NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

EXECUTIVE SUMMARY

OF

THE REPORT

OF

THE NASD SELECT COMMITTEE

ON

STRUCTURE AND GOVERNANCE

TO

THE NASD BOARD OF GOVERNORS

The NASD Select Committee on Structure and Governance

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I.

OVERVIEW

The National Association of Securities Dealers ("NASD") is the nation's only registered securities association. It is also the largest self-regulatory organization in the securities industry. In terms of its membership size and scope of responsibility, the NASD's oversight and regulatory obligations surpass those of every other SRO, including the major securities exchanges.

By Act of Congress, every securities broker-dealer firm in the United States transacting business with the public must be a member of the NASD. The NASD oversees the activities of over 5,400 securities firms, more than 57,000 member branch offices, and nearly 500,000 registered securities professionals. NASD members include general securities firms and firms that specialize in equities, corporate debt instruments, derivative products, certain insurance products (e.g., annuities), direct participation programs (e.g., limited partnership interests), and municipal and federal government securities.

The NASD establishes Rules of Fair Practice for all securities transactions among broker-dealers and between broker-dealers and private investors, trading rules for the over-the-counter markets, and operational rules for its member firms. It conducts examinations of member firms; investigates possible violations of association rules, SEC regulations and the federal securities law; and conducts disciplinary proceedings involving member firms and associated individuals. It is the principal arbitration forum for securities disputes and reviews all member advertising and corporate finance agreements. The NASD administers qualification testing for all securities principals and registered representatives, both on its own account and on behalf of state securities authorities.

The NASD is also the primary regulator, and the owner, of the Nasdaq stock market. Established just 25 years ago, the Nasdaq stock market currently includes over 5,000 issues with a total capitalization of over $1 trillion. In 1994, Nasdaq trading volume exceeded 74.3 billion shares (more than twice 1990 levels), with a value of $1.45 trillion (three times 1990 levels). Daily volumes in 1995 have reached 600 million shares. The Nasdaq composite index, set at 100 in 1971, is now over 1,000. The Nasdaq market is a major source of capital for America's growth companies.

Ordinarily, this record of achievement would be sufficient evidence that the NASD has discharged its statutory obligations and commercial functions in a responsible manner. And that appears generally to have been the case until mid-1994. Since then, the

NASD has been the subject of intense public criticism regarding its regulatory oversight of member firms and its stewardship of the Nasdaq market.

Reports have appeared in the press that are severely critical of the NASD's governance and performance. These include charges that large member firms, particularly Nasdaq market makers, control the NASD for their own benefit, and conversely, that small NASD member firms, and issuers, investors and other members of the public, have scant voice in NASD or Nasdaq market governance. Consequently, critics contend, the NASD's regulation of the Nasdaq stock market has been flawed and uneven and the NASD's policing of its member firms has been ineffective and unfair.

The Securities and Exchange Commission ("SEC"), which oversees every aspect of the NASD's governance and operations, has initiated an investigation reportedly focusing on the NASD's enforcement of Nasdaq trading rules. The U.S. Department of Justice has initiated an investigation in response to an academic study asserting that Nasdaq market makers collude in setting prices on the Nasdaq market.

Amidst this wave of criticism, and with the concurrence of the SEC Chairman, the NASD asked former U.S. Senator Warren Rudman to lead a review of NASD governance and oversight. In November 1994, the NASD Board of Governors appointed this Select Committee chaired by Senator Rudman. The members of the Committee, selected by the NASD Board, include individuals with significant experience in the securities industry and NASD governance. The Select Committee retained the law firm of Paul, Weiss, Rifkind, Wharton & Garrison to serve as Committee Counsel.[1]

The Charter issued to the Select Committee by the NASD Board called specifically for a review of NASD governance structures and the NASD's oversight of the Nasdaq market, without duplicating the pending SEC and Justice Department investigations. In view of this Charter, and in light of the public criticisms regarding the NASD and the Nasdaq market, the Select Committee decided to examine the following broad questions:

1. Whether the NASD is appropriately structured to regulate the broker-dealer profession and to oversee and operate the Nasdaq market.

2. Whether the NASD's procedures for regulating its members' conduct, and in particular the NASD's disciplinary processes, ensure fairness, effectiveness and professionalism for all parties, including the public.

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[1] Senator Rudman is a partner of the Paul, Weiss firm. The firm, however, did not charge for his work in this matter. Exhibit A-1 identifies and provides background information concerning the members of the Select Committee.

3. Whether the NASD's governing entities and processes provide NASD members and the public an appropriate voice in policymaking and governance.

4. Whether the NASD's policy and rulemaking processes are suitable for the Nasdaq market.

As noted, the Select Committee's Charter excluded the federal investigations. It also did not ask the Select Committee to address the structure or relative merits of the dealer market for securities trading as opposed to an auction market, or the merits of Nasdaq's trading systems. Nor did its Charter ask the Committee to evaluate the system of self-regulation established by Congress for the U.S. securities industry 61 years ago. Those are matters for broker-dealers, issuers and investors to address in the first instance, and for the SEC and Congress to decide as matters of national policy.

The Select Committee's review ("Review"), conducted from December 1994 through August 1995, included interviews and discussions with nearly 200 individuals knowledgeable and experienced in NASD affairs. Among these were the NASD's most ardent supporters and its fiercest critics. The Review also included an examination of the NASD's enforcement and disciplinary procedures, the functions, resources and operations of the NASD's different units and "business lines," and the procedures, composition and functions of its governing entities. The NASD provided the Select Committee with NASD and Nasdaq Board and Committee minutes going back five years (and in some instances, ten or more years), budgets, corporate documents, data regarding membership and enforcement efforts, and prior studies by NASD task forces. The Review also included a survey of the NASD's eleven districts, discussions with state and federal securities regulators, an examination of the development of self-regulation in the U.S. securities industry, the NASD's role in that system as it has evolved over the past 56 years, and the growth of the Nasdaq market during the quarter century since its establishment.

The Select Committee met regularly to discuss and review the status, direction and results of the Review, and also to hear directly from certain individuals. In addition, the Committee and its Chairman were briefed regularly by Committee Counsel (including briefings on all interviews conducted by Counsel). The Committee closed the record of its Review on August 28, 1995.

Having concluded its Review, the Select Committee unanimously adopted the findings and recommendations contained in its Report, which the Committee now issues to the NASD's Board of Governors.[2]

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[2] This Executive Summary is part of, and should be read in the context of, the Select Committee's entire Report, including the additional material, analysis, and discussion contained therein. This Executive Summary does not purport to be a substitute for the entire Report.

periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.[2]

While self-regulation would apply in the first instance, Congress provided that the federal government would retain ultimate authority to regulate the self-regulators, ensuring that they discharged their obligations diligently and fairly. SEC Chairman Douglas put it this way:

> Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, clean, ready to use but with the hope that it would never have to be used.[3]

Congress and the SEC have acknowledged that self-regulation has certain limitations, deriving primarily from the "inherent conflict" between the self-regulators' commercial interests and their regulatory obligations. Congress has determined, nevertheless, that because SROs and their members have a strong interest in maintaining industry integrity and public confidence, self-regulation subject to SEC oversight remains the best system. Proposals to abandon or modify this system by divorcing regulatory oversight from commercial interests -- including such a proposal by the NASD itself in 1976 -- have consistently been turned aside.

Although the SEC and Congress have not imposed any standard governance format on the SROs, they have established certain guiding principles. Central among these, in addition to fair representation of the SROs' members, is representation of the public on the SROs' governing bodies. The "public" means individuals or institutions not affiliated with the SROs' members. Its "representatives" for these purposes include a broad spectrum of individuals and organizations, including: securities issuers, investors, endowment and pension funds, trust companies, academics, former government securities regulators, experienced and knowledgeable professionals and others who, though not affiliated with an SRO member, have a broad knowledge of and strong interest in the securities markets.

Public representation reflects the quasi-governmental status of the SROs. It also ensures a balanced perspective and diversity of informed viewpoints on the SROs' governing bodies, thereby enhancing both the system of self-regulation and the vitality and competitiveness of the nation's securities markets.

Congress and the SEC have also emphasized the Exchange Act requirement of "fair representation" of the SROs' overall membership on the SROs' governing bodies. This requirement keeps the "self" in self-regulation and also provides an important check against any one segment of the SROs' membership dominating their governance. The SEC

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[2] Joel Seligman, THE TRANSFORMATION OF WALL STREET 186 (1982) (hereafter "WALL STREET"), quoting, William O. Douglas, Address before the Hartford Bond Association, Jan. 7, 1938.

[3] William O. Douglas, DEMOCRACY AND FINANCE 82 (1940).

has stressed that the SROs' governing bodies should be balanced even as among its members, and not only as between members and the public.

