

NASD Member Firm Issues

Has the pendulum swung too far?

Remarks by Howard Spindel

Good afternoon! I'm here again, with my good friend Bob Lehman who, like me, deals constantly with issues affecting NASD firms. Before I begin, I must warn you about a few things. First of all, although my remarks are for mature audiences, I am not Dennis Miller; I'll attempt to keep them clean. After all, I wish to observe high standards of commercial honor and not violate NASD Rule 2110. Secondly, as most of you know, I am affiliated with many different organizations as a member, officer or principal. None of my remarks, however, should be construed as representing the official position of any of those organizations.

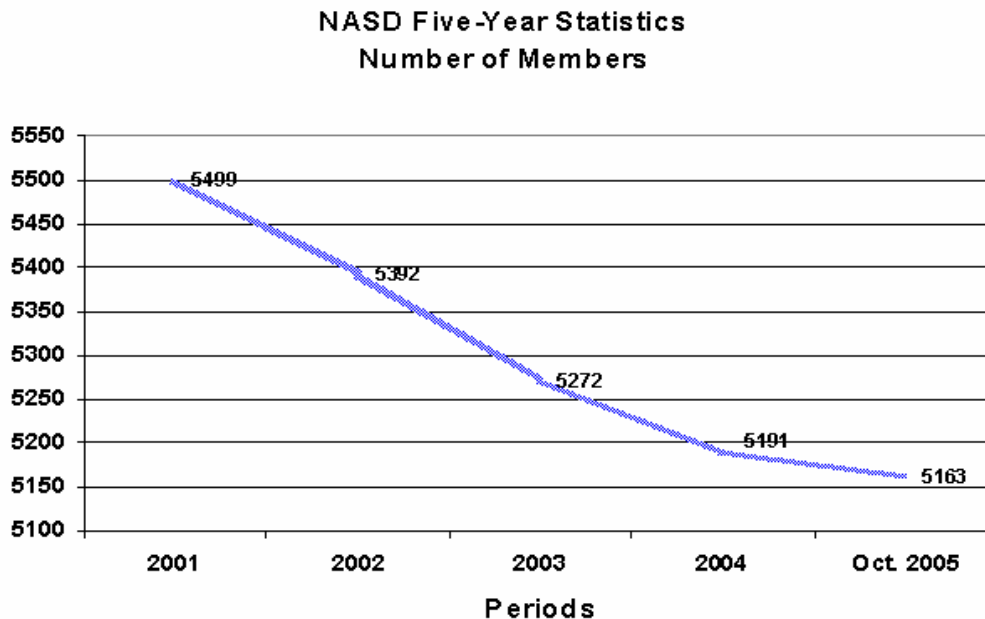
After I spoke last year, a number of members of the audience asked me whether I like the SEC and NASD. Indeed, I do like them very much. On an overall basis, they have been very good to my family and me. While they might have made your lives difficult, they have enabled me and my wife to raise our sons and have enough money left over to buy presents this holiday season for my four grandchildren.

The title of my remarks is "Has the Pendulum Swung Too Far?". If the answer to that rhetorical question is "No," then my remarks today would be quite brief. I've been asked to keep you busy for the foreseeable future. Therefore, the answer to the question is resoundingly "Yes!", and I'm going to tell you why that is.

