

SECURITIES AND EXCHANGE COMMISSION HISTORICAL SOCIETY  
in cooperation with the  
UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
with the support of  
NORTHWESTERN UNIVERSITY SCHOOL OF LAW  
A MAJOR ISSUES CONFERENCE:

SECURITIES REGULATION IN THE GLOBAL INTERNET ECONOMY

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## P R O C E E D I N G S

## WELCOME AND CONFERENCE OVERVIEW

1  
2  
3 MR. RUDER: Good morning. My name is David Ruder.

4 I am the Chairman of the Securities and Exchange Commission  
5 Historical Society. I have some introductory remarks to  
6 make. And Associate Dean Wentz at Northwestern has assigned  
7 me some administrative duties as well.

8 First of all, we apologize that some of you do  
9 not have your name tags. A delivery company which we shall  
10 not specify failed to deliver the name tags from Chicago  
11 here today. They should be here shortly and at the breaks  
12 you can find them.

13 Those of you who want continuing legal education  
14 credit can sign up at one of the breaks or at lunchtime.  
15 The luncheon will be held on that side of the room and we  
16 will have a few minutes break between the end of the morning  
17 and the luncheon.

18 There are a few reserved seats down here for  
19 speakers. If there are any speakers who are feeling cramped  
20 or they are standing somewhere we would urge you to come down  
21 in front to be here and watch the proceedings. And then when  
22 you come up on the podium then other speakers can take your  
23 place.

24 The SEC Major Issues Conference is being presented



1 in cooperation with the United States Securities and  
2 Exchange Commission with the support of Northwestern  
3 University School of Law. On behalf of these three  
4 organizations, I am pleased to welcome all of you to this  
5 important conference. You may think I am stretching when I  
6 welcome you on behalf of three organizations but I believe I  
7 am entitled to do so. I am the Chairman of the Historical  
8 Society. From 1987 to 1989, I served as Chairman of the  
9 SEC. And for many years I have been a Professor of Law at  
10 Northwestern University School of Law.

11 This is a major event for the Securities and  
12 Exchange Commission Historical Society which has been in  
13 existence for only two years. The purpose of the Society is  
14 to preserve the history of the Securities and Exchange  
15 Commission, to sponsor research and educational programs  
16 regarding the Securities and Exchange Commission and to  
17 enhance the understanding of the United States and the  
18 world's capital markets.

19 The Society came into being at the suggestion of  
20 three SEC staff persons, the General Counsel Harvey  
21 Goldschmid, the Solicitor Paul Gonson, and the Secretary  
22 Jack Katz. Chairman Arthur Levitt embraced the idea and  
23 asked me to undertake the formation of the Society. The  
24 task was easy for two reasons.

25 First, many former SEC staff members

7

1 enthusiastically supported the idea and many of them are  
2 serving as trustees of the Society.

3           Second, two former staff members, Paul Gonson,  
4 then retired from the Commission, and Harvey Pitt worked  
5 tremendously hard to form the Society. Harvey provided staff  
6 support, space and legal advice from his office and used his  
7 boundless energy to bring about formation of the Society as a  
8 not-for-profit corporation. Paul provided his long SEC  
9 experience, his great wisdom and his energy and enthusiasm.

10           With Harvey as President and Paul as  
11 Secretary/Treasurer and with an outstanding board of  
12 trustees, including former Chairman Arthur Levitt, the  
13 Historical Society has become a viable and visible entity in  
14 a very short time. Today with Harvey serving as Chairman of  
15 the SEC and Paul now serving as President of the Society we  
16 are confident the Society will continue to grow and prosper.

17           The Society plans a variety of activities. It  
18 will collect the personal papers of SEC commissioners and  
19 staff members. It will serve as a clearinghouse and  
20 coordinator of SEC reports and other documents relating to  
21 the history of our financial markets. It will provide a  
22 website allowing scholars and the public to obtain valuable  
23 historic information. It will and already has begun a  
24 project to record oral histories of those persons who have



25      been central to many key events in the financial markets. It

1 will publish scholarly papers and reports of conferences such  
2 as this SEC Major Issues Conference.

3 This conference is modeled after several  
4 conferences held in the 1980s at which the Commission  
5 identified the important policy issues of the day. Jack  
6 Katz, the Commission's Secretary, deserves great credit for  
7 identifying the desirability for this conference and for  
8 organizing the support of the SEC. I have told him if this  
9 is a success we will be extremely proud of him, and we're  
10 proud of him anyway.

11 It now gives me great pleasure to allow three  
12 persons about whom I feel the keenest sense of admiration to  
13 join me in welcoming you. I am going to introduce them  
14 briefly and they will then talk to you.

15 The first will be David Van Zandt, the brilliant  
16 dean and my boss at Northwestern University School of Law.

17 The second will be Dick Phillips of Kirkpatrick  
18 and Lockhart who has been wonderful as Chairman of the  
19 Program Committee that organized this conference.

20 The third will be Harvey Pitt, Chairman of the  
21 Securities and Exchange Commission who will undoubtedly be a  
22 wonderful Commission chairman and whom I will be introducing  
23 again to you at dinner this evening.

24 MR. VAN ZANDT: Thank you very much, David. You



1 should all know that no one can be Dave Ruder's boss.

2 But I am very pleased to see all of you here  
3 today. We are especially proud at Northwestern Law School to  
4 be one of the supporters of this conference. I would like  
5 to thank David specifically for his work on this along with  
6 Jack Katz, the Secretary of the SEC, our conference chair  
7 Dick Phillips of Kirkpatrick & Lockhart and finally, of  
8 course, Harvey Pitt who's had a long association with our  
9 various conferences at Northwestern.

10 Lastly, Associate Dean Pete Wentz and Deborah  
11 Williams at the Law School have worked very hard with the  
12 planning committee to organize today's conference.

13 As I said, it is a great honor to be part of this.  
14 I think these issues are going to be -- are important to  
15 discuss now for the future of the SEC as well as our  
16 financial markets here in the United States and around the  
17 world. We are extremely proud of our relationship that we've  
18 developed with both the SEC and the SEC Historical Society.  
19 And over the years we have been fortunate to be able to put  
20 on any number of conferences on securities regulation,  
21 whether our Garrett Institute at Northwestern's Law School in  
22 the spring, our support for the Securities Regulation  
23 Institute in San Diego every January.

24 The last thing I will say is this really is

25 emblematic of what we're trying to do at Northwestern Law.

1 The world is a dramatically changing place, particularly for  
2 our young students who are coming out now. It's a very  
3 different world than 20 years ago when I graduated from law  
4 school. It's very important for them to understand what's  
5 happening in the world. We at Northwestern try through  
6 conferences like this, through things we do in the curriculum  
7 at the school to try to educate our students to be prepared  
8 for this what is a rapidly changing, a rapidly changing  
9 world.

10 Again, I think it will be a great conference. I  
11 once again want to welcome all of you and thank you all for  
12 the opportunity for Northwestern's Law School to participate  
13 in this.

14 Thank you.

15 MR. PHILLIPS: Good morning. Let me add my  
16 welcome to this Major Issues Conference on Securities  
17 Regulation in the Global Internet Economy. You should know  
18 that our ability to hold this conference as scheduled is due  
19 in large measure to the support that we have had from the SEC  
20 and from its Chairman Harvey Pitt. They refused to accept  
21 cancellation as a response to the events in the aftermath of  
22 September 11. We owe many thanks to Harvey, to Jonathan  
23 Katz, Secretary of the Commission, to the staff of the  
24 Commission, to Dave Ruder, Chairman of the Historical

25 Society, to the trustees of the society and the Program

1 Committee for the work that they have done in putting  
2 together this conference.

3 And in particular I'd like to thank the foreign  
4 participants who also refused to accept cancellation as a  
5 response to the problems we have had with air travel in the  
6 United States. They came here despite these difficulties to  
7 share with us their thoughts on the global issues confronting  
8 securities regulation today.

9 In one sense it's particularly appropriate that in  
10 the aftermath of September 11 we focus this conference on  
11 global securities regulation. September 11 taught the United  
12 States one self-evident but profound lesson, that with the  
13 increasing globalization of the economy and of populations  
14 the well-being of every nation no matter how strong depends  
15 on the goodwill and cooperation of the international  
16 community. In the era of globalization no nation can be an  
17 island unto itself.

18 What's true for our nation as a whole applies with  
19 even greater force to the capital markets and to the  
20 regulatory regime that is vital to its well-being. In our  
21 global economy we must remember that capital can move across  
22 the globe even easier than merchandise and people. And to an  
23 increasing extent investors in the United States and all over  
24 the world are investing their capital wherever they see



25 opportunities across the globe. And the participants in

1 those markets, the financial services firms, the issuers of  
2 securities, are fast becoming global and international multi-  
3 national companies and losing their national character.

4 Now, we have every reason to be proud of the  
5 efficiency of the United States markets and the effectiveness  
6 of federal securities regulation in the United States. But  
7 the pace of globalization is quickening at internet speed.  
8 In a few decades it may well be that any national system of  
9 regulation is no more meaningful than an effective system of  
10 state Blue Sky regulation was in the latter part of the 20th  
11 Century.

12 Any system of regulation must take into account  
13 the need to protect investors on a global basis. And the day  
14 is rapidly coming when we, the people interested in  
15 securities regulation, will have to recognize that the world  
16 is now our stage and we must begin to explore how we can  
17 operate effectively on that global stage.

18 We must be asking questions: How can we adapt  
19 national systems of disclosure and accounting principles into  
20 an internationally accepted set of principles? How can we  
21 modify national market systems to accommodate global trading?  
22 How do we adapt a very parochial, label-conscious rather than  
23 functionally-conscious system of regulating money management  
24 so that it can mesh more effectively on a global scale? And

25      how, and most important of all, how do we enforce national

1 systems of regulation across national boundaries? Do we need  
2 more formal mechanisms or can we rely upon the informal  
3 system of MOUs and cooperation between securities regulators  
4 of different countries?

5           These are the questions that are becoming more and  
6 more meaningful to us as persons interested in securities  
7 regulation. And these are the questions that we must face  
8 and the SEC must face in the next decade. Fortunately, the  
9 SEC is blessed with a Chairman who brings to his job not only  
10 enormous experience in working on a day-to-day basis with  
11 securities regulation but with the energy and most important  
12 of all the vision to transform our effective national system  
13 of securities regulation in one that will protect investors  
14 on a global basis. And it's to that task that we hope that  
15 this conference will assist him and you as persons interested  
16 in securities regulation in thinking through the issues.  
17 What you will hear in the next two days is only a beginning  
18 that will occupy center stage of our thought processes in  
19 fashioning global securities regulation.

20           I'd like to now turn to Chairman Harvey Pitt and  
21 ask him to add his words of welcome to those of the rest of  
22 us. Thank you.

23           CHAIRMAN PITT: Well thank you, Dick. And good  
24 morning.



1 Ruder through life is that I always know to what I should  
2 aspire next. And so I owe David a great debt of gratitude: I  
3 now know where I'm headed after this job.

4 I'm actually quite proud and honored to welcome  
5 all of you to the first Major Issues Conference that's  
6 jointly sponsored by the SEC Historical Society and the  
7 Securities and Exchange Commission. The Historical Society  
8 and the Commission are two organizations for which I have  
9 enormous affection and with which I feel a very close  
10 identification.

11 The Commission along with the rest of the world  
12 began a new millennium this year. The issues that confront  
13 us are quite complex. And the solutions are not readily  
14 apparent. It will take great minds, those on our staff,  
15 those of securities regulators around the globe and those of  
16 the members of the Historical Society to help the SEC frame  
17 the right issues and divine appropriate responses. It's a  
18 difficult task but I have to say it's one that's quite  
19 exciting and energizing. I know of no better place to be  
20 right now than the SEC as we try to grapple with new  
21 concepts, new problems, new players, new products, new  
22 technology, new markets and new global realities.

23 By organizing this conference the SEC Historical  
24 Society makes a major contribution to our success in

25      addressing these very difficult issues.    The Historical

1 Society, as David indicated, is the brainchild of my  
2 predecessor Arthur Levitt. Arthur conjured the notion and  
3 then David Ruder and Paul Gonson helped make it a reality.  
4 And it's only fitting that Arthur has become a valued trustee  
5 of the Society now that he has graciously passed the mantle  
6 of SEC leadership to me.

7           With your indulgence I would like to take a few  
8 moments to thank those people who made this conference  
9 happen. I would like to commend my colleague, my predecessor  
10 thrice removed and my personal friend Chairman David Ruder  
11 for convening so many accomplished and brilliant minds to  
12 discuss the pivotal issues of the day. The Historical  
13 Society could not be in better hands.

14           David has led the Commission and the Securities  
15 Bar with a prescience that has long served investors and the  
16 markets well. So it's certainly no surprise that he would  
17 spearhead this timely and important effort.

18           And I want to express my special thanks to Senator  
19 Paul Sarbanes, the distinguished Chairman of the Senate  
20 Banking Committee, a man I am privileged to call a friend,  
21 for taking time out from his busy schedule in these difficult  
22 times to share with us his unique perceptions and learned  
23 views. We certainly understand the considerable demands on  
24 Senator Sarbanes' time and appreciate the special efforts he



25 has made to spend time with us at lunch today.

1 I also want to acknowledge the hard work and keen  
2 insights of Dick Phillips, our appropriate well-respected  
3 conference chairman, and the other impressive members of the  
4 organizing committee for this Major Issues Conference.

5 And I want to thank in advance each panelist for  
6 his or her participation these next two days. Our  
7 distinguished group of panelists reflects a wide spectrum of  
8 views and backgrounds. Their insights into these issues will  
9 help shape the Commission's and perhaps the international  
10 community's agenda in the coming years.

11 Certainly when we were planning this conference we  
12 never anticipated the tragic events of September 11 casting  
13 such a long shadow over our nation and indeed the world. The  
14 important thing to remember, however, is that many wonderful  
15 and talented people have given of their time and treated us  
16 to an important glimpse of issues that the SEC and our global  
17 counterparts will have to consider over the coming months and  
18 years. The views you hear expressed may not be the views of  
19 the Commission just yet, but part of the magic of a major  
20 issues conference like this one is the real possibility that  
21 the views you hear expressed will someday be views  
22 articulated and embraced by the Commission and its regulatory  
23 colleagues around the world.

24 So I want to thank all of you for making this

25 conference a reality. And now with the promise of no more

1 welcoming talks I turn it back over to David and Dick. Thank  
2 you.

3 (Applause.)

4 MR. PHILLIPS: Let's start with our first panel on  
5 the markets. Annette, would you have your panel come up here  
6 so we might proceed.

7 We've got an overwhelming response to this  
8 conference. We can't let people stand for three hours so  
9 we're bringing in more chairs. And I would ask that the  
10 people in the last two rows please remove their belongings so  
11 that we can remove the tables and put in chairs. If you  
12 would do this at the coffee break.

13 And those of you who are standing, have heart,  
14 there will be coffee and chairs very soon.

15 (Pause.)

16 MR. PHILLIPS: Five minutes for two speakers who  
17 are scheduled to be here by 10:00.

18 (Pause.)

19 MR. PHILLIPS: Let's start with our program and  
20 the two speakers will be joining us very shortly. It gives  
21 me great pleasure to introduce as the panel leader and  
22 moderator for this morning Annette Nazareth, Director of the  
23 Division of Market Regulation at the SEC since 1999.

24 Prior to coming to the Commission Annette has had

25 a rich experience serving as counsel in various securities

1 firms in New York. She has been a managing director of  
2 Salomon Smith Barney, general counsel of the Capital Markets  
3 Division and a senior counsel of the Fixed Income Markets at  
4 Lehman Brothers. Prior to that she was a working lawyer at  
5 Davis Polk & Wardwell.

6 Her background makes her uniquely qualified to  
7 deal with what is probably the most difficult issues facing  
8 the SEC, how to regulate the capital markets in an era of  
9 globalization.

10 Annette, I leave it to you to introduce the  
11 members of your panel.

12 REGULATION OF THE SECURITIES MARKETS: HOW CAN  
13 REGULATION MORE EFFECTIVELY FACILITATE CAPITAL FORMATION IN  
14 THE NEXT DECADE?

15 MS. NAZARETH: Thank you, Dick.

16 Well, fortunately we have three hours so we have  
17 lots of time to resolve all of these gnarly issues. We're  
18 glad to see that Rick Ketchum made it. We tricked him by  
19 starting early. Although I must say that Doug Atkin very  
20 generously agreed to represent the Nasdaq position.

21 MR. ATKIN: I was trying to help, Rick.

22 MR. KETCHUM: I'm doing Instinet today and Doug's  
23 doing Nasdaq.

24 MS. NAZARETH: Right. That's right. We thought

25 we'd make it more lively that way.

1 Well, thank you all very much for being here this  
2 morning. As Dick said, this panel is entitled Regulation  
3 of the Securities Markets: How Can Regulation More  
4 Effectively Facilitate Capital Formation in the Next Decade?  
5 It will focus generally on the role of regulation in the  
6 securities markets and how regulatory decisions impact  
7 various market structure issues.

8 I am honored to be joined today by a distinguished  
9 group of panelists: Doug Atkin, President and CEO of  
10 Instinet; Phil Defeo who is actually at the end of the table  
11 here, Chairman and CEO of the Pacific Exchange; Andrei  
12 Shleifer, who is a Professor of Economics at Harvard; Ed  
13 Kwalwasser, Group Executive Vice President, Regulatory  
14 Services, of the New York Stock Exchange; and we also have,  
15 as I said, Rick Ketchum who is with Nasdaq.

16 I guess we were supposed to have Bob Glauber.  
17 What happened to Bob Glauber? Well, we have one more. Who  
18 would like to represent the view of Bob Glauber?

19 As you may know, we delivered a paper to the SEC  
20 Historical Society entitled "Lending a Hand to the Invisible  
21 Hand: How a National Market System Contributes to the  
22 Evolution of the U.S. Securities Marketplace." And that  
23 paper is intended to provide a foundation for this morning's  
24 panel discussion.



I'd like to begin by giving you an overview of

1 some of the themes touched upon in that paper on the  
2 assumption, which I assume is a good one, that none of you  
3 have read it. Before I do though I thought I would  
4 acknowledge the tremendous debt to Onnig Dombalagian, one of  
5 the Division's attorney fellows, who took the laboring oar in  
6 its production.

7           The primary goal of our paper is to reexamine the  
8 Commission's role in facilitating the U.S. national market  
9 system particularly in light of technological advances  
10 experienced by the securities industry over the past quarter  
11 of a century. In 1975 when Congress gave the SEC the mandate  
12 to facilitate the establishment of a national market system it  
13 had grown dissatisfied with the increasing fragmentation of and  
14 barriers to interaction among the equities markets. Congress  
15 believed that a national market system would foster  
16 efficiency, enhance competition, increase information  
17 available to broker/dealers and investors, facilitate the  
18 offsetting of investors' orders and contribute to the best  
19 execution of such orders.

20           Specifically, Congress identified the following  
21 five objectives of a national market system:

22           Economically efficient execution of securities  
23 transactions;

24           Fair competition among brokers and dealers, among

25 exchange markets and between exchange markets and markets

1 other than exchange markets;

2 The availability to brokers, dealers and investors  
3 of information with respect to quotations for and  
4 transactions in securities;

5 The practicability of brokers executing investors'  
6 orders in the best market; and finally,

7 The opportunity consistent with the preceding four  
8 objectives for investors' orders to be executed without the  
9 participation of a dealer.

10 Since 1975 the securities markets all have  
11 substantially upgraded their trading facilities to take  
12 advantage of state-of-the-art communications networks, order  
13 routing and execution facilities and computational power.  
14 Securities firms likewise have invested in new technologies  
15 to automate the processing of customer orders as well as to  
16 facilitate trading by both institutions and retail investors  
17 through proprietary networks and, more recently, the internet.

18 Alternative trading systems offer investors new  
19 ways to translate their trading interest into executed  
20 trades. And globalization may further increase the  
21 accessibility of foreign equity markets and intensify  
22 competition for trading services throughout the world.

23 In light of these developments some have  
24 questioned the appropriateness of the Commission's national

25 market system mandate as well as the approach the Commission

1 has taken to fulfill those obligations. Government  
2 intervention, they argue, has done more harm than good, for  
3 example, by entrenching outdated linkages and communications  
4 systems that impede the evolution of the marketplace.  
5 Instead, market forces should be allowed to operate  
6 relatively unimpeded so that competition and innovation will  
7 flourish.

8           Our paper argues, however, that the key rationale  
9 for authorizing regulatory intervention -- to eliminate anti-  
10 competitive burdens and assure cross-market access to market  
11 information and trading opportunities -- remains as important  
12 today as it was in 1975. Despite the rapid changes in the  
13 marketplace resulting from new technology and competition the  
14 commercial incentives of markets and broker/dealers remain  
15 sufficiently misaligned from the interests of investors and  
16 issuers that a market structure dictated solely by  
17 competitive forces would be inadequate.

18           While the precise approaches to implementing a  
19 national market system naturally must change with the times,  
20 I believe there is a role for regulation in assuring that the  
21 marketplace evolves in a manner that protects investors and  
22 serves the public interest. Clearly, in a free market  
23 society there is a preference for allowing market-based  
24 approaches to determine market structure. Market forces

25 acting alone, however, may fail to ensure that markets

1 produce an efficient level of services in certain  
2 circumstances.

3 Inefficiencies may occur, for example, if certain  
4 market participants are relatively immune to competitive  
5 forces because they have dominant market power, or if the  
6 transaction costs of bringing buyers and sellers together,  
7 whether within a market or across markets, are too high  
8 compared to the benefits to be gained in any individual  
9 transaction.

10 And market forces may fail to take into account  
11 the collateral consequences or externalities of providing  
12 certain services that are not reflected in the prices at  
13 which transactions occur. Regulation generally is thought to  
14 be justified when government intervention can help overcome  
15 barriers to competition and reduce transaction costs.

16 I'd like to highlight potential sources of  
17 inefficiency in the U.S. securities markets that I believe  
18 call for prudent regulatory responses. First, individual  
19 investors may encounter prohibitively high transaction costs  
20 in bargaining for a reasonable degree of market transparency  
21 and access, particularly coordinated inter-market  
22 transparency and access, even if investors as a whole benefit  
23 from their availability. The ability of investors to  
24 negotiate for such services absent regulatory intervention



25 largely depends on their sophistication, negotiating leverage

1 and independent sources of market information.

2 Many investors do not understand the processes by  
3 which orders are executed. And even if they do, it is  
4 unlikely that they have sufficient leverage to negotiate  
5 favorable terms. Individual investors may also experience  
6 significant difficulty in organizing collective actions by  
7 investors scattered throughout the marketplace.

8 For example, negotiating for standardized,  
9 consolidated information from multiple markets or intermarket  
10 access creates significant collective action problems since  
11 the bargaining leverage and cost necessary to negotiate such  
12 an arrangement far exceeds the benefits to any single  
13 investor. And institutional investors may simply prefer to  
14 trade among themselves rather than undertake to negotiate  
15 arrangements that benefit all investors.

16 As the number of market centers increases the  
17 ready availability of pricing data and execution services  
18 from each of them becomes critical for assuring efficient  
19 price discovery and best execution. Were the markets to rely  
20 solely on commercial incentives, however, insufficient levels  
21 of transparency and access likely would be produced. Left to  
22 their own devices market centers no doubt would provide a  
23 baseline level of price transparency such as end of day  
24 closing prices for reputational purposes and in some cases

25     distribute additional data for promotional reasons.

1           History has shown, however, that markets tend to  
2           limit their most useful data to members or other restricted  
3           groups to prevent, for example, competitors from free riding  
4           on their price discovery process. And in general an  
5           individual market does not have an incentive to make its  
6           market data more widely available unless the benefits of  
7           transparency or access it receives in particular cases  
8           significantly outweighs the potential costs it incurs.

9           With respect to execution services, market  
10          naturally have an incentive to offer access to a critical  
11          mass of market participants that permits orders to be  
12          executed in a timely fashion but not necessarily to all those  
13          interested in trading. And there are real competitive  
14          disincentives to permitting intermarket access because of the  
15          potential loss of liquidity and trading revenues to other  
16          market centers.

17          Therefore, because the free market tends to  
18          underproduce transparency and access, regulators must  
19          consider the most appropriate means to assure that a baseline  
20          level of both market data and execution services is available  
21          to all investors.

22          A second source of market inefficiency is the  
23          potentially anti-competitive use of dominant market power.  
24          Because liquidity attracts liquidity there may be a tendency for

25 trading to concentrate in a single dominant market over time.

1 Once a market has established itself as the dominant market  
2 it may seek to use its market share to preserve its dominant  
3 market position, including through actions that may have  
4 significant anti-competitive consequences. Such actions may  
5 include compelling exclusive participation as a condition to  
6 access while blocking access by competing markets. These  
7 actions undermine market efficiency, however, to the extent  
8 that they prevent intermarket order interaction and deter  
9 competition.

10 To the extent that barriers to competition prevent  
11 investors from obtaining information about market prices from  
12 competing markets, investors' trading decisions are less  
13 likely to be fully informed and markets may be unable to  
14 discovery prices efficiently. Regulators, therefore, must  
15 consider the circumstances under which intervention may be  
16 appropriate to facilitate the interaction of orders across  
17 markets and thereby improve opportunities for best execution  
18 and more efficient price discovery.

19 Principal-agent conflicts are a third potential  
20 source of market inefficiency. Broker/dealers face  
21 significant conflicts of interest when acting on behalf of  
22 investors. For example, although broker/dealers have best  
23 execution obligations to their customers they also have an  
24 incentive to minimize their search costs for trading

25 opportunities. For example, market intermediaries such as

1 retail brokers handling small orders may have an incentive to  
2 route their order flow to one of a limited number of markets  
3 instead of canvassing multiple markets.

4           And while broker/dealers owe a duty of loyalty to  
5 their customers they also may be tempted to exploit the  
6 information gleaned from informed customer orders or take  
7 advantage of uninformed retail investors when trading for  
8 their own account. Without efficient means for investors to  
9 negotiate for and enforce basic protections, broker/dealers  
10 may seek to use their privileged position in a manner that  
11 disadvantages their customers and undermines the efficiency  
12 of the marketplace.

13           Regulation can help address principal-agent  
14 conflicts by reducing the costs of compliance with agency and  
15 obligations and raising the stakes of non-compliance. The  
16 Commission, for example, has sought to reduce broker/dealer  
17 search costs by improving access to basic market data and to  
18 deter loyalty breaches by enforcing various order handling rules.

19           A fourth potential source of market inefficiency  
20 is internalization and its impact on public price discovery.  
21 As you may know, some market intermediaries use the  
22 information generated by markets that conduct efficient price  
23 discovery to internalize orders that do not interact with the  
24 public marketplace. By skimming these orders away from other



25 markets internalization may have a significant deleterious

1 impact on public price discovery. Negative externalities  
2 associated with internalization and the related payment for  
3 order flow practices include poorer executions due to the  
4 loss of price improvement opportunities in the broader  
5 market, market fragmentation and the associated reduced  
6 incentives to narrow the spread through aggressive quotes and  
7 limit orders, and lower levels of price transparency as  
8 markets with active price discovery mechanisms seek to deter  
9 competitors from using their prices to internalize order  
10 flow.

11 Regulatory approaches to addressing the  
12 consequences of internalization typically attempt to preserve  
13 the transparency of market information while dampening the  
14 incentives to internalize. Possibilities include more  
15 aggressive disclosure requirements, affording price  
16 protection to limit orders, promoting greater exposure of  
17 customer limit and market orders, and strengthening the duty  
18 of best execution.