Finally, Congress has encouraged the SROs to continue their "healthy experimentation with regard to decision-making processes, keeping in mind at all times that they are quasi-public agencies, not private clubs, and that their goal is the prevention of inequitable and unfair practices and the advancement of the public interest."[4]

III.

DEVELOPMENT OF THE NASD AND THE NASDAQ STOCK MARKET

A. NASD

As originally conceived, the NASD was to play a unique role in the securities industry. Unlike the other SROs -- the securities exchanges -- the NASD was not then affiliated with a particular securities market. The NASD was thus designed to serve as the residual SRO, regulating the nation's non-exchange, over-the-counter ("OTC") securities markets and the broker-dealer profession. The OTC markets then consisted of a variety of securities firms trading a wide array of products throughout the United States. The Nasdaq stock market did not even exist when the NASD was formed in 1939.

In the years since the NASD's creation, Congress has significantly expanded its oversight role and responsibilities. It has required the NASD to enforce rules regarding trading in municipal bonds, and to oversee certain aspects of the U.S. government bond market. In 1983, Congress essentially required all broker-dealer firms to become and remain members of the NASD, eliminating the "SECO" program, which had allowed broker-dealers to opt for direct regulation by the SEC. Within the securities industry itself, a steady stream of new products, trading mechanisms and methods of conducting business has typically fallen to the NASD to regulate.

The composition of the NASD's governing bodies has reflected its status as an SRO obligated to regulate a diffuse membership and securities markets spread across the nation. NASD governance has thus been characterized from the start by largely decentralized administration and heavy reliance on volunteer member leadership. The major securities exchanges, by contrast, have had more centralized governance, reflecting their far smaller and more homogeneous memberships principally trading on a central "floor."

Although the composition of the NASD's governing bodies has remained markedly constant over time, the continuing expansion of the NASD's powers, constituencies and responsibilities has magnified the need for greater public representation. So

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[4] Securities Industry Study, Report of the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, S. Doc. No. 93-13, 93d Cong., 1st Sess. 2-3 (April 6, 1973).

recognizing, Congress amended the Exchange Act in 1975 to require at least two public members on the NASD's Board. Subsequently, additional public members were added by the NASD itself in response to the recommendation of an NASD Special Committee in 1990. The explosive growth of the Nasdaq market in the years since 1990 has further magnified the public's claim to representation on the NASD's governing bodies.

B. The Nasdaq Stock Market

The Nasdaq market did not exist when the NASD was created. It was only established in 1971, as a relatively simple automated quotation system. Since then, it has developed into one of the world's largest securities markets. It has been regulated from the start by the NASD, which has also owned it since 1976.

In the United States, the Nasdaq stock market is now second only to the New York Stock Exchange -- established nearly 200 years earlier -- in terms of size and importance to the economy. But while the New York Stock Exchange has evolved into its current form over two centuries, the NASD has had to adjust to the burgeoning expansion of Nasdaq in a relatively brief period of time.

Nasdaq's recent dramatic growth is apparent by comparing the market today and just several years ago. Nasdaq's trading volume has more than doubled over the past five years alone, from 33 billion shares in 1990 to 74 billion in 1994. The value of the shares traded over Nasdaq in 1994, $1.45 <u>trillion</u>, exceeds 1990 levels by nearly one <u>trillion</u> dollars. The steady upward movement has continued in the first half of 1995. There is no indication that this explosive growth since 1990 was (or could have been) foreseen.

This does not mean that the NASD has been blind to the implications of Nasdaq's development for the NASD's governance structure. The growth of Nasdaq prior to 1990 made the NASD responsible to a significant public constituency. Accordingly, as noted, the NASD increased public representation on its Board while reducing member representation. It has also established Standing Committees to represent Nasdaq's different constituencies in the NASD's governing councils. It has strengthened its enforcement procedures to maintain public confidence in the Nasdaq market. It has, in short, taken reasonable steps to try to accommodate the sprawling Nasdaq market and the market's diverse constituencies within the NASD's existing structure.

The core question, however, is whether that structure best serves the NASD as it exists today: a huge membership association charged with regulating 5,400 firms and nearly one-half million securities professionals spread across the United States while operating and overseeing a trillion dollar securities market with its own divergent constituencies. This question was the focal point of the Select Committee's Review.

IV.

THE NASD AND THE SECURITIES EXCHANGES

Critics allege that the NASD's ownership of Nasdaq is inappropriate, and that the Nasdaq and the NASD should be divorced, because of the "inherent conflict" in the NASD's dual roles as both regulator and proprietor of the Nasdaq stock market. But that is a "conflict" inherent in the self-regulatory system itself. The same "conflict" inheres in the New York and American Stock Exchanges, which also own and operate the markets they regulate. Certain critics so recognize and have therefore proposed across-the-board changes to the self-regulatory system. That, however, is a matter for Congress and the SEC, not this Committee.

On the other hand, the NASD is burdened with certain internal tensions that differ from those of the major securities exchanges because of the NASD's more heterogeneous membership and its wider array of responsibilities as the mandatory national broker-dealers' association.

Although all securities broker-dealers are required by statute to be members of the NASD, not all have interests in the Nasdaq market. Even among those who do, interests frequently diverge. Indeed, certain segments of the NASD's membership have antagonistic interests regarding Nasdaq policy and systems. Accordingly, the NASD's policy decisions relating to Nasdaq often advance the interests of one group of NASD members at the expense of another. This situation is not helped by the fact that the NASD, through its ownership of Nasdaq, also owns and operates commercial trading systems that compete with systems owned by NASD member firms, and those competitor systems are regulated by the NASD. If NASD members dislike this state of affairs, they have little recourse -- for they are required by statute to remain members of the NASD, subject to NASD rulemaking and discipline, so long as they wish to remain in the securities business, no matter how vehemently they may disagree with NASD policies.

These circumstances sharply differentiate the NASD from the exchanges. Exchange members are fewer in number and share common commercial interests in their markets. The exchanges themselves, unlike the NASD, regulate discrete, free-standing and more centrally-located auction markets. Moreover, members of the New York and American Stock Exchanges may resign their memberships at will. If they believe that their interests are not served by, or sharply diverge from, the policies of the exchanges, they are free to leave and still remain in the securities business. Not so members of the NASD.

The NASD is also different from the exchanges in that it constantly faces competing demands for its attention and resources as the overseer of the Nasdaq market on the one hand, and regulator of the entire U.S. broker-dealer profession on the other. No other SRO faces comparable obligations or carries equivalent burdens.

V.

THE COMMITTEE'S FINDINGS

To the extent that the NASD's two broad missions, as membership association and as overseer of the Nasdaq market, have become confused -- in reality or in appearance -- both are disserved. Unfortunately, the NASD's governance structure has added to the confusion by placing direct responsibility for both missions in one professional staff and one set of committees reporting to one governing Board. Under that structure, the NASD Board must attempt to meet the needs and demands of Nasdaq's widely dispersed and often differing constituencies while simultaneously providing fair and effective regulation of the NASD's broker-dealer members. It is largely a mission impossible.

Fundamental change is required. In the Committee's view, the NASD's relationship with Nasdaq should be restructured so as to put substantial "daylight" between the membership association and the market, with separate governing bodies whose compositions are tailored to the particular requirements of their respective missions and constituencies. This restructuring, the Committee believes, can and should be accomplished without divorcing the NASD and Nasdaq.

A divorce (as opposed to some separation) would be undesirable, in the Committee's view, because it would remove the regulator of the broker-dealer profession entirely from the dealer market. This would sacrifice a key benefit of the self-regulatory system, which links industry expertise with industry regulation, so that each is informed and enhanced by the other. A divorce would also require duplicative enforcement machinery, unless the new Nasdaq were to be relieved of any responsibility for policing the Nasdaq market. But in that event, the "policeman," NASD, having no other connection to the marketplace, could find itself hampered by its lack of commercial and technical expertise, thereby impairing effective regulation.

The Select Committee favors instead a reorganization that will retain the benefits of the NASD's existing structure while overcoming the problems created by rapid changes in the Nasdaq market, particularly over the past several years.

Those changes, as noted, have highlighted the divergent economic interests served by the Nasdaq market and regulated by the NASD. As the problems caused by those circumstances continue to surface, and as tensions continue to escalate, alteration of the existing structure should help the NASD arrive at reasonable solutions that receive broader public acceptance.

A. The NASD-Nasdaq Relationship

The Nasdaq Stock Market, Inc. is the product of the 1993 merger of two NASD subsidiaries that had operated Nasdaq market systems and provided Nasdaq subscribers with market services. The resulting subsidiary, Nasdaq, retained the serviceoriented functions of its predecessors. The composition of the Nasdaq Board tends to reflect this narrow role. Until this year, for example, the Nasdaq Board had no public directors. Its activities have focused on operational, marketing, and financial issues.