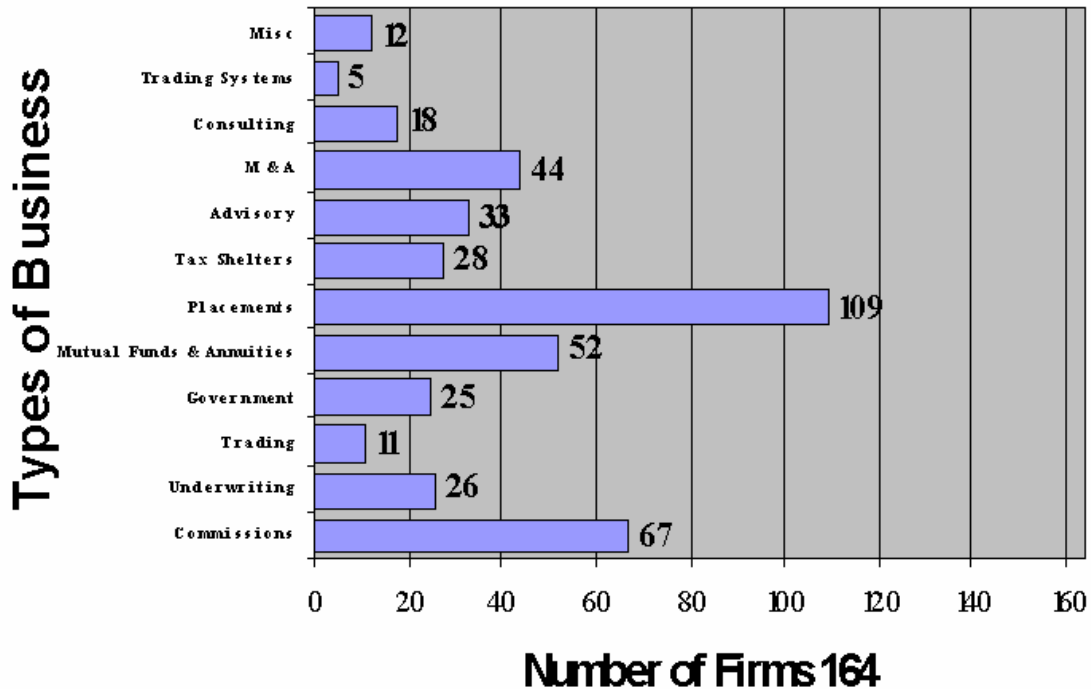
The membership

First, I need to set the background for you. How many NASD members are left? That implies that members are leaving. They sure are. Observe the slide that I've just displayed. As you can see, membership is declining steadily. And this is in spite of new members joining the ranks.

Who are these new members?



I had one of my staff people do a survey of the business types of the members that have joined NASD this year. The most popular function named by those that joined NASD recently is the private placement business. Some also joined because they are essentially commission collectors on behalf of their owners. Others join because they are in the M & A business or are involved in marketing tax shelters. Most important is what the new firms are not.