19 Finally, the transaction costs of standardizing  
20 intermarket trading are a fifth potential source of market  
21 inefficiency. To the extent that markets are willing to  
22 coordinate the distribution of market data or access to  
23 execution services they must jointly develop intermarket  
24 standards and mechanisms that are compatible across all

25 markets. These are needed, for example, in connection with

1 the formatting of market data and orders, the structure of  
2 intermarket linkages and the coordination of market  
3 surveillance, trading halts and procedures for locking cross-  
4 markets.

5           Because of collective action problems, however, as  
6 well as antitrust concerns, the marketplace may find it  
7 difficult to establish these standards and mechanisms on its  
8 own. Accordingly, there may be a role for the regulator to  
9 play as mediator or coordinator to assure that they are  
10 developed and implemented.

11           In addition to describing the potential sources of  
12 marketing efficiency, our paper discusses some of the ways  
13 that the Commission has sought to address them. I think it's  
14 fair to say in implementing its statutory mandate the  
15 Commission generally has sought to use a light touch, relying  
16 as much as possible on market forces to shape the evolution  
17 of the marketplace while guaranteeing certain basic  
18 protections for investors.

19           You're laughing, Ed.

20           MR. KWALWASSER: I am.

21           MS. NAZARETH: Depends on your perspectives.

22           MR. ATKIN: The rest of us merely smiled.

23           MS. NAZARETH: Did I say generally light touch? I  
24 did say generally.

PANELIST: When a heavy touch is needed you will

1 get it.

2 MS. NAZARETH: That's right. Like a parent, if  
3 you need more you get more.

4 (Laughter.)

5 MS. NAZARETH: To the extent possible, the  
6 Commission has preserved room for private negotiations among  
7 markets and market participants to implement the national  
8 market system. In some instances the Commission has found it  
9 necessary to intervene, such as in the area of price  
10 transparency. This has resulted, for example, in the  
11 mandatory collection and centralized distribution of  
12 consolidated quotation and transaction information through  
13 various SRO-sponsored joint plans.

14 With respect to access to execution services the  
15 Commission's approach has involved the removal of anti-  
16 competitive barriers through fair access requirements, the  
17 elimination of rules limiting members' interaction with other  
18 markets, and the promotion of affirmative access among markets  
19 through negotiated or mandated linkage plans.

20 Finally, the Commission has addressed principal-  
21 agent conflicts through rulemaking designed to enforce  
22 agency duties. For example, the Commission has adopted rules  
23 requiring market intermediaries to display best price  
24 customer limit orders in the quote stream and make them

25      accessible to the public either through the market maker's

1 quote or through an ECN or alternative trading system.

2           The Commission also has adopted rules requiring  
3 broker/dealers to disclose payment for order flow  
4 arrangements and requiring market centers and broker/dealers  
5 to disclose the quality of their order execution and order  
6 routing procedures to assist investors in making trading  
7 decisions.

8           The Commission has come under some criticism,  
9 however, for the methods it has used to address various  
10 market inefficiencies, particularly by those who advocate  
11 less government intervention and greater reliance on market  
12 forces to shape market structure. We argue in our paper that  
13 although some of the mechanisms for the national market  
14 system have been characterized as outdated, the concept of a  
15 national market system remains a necessary part of the  
16 regulatory framework for addressing market inefficiencies.

17           I hope, and I can already tell from some of the  
18 smirks that I've gotten, that we will have a spirited debate  
19 among our panelists on these issues and a host of other  
20 related matters. But first I thought it would be interesting  
21 if we could turn to Andrei Shleifer who, as I mentioned  
22 before, is a professor from Harvard University, to speak for  
23 a few minutes on some of his work with respect to the  
24 markets.



And before he begins I would like to welcome Bob

1 Glauber who is here from NASD. And we apologize, Bob, we  
2 tricked you. We were under some pressure to start early so  
3 either had to start early or have a three hour and 15 minute  
4 session, so.

5 MR. GLAUBER: Well, I was going to apologize for  
6 being late. But I apologize for not being early.

7 MS. NAZARETH: You have to apologize for being on  
8 time. Thank you.

9 Andrei, you can do whatever.

10 I was going to tell people that I wanted you to  
11 know that I was sitting down. My kids sometimes say, How do  
12 you know? So I was sitting.

13 MR. SHLEIFER: Thank you very much. It's a great  
14 honor to be here. And I would like to thank in particular  
15 Annette Nazareth for both inviting me and for providing a  
16 very stimulating paper.

17 I think that many of the discussions or debates  
18 that are going to take place at this conference deal with  
19 some very specific and specialized issues of securities  
20 regulation. But as I detected in the paper, many times the  
21 views that one has about very specialized and specific issues  
22 really are shaped to a large extent about broad philosophical  
23 ideas about the role of regulation in society and what  
24 institutions like the SEC should be doing.



1 focus on these specialized issues which other members of the  
2 panel are vastly more qualified than I am to comment on, I  
3 was hoping to comment on the history of  
4 regulation in the United States in general, on some of the  
5 issues that have come up with securities regulation in  
6 particular, and as well on some of the lessons we've learned  
7 from the history of regulation of financial markets around  
8 the world. And this, obviously, given the breadth of the  
9 topic will be a rather short history.

10 I think it's important to remember that regulation  
11 of markets in the United States begins in earnest really  
12 during the progressive era at the end of the 19th/beginning  
13 of the 20th Century. And it begins in the aftermath of the  
14 industrial revolution after the Civil War. The United States  
15 during this period saw tremendous technological progress,  
16 much as we see in the financial markets today. It saw  
17 tremendous growth of industry and railroads, tremendous  
18 growth of productivity, mass movement of labor from the  
19 countryside into the cities.

20 Yet this technological progress was also  
21 accompanied by various social ills. It was accompanied by  
22 massive growth in industrial accidents. At the end of the 19th  
23 century something like two million people a year in the  
24 United States -- remember, the population was a third of the

25 size it is today -- were hurt in

1 serious industrial accidents. Something like 35,000 people a  
2 year died in railroad accidents. People were concerned with  
3 unsafe drugs, unsafe food, unsafe water and so on.

4           What is perhaps equally important is that a lot of  
5 the issues we discuss today were also central to discussion  
6 of whether regulation was necessary to address the social  
7 problems. And two central themes were discussed: first, can  
8 competition solve these problems? Can competition for labor  
9 make sure that the necessary precautions to prevent accidents?  
10 Can competition among food and drug companies provide for safe  
11 water, safe food and safe drugs?

12           As we see all  
13 over both the muckraking literature and the political  
14 campaigns of the turn of the century, while  
15 competition was responsible for tremendous growth of incomes  
16 and productivity in the United States, it did not solve all  
17 the problems. Companies did not have strong enough  
18 incentives to undertake precautions. They did not have strong  
19 enough incentives, despite all the competition, to provide all  
20 the necessary information and disclosure to their customers  
21 and so on.

22           What is perhaps even more interesting is that the  
23 central theme of the progressive era is the failure of

1 litigation and the failure of courts to address social  
2 problems. Although tort law was the most rapidly developing  
3 and most intellectually exciting area of law, most  
4 commentators complain about the failure of the courts to  
5 address the grievances of the injured workers or of consumers  
6 poisoned by bad food or bad medicine.

7 Part of the problem of the courts was, of course,  
8 that they were on the payroll of political parties, the  
9 judges were on the payroll of political parties. Another  
10 concern was just straightforward subversion of courts by the  
11 robber barons through intimidation and corruption.

12 And so what we see during the Progressive Era,  
13 ironically both in the speeches of Theodore Roosevelt and in  
14 the speeches of Woodrow Wilson, is these two recurring  
15 themes: that competition is working well but it is not  
16 working well enough and that courts are not working well  
17 enough to address the problems. The Progressive Era  
18 measures like the creation of the Interstate Commerce  
19 Commission, the safe food and drug regulations, the antitrust  
20 laws, the banking laws and the various state laws related to  
21 workers' safety arise as a direct response to these failures  
22 of more benign market mechanisms if you like such as  
23 litigation and competition to deal with the problems that the  
24 society wants addressed.

After World War I and during the 1920's the



1 progress of regulation in the United States or development of  
2 regulation basically ends. But then we see another  
3 tremendous growth in the 1930's. And what is extraordinary  
4 perhaps is that these same themes arise again in the advocacy  
5 of regulation in various markets including in the '33 and '34  
6 securities acts.

7           If you read the writings of James Landis who was  
8 the person primarily responsible for the writing of both of  
9 these acts, you see the reference both to the existing  
10 problems as well as to the failure of the standard solution.  
11 So he talks about the problems of stock manipulation. He  
12 talks about the problems of stock market pyramiding. He  
13 talks about the promoter's problem, that is to say the  
14 problem of misinforming investors by  
15 promoters trying to raise money in new securities issues.  
16 And he recognizes many of the same problems that Annette  
17 Nazareth refers to today.

18           There are clear counterparts in the 1920's and  
19 1930's of the problem that intermediaries basically want  
20 investors to trade rather than to make money and, therefore,  
21 undertake actions to promote volume rather than  
22 prudent investment activities. Landis recognizes that  
23 intermediaries want investors to buy new issues which they  
24 themselves want to sell and that the interests of the

25 intermediaries and investors are far from aligned in new

1 securities issues. He recognizes that intermediaries want to  
2 limit disclosure of information, to raise the trading costs  
3 because one man's trading cost is another man's profit. And  
4 he recognizes perhaps a much more severe problem in the  
5 1920's and early '30's than it is today that intermediaries  
6 quite often want to trade ahead of their customers based on  
7 the information on order flow.

8           What is, as I said, even more interesting to me is  
9 that Landis writing in the 1930's also sees the limitations of  
10 competition and litigation in addressing these problems.  
11 Competition does not do it because he recognizes small  
12 investors typically do not have enough information to really  
13 make informed choices. And when they do get information they  
14 often do not have the ability to process it. Landis moreover  
15 recognizes that the incentive to provide accurate information  
16 so that intelligent choices can be made between the competitors  
17 are often limited.

18           Landis also recognizes that the same problems of  
19 courts that motivated progressive reforms 30 years earlier  
20 exist because the intermediaries tend to be politically and  
21 financially much more powerful than small investors. And,  
22 again, the outcome of all this, as you know, were the '33 and  
23 '34 Acts.

24           Now, I should say that I don't mean these comments

25 to be an unambiguous endorsement of regulation. Over the

1 last 100 years of regulation in general, and even in some  
2 cases in securities regulation, we have seen some very  
3 conspicuous failures.

4 What are some of the problems of regulation?

5 Well, I think I can give you pretty much the standard list.

6 We have many instances of misguided regulation.  
7 Here my favorite example is the fact that in the late 1920's  
8 and early 1930's the United States actually had a pretty well  
9 functioning market for borrowing stock. So people who wanted  
10 to borrow stock and sell it short in fact could go to the so-  
11 called loan market and borrow stock on the same  
12 terms generally speaking as the professional. In the early  
13 1930's J. Edgar Hoover has decided that shorting stock was  
14 anti-American and so this market was effectively shut down.  
15 As a result, today we see that  
16 sophisticated institutional investors are in fact paid  
17 for lending their stock, whereas individual investors generally  
18 get ripped off by the intermediaries who in fact  
19 collect all the profits on stock lending activities.

20 There are the well-recognized problems of  
21 regulatory influence and regulatory capture. As we've seen  
22 in the last 10 or 15 years in the United States if you look  
23 at disclosure of executive compensation, in particular stock  
24 option compensation, it has been misleading at best. If you

25 look at the growth of such practices as pro forma earnings,

1 again I think we've probably moved backwards in our  
2 accounting practices rather than forwards. All of that  
3 happened under the influence of market participants who have  
4 an economic interest in less than full disclosure.

5           And, finally, I think it's important to recognize  
6 in the more optimistic spirit that there are often very  
7 substantial difficulties, technical difficulties, in figuring  
8 out exactly how regulation should proceed. One of the areas  
9 where these problems are very severe is the area of  
10 information disclosure, for there is a fundamental conflict  
11 between the imperative of disclosing more information on the  
12 one hand and the basic psychological reality that people's  
13 ability to process information and to use it to their own  
14 advantage is often quite limited. More information, and we  
15 know this from the evidence, often leads to more trading  
16 and much inferior economic performance for individual  
17 investors.

18           So where does this all lead us? What's the bottom  
19 line on securities regulation? As I've said, there are many  
20 benefits but there are also potential costs. What do the  
21 data tell us?

22           Well, the data come from a variety of sources.  
23 Some of the data come from comparisons of countries around  
24 the world and some of the data come from individual case

25 studies. The overall scorecard on



1 securities regulation, and I should say unlike most other  
2 kinds of regulation the overall scorecard on securities  
3 regulation around the world has been pretty good in the sense  
4 that countries that regulate financial markets work more  
5 heavily through company laws, through security laws and  
6 through the enforcement of these laws generally have much  
7 better developed, broader financial markets,  
8 with a larger number of issuers and larger participation by the  
9 citizens of those countries.

10           The cross country positive association between the  
11 degree of investor protection on the one hand and the  
12 financial development has been actually quite striking. We  
13 see this for both equity markets and debt markets. We see  
14 this for various kinds of measures of investor protection,  
15 whether we're looking at company laws or whether we're  
16 looking at securities laws. We also see this in the data on  
17 changes in regulation.

18           In some sense this should not be surprising to  
19 this audience. The United States has by far the most  
20 regulated securities markets in the world. It also has by  
21 far the most developed securities markets in the world. So  
22 if we look around the room we understand why United States is  
23 one of the observations that is very consistent with this  
24 evidence.

We've also had some very clear case studies. In

1 the early 1990's as several economies in Eastern and Central  
2 Europe emerged from Communism they have adopted very  
3 different approaches to securities regulation. One of the  
4 most striking comparisons is that between Poland and the  
5 Czech Republic. Poland has basically borrowed as much as  
6 it could from the United States and adopted a very stringent  
7 approach to securities regulation with an independent and  
8 powerful securities commission with many regulatory powers.  
9 The Czech Republic adopted a different approach saying that  
10 regulators could trust markets and competition. The  
11 Securities Commission consisted of two people in the corner  
12 office of the Ministry of Finance.

13 What we saw in the following six or seven years is  
14 basically complete degradation of securities markets in the  
15 Czech Republic with massive expropriation of minority  
16 shareholders. This is compared to rapid growth of the Polish  
17 market, with a large number of new companies listing on the  
18 exchange, much wider participation of investors in securities  
19 markets than one saw in the Czech Republic.

20 Now, one can debate about what is crucial about  
21 securities regulation, and there are still academic debates  
22 going on about whether it's company law or securities law.  
23 What are the crucial success elements of the U.S. securities  
24 regulation? Is it the very important focus on the

25 regulation of intermediaries rather than investors and

1 ultimate issuers? Is it the legal powers of the  
2 regulator? Is it the competition between market  
3 participants that is so central to the U.S. scheme? But I  
4 think the bottom line on the positive association between  
5 regulation, investor protection more generally, and financial  
6 success is very clear.

7 Now, let me conclude by just asking  
8 what are the implications of all of this for the discussion  
9 at hand, in particular for the issues that Annette Nazareth  
10 has raised? I think I want to make four points in this  
11 regard, the last of which is going to be a question.

12 The first point goes back to my introductory  
13 comment about the fact that underneath all the technical  
14 discussions there may be some broad empirical and  
15 philosophical differences. I think we understand very well  
16 now based on both our own history and the experience of other  
17 countries, that ideological arguments against regulation are  
18 flawed. Annette makes a compelling case about the divergence  
19 of private and social interests in a number of areas such as  
20 the provision of information and of liquidity. And  
21 one can probably add other items to her list. So it's  
22 not a matter of ideology, "yes regulation" or "no  
23 regulation," it's a matter of alternatives and choices.

24 I think that one also has to be skeptical that the

25      problems that Annette raises can successfully be resolved

1 privately through litigation. I think that problems of  
2 asymmetric economic political power between small investors  
3 and intermediaries remains very large despite the possibility  
4 of class action suits. And I think it is probably still in  
5 many instances too expensive for small investors to seek  
6 recourse in courts. I think these problems are exacerbated  
7 by the fact that in many instances over the last decade  
8 Congress chose to protect the issuers rather than small  
9 investors. And I think it's also important to realize as we  
10 have seen in recent litigation against securities analysts  
11 that the security industry is quite good at protecting itself  
12 from the complaints of its customers.

13 I also am not sure that the problems that Annette  
14 is raising will be resolved by competition. And I say that  
15 despite the recognition that in the United States the benefit  
16 of competition in the securities industry for the reduction  
17 in transaction costs and the increase in participation in  
18 financial markets have been tremendous in the last  
19 20 or 25 years. Yes, competition has done an enormous amount  
20 of good but I think one should not make a jump from that to  
21 saying that competition will solve all the problems.

22 I think that as we've seen, and as I've already  
23 indicated as we've seen in the last decade, I don't think  
24 that competition in the securities industry has brought

25 better information to investors. It has brought more



1 information but I'm not sure it has brought more accurate  
2 information to investors on which to base informed judgments.  
3 I think the incentives to distort information  
4 presented to investors have been tremendous. As  
5 importantly, we're seeing some very significant  
6 problems in the private incentives to provide liquidity which  
7 is fundamentally a public good.  
8 While the forces of competition and litigation should not be  
9 neglected, I don't think that a whole story.

10 That, of course, raises the question:  
11 will regulation do better especially in light of all the  
12 issues that it may present? Here I should say that I'm very  
13 fortunate that I provide the broad overview, so that question  
14 I'm going to leave to the rest of the panelists.

15 Thank you very much.

16 (Applause.)

17 MS. NAZARETH: Thank you very much, Andrei.

18 I thought to set the stage for our discussion we  
19 could start with a few very general questions for the panel  
20 on the relationship between regulation and economic  
21 efficiency. I thought it would be interesting to ask those  
22 on the panel who are subject to regulation in their very  
23 objective views what role should regulation play in  
24 the effective operation of the securities market.

25

How about you, Ed, can I start with you?

1                   MR. KWALWASSER: As head of regulation for the New  
2                   York Stock Exchange I'm in favor of regulation.

3                   MS. NAZARETH: Excellent.

4                   MR. KWALWASSER: And I think what the Commission  
5                   should be doing is setting guidelines and setting direction.  
6                   At least from my point of view when we run into problems with  
7                   the Commission's regulation is when the Commission tries to  
8                   get into the detail of running our business. And the  
9                   Commission may be right and we may be wrong but I hate to  
10                  disagree with the head of Market Regulation --

11                  MS. NAZARETH: Feel free.

12                  MR. KWALWASSER: -- and a professor at Harvard,  
13                  nevertheless I think that technology has made it so easy for  
14                  competition to get into our business and it's so cheap for  
15                  competition to get into our business, or competitors to get  
16                  into our business that competition drives what we do  
17                  tremendously. We think anything we do what's the competitive  
18                  implications? Are we going to gain order flow or are we  
19                  going to lose order flow? Are we going to gain more listed  
20                  companies because of what we do or are we going to lose  
21                  listed companies?

22                  We're in the business of selling market data or  
23                  selling transactions. And we have to get information out in  
24                  order to do either of those two things. And so I think that,

25 one, competition has changed the landscape from the '70's

1 when I think the Commission was right when it formed or  
2 helped form two highly anticompetitive consortia of SROs but  
3 they were necessary at the time because that was the only way  
4 to get information out and to get transactions done across  
5 markets. I no longer think that that's the case.

6 And, also, I think the most important change in  
7 regulation, at least from the stock exchange's point of view  
8 occurred in the early '70's and that's when the New York  
9 Stock Exchange got a public board and went away from a board  
10 made up of only of our members. Right now half the board is  
11 made up of issuers, representatives of the public, beginning  
12 with Carl McCall, the head of the New York State Pension Fund,  
13 Leon Panetta, to various CEOs of listed companies. The other  
14 half is made up of members. And the tie is broken because  
15 there are two management people on the Exchange's board.

16 And not only that, there are tremendous  
17 differences among members of the brokerage community. We  
18 have people from the Floor who don't necessarily have the same  
19 interest as the upstairs firms.

20 So I think that the common interest that I have  
21 seen working with the board is that they look for what's in  
22 the public interest as opposed to what's in the interest of  
23 our members or in the interest of the listed companies. We  
24 try to find a middle ground. And I think that goes a long

25 way as long as the Commission is setting the road on which we

1 should travel. And I think that would be helpful.

2 Rick?

3 MS. NAZARETH: Rick?

4 MR. KETCHUM: I think there's a lot to what Ed  
5 said. Given the nature of this as sponsored by the SEC  
6 Historical Society I thought it would be useful to take a  
7 little bit, build on Andrei and take a little bit of an  
8 historical tinge on this theory that I've probably at least  
9 two-and-a-half hours to be partisan so I've got plenty of  
10 chances.

11 I think to me the answer to the question is that  
12 the SEC's activist regulatory role isn't driven by the stars,  
13 it's driven by some choices over a period of years that I  
14 think we're correct. In at least my limited mind there are  
15 sort of three different market models and regulatory models  
16 you can operate, two of which don't require nearly the  
17 activist regulation, the third does.

18 The first model I would basically call a  
19 professional markets model. One sees it a lot when the  
20 government cares a great deal about controlling that market,  
21 whether it be because they're raising money or controlling  
22 their currency in some way or another. And in that model the  
23 entire focus is on encouraging professional trading and  
24 regulatory demands and needs focused pretty much on sanctity

25 of contracts and systemic risk. And the assumption is that



1 with that you're willing to give up any kind of  
2 organized efforts to effectively treat retail investors or  
3 normal investors the same as you do professional investors.  
4 Nor are you going to be terribly hung up with regard to  
5 concepts of either information sharing or even to some large  
6 degree manipulation on the assumption that the markets are  
7 large, efficient and that, again, you're not going to spend  
8 all your time worrying daily as to whether one particular  
9 retail investor was particularly hurt or not hurt.

10           And with apologies this is, all of this is  
11 dramatically overstated.

12           The second piece is what I will call the  
13 integration of retail and institution to some degree but in a  
14 non-risk taking mode. It is a conclusion that you don't want  
15 to take risks from the standpoint of conflict of interest,  
16 that you want to provide one effective measure in which  
17 retail orders are executed, shown, etc., that you want to  
18 provide an effective market model. And then you spend a  
19 great deal of time letting people cut deals around the edges  
20 in order to allow institutional or large person trading to  
21 work efficiently, usually without much care, with sort of  
22 dichotomy of emphasizing fairly close total transparency with  
23 respect to one set of the market and virtually no  
24 transparency with respect to the rest. And you see a lot of

25 that in Europe, Japan in the manner in which things happen

1       there.

2                   The SEC path I think is really an interesting one  
3       historically to me because I think it is, I'd say a little  
4       bit more than Andrei, I'd say quite different than what's been  
5       done in the rest of the world. And I think Annette  
6       identified some of the reasons, I think it's keyed off of a  
7       relatively large if not profoundly optimistic view of  
8       competition, the ability to mingle individual investors and  
9       professional investors and the ability of regulators to sort  
10      that out.

11                   And, again, in deference to the historical theme I  
12      would suggest three sort of not usually focused on events  
13      that the SEC took that I think were profound in setting this  
14      forward and basically driving most of what the SEC's done  
15      since. And I will apologize now to the two experts in the  
16      crowd because I will probably mangle each of these events or  
17      at least the two out of three I wasn't involved with. And  
18      that's the advantage of being a recovering lawyer, you don't  
19      have to worry about facts as much.

20                   The first of those I think was driven right in the  
21      '30's with respect to where the SEC was pushed by Congress  
22      initially to decide whether or not there should be a  
23      segregation of brokerage and dealer functions in the  
24      securities markets, and that ranging from the broker/dealer

25 seg report and Saperstein letter, etc. It was basically a

1 time in which the Commission wrangled up and down as to  
2 whether it would choose to be a risk taker, whether it would  
3 choose to have an environment in which people could mingle  
4 inherently conflict-laden functions and whether that was  
5 worth it from the standpoint of, one, because it already  
6 existed in two different types of markets, a dealer market  
7 and a specialist market and, secondly, whether it was worth  
8 it from the perceived organizational and liquidity benefits  
9 that might be provided.

10 I think the Commission called that one right. I  
11 think that as night follows day that led to the development  
12 of two liquidity-based models, both a specialist model in  
13 which the specialist was allowed to operate as a dealer and a  
14 dealer market that could benefit from technology to begin  
15 providing something meaningful and organized as time goes on.  
16 It also as night follows day created a need for regular  
17 regulation as Annette indicated because it drove a conflict  
18 of interest environment different in a single specialist  
19 environment, the market maker environment, but in both cases  
20 one that had very significant conflicts of interest.

21 The second historical event that I think drove much  
22 of what's happened since is sort of a little bit before  
23 one focuses on Congress and the rest, and that was the  
24 multiple trading decision in which the SEC determined that

25 one unnamed stock exchange would not have the ability to say

1 that its members could not trade anywhere else. It was long  
2 before anybody worried about a third market, long before  
3 anybody worried about a national market system. But,  
4 again, that decision effectively set the Commission down a  
5 pluralistic vein just as the broker/dealer seg decision set  
6 it down on a vein emphasizing liquidity provision that as  
7 night follows day drove the national market system, drove  
8 intermarket linkages, drove a variety of decisions that  
9 happened from there.

10 The third decision was the Commission's  
11 interpretative letter with respect to Instinet. I put this  
12 on for two reasons, one, because Doug's on the panel and,  
13 secondly, to remind Doug that I signed that and I used to be  
14 one of the good guys.

15 (Laughter.)

16 But I think, again, this was, this also I put this  
17 on because it was I think an interesting time of the  
18 Commission taking a variety of risks with respect to  
19 narrow definitions in the statute which I think Dick Phillips  
20 sitting in the front once referred in one of my favorite  
21 introductions in an SEC speech as the Commission's effort to  
22 engage in lawlessness. But this was one actually that the  
23 courts didn't turn back, unlike most of the things I did in  
24 my time. But this, in the Instinet letter the Commission

25 determined to encourage innovation and to take a risk with



1 respect to a narrow definition of what a securities exchange  
2 was and treat Instinet as a broker. That, along with a great  
3 deal of innovation from an Instinet standpoint, a level of  
4 technology and demand from an institutional community, a  
5 level of competition that occurred because of what it did,  
6 and a regrettable lack of response from my own institution  
7 led to, again I think as night follows day, the Commission's  
8 order handling rules and the ATS rules, automated trading  
9 rules that basically set up a framework to handle an even  
10 more pluralistic environment that attempted to merge  
11 liquidity providers some of which that organize or organizers  
12 of liquidity providers, some of which operated as  
13 classical markets and some of which operated as brokers or  
14 something halfway between brokers and classical markets.

15 I think once you make those three decisions, and I  
16 think the Commission made each of them profoundly correctly,  
17 you engage in a process which is inherently messy. It is  
18 pretty simple if you only have one market structure and  
19 everyone's got to play under the same rules and except for  
20 professionals who get to do it without any regulation or  
21 transparency at all. Or it's pretty simple if you just  
22 basically sort of have an environment in which professionals  
23 can work pretty comfortably and you don't care about retail  
24 investors. It gets awfully complicated when you try to

25 encourage liquidity, try to encourage competition and then

1 step back and take a look at the results.

2 And I think the 70 years of history of the SEC  
3 almost from a market structure standpoint is absolutely  
4 fascinating as to what happens. And by getting those  
5 decisions right the SEC's had many opportunities to get the  
6 little ones wrong. But nevertheless, by getting those right  
7 I think they created what the U.S. securities markets are  
8 today. And it is to me perhaps the most fundamental  
9 justification of why a regulatory presence is important.

10 MS. NAZARETH: Thank you, Rick.

11 Doug, do you have anything to add to that?

12 MR. ATKIN: Thanks for signing that letter, Rick.  
13 Appreciate it.

14 MR. KETCHUM: I often reconsider it in my sleep.

15 MR. ATKIN: Now, the other letters you've signed  
16 more recently...

17 I think first of all, we certainly believe that,  
18 and history has proven, and I think Annette and Andrei and  
19 others have said I think far more articulately than I could  
20 that history has proven that regulation has an important role  
21 to play in the securities markets. It has made the U.S.  
22 markets in some ways the strongest markets in the world  
23 although we think in some other areas of the globe there are  
24 certain aspects of market structure that are ahead of the

25 United States. But overall the U.S. markets are certainly

1 the strongest markets in the world.