Primary authority over the Nasdaq market is held and exercised, not by the Nasdaq Board, but by the Board of the NASD and its Standing Committees. Indeed, the Nasdaq Board acts essentially as a "committee" of the NASD -- but with generally less influence over Nasdaq policy and rulemaking than certain other NASD committees (such as the Trading Committee).

This unitary governance structure may have been suitable when Nasdaq was little more than an automated quotation service of limited scope and importance. It is no longer suitable today. Instead, the Committee believes, the demands imposed on the NASD by the Nasdaq market can best be met by reconstituting the Nasdaq subsidiary as a relatively autonomous entity, whose sole responsibility would be to operate and oversee the Nasdaq and other OTC markets, and whose governing Board would be composed equally of public and NASD member directors.[5] This structure would be analogous to those of the major exchanges, except that, recognizing the differences between the exchanges and the dealer markets, Nasdaq (a dealer market) would remain under the overall umbrella of the NASD, the dealer's statutorily-designated SRO. The NASD, in turn, would remain responsible for enforcement (as further detailed below).[6]

B. The NASD's Membership

A 1963 SEC study of the securities industry noted that "[t]he diversity and lack of organization of the over-the-counter markets have continually perplexed those seeking to study or regulate them."[7] The same holds true today.

The NASD's members are large in number, varied in size, business operations, and securities specialty, and geographically dispersed. For example, over 3% of the NASD's 5,400 members specialize in securities other than equities, such as mutual funds, insurance products, direct participation programs, and municipal or U.S. government bonds. Approximately 80% of the registered representatives subject to NASD oversight are associated with only 148 member firms. Half of those are associated with insurance or mutual fund firms. In contrast, only 26% of the registered representatives are associated with the largest national and regional securities firms.

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[5] Exhibit A compares public membership on the NASD and its subsidiary Boards from 1990 to date, with the public representation proposed for the governing Boards by the Select Committee.

[6] Diagrams describing the NASD's current corporate structure and the new structure recommended by the Select Committee are attached as Exhibits B and C, respectively.

[7] Securities and Exchange Commission, Report of the Special Study of the Securities Markets, H. Doc. No. 95, 68th Cong.; 1st Sess. pt. 2 at 541 (1963).

Most NASD member firms are relatively small. Approximately 55% report gross revenues from their securities business below $680,000. 80% report gross securities revenues under $4 million. Fewer than 5% report gross revenues over $80 million. The number of NASD member firms that generate securities revenues over $375 million is only 43, or 0.8% of the membership.

The largest segment of the NASD membership, including many of the smaller firms, is engaged in a general securities business on a "fully disclosed" basis; that is, these firms perform brokerage functions and consummate transactions through the facilities of larger, "self-clearing" firms. The smaller introducing firms have, on average, fewer than 20 registered representatives.

Only 500 NASD member firms -- less than 10% of the membership -- are market makers in Nasdaq securities. These firms include wholesale firms that make markets in thousands of different stocks; integrated firms that make markets in hundreds of stocks and have brokerage and/or underwriting operations as well; and smaller firms that make markets in just a few stocks. Essentially, this single, relatively small component of the NASD's membership equates with the entire membership of an exchange. Its interests, particularly in the Nasdaq market, frequently differ from those of other NASD membership constituencies.

C. The NASD's Governing Entities

The NASD's 11 District Committees and over 30 Corporate and Standing Committees, all composed of volunteer members, perform the NASD's principal enforcement, policymaking and operational functions, subject to the NASD Board's oversight.

District Committee members are drawn from the district's member firms and branch offices. They are nominated based on their industry experience, expertise in a particular specialty, and willingness to devote substantial time to NASD affairs. The primary role of the District Committees is enforcement. Each year, District Committee members sit on hearing panels in hundreds of NASD disciplinary proceedings and deal with other significant enforcement matters such as new member applications.

The NASD's Standing Committees -- composed of volunteers from among the NASD's member and, in some cases, non-member constituencies -- are assigned by the NASD Board particular responsibility for certain broad matters (e.g., membership, marketing, arbitration). An effort is made to see that these Committees are also representative of the NASD's different member and non-member constituencies (e.g., the Trading, Issuer Affairs, and Institutional Investors Committees). Certain Committees, such as the National Business Conduct Committee ("NBCC") and the Market Surveillance Committee, also play an adjudicative role in NASD disciplinary proceedings. All of the NASD's Committees are involved in, and are often the principal sources of, NASD policy development.

At the apex of NASD governance sits the NASD Board of Governors. A majority of its 29 members is elected by and from the membership of the NASD's 11 districts. The rest, including the NASD President, the public and the other industry governors, are elected by the Board itself. The Board's composition is designed to reflect the NASD's diverse constituencies, and to draw on a broad range of skills and experience.

During the period 1990-1995, 21% of the NASD's governors were drawn from the public, including Nasdaq issuers. Another 19% had a primary business involving securities other than equities. More than one-third were drawn from self-clearing, exchange-member firms; these included individuals from both national firms and regional firms who had different areas of expertise and more involved in various aspects of the firms' operations. The remainder were drawn from various segments of the securities industry. In a few cases, "solo practitioners" have served as governors. Only one or two Nasdaq traders (that is, individuals whose primary occupation is making markets in Nasdaq stocks) typically sit on the NASD Board at any given time.

Neither the NASD's formal procedures for selecting Board or Committee members, nor the composition of those governing bodies, suggests systemic bias or domination of the NASD's affairs by any single constituency. All elements within the NASD's membership have the opportunity to participate in NASD governance, and have in fact done so.[8]

Nonetheless, given the significant developments in the marketplace since 1990, the Select Committee believes that the composition of the NASD's governing bodies should now be broadened to provide for more balanced and effective representation of certain key constituencies, as follows.

First, although the NASD Board has public governors, they constitute only 21% of the Board. The trend in the securities industry, however, has been 50% public membership on SRO Boards. The governing Board of the NASD should have a majority of public governors.

This is desirable, in the Committee's view, to ensure adequate representation of the public interest as the NASD carries out its quasi-governmental functions; to maintain and enhance Nasdaq's competitive position; and to preserve public confidence in the NASD's oversight of the broker-dealer profession.

The Committee does not believe that greater public representation would detract from self-regulation. By recognizing that knowledgeable users of the markets bring a diversity of viewpoints to policy development, and by giving non-members a more

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[8] Based on certain problems that have arisen during the nominating process at the District Committee level, particularly in the district that includes New York City, the Select Committee makes certain recommendations concerning the district nomination process (see infra at 26).

significant role in decision making, public confidence in the self-regulatory process should be enhanced. While the NASD's traditional approach of requiring significant member participation in governance has made self-regulation more meaningful, that concept is not sacrificed by increasing public representation in the NASD's governing councils.

Second, the record indicates an imbalance in the representation of small member firms on the NASD Board. Although 80% of the NASD's members report gross securities income of less than $4 million, only 11% of the NASD member governors from 1990-95 were drawn from those firms. It appears to the Committee that this imbalance stems, in part, from the heavy demands that accompany service on the NASD Board, and also in part from a sense that those firms which account for a dominant share of the industry's revenues should have a significant role in governance. But increasing small firm representation (by taking such steps as reducing or more fairly distributing the workload) is not inconsistent with retaining a significant role for larger firms in NASD governance. The goal is balance, not exclusion.

Third, since institutional ("buy side") investors are significant Nasdaq constituencies, their interests should receive more significant representation in Nasdaq governance.

The Select Committee believes that its specific recommendations (infra at 23-28) will help the NASD meet these objectives.

D. Effectiveness of NASD and Nasdaq Governance

The NASD's existing structure continues to be well-suited to the NASD's traditional regulatory (i.e., enforcement) functions. Volunteer participation and dispersion of authority among various committees afford a balanced and sound perspective for effective oversight of the broker-dealer profession. This system has been accepted by the industry, by regulatory authorities, and by the investing public. With significant additional public participation (see infra at 22-25), it should be even stronger.

However, as discussed above, effective oversight of the Nasdaq stock market requires a governance structure dedicated to discharging that complex and demanding task, designed specifically to meet it, and not simultaneously burdened with responsibility for regulating the broker-dealer profession. It requires also that the composition of Nasdaq's governing bodies adequately reflect Nasdaq's different constituencies. The Nasdaq Board should therefore have 50% public membership.

Creating such a governance structure for Nasdaq, coupled with greater professional management, should help secure Nasdaq's future in the "Market 2000."

E. NASD Rulemaking for the Nasdaq Market

Much of the work in the NASD's rulemaking for Nasdaq is performed by the NASD's Standing Committees. Those Committees initiate rule proposals and, seriatim, provide comments on rules proposed by other Committees. There is no set system for establishing a Committee's jurisdiction regarding a particular matter. In most cases, however, a variety of interested NASD and Nasdaq constituencies have an opportunity to participate in the process.