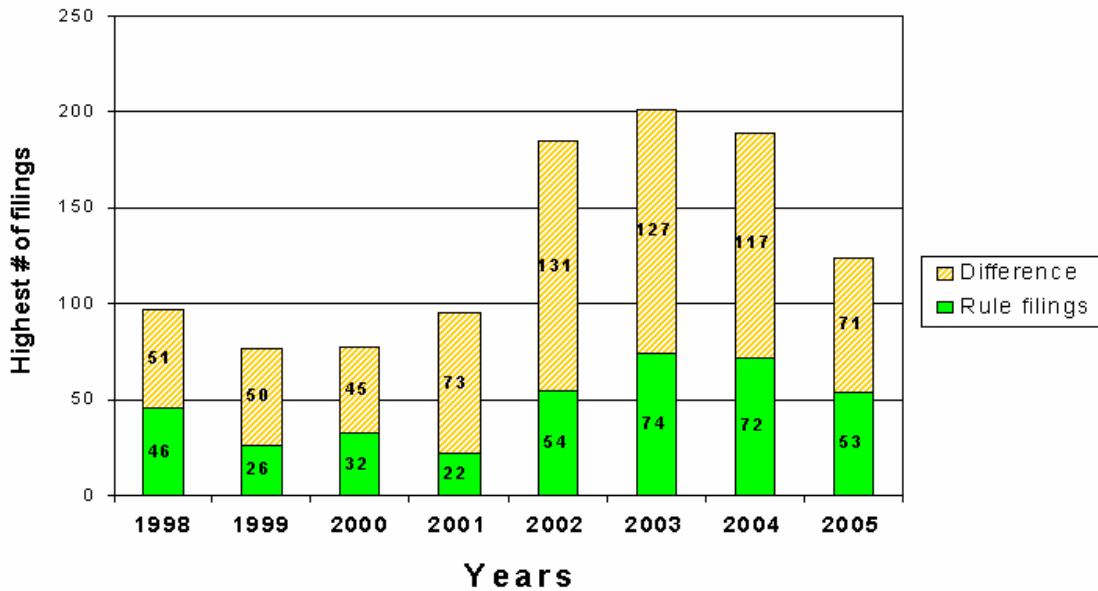


Very few of the new members are retail firms, very few are market makers, very few engage in proprietary trading. Yes, my friends, the nature of NASD's membership has changed. Most of the new firms are likely to be smaller than small; in fact, they're tiny in comparison to the industry giants. According to Elisse Walter, the largest NASD member employs as many registered people as the smallest two thirds of the membership combined. In fact, the majority of NASD firms have fewer than ten registered persons.

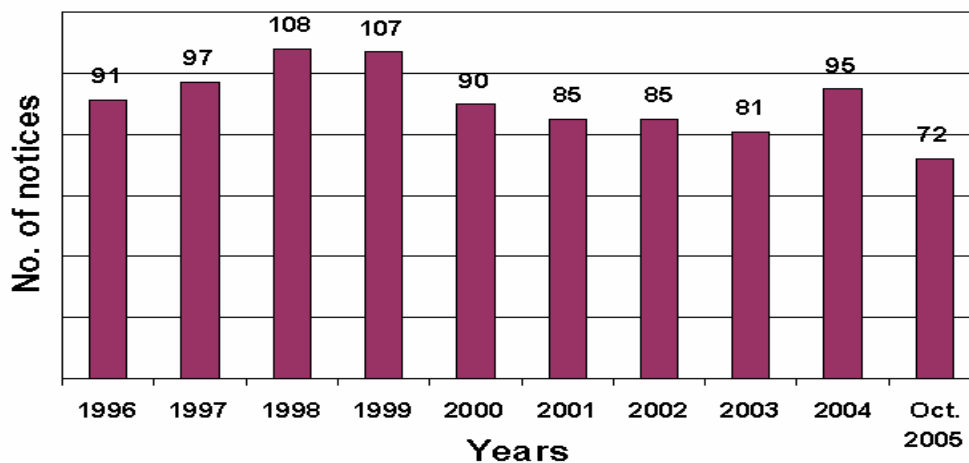
These tiny members need to be served, as do larger members. They need a regulatory infrastructure that is simple enough to deal with but commensurate with the need to protect the general public and the clientele with whom they deal. Our friends at NASD and the SEC are not serving these members as well as they should or could. They have bombarded the membership with more rules than you can shake a stick at. Some of these rules arguably should not even apply to the small firms, but are thrust on them by well-meaning bureaucrats who don't seem to consider the impact on the industry as a whole. And when the industry suffers or declines, the general public--whose benefit the bureaucrats claim to champion--will suffer, and has suffered, as well.

Busy NASD staff

Let's put these strong remarks into perspective. For example, how busy is NASD's staff? Observe the stacked bar chart on the screen. As you can see, there are several data for each year. We derived the data by simply taking the highest sequential number assigned to NASD filings for each year or period and counting the number of rule filings that were actually made in each year. The lower bar is the number of actual filings per NASD's website, the higher number apparently includes filings not made or publicized.



Note how much more prolific NASD staff has been over the past four years as compared to the four years prior to that period. The number of Notices to Members has declined lately but is still going at an unhealthy two-per-week clip.



To compare with other impositions with which we deal, how many FASB statements have been produced in the past 30 years? Only about 150. And the FOCUS report has seldom been revised in order to deal with changes based upon FASB statements; the last tweak that I can remember related to FAS 140, and it hardly applied to

any small firms anyway. In spite of massive changes in the securities industry and in accounting principles over the past 30 years, I don't believe that the official FOCUS report instructions have changed at all.

The New York Stock Exchange has published an Interpretation Handbook to lead us through the minefield of change. I created this guide about 30 years ago when I was the Exchange's Manager of Capital and Operational Standards. It started as a very ambitious project but slowed down significantly over the years, partly because for SEC rules, in particular, it depends on SEC staff review, which has been deliberately exacting but excruciatingly slow.