2 I think the SEC in general has tried to really  
3 reconcile, and it hasn't been easy, has tried to reconcile  
4 the goals of greater centralization and greater competition.  
5 And those things are always a bit in conflict. And largely I  
6 think due to technological constraints. And as I think it  
7 was Andrei or Ed said, in the '70's the creation of these  
8 "anti-competitive SRO's" were largely created because of  
9 technology constraints. And because of technology  
10 constraints largely I think there's been a leaning towards  
11 more centralization than competition, that when push comes to  
12 shove, and again I think largely because of technology in the  
13 past, we've leaned towards more centralization which does  
14 have an impact on lessening competition.

15 I think though that this is really the appropriate  
16 time to reevaluate the whole model that we're really  
17 operating under and the lens we're looking at this all  
18 through. Fundamental changes are occurring in technology, of  
19 course, have occurred in technology and in the markets  
20 themselves. You know, in the markets themselves these  
21 neutral if you will SROs or SIPs or whatever you want to call  
22 them which, you know, in Annette's talk were supposed to stay  
23 neutral to all market centers and market makers and brokers,  
24 are and, you know, should have the right to move forward and

25 change the role that they play in the marketplace.

1           I think though if you do that you cannot ignore  
2 the past. We've been talking a lot about history. And a lot  
3 of the, a lot of the baggage or the benefits, some would say  
4 the burdens that come with, came with these SRO's and these  
5 SIPs I think need to be closely evaluated in what Nasdaq, for  
6 example, can take with them as it competes in the for-profit  
7 arena.

8           The ECNs, as, you know, as was said earlier the  
9 order display rules and all of that was really leaning toward  
10 centralization over competition. It is our view and remains  
11 our view, and I think in some ways I believe it might be the  
12 New York Stock Exchange view, but I don't want to speak for  
13 the New York Stock Exchange, that ECNs or marketplaces are  
14 stores that sell liquidity. And if you want to buy liquidity  
15 from our store you should come to our store and you should  
16 come through the front door of our store. And what's really,  
17 what has gone on in this competition versus centralization  
18 issue is ECN quotes have been mandated to go into Nasdaq and  
19 access to that liquidity has been mandated through Nasdaq  
20 systems.

21           And while Nasdaq was neutral I think, you know,  
22 that is certainly less problematic. But as Nasdaq changes  
23 its role and becomes more of a competitor I think we really  
24 need to take a look at that fundamental issue.

And I think technology, we can't forget technology



1 and the advances that have been made. And I think it gives  
2 us an opportunity to really look at this in a different way.  
3 New readily available technology such as smart routers, such  
4 as new networking devices I think mean that a national market  
5 system can be virtually integrated without mandating all  
6 markets to participate in a single mainframe trading system.

7 So I think we now are at the, really the  
8 crossroads and we have a huge opportunity to get the benefits  
9 of centralization but do it virtually and allow competition  
10 to reign at the same time.

11 MS. NAZARETH: Thank you.

12 Do you think then, Doug, that the principles are  
13 still valid? Are you arguing that the means by which you  
14 achieve these goals are somewhat antiquated but that the  
15 principles are valid?

16 MR. ATKIN: Yeah, exactly.

17 MS. NAZARETH: You do believe there are benefits  
18 to having more centralization? There are benefits to  
19 investors from assuring that they receive best execution --

20 MR. ATKIN: Yes.

21 MS. NAZARETH: -- as they have the cross market?

22 MR. ATKIN: Absolutely. But, again, I would say,  
23 and there is no such thing as a perfect analogy, that right  
24 now for some reason when consumers go out and purchase 100

25 shares of Intel or Cisco or what have you, IBM, a listed

1 stock. Yeah, they still trade. That it's really one of the  
2 few instruments or consumer products that you buy where  
3 actually the, if you will, the government or a regulatory  
4 body says that everyone who in essence is involved in making  
5 a market or participating in that marketplace has to post the  
6 price to a central location and there's a lot of rules and  
7 regulations about, you know, the dissemination of that  
8 information.

9                   Whereas today we all know whether it's a small  
10 priced item or a medium priced item like a Sony Walkman or a  
11 DVD or even things like an automobile we call can go on the  
12 internet today and through services basically say I'm  
13 interested in a Volkswagen Beetle that's yellow, it has  
14 these, you know, these extras, and it will go out and grab  
15 the best price from anywhere in the country or the world for  
16 that piece of merchandise.

17                   So I think --

18                   MS. NAZARETH: Well, is your agent going to do  
19 that for the principal? Isn't that one of the challenges  
20 that we have?

21                   MR. ATKIN: Yeah.

22                   MS. NAZARETH: I mean even today you have smart  
23 routers that could find the best price but are they being  
24 utilized necessarily by the agents who may have other

25 external reasons for not seeking the best execution?

1           MR. ATKIN: Well, I think the agents as these  
2 continually are developed and there's more competition on the  
3 smart routers or the aggregators I think more and more people  
4 will use them. I also think that the technology is there to  
5 allow the consumers to check up very easily on their  
6 intermediaries with these simple tools like going, like  
7 they're using to buy other consumer goods.

8           MS. NAZARETH: Ed, did you have a comment?

9           MR. KWALWASSER: Yeah. I think in fact ITS, which  
10 is what we're talking about, is a substantial disincentive to  
11 people using smart routers. Because I could send an order to  
12 any market and essentially while we've taken away  
13 execution responsibility from the broker to his customer and  
14 put it on the marketplace saying "you guys in the marketplace,  
15 once you get the order figure out where to send it" as opposed  
16 to letting each broker -- if each broker had that  
17 responsibility I think fairly quickly they would make a  
18 determination where their customers for that type of orders  
19 get best execution and you wouldn't need this kind of system.

20           So I think the fact that we have the system  
21 disincentivizes people to use that kind of technology.

22           MS. NAZARETH: But you still have to be sure that  
23 the broker can access the market that has the best price.

24           MR. KWALWASSER: Yes. Absolutely.

MS. NAZARETH: So there's still a role for

1 regulation and protocols in ensuring that you're just not  
2 seeing where the best price is --

3 MR. ATKIN: Yeah, well --

4 MS. NAZARETH: -- but you can actually get to it.

5 MR. KWALWASSER: I don't think any of us  
6 disagrees.

7 MS. NAZARETH: Right.

8 MR. KWALWASSER: And I think it was maybe Andrei who  
9 said that designing it, making sure that investors are  
10 protected and the design and the criteria are put out by the  
11 Commission that investors need to get best price information.  
12 Exactly how we go and do that, a centralized design through  
13 ITS I think is a fairly antiquated way of going about that  
14 and a high cost way and it disincentivizes I think a lot of  
15 innovation and competition from occurring and getting  
16 investors even better products and even better market data  
17 and better access.

18 MR. KETCHUM: I guess I have a hard time  
19 understanding that. I understand very easily how the trade-  
20 through rule in connection with ITS may disincent people.  
21 ITS in effect does two things, it provides perhaps a too low  
22 cost but a low cost way to access marketplaces. Once you've  
23 gotten there, recognizing that marketplaces are vibrant and  
24 the best price isn't necessarily going to still be there, and

25 at least if you have marketplaces that still emphasize some



1 handling of that order and some effort to get price  
2 improvement, that strikes me as not too bizarre, it doesn't  
3 restrict the ability to go otherwise. Trade-through rules  
4 do. And trade-through rules do have a significant ability on  
5 people who value first getting as much liquidity as they can  
6 rather than searching out each and every best price which  
7 does strike me as something that becomes much, much harder in  
8 a more pluralistic, more competitive and faster environment.

9 But I guess I don't -- in fact, ITS has  
10 historically over the years allowed other markets to compete  
11 with the primary market, done that reasonably well. It  
12 remains the only efficient means to allow liquidity providers  
13 who are not sitting on the floor of a primary market to  
14 participate in an opening where there's a substantial  
15 imbalance of supply and demand. And with that it strikes me  
16 as doing not profound or dramatic things but certainly not  
17 anticompetitive things.

18 MR. ATKIN: Yeah, I would just say I guess my view  
19 of how ITS and regional stock exchange competition I think  
20 it's actually what it does is it's giving historically in my  
21 view regional stock exchanges a business of sending order  
22 flow to the New York Stock Exchange. And, again, my view is  
23 that if you are an exchange that you are a storer and an end  
24 point of liquidity and it's the broker's job to go to

25      wherever the best price is. An exchange competes as an

1 endpoint of liquidity but I do not think an exchange should  
2 be forced to link up with another exchange at that level. I  
3 think there's far more efficient ways for that to happen.  
4 And that will really breed lots more competition at the  
5 exchange level in our opinion.

6 MS. NAZARETH: Let me ask Phil Defeo a totally  
7 uncontroversial question which is, Phil, are you comfortable  
8 with Ed's characterization of the way the New York Stock  
9 Exchange Board operates such that a dominant market that's  
10 competing with a regional has a board that is ensuring that  
11 the public interest is being protected and that there is less  
12 need for, to exaggerate somewhat of what Ed said, there's  
13 somewhat less need for regulation because competitive forces  
14 will ensure the most economically efficient result?

15 MR. DEFEO: Well, I have to say as the head of a  
16 small exchange when faced with huge competitors I really do  
17 believe that Ed's point that the New York Stock Exchange  
18 board members only look out for the best public interest and  
19 not for the exchange themselves, I'm sure that's true. And  
20 I'm sure you believe that. And I'm sure the people on the  
21 board have every bit of interest in driving business to the  
22 best market no matter whether it's the New York Stock  
23 Exchange or any other market.

24 The interesting thing about the constituencies

25 that you deal with this in the exchange make an exchange kind

1 of unique. And Ed did allude to a couple of things that are  
2 interesting. One is the constituencies on a board that make  
3 an exchange what it is are varied and different and they all  
4 have different interests.

5           At our exchange we have 50 percent of our  
6 governors are public, public in terms of disinterested public  
7 governors, not necessarily issuers, certainly not people who  
8 have a vested interest in our exchange at all. The rest of  
9 the constituency comes from various Floor people. These  
10 could be brokers who have one set of interests or they could  
11 be small local market makers who have a different set of  
12 interests or, again, national market makers who have a third  
13 set of interests.

14           In addition to that, we have approximately 65  
15 percent of our owners who have a different set of interests  
16 in that they're lessors or absentee investors who look to  
17 lease seats to people who wish to trade.

18           All of that leads to a confluence of interests  
19 which make an exchange a particularly interesting place to do  
20 business. So if you think of that then you really have to  
21 ask yourself I guess if you're the New York, certainly we ask  
22 ourselves, is what is our best interest and whose interest do  
23 we serve? On any given day it might be the last caller one  
24 would say. I'd have to say though that more often than not

25 the thing you have to keep in front of you is what's best, to

1 the extent you can figure it out, for the retail investor.

2 To the extent it makes sense for the market and  
3 improves the market then the things we do in fact over time  
4 will strengthen the market in general. And if we do a good  
5 job for our customers then we think that we'll get our fair  
6 share. We are advocates of effective, proactive regulation.  
7 We're advocates of very clear standards for investors so they  
8 have the ability to choose. We talk about standards but  
9 they're not clearly understood if the investor is less  
10 educated today some people would say with the amount of  
11 information they get than more than our collective  
12 responsibility and I think the SEC's responsibility is to  
13 ensure there is fairness through clarity, consistency and  
14 transparency of information.

15 I don't look for necessarily the SEC to define or  
16 try to divine every single protection that might be developed  
17 for the market. First of all, it's impossible. Frequently  
18 we've seen, and we've seen in our cases in the exchange that  
19 the more controversial an issue might be the longer it takes  
20 to get it passed. That's because those who would consider  
21 the issue have, in the SEC for example, have a lot to do in  
22 terms of understanding the impact of that issue and worrying  
23 that it will in fact be for a public good.

24 Certainly when they put things out for public

25 comment it then engenders a lot of thoughts that neither they



1 nor perhaps even the originators had envisioned and that  
2 slows the process further.

3 I kind of wonder whether or not you can ever  
4 understand what a market change will be unless it's in  
5 hindsight. The law of unintended consequences clearly is at  
6 work in our markets and we have tremendous number of  
7 constituents who are very creative and always figure things  
8 out better than any of us thought when we started to develop  
9 a new practice or rule or structure. So I kind of wonder  
10 whether or not we wouldn't be more prudent to effectively  
11 understand all the changes that are made and be less  
12 restrictive in them in terms of allowing them to happen. I'm  
13 really for a more open market. I think if you ask what's the  
14 value of regional exchange, what it ought to be is someone  
15 who can be quicker and more innovative perhaps than a  
16 dominant market. In fact, if you think about it it has to be  
17 if it's to exist.

18 But the very act of being an incubator of  
19 innovation is difficult when you cannot achieve regulatory  
20 certainty. And the more radical the change might be the more  
21 difficult it is to get done.

22 So I'm for regulation. I think they've done a  
23 fabulous job of making changes. I believe the changes ought  
24 to be quicker. And I think that we ought to not be fearful

25 of abrogating changes or changing the management of exchanges

1 for example if they don't act in the public best interest.

2 MS. NAZARETH: Thank you.

3 Bob Glauber, do you have -- you're in the unique  
4 position of being a market regulator and you're not running a  
5 market. Do you have anything to add on the role of market  
6 regulation?

7 MR. GLAUBER: I'm personally in the unique  
8 position of being last which is very nice as well.

9 I think you're right, Annette, we are, we don't  
10 own the market. We certainly are on our way to divesting the  
11 last pieces of the Nasdaq market. And we are just a  
12 regulator. So in a sense I stand in a different posture, I  
13 guess Andrei and I are closer to the same role in this than I  
14 am to the other four members of the panel.

15 I guess first on regulation, who would sit on a  
16 panel sponsored by the SEC and not be for regulation in some  
17 form? But I can say honestly that I'm for it. As Andrei said  
18 at the beginning, regulation is a merit good in markets. We  
19 have the markets we have with the participation we have and  
20 therefore the profitability and the well-being of those  
21 markets because they are deemed as well regulated as compared  
22 to other markets. It really is a merit good.

23 The specific reason for regulation, of course, is  
24 the notion of market failure. And I know from years of

25 teaching this stuff at Harvard, one person's market failure

1 is not another person's notion of market failure. So having  
2 said that it doesn't decide much.

3 One of the big market failures we're talking about  
4 is the existence of entry barriers and the necessity, as Doug  
5 has been talking about, of sponsoring competition to overcome  
6 those inherent entry barriers. My read is that we've done a  
7 pretty job of sponsoring competition. The other side of  
8 competition, of course, is fragmentation. And now what we  
9 have to do is deal with that consequence of sponsoring  
10 competition and make sure that the cost of fragmentation that  
11 comes with the competition doesn't overwhelm the benefits of  
12 the competition. And I think that that's to a great extent  
13 what we're talking about throughout all of the detailed  
14 arguments.

15 So given my different role I'm going to be quiet  
16 now on the details.

17 MR. KWALWASSER: I just wanted to say that the  
18 broker/dealers who are on our board who are members are  
19 members except for the four floor firms. And, in fact, three  
20 of our specialists, three of the four are part of very large  
21 companies. So members of all the exchanges and markets. And  
22 I would assume that most of them are on the boards of all of  
23 the markets and exchanges so that they have no particular  
24 interest if there's a better market for their customers on

25 Nasdaq for our securities than there is on the New York Stock

1 Exchange to send them to the New York Stock Exchange. They  
2 have a duty to their customers which at least from my view of  
3 how they act they try to live up to that duty and make sure  
4 that regardless of whether it's the New York Stock Exchange  
5 that what we're doing is the best thing for their customers.

6 MS. NAZARETH: Well, I think it's time for a well-  
7 deserved coffee break. We're going to take a 15-minute break  
8 and reconvene after that.

9 (Recess.)

10 MS. NAZARETH: Thank you for returning. We will  
11 make a concerted effort to speak more directly into the mikes  
12 for those of you who had some difficulty hearing. I feel  
13 very bad for you because the incredible amount of wisdom that  
14 was shared in the first portion of this is just difficult to  
15 replicate. But we'll continue.

16 I thought I would start off by asking Doug Atkin,  
17 if he's ready, his views, and we can certainly then ask  
18 others, how effective do you think the SEC's regulatory  
19 framework which as you know is supposed to be a flexible  
20 framework, how effective has that been in accommodating  
21 market centers with differing structures and different  
22 business models? I mean you talked earlier, Doug, about the  
23 goal of, you know, to have competing market centers but to  
24 have, you know, some level of centrality and order

25 interaction. But obviously it's very difficult in any sort



1 of regulatory framework to have the total level of the  
2 playing field and to have results that don't have somewhat  
3 disparate effects on different market models. And so I  
4 wondered if you could comment on that?

5 MR. ATKIN: Sure. Yeah, I think first of all  
6 these are, you know, extremely difficult issues. And I think  
7 the SEC in general and you and the staff in particular have  
8 really made some excellent strides in trying to wrestle this  
9 very complicated issue to the ground because I think this  
10 gets right to the heart of the matter.

11 As I said, our view I think starting from let's  
12 say 100,000 feet is that our definition of what a broker does  
13 and what a marketplace does are two different things. A  
14 broker you give an order to and they go wherever they have to  
15 to get best execution. They go to whichever end point of  
16 liquidity or marketplace they need to go to to get best  
17 execution. And a marketplace or an exchange is one of those  
18 end points.

19 And what has been going on in the United States  
20 has been if you will having end points, competing end points  
21 of liquidities called ECNs being, if you will, guided into  
22 Nasdaq to operate within the Nasdaq infrastructure. And I  
23 think that has worked to some degree. It certainly worked a  
24 lot better in our opinion when Nasdaq was playing a neutral

25      role, if you will, as the place where competing market

1 makers, if you will, and competing ECNs reported their  
2 trades. It was the marketplace just, you know, not being  
3 disparaging at all, like a fish market or a flea market where  
4 everyone brought up their stall.

5 MS. NAZARETH: Could you choose another market,  
6 Doug?

7 (Laughter.)

8 MR. ATKIN: Fish, all right.

9 MS. NAZARETH: Fish.

10 MR. ATKIN: And Instinet brought up its stall and  
11 Merrill Lynch and Goldman Sachs but Nasdaq did not have its  
12 own stall and Nasdaq did not compete with those entities in  
13 the execution of stocks. So if you will, forcing the ECNs to  
14 operate within Nasdaq when Nasdaq was much more neutral, as I  
15 think the act we talked about said it needed to be, was one  
16 thing.

17 Now that Nasdaq is, and again I think has every  
18 right to want to change its structure and to fundamentally  
19 change its role in the marketplace from being this neutral  
20 marketplace to a for-profit exchange I think it really is  
21 unrealistic and I think it will stifle competition if the  
22 model is to continue to force ECNs to operate under and  
23 within that infrastructure.

24 And if you look around the world I think a model

25 is out there that, you know, something that we're quite

1 involved with, for example, is a small company used to be  
2 called Tradepoint, started as a for-profit electronic  
3 exchange in the U.K, fought to get liquidity, did not link up  
4 with any other exchanges. The other exchanges didn't want  
5 them to link up so that they could free ride their liquidity.  
6 They were in a battle to win order flow as an end point. It  
7 was not all that successful. Instinet and a few investment  
8 banks and a mutual fund complex bought Tradepoint and then  
9 merged it with the Swiss Bourse which is now called Virt-x.

10 But my point is that Virt-x is going out and  
11 competing for liquidity from customers, be it professional  
12 customers, mutual fund customers, etc., and it is doing so  
13 and will win on its ability to gain liquidity. Virt-x is not  
14 forced to operate under the London Stock Exchange or under  
15 the Paris Stock Exchange. And I think if you have one end  
16 point of liquidity being forced to operate under another end  
17 point of liquidity and one gets to make the rules I think,  
18 you know, you get what you're now seeing with some of the  
19 proposals coming out of Nasdaq.

20 So a long answer to your question, Annette, what  
21 we would like to see is a perfect situation would be in our  
22 minds if Nasdaq wants to go out and be a competing stock  
23 exchange that they if you will leave that SIP behind that was  
24 built up under the '75 Act to be the neutral securities

25 information processor, they go out and build an electronic

1 matching system like Island did, like Instinet did, like  
2 Archipelago did, and that execution facility can have no  
3 beneficial relationship with that SIP that any other  
4 execution entity can't have. And that just isn't the case  
5 right now.

6 MS. NAZARETH: Rick, do you have any comment?

7 MR. KETCHUM: Well, I guess a couple of thoughts.  
8 First, I think it's probably useful to note that there is one  
9 reason that ECNs today, until Archipelago moves to its new  
10 legal status and begins operating as an exchange, operate on  
11 Nasdaq was because we let them and because we linked them.  
12 I'm not aware of any SEC rule that said that thou shalt link  
13 with Nasdaq. I'm aware of a rule that said thou shalt link  
14 and be accessible to investors and people who represent  
15 investors somewhere and that your orders be included in the  
16 consolidated quote system somewhere.

17 It is true in Nasdaq stocks that Nasdaq operates  
18 as the exclusive SIP, which for everybody in the audience  
19 that doesn't live this every day, exclusive securities  
20 information processor which is a defined term in the  
21 securities laws and the Exchange Act coming out of the '75  
22 Act amendment, and the exclusive part of it is that Nasdaq  
23 not only disseminates information from market makers and ECNs  
24 who chose to give it that information as opposed to choose to

25 give it to Chicago Stock Exchange, Boston Stock Exchange,



1 Cincinnati Stock Exchange and now the Pacific Stock Exchange,  
2 and Nasdaq does that process of consolidating. Whereas, on  
3 the other side that process is done by SIAC which for New  
4 York and Amex was the securities information processor in  
5 which New York only owns two-thirds of it as opposed to all.

6 And I think that's a better environment. And  
7 Nasdaq in effect did that because at the time the plan was  
8 put together the only one exchange was interested in actively  
9 operating and that was Chicago Stock Exchange, then Midwest.  
10 And none of them were interested in spending a lot of money  
11 to build a quote collection facility. But the quote  
12 collection facility should be separate. In fact, the Nasdaq  
13 UTP plan participants have just put together an RFP to do  
14 that.

15 Nasdaq does collect quotes of market makers and  
16 ECNs that want to be part of it and intends to continue to  
17 collect quotes of market makers and ECNs who want to be part  
18 of it. There are exchanges that intelligently enough are  
19 seeing competitive opportunities in that marketplace and  
20 providing opportunities for either ECNs or market makers to  
21 choose an alternate place to have their orders/quotes  
22 disseminated. And I'm actually not aware of any ECN that  
23 isn't actively negotiating and at least discussing that with  
24 a variety of different exchange environments.

So I don't see Nasdaq in a unique position vis-a-

1 vis other markets other than the fact that it has over time  
2 collected most of the market share in those securities. And  
3 we'll hope we can continue to maintain that. But that's  
4 certainly not clearly identified.

5 I do think, though, that if you look, if you look  
6 at the experiences elsewhere I think there is a choice. And  
7 I wouldn't second guess the Commission on it. Virt-x does  
8 operate and provides very useful competition in the European  
9 environment. Outside of Swiss stocks which are operated with  
10 a monopoly on to start with I think that still is a fairly  
11 small market share, although I think it is a very effective  
12 entity and I suspect it will continue to be more and more  
13 competitive.

14 The environment and ECN environment in Nasdaq  
15 stocks where they provided tremendous value added in the  
16 '80's and early '90's also led to an environment in which  
17 retail orders were not effectively integrated into that, in  
18 part because those prices weren't part of the consolidated  
19 best bid and offer. The result was that there were  
20 significant differences in prices. The SEC could have solved  
21 that in different ways. It could have said brokers have a  
22 responsibility to get those better prices for their customers  
23 even if they may not all have a link to each of the places  
24 that give the quote, even if they may not have an easy way

25 down at a decentralized level of knowing what that best price

1 is because it's not consolidated.

2 They chose to say that the broker should have that  
3 responsibility in an evolving definition of best execution  
4 but it should come with a guarantee that there would be some  
5 linkage from someone and some ability to access consolidated  
6 information.

7 Having lived through a pretty painful experience  
8 in part of Nasdaq's history as a result of the early  
9 environment I think that those were good decisions.

10 MS. NAZARETH: Ed, I wanted to ask you from the  
11 stock exchange's perspective a similar question. From the  
12 perspective of a traditional market and an SRO have the  
13 recent regulatory changes that were designed to accommodate  
14 ECNs and other market centers worked effectively? And to  
15 what extent do you think that they have created an unlevel  
16 playing field with the traditional markets?

17 MR. KWALWASSER: Well, one, we think that they  
18 have worked effectively, that they do provide competition,  
19 and competition is helpful to us to make sure that we're  
20 always on top of our game. We think that there are  
21 differences between the ECNs which are treated as  
22 broker/dealers and exchange markets, whether they're the  
23 regional markets or the New York Stock Exchange. And so to  
24 some extent I know that ECNs and other people say that they

25 ought to be able to get into the quote stream and put up

1 their own quotes without having to come through a market  
2 whether it's our market or any other market, but there are  
3 substantial obligations on both Nasdaq and on all of the  
4 regulated exchanges who are regulated as exchanges, whether  
5 you call yourself a market or an end point, it's really the  
6 Commission has said you're a broker/dealer and so you should  
7 be treated, you have much fewer obligations, frankly, than we  
8 do. And we think that the tradeoff is working by and large.

9 We understand we have to make rule filings. They  
10 don't have to make rule filings. And sometimes, many times  
11 we get frustrated by the length of time it takes to get some  
12 of those filings. On the other hand there are some  
13 advantages. And so we think that on average it seems to work  
14 out.

15 MS. NAZARETH: That's interesting. I guess you'd  
16 also take the position that if an ECN chose to they could  
17 register as an exchange and to the extent --

18 MR. KWALWASSER: Well, clearly Archipelago --

19 MS. NAZARETH: Right.

20 MR. KWALWASSER: -- has chosen to do that. And  
21 anybody else that takes on the same obligations that any  
22 other exchange or marketplace takes on should have the same  
23 privileges as that marketplace. I think people who don't  
24 take on those same obligations shouldn't stand in the same

25 place as the markets that do.



1 MS. NAZARETH: And obviously traditional exchanges  
2 have SRO obligations. They have the self-regulatory  
3 function. Do you view that as a competitive disadvantage  
4 vis-a-vis ECNs? And I guess I'd like to segue into another  
5 question that I'd like Bob Glauber's input on which is  
6 whether or not you think that the U.S. regulatory system  
7 could be improved if we had more centralization of the SRO  
8 function?

9 Go ahead, you start.

10 MR. KWALWASSER: Well, we think that and you ought  
11 to know that more than one-third of all the people who work  
12 for the New York Stock Exchange are in regulation. So this  
13 is not something that we do in our spare time.

14 We think that it's important for us as a company  
15 to have a regulatory obligation and carry that obligation out  
16 to the best that we can. We think that the integrity of the  
17 marketplace, the integrity of our members are both important  
18 to us and important to the membership. And so we don't look  
19 at it as a burden, we don't look at it as something that we  
20 want to disassociate ourselves with. It's expensive. It  
21 takes a lot of people. A lot of people get mad at us for  
22 suing them.

23 But on the other hand, the membership, the total  
24 membership thinks that it's worthwhile because they present

25 themselves to the customers as part of an organization that

1 hires high integrity. And they sell that. So they  
2 understand that sometimes that means that we might bring a  
3 proceeding or tell them they can't do something that they  
4 would like to do. And if it was only one member all the time  
5 probably that member wouldn't be too happy but they  
6 understand that it's part of a collective and that collective  
7 values the regulatory environment that we're in.