The Review confirms that the NASD Board acts primarily as a "referee" in the rulemaking process. When Committees representing Nasdaq constituencies disagree, the NASD Board is likely either to appoint a task force or to await consensus at the Committee level, often for protracted periods. On the other hand, when public or internal pressures reach a boiling point, the Board will on occasion react in haste, all too decisively, to protect Nasdaq, sometimes without adequate analysis, staff work or consultation with key constituencies.

The existing process -- designed not for governing a market, but for promulgating Rules of Fair Practice for the broker-dealer profession -- has negative consequences for both Nasdaq and the NASD. First, an NASD Committee with substantial interest and expertise in a Nasdaq matter can dominate debate, often by default In many instances, that Committee has been the NASD's Trading Committee. Since that Committee consists mostly of traders from market-maker firms, its influence in Nasdaq rulemaking contributes to the view that market-maker interests are paramount in Nasdaq matters and in NASD matters generally, including discipline and enforcement.

Second, the process frequently places the NASD in the no-win position of trying to resolve the sharply divergent interests of various segments of the NASD's own membership in the Nasdaq market.

Finally, Nasdaq constituencies facing an impasse on issues of importance to them frequently give public voice to their concerns. Heated public arguments over Nasdaq trading rules generate additional controversy regarding the NASD's stewardship of the Nasdaq market. This electric atmosphere does not help the NASD to reach reasoned and well-informed decisions.

At bottom, the Select Committee believes that the rulemaking process for Nasdaq would be far more effective if it were separated from regulation of the broker-dealer profession and delegated to an empowered Nasdaq Board with undivided authority for the OTC markets, and with balanced representation of all relevant market constituencies. Thus constituted, the Nasdaq Board, supported by a similarly separate expert professional staff and volunteer committee structure, would have the skills and the mandate to initiate rulemaking proposals, undertake the analysis necessary to assess the market impact of proposed policies, and make informed, reasoned, and timely decisions. Because the Nasdaq Board would have significant independent and separate authority, the NASD Board would no longer be vulnerable to the charge that its enforcement policies for the broker-dealer profession are geared to serving the interests of large Nasdaq market-makers.

F. Enforcement and Discipline

In assessing the NASD's enforcement process as a component of NASD governance, the Committee, consistently with its Charter, did not attempt to duplicate the ongoing federal investigations. In addition, the Committee determined that it had neither the authority nor the resources to conduct inquiries into or express views concerning any particular cases; and the Committee has conducted no such inquiries, nor does it express any such views in its Report. Similarly, the Committee expresses no views concerning the SEC or Justice Department investigations or any pending litigations or proceedings; and nothing in the Select Committee's Report should be taken to suggest otherwise.

Instead, the Committee focused this part of its Review on the process by which the NASD carries out its enforcement role. The question for the Committee was whether that process is designed overall to achieve fair and effective enforcement.

The NASD's enforcement burdens are enormous, far exceeding those of any other SRO. While the major exchanges each have approximately 500 member organizations, the NASD has 5,400 members, which in turn employ over 500,000 registered representatives. Also, while the exchanges' activities are centered on the trading floors, the NASD regulates its members' trading activities in OTC markets throughout the country.

The NASD's enforcement effort reflects the scope of its duties. In 1994, for example, the NASD conducted nearly 10,000 examinations of member firms and registered representatives, 545 market surveillance investigations, and 69 special enforcement investigations, referring 91 cases to the SEC. In addition, the NASD monitors trading on the Nasdaq market on a real-time basis, conducting thousands of inquiries each year.

Of course, these data do not address whether the NASD's enforcement procedures are effective or fair. The Committee attempted to examine that issue by reviewing NASD rules and records, including SEC oversight reports, and interviewing individuals and government regulators experienced in all aspects of NASD enforcement. Based on this examination, the Committee believes that the NASD's enforcement process, while not without serious flaws which should be remedied, on the whole is fair and effective.

1. *Examinations*

The NASD's district offices conduct routine ("cycle") examinations of every member firm and branch office. They also conduct "cause examinations" of member firms upon receipt of a customer complaint or a report (required by NASD rules) that a member firm has terminated a registered representative for reasons of professional misconduct. These examinations vie with one another and with the NASD's special investigations for personnel and financial resources.

The examination task is large and complex, and the resources the NASD has allocated to it are stretched to the limit. The NASD is taking interim steps to remedy this problem, but the Committee believes that substantially more can and should be done.

The resource problem became apparent during the Review in a number of ways, beginning with the districts' handling of customer complaints. Those complaints, which trigger cause examinations, play a significant role in NASD enforcement, and the NASD has promulgated national policies to ensure that they are properly handled. Nevertheless, it appears that, because of insufficient resources, various NASD districts do not adhere to the national policy requiring that all customer complainants be contacted by the investigating NASD examiner at the outset of the inquiry. This is a significant and unhealthy departure from an important national policy. That policy is designed both to maximize the efficiency of field investigations and preserve public confidence in the NASD enforcement process. Both goals suffer when the policy is not honored.

The Review produced indications that the failure of districts uniformly to implement this policy has impeded the NASD's disciplinary effort. The percentage of NASD customer complaint investigations resulting in disciplinary proceedings is extremely low, only 2% last year. While the Committee is not in a position to say that the proportion should have been higher, other knowledgeable observers and participants have so asserted. The Committee also learned of certain instances, perhaps isolated, in which state regulators successfully pursued disciplinary actions based on customer complaints, where the NASD had not.

Routine NASD examinations of member firms and their branch offices also appear to suffer from a lack of resources. The SEC has specifically noted this problem in its oversight reports during the past several years. Similarly, NASD district directors report that, because of insufficient resources, they are hard-pressed to undertake special enforcement programs in their respective districts.

NASD members as well as their customers are entitled to rely on the association to make available at all times the resources necessary to ensure effective enforcement in all important areas. The Committee's review of the NASD's financial position shows that the association has the wherewithal to do so. The NASD should allocate and deploy the necessary additional resources promptly in its district enforcement activities.

2. *Disciplinary Process*

The core of the NASD's disciplinary process is member participation and peer review. Panels of industry volunteers, usually drawn from the District Committees, sit as arbiters of member conduct in cases "prosecuted" by the NASD staff. The District Committees' decisions are reviewed by the National Business Conduct Committee ("NBCC"), which serves as the NASD's final appellate body, subject to the rare call of a case by the NASD Board. The SEC oversees the entire process and serves as the first purely governmental forum for review of NASD decisions.

The NASD's disciplinary process still follows the overall pattern established soon after the NASD was founded in 1939. Hearings are conducted according to an informal code of procedure. Discovery is limited. There is no formal motions practice. The hearing panel's written decision is usually drafted by the NASD attorney involved in the case. Rules of evidence and procedure common in a legal proceeding do not apply.

The Review showed that, overall, the NASD disciplinary process functions well. While one can point to mistakes of law or of judgment, there is no indication that these are systemic. In fact, the NASD's record before the SEC is on a par with that of the other SROs. The SEC issued 114 decisions during 1993 and 1994 in appeals by respondents from NASD disciplinary decisions, the cases most likely to evidence deficiencies in the NASD's disciplinary program. The Select Committee's review of those decisions does not suggest that the NASD's disciplinary process is unfair or otherwise ineffective, any more than a similar sampling of federal court of appeals decisions would suggest that the federal judicial system is flawed. In a small number of cases, the SEC chided the NASD for being too harsh, and in a similar number of cases cited excessive leniency.

While the NASD's process appears suited to the organization's enforcement role, after half a century, certain of the NASD's disciplinary procedures are showing signs of age. During the 1980s and 1990s, the NASD has confronted increasingly complex and contentious disciplinary matters -- such as large penny-stock and market manipulation cases -- which have sorely taxed the NASD's informal procedures. Even in more routine matters, the issues that the NASD addresses today increasingly turn on questions of law rather than industry standards and practice. Further, as a result of its relatively new sanction guidelines, the NASD is now likely to impose more severe penalties when infractions are found, including high fines, suspension from NASD membership, and permanent expulsion from the securities industry. Accordingly, respondents in NASD disciplinary proceedings more often retain counsel. The NASD hearing room has come increasingly to resemble a courtroom, rather than the traditional business forum for which the existing procedures were designed.

While the Select Committee believes that the core of the system -- peer review -- continues to serve the public and the industry well, certain reforms would significantly improve the system, ensuring its ability to cope with the issues that NASD disciplinary panels face today. The Committee's recommendations in this regard include, among others detailed below (see infra at 25-26), (i) the assignment, in certain cases, of professional hearing officers to serve on disciplinary panels with NASD member volunteers, (ii) the assignment of NASD attorney-advisors to assist the members in all other cases, and (iii) the promulgation of certain formal rules to enhance the fairness and orderly conduct of all NASD disciplinary proceedings, and to facilitate SEC review.