Not to be outdone, NASD staff published its own Guide to Rule Interpretations. In the past 30 years, it has been issued twice, the last time nine years ago, in 1996. It has been supplemented every once in a blue moon by publication of interpretive guidance on NASD's website, but even so, that's not comprehensive guidance I can hold in my hand on the subway. I don't know why they can't publish more often; perhaps, it's because they prefer to issue new rules instead of interpreting the old ones.

Complexity and how to deal with it

Yes, the complexity of our business is overwhelming. Most NASD members are small; correction – tiny. They don't have the sophistication of the giants in our industry. If the members are to be subjected to thousands of pages of rules and regulations they need guidance. This guidance can come from various sources.

I am delighted to learn that, on November 18th, Robert Glauber gave a speech in which he announced that coming soon, to a district office in your neck of the woods, will be a system for better guidance and it will make the advisory process easier. Part of that system will include the publication of “a list of consultants, lawyers and technology professionals and others you can turn to when [NASD is] not the best source of information you're looking for.” On paper, these initiatives are great ideas. We should give them the opportunity to be successful. We must recognize that they presume that guidance can emerge from regulators as fast as the issues themselves emerge, and that regulatory staff will be able to provide responses to questions quickly and without hesitation. Unfortunately, the experience of the past has shown this to not be the case in many instances. I hope that the “consultants, lawyers, and others” that he referred to will be able to adequately supplement regulator staff in ensuring that knowledge and understanding goes to where it's needed. This is not easy. Often, new rules become effective with very poor guidance from anyone.

Let me give you some examples:

Examples of troublesome rules

- FAS 154 goes into effect for years beginning after December 15, 2005. Issued by FASB about six months ago, it changes the way we reflect items on financial reports, such as the effect of changes in accounting principles. Up until now, we

would reflect the cumulative effect of these changes in a separate line item on income statements. Under the new protocol, the changes are supposed to be reflected retroactively. Does that mean that we need to show these items in a different place on FOCUS reports? Possibly, but if so, where? If we reflect the changes retroactively, do we need to refile FOCUS reports? I sure hope not. Would previously prepared net capital computations need to be changed? That would be somewhat absurd. What guidance have you seen from the regulators on these issues? I haven't seen anything published, yet I know that the issue has been discussed with some regulators. Perhaps we'll hear guidance later this afternoon, but why should it take six months to deal with these issues?

- In spite of NSMIA, we are still stuck with state rules that are inconsistent with SEC and NASD rules and processes, especially with respect to registrations or financial statement filings. Some states are notoriously difficult on these issues.
- In NASD's quest for better transparency of trade data, we are confronted with technically complex OATS and TRACE rules. Tiny firms typically use others, often their clearing firms, to process these data. That's a great idea. Where the idea fails is that the rules require the tiny firms to periodically check on the regulated firms to which they assign these duties. Frankly, if I need to check on whether Bear Stearns, Pershing or similar firms are doing their jobs properly the entire purpose of giving them the jobs in the first place is defeated. In May, OATS Phase III finally will kick in. For details, one should read Notice to Members 05-78. Indeed, NASD has introduced some automatic exclusions for certain firms and has created a process where other firms may request an exemption from certain of the OATS rules provisions. On the other hand, note that the OATS rules are extremely specific and in the past have been enforced on a zero tolerance basis with the same exuberance as that of a state trooper with a radar gun.