8 We think of it as a positive and not a negative.

9 MS. NAZARETH: Bob?

10 MR. GLAUBER: Yes. Well, let me start by pointing  
11 out I suppose what is to me obvious, may not be to everybody  
12 in the room, that 100 percent of the people at NASD do  
13 regulation.

14 MR. ATKIN: What about the Amex people?

15 MR. GLAUBER: That this is our business. And  
16 we're delighted to be in it.

17 I think on the issue you asked, Annette, that  
18 there obviously are some benefits to some consolidation in  
19 the SRO structure, obvious efficiency benefits which would  
20 place less burden on firms. We coordinate pretty well with  
21 the other SROs that have responsibility. We don't coordinate  
22 perfectly. Firms have sequential examinations. And I think  
23 there would be the benefit of less burden to some further  
24 consolidation. Clearly, the other place where there would be

25     some benefit is less regulatory rule conflict.   Again, I

1 think we work very well with the other SROs. We work well  
2 in particular with Ed sitting next to me. But there is  
3 always the opportunity for some conflict despite how hard we  
4 work. Whatever lower costs and less burden is  
5 experienced will ultimately benefit investors because those  
6 benefits and cost will be passed on through. And, of course,  
7 there are going to be benefits for the market as a whole,  
8 sort of public good benefits of the better sharing of  
9 regulatory information.

10 Having said that, I think there's a question of  
11 how far you want to have that go. There are offsetting  
12 considerations. There are without any question some benefits  
13 of regulatory competition in the best sense of the word. And  
14 we see it in a variety of markets. I come to this from  
15 having been involved in banking regulation with Treasury and  
16 I think that there are really some benefits from regulatory  
17 competition there. So they're really all offsetting  
18 influences. I think there will be some benefit from the  
19 shrinking. How far one wants it to go, Annette, I think is a  
20 worthwhile question.

21 MS. NAZARETH: Phil, did you have a viewpoint?

22 MR. DEFEO: Centralized regulation, I don't have a  
23 strong view on that. I start with the idea that wherever it  
24 can be done most effectively we ought to do it. And

25 effectively in that regard to me means at least cost

1 effectively, number one. Number two, there are those  
2 functions that would lend themselves I think generally to  
3 possibly centralizing of again that you'd have to look at the  
4 costs. And there are those functions which tend to be more  
5 exchange or market-specific which I view would not  
6 necessarily lend themselves to centralization.

7           Among the ones I would not -- that I do not think  
8 would lend themselves to centralization would be things like  
9 the rule writing process. And if you consider that part of  
10 regulation, which some people may not but I do, I kind of  
11 think that is also a business function and it helps us define  
12 who we are and competitively who we are versus other markets.

13           Things like perhaps enforcement and maybe DEA  
14 functions might well be considered something that could be  
15 subject to centralization.

16           MS. NAZARETH: Thank you.

17           MR. KETCHUM: I can't help but ask this, I've got  
18 both of the two players in something that has some interest  
19 to Nasdaq. With the approval of a different market  
20 structure, Pacific and the operation of Archipelago, and the  
21 fact that Archipelago will integrate a broker/dealer to re-  
22 route orders from that exchange to other markets in both  
23 Nasdaq and exchange listed securities there is on the Nasdaq  
24 side an audit trail that follows orders through the life of

25 it as it gets handed around and as decisions are made in the



1 trading desk. How are you two going to work together when a  
2 decision is made from a trading desk to shift, send an order  
3 to Archipelago that is then re-routed back to another market  
4 liquidity center to rest in order for that audit trail to be  
5 able to work with respect to multiple markets? Addressed to  
6 either Bob or to Phil.

7 MR. DEFEO: With great care for the protection of  
8 customers is how we would do it.

9 MS. NAZARETH: There you go.

10 MR. KETCHUM: I feel better already.

11 MS. NAZARETH: Excellent answer.

12 I thought I'd raise an issue because I know Doug  
13 with his, particularly with his experience at Instinet in the  
14 global marketplace has a few views shall we say on some of  
15 the benefits of market structure in some of the foreign  
16 markets and has sort of been an advocate of some of the  
17 attributes of those markets. Could you talk a little bit  
18 about that, Doug, and tell us where you think we could learn  
19 some lessons from some of our foreign market competitors?

20 MR. ATKIN: Yeah. Let me again first start by  
21 saying that I think in general the financial services  
22 industry, both the regulation and the businesses themselves,  
23 America has really had the dominant model. I think there are  
24 certain pockets of the industry where we can learn some  
25 things from other places in the world. I think one of the



1 places and one of the pockets is Europe in terms of how  
2 market structure did evolve and how competition -- how they  
3 did, if you will, deal with this competition versus  
4 centralization just a bit differently.

5 I was fortunate enough to live over in Europe  
6 starting in 1992. And one of the first things I did was go  
7 around and meet with the heads of the stock exchanges. So  
8 you fly from one great city to another, it was actually a  
9 nice couple of weeks, you fly from one great city to another  
10 and see one beautiful building after another. I mean the old  
11 stock exchanges, for those of you who haven't been to Europe,  
12 are some of the most beautiful buildings in the world. And  
13 when you walked in though in 1992 you might as well have been  
14 in a time warp because that model for stock trading in Europe  
15 for 1992 was largely the same model that was used since the  
16 17th Century. There was really no technology applied to  
17 trading. Men in long jackets trading stocks for three hours  
18 and then eating lunch for four hours.

19 Yeah, and some part of me said this doesn't look  
20 too bad actually.

21 (Laughter.)

22 MR. ATKIN: And I had to spoil it.

23 Yeah, and probably actually one of my biggest faux  
24 pas, of which there have been many, is I was at the Amsterdam  
25 Stock Exchange with the then head at a meeting around 10:00



1 in the morning. And he took me out over the balcony and  
2 showed me the Floor. And I said, What time does the exchange  
3 open? And he said, It is open.

4 (Laughter.)

5 But anyway, what happened, to be serious, what  
6 actually did happen was the London Stock Exchange saw what  
7 was going on a lot of the big firms, largely American firms,  
8 were buying and consolidating operations up in London and  
9 wanted to create a pan-European stock market. So they went  
10 to the London Stock Exchange and the most innovative model  
11 that they felt at the time that was conducive to trading pan-  
12 European stocks was really the Nasdaq model. So they created  
13 something called SEAQ International which was an OTC Bulletin  
14 Board Nasdaq style trading system that compared to the 17th  
15 or 16th Century model was a major, major leap forward.

16 And what happened within the first year-and-a-half  
17 of trading of pan-European stocks in London was approximately  
18 50 percent of all the trading in Dutch shares, in  
19 Scandinavian shares, in German shares, in Italian shares,  
20 etc., moved to London.

21 Now, I think it's important to understand what did  
22 London have to do or not have to do in order to set up  
23 operations to trade pan-European stocks? Did London have to  
24 go to the Paris, to the French government or the local Paris  
25 authorities and ask their permission? The answer was no. If



1 they did have to go and ask permission to the French  
2 authorities or to the local equity regulators I'm sure the  
3 answer would have been something like we don't really have  
4 any problem with that as long as you do it within the Paris  
5 Stock Exchange. Right? So forcing the competition again  
6 within which we think is false competition.

7           So what you had was free and unbridled  
8 competition. They took half the market volume and market cap  
9 away from the local European markets. And what did the local  
10 European markets do? They couldn't use any regulatory or  
11 governmental -- get any help to bring it back so they  
12 actually had to innovate. And what they did was met in the  
13 proverbial smokey rooms and said, you know, look boys,  
14 because there were only boys doing it, we've lost 50 percent  
15 of our market cap to a more efficient model. We can sit here  
16 and watch the other 50 percent go or we can actually  
17 innovate, not do incremental improvements to the old model.

18           And what they built were virtual electronic stock  
19 exchanges, actually automating the auction market. And what  
20 quickly happened was a repatriation of that volume and that  
21 liquidity back from SEAQ International to the local markets.  
22 The local markets then are all competing with each other to  
23 win the pan-European stock trading. And basically any time  
24 one market puts in an innovation other markets quickly copy  
25 it. And what is going on is Euronext does dominate French





1 trading, Virt-x does dominate Swiss trading, the London Stock  
2 Exchange does dominate U.K. trading but, boy, are they always  
3 under threat, and huge threat, from another marketplace. And  
4 whoever wins in this model of free and open competition I  
5 think the real winners are investors as those markets have  
6 really transformed themselves.

7           And I think if you take that back to the situation  
8 here I really think we need to figure out a way in practice,  
9 not optically, to have those that want to go compete with  
10 Nasdaq to be able to compete with them as end points of  
11 liquidity, without using their infrastructure, without having  
12 to be under their rules. And, you know, a lot of it gets  
13 caught up in Nasdaq's basically taking that SIP, the  
14 securities information processor, with them as they go  
15 public.

16           And going back to an earlier comment about  
17 obligations and benefits, I'm sure there's some obligations  
18 on the regulations side but if you auctioned off that SIP I  
19 think you'd get a lot of people paying a lot of money for it.  
20 So.

21           MS. NAZARETH: Rick, would you like to respond to  
22 that? You know, we started off saying that it would have  
23 been a much more interesting conference if we had asked Doug  
24 and Rick to reverse positions. But I think it will be  
25 justified.



1           MR. KETCHUM: And that's what I'm confused about.  
2 I just had that speech of Doug's to give and I don't know  
3 what to do now.

4           MR. ATKIN: In our next lives, Rick.

5           MR. KETCHUM: I guess a couple thoughts from the  
6 history side of Europe. I won't repeat what I said earlier  
7 on the U.S., maybe a little bit.

8           Doug's analysis is absolutely right from the  
9 standpoint of International SEAQ and from the ability of  
10 European exchanges to take it back. I would say interestingly  
11 I think one of the primary ways that they took it back was to  
12 eliminate any requirements that institutional investors  
13 cleared their orders on the Floor or through books or in any  
14 way limited their ability to effect action which was one of  
15 the main ways that International SEAQ managed to get their 50  
16 percent. So I'm not sure it was pure exchange mechanics that  
17 drove that as much as a combination of much more efficient  
18 markets, as Doug's correct, and much less transparent rules  
19 or rules that required any clearing of institutional trades.

20           Since then there has been a lot of competition.  
21 We're one of the ones trying to compete in that area with  
22 Nasdaq Europe. Virt-x, partially owned by Doug, has been a  
23 splendid initiative with a great deal of efficiency. And for  
24 the first time, interestingly, an attempt to try to break  
25 through and actually provide efficient clearance and



1 settlement, something that the European exchanges have been,  
2 despite this incredible competitive fervor, absolutely  
3 uninterested in doing in 20 years. So I'm not sure the  
4 competition has been perfect from a European standpoint,  
5 maybe as opposed to a clunky U.S. standpoint where the trades  
6 cost one-fifth as much to clear and settle as in Europe.

7           Last piece is while loads of people are competing  
8 right now there's a great deal of fervor and I think a good  
9 deal the result of that potential competition making each of  
10 the European exchanges better and focusing on things like  
11 clearance and settlement. Nobody has had a significant  
12 market share impact since the market share move back to the  
13 continental bourses from International SEAQ. During that  
14 time ECNs account for about 35 to 40 percent of trading in  
15 Nasdaq securities, a little less than 10 percent in New York  
16 Stock Exchange securities. And one ECN in itself accounts  
17 for the majority of trading on the American Stock Exchange.

18           In addition, while New York has been extremely  
19 impressive in holding their market share of total share  
20 volume their market share of actual transactions is  
21 substantially less as exchanges in the intermarket have  
22 focused on trading retail sized orders in a more online  
23 environment. And not only that, the amount of competition  
24 among ECNs has expanded dramatically during that period.  
25 There are certainly arguments one way or another as to which



1 is more efficient, whether the give-up for liquidity and  
2 plurality on the U.S. side is better than focusing on a  
3 single system that has trouble finding intermediaries  
4 participating exactly how they do it other than orders  
5 matching orders, but I think from a competition standpoint  
6 and from a market share standpoint if you look at liquidity  
7 providers the U.S. systems work pretty well.

8 MS. NAZARETH: Thank you.

9 Andrei, you're written a bit about -- you've  
10 written a lot about some of the foreign markets but you wrote  
11 an interesting piece that discussed the Neuer Markt in  
12 Germany and how they borrowed a number of the principles from  
13 the U.S. markets in order to be more competitive. Could you  
14 discuss that a bit?

15 MR. SHLEIFER: The Neuer Markt, as some of you may  
16 know, has been a rather controversial experience, has had  
17 some benefits and it's had some issues as well. It's been a  
18 market that was created in Germany for the listing of new  
19 companies. It adopted a disclosure and reporting system which  
20 was vastly more transparent than those used by major listed  
21 German companies. And it adopted it by contract:  
22 a company that wished to be listed on Neuer Markt  
23 had to agree as part of its contract with the exchange to  
24 adhere to certain disclosure accounting and so on,  
25 principles.





1                   Now, what has happened following the creation of  
2 Neuer Markt, a very large number  
3 of new German companies and some old German companies  
4 listed on this market so that the number of listed German  
5 companies which basically has stayed roughly constant at 400  
6 from the time of World War II to the mid-'90's has increased  
7 from 400 to 1,000 in a period of several years.

8                   Then followed the collapse of  
9 Neuer Markt. There are two theories of this, and I'm  
10 going to leave them as the two theories. One is that the  
11 adoption of these disclosure rules, U.S. style disclosure  
12 rules, in fact has been tremendously beneficial and has  
13 enabled 600 German companies  
14 that wouldn't possibly have been able to list otherwise to go  
15 to the capital markets and raise external funds. That's the  
16 optimistic view.

17                   The less optimistic view is that the Neuer Markt  
18 saw another internet bubble just like the Nasdaq saw in the  
19 late 1990's and that what it brought to the table is looser  
20 listing standards than were applicable on Deutsche Borse, the  
21 traditional German exchange, and therefore many more  
22 companies that shouldn't have listed in the first place were  
23 able to list.

24                   My guess is that the truth is that there was some  
25 of each, that is to say that it was probably the case that



1 the better disclosure requirements the companies opted into  
2 as the price of listing on Neuer Markt were in fact  
3 beneficial and there were a great deal of benefits to some of  
4 the newer companies but we probably saw some of the same  
5 phenomena as we saw in the United States in '98 and '99  
6 taking place as well.

7 MS. NAZARETH: Thank you.

8 I thought we could turn to access and linkage  
9 issues because intermarket linkages are a major element of  
10 the national market system. And the SEC's approach has been  
11 to encourage negotiated linkages among markets. After all  
12 the price transparency achieved through consolidated market  
13 data is of little use to investors without access to those  
14 best prices.

15 The New York Stock Exchange, to cite one  
16 organization, has been critical of the ITS plan which is the  
17 existing intermarket linkage for listed securities. So I  
18 thought I would ask, Ed, in your view what are the most  
19 significant problems with ITS? Should it be fixed or should  
20 it be abandoned? And if it were abandoned what would you put  
21 in its place?

22 MR. KWALWASSER: Well, we think it should be  
23 abandoned for us. If other people want to continue to be  
24 part of that source then that's fine, fine with us.

25 We think that technology has advanced so much that



1 with smart routing the member firm or the broker/dealer  
2 should be able to go to the market that provides its customer  
3 for its type of order best execution. Even if it gets down  
4 to the Floor we know that our members can re-route it. It's  
5 easy. We don't know of anybody who's not connected who wants  
6 to be connected to the New York Stock Exchange. And I think  
7 Doug said let them come in the front door. We see no reason  
8 that another market should be able to free ride off of our  
9 prices. We think that if there wasn't ITS that regional and  
10 other exchanges would actually have to compete on quotes and  
11 try to make a much better market which is what the SEC  
12 thought when ITS was first put into place that there would be  
13 a competition based on quotes. Well, it turned out for  
14 whatever reason that there isn't any competition based on  
15 quotes, that regional markets, many regional markets auto  
16 quote a price away from the market and guarantee customers  
17 that they will do a trade at the price of the primary market  
18 if the customer comes in.

19           So you can't actually see what the liquidity is in  
20 the U.S. even though everybody is linked and all of the  
21 quotes are up there because those aren't real quotes from a  
22 lot of the participants in ITS. And we think that's not bad.  
23 And that if there wasn't this linkage there would be an  
24 incentive to put real quotes up so that people would draw  
25 liquidity to their markets.



1           The introduction of decimals, or there's nothing  
2 wrong with decimals, but pennies has made the trade-through  
3 rule just about unworkable. And we're pro trade-through  
4 rule. And we would like to find a way if we're going to stay  
5 in ITS to make it work. But the market is moving so fast and  
6 trades, the quotes change by a penny. And there might be 200  
7 shares at a penny better which would mean our specialist  
8 would have to stop doing a 25,000 share transaction to save  
9 its institutional customer \$2.00. And by the time he gets  
10 back the quote may have changed and that 25,000 share  
11 transaction won't be able to get done but the customer will  
12 have 200 shares at a penny better than he would have had.

13           We just don't think that those kind of things  
14 work. And you can't change them because everybody in ITS has  
15 to vote to change anything. And we think that's right when  
16 you're in ITS because we don't want, frankly, the other  
17 markets to change our market structure and they don't want us  
18 to change their market structure, which is perfectly correct,  
19 I think. So as long as there's no impediment to actually  
20 getting to any market in the U.S., and to the best of my  
21 knowledge there isn't any impediment to getting to any market  
22 in the U.S., we don't think that you need to have a  
23 government-sponsored cabal, to use a pejorative term, SROs  
24 having to work together, which would in any other  
25 circumstance would be an antitrust violation other than the





1 fact that this is Commission overseen and blessed. And we  
2 just don't think that that's the way to go in the 21st  
3 Century.

4 MS. NAZARETH: Phil, would you like to have a  
5 defense of the regional markets?

6 MR. DEFEO: Yes. I guess I would say a couple  
7 things on ITS.

8 First of all, you harken back I guess, and those  
9 who were around at that time, and I was not but I've read a  
10 little bit, say that that market in that whole national  
11 market system started in 1975 or about then. And it was a  
12 set of plans that were in place at the time to solve the  
13 problems of the time.

14 Since that time lots of things have changed. The  
15 world is not the same today as it was then. And, truly,  
16 markets are more accessible. And, truly, with the internet  
17 you can see a lot more information about the various markets.  
18 That does not mean though that ITS is fully broken or should  
19 be scrapped.

20 I would say several things. I really think that  
21 one of the things we need to do with ITS first is eliminate  
22 the unanimous voting of ITS. It does create a situation  
23 whereby you cannot get anything done unless everybody agrees  
24 that it does not threaten or materially weaken them. And  
25 it's very, very difficult to make changes in the system.



1 We've seen that over the years with many of the changes that  
2 we as a small regional have tried to get done.

3 Frequently the vote is 8 to 1 and one party  
4 blocking the changes. So we would like to see that change.

5 But having said that, we're not strong proponents  
6 of necessarily scrapping the model. Certainly it does  
7 provide a way for people to get at markets, not only the New  
8 York markets but there are other markets as well. And while  
9 one would argue as has been said that those other markets  
10 aren't material, I would have to say that whether or not  
11 those markets have been material in the past I think in the  
12 future they will be. And to restrict them and prevent them  
13 from not having access and having the ability to grow would  
14 be a mistake.

15 So I would look to carefully modify ITS and open  
16 up the restrictive structure of ITS. I wouldn't necessarily  
17 vote to eliminate it out of hand.

18 MS. NAZARETH: Doug, do you have the ECN  
19 perspective on linkage?

20 MR. ATKIN: Yeah. Again, our view would be that  
21 these end points, that we are in favor of access criteria.  
22 We think it is important for whether it is all, you know,  
23 NASD members or whatever the criteria that the SEC decides is  
24 best in terms of access that that actually comes to fruition.

25 I believe that ITS being the centralized solution



1 that does allow one exchange or liquidity pool to free ride  
2 off another exchange just doesn't work and it actually  
3 stifles competition. We think that the linkages should  
4 actually be one level up and be really the brokers who are  
5 responsible for getting best execution on behalf of investors  
6 who are the fund managers. They already have the tools, the  
7 tools are already out there that link up all these disparate  
8 liquidity pools. And as long as it is policed that a  
9 liquidity pool does provide access to who it supposed to  
10 provide access to, we think that is a far better solution  
11 than keeping ITS. It's just at the wrong level of the  
12 markets.

13 MS. NAZARETH: Rick, do you have a view on whether  
14 implementation of some sort of open access standard would be  
15 a viable alternative to hard linkages? This has some  
16 relevance, and I'm sure Bob Glauber has views on this as  
17 well, it would have some relevance for the alternative  
18 display facility that the NASD presumably will create after  
19 Nasdaq -- at the time Nasdaq becomes an exchange.

20 MR. KETCHUM: I think it's a good question. And I  
21 think it strikes me the short answer to it is yes, I think  
22 the Commission ought to be open to experimenting with open  
23 access standards and seeing how it works. And the alternate  
24 display facility might be a good place to start.

25 It seems to me all of this, again to put a little



1 historical connotation, is something that there isn't a  
2 simple answer to. Just as the Commission's order handling  
3 rules in 1996 would have destroyed the securities industry  
4 and been profoundly bad for investors when they were more or  
5 less initially proposed in the 1970's and then repropose  
6 again in the 1980's, they were the right thing to do more or  
7 less in the '90's because of changes in technology.

8           Things being noted today are reason for the  
9 Commission to stay open on a variety of these issues and look  
10 hard. It is true that much of the innovation, ECNs provide  
11 much of the demand resulting from institutions and active  
12 traders, individual traders controlling their own orders is a  
13 demand for liquidity that gets slowed down if you at least  
14 combine a linkage system and a trade-through. And that is a  
15 legitimate concern.

16           It is true that there are some incredibly  
17 promising smart order routing technologies being innovated in  
18 today that allow markets to compete in ways that 20, 30 years  
19 ago wouldn't have happened. And the result would have been  
20 that other markets other than the primary market would have  
21 simply been ignored as a matter of efficiency. And that is  
22 encouraging from a competition standpoint.

23           It is not true that people regularly use smart  
24 order routing techniques in order to route retail orders  
25 today, nor is it likely to be true six months from now. And





1 I think that would be why I would be hesitant in pulling out  
2 a linkage like the ITS which is already in place and which  
3 has the great benefit of being totally voluntary so you can  
4 use it as a market or not. The subsidy concerns Ed raised  
5 and Doug raised are real. And I think they're a matter of a  
6 balance. But I think a good argument could be made that  
7 right now ITS continues to serve a very valuable purpose.

8           Going forward though I think there may well be a  
9 situation in which markets should be able to choose to either  
10 be part of a linkage system or if they choose not to be to  
11 not be. And I think that the right time for that to come is  
12 not something that is easy and I think the Commission will  
13 have to struggle with some. But I do think that we're moving  
14 into an age where there can be more flexibility in that than  
15 there has been in the past.

16           MS. NAZARETH: Bob, can you talk about open access  
17 standards and also how if we move in that direction the  
18 Commission can meet the challenge of policing the  
19 effectiveness of open access standards given obviously in a  
20 very decentralized world like that it's going to be very easy  
21 for people to create barriers to access in a way that is  
22 obviously somewhat more difficult in a centralized single  
23 pipe.

24           MR. GLAUBER: Well, of course we're being drawn  
25 into this particularly because of the honor that the

1 Commission has bestowed upon us to run what is called the  
2 residual market but now Annette quite correctly has called an  
3 alternative display facility. Under the '75 Amendments we  
4 have an obligation to make certain that there is non-exchange  
5 competition in Nasdaq stocks. And we will, of course, on  
6 that abide by what we are required to do.

7           Having said that, our whole thrust, as I think  
8 most in the room know, is to direct ourselves back to being a  
9 regulator and not the runner of a market. So we're anxious  
10 that this new facility, as we like to call it, is not a  
11 market, that it -- that we not be led back into the  
12 obligation of running a market as the price we pay for  
13 disengaging ourselves from another market, Nasdaq. And I  
14 think that's understood.

15           This will be a facility which will display quotes  
16 and will report trades. It has to be done, obviously, in an  
17 appropriate way and will not execute those trades. I think  
18 clearly execution of those trades we view as being a market  
19 and it is something that we are looking forward to not being.

20           We understand that best execution requirements  
21 obligations require that the quote be reachable. And so we  
22 have to talk about order routing. We're anxious that that  
23 order routing be, frankly, as straightforward and simple as  
24 possible so that we not again be moved into the role of being  
25 a market. That the routing among



1 members of this we hope will be done by rules so that it will  
2 be flexible.

3           The routing, and this gets to, more directly to  
4 Annette's question, the routing to other exchanges we think  
5 should be arranged for by the brokers that are involved in  
6 it, that they should make arrangements with the other  
7 exchanges to be able to simultaneously reach our quotes and  
8 reach the quotes on the other exchanges. And we're anxious,  
9 of course, to go forward with this as quickly as possible so  
10 that we can complete the total separation of Nasdaq from the  
11 NASD and concentrate on our obligations as a regulator and  
12 what we believe should be what we do.

13           MS. NAZARETH: Doug, does this description of the  
14 alternative display facility comport with your expectations?  
15 Do you have any views on that?

16           MR. ATKIN: I think our team's, Instinet certainly  
17 is interested in seeing the creation of the alternative  
18 display facility and our team working closely with Bob's  
19 team, and I know Bob's team is working others in the  
20 industry, I think it's moving, it's clearly moving in the  
21 right direction. Like all of these things, the devil is just  
22 always in the details. But conceptually we think it's moving  
23 in the right direction.

24           MR. KWALWASSER: I think as sort of a bottom line  
25 that markets are interested in doing business, that they have



1 no real interest in putting up barriers to prevent people  
2 from bringing orders. If they do they're going to go out of  
3 business. I mean I know decimals were a great regulatory  
4 triumph for the Commission but what they created was a fairly  
5 opaque market where people can't see what the real bids and  
6 offers are.

7 In order to induce people to come to our market we  
8 have filed with the Commission, and I'm happy to say the  
9 Commission has published, something that we call OpenBook  
10 which will have our whole limit order book displayed to  
11 anybody who wants to see it in hopes of trying to give people  
12 a feel for what liquidity is. Now, we don't know whether  
13 when we do that there's going to be anything on the book,  
14 frankly, with people think that they become too exposed or  
15 people think it's a good idea to advertise. But we're  
16 willing to take the risk because we want to incent people to  
17 come to our market.

18 And I think that all markets have that as their  
19 underlying theme. I know I'm sure Nasdaq wants people to  
20 come to Nasdaq. And the Pacific wants people to come to  
21 Pacific. And we're going to do everything that we can that  
22 we think makes sense to incent those people to come.

23 And so it doesn't seem to me that we were back  
24 where we were at one time where clearly New York only gave  
25 quotes to New York members and you needed to have an office



1 below Chambers Street. For those of you who are not New  
2 Yorkers that's about nine blocks away from the Exchange. You  
3 know, if you didn't have an office then you couldn't clear  
4 securities as a New York Stock Exchange member. Well, that  
5 ain't the case anymore. And we're in a new world where it's  
6 fairly easy to become a liquidity provider if you have a  
7 better idea than we do or anyone else.

8           And so I think that the Commission has to take  
9 that, you know, whatever the right answers are the Commission  
10 has to take that into account as one of the underlying  
11 principles that if Nasdaq goes public, going to be a public  
12 company, they're going to have an interest in making money.  
13 And they make money by selling transactions, among other  
14 things.

15           We also on the New York Stock Exchange, we did  
16 away with most commission fees for people on our Floor. Not  
17 that anybody asked us to do that, and they might have been  
18 unhappy some of them but we thought that was one way to  
19 incent people to come to the exchange by lowering transaction  
20 costs, not raising the income of our specialists. We thought  
21 that if they were to make money they should make money by  
22 making good markets where customers want to come because  
23 that's the best price for the security and they'll get the  
24 best execution.