While some have argued to the Select Committee that these reforms would diminish the self-regulatory aspect of the disciplinary process, the Committee disagrees. First, utilizing professional hearing officers familiar with legal procedures will not eliminate the influence of member volunteers, who will still bring their business experience and judgement to bear in evaluating the facts and assessing penalties. To the extent of any dilution of industry participation, it will be balanced by more orderly and efficient conduct of complex or contentious cases. Second, the New York Stock Exchange utilizes professional hearing officers, and the NASD itself currently uses attorney-advisors to assist its volunteer panels in certain cases. Third, both the New York and American Stock Exchanges have formal practice procedures similar to those recommended by the Committee for the NASD. Finally, of course, to the extent that the NASD's disciplinary hearings are improved, so is self-regulation.

3. *The Overall Record of NASD Enforcement*

To evaluate contentions that the NASD's enforcement process is unfair or ineffective, the Select Committee looked for any material indications that the NASD had systematically skewed its enforcement process inappropriately. Subject to the important caveat that the Committee had neither the mandate nor the information necessary to evaluate particular cases (and did not purport to do so), the Committee found no such indications. Instead, the results of such analyses as the Committee could perform (recognizing, again, that it did not have the mandate or subpoena powers of a government agency) confirm the Committee's overall impression of the NASD's disciplinary system: it works well, albeit not perfectly, and is not deliberately biased.

The SEC's periodic oversight reports of the NASD's enforcement process over the past several years are not inconsistent with this view. They do not reflect overall dissatisfaction with the NASD's enforcement system. In instances where those periodic reports noted an apparent failure of the NASD to pursue a matter appropriately, the NASD responded to the SEC with an explanation of its actions. The only repeated criticism in these SEC reports was that the NASD had not devoted sufficient personnel and resources to certain enforcement matters. While this is a serious criticism, with which the Committee agrees, it is not an indictment of the process.

The data available to the Committee regarding NASD disciplinary proceedings also lend no support to the suspicion, voiced by critics, that the NASD does not pursue violations by large firms or violations of duties owed by member firms to customers. Over the past three years, the NASD has brought more disciplinary proceedings against New York Stock Exchange firms and associated persons than has the New York Stock Exchange itself. Further, in 1993 and 1994, taking all assumptions adverse to the NASD, a substantial plurality of NASD disciplinary proceedings involved solely a breach of the duties owed by members to customers, rather than breach of duties owed to other members or to the NASD itself.[9] The data also show that the NASD has borne its share of the load associated with

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[9] There is no contradiction between these data and the relatively low number of disciplinary actions initiated by customer complaints (discussed supra at 16). Cases involving breaches of duties owed to customers are quite frequently initiated by the NASD without a customer complaint.

large and complex industry investigations involving fraud or market manipulation, and has provided substantial assistance to regulatory authorities in other cases.

Nor do the data support the proposition that the NASD systematically shuts its eyes to certain trading violations by Nasdaq market makers; more specifically, "backing away" from quotes. A central fact in the NASD's recent handling of backing away complaints is that, in 1994, the number of complaints filed with the NASD alleging that Nasdaq market makers "backed away" suddenly increased by nearly hundreds of times the level of prior years. Nearly 90% of those complaints were filed by one NASD member firm, which has (and is) engaged in a heated controversy with the NASD, while most of the remainder were filed by a few other member firms opposing the NASD in the same controversy. The NASD concedes that its market surveillance system nearly choked on the unexpected workload, and that other areas of market surveillance suffered in consequence.

The available data also show that NASD policy calls for investigation of patterns of late trade reporting that could reflect a rule violation, particularly in circumstances that suggest market manipulation or other fraudulent conduct. However, NASD officials say that the NASD's general oversight of late-trade reporting on the Nasdaq market has encountered problems in recent years. Particularly in 1994, the resources that the NASD devoted to Nasdaq trading violations were beset, according to NASD officials, by the unanticipated onslaught of backing away complaints (discussed above). Moreover, both NASD and member firm officials report that technical problems associated with automated last-sale reporting have burdened NASD enforcement efforts in this area. This is apparently a difficult area for the NASD to monitor, and it was no less difficult for the Select Committee to review. The Select Committee can draw no firm conclusions in this area.

The Select Committee does believe, however, that the NASD's overall enforcement policy would benefit from increased attention by the NBCC, which is charged with this function under the NASD's governance structure. By all accounts, the NBCC has largely deferred this function in the light of a workload requiring it to review all NASD disciplinary cases, even if they involve settlements or non-appealed decisions. The NBCC opposed certain of the suggestions by a prior NASD task force to reduce this workload. Although the NBCC apparently adopted this position out of regard for the NASD's tradition of peer review, this Select Committee believes that peer review would not suffer if the NBCC assigned such tasks to the NASD's professional staff. This would permit the NBCC to focus more of its attention on enforcement policy, the heart of effective self-regulation. Further, and precisely because of the NBCC's critical role in enforcement policy, the Committee recommends that it be reconfigured with significant public membership.

The Committee believes also that NASD enforcement policy would benefit from more formal, regularized coordination with federal and state securities officials and the officials of other SROs, in addition to the numerous informal communications that regularly occur. The Select Committee heard several complaints regarding failures by NASD district offices to coordinate their activities with state regulators, and other instances where, in the eyes of state regulators, the NASD's enforcement efforts appeared inexplicably to lapse.

While these isolated instances, even if they occurred, do not suggest any systemic problem, regular, high-level coordination with other securities regulatory authorities would provide the NASD an opportunity to address such issues as they arise. High-level coordination should lead also to more efficient allocation of enforcement resources while helping to eliminate redundancy. It would enhance the opportunity for regulators to detect patterns of activity that reveal misconduct where no individual regulator has sufficient evidence of its own. In short, the potential benefits of such coordination are significant, and should actively be pursued by the NASD with state and federal regulators and the other SROs.

G. Internal Review

The NASD's Office of Internal Review is only in its developmental stages, although important steps have been taken in recent months. The NASD now has an internal financial and management information systems audit capability, and the Office also conducts special program audits.

The NASD's district review operation, however, is moribund. This is a significant deficiency. Effective auditing of the districts by the NASD is essential to ensuring that national enforcement policy is honored (as in the handling of customer complaints), that deficiencies are detected and promptly remedied (for example, by allocating additional resources to the district), and that other problems are identified and addressed before they escalate.

It is similarly critical that an organization as large as the NASD, with quasi-governmental functions, have a vigorous and independent Internal Review Office equipped with the necessary authority and resources to conduct special investigations on its own initiative or at the request of any NASD unit or senior official.

That same independent and empowered Office should serve also as an "Ombudsman" -- a key role not fulfilled in the NASD's existing structure -- to receive and address concerns and complaints from any source (within or outside of the NASD) concerning any of the NASD's operations, policies or personnel. In this respect, the Committee notes that it received complaints that certain allegedly "disfavored" NASD member firms have been harassed or unfairly "targeted" by NASD enforcement personnel. NASD officials deny that this is so. This Committee is in no position to resolve the issue. But it is precisely the type of issue that should be (and indeed, should have been) promptly addressed and resolved by a strong and independent Office of Internal Review. While any such harassing conduct would be intolerable, it is equally unacceptable for such charges to fester unresolved if the alleged conduct did not occur.

In sum, this Committee believes that vigorous, independent, responsive, and ongoing internal review would significantly bolster NASD governance and enforcement.

VI.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

A. Overall Conclusions

Based on its Review, the Select Committee concludes that the NASD has discharged its self-regulatory responsibilities, not of course with perfection or without difficulty, but professionally and reasonably. The NASD's role as the primary regulator of the broker-dealer profession and the non-exchange securities markets, combined with its stewardship of the vast Nasdaq market, is both difficult and unique. No other SRO is faced with such complex and challenging obligations.

The Committee's Review does not support the claims of those who assert that the NASD is controlled by and for the benefit of Nasdaq market makers. Nor does it support those who assert that the NASD cloaks in regulatory garb actions that are in fact designed solely to advance the commercial interests of certain segments of the NASD's membership.

The Select Committee does find, however, that the NASD's governance structure has failed to keep pace with the significant growth and continuing evolution of the Nasdaq market, and the concomitant expansion of the NASD's regulatory responsibilities. In some cases, the existing governance structure has led to ineffective rulemaking for the Nasdaq market. In others, it has required the NASD to mediate economic clashes among its members arising from their divergent interests in the Nasdaq market -- a daunting role which the NASD, as a membership association and regulator of the entire broker-dealer profession, did not seek and was never designed to play. The current structure has also placed the NASD, as the owner of Nasdaq's trading systems, in the unenviable position of regulating the competing systems owned by NASD members.

The NASD's existing governance structure thus blurs the distinction between regulating the broker-dealer profession and overseeing the Nasdaq stock market. Both missions are thereby disserved.