Rules don't well recognize member diversity

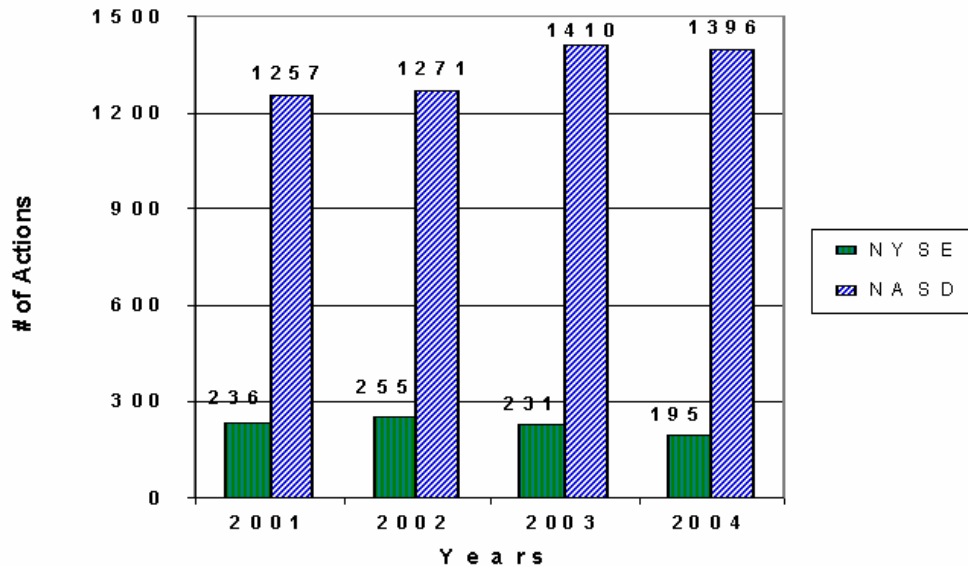
The burdens imposed on tiny and small firms are onerous and often have little to do with protecting the public and the marketplace. There are huge differences in the ways that large firms are penalized and the ways that small firms are penalized. For a transgression committed by a large firm, as sizeable as the fines can be, they are chump change when compared to the relative size of fines levied on small firms. At large firms, individuals are seldom disciplined for transgressions that don't involve issues of moral turpitude; at small firms the prosecutors seem to delight in raking individuals over the coals. And they love publicity. For the large firms, it hardly matters any more whether they get slapped with a \$10,000 fine for not reporting trades properly; it's simply a cost of doing business. For a small firm, a transgression such as a minor failure over a rule as innocuous as a reporting obligation can mean that the firm needs to sit in regulatory purgatory for the next five years as the firm will not be able to avail itself of an exemption from some of the OATS reporting requirements or the safe harbor provisions of Rule 1011 so that it can expand its business under Rule 1017. That particular rule has almost no

impact at all on large firms. Now, if you really wish to be tortured, try dealing with rules such as 1013, 1014 and 1017.

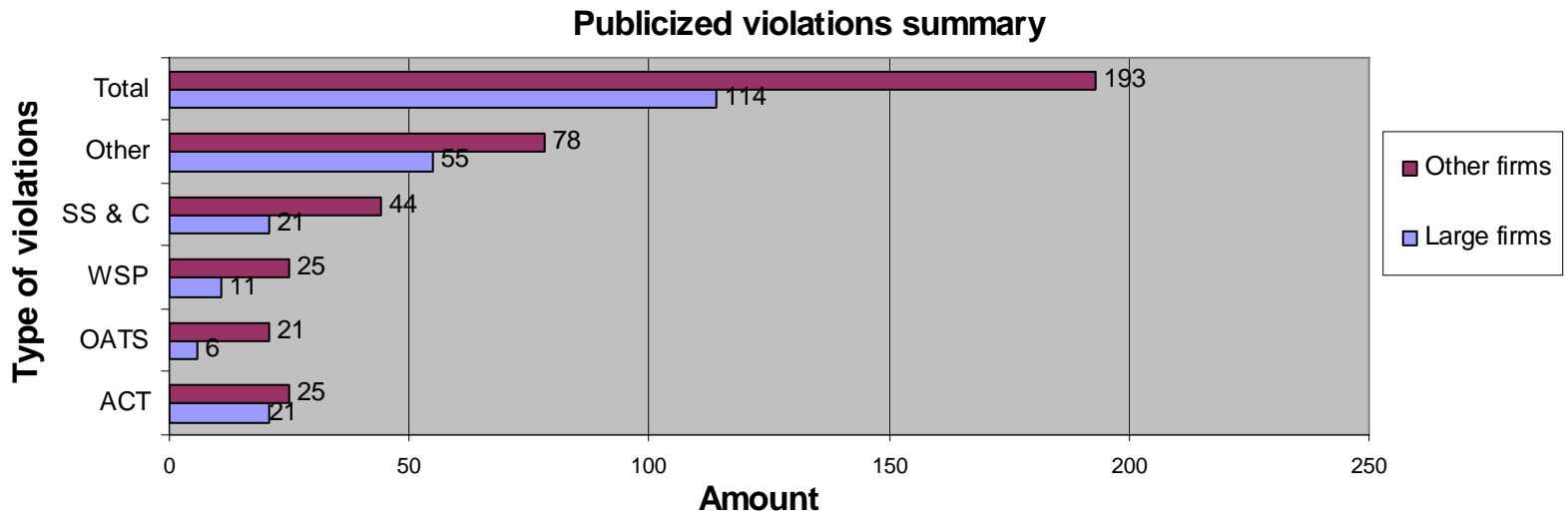
NASD bureaucrats who deal with these rules seem to have two speeds - Slow and Stop. Interestingly, in the area of approving broker-dealers and their activities, their counterparts at the various exchanges know quite well how to perform functions that are similar. For example, the Pacific Exchange in about a month does what takes NASD 180 days! Unfortunately, however, NASD is the only game in town for most broker-dealers.

