fully adequate to ensure that they can survive and do business under adverse circumstances. And no one can bring greater resources or expertise to bear than our industry, acting collectively, to see that such plans are not only formulated, but followed." The Institute echoes these sentiments. We believe that governance changes made by NASD as a result of the Nasdaq 21(a) Report are currently sufficient to address the governance concerns raised by the SEC in the Release, as those concerns apply to NASD. NASD By-Laws already provide for Non-Industry and Public Directors and Governors and mandate that the number of Non-Industry Governors will exceed the number of Industry Governors. The Institute believes that the investing public is already well represented on the NASD Board and on NASD Standing Committees. We remind the SEC of something it should already know well. Formulating regulatory policy and creating regulatory programs for the securities industry is extremely complex business. We believe this important task cannot be accomplished effectively solely by members of the public who may have little or no knowledge of the industry or securities regulation, regardless of how well meaning they might be. The Institute is also concerned that the governance structure proposed in the Release will result in board members deferring entirely to NASD staff on matters of regulatory policy and rulemaking. This will effectively eliminate industry input that has been deemed so integral to the effectiveness of self-regulation. Finally, we disagree with the SEC

that these proposed rules are consistent with the "fair representation" requirements imposed by Section 6(b)(3) of the Exchange Act. The SEC uses as the basis for its conclusion the amendments to the NYSE Constitution approved by the SEC in December 2003 and the undertakings imposed by the SEC settlement of its administrative enforcement action against the CHX in September 2003. These radical changes to the governance structures of the NYSE and CHX evolved from settled regulatory enforcement actions. In neither case can it be said that the "fair representation" requirements were carefully studied before the governance changes were adopted and they were adopted in corporate structures that are radically different from that at NASD. The Institute is not convinced that the SEC has sufficient authority under the Exchange Act to impose similar radical governance changes on NASD through the rulemaking process. Assuming that the SEC does have such authority, the Institute urges the SEC to carefully study the effects of these two experiments before imposing the proposed radical changes to governance structure on NASD. The Institute does support adoption of the SEC's proposal to prohibit a person subject to any statutory disqualification, within the meaning of Section 3(a)(39) of the Exchange Act, from serving as a director or officer of NASD.

<u>The Proposal As To The Separation Of Regulatory And Market Operations Should Be Adopted</u> – The Institute supports the SEC proposal to require SRO's to effectively separate their regulatory function from their market operations and other commercial interests. Consistent with this proposal, we urge the SEC to accelerate the divestiture of Nasdaq from NASD. This will absolutely eliminate any conflicts that may exist in NASD's current roles as self-regulator and trading facilities operator. We believe the industry and investors will be better served when NASD has as its primary focus its regulatory responsibilities. The Institute will have more to say on this issue in its comments to the SEC's Concept Release Concerning Self-Regulation. The Institute supports the SEC proposal to use funds from regulatory fees, fines and penalties exclusively to fund SRO regulatory operations and other programs directly related to SRO regulatory responsibilities, and to keep necessary books and records to evidence compliance with this requirement. We agree with the SEC that funds from regulatory fees, fines and penalties should not be used to pay dividends or distributions to members or to fund SRO executive compensation or employee bonuses. We recognize that regulatory fines and penalties have increased substantially over the past few years and in many cases seem to bear no relationship to formal,

written SRO sanction guidelines. We urge the SEC to require enhanced transparency with respect to the assessment, collection and use of these funds so that the SEC, public and SRO members can easily monitor how these funds are being assessed and utilized. For example, SRO's could easily provide statistics on the regulatory fines and penalties assessed to members for violations by different members of the same rule(s) and the SRO's determination as to how the fine or penalty assessed in each different case comports with the sanction guideline applicable to the rule violated.