The NASD's existing structure would also benefit from increasing public representation on the NASD's governing bodies. Not only would a full measure of public representation befit the NASD's current stature and importance, it should also bolster confidence in the NASD's policies. It would not be inconsistent with self-regulation, because NASD members would still be fairly represented in the association's affairs and have ample opportunity to bring their expertise and viewpoint to bear.

Regarding NASD enforcement, the Committee believes that the core of the NASD's disciplinary process is sound. No doubt, mistakes have been made, and some judgments certainly can be questioned in retrospect, but the overall process is designed to be effective and fair. At the same time however, NASD disciplinary proceedings have become more contentious, complex and consequential than the existing system was designed to accommodate. New measures are required to address these developments.

This will entail certain changes significant in the conduct of most NASD disciplinary proceedings. It will also entail greater national oversight within the NASD itself, greater public participation, more frequent, formal coordination of enforcement efforts with the SEC, the states and the major securities exchanges, and prompt deployment of increased financial and human resources. The Committee believes that these measures can be implemented without compromising the principle of peer review.

Finally, the Committee believes that the critical internal review function (including regular district audits) has not been given the mandate, resources or prominence necessary for effective oversight within the NASD itself. Significant improvement is required.

B. Principles of Effective Governance

Based on its Review, the Committee believes that, to be fully effective, the NASD's governance structure should conform to the following principles:

- The NASD and the Nasdaq market should not be divorced, but regulation of the broker-dealer profession should otherwise be separated from and performed independently of regulation of the Nasdaq and other OTC markets.

- To this end, the governing Board charged with regulating the NASD's member firms should be separate and independent from the governing Board responsible for overseeing the Nasdaq market. So, too, should their respective professional staffs. Those two governing Boards and staffs, however, should remain associated within a single SRO structure. This will maintain the strength of the existing NASD organization in linking commercial and technical expertise to regulation so that each informs and enhances the other. (See Exhibit C.)

- In all events, enforcement should be independent of responsibility for the Nasdaq and other OTC markets and should be the paramount task of the Board charged with regulating the broker-dealer profession.

- The separate governing Boards responsible for regulating the broker-dealer profession and for regulating the Nasdaq market should each have 50% public membership. The parent (or equivalent) Board should have a majority of public members. Other governing bodies with substantial policymaking or oversight authority also should have strong public representation, as appropriate to their specific tasks.

- The public members of the Boards and other governing bodies, though not affiliated with NASD member firms, should have sufficient knowledge, experience and interest in the securities industry or markets to play a meaningful role in governance, and should represent a wide spectrum of skills and interests.

- Apart from public representation, the composition of the separate governing Boards should be tailored to reflect the interests of their respective constituencies.

- In addition, the composition of the Board responsible for regulating the broker-dealer profession should provide for balanced representation of the NASD's diverse membership, including small and large firms and firms involved in different business specialties.

- The Nominating Committees for the principal governing bodies should be composed equally of NASD members and public representatives, and the selection process should provide an opportunity for all interested and qualified constituencies to participate.

- The NASD's professional staff should take an active management role, and should ensure that all governing bodies are equipped to reach decisions in a fully informed and timely fashion and that the views of all relevant constituencies are taken into account.

- NASD discipline and enforcement should be, in fact and appearance, fair, effective and professional.

- The NASD should have a strong, independent and well-equipped Office of Internal Review, with provision for regular district audits and an Ombudsman.

- The NASD should at all times devote the financial and human resources necessary to meet its paramount regulatory obligations.

C. Specific Recommendations

Guided by the foregoing, and based on the Review, the Select Committee makes the following specific recommendations:

1. *Corporate Restructuring*

(a) The NASD should reconstitute and establish Nasdaq as a strong, independent operating subsidiary, not divorced from the NASD, but with as much autonomy and authority over the Nasdaq and other OTC markets as the law will allow.

(b) The NASD should create a separate, strong and independent operating subsidiary, NASD Regulation, Inc. ("NASDR"), responsible for regulating the broker-dealer profession.

(c) The NASD should retain ultimate policymaking, oversight and corporate authority as parent holding company and statutory SRO. However, to effectuate the purposes of this proposed restructuring, the NASD should grant substantial deference to its operating subsidiaries in the areas of their respective jurisdiction.

(d) The composition of the Boards of the NASD, Nasdaq and NASDR should be tailored to meet their respective responsibilities and to reflect the interests of their respective constituencies.

(e) The governing Boards of Nasdaq and NASDR should each have 50% public membership, meaning directors drawn from outside the membership of the NASD and representing a broad spectrum of skills and interests. The Board of the NASD should have a majority of public members, also representing a broad spectrum of skills and interests.

(f) Board compositions that would satisfy the foregoing criteria are depicted in Exhibit D.

(g) The members of the NASD Board of Governors should be selected as shown in Exhibit D. Although, as there shown, certain NASD governors would be selected by the Nasdaq and NASDR Boards, those governors should not be directors of Nasdaq or NASDR at the time of their selection. The public governors on the NASD Board should be proposed by an NASD Nominating Committee and elected by the NASD Board, with provision for public governor candidates to be proposed as well by any NASD member, under rules to be established by the NASD Board.

(h) The district members of the NASDR Board should be proposed by District Nominating Committees and elected by the NASD districts, under rules to be established by the NASDR Board (including rules for contested elections). The remaining members of the NASDR Board should be proposed by an NASDR Nominating Committee and elected by the NASDR Board. The NASDR Board should establish procedures permitting NASD members or the public also to propose candidates for non-district seats.

(i) The members of the Nasdaq Board should be proposed by a Nasdaq Nominating Committee and elected by the Nasdaq Board. The Nasdaq Board should establish procedures permitting NASD members or the public also to propose candidates.

(j) The Nominating Committees of the NASD, NASDR and Nasdaq, respectively, should be composed equally of individuals affiliated with NASD member firms and individuals drawn from the public. The members of the Nominating Committees need not be present members of the respective Boards.

(k) The Nasdaq and NASDR Boards should select, respectively, the CEOs of each entity. The NASD Board should retain the authority to reject or dismiss the CEOs chosen by Nasdaq and NASDR, but should exercise such authority only in exceptional cases.

(l) The NASD Board should choose the CEO of NASD.

(m) The CEOs of the NASD, Nasdaq, and NASDR, respectively, need not be affiliated with an NASD member, but may be drawn from the public or from the professional staffs of NASD, NASDR or Nasdaq.

(n) The principal functions of NASD, NASDR and Nasdaq, respectively, should be as shown in Exhibit E.

2. *Discipline and Enforcement*

(a) The NASD should significantly augment its disciplinary procedures, and allocate the necessary financial resources and personnel at both the district and national levels, so as to ensure effective, fair and professional enforcement.

(b) The NASD should establish an Office of Professional Hearing Officers within NASDR. The professional hearing officers should be NASDR employees and should sit, along with two industry representatives, in every NASD disciplinary proceeding in which either the respondent or NASDR so elects, or the Board of the NASD or NASDR so determines.

(c) In all disciplinary proceedings, ex parte contacts between the disciplinary panels -- including the District Business Conduct Committees and the Market Surveillance Committee and the parties or their representatives -- including attorneys presenting the case for NASDR -- should be prohibited.

(d) Before any proposed settlement of a disciplinary proceeding is approved by a panel sitting without a professional hearing officer, it should be reviewed by a designated NASDR staff attorney (other than the attorney presenting the case) to determine and advise the panel whether the proposed settlement conforms to NASD policy, including sanction guidelines.

(e) The documentary discovery rights of respondents in NASD disciplinary proceedings should be expanded to furnish respondents, at a reasonable time in advance of the initial hearing, with all non-privileged materials in the NASD's possession (including exculpatory evidence) directly relevant to the dispute. The precise rules should be established by NASDR. Also, NASDR should establish rules for a motions practice suitable for NASD disciplinary proceedings. Disciplinary panels, including NBCC panels, should be given the power to impose sanctions on either side for frivolous practice or contumacious behavior by the parties or their counsel.

(f) The workload of the NBCC should be reduced in order for it to address national enforcement policy issues and ensure uniformity in NASD membership application processing. To help achieve this goal, the professional staff assigned to the NBCC should be delegated the responsibility to review all settlements and non-appealed disciplinary cases, referring to the NBCC itself only such settlements and non-appealed cases, if any, as appear inconsistent with NASD enforcement policy or sanction guidelines. Public members should serve on the NBCC, but NASD member firms should be in the majority.

3. *District Committees*

(a) District Nominating Committees should be directed to consider diversity in the size and type of firms represented on the District Committees, especially in districts that have larger-than-average Committees.

(b) In the event of a contested election for District Committee seats, the NASD and its staff should remain strictly neutral. To the extent that NASD or NASDR resources are employed in the election process, they should be made available on an equal basis to all candidates.