Some Gruesome Statistics

In spite of the fact that the New York Stock Exchange monitors broker-dealers that are mostly involved with the vast majority of securities transactions executed and probably employ most of the registered personnel in the securities industry, New York Stock Exchange hardly brings any disciplinary actions against its constituency especially when compared to what NASD does. Have no fear that the New York Stock Exchange is not doing its job properly; the statistics simply suggest that many of the actions taken by NASD would have been dealt with just as effectively in a kinder, gentler, non-publicized manner by the New York Stock Exchange had it been the regulator in charge.



When we observe violations publicized by NASD, we can see that many of them are not for transgressions of moral turpitude but rather are simply instances where some trades weren't reported properly or where written supervisory procedures were inadequate. In that vein, I am reminded that the fact that written supervisory procedures were inadequate does not mean that specific rules other than the supervision rules were violated. This is similar to enjoying a meal at Grandma's house but criticizing her because she didn't prepare her world famous soufflé from a written menu. On the chart you have in front of you, I tried to separate, quite unscientifically, the large firms from the others. Though most of the transgressions apply to smaller firms, the larger firms have their fair share, too. The impact of a violation on a small firm is much harsher than on a large firm.



Clear, appropriate, consistent rules

I very much admire Robert Glauber. Every time I log onto NASD's website I see his face accompanied by the mantra: "We must set clear and appropriate rules and enforce them rigorously and consistently."



The first clause of that mantra is a prerequisite to the second. Setting clear and appropriate rules is extremely important. The corollary to that is to decide whether rules that are applied to all members really should be. Once that's done, the regulators need to consider abrogating, softening or suspending enforcement of existing rules, especially as they apply to small firms. And when we speak of "consistent" application of the rules, it's vital to consider the impact on all of the members. Whenever possible, the impact should be at least somewhat consistent.

Some inappropriate or somewhat unnecessary rules

Take the requirement for the WSPs that many members have satisfied by using canned versions produced for them by consultants and lawyers. The truth is that nobody at small members reads them. Well, let me correct that, hardly anyone really reads them regularly. I tend to read the ones that might apply to me about as often as I read the owner's manual for my Toyota or the Vehicle and Traffic laws of New York State. Somehow, I manage to comply with rules simply because I can refer to the NASD

Manual or Notices to Members and other resources to find out what the rules are, and then use logic and common sense to comply. In over 99% of cases with small firms, I can actually figure out who is in charge of what, and know quite well what needs to be done and when it needs to be done, all without looking at the dust-laden copy of the WSP's. I'm sure most if not all of you can do the same. I'm always troubled by examiners who review WSP's with a view toward finding errors consisting of the omission of references to the last ten rules that were adopted since the last examination, even rules that have no applicability in many instances. And when the WSP's are updated, they often are not much more than a recitation of the rules themselves but that seems to satisfy the examiners. What does that prove?

We have other rules that are totally mechanical, for instance, providing notifications to customers or registered personnel. Most of us comply with these, for sure, but then we have examiners asking for evidentiary proof that we performed our tasks properly. Frankly, unless I were to obtain a receipt from each customer that evidences that he has received the privacy notice that he has just disposed of in the trash, I can't prove anything. Why can't examiners simply accept a representation that I did what I'm supposed to do? Rule 3080 compliance, notifying people to read what is basically contained in the Form U4 itself, seems to presuppose that registered people are so stupid that perhaps they shouldn't be hired in the first place.