25           And I think by and large that the Commission has





1 to take that into account more than they have taken in into  
2 account in the past as one of the underlying factors, not  
3 that we're going to do everything right and not that we're  
4 going to do everything that makes you happy or Doug happy or  
5 Phil happy, but I think that as part of what you're looking  
6 at that has to be taken into account.

7 MS. NAZARETH: Rick, do you think that in light of  
8 decimalization and the effects that Ed describes that the  
9 Commission should play a greater role in encouraging or  
10 mandating deeper data to be available or do you think that  
11 this is truly a case where competitive market forces will  
12 lead to the correct result?

13 MR. KETCHUM: I think you have the great benefit  
14 this time in the basic rules of the '75 Act amendments on  
15 first wait and see what happens. And the answer right now  
16 signs seem to be very clearly that competition is absolutely  
17 going to respond to the opaqueness that Ed properly indicates  
18 came from decimalization, that the best bid and offer no  
19 longer tells you where you can buy or sell very much stock.  
20 So it's not nearly as valuable information as it used to be.

21 ECNs have led here. They have put their  
22 information up on the web. Albeit there's a difference  
23 inputting information a place you can see it and where you  
24 can access it, but obviously ECNs by nature to their  
25 participants show their entire book. The New York Stock



1 Exchange is moving in that direction. SuperMontage is all  
2 about the fact that it simply isn't valuable anymore to see  
3 the initial level or the best bid and offer without seeing  
4 more. It's valuable but it doesn't give you a good enough  
5 picture to really understand what the market is or even the  
6 picture that Nasdaq's full stream of data which shows quotes  
7 of various people doesn't give you enough of that picture.

8 So I think the answer to this one I believe is  
9 pretty easy for the Commission. I think there is a charge  
10 from every direction to provide depth and an indication that  
11 it's a good thing to come to one market or another because  
12 there is some depth and people should feel confident about  
13 being able to trade there. So I think the Commission's  
14 regulatory desires and competitive desires here are  
15 coinciding perfectly and it is a perfect area to allow  
16 competition to roam fairly freely.

17 MS. NAZARETH: Thank you.

18 Phil, can you describe how ArcaEx is going to  
19 treat its limit orders?

20 MR. DEFEO: Sure. Arca, ArcaEx the new exchange  
21 is going to publish its limit order book real time on the  
22 internet and it's going to be available to everybody free.  
23 So we think that's a good thing for the marketplace. We  
24 think it encourages disclosure. We think disclosure and  
25 transparency is a very good thing for the market and so we're



1 going that way.

2 I just had a question for Ed. I didn't know, I  
3 haven't read the filing, so I guess is the book you're going  
4 to publish, Ed, is that a real time book?

5 MR. KWALWASSER: Yes.

6 MR. DEFEO: Okay. No delays?

7 MR. KWALWASSER: Well, it's going to be updated  
8 every 10 seconds. But other than that there are no delays  
9 because we have to go around the whole, the whole market.

10 MR. DEFEO: Okay. I guess that's the difference,  
11 we in the ECN world kind of think of no delays as real time.

12 (Laughter.)

13 MR. DEFEO: Only kidding.

14 MR. KWALWASSER: This is what our customers told  
15 us they want so that's what we did.

16 MS. NAZARETH: Turning now to a less controversial  
17 topic, principal agent conflicts of interest, internalization  
18 and payment for order flow. As you know, the SEC has  
19 historically tolerated payment for order flow and  
20 internalization practices.

21 And, Ed, I thought I'd start with you. In your  
22 view do you think that these practices negatively impact the  
23 quality of U.S. markets by for example interfering with best  
24 execution obligations and reducing the incentives for full  
25 competition? And you have to say more than yes or no.



1 MR. KWALWASSER: Oh, darn. Sometimes.

2 (Laughter.)

3 MR. KWALWASSER: We think that if they were -- We  
4 think they do, and when they impact we think clearly is based  
5 on ordinary economic analysis, that if you don't have all of  
6 the orders into the system determining, finding the right  
7 price is hampered. How much I can't tell you. It depends on  
8 how much doesn't meet the market so that we can set the right  
9 price.

10 It certainly affects a broker's best execution  
11 responsibility to -- and to some extent when we've gone out  
12 and looked at our members, some of our members that sold  
13 their order flow they did analysis and they determined that  
14 they got a better execution on New York but they -- but we  
15 don't get paid so we're going to where we get paid. And, you  
16 know, one of our members told me that if it becomes between  
17 my customers and my stockholders my stockholders always win.

18 We think that that's not the right way for  
19 broker/dealers to behave, that their customers should come  
20 first. If they're doing it just for speed of execution which  
21 is certainly a legitimate reason and they want a guarantee,  
22 then let them buy from customers on the offer and sell to  
23 customers on the bid. And so the customers will get the  
24 benefit of internalization rather than the broker getting the  
25 benefit of internalization when the customer's order doesn't





1 have a chance to interact with the market.

2 And so we think that if you're going to  
3 internalize you ought to internalize for the benefit of the  
4 customer not the benefit of the broker.

5 MS. NAZARETH: Doug?

6 MR. ATKIN: I think just a couple comments. And  
7 this is an area where I think the Commission has done a  
8 terrific job of in some ways through education and through  
9 shedding more daylight on this whole practice it's in some  
10 ways being arbitrated out of the marketplace, that investors  
11 are really beginning three years ago, four years ago even,  
12 investors really did think that they were paying 5.95 for  
13 their 500 shares of Intel. And, you know, I equate it to  
14 that's you're comparing things on the sales tax of the  
15 washing machine rather than the price of the washing machine  
16 itself.

17 And it's taken a while but through things like  
18 order disclosure rules, pressure on, competitive pressures on  
19 some of these traditional and E-brokers to give their  
20 customers better executions. And a number of E-brokers  
21 really breaking with the pack a few years ago and not doing  
22 payment for order flow and getting smart routing techniques  
23 and using execution quality, total execution quality as a  
24 competitive advantage to get more accounts and more business  
25 I think you are seeing this whole thing, if you will, come to



1 an end in the way that it should come to an end via  
2 competition and better services and better quality taking  
3 care of internalization.

4 MS. NAZARETH: I wish we could take some credit  
5 for the reduction in those practices. I suspect that the  
6 biggest factor in the lessening of the practice of payment  
7 for order flow at least is the fact that the spreads have  
8 been so dramatically reduced because of decimalization I  
9 think while we're happy to take credit where it's due I'm not  
10 sure that we've had as positive an impact as perhaps you've  
11 said.

12 Phil, you've had some experience and some views  
13 with payment for order flow. Do you have anything to add?

14 MR. DEFEO: I don't know for a public audience. I  
15 think a couple things. I've had some experience in it not so  
16 much from the equity market but from the options market.

17 Payment for order flow has existed for many years  
18 in the equity market. And you've got better qualified people  
19 than me to talk about it. The options market though is  
20 particularly interesting as a study.

21 Prior to August of '99 most options were listed  
22 singly. So if you wanted to trade Microsoft, for example,  
23 you came to the Pacific Exchange and not someplace else. With  
24 that kind of structure a couple of things occurred in the  
25 market. One is customers paid, and I say customers, in this



1 case broker/dealers paid to route their orders to an  
2 exchange. Secondly, there was virtually no payment for order  
3 flow.

4           When a multiple listing occurred, which I think  
5 has just generally been a good thing but it's a very  
6 interesting thing to study, two things happened in rapid  
7 sequence. One is order flow providers immediately, almost  
8 immediately, within a few months paid nothing to route order  
9 flows to exchange. Everybody took their fees to zero. Not  
10 right away, not in any concerted effort but one exchange  
11 followed by another, followed by another, each bettering  
12 themselves to do away with revenue that they needed.

13           Following that the marketplace itself began to  
14 change in that national market making firms began to  
15 negotiate with order flow providers to develop payment  
16 programs for order flow. These payment programs actually  
17 began to create a marketplace where the national market  
18 making firms negotiated a deal across all exchanges to pay  
19 for order flow in a variety of ways. And what this caused  
20 was order flow to be moved in some cases from exchange to  
21 exchange depending upon where that national market maker  
22 would necessarily be a specialist or a lead market maker or a  
23 DPM or CBOE.

24 Now, if you look past the last two years since  
25 that occurred what's really happened in the marketplace for



1 options? Again, I don't have any conclusions but I am  
2 somewhat observant of these things. One is there are less  
3 smaller players in the market today than there were two years  
4 ago. There are less small market makers and less players.  
5 Generally the smaller players have been purchased by larger  
6 players who have then been purchased by even larger players.

7           On our exchange we've gone from 44 lead market  
8 makers to 17 in the period of two years. And I think if you  
9 looked at other exchanges you would see similar activities  
10 with the emergence of very large national firms.

11           I don't know of the studies that would suggest  
12 that spreads have widened or narrowed. Certainly the  
13 liquidity parameters have changed and how people manage their  
14 business in the options world has changed, but certainly the  
15 payment for order flow issue in all of its forms, and there  
16 are many forms except a direct payment, has caused the market  
17 to change a bit. And if I had to say what we continue to  
18 need in our options marketplace would be continued  
19 transparency in the market and disclosure in the market that  
20 force reporting of those issues in terms of the kinds of  
21 payments made and also tracking and performance of trade-  
22 throughs when they occur. I mean customers, retail customers  
23 deserve the best markets and they ought to get them.

24           MS. NAZARETH: Thank you.

25           It seems to me that Doug did speak favorably about





1 the new execution quality disclosure rules and, you know, his  
2 view that they are or they will have some positive impact in  
3 reducing principal-agent conflicts and promoting best  
4 execution.

5 Ed, I think you have a few views on the execution  
6 quality disclosure rules, should I give you fair time?

7 MR. KWALWASSER: Well, I think by and large  
8 they're good. I think we have to look at some of the things  
9 that are in there and make them better. One of the areas  
10 that we look at that we think really misrepresent what goes  
11 on on the floor of the exchange is because of decimals the  
12 quoted spread is very small in terms of numbers; it could be  
13 three or five hundred shares. And if a 50,000 share order  
14 comes in and the quote is for only 500 shares and even if  
15 25,000 are done at the quoted price but the next 25,000 are  
16 done a penny away from the quoted price that whole order  
17 would be considered to be executed outside the spread.

18 We don't think that that makes any sense. You  
19 could have both of those statistics, those orders that met  
20 what the quoted market is, but I don't think anybody has an  
21 expectation if they send down a 50,000 share order when  
22 there's a 500 share market that they're going to get all  
23 50,000 shares at the same price as the 500 shares.

24 So I think that there are certain things like that  
25 that we also see, there's quote exhaustion. By that I mean



1 again we have 500 shares. And there are 15 orders that come  
2 down for 500 shares. Well, the first one will get an  
3 execution at the quote and the next 14 will be all executed  
4 outside the quote if the quote change is based on it.  
5 Because those of you who don't know, it's the quote at the  
6 time the order is sent that is the quote that the Commission  
7 rules tell us to look at in determining whether an order was  
8 executed inside or outside the quote.

9 So we think the Commission ought to look at those  
10 two things, see whether they are actually what the Commission  
11 wants to measure, whether that's giving an investor the  
12 information that they need to make a determination where they  
13 want to send the order. We think that there are better  
14 metrics and we'd be happy to discuss them with the Commission  
15 staff.

16 MR. GLAUBER: Annette?

17 MS. NAZARETH: Sure.

18 MR. GLAUBER: If I may, I think those comments are  
19 fair. And clearly like any rule it needs to be fixed. But  
20 we shouldn't lose sight of the fact that this whole issue I  
21 think of payment for order flow and what's happened to it is  
22 really a great success story, as a number of other people  
23 have said. I think that through these disclosure rules,  
24 through decimalization, I mean there's no question that's a  
25 big part of it, what is a fundamental principal-agent problem



1 has in fact been brought on its way to being solved.

2 I mean the issue is whose order is it and who  
3 should benefit from it? And I think that these rules or I  
4 think that what's happening through the combination of this  
5 rule and decimals is that we're solving that. And we  
6 shouldn't lose sight of it.

7 MS. NAZARETH: Well, there is clearly a tension  
8 between, you know, prohibiting it and providing sufficient  
9 information to investors so that they can, you know, act upon  
10 the information. I think with respect to the execution  
11 quality disclosure rules as you know where somewhat early in  
12 the process New York has gone out ahead of the pack and is  
13 disclosing execution quality statistics for the listed market  
14 and the Nasdaq market will be following in short order. So I  
15 think we are obviously very interested in seeing what the  
16 impact will be of this disclosure across all markets,  
17 understand its usefulness to investors, respond with, you  
18 know, any adaptations that we find are appropriate.

19 But like a number of the panelists here, I  
20 think I am optimistic that this was really the appropriate  
21 approach that trying to ban the practice outright was  
22 virtually impossible because payment for order flow and other  
23 reciprocal arrangements, internalization and other reciprocal  
24 arrangements take so many forms that it is virtually  
25 impossible for a regulator to craft a rule that would



1 effectively prohibit the practice and therefore it would just  
2 be, you know, an exercise in imagination for the attorneys to  
3 figure out ways around it. And I think it's much better to  
4 shed some light on the practice.

5 I'm not convinced as of yet that we're -- I think  
6 we still have a few dark clouds over the practice but I think  
7 as these things get fully implemented as, frankly, is our  
8 hope if the data is sort of more widely reviewed by academics  
9 and other economists and other market commentators and you  
10 actually have the information essentially put forth to your  
11 average investor in a more understandable and comprehensible  
12 way rather than having, you know, tables of statistics I  
13 think it could have a profound impact. And that's our  
14 whole --

15 MR. GLAUBER: Annette, again, I think you're  
16 exactly right in what you said at the end. And it goes  
17 back to the original theme of or one of the themes of your  
18 paper that here is an opportunity I think to solve a problem  
19 not by directly dealing with it in a heavyhanded way but by  
20 going back and trying to understand what are the forces that  
21 lead to it and deal with those forces, in this case  
22 informational asymmetry forces.

23 And I think the Commission has gotten it, is on  
24 its way to getting it right, completely right.

25 MS. NAZARETH: Rick?





1           MR. KETCHUM: I really agree with what everyone  
2 has said here. I'd say it seems to me that there's two sides  
3 of this though and probably useful to note the other side  
4 too. And it really comes from what Ed noted before. In  
5 fact, I'm delighted to hear him because in an earlier set of  
6 discussions about these things we were on different sides in  
7 New York about being able to measure orders at and around,  
8 away from the best price.

9           I think this information is enormously valuable  
10 information. It will encourage people to compete. It will  
11 encourage people to evaluate. And from that standpoint it is  
12 good.

13           The one thing the Commission could do wrong here  
14 is to encourage a perception or, worse yet, an actual use of  
15 the information from the standpoint of regulatory or  
16 litigation of false precision because in effect what you have  
17 is a collage which if looked at in its whole with each  
18 investor or broker/dealer or intermediary choosing to value  
19 and weight different values somewhat differently and allow  
20 people to make more intelligent decisions and that's a good  
21 thing.

22           The great risk with respect to this over time is  
23 that regulators lock into it or encourage other people from  
24 the litigation standpoint to identify one thing as the  
25 perfect answer of what a market or what an intermediary



1 should provide from a best execution standpoint. And Ed gave  
2 a perfect example of how that doesn't work very well when you  
3 do that. On the other hand, if you take it as a whole and as  
4 a collage I mean the Commission's rules are a tremendous step  
5 forward.

6 MS. NAZARETH: Thank you.

7 As we obviously start to draw to a close on this  
8 panel I wondered if I could just throw out a very general  
9 closing question which is do any of the panelists have any  
10 specific ideas on how securities regulation could be changed  
11 to improve the functioning of the U.S. markets, in 30 words  
12 or less.

13 MR. KWALWASSER: I do.

14 MS. NAZARETH: Remembering that we have a group  
15 that's getting hungry for their lunch.

16 MR. KWALWASSER: Yeah. And this is easier said  
17 than done. And I think, because I'm not sure I know how it  
18 gets done, but it's dealing with rule proposals whether it's  
19 ours or Rick's or Phil's or anybody else in a more rapid  
20 manner so that when we finally get the rule passed, if that's  
21 the thing, it's not so old that it no longer deals with the  
22 circumstances that we're dealing with.

23 On January 7 one of our rules that we proposed  
24 five-and-a-half years ago is going to become effective. And  
25 we think that's a good thing that it's becoming effective.



1 We don't particularly think it's a good thing that it took  
2 five-and-a-half years.

3 MS. NAZARETH: And I assume that was one of your  
4 non-controversial rules?

5 MR. KWALWASSER: It was. It says that a member  
6 couldn't trade ahead of his customer.

7 MR. KETCHUM: This will not be an effort to pile  
8 on after waiting two hours and 45 minutes. I do think that  
9 one of the challenges of a more competitive environment that  
10 the Commission faces is that one of the great values of  
11 legislation in, as what I said at the beginning, is an  
12 inherently messy environment that I think has served the U.S.  
13 market and U.S. financial markets and investors quite well is  
14 that the Commission along with looking at the various  
15 different points in which public goods breaks and private  
16 interest breaks down is that when you really role that down  
17 the Commission is required in a more competitive environment,  
18 in a more complex environment to act as an umpire on a fairly  
19 regular basis.

20 And just like instant replay doesn't work when it  
21 takes too long and is used too often I think that the speed  
22 in which decisions need to be made in this environment is  
23 different than they were when I was stuck with your job,  
24 Annette, when we could take as much time as we wanted and it  
25 was right.



1 (Laughter.)

2 MS. NAZARETH: And nobody dared criticize Rick.

3 MR. KETCHUM: But I do think that's the great  
4 challenge to the Commission. It's not to suggest that it's  
5 an easy challenge because all of us have very strong views as  
6 to what the right answer is. And that probably the reason  
7 that one took five-and-a-half years as well as some of mine  
8 take five-and-a-half years is that there are other people  
9 that think it's just as outrageous as we think it's  
10 absolutely right.

11 But I think in the end what's going to be  
12 important in this situation is for the Commission to make  
13 decisions and to make decisions quickly.

14 MS. NAZARETH: Thank you.

15 MR. PHILLIPS: Thank you, Annette, and thank you,  
16 panel, for a very stimulating discussion. We have luncheon  
17 served and we'll here --

18 (Applause.)

19 MR. PHILLIPS: That was truly spontaneous. Even  
20 though it delayed lunch.

21 We're going to have lunch served in about 15  
22 minutes. The waiters are setting the table. And we'll hear  
23 from Senator Paul Sarbanes on the legislative front. See you  
24 in 15 minutes next door.

25 (Recess.)





1 LUNCHEON ADDRESS

2 MR. RUDER: I have just one or two announcements  
3 to make. I have been an administrator all my life. I'm  
4 still here.

5 The reception at dinner will be in this room  
6 tonight. Tomorrow we have the entire room for our program  
7 and another room for luncheon. So you don't have to worry  
8 about not having a seat. And, again, if anyone needs CLE  
9 credit it's available outside.

10 It's my privilege for the second time to give an  
11 abbreviated introduction of Harvey Pitt. And here he comes.

12 (Applause.)

13 CHAIRMAN PITT: I think next year when we do this  
14 we have to get rid of the introduction for the introducer to  
15 the speaker.

16 In any event, it's my personal honor to introduce  
17 our keynote speaker. And I think we're most fortunate to  
18 have Senator Paul Sarbanes, the highly respected and  
19 distinguished Chairman of the Senate Banking Committee, a man  
20 I'm privileged to consider a friend as well as a professional  
21 colleague.

22 Collectively, we at the Commission could not be  
23 more pleased to have Chairman Sarbanes as our advocate and  
24 oversight chairman. And I say that not just because I took a  
25 solemn oath before the Banking Committee with Chairman



1 Sarbanes presiding. Chairman Sarbanes' life truly reflects  
2 the American dream. His parents immigrated to Salisbury,  
3 Maryland where Chairman Sarbanes was born and grew up from  
4 Lakonia, Greece whose rich history dates back thousands of  
5 years to ancient Sparta. It is possible that Chairman  
6 Sarbanes may have descended from Hercules --

7 (Laughter.)

8 -- the legendary hero. Now, there is no actual  
9 proof of that.

10 Certainly his academic achievements suggest as  
11 much. Chairman Sarbanes graduated Phi Beta Kappa from  
12 Princeton. He attended Oxford as a Rhodes Scholar where he  
13 received an Honors Degree in philosophy, politics and  
14 economics. And he went on to receive his law degree cum  
15 laude from Harvard.

16 Much to our collective good fortune Chairman  
17 Sarbanes then embarked upon a distinguished and lifelong  
18 career of public service. He served in both city and state  
19 government in Maryland as well as on President Kennedy's  
20 Council of Economic Advisors in the early 1960's.

21 In 1970 he began the first of three consecutive  
22 House terms. In 1976 he was elected to the Senate for the  
23 first time and having just been reelected once again is now  
24 serving what will be his fifth full term.

25 True to his Spartan roots he goes about the



1 business of government quietly but effectively. Elizabeth  
2 Drew in her book "The Washington Journal" wrote, and I quote,  
3 "Paul Sarbanes would not have looked at all bad at the  
4 Constitutional Convention." Giving Elizabeth Drew her due I  
5 can think of no higher praise for a public official. He has  
6 never lost an election and his large margins of victory  
7 testify to the deeply felt respect and esteem his  
8 constituents have for him in a timing of otherwise cynical  
9 attitudes towards politics and politicians. He is the  
10 longest serving senator in Maryland's history, a record to  
11 which he keeps adding.

12 Even more impressive than his public service is  
13 the fact that Chairman Sarbanes married 40 years ago and  
14 collaborating with his wife has produced his most artistic  
15 and beautiful works, three children notable for their  
16 successful lives and careers and the five grandchildren they  
17 have bestowed upon Chairman and Mrs. Sarbanes.

18 On a personal note I would like to express my  
19 sincere thanks to Chairman Sarbanes not only for joining us  
20 today but also for his invaluable leadership during and after  
21 the events of September 11. Chairman Sarbanes' dignified  
22 bipartisan approach to these events set a wonderful tone and  
23 example for us all. I also congratulate him on his truly  
24 effective leadership in getting comprehensive and historical  
25 money laundering legislation included in the anti-terrorism



1 bill that was recently signed into law.

2 On behalf of the Commission and the SEC Historical  
3 Society I want to thank Chairman Sarbanes from taking time  
4 out from his busy schedule in these difficult times to share  
5 with us his unique, perceptive and learned views. And so it  
6 is my great pleasure and honor to present the senior Senator  
7 from Maryland, the Honorable Paul Sarbanes.

8 (Applause.)

9 SENATOR SARBANES: If you could see what we have  
10 to navigate here it's liking trying out for Broadway here.

11 I'm very pleased to be with you today. And I want  
12 to thank Chairman Pitt for an extraordinarily generous  
13 introduction. He constantly referred to me as Chairman.  
14 Every time I hear that all I can think of is saying "All hail  
15 to Vermont."

16 (Laughter.)

17 Also, I guess it's the prerogative of chairmen to  
18 go around calling each other chairman all the time. So,  
19 Harvey, thank you very much indeed.

20 I'm very pleased to come. I see some familiar  
21 faces from years past. As some of you may recall, in the  
22 96th Congress, my first term in the Senate, I actually was  
23 Chairman of the Securities Subcommittee of the Banking  
24 Committee. And in that Congress I worked with some of the  
25 people I see in the room to enact the Small Business





1 Investment Senate Act of 1980 which eased some of the  
2 restrictions on venture capital companies imposed by the  
3 Investment Company Act of 1940 in order to facilitate small  
4 business investment while preserving essential investor  
5 protection. So, you know, my sort of baptism in fire in the  
6 Senate was working on securities issues. Harold Williams  
7 actually was the Chairman of the SEC at that time.

8           And I'm particularly pleased to come and  
9 participate in this conference sponsored by the Securities  
10 and Exchange Commission Historical Society. Of course, the  
11 SEC has had a very distinguished history extending over  
12 three-quarters of a century. And I appreciate much of the  
13 Commission's modern history has been written by many of the  
14 men and women assembled in this room. I strongly support  
15 this effort not only to preserve the history of the  
16 Commission but to encompass research and educational programs  
17 within the Society's mission.

18           I was talking to David Ruder the very  
19 distinguished chairman earlier here at lunch and of course I  
20 said, When did you actually become Chairman of the SEC? And  
21 he says in early August of 1987. Of course, two-and-a-half  
22 months later he had a full agenda in front of him. There's  
23 no causal connection I hasten to add, his assuming the  
24 chairmanship and what happened after.

25           These causal connect -- I love to collect stories



1 about causal connections. It's kind of an interesting  
2 exercise. And I will share one with you. It's a complete  
3 diversion from my subject but it's these people visited this  
4 village and they noticed this man who was walking around town  
5 snapping his fingers. Everywhere he went he was snapping his  
6 fingers. He did this hour after hour. So finally they went  
7 up to him and they said, Sir, we've been watching you now  
8 since we arrived in this village some hours ago and we  
9 noticed you're spending all of your time going up and down  
10 the street snapping your fingers. Could we ask you why?

11 And the man says, I'm keeping the elephants away.  
12 And they said to him, There aren't any elephants around here.  
13 And the man said, You see, it's working.

14 (Laughter.)

15 So I pass this on to the Chairman of the  
16 Commission in his endeavors.

17 (Laughter.)

18 Let me just say that it's appropriate that the  
19 Commission's Historical Society has undertaken the study of  
20 the past. But I think it's particularly appropriate that you  
21 have a conference that looks to the issues of the future.  
22 Your subject of course, securities regulation in the global  
23 internet economy, could hardly be more timely. We live in a  
24 time of change which is of course an old cliché, but in this  
25 case the expression is sturdy conventional wisdom. The



1 changes wrought by the internet are sobering not only in  
2 their breadth and depth but also in their rapidity. They  
3 affect the markets directly but also indirectly through  
4 changes in the society at large and they obviously require us  
5 to look ahead.

6           And I notice that the panels specifically we're  
7 looking ahead at the developments over the next decade.

8           The changes that arise as a consequence of the  
9 internet economy have now been compounded by others which  
10 none of us could have anticipated at the time this conference  
11 was in the planning stage and those are, of course, what has  
12 occurred as a consequence of the ferocious assault of  
13 September the 11th. Someday economic historians with the  
14 benefit of hindsight will be able to catalog and calculate  
15 the losses with some certainty. But the profoundly human  
16 losses of the families torn apart, the communities devastated  
17 will forever remain incalculable. And if you really want  
18 that brought home in a very personal way just read one page  
19 the New York Times publishes in every issue telling  
20 encapsulated stories of people who were lost in the World  
21 Trade Center.

22           I can only do that sparingly because I find it  
23 very moving to hear this recitation of the broad diversity  
24 and range of lives of the people they talk about and  
25 incredible talent that's reflected in so many of those



1 stories.

2           The nation, of course, faces an unparalleled  
3 challenge. We've been working very hard in the Congress to  
4 work closely with the President in trying to address the  
5 situation. We appreciate and I think it's important for the  
6 country to understand that there is no easy, quick or simple  
7 solution. We really have to reach down and draw on the best  
8 qualities of mind and heart in order to address the situation  
9 with what I would describe as a steely resolve. It has to be  
10 an absolutely determination I think to stay with this issue  
11 until we can eradicate terrorism around the world as a menace  
12 of course to all humane values.

13           And we have to be certain as a nation to stay with  
14 it and see it through. And we try in the Congress to be very  
15 supportive of the President in that regard.