4. *Office of Internal Review*

(a) The NASD should create a strong, independent and responsive Office of Internal Review, to be housed in and administered by the NASD parent. This Office should conduct regular internal audits and reviews of the NASD's and its subsidiaries' operations, including the districts. The Office should also be equipped with the necessary authority and resources to conduct special internal investigations on its own initiative or at the request of the NASD Board, the Nasdaq Board, the NASDR Board, or the CEOs of the NASD, Nasdaq or NASDR.

(b) The Office should serve also as an "Ombudsman" for receiving and addressing concerns and complaints, whether anonymous or not, from any source (within or outside of the NASD), concerning the operations, policies, or activities of the NASD, Nasdaq, or NASDR, or any staff members.

(c) The hiring, firing and compensation of the professional staff serving in the Office should be exclusively the province of the NASD's CEO and the NASD Board. The Office should have authority to raise issues directly with any operating entity, unit or official within the NASD organization.

5. *Coordination with Other Regulators*

On at least a semi-annual basis, high-level NASD and NASDR officials should engage in formal consultations to coordinate national enforcement policy with the other principal securities industry regulators, i.e., the SEC, state regulators, and the New York and American Stock Exchanges.

6. *Membership Voting*

The Select Committee finds no reason to change the NASD's decision, approved by the SEC in 1994, to eliminate the requirement of membership voting on proposed rule changes except in those unusual cases in which the NASD Board or NASDR Board determines otherwise.

7. *Professional Staff*

The NASD, NASDR, and Nasdaq professional staffs should take an active role in management and in identifying and pursuing issues and recommending proposed solutions, policies and rules.

8. *Individual Investors*

The Committee notes that, in accordance with the principles of effective governance endorsed by this Committee, the NASD is creating an Office dedicated to representing the interests of individual investors and making certain that those interests are taken into account in policy and rulemaking.

9. *Allocation of Financial Resources*

The NASD should allocate the necessary financial resources and personnel to achieve the foregoing goals as soon as practicable. In particular, the NASD should significantly increase the resources it currently allocates to enforcement and discipline and to internal audit and review.

RESPECTFULLY SUBMITTED,

THE NASD SELECT COMMITTEE ON STRUCTURE AND GOVERNANCE

Hon. Warren B. Rudman, *Chair*
Jean W. Gleason
Stephen L. Hammerman
Peter S. Lynch
Robert H. Mundheim
Irving M. Pollack
A. A. Sommer, Jr.

Mark A. Belnick, *Chief Counsel*
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-and-

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Washington, D.C. 20036-5694

September 15, 1995

<u>Exhibit A-1</u>

CHAIRMAN AND MEMBERS
OF THE NASD SELECT COMMITTEE
ON STRUCTURE AND GOVERNANCE

Warren B. Rudman (Chair): Partner, Paul, Weiss, Rifkind, Wharton & Garrison; former United States Senator from New Hampshire.

Jean W. Gleason: Partner, Fullbright & Jaworski; former Associate Director, SEC Division of Investment Management.

Stephen W. Hammerman: Vice Chairman, Merrill, Lynch & Co.; former Chairman, NASD Board of Governors, and currently a member of the Board of Directors of the New York Stock Exchange.

Peter Lynch: Vice Chairman, Fidelity Research and Management.

Robert Mundheim: General Counsel, Salomon Brothers; former Dean, University of Pennsylvania Law School, and former Vice Chairman, NASD Board of Governors.

Irving M. Pollack: Special Counsel, Storch & Brenner; former SEC Commissioner and former Director, SEC Division of Trading and Markets and SEC Division of Enforcement.

A.A. Sommer, Jr.: Counsel, Morgan, Lewis & Bockius; former SEC Commissioner, and currently Vice Chairman, NASD Board of Governors.