Robert Glauber is absolutely correct. The rules need to be clear, and they need to be appropriate. So what do we get instead? -- more and more rules, many of them unclear, and the existing rules keep getting harsher. For example, some regulators have been talking about increasing minimum net capital requirements, especially for the so-called nickel B-D's. To support their position, they use as an example the fact that a New York City taxicab medallion costs over \$300,000, yet currently one can operate a broker-dealer with a mere \$5,000.



This use of irrelevant statistics is laughable, if not downright irresponsible. Let's compare taxicabs and broker-dealers. Taxicabs hold, albeit temporarily, very valuable possessions – me or my family. Taxicab drivers traditionally have been recent immigrants who have virtually no personal financial net worth. In spite of those facts, when I wish to travel from the Marriott Marquis, where we are today, to many other places in this great city, I hail a cab. What do I rely on? The licensing authorities ensure that the drivers know how to get me where I wish to go, they ensure that the vehicles are relatively new and kept in good condition, and they ensure that in the unlikely event that an accident occurs there is some kind of insurance scheme to protect me. I do not ask the driver for his or her statement of financial condition before I embark on my journey, for fear of hearing expletives thrust upon me in what would probably be a foreign language that I don't understand. (Frankly, was that to happen, I'd prefer not to understand the expletives.)

On the other hand, a limited purpose broker-dealer never holds anything of value and is only a sideline bit player, although an important one, in the capital intermediation process. I don't ask such a broker-dealer for a statement of financial condition any more than I would ask a physician or a barber for one just because they intend to use sharp instruments near my carotid artery and could easily kill me. In the latter cases, I rely on the fact that the professionals are well-trained and regulated. It's nice to know that they have insurance but no amount of insurance would protect me if they really messed up. And, were I to inquire of them about their insurance coverage, I somehow doubt that they would render services for me, concluding incorrectly that I was probably an attorney.

New York City taxicab medallions cost \$300,000 for a similar reason that New York Stock Exchange seats cost over \$3,000,000; there's a finite supply of them and a great deal of income can be generated with them.

With respect to SOX, we need to hope that it won't ever apply to small broker-dealers. I suspect they will have an ally in SEC Commissioner Cynthia Glassman who in a speech on November 17th expressed clear concerns about whether the 404 process might need some modification to make it less burdensome. The best way to make it less burdensome for small broker-dealers is to make sure that it never applies to them.

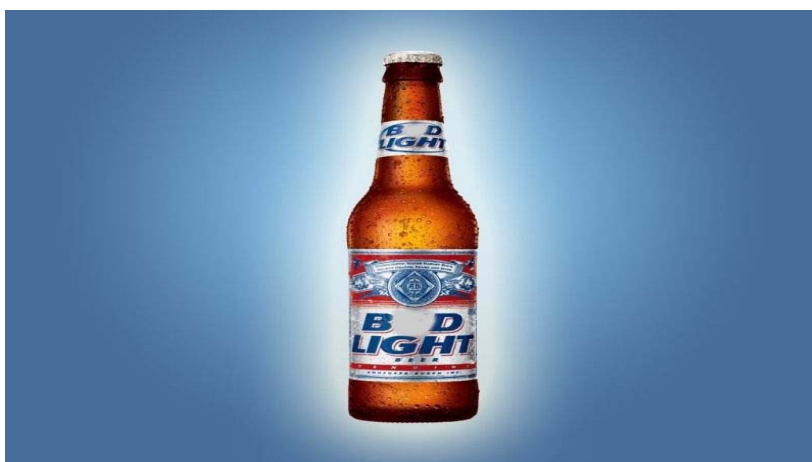
Perhaps there's a better way

Last year I floated a trial balloon pointing out that of all of the rules that shouldn't apply to small broker-dealers, the worst one was the net capital rule. At the time, I wasn't concerned that my personal income would be affected by such a remark. I figured that the regulators might ignore the voice of one person even though there were many people who spoke to me afterward to indicate their support for such an exemption. What I didn't know then was that in September 2005 a task force of the American Bar Association would issue a 62-page report containing recommendations with respect to private placement broker-dealers. All of you should read this report. It is buried in the bowels of the SEC's website as part of a collection of written statements received, and

presentations made, with respect to the Advisory Committee on Smaller Public Companies.