16           I want to take a moment since those who work at  
17 the epicenter of the financial markets were hit so hard to  
18 commend Harvey Pitt and his fellow commissioners,  
19 Commissioners Hunt and Unger, and the SEC staff for their  
20 successful efforts in keeping the securities markets on an  
21 even keel in the wake of the attacks. The markets, as you  
22 all know, were closed down for the longest period of time in  
23 our history. Harvey was in New York on the spot in that  
24 critical week. And I think in the end very wise decisions  
25 were made in terms of when to bring the markets back up. I





1 think there had to be some real sense of certainty that once  
2 brought back up they could carry through and handle the  
3 situation. I think it would have been a double blow if  
4 they'd come back up and then had to go back down again.

5           So I think that some very smart decisions were  
6 made. The Commission, of course, used prudently emergency  
7 relief measures which actually had been developed by Chairman  
8 Ruder at an earlier time in response to the stock market  
9 difficulties in October of 1987. It's very interesting, some  
10 of those powers have been sitting there ever since not used  
11 and they came into good stead at this particular time.

12           On the day they reopened the exchanges were able  
13 to handle the largest volume of transactions, one day volume  
14 of transactions in our history without really any hitch. And  
15 I want to again commend the SEC, the Chairman and all of his  
16 colleagues and also the stellar work of the exchanges and the  
17 financial industry of being able to go the distance.

18           We held a hearing on the 22nd of September which  
19 had previously been scheduled. We were going to address the  
20 issue of financial literacy which I think is an important  
21 topic, and I'm going to refer to it a little later in the  
22 talk here this afternoon. But we already had Treasury  
23 Secretary O'Neil, Chairman Greenspan and Chairman Pitt lined  
24 up for that hearing. So we went ahead with the hearing and  
25 of course shifted the topic or the subject to how we would



1 respond in reaction to the situation.

2           And we also had a second panel that we brought in  
3 Dick Grasso from the New York Stock Exchange and Wick  
4 Simmons from Nasdaq to talk about their efforts. And I think  
5 the industry did an absolutely first rate job of working with  
6 the Commission and others in terms of getting back into  
7 operation. And before it sort of lapses into history and is  
8 taken for granted I want to underscore what a very impressive  
9 accomplishment it was.

10           In the work of the Banking Committee which I am  
11 now privileged to chair, Harvey alluded to the fact that I am  
12 now the longest serving senator in Maryland's history. It's  
13 a little bit like Cal Ripken, every day you go to work you  
14 set a new record. But when I was first elected to the Senate  
15 I was very critical of the seniority system.

16           (Laughter.)

17           But obviously as time has gone by I have come to  
18 see its virtue.

19           Actually, the work of the committee since  
20 September 11, so only just a very short period ago, focused  
21 almost entirely on trying to get comprehensive money  
22 laundering legislation. We actually had scheduled a series  
23 of hearings to begin on the 12th of September on this issue.  
24 In other words we put the money laundering issue on the  
25 committee agenda ahead of what took place in New York because



1 you know now for a number of years there's been a lot of  
2 effort to try to get effective money laundering legislation  
3 as we deal with the drug trade, deal with organized crime,  
4 deal with corrupt foreign leaders who use the system to  
5 protect their ill-gotten gains.

6           And, of course, September 11 gave us yet another  
7 and obviously very strong, powerful reason to move ahead.  
8 And in the end we were able to enact a comprehensive money  
9 laundering legislation as part of the anti-terrorism bill.  
10 It will affect a broad range of industries. And, in fact,  
11 I'm going from here back to the hearing Subcommittee Chairman  
12 Evan Bayh is holding. We have some measures in I believe  
13 that will even further allow us.

14           But amongst the provisions here that will affect  
15 the securities industry and the work of the SEC in important  
16 ways it creates an important equivalency between the industry  
17 and banking institutions. Broker/dealers are now required to  
18 report suspicious activities. No claim can be brought in  
19 arbitration against a securities firm for disclosing  
20 information about a customer in the course of making a  
21 suspicious activity report. And information from those  
22 reports can be shared with the self-regulatory organizations.

23           One of the contentions, arguments that was put to  
24 us is we need to have this information shared about but under  
25 the current arrangements there are potential liabilities and



1 restrictions that keep us from doing that. And we went ahead  
2 and sought to provide some protection in order to make that  
3 possible.

4           The legislation also calls for a study of how the  
5 Bank Secrecy Act should apply to investment companies. This  
6 is a study to be completed by the SEC, the Treasury and the  
7 Federal Reserve Board and as part of the new law's broader  
8 purpose to modernize the nation's financial transparency and  
9 anti-money laundering efforts.

10           This was a bipartisan effort. And I want to  
11 underscore that. Harvey Pitt mentioned that in his generous  
12 introduction. It came out of the committee unanimously.  
13 We intensified the pace of work but we did not drop out of  
14 the process any of the essential elements of it. We tried  
15 to, you know, if we laid down a mark, people proposed  
16 amendments to the mark, we had a committee hearing, all in  
17 fairly quick order. But at least we held to the regular  
18 process which I'm very frank to tell you I think is important  
19 to do in times, even more important in times of process if  
20 you possibly can do so.

21           These procedures that we worked out over a long  
22 period of time, and those of you who practice this very  
23 sophisticated law before the SEC will appreciate this, these  
24 procedures have evolved through a lot of tests. And we put a  
25 process in place because we calculated over time this works





1 best at getting us good results and protecting us from bad  
2 consequences.

3           So I think when we face a time of crisis, and we  
4 practiced it here but I'm applying this more generally, I  
5 think it's very important if it's at all possible to stick to  
6 the regular process. We may speed it up a little but we  
7 shouldn't just simply jettison all of these careful in a  
8 sense new process protections that have been built up over  
9 time. And we tried to do that in the course of passing this  
10 legislation. And one of the consequences of it is that the  
11 legislation itself encompasses some very important due  
12 process protections, issues that were raised in the course of  
13 our hearings and in the mark-up and to which we tried to  
14 respond.

15           Now, we worked together I think the way a  
16 legislative body ought to with a high degree of  
17 craftsmanship, with respect to differing points of view and  
18 an effort to accommodate issues. And we fortunately were  
19 able to leave ideology somewhere in the back room and really  
20 deal with this in a very practical and pragmatic way.

21           Mindful of the work of the Historical Society I  
22 think rather than trying to talk about specific changes ahead  
23 that you're in sense addressing let me just take a few  
24 minutes to talk about some basic principles that I think  
25 ought to underlie any responsible approach to change. These



1 of course derive from our past experience and constitute a  
2 link to the future.

3 First, and this is really a reflection of economic  
4 challenges we face right now, is the obvious statement that  
5 our markets and the economy are independent -- interdependent  
6 and we now face very severe economic challenges. The  
7 unemployment rate a year ago was 3.9 percent. It is now 5.4  
8 percent and obviously climbing. It's gone from 4 percent to  
9 5.4 percent in just a matter of a few months. In October it  
10 went to 5.4 jumping from 4.9, the single biggest monthly jump  
11 in 15 years. Really the number of unemployed has gone from  
12 5.5 million to 7.75 million. In October we lost 415,000  
13 jobs, the largest drop since May of 1980. Of course, the  
14 economy had been shedding jobs in the previous months.

15 We have people now, another large increase in the  
16 number of people working part-time because they can't find  
17 full-time employment. And the Bureau of Labor Statistics  
18 tells us that these are persons whose hours were cut due to  
19 slack work or business conditions. And it's been spread  
20 across most industry groups.

21 So we face a very severe challenge and obviously  
22 one of the first priorities is to do what we can to get the  
23 economy back on track and functioning again. And I think  
24 it's obvious to say that the markets can't really prosper if  
25 the economy is not prospering. The two are obviously



1 interrelated. And we need I think always to keep that in  
2 mind.

3 The second I think very important principle is  
4 investor confidence. This is something about which I feel  
5 very strongly as many of you know from statements I've made  
6 of previous interaction. Indeed, it's the mandate of the  
7 Securities and Exchange Commission to preserve and strengthen  
8 that confidence.

9 William O. Douglas when he was chairman stated "we  
10 are the investor's advocate." The markets cannot operate  
11 efficiently unless they command the confidence of the men and  
12 women who invest in them.

13 Dick Grasso made this point very succinctly when  
14 he stated, and I quote him, "The investing public is the  
15 driving force behind the capital marketplace and, therefore,  
16 the single most important and influential constituency in  
17 determining the future of the markets."

18 The investing public today of course is large and  
19 diverse, more so than at any time in the past. Some 84  
20 million people of all occupations, ages and backgrounds are  
21 shareholders. About 40 percent of them have income below  
22 \$50,000 a year. Roughly half o all U.S. households now own  
23 equities directly or indirectly. And, of course, the  
24 regulatory scheme within which they invest relies heavily on  
25 full and fair disclosure.



1           The Commission's Office of Investor Education and  
2 Assistance has an important role to play. And I applaud an  
3 education program that has been expanded to include town  
4 meetings, publications and other forms of outreach. And we  
5 look forward to working very closely with Chairman Pitt and  
6 his colleagues in furthering this financial literacy effort  
7 as we look forward with Chairman Greenspan and Secretary  
8 O'Neil and with the private sector. I see many enterprises  
9 in the private sector instituting their own financial  
10 literacy programs. And we hope to encourage those and also  
11 derive some important lesson from them.

12           Disclosure becomes meaningless, of course, if  
13 stock and mutual fund prospectuses and other disclosures are  
14 not clear to the average investor. So I think the  
15 Commission's plain English program is an important  
16 initiative. Clarity of disclosure should be the benchmark  
17 for all forms of solicitation, including some thought needs  
18 to be given to the telephone and internet.

19           Increasingly investors receive cold calls from  
20 broker/dealers promoting stocks in small speculative  
21 companies. And figuring out I think how to promote standards  
22 in these solicitations is a challenge that ought to be  
23 addressed. Financial literacy presumes that an interested  
24 investor has timely access to material information. In the  
25 past, as we know, public corporations tended to treat





1 analysts and large investors as preferred customers giving  
2 them information before it became available to the general  
3 public. The Commission took an important step toward ending  
4 this practice with regulation and fair disclosure. And I am  
5 encouraged by a recent PriceWaterhouseCoopers survey that  
6 indicates a broadening acceptance of the new rule despite  
7 initial conflicts.

8 Investors need to be fully informed about the  
9 quality of the order execution. The SEC has adopted a final  
10 rule requiring the source for this information. And while  
11 the effective date has been extended I presume that the rule  
12 will be implemented and I think it will be helpful.

13 A focused and vigorous enforcement effort also  
14 goes hand in hand with disclosure. Of course, Harvey Pitt  
15 has moved through virtually every position in the SEC. I  
16 like a chairman who, let me just enumerate these, was staff  
17 attorney in the Commission's Office of General Counsel.  
18 That's where he started. Then legal assistant to SEC  
19 Commissioner Francis Wheat, Special Counsel in the Office of  
20 the General Counsel of the SEC, editor of the SEC's  
21 Institutional Investors Study Report, chief counsel of the  
22 SEC's Division of Market Regulation, executive assistant to  
23 the SEC Chairman Ray Garrett, and then finally the youngest  
24 General Counsel in the Commission's history. And I figure a  
25 chairman like that knows where all the bodies are buried.



1 (Laughter.)

2 I think that's a very important asset he carries  
3 in as he deals with his responsibility.

4 I think investors need to be able to count on the  
5 accuracy of the financial information they receive which  
6 applies both to the registrant's financial statements and the  
7 auditor's that certified. "USA Today" reported that in the  
8 past three years there have been 464 cases where financial  
9 statements had to be restated and that in 2001 more than  
10 \$31 billion in market value as wiped out when stock prices  
11 fell in certain companies after they restated their earnings.

12 The Commission's commitment to have a continuing  
13 dialogue and partnership with the accounting profession is  
14 commendable. I mean I'm a great believer in dialogue. We  
15 try to practice it on the Hill. And you can get a lot done  
16 as long as the goal remains to minimize the possibility for  
17 financial fraud and to respond forcefully should it occur.  
18 It seems obvious to me that a financial analysts cannot be  
19 susceptible to pressure from investment bankers and their  
20 firms. Important steps have been taken to remedy this  
21 problem. The SIA has instituted best practices. The NASD  
22 has issued a rule on some fronts that go on beyond that and  
23 reform their own practices. But I think it's a problem that  
24 cannot be ignored. And if you stop and think about it it  
25 obviously can undercut investor confidence.



1           The enforcement standards recently articulated by  
2           the Commission will take into account voluntary cooperation.  
3           And I'm supportive of this because the strategy improves  
4           compliance. And I'm willing to try what can work and if you  
5           can achieve the result with a light hand rather than a heavy  
6           hand, so much the better. But we need to achieve the  
7           results.

8           The SEC -- let me now just turn finally to  
9           something I feel very keenly about. The SEC's  
10          responsibilities are immense. And to carry them out the  
11          Commission needs resources commensurate with the task. I  
12          think this has been neglected. And I think that the  
13          Commission first of all must be able to offer a salary scale  
14          that will keep talented staff from having to move on for  
15          financial reasons.

16          At present the federal bank regulators are able to  
17          pay their professional staff on a higher salary scale than  
18          the SEC. So you have some instances in which people are  
19          moving not to go into the private sector where the gap is  
20          very large indeed but simply to shift over in the public  
21          sector in order to take advantage of the extra premium that  
22          the bank regulators are paid. This imbalance, that  
23          particular one, we can really never remedy the imbalance with  
24          the private sector, I think that's fairly obvious, but we can  
25          bring the public sector salary and benefits up to a level



1 where if that's the career that people want to commit  
2 themselves to they can do so and still be able to lead a  
3 reasonable life including educating their children which is  
4 often a major challenge.

5           The enactment of Investor and Capital Markets Fee  
6 Relief Act which the Majority Leader Daschle has promised to  
7 deal with this year will, of course, authorize pay parity for  
8 the Commission. And we anticipate the enacting of that  
9 legislation and at least addressing this particular problem  
10 in the near future. Obviously our securities markets if they  
11 are to remain the envy of the world need to attract as  
12 regulators people of high quality and dedication.

13           Secondly, the budget resources of the SEC in my  
14 judgment have not kept pace with the growth in the markets.  
15 For example, over a 10-year period the number of SEC review  
16 staff has remained stationary while the value of public  
17 offerings nearly tripled. The dollar volume of securities  
18 transactions on exchanges and over the counter has increased  
19 at an annual rate of some 35 percent, the number of SEC  
20 employees has increased at a rate less than 4 percent.

21           I'm concerned that its resources have been spread  
22 too thin, sufficiently concerned to have asked the General  
23 Accounting Officer for a study of this very question. This  
24 is not a new concern. Twenty years ago I remember raising  
25 with chairman designate John Shad this very issue and





1 actually pointing out at that time that an inadequate SEC  
2 staffing really throws a burden on a private sector since  
3 initiatives are often delayed or thwarted because they can't  
4 reach a speedy decision within a reasonable period of time.  
5 So the private sector in my judgment, and by and large the  
6 private sector that interrelates to the SEC has been good on  
7 this issue in recognizing that unless the SEC has adequate  
8 resources to do their job the consequence of that will be to  
9 thwart the private sector in its ability to move forward.

10 So the time periods in which people can get  
11 judgments and the quality of the judgments which they receive  
12 have to be at a high level that corresponds to the level of  
13 activity in the private sector. Obviously lagging pay scales  
14 and inadequate resources make it difficult to attract young  
15 and talented people graduating, coming out of school and to  
16 retain professional staff members in which the SEC has often  
17 made a huge investment in their training and their  
18 professional development. And I look forward to working with  
19 Chairman Pitt to ensure that the Commission has an adequate  
20 budget and competitive pay scale as we move into the next  
21 fiscal year.

22 Finally let me just close with this observation.  
23 More than any other assembly in America the group right here  
24 today recognizes that healthy markets are essential to  
25 keeping our economy strong and recognizes that the SEC has a



1 central role to play in ensuring the integrity of the markets  
2 on which investor confidence depends. In effect, a chain  
3 links the trust of the ordinary  
4 investor to the vigor of our economy. And it is the SEC's  
5 responsibility and that of the industry since it has an  
6 important self-regulating responsibility, it's their  
7 obligation to keep that chain between the investor confidence  
8 and the economy unbroken.

9 A dear friend of mine with whom I was in school  
10 and former commissioner once described the SEC as a jewel  
11 among government agencies. And those of you who are focused  
12 on the history of the SEC would fully appreciate the  
13 importance of that description. I am determined that that  
14 statement should stay true and that the SEC should, as it has  
15 done through so much of its past be a jewel among government  
16 agencies and maintain the very highest standards.

17 Thank you very.

18 (Applause.)

19 MR. RUDER: Thank you all. We will begin the  
20 program shortly in the next room. And, Senator Sarbanes, our  
21 greatest thank to you.

22 Chairman Pitt will be with you in a moment. Thank  
23 you.

24 (Recess.)

25 \\  
26



1                   A F T E R N O O N   S E S S I O N

2                   MR. PHILLIPS:  Let's begin this afternoon's  
3 session, "Regulation of Investment Funds, Investment Managers  
4 and Market Professionals."  Let me introduce Dave Silver, the  
5 moderator and panel leader of this panel.

6                   As many of you know, Dave is a former president  
7 for 14 years of the Investment Company Institute and recently  
8 retired for the second time from a five-year stint as  
9 Chairman of the ICI Mutual Insurance Company, the captive  
10 insurance carrier for the mutual fund industry.

11                  Going back before Dave joined the ICI he was a  
12 member of the SEC staff playing a prominent role in the  
13 special study of the securities markets, particularly in the  
14 chapters of the study on market structure and the roles of  
15 specialists and other professional participants in those  
16 markets.

17                  Dave brings a wealth of experience in the  
18 securities industry and in the investment management industry  
19 to this panel today.  In addition to experience in the  
20 domestic industry he has been very active as an advisor on  
21 investment company regulation in China and other foreign  
22 countries and prominently active in the investment company  
23 activities of IASCO.

24                  It gives me great pleasure to introduce my friend  
25 and colleague Dave Silver.

1                   REGULATION OF INVESTMENT FUNDS, INVESTMENT  
2 MANAGERS AND MARKET PROFESSIONALS: ARE CHANGES NEEDED IN  
3 ORDER TO PROTECT INVESTORS IN THE NEXT DECADE?

4                   MR. SILVER: Thank you, Dick.

5                   I have to say when we get to a '40 Act panel we  
6 get down to the real aficionados of regulation. I might also  
7 say, Dick, thank you again for your kind remarks. It was  
8 interesting capstoning my career with a stint as president of  
9 an insurance company because in all of the 30 years before  
10 that I thought I really knew what went on in the securities  
11 markets. However, it's only though when you become  
12 president of an insurance company and you get the claims that  
13 you really find out what goes on behind the scenes.

14                  I also have one apology to make. This panel is  
15 dedicated to giving you the total, complete, ultimate answers  
16 to all of the problems concerning investment management.  
17 However, that was predicated on a three hour panel. We've  
18 now lost a half an hour and the world will be deprived of  
19 those complete, total and ultimate answers to all of the  
20 problems.

21                  First I would assure you that this panel will not  
22 discuss the usual suspects at investment company regulatory  
23 panels. Thus, those of you who wanted to hear yet another  
24 session on the level of advisory fees or corporate governance  
25 as they pertain to mutual funds will have to go elsewhere.





1       Instead we will explore a different set of probably  
2       unanswerable questions about investment management issues  
3       which concern the scope of '40 Act regulatory coverage, hence  
4       the title of the background paper, "At the Frontiers."

5               The SEC has previously confronted the issue of the  
6       scope of its jurisdiction in the '40 Act context, most  
7       notably with respect to variable insurance products and bank  
8       commingled managed agency accounts. However, these products  
9       primarily involve the scope of specific statutory exemptions  
10      rather than the outer limits of the Act's primary coverage.

11             Recent years have seen rapidly changing  
12      technological and financial environments which have spawned  
13      new investment products unimaginable 60 years ago. These  
14      changes have created multiple challenges involving both the  
15      scope of the Commission's '40 Act authority as well as its  
16      ability to cope effectively with rapidly mutating products  
17      within its traditional jurisdiction.

18             In the background paper I saluted the truly heroic  
19      efforts of the Commission and its staff in keeping the  
20      Investment Company Act evergreen. However, as technology  
21      marches on in the 21st Century I believe there is now a  
22      legitimate question as to whether this 60-year-old statute  
23      already plastered over with bandaids is a prime candidate for  
24      a model changeover or merely requires a few more patches.  
25      Thus, lurking in the background of our discussion is whether



1 it is time to reexamine the Investment Company Act at a  
2 fundamental level and the interrelationships between the '40  
3 Act, the Advisors Act and the Exchange Act, each with  
4 different regulatory triggers and self-contained in a way  
5 which is no longer realistic in the modern world.

6 It is this latter point which I believe is in a  
7 sense complementary to real world developments. The mega-  
8 financial institutions of today are providers of a full range  
9 of both traditional and hybrid financial products and  
10 services which do not respect the product and provide  
11 boundary lines of the separate federal securities laws which  
12 themselves reflected the organization of the pre-Depression  
13 securities industry. In my view the amalgamation of  
14 providers and products which now exist on a continuum create  
15 a need for greater integration between the regulatory statutes.  
16 While this may be a thought for another day we will dip our  
17 toes into that water in the presentation of Stuart Willey,  
18 Chief Counsel for the regulation of investment management  
19 business of the U.K. Financial Services Authority which now  
20 administers a broadly integrated financial services  
21 regulatory statute.

22 Our other panelists are also superbly qualified to  
23 discuss newly developed investment products and arrangements  
24 which have strained if not fractured traditional regulatory  
25 concepts. Web based portfolio services which have added a

26 new dimension of empowerment to investors who want total

1 control over their investments but within a framework of  
2 professional advice is one of these products.

3 Steve Wallman, the father of web-based portfolio  
4 services that together with certain other products changed  
5 the traditional definition -- challenged the traditional  
6 definition of what constitutes an investment company will  
7 share his thoughts as to how these products fit or should fit  
8 within the federal securities laws. If web-based portfolio  
9 accounts fall outside the definitional test contained in  
10 Section 3(a)(4) of the Act the policy issue which Steve and  
11 his competitors must face sooner or later is whether  
12 investors in these services are being deprived of appropriate  
13 '40 Act protections. I do not say the whole '40 Act, I said  
14 appropriate '40 Act protections.

15 And one of the things we hopefully will get into  
16 is the fact that the '40 Act trigger of being an "organized  
17 group of persons" is an all or nothing proposition, you're  
18 either in the Act or you're out of the Act, irrespective of  
19 the fact that certain of your activities may call for certain  
20 of the protections contained in the '40 Act.

21 We will also discuss hedge funds, an arrangement  
22 that does rely on specific statutory exemptions from '40 Act  
23 regulation. The issue is whether these funds present risk to  
24 investors that could be ameliorated or avoided if they were  
25 brought under the '40 Act. I confess to some degree of



1     puzzlement as to why the single word "hedge" is used to  
2     encompass the 15 or so different kinds of funds with vastly  
3     different volatility expectations yet all bear the label of  
4     hedge funds.

5             Second, I am also puzzled as to how many  
6     individuals own these funds, who they are, have they received  
7     and relied on truly disinterested advice and do they have any  
8     meaningful understanding of the risks? In other words, are  
9     the 3(c)(1) and 3(c)(7) exemptions operating as well in the  
10    real world as in the world of statutory words?

11            I do confess to one bias, and that is a belief  
12    that the rich as well as the poor deserve the protection of  
13    the federal securities laws as well as being equally  
14    prohibited from sleeping under the bridges of Paris. I might  
15    have tempered the unflattering implications of my last remark  
16    if we did not have Jim Dannis with us who as a thoughtful and  
17    highly articulate spokesman for the hedge fund industry will,  
18    I am certain, give me my comeuppance.

19            In addition to probing beyond the frontiers of the  
20    '40 Act we will also consider two issues that have arisen  
21    within the periphery of the statute. I am referring  
22    particularly to the regulatory status of exchange traded  
23    funds and also to the dissatisfaction expressed by some  
24    segments of the securities industry about the prohibitions on  
25    affiliated transactions contained in Section 10 and 17 of the





1 Act. Exchange traded funds are an innovative breakthrough  
2 designed to combine the benefits of the instant liquidity  
3 available on stock exchanges to closed-end funds with net  
4 asset value redemptions heretofore the hallmark of open-end  
5 funds.

6 Over the years the securities industry and the SEC  
7 have grappled with the problem of the inevitable discounts  
8 from net asset value at which the shares of listed closed-end  
9 funds trade. Exchange traded funds seek to substantially  
10 eliminate the closed end discount through the creation of  
11 arbitrage opportunities by issuing two separate classes of  
12 shares, one entitled to net asset redemption and the other  
13 not. These funds, until now index funds, have seemed to live  
14 up to their promise. And it may well be that a 60-year  
15 breakthrough has occurred.

16 However, the SEC has not conducted, as far as I  
17 know, any evaluation in depth as to how these funds are being  
18 operated and their impact on the trading markets to determine  
19 how the exemptions granted by the Commission have worked out.  
20 It would seem that such a study may now be more important in  
21 view of the fact that the Commission has just issued its  
22 concept release seeking comments as to whether the exemptive  
23 relief granted to present ETFs should be extended to a new  
24 class of funds with managed portfolios.

25 If Steve Wallman is the father of web-based



1 portfolio services, Kathleen Moriarty is certainly the  
2 protective and effective legal godmother of ETFs. I do not  
3 know if there is anyone else who has spoken more lucidly and  
4 intelligently about this new development.

5           The second problem area I just mentioned as  
6 arising within the periphery of the '40 Act involves the  
7 prohibition against securities transactions between  
8 registered investment companies and various affiliated  
9 persons. The problem is one that surfaced a year or two ago  
10 when the Securities Industry Association urged the SEC to  
11 relax these prohibitions. While these restrictions are as  
12 old as the Act they have come to have a greater impact as  
13 highly diversified financial conglomerates emerge,  
14 particularly in the wake of the repeal of the Glass Steigel  
15 Act.

16           Steve West, who has practiced investment company  
17 law longer than any other practitioner I know, will comment on  
18 this issue as well as industry structural issues which he has  
19 thought about I know for at least the 40 years that we have  
20 discussed these matters.

21           It is significant to note that American-based  
22 organizations are joined by foreign financial organizations  
23 as complainants about the conflict of interest provisions of  
24 the '40 Act. During the 1980's the Investment Company  
25 Institute on behalf of the American fund industry discussed



1 the possibility of some form of reciprocity between the U.S.  
2 and the European Union. None of the issues that emerged  
3 appeared as intractable as the unwillingness of the Europeans  
4 to comply with the type of restrictions contained in Section  
5 17 of the Act. This is understandable in view of the fact  
6 that in several European countries securities transactions  
7 between funds and affiliates are permitted and are common.

8           Bob Pozen will comment on this and  
9 the other issues we discuss today. Bob's experience  
10 ranges from the academic to the practice of law and more  
11 lately as an industry executive as President of Fidelity  
12 Management and Research. In recent years he has served on  
13 the President's Commission on the future of the social  
14 security system, a much easier problem than the Investment  
15 Company Act conundrum.

16           A final word. As I have suggested, I hope our  
17 focus will be on whether the regulatory status of these  
18 products makes sense from the policy standpoint of investor  
19 protection. In this endeavor our starting point is the  
20 principles underlying the Investment Company Act as set forth  
21 in the background paper. I should emphasize that this is  
22 intended as a point of departure and not to imply that the  
23 '40 Act should apply in whole or in particular part to any of  
24 these products.

25           But should we stray too far afield or commit any



1 other foolish errors we will most certainly be called to  
2 account by Paul Roye who next week will have this third  
3 anniversary as Director of the Division of Investment  
4 Management. Paul was able to hit the ground running in his  
5 current job because of his years as a practitioner and his  
6 previous incarnation as a member of the SEC staff. He has  
7 had the burdens and satisfaction of presiding over the  
8 division during this period of innovation and change. And we  
9 all await his views on what the future holds.