The Proposal As To Member Voting And Ownership Limitations As Applied To The NASD Should Not Be Adopted - The SEC's proposal on voting and ownership limitations is based on the assumption that SRO's will demutualize and thereafter will be dominated by a few broker-dealer members who, either directly or indirectly, accumulate a controlling interest in the SRO's securities. The NASD has no reason to demutualize so long as it is permitted to divest itself from Nasdaq. In its present form as a not-for-profit it has no stock. Each member gets one vote in elections for NASD Board of Governors. We do believe, however, NASD in particular, because its members come from such diverse business environments, should revise the composition of its Board of Governors and Committees to be more representative of its members. In particular we believe that our members are grossly underrepresented, especially on the Board of Governors, in light of the total number of independent firms and the number of independent registered representatives affiliated with these firms.

The Proposals For A Code Of Conduct and Ethics And Governance Guidelines For Directors Should Be Adopted - The Institute supports as proposed the SEC proposal to require SRO's to adopt a code of conduct and ethics for directors, officers and employees and to adopt governance guidelines. We can see that, for example, private attorneys serving on the NASD Board of Governors or Committees may present a conflict of interest if they or their law firm also represent members or their associated persons before NASD. The code of conduct and ethics should be waived only by the SRO Board after a recorded discussion and formal vote. We agree that the code of conduct and ethics, at a minimum, must establish policies and procedures regarding: conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of SRO assets; compliance with laws, rules and regulations by directors, officers and employees; and the reporting of illegal or unethical behavior. We also support the

SEC's proposal that governance guidelines, at a minimum, should establish policies regarding: director qualification standards; director compensation; director orientation and continuing education; management succession; and annual performance evaluations of board members. We also suggest that the SEC consider making available to members the annual performance evaluations of board members in order for members to better understand how effectively the board is functioning.

2. Revised Form 1 and New Form 2

The Institute supports specifically the SEC proposals to harmonize the procedures for application as a national securities exchange and as a registered securities association and require SRO's to disclose detailed information about various aspects of their operations including their governance and organizational structure and regulatory programs on disclosure forms (Forms 1 and 2) filed with the SEC. We believe strongly that the only practical way to create meaningful transparency that will enhance the self-regulatory process is to require disclosure of more detailed financial and operational information. The Institute also supports the SEC proposal to require SRO's to disclose more detailed information on current and proposed exhibits to these forms. We agree with the SEC's proposal to require disclosure on exhibits of information such as a description of the responsibilities, structure and composition of any executive board and each committee and financial information, including an itemization of revenues and expenses. We also support the SEC's proposal to require SRO's to submit significant additional information on the exhibits, such as more detailed disclosure about the SRO's regulatory programs and regulatory expenses as a proportion of their total budget, and separately as a proportion of their total annual revenues, aggregate amounts the SRO expends on regulatory activities, surveillance activities and disciplinary activities. Finally, we urge the SEC to require SRO's to post Forms 1 and 2 and their attendant exhibits on their web site in order to further enhance transparency with respect to the issues presented on these forms and exhibits.

3. Proposed Rule 17a-26

The Institute supports the adoption of proposed Rule 17a-26, under which SRO's would be required to submit certain quarterly and annual reports with respect to the key aspects of their regulatory programs to the SEC. As proposed, the quarterly reports would include information with respect to the SRO's surveillance program; complaints received; investigations, examinations and enforcement cases; and copies of final agenda from any board or board committee meeting. The annual reports would include a discussion of regulatory

program procedures, the effectiveness of the regulatory program, internal controls addressing conflicts of interest, employment arrangements with senior regulatory personnel, and efforts to comply with undertakings made to the SEC. We believe this information, like that filed on and with Forms 1 and 2, will provide the transparency necessary to ensure that the SRO is dealing effectively with regulatory and governance issues that are equally important to the industry they regulate and to investors. The Institute does not support the SEC's proposal to accord confidential treatment to all information filed in accordance with proposed Rule 17a-26. Rather, the Institute urges the SEC to consider permitting the SRO to request confidential treatment only for information that the SRO reasonably believes would create a competitive disadvantage to the SRO if disclosed. The Institute supports the SEC's proposal to require SROs to certify the currency, truthfulness, and completeness of such reports.

Thank you again for giving us the opportunity to comment on this SEC initiative that is of critical importance to the future of our industry. If you have any questions about any of our comments, please feel free to contact me.

Respectfully submitted,

Dale E. Brown, CAE
Executive Director & CEO

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