The link “[sec.gov/rules/other/265-23/gvniesar091205.pdf](https://www.sec.gov/rules/other/265-23/gvniesar091205.pdf)” is on the screen in front of you.

Not surprisingly, some of what I recommended last year is exactly what was also recommended by the task force, which consisted of 22 prominent attorneys. It took them 62 pages to promote the differentiation of certain broker-dealers from the diverse group that they’re in, but the report is wonderful. Last year, I showed you a doctored-up picture of a beer bottle to almost accomplish the same thing.



■ Report and recommendations of the Task Force on Private Placement Broker-dealers

- Eliminate FINOP requirement
- Require greater fidelity bond
- Eliminate many financial record-keeping requirements
- Eliminate audit requirement
- Concentrate on escrow requirements and general solicitation issues
- Eliminate net capital rule?

Yes, I want a light version of BD compliance and so does the task force. Actually, in some respects the task force went further than I did. I wouldn’t have dared to say publicly, as it did, that the audit requirement should be eliminated. I do like to arrive home every day in one piece and auditors armed with sharp pencils have been known to inflict great harm.

In other respects, however, the task force didn’t go far enough. Their recommendations covered only private placement firms; I recommended eliminating some of the maddening rules for any firm that does not hold the assets of customers or have a significant relied-upon function in the marketplace, such as a market-maker or a clearing firm. Those exempted from the potpourri of unreasonable rules should not only include private placement firms but should also include ordinary proprietary traders, or commission-collecting vehicles.

How should customers or other counterparties to the small brokers that I described above be protected? Probably by some sort of insurance or guaranty scheme as an optional substitute for net capital and many other of the gobbledygook rules that we currently have in place. A firm that only does trading for its own account shouldn't be required to have anything. Its clearing broker will protect itself by monitoring equity levels and trading activity and by requiring clearing deposits, just as clearing firms have been doing for decades.

Tilted playing field

We must consider, too, that in adopting the concept of consolidated supervised entities, the SEC has further tilted the playing field in favor of the large firms. Once they operate as consolidated supervised entities, the arcane haircut rules that apply currently to the larger firms will no longer apply. Instead, their haircuts would likely be reduced through the use of VaR techniques. Even customers might get a better deal soon, as there has been talk of using portfolio margining instead of the antiquated strategy-and-product-based margining to measure the risk of carrying financial instrument positions.

Plea to regulators

To summarize my heartfelt feelings about a few things you should be doing in the immediate future, please dear regulators, study the existing rules and simplify them, especially for small firms. Please establish a separate class of broker-dealers that won't be subject to the stricter regimen of the larger firms. Please rid us of the use-it-or-lose-it rules relating to registrations. In this regard, the New York Stock Exchange proposal to modify Rule 345B is a partial step in the right direction. Please stop driving us all crazy over non-egregious, almost victimless transgressions of hyper-technical rules. Please stop charging individuals for offenses that are really committed by their firms and over which the individuals often have little or no control. Please approve new members and changes at existing members promptly and without processes that disserve the members and the general public. Please work with us, not against us.

I am throwing down the gauntlet to the regulators. Yes, I will send copies of these remarks to senior people at the SEC and to the senior management of NASD, hoping that they will stimulate a positive dialogue for change. In fact, Robert Glauber has made it clear that he encourages such dialogue. Considering that there has been a recent change at the top ranks of the SEC, maybe my remarks and the remarks of others will create some good. I would be delighted to hear concurring opinions or even opposing ones from any of you.

Now we'll throw it open for questions. And you accountants in the audience, please don't attack the messenger who reported on the task force recommendation that called for elimination of audit requirements. Don't worry; with the proliferation of hedge funds and their increased regulation, you'll still have plenty to do!