10 That I think will serve as teeing up some of the  
11 issues and to introduce our distinguished group of panelists.  
12 And I next turn to Steve West to give us an overview and an  
13 inkling as to where the final and ultimate solutions lie to 14  
all of the problems.

15 MR. WEST: Thank you, David.

16 And I agree with your idea that most of the people  
17 here I'm sure are more interested in the '33 and '34 Act than  
18 they are in the Investment Company Act. Nevertheless, count  
19 your blessings that you don't have to go through another  
20 panel on the Public Utility Holding Company Act. So we're  
21 down to one of the oddball regulatory statutes.

22 My role as the first speaker here is to outline  
23 the general areas of regulatory concern for pooled products  
24 and investment managers. And this will lay the foundation  
25 for the subsequent analysis of whether or how several new

26 pooled products which David has mentioned should be regulated



1 under the '40 Act.

2           Eleven years ago in 1990, the 50th anniversary of  
3 the '40 act, I wrote a report for the Investment Company  
4 Institute which was predictably titled and appropriate for  
5 today's conference "The Investment  
6 Company Industry in the 1990's: A Rethinking of Regulatory  
7 Structure Appropriate for Investment Companies in the  
8 1990's, the Background and Premises for Regulation with  
9 Recommendations of the Board of Governors of the Investment  
10 Company Institute for Regulatory Changes."

11           In Tab 2 of the material, the tab that says  
12 "West paper," there is that summary of the 20 recommendations  
13 at the end of my Report. When I get back to that it's  
14 interesting to see how many of those recommendations have  
15 actually been adopted and how many have not been.

16           But before I get to that I would like to recite  
17 what I have identified as the nine regulatory areas of  
18 concern with respect to pooled products generally. And this  
19 listing of nine regulatory areas which the '40 Act addresses  
20 will be useful foundation in assessing whether some of these  
21 new products you'll hear about should be regulated or not and  
22 how they should be regulated based on whether they pose  
23 problems or potential abuses in the areas that I think the  
24 '40 Act has covered.

25           And I would just list the areas that the '40



1 Act encompasses. First is governance, which we all know  
2 about that is the corporate form of the independent  
3 directors.

4 The second is economic regulation of both  
5 management fees and distribution fees.

6 The third is capital structure, primarily focused  
7 on closed-end funds for a simplified capital structure and  
8 with open-end funds with the pass of a hand because they  
9 were absolutely unimportant at the day, one class of voting  
10 stock, that's it; disclosure of fundamentals of investment  
11 policies for the pool; custodial requirements, regulation of  
12 distribution of open-end fund shares under the '33 Act;  
13 issuance and redemption and repurchase of shares requirements  
14 so the shareholders and investors are not diluted in their  
15 asset value; the closed and open end dichotomy structure,  
16 you're either a closed-end company or an open-end company and  
17 there's no in between. That was originally the case. Now,  
18 of course, that has been modified.

19 And last and ninth is the one that I will speak to  
20 later which is the self-dealing situations and conflict  
21 protections for transactions with affiliated persons, that  
22 is between the pooled vehicle and affiliated persons,  
23 covered primarily by Section 17.

24 Going back to the regulatory recommendations  
25 that we made, I would like to see if I can find the list of



1     them and we can see what they were. They're in the materials  
2     as I said. But just running through them quickly there were  
3     20. And the point is that there were seven  
4     of those that were adopted or followed. And this is  
5     sort of interesting, the list of the ones that were adopted  
6     and followed are in the materials, but four of the ones were  
7     actually for changes and the SEC or the Congress actually  
8     made those changes to the regulatory structure. Three of the  
9     recommendations were not to change anything.

10                 So of the 20 regulations, seven got adopted.  
11     There are 13 still to go. As I look back on them they  
12     are still quite current and interesting to consider how  
13     things should be regulated.

14                 The two recommendations adopted that were most  
15     significant were the elimination of dual, duplicate state  
16     regulation of investment companies which was a big step  
17     forward. The second one which relates to Jim Dannis' hedge  
18     funds was to make exemptions for '40  
19     Act regulations for investors in pooled vehicles who were  
20     institutional type investors who presumably could protect  
21     themselves. And a number of these products, particularly  
22     Steve Wallman's product, is not under that approach of --  
23     he's a little different.

24                 Now I would like to get back to the subject of

1 Section 17 and what I consider the core protective section of  
2 the Act, and that is the overall treatment of transactions  
3 between a pool and its affiliated persons. I think that  
4 these particular prohibitions and limitations are central.  
5 And as I will say later should not be fiddled with or  
6 eliminated, and if they are, with great care.

7           There are three reasons for the flat prohibition  
8 against a principal transaction between a fund and its  
9 affiliated person. Primarily it relates to securities  
10 transaction but it could relate to any property. Most people  
11 assume that the real problem is fair pricing, fair transfer  
12 price between the affiliated person and the fund. And that  
13 clearly is one issue. It is the issue which can most easily  
14 be addressed if you have liquid markets and market  
15 information so that you can test the transfer price with the  
16 overall independent market.

17           But there are two other aspects that are not  
18 generally considered that I think raise potential abuses that  
19 should be considered carefully. The first of these is the  
20 inability to measure the profitability or revenue stream  
21 which the sponsors are taking from the fund to themselves.  
22 You will note that Section 17 does permit affiliated  
23 brokerage transactions. One of the reasons for that or one  
24 of the reasons that it does not present this problem, is that  
25 you can measure the amount of the brokerage commissions going



1 to the affiliated person. So you can put those transactions  
2 into some sort of perspective as to what the affiliated person  
3 is taking from the fund or how they're dealing with the fund.

4 With principal transactions you cannot do that  
5 because, and I'm talking particularly of principal transactions  
6 dealing out of inventory; you cannot measure the profit  
7 or loss, all you can do is measure the principal volume which  
8 doesn't tell you much. So there is that issue of non-  
9 transparency so that the regulators cannot distinguish or the  
10 public cannot distinguish the amount of potential revenue  
11 that the sponsor is getting from the fund that he's running.

12 The third one, again, that is not usually thought  
13 of is a motivational issue which can never be measured. And  
14 that's one of the reasons why a prohibition works as opposed 15  
16 to an attempt to regulate. By a motivational issue what I  
17 mean is the reasons an affiliated person may have to either  
18 increase or reduce his inventory of the security related  
19 to prices at the time and using the fund as his sort of  
20 backup reservoir for inventory control. As a result the fund  
21 potentially could make  
22 transactions which are more for the reasons of the inventory  
23 of the affiliated person than for the purposes of investment  
24 of the fund.

25 Now, these things all sound like bad things. And,  
of course, I'm not suggesting anybody would do any of those.





1 The problem from a regulatory point of view is that nobody  
2 can measure them and nobody can really see what's happening.  
3 And that's the difficulty with elimination or weakening  
4 of Section 17. I might say that I don't think the prohibition  
5 should apply to riskless principal trades where these  
6 particular items of concern don't exist.

7 So in conclusion I would like to suggest to Mr.  
8 Roye and the SEC and future regulators that the burden of  
9 proof for extending Section 17(a) exemptions or even its  
10 elimination is high. And the benefits to the public are  
11 somewhat obscure, of course, except for the sponsors of  
12 the funds that have affiliated dealers who can trade.

13 I don't think the investors in the funds are  
14 suffering because the fund can't deal with an affiliate  
15 except in special circumstances which have been given  
16 exemptions. And if they are suffering there is a  
17 disclosure issue and I don't see any disclosure that those  
18 funds are suffering. A lot of funds that are sponsored  
19 by dealers and cannot deal with them as principal in many  
20 markets are doing well. So I think there should be a very  
21 serious concern of any extension of those exemptions.

22 And one last point on this, as David mentioned,  
23 this was the rock on which global reciprocity of fund sales  
24 crashed. The one area which the Europeans and the sponsors  
25 of USITs funds in Europe would not give up was the ability to



1 deal on a principal basis with their affiliated dealers. And  
2 I think that suggests the reason for that, it is very  
3 profitable.

4 So with that conclusion and that hope for the  
5 future of regulatory conflict of interest statutes and also  
6 the nine principles of regulation we will turn to the next  
7 speakers who will have products that we'll see whether any of  
8 those nine principles really apply to their products.

9 MR. SILVER: Could I, before letting Steve and Bob  
10 off the hook, note that one may agree with you that principle  
11 is on one side of this, but spelled the other way. But  
12 perhaps there is a doctrine of necessity which supersedes.  
13 If the trend towards mega-financial institutions continues I  
14 don't suggest we're going to get down to five providers as in  
15 Germany, but if you end up with 20 or 30 or 50  
16 mega-financial institutions aren't you depriving the  
17 shareholders of the funds sponsored by these financial  
18 institutions the ability to deal with the sponsoring  
19 institution who after all may be the primary markets for  
20 certain securities or the primary underwriters of certain  
21 securities?

22 MR. WEST: That clearly is a consideration. When  
23 it comes to that but I don't think we're anywhere near that  
24 in this situation in the capital markets today. I think,  
25 Bob, you had something?



1           MR. POZEN: I was just going to pursue that  
2 same line to say to broaden it out a little for the  
3 audience, the reason why this was the big issue between the  
4 U.S. and Europe when there was a committee. I think  
5 it was called the Committee of Experts so everybody felt very  
6 good about being on this committee. But the key was that all  
7 the continental European institutions were universal banks  
8 which had underwriting securities firms as part of the banks,  
9 and so this was the way they did it. Everything you say  
10 being true, Steve, they would say they've had this system for  
11 years and it's worked.

12           I think it's unusual when you think about it, that  
13 the U.S. mutual fund industry at the top  
14 is actually dominated by a relatively small number of  
15 independent firms, Fidelity, Vanguard, Capital Research  
16 and Putnam which is a subsidiary of Marsh Mack. So  
17 that the history of the mutual fund industry is one that  
18 grows up more out of Boston than out of New York, and is one  
19 of independent money managers which were not  
20 attached to the securities underwriting firms.

21           So I guess I'd like to emphasize that this is at  
22 one level a technical issue and there are various technical  
23 arguments which you've articulated very well. But really  
24 ultimately the issue comes down to a broader question:  
25 what will be the structure of the industry? As David



1 says, as we move to more conglomeration, this question will  
2 become more important. So I would say if we were to change  
3 Section 17 we would accelerate the change in  
4 the structure of investment management.

5 In short, underlying the Section 17 debate is a  
6 major policy question about how we want these sorts of  
7 investment management firms to be organized.

8 MR. WEST: You're absolutely right. And that is  
9 clearly the origin. And I would say to the Europeans, well,  
10 this is the way you've done it and it seems to work but you  
11 don't know that it's worked well, you don't know what the  
12 abuses are. And the other hand you could do business with  
13 your competitors, they just didn't feel they wanted to.  
14 That's a different point than David's point where you have  
15 a principal market maker. But in Germany there were five or  
16 six sources of trading markets.

17 MR. POZEN: And we've had example that takes a  
18 step toward the European model - the 10(f) exemption where  
19 if you do securities underwriting and you're a major  
20 underwriter, your affiliated funds can buy from the syndicate  
21 even though you're part of the syndicate. Of course, there  
22 are a variety of protections built into that exemption so  
23 that, say, if Merrill was involved with the underwriting  
24 it was the main underwriter, then Merrill wouldn't profit  
25 as part of the syndicate if another firm in the syndicate





1 sold municipal bonds to a Merrill fund.

2 So I think there's already been some  
3 flexibility in that one context. And that's probably  
4 because the municipal bond underwriting is  
5 dominated by a set of firms all of which have funds.

6 So again, if this were  
7 only a technical problem, we could probably come up with a  
8 technical solution. But it's essentially a structural issue  
9 about how we want the investment management industry to be  
10 structured in the United States. And that's a very big  
11 issue.

12 MR. WEST: This was one of the issues we would  
13 have solved in the last half hour if we had it.

14 MR. ROYE: David, if I could just add one point on  
15 the necessary issues, I mean there is -- the Commission has  
16 accepted the necessity argument in several cases involving  
17 funds, principally money market funds where the affiliate was  
18 a large dealer in money market instruments. We've issued  
19 several orders allowing the funds to deal with an affiliated  
20 dealer with appropriate protections in those situations.

1 And, you know, the argument was that the funds would be  
22 disadvantaged, they couldn't deal with the principal dealer  
23 in those securities.

24 And there are a series of protective conditions  
25 that we have in those securities, you're talking about very



1 liquid type instruments and, you know, there's price  
2 transparency and, you know, lesser concerns in those kind of  
3 securities. But there is precedent for that concept.

4 MR. SILVER: These are ones with transparency and  
5 sell on a yield basis basically. But I have been really  
6 waiting to hear from Kathleen as to how someone or some  
7 people have managed to square the circle. For as  
8 long as I remember engineers within and without the industry  
9 have tried to find a way to end or ameliorate the discount at  
10 which closed-end, listed closed-end funds sell.

11 Kathleen is going to tell us how this was done and  
12 what the future holds.

13 MS. MORIARTY: Good afternoon. Two disclaimers.  
14 Like Annette, I am sitting -- I mean I am standing. No, I'm  
15 also small in size.

16 The second thing is I've neither been a regulator  
17 nor a professor so I probably am distinguished from most  
18 other people in that regard on this panel and the other  
19 panelists. I'm more of a journeyman lawyer who got involved  
20 quite by accident in an exercise conducted by some people at  
21 the American Stock Exchange. And talk about the law of  
22 unintended consequences it was really not an exercise in  
23 trying to figure out a way to solve all the problems of the  
24 world or to square the circle within the '40 Act. It arrived  
25 or derived from a number of pragmatic questions and issues.



1           And the two main driving sources I suppose you  
2 could say of the construct of this industry was the first was  
3 the American Stock Exchange was interested in thinking of  
4 additional products that it could bring to bear to the market  
5 because it was losing share to the NASD and the New York and  
6 it was being marginalized to some degree. So that was an  
7 exchange issue, if you will.

8           The other issue was that at the time, this really  
9 began say in '88 although it wasn't presented at the  
10 Commission at that point, program trading had been more and  
11 more available to large institutions for a variety of  
12 reasons, including technology. And the efficacy of that and  
13 the desire for that kind of activity was trickling down into  
14 midsize institutions and to smaller, perhaps wealthier  
15 individuals and there was a desire to achieve some of the  
16 benefits of program trading for a smaller investor.

17           So with that the thought was really dreamt up by  
18 Nate Most who had a commodities background. And Nate's view  
19 was taking, for example, the S&P 500 which was the original  
20 ETF in this country, based on the original ETF of this  
21 country, he regarded the S&P 500 as a basket of 500  
22 securities much in the way you would look at a variety of oil  
23 barrels or bushels of wheat. And his thought was why  
24 couldn't you lodge the 500 securities in one place and then  
25 issue receipts for those 500 securities and trade the



1 receipts and leave the 500 securities in place.

2           So he had that kind of fundamental idea in mind.  
3 And a lot of it was kicked around as to how it would fit into  
4 the regulatory structure that was present at the time. And  
5 the idea was ultimately to create something as simple as  
6 possible but that would have some ability to change as the  
7 underlying basket changed. The idea of an ADR or a  
8 depository receipt wasn't quite right because for a variety  
9 of reasons it couldn't really change. And on the other hand  
10 an open-end fund at that time wasn't desired because the  
11 construct didn't really contemplate a lot of management. The  
12 idea was to have a pool of securities that could change as  
13 the index changed but otherwise not to very much else but to  
14 provide a cheap, efficient and transparent real time vehicle  
15 to own the 500 or some other index product.

16           So that's how it really devolved. And so the unit  
17 trust structure was chosen because it was a sort of a halfway  
18 point between a depository receipt and an open-end vehicle.  
19 And so we went about approaching the Commission with the  
20 question of whether or not we could create a unit investment  
21 trust which does issue redeemable securities like an open-end  
22 fund and is, of course, required to price at NAV, etc., just  
23 like an open-end fund, whether that vehicle could, in  
24 addition to issuing securities on that basis, fractionalize  
25 those shares into small pieces and sell the small pieces on





1 an exchange the way a closed-end fund did.

2 And the way that this was going to be achieved,  
3 and I have to give the Commission and the staff great credit,  
4 they really listened to this sort of off-the-wall scheme and  
5 were ultimately persuaded by a series of hypothetical  
6 arguments because in fact no vehicle at that point had  
7 existed. So we could only present what we thought might  
8 happen and try to work within the construct of the Act.

9 It was never desired that the fundamental  
10 protections of the '40 Act wouldn't extend to the  
11 shareholders. The real issue on the exchange fund side as  
12 really trying to get certain prohibitions or limitations or  
13 restrictions limited or changed to allow the structure of the  
14 vehicle to operate. So there weren't issues, for instance,  
15 involving Section 17 or a whole variety of mechanisms  
16 provided to correct the original abuses of the '40 Act.  
17 Really rather it was when the '40 Act was adopted, as Steve  
18 said, it had divided the constructs into closed ends and open  
19 ends. And, you know, one issued continuously and at NAV only  
20 and one traded on an exchange only and the two didn't mesh.  
21 And we wanted to mesh the two of them.

22 So that's really where a huge portion of the  
23 effort and discussion went forward. And that was combined  
24 with the concept that to make the thing work easily and  
25 cheaply and efficiently the fund itself would accept not cash



1 contributions but would accept the basket in kind, again the  
2 commodity concept. So people who wanted to contribute to the  
3 fund were going to deliver, in the case of the S&P 500, all  
4 500 stocks in the correct basket weighted mechanism that  
5 reflected the S&P 500.

6 And, similarly, if those people were going to  
7 redeem they were going to get the in kind basket. So it was  
8 going to eliminate a huge number of transaction costs and  
9 settlement charges and a whole variety of things.

10 MR. SILVER: Taxes.

11 MS. MORIARTY: Well, that was an unintended  
12 consequence. No one was thinking about taxes. We were  
13 really thinking about the efficiency and economy of trading  
14 baskets because, again, the thing had the genesis in a  
15 program trade.

16 So the concept was the big players would  
17 contribute or redeem at NAV the basket and the pieces that  
18 were traded would be traded on the exchange at market price.  
19 And the market price would hopefully come close the NAV  
20 because since you have a totally open-ended vehicle, unlike a  
21 closed-end vehicle you have continuous issuance and you have  
22 redemption, the vehicle can open and close with market demand  
23 so you don't have a premium discount problem because the  
24 market demand isn't involved with a vehicle that has either  
25 too limited a supply or too much of a supply.



1           So what would happen theoretically was  
2 arbitrageurs would, depending on which way the share price  
3 was deviating from the actual NAV or the portfolio basket's  
4 value, depending on which way it went either arbitrageurs or  
5 other large market players would come in and contribute more  
6 and make the fund larger, make the shares more available and  
7 then drive the price down. Or if the price were the reverse,  
8 buy the shares and redeem them and contract the fund. And  
9 that largely has been the outcome.

10           The Amex is at some point going to be publishing a  
11 study that they have commissioned to analyze all of the  
12 spreads between the prices been share price and the basket  
13 price. And I think what you'll see is, no surprise to  
14 anybody and a lot of this has been written up already, that  
15 the larger the fund, the more liquid the fund, the more  
16 liquid the underlying shares, and especially in a domestic  
17 context of you're talking about domestically traded the  
18 underlying shares, the closer the price and the NAV will be  
19 to each other. As you move into a highly illiquid, thinly  
20 traded basket of underlying shares and/or shares that are not  
21 issued in this country but somewhere else and trade in a  
22 different time you have a variety of other issues which  
23 slightly make the NAV and the share price that's traded  
24 different, but not considerably different.

25           So that was really the genesis of the product.



1 And then in addition to that we required a whole bunch of '34  
2 Act exemptions because we really wanted the receipts or the  
3 fractionalized interests that were traded to be treated like  
4 an equity security in a secondary market, like an industrial  
5 share, so they could be margined, they could be shorted, they  
6 could be treated subject to limit orders, what have you.

7 So actually an ETF in a way is sort of a hybrid of  
8 a closed end and open end and an industrial share in terms of  
9 the way it's traded. And it both drove and is driven by the  
10 technology of the time. This would not have been possible 20  
11 years ago.

12 What we are now seeing is two sets of things. One  
13 set of things is that different baskets and different  
14 products are now being thought about converting into an ETF  
15 structure or adding on an ETF share class. And the most  
16 talked about one is the actively traded fund. And the  
17 Commission has just issued a concept release last week and it  
18 asks a number of interesting questions. And I think those of  
19 us involved will be extremely interested to see what the  
20 comments are and what the Commission's response is.

21 In addition to that, this idea has caught on  
22 rapidly in the past two years abroad. And two years ago when  
23 I was at a conference somebody from London didn't know what  
24 an ETF was and thought it was just a, you know, closed-end  
25 fund. Two years later there are ETFs in a variety of





1 countries with a variety range of places in Asia, Canada,  
2 here, Europe and a variety of other places.

3           And that's where we begin to see cross-listing.  
4 And when you start seeing cross-listing with the ultimate  
5 desire of 24/7 trading you begin to see the issues that were  
6 just talked about which is how do you merge and harmonize,  
7 say, a European version of how a pooled vehicle works as  
8 opposed to an American version? And there are fundamental  
9 principles as to how you regulate this industry whether it's  
10 done by independent directors or whether it's done by a  
11 unified banking system as a fundamental issue.

12           So it's a wonderful area to practice in because it  
13 sort of crosses all lines and raises a lot of questions. My  
14 own point of view is the '40 Act has served the ETF industry  
15 well. Oftentimes when we come down to the Commission to talk  
16 about a new product we think we've thought of all the answers  
17 and they often ask questions that despite our best efforts we  
18 never thought about. So it's a real compromise and a working  
19 collaboration.

20           The only thing I would echo that's been said  
21 before is at the IM in particular is woefully understaffed  
22 and underpaid and, therefore, the exemptive process which I  
23 think works takes too long therefore really allowing only the  
24 largest players to be innovators because it costs a lot of  
25 time and money. Some of these products have taken three or



1 four years to go through the pipeline.

2 But I think the '40 Act is a flexible creature. I  
3 think it works.

4 MR. SILVER: Thank you, Kathleen.

5 I have one question, perhaps a little far out.  
6 But I'm fascinated by the role of the arbitrageurs in this  
7 picture. I assume, and go along with my assumption for a  
8 moment, that many of the arbitrageurs have either laid off  
9 already through derivatives or shorting a position that they  
10 acquire, so that there is really a kind of minimal risk to  
11 the arbitrageurs. The fund has created the opportunity for  
12 arbitrage by creating two classes of securities, one of which  
13 never existed before.

14 Does a fund director have some kind of obligation  
15 to determine whether there are other ways to do this so that  
16 there is not a third party taking an opportunity which the  
17 company, the investment company itself might have? To take  
18 an obvious example, could an investment company create a  
19 subsidiary that would do exactly the same thing that the  
20 arbitrageurs are doing at a fairly low risk level?

21 Those of you whose memory goes way back would  
22 recognize the fact that I'm posing a kind of Moses against  
23 Burgin situation in which there may be an opportunity on the  
24 part of the fund being given to third parties.

25 MS. MORIARTY: A couple of thoughts on that. One



1 is, of course, the original creatures were unit trusts. They  
2 did not have a board of directors. So that would not have  
3 come up in that context. Most of the newer ones, however,  
4 are open end companies and hence their boards certainly could  
5 consider that question.

6 I will say, and this will come as a surprise to  
7 Paul, that I have had some discussions with certain people  
8 who are thinking of doing just that or in fact aren't even  
9 thinking of going the subsidiary route but are contemplating  
10 just buying back their own shares under the same concept. So  
11 that's now so off the wall as you might suggest.

12 I can see pluses and minuses on both sides of  
13 that. On the one hand you could argue -- I mean I take issue  
14 with the concept that these are two sets of classes. They  
15 are really one class, some of which, some of which have  
16 slightly less rights than the others so you could argue  
17 that's two classes. Functionally they're one class.

18 On the one hand you could argue that the fund is  
19 never harmed by the secondary market trading because it takes  
20 place outside of the fund and that the fund only holds the  
21 basket that it holds and only gives up the basket or takes in  
22 the basket at NAV. So there is never any dilution problem.

23 You could also argue that the fund might be able  
24 to benefit from arbitrage trading and therefore help its  
25 shareholders. Depending on the circumstance -- and I'm not



1 an arbitrageur -- you might be able to find yourself in a  
2 situation where the fund might be able to trade ahead of all  
3 other arbitrageurs in which case you might be preferring the  
4 fund to all others. And then that might be a policy question  
5 as to whether that's a good idea or not.

6 From a practical point of view if somehow the fund  
7 had an advantage over trading against all other market makers  
8 no other market makers would play. So it might work out just  
9 fine.

10 MR. SILVER: I have a second question. Perhaps if  
11 --

12 MR. ROYE: David, before you go to your second  
13 question, if I could maybe just respond to that question.  
14 And before I do respond let me just make it clear that these  
15 are my views, they don't necessarily reflect the views of the  
16 Commission.

17 But I mean your question as to whether or not the  
18 directors have an obligation, you know, to pursue these  
19 arbitrage opportunities --

20 MR. SILVER: To look at it.

21 MR. ROYE: Well, you know certainly they're free  
22 to look at it. I mean whether or not they have an obligation  
23 I don't think, my own view is that I don't think they do have  
24 an obligation to pursue the opportunity. However, if the  
25 directors do want to pursue the opportunity, the fund wants





1 to pursue the opportunity directly or through a separate  
2 subsidiary I think we'd be concerned about the issues that  
3 that introduces into the product, perhaps introducing  
4 conflict of interest type concerns, motivation to profit  
5 through the arbitrage mechanism could raise concerns. And  
6 we'd also have to look at, you know, maybe some 17(d) issues  
7 which is another affiliated transaction provision that  
8 deserves some clarity.

9 MR. SILVER: The second question was really  
10 addressed to you also as well as Kathleen.

11 I read the concept release with great interest and  
12 you touched upon this. I'm not certain as to how this fits  
13 into the regulatory imperatives that will determine whether  
14 or not you grant the exemptions, but with presently existing  
15 ETFs and perhaps with the new ones there is a whole market  
16 impact question I think to be explored.

17 Traditionally we know at times  
18 of great market stress the open-end funds have generally met  
19 the increased redemptions on the day of a market break  
20 through the cash position that the fund has. So, in fact,  
21 not intended this way historically but it has worked out that  
22 in times of market stress the open-end industry has acted in  
23 a sense you might say as an auxiliary specialist or whatever  
24 you want to say, it absorbs selling pressure and  
25 doesn't transmit that pressure into the primary market.



1                   With the BFT's all sales by existing  
2                   shareholders of the funds are pretty much immediately  
3                   transferred into the primary market. So that you can get a  
4                   very different effect, market impact as these funds operate.  
5                   And I go back to the origins of the '40 Act where one of the  
6                   great concerns and is the reason that provisions were put in  
7                   the Act for a so-called size study was what would happen if  
8                   open-end funds got into a situation where they dumped  
9                   securities into the market at times of market stress? So  
10                  that certainly the framers of the '40 Act were concerned  
11                  about this kind of problem. Are you going to look into  
12                  analyzing this from say a '34 Act point of view and not only  
13                  from a '40 Act point of view?

14                  MR. ROYE: I think it's fair to say if you look at  
15                  the concept release that we do ask for comment generally on  
16                  the impact that ETFs have had, the existing ETF products.  
17                  There have been I guess assertions that ETFs have contributed  
18                  to volatility in the markets, particularly for example the  
19                  cubes in the Nasdaq market. And I know we've taken a look at  
20                  that issue and our economists have looked at this issue and  
21                  haven't been able to identify a correlation.

22                  But we do ask for comment on that issue and just  
23                  impacts on the existing products. And we're also seeking  
24                  views on what may happen with some of the new products that  
25                  Kathleen is talking about.



1 MR. SILVER: Do you have any comment?

2 MS. MORIARTY: I would say, and I have to caveat  
3 this because I'm really bad with numbers which is why I  
4 became a lawyer, but my understanding anecdotally, and I  
5 think probably there will be studies and discussions in the  
6 press, etc., my understanding is that on the days of the  
7 greatest stress some of these funds have had their greatest  
8 inflows of contributions partly because people are covering  
9 their shorts so the portfolios are increased to meet the  
10 shares to cover the shorts.

11 The other thing is that the arbitrage -- well, if  
12 you talk to upstairs market makers, regular market makers,  
13 specialists what they pretty much consistently say is that  
14 rather than impeding liquidity the existence of ETFs has  
15 rather helped liquidity. And what I usually hear it  
16 described as, as either a triangular stool or some other sort  
17 of three part type creature they usually say the liquidity is  
18 enhanced if you have a market for the underlying shares and  
19 then you have futures markets for the same underlying shares  
20 and then you have ETFs for the same thing, you have three  
21 ways of achieving liquidity and it actually enhances and  
22 supports the market.

23 So I without, you know, being a statistician or  
24 seeing all the data I would think that at least from my own  
25 experience and what I've heard that it's rather the reverse,



1 that it helps rather than hurts.

2 MR. ROYE: I think when you look at the -- there  
3 was a study done after the '87 market crash and I think  
4 indeed one of the recommendations was that if you had a  
5 product like the index ETFs that it would enhance liquidity.

6 MR. SILVER: Next, moving on, we have the first of  
7 two panelists who are making special appearances here today.  
8 Just as in a court challenging the jurisdiction so they are  
9 not conceding that they have anything to do with the '40 Act  
10 but as a matter of courtesy they're going to tell us why.

11 And first Jim Dannis speaking on behalf of the  
12 hedge funds.

13 MR. DANNIS: Thank you, David.

14 David referred to me in his kind introduction as a  
15 spokesperson for the hedge fund industry. To paraphrase: if  
16 nominated I will not stand, and if elected I will not serve.  
17 There are security issues. These comments today are solely  
18 my own.

19 What I'd like to do is divide my presentation, my  
20 ten minutes, into two parts. First I'd like to give a very  
21 quick overview of the hedge fund sector, talk about some of  
22 the trends that we observe as investors in hedge funds. And  
23 let me footnote this: my firm is an investor in hedge  
24 funds. And so when talk turns to investor protections we  
25 speak from the position of looking at protections that would





1 be made available to us if they were felt to be necessary.  
2 When you hear my comments you'll see that we generally  
3 feel these protections are not necessary in the current  
4 environment. But in any event, I want to give an overview  
5 of the sector and then turn back to the questions that David  
6 highlighted in his introduction. They are important and  
7 challenging questions. I don't want to simply present the  
8 fact that hedge funds are exempt or largely exempt from  
9 regulation and then sit down. Really what we need to do is  
10 look at the question of benefits and burdens and be sure that  
11 the current regulatory scheme is appropriate and protects  
12 investors and markets.

13 The hedge fund sector -- by the way, these  
14 slides are in people's books as well. So if you can't see  
15 the small text on the screen just pull them out.

16 The hedge fund sector is significant and it's  
17 growing very rapidly. We estimate that there are currently  
18 about 6,000 hedge funds globally managing about \$500 billion  
19 of assets before leverage. You can contrast that with the  
20 usual reference point for the size of the U.S. mutual fund  
21 industry which is about \$7 trillion.

22 The funds flows into the hedge fund sector have  
23 been particularly strong. The slide reflects funds flows only  
24 to June. If you update that to September, there was \$22  
25 billion net inflow into hedge funds for the first 9 months



1 of the year. That's almost three times the amount that  
2 flowed into hedge funds for all of the prior year. And so  
3 clearly this is a sector that is large and is growing.

4 Now, I don't have time in my ten minutes to take  
5 up David's invitation and try to distinguish the 15 or 20 or  
6 indeed infinite number of different hedge fund investment  
7 strategies or describe why some of them are hedged and in  
8 fact some of them are not. Let me leave it at this, the  
9 categorization you see on the slide shows a traditional  
10 breakdown of different hedge fund asset classes.

11 I think the take-away point from this is that what  
12 we call the long/short equity strategy, which really is the  
13 traditional hedge fund going back to 1949, the Albert Jones  
14 model, that's the bulk of the hedge fund sector. Almost 50  
15 percent of hedge fund assets are in what we call long/short.  
16 And what is long/short? It's simply managing a combined  
17 portfolio of long and short equity positions with a view to  
18 minimizing downside risks and achieving an absolute return  
19 regardless of market conditions.

20 The investor base for hedge funds is changing. If  
21 you were to have a similar presentation to this ten years ago  
22 virtually all investors in hedge funds would have been  
23 individuals. There was a very small hedge fund investor base  
24 and a very small number of hedge funds. Access was  
25 difficult and it tended to be word of mouth. A very limited,



1 small club.

2           Clearly, wealthy individuals and family offices  
3 still remain the dominant investor base for hedge funds.  
4 This data is from a report by Freeman & Co. who specializes  
5 in asset management issues. Their estimate is that  
6 somewhere around 80 percent of hedge fund capital is  
7 provided by individual and family offices.

8           While that's the case, there is a very important  
9 trend that has occurred really over the last couple of years,  
10 and that is the increasing institutional participation in the  
11 hedge fund market. I will come back to this in a second. It  
12 really is changing the character of the hedge fund industry  
13 and is changing the kind of demands that are being placed on  
14 hedge funds in terms of their business practices, their  
15 disclosure and a whole range of items.

16           The point is institutional demand is growing  
17 substantially. By one metric pension funds, U.S. pension  
18 funds, are forecast to increase their exposures to hedge  
19 funds by two to three times over the next couple of years.

20           One of the things that flows from increased  
21 institutional interest in hedge funds is the Street response.  
22 If you look at the standard asset allocation  
23 models used by the Street firms now, hedge funds are  
24 often treated as a separate asset  
25 class and have a place in the asset allocation models. This



1 is just one example.

2           So why are hedge funds attracting this increased  
3 interest of investors and, in particular, institutional  
4 investors? There are really four reasons for it. And let me  
5 run through them very quickly.

6           The first is returns. We can come back to the  
7 question of how the numbers are reported and what the numbers  
8 really mean because I'm the first to say that the various  
9 information bases published about hedge fund performance are  
10 imperfect. But if you look at  
11 the numbers as far as we can sort them as investors, the main  
12 point here is that hedge funds can provide attractive risk-  
13 adjusted returns. Look at merger arbitrage in the upper  
14 left-hand corner of this scatter chart and you see that the  
15 return for the strategy over the 10-year time series is  
16 roughly the same as the S&P 500 but with a volatility roughly  
17 the same as U.S. bonds. So what does that mean? Equity-like  
18 return, bond-like volatility. That's interesting.

19           Capital preservation, the second reason, has  
20 become all the more acute during the difficult markets we  
21 faced in the last several months. This is a run we did  
22 from September 2000 through the end of September 2001  
23 and it shows the performance of long/short equity hedge  
24 funds. Again this is roughly 50 percent of the hedge fund 25  
asset class. We show returns versus the marketing



26 indices, and we also put in Lipper large cap core mutual

1 funds. What does the graph show? It shows that the hedge  
2 funds managed to preserve capital when long only investors  
3 obviously did not.

4           The third point about hedge funds which is  
5 interesting for those of you who are students of portfolio  
6 construction is that they have low or moderate, let's just  
7 call it modest, correlations to traditional asset classes.  
8 And we put some data up here on the chart. What that means is  
9 that for an institution which is interested in constructing a  
10 diversified portfolio, the addition of hedge funds can  
11 essentially improve the efficient frontier. What do I mean  
12 by that? For a given level of risk the addition of hedge  
13 funds can improve the return. For a given target return  
14 the addition of hedge funds can reduce risk.

15           The final point is a qualitative one but it's  
16 really quite important. If you look at the last several  
17 years, and indeed if you look back even longer than that, you  
18 see a steady migration from the propriety desks at investment  
19 banks and from the traditional asset management firms into  
20 the hedge fund space. A reason for that obviously is  
21 the compensation incentives which can be much higher in  
22 hedge fund land. But what it tells the investor is that  
23 if I believe that active management can provide  
24 value and I believe that I want to find the smartest and the  
25 most talented managers to provide active management services



1 to me, I find increasingly that I look at the hedge fund  
2 sector for those services.

3 Let me skip over a couple of slides here.

4 There's a market driven trend which is actually  
5 quite significant in terms of the way the hedge fund market  
6 is structured now. Intermediaries, by which I mean  
7 consultants and also funds of hedge funds, of which our firm  
8 is one, are playing an increasing role in the marketplace.  
9 What intermediaries basically do is address the fact that the  
10 hedge fund space has exploded. There is now a much larger  
11 number of funds. There is now a much more difficult job in  
12 terms of screening them, doing diligence on them, assessing  
13 them, and constructing a portfolio that optimizes the values  
14 you're seeking to optimize.

15 So the end result is that individual investors as  
16 well as institutions are increasingly using professional  
17 intermediaries to access and make allocations to hedge funds.  
18 That's a very important difference, again, from the way the  
19 world worked only a couple of years ago in this sector.  
20 Again, the numbers are difficult to make precise, but our  
21 estimate is that of hedge fund demand in the aggregate, funds  
22 of funds account for roughly 20 to 30 percent.

23 Let me come back now to the questions that David  
24 outlined. The way that David cast it, and this is really the  
25 principal issue, do hedge funds present risks to investors



1 that could be ameliorated or avoided if hedge funds were  
2 subject to the 1940 Act?

3 I think that's a very easy question to answer.  
4 And the answer, of course, is yes.

5 If you were to apply the full set of substantive  
6 requirements of the '40 Act to hedge funds would risks to  
7 investors -- I'll come back to what "risks" mean --  
8 theoretically be reduced? Of course they would. But the  
9 hedge fund sector I think would, at least as we know it  
10 today, not exist.

11 You can make an analogy to private placements.  
12 You could ask yourself if private  
13 placements of securities, to come back to this morning's  
14 panel, present risks to investors that could be ameliorated  
15 if we were to apply the full registration, prospectus and  
16 civil liability provisions for public offerings. That's a  
17 given. The point is what's the right balance here?

18 The conclusion that I come to as an investor in  
19 the market is that the ability for sophisticated investors,  
20 be they individuals or institutions, to have access to a  
21 highly innovative and highly professional set of money  
22 managers is the right balance. The exemptive provisions of  
23 the securities law, and the other members of the panel  
24 can speak much more eloquently than I about the legislative  
25 background and the policies, make a very basic



1 judgment or cut. And that is that sophisticated investors  
2 should have access to innovative products in the marketplace.  
3 And that basically is the judgment that is supporting the  
4 exemption for hedge funds.

5 As a quick addendum, many of us fall into the trap  
6 of saying hedge funds are unregulated. Of course that's not  
7 true. And Paul and the staff have done what I think is a  
8 tremendous job in going after some of the clear abuses and  
9 frauds that occur in the hedge fund space. And antifraud  
10 provisions do apply to hedge funds. If assets are stolen, 11  
11 if marketing materials are materially misleading well, of  
12 course, the antifraud provisions apply. And, again, I  
13 think that that's a very important thing in coming to a  
14 conclusion about the overall balancing of risks and rewards  
15 of the current regulatory model.

16 Let me end it right there. I think I may have  
17 used close to my ten minutes. And we can open it for  
18 discussion and questions.

19 MR. SILVER: Thanks, Jim.

20 I think that implied in what you said, and perhaps  
21 under the current regulatory regime, we are faced with  
22 an unfortunate dichotomy, either you're in the Investment  
23 Company Act or you're out of it. And I certainly agree that  
24 a lot of the things that hedge funds may legitimately do  
25 would be very difficult if not impossible under the Act. But





1 we're talking about the brave new world of the future on this  
2 panel and why should, for example, to take a somewhat  
3 noncontroversial point, or I hope noncontroversial, why  
4 shouldn't the securities custodial provisions of the '40 Act  
5 apply to hedge funds? If they're a good thing for investment  
6 companies why aren't they a good thing for hedge funds?

7 Why are the rich folks, as I said before, not  
8 getting the same protections as the poor folks? Why aren't  
9 they getting the prospectus? Why aren't they subject to the  
10 same disclosure provisions and advertising restrictions at  
11 open-end funds?

12 These would not inhibit the investment activities  
13 of the funds. But as I say, unfortunately, under the present  
14 setup it seems that you're wholly in or you're wholly out.  
15 And I was puzzled at the Commission staff's 1992 report which  
16 said that we have to have private investment companies not  
17 subject to the Act. It kind of always seemed to me that the  
18 staff threw up its hands and realized that to try to reform  
19 the Investment Company Act to make it more modular was  
20 probably a more difficult task than simply throwing up their  
21 hands and say, okay, you go have this wholly outside the Act.

22 MR. DANNIS: Let me answer that with two slices.  
23 The first observation would be that the  
24 practices that institutions are bringing to the hedge fund  
25 market, and by that I mean the pension funds who are



1 investing, their consultants and intermediaries like  
2 ourselves, on matters such as custody, disclosure, regular  
3 periodic disclosure, monitoring use of leverage, use of  
4 derivatives, organizational structure, the whole gamut of  
5 items that I think would be covered in the nine items  
6 mentioned as the stalwarts of investment company  
7 regulation, the institutions are looking at those points as  
8 we decide whether to make an investment in a hedge fund or  
9 not.

10                 So the first question is whether there is really  
11 a need for imposition of that set of rules when the investor  
12 base understands the policies underlying them and is  
13 protecting its own investment. And, again, from our  
14 perspective we certainly ask everyone that we invest with,  
15 and indeed everyone that we consider investing with, "tell us  
16 about your custody, let's look at your disclosure."

17                 Then the second cut, very quickly,  
18 is a policy reason not to import piecemeal some of  
19 the preexisting pieces of the '40 Act. Although I agree, you  
20 could make a good argument that it's not that painful.

21                 I think the downside to that is we're not creative  
22 enough today to imagine what innovations, what changes, what  
23 developments may occur in the future. And, again, why upset  
24 the basic balance if as a policy matter that basic balance is  
25 working?



1 MR. SILVER: Paul, you wanted to comment?

2 MR. ROYE: Yes. I was going to ask James as  
3 follow-up to his answer to your question, David, whether or  
4 not he has a sense that the hedge fund industry is large  
5 enough at this point that, you know, some of the practices  
6 that the institutions are forcing on the hedge fund community  
7 could be reflected in best practices. You have the Managed  
8 Funds Association that's out there that represents the hedge  
9 fund industry. But they're hedge funds that are here today,  
10 gone tomorrow.

11 Is the industry at a state where some of these  
12 practices could be reflected in the industry could step up to  
13 the plate on these issues?

14 MR. DANNIS: That's an excellent question. And I  
15 think that my reaction to it is that that may well become  
16 a focus and a trend in the future. Looking  
17 at it historically, looking at what's happened so far,  
18 there's been relatively little in terms of organized efforts  
19 to get hedge fund investors or managers or intermediaries  
20 together to define and to put into practice best practice  
21 standards. The only one I can think of is there is  
22 something called IAFE, I-A-F-E, which I must confess I wasn't  
23 deeply familiar with before I read their product. And they  
24 got together a group of investors including institutions and  
25 hedge fund managers and did a relatively thorough job of



1 describing the costs and benefits of disclosure of positions  
2 depending on the strategy that was used by a hedge  
3 fund.

4                   Now, the reason why I mention that is that  
5 it really hasn't received a great deal of  
6 currency in the hedge fund community. You have to dig to  
7 find it. And it really hasn't been something that people  
8 say, oh, gee, let's use this as a reference point. I think  
9 the industry is still very young in the sense of participation  
10 of institutions and professionalization. So I think industry  
11 organization may well come but it's a bit early.

12                   MR. POZEN: Could I ask a question? As  
13 someone who has been involved in the mutual fund  
14 industry, one of the biggest concerns  
15 is the differential in the regulation of fees.  
16 The '40 Act allows performance fees, which one would think  
17 generally would be good for shareholders because they align  
18 the interests of the shareholders with the managers. With a  
19 performance fee, the manager has a base fee and does better  
20 if the fund does better than some benchmark and does worse if  
21 the fund does worse. I did a quick survey in connection  
22 with the 2<sup>nd</sup> edition of my book and found that approximately  
23 140 of the seven or eight thousand funds in the industry  
24 had performance fees. This is an incredibly low number.  
25 Moreover, those 140 were almost all concentrated in a very



1 small number of complexes. And one of those complexes only  
2 had them in cases where they had sub-advisors. So that would  
3 show you something about how rarely performance fees are used.

4 I think the reason is that the SEC's rules on  
5 performance fees are very strict. They require a symmetrical  
6 structure, the same on the downside as the upside over  
7 certain periods against certain types of benchmarks. In the  
8 hedge fund industry by contrast, it's well known you usually  
9 have a base fee, which can be 1 percent, or even 1.5 percent  
10 of assets, and then you usually have a 20 percent performance  
11 fee only the upside after a certain return is reached.

12 Now, I can see arguments for both situations. I  
13 can see arguments for the SEC's position on strict  
14 symmetrical rules. I can see arguments for more flexible  
15 performance rules. But the thing that's very difficult is  
16 for mutual funds to be in a situation where we're under this  
17 very strict set of rules and hedge funds are  
18 not. The result has been, as your chart shows,  
19 that some managers have left mutual funds  
20 to go to hedge funds. These managers see that 20  
21 percent of the upside, with nothing on the downside, is not a  
22 bad deal.

1                   Again, I can see arguments for both sides. But  
2 right now we have this tremendous disparity and that I find  
3 hard to accept. Either we should have similar rules in which  
4 both mutual funds and hedge funds have flexibility in  
5 performance fees or we should have rules in which both sides  
6 have to live by stricter rules.

7                   MR. SILVER: Jim? Paul?

8                   MR. ROYE: Well, on the performance fee front I  
9 mean I can say in the three years I've been Division Director  
10 I don't think we've had a fund group or anyone from a fund  
11 come in and say we'd like to charge a hedge fund type  
12 performance fee.

13                  MR. POZEN: I think that's because your no-action  
14 letters have made it very clear that there are extremely  
15 limited circumstances in which that would be a worthwhile  
16 discussion.

17                  MR. ROYE: Yeah. You know, the current  
18 performance fee formulation is a fulcrum fee. You know, if  
19 you underperform your fee is reduced, if you overperform you  
20 get a bonus. I don't know if we want to debate the theory  
21 and --

22                  MR. POZEN: Plus your performance has to exceed  
23 the benchmark after expenses.

1                   MR. ROYE: Yeah. But theoretically, and some of  
2 my investment advisor staff colleagues can correct me if I'm  
3 wrong here, but theoretically you could have a fund if you  
4 had the right type of investors in the fund, i.e.  
5 sophisticated investors, and charge a hedge fund type  
6 performance fee. I think the rule contemplates that.

7                   But you're right, I mean the problem of the  
8 difference in the compensation has led to some interesting  
9 issues for us because we see more and more mutual fund  
10 managers looking to sponsor hedge funds. And, you know,  
11 Laurie Richards and Gene Golkie can, you know, tell you  
12 about, you know, some of the conflicts and issues that  
13 creates in terms of, you know, the same manager managing a  
14 mutual fund and managing a hedge fund and situations where  
15 maybe the manager participates, you know, directly in the  
16 profitability of the hedge fund.

17                   You know, so it does raise some issues. And, you  
18 know, maybe it's something that we need to think about, the  
19 compensation structures and how they're structured.

20                   MR. DANNIS: I'd add just a small overlay to that.  
21 I think that if the field is to be leveled my vote is to  
22 allow more flexibility in the regulated mutual fund side.

23                   (Laughter.)

24                   MR. ROYE: Thank you. We appreciate your support.

25                   MR. SILVER: I think Steve West has a comment.



1 But I might say that in 1970 when the advisor fulcrum fee was  
2 worked out between the SEC and the industry Dick Phillips,  
3 Steve and myself came up I think with that ingenious  
4 provision. And as Kathleen said, we're all lawyers and  
5 therefore we couldn't add. So nobody has used it since as  
6 Bob points out.

7 MR. WEST: I'd like to point out that this  
8 particular discussion is an excellent illustration of the  
9 type of regulation that the Commission and others should  
10 think about in the future. What Bob Pozen raised is a type  
11 of regulation that focuses on competition among the industry  
12 players. That's sort of the European antitrust concept.

13 What we have traditionally focused on here and I  
14 think would be the other side of this is regulation for the  
15 benefit of the public users or investors. So, therefore, if  
16 you're dealing with a public product which is the regulated  
17 mutual fund you think in terms of what's a good idea for the  
18 investor and fair and you come up with a symmetrical  
19 performance fee.

20 On the other hand, if you're thinking about  
21 competition and the flow of talent and all those kind of  
22 things, and unfair competition, you think about, well,  
23 anybody who's in this business whether it's the rich guy,  
24 it's the poor guy, it's the public or the little guys, they  
25 all should be writing letters saying economics rules. And so



1 I think it's a perfect illustration of that dichotomy as to  
2 what regulation should really be doing here.

3 MR. DANNIS: Let me add just one point which is  
4 the observation that embedding a hedge fund in a mutual fund  
5 structure can raise conflicts or incentives that need to be  
6 looked at. I don't want to wade into that because it's an  
7 issue that I think is really to some extent industry  
8 response to the point that Bob and I have been discussing  
9 and that we've all been discussing about the fee  
10 structures.

11 But from the perspective of an investor in hedge  
12 funds certainly it's high on our list to look at conflicts  
13 and incentives. And generally speaking the practices that we  
14 employ would require that to invest in a hedge fund embedded  
15 in a mutual fund structure we've got to climb up a fairly  
16 steep hill to get comfortable. So, again, I think that's an  
17 area where to the extent there is a regulatory focus it  
18 probably makes some sense.

19 MR. SILVER: I've been told that 4:00 o'clock is  
20 upon us and we have a 15 minute break. And after the break I  
21 assure you we will get to those ultimate questions and solve  
22 them to everyone's satisfaction.

23 (Brief recess.)

24 MR. SILVER: Jim Dannis had a good argument that  
25 he shouldn't be here. Steve Wallman has a slightly different





1 kind of argument that he doesn't even belong in this building  
2 at this point. And by this time he must wonder what he's  
3 doing here. But he'll tell us.

4           So, Steve, why don't you go ahead with the  
5 investment service that I characterized and really meant it  
6 as one of the two great innovations in the investment  
7 management area and really does empower investors to an  
8 extent that we've never seen before. And I think as you  
9 commented or someone else commented before, a highly  
10 technologically driven product and depending as it does on  
11 the internet really is at the cutting edge of investment  
12 management services broadly defined.

13           Go ahead, Steve.

14           MR. WALLMAN: Thank you, Dave.

15           And you're absolutely right. I should not be  
16 here. This should be a broker/dealer panel asking the panel  
17 of why mutual funds are not regulated as broker/dealers which  
18 I think is a much more pervasive and seminal question to ask.  
19 It's far more important and I think it's one that we should  
20 have an entire session devoted to. But in the meantime we'll  
21 go to this.

22           I thought it would be useful to give you a little  
23 bit of background on what we're talking about because I think  
24 there is a lot of misunderstanding about what folio investing  
25 is all about and what this innovation allows people to do. I

1 think we can do it quite quickly.

2           If you go and think about what we had in the  
3 beginning, the beginning meaning sometime in the last maybe  
4 60 years we've had basically two kinds of investment vehicles  
5 for people to use as means or services, products systems,  
6 however you want to define it, to invest in if you're the  
7 investing public. One as stocks, one was mutual funds.

8           Those break down, of course, in different things.  
9 Mutual funds can be passive or actively managed, indexed,  
10 etc. Stocks can be offered through full service brokerages  
11 or discount brokerages. But basically you have stocks, you  
12 have mutual funds.

13           Mutual funds had some great advantages. They  
14 offered cost-effective means to diversify. Professional  
15 portfolio management frequently was embedded within the  
16 mutual funds, especially if they're actively managed funds.  
17 Stocks obviously have terrific advantages too, control and  
18 flexibility as to what it is you're actually owning, tax  
19 efficiency compared to funds in a major way.

20           Stocks also have disadvantages as to funds.  
21 There's inadequate diversification through just owning a few  
22 stocks. You don't get the benefit of thinking about your  
23 investments as a portfolio. And those of you experienced  
24 with portfolio theory know that portfolios actually act  
25 differently than just simply the sum of the underlying

1 stocks. They're also difficult to select stocks. They're  
2 high cost even with some of the deepest discount brokerages.  
3 You can't do simple things. No dollar based investing and  
4 you can't really do cost effective odd lot trading.

5 With mutual funds you get a similar set of  
6 disadvantages. Lack of customization: you can't really  
7 decide for yourself what you want to own. Inability to  
8 control taxes, not only the famous problem with regards to  
9 the capital gains distributions when investors don't want  
10 them but the inability more importantly to actually, for  
11 example, harvest tax losses in a fund which you can do if you  
12 own underlying stocks. High fees for higher assets, little  
13 flexibility in pricing in the traditional fund vehicle. And  
14 because you don't understand what's in the fund many times,  
15 the lack of transparency, you can get things like style  
16 drift, etc. And, of course, from a corporate governance  
17 perspective there is no way for the individual investor to be  
18 able to vote the underlying securities.

19 Technology though now offers the ability to  
20 combine the advantages of both. You can get through a new  
21 system like folio investing diversification. Professional  
22 portfolio management can also be provided as a separate  
23 activity. You can have the control and flexibility of  
24 stocks, tax efficiency, etc., etc.

25 Looking at it a different way, if you want to look

1 at it from the standpoint of investment management what  
2 technology now allows for is a remarkable amount of  
3 customization and tax efficiency as well as lower  
4 distribution costs and a superior vehicle for delivery  
5 basically the core asset management concept and it's simply a  
6 different delivery vehicle. You can take investment  
7 management and deliver it through traditional '40 Act company  
8 structures and through new structures such as ETFs, or you  
9 can take investment management and deliver it through what  
10 has traditionally been viewed as separate managed accounts  
11 which is what the wire houses have been doing for decades now  
12 or through folio type offerings.

13 So one value add is the investment management,  
14 another value add are different kinds of delivery vehicles  
15 that let you do different things. The thing is that the  
16 delivery vehicles are in fact different. And because of the  
17 differences there are differences in how they're regulated.

18 Consumers also have recognized the benefits of  
19 some of these different delivery vehicles such as managed  
20 accounts. They've demanded them. And if you look at the  
21 actual growth rates over the last half decade, and it's been  
22 increasing actually and accelerating, you'll see that  
23 separate managed accounts have really been something that  
24 investors have recognized the benefits of and have been  
25 embracing.

1                   Let me give a very brief overview of folio  
2 investing itself. It is a brokerage account. It's regulated  
3 as a brokerage offering. The fees are clear and they're  
4 charged to the holder of the account as opposed to in a  
5 mutual fund, for example, where from our own studies and  
6 others we know that investors frequently don't understand how  
7 much they're being charged in a mutual fund. And in some  
8 cases don't even know that they're being charged in a mutual  
9 fund.

10                   We actually did a survey and found that about  
11 three-quarters of the people surveyed did not realize that  
12 mutual funds had any cost on them. And we then asked how  
13 people thought they were having the fund compensated and  
14 people were saying, well, we're not sure. But when you press  
15 them they came up with some interesting ideas, some of which  
16 we may create a product around. Things like the companies  
17 were actually paying to be in the mutual fund itself and  
18 that's how the mutual fund was making its money. People  
19 didn't think they were being charged.

20                   So clearly there are some inadequacies with regard  
21 to the current disclosures that are not in the same kind of  
22 concerns that you have in a brokerage account.

23                   There's obviously nothing that's