Exhibit A

Public Representation: Current and Proposed Governing Boards

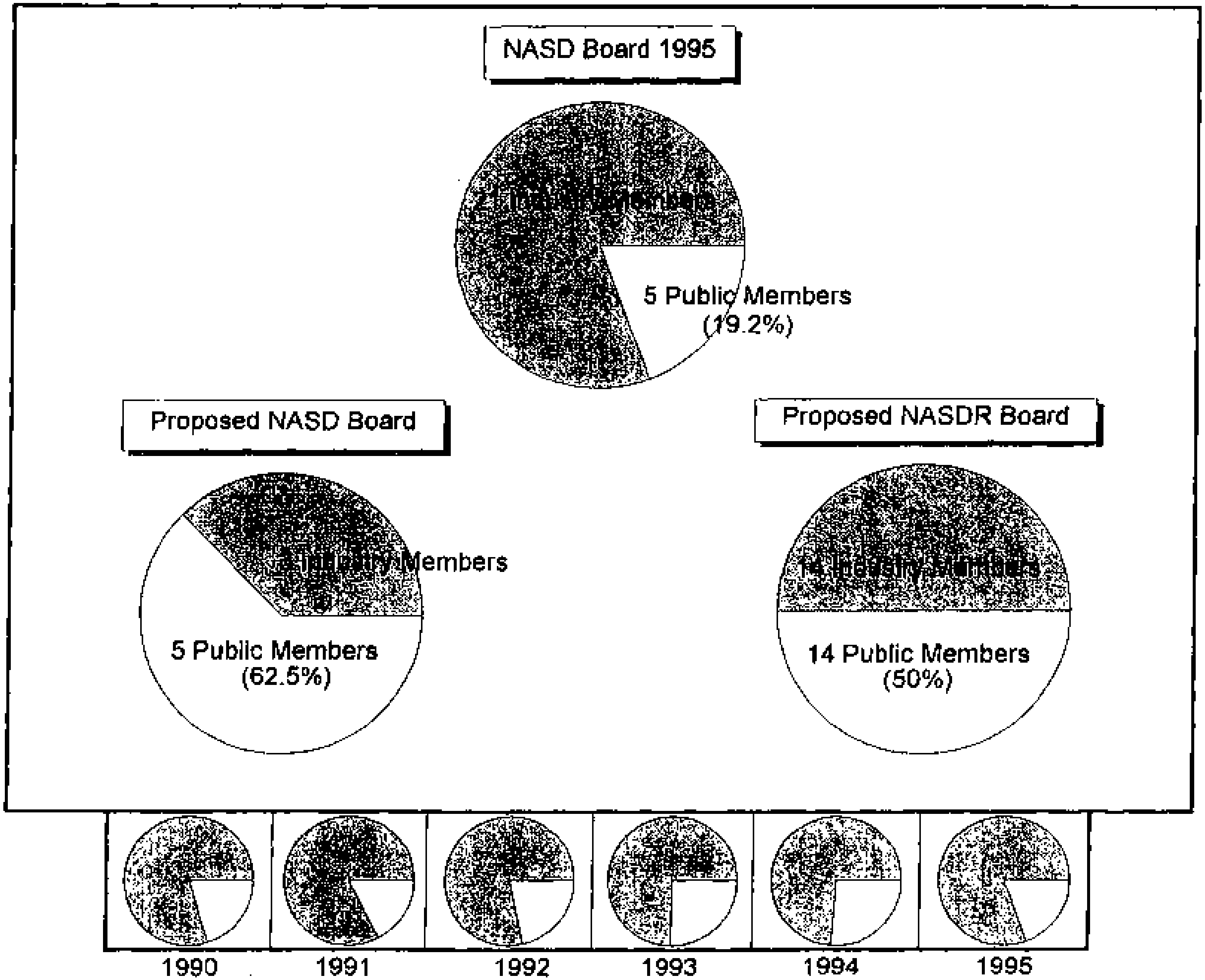

Exhibit B

Current NASD Corporate Structure

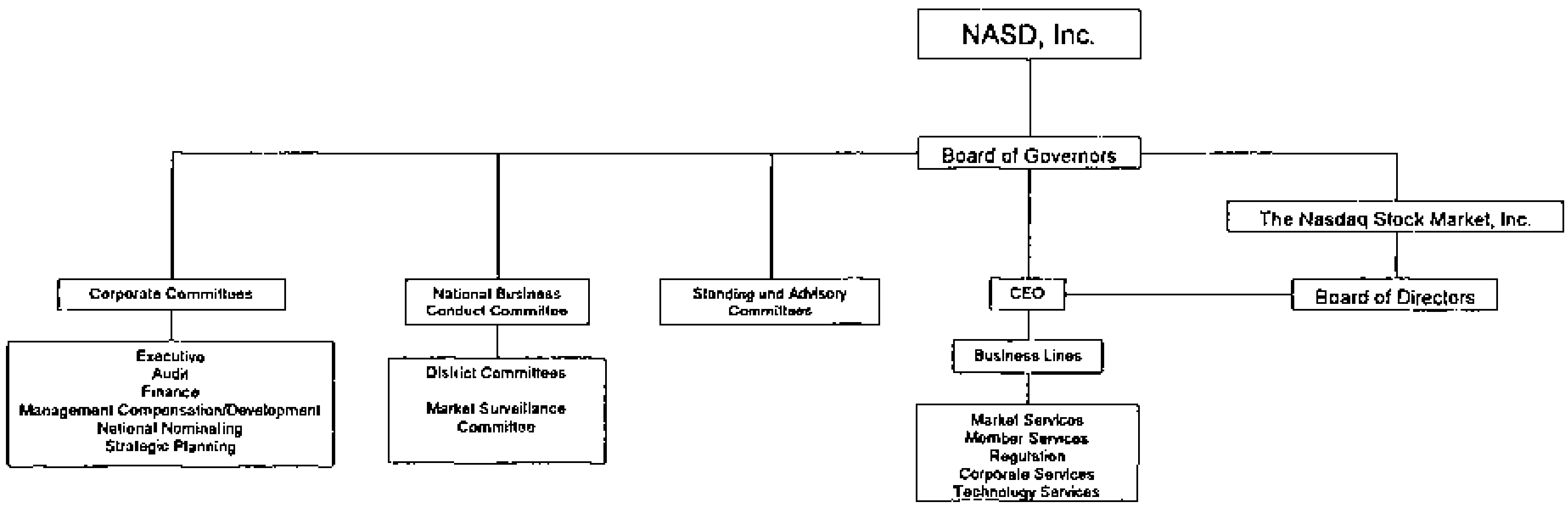

Exhibit C

Recommended NASD Corporate Structure

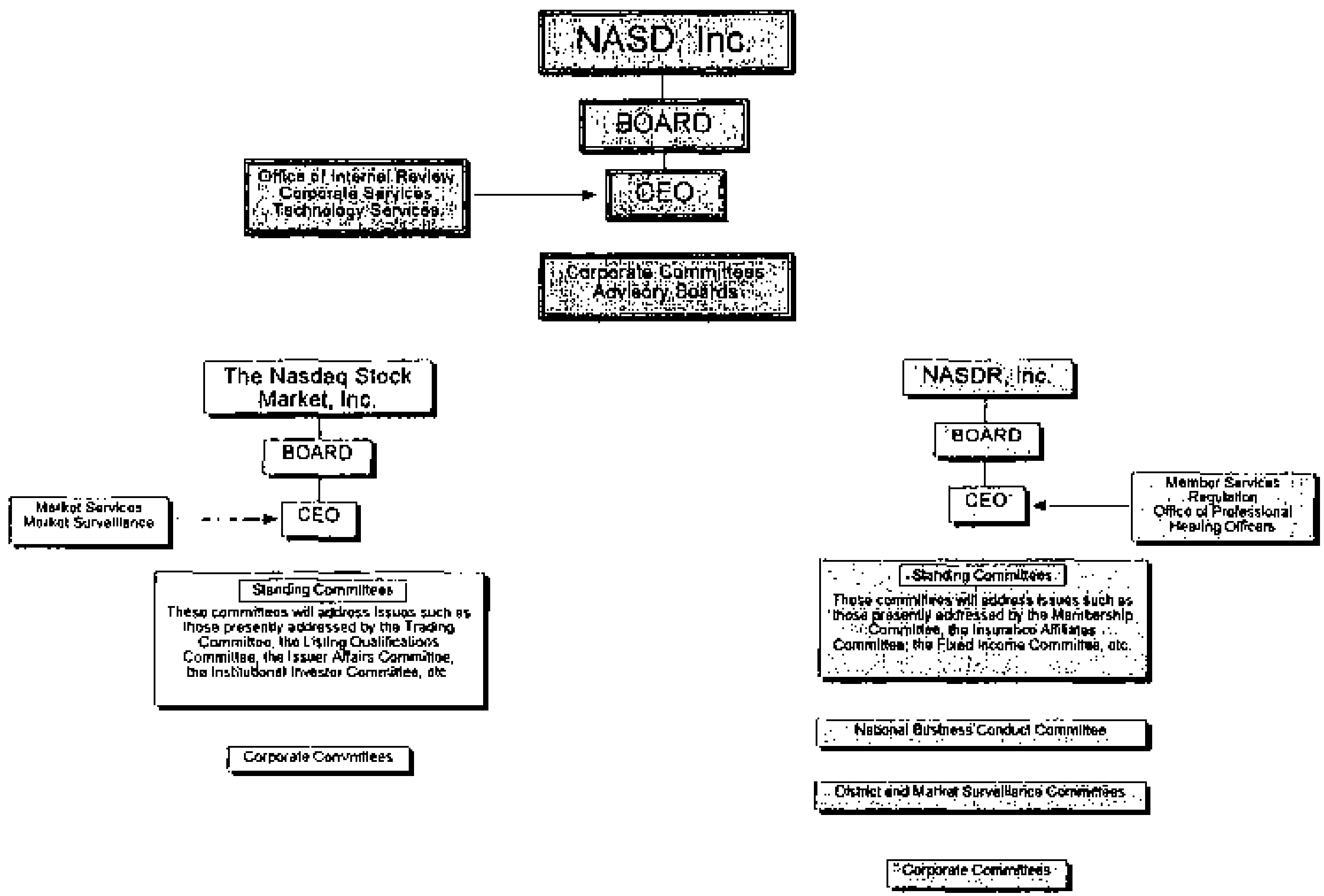

Exhibit D

Current and Proposed Makeup of NASD and Subsidiary Boards

NASD, Inc. Board of Governors	
Current	**Proposed**
President of NASD 13-15 Governors elected by NASD members in the various NASD Districts 11-13 Governors elected by the Board (the "at-large" Governors)	CEO of NASD 1 industry representative selected by the Nasdaq Board 1 industry representative from the NASD Districts selected by the NASDR Board 1 at-large industry representative selected by the NASDR Board 5 public members representing a broad spectrum of skills and interests

The Nasdaq Stock Market, Inc. Board of Directors	
Current	**Proposed**
President of NASD/Nasdaq 4 public representatives (including 2 issuer representatives) 10 industry representatives (including 1 current NASD Governor)	CEO of Nasdaq 8 public members representing a broad spectrum of skills and interests 4 "market maker" representatives 4 industry representatives from firms that are not primarily "market makers" CEO of NASD (ex officio, non-voting)

Proposed Makeup of the NASD Regulation, Inc. Board of Directors
CEO of NASDR 11 representatives of member firms elected by the NASD Districts 3 at-large industry representatives 14 public members representing a broad spectrum of skills and interests CEO of NASD (ex officio, non-voting)

Recommended Role and Composition of NASD and Subsidiary Boards

NASD, Inc.

Makes ultimate policy decisions and exercises ultimate review authority over the decisions of the two operating subsidiaries, including NASDR disciplinary decisions (but with substantial deference to each subsidiary's expertise in the areas of its jurisdiction)

Resolves jurisdictional or other disputes between Nasdaq and NASDR

Administers the Office of Internal Review

Administers common overhead and technology of Nasdaq and NASDR

Establishes a consolidated corporate budget

Manages external relations on major policy issues, including relations with Congress, the SEC, state regulators, other SROs, business groups and the public at large

Retains overall responsibility for ensuring that the NASD's statutory obligations and functions are fulfilled

Board of Governors

CEO of NASD
1 industry representative selected by the Nasdaq Board
1 industry representative from the NASD Districts selected by the NASDR Board
1 at-large industry representative selected by the NASDR Board
5 public members representing a broad spectrum of skills and interests

The Nasdaq Stock Market, Inc.

Oversees and operates the Nasdaq market

Designs and operates Nasdaq trading systems, and promulgates rules for those trading systems and for the other OTC markets

Conducts market surveillance, including trading halts

Establishes fees for market services

Prepares the annual budget and strategic plan for the Nasdaq subsidiary

Board of Directors

CEO of Nasdaq
8 public members representing a broad spectrum of skills and interests
4 "market maker" representatives
4 industry representatives from firms that are not primarily "market makers"
CEO of NASD (ex officio, non-voting)

NASD Regulation, Inc.

Establishes rules and regulations for the broker-dealer profession generally (including Rules of Fair Practice and membership requirements)

Administers the enforcement and disciplinary systems, including investigation and adjudication of all cases referred by the NASD or Nasdaq, or initiated by NASDR itself

Administers the Office of Professional Hearing Officers

Conducts arbitrations

Conducts qualification examinations and operates the CRD system

Oversees all District Offices and compliance activities (including review of underwriting agreements, advertising, and enforcement of MSRB rules)

Establishes the annual budget and strategic plan for the NASDR subsidiary

Board of Directors

CEO of NASDR
11 representatives of member firms elected by the NASD Districts
3 at-large industry representatives
14 public members representing a broad spectrum of skills and interests
CEO of NASD (ex officio, non-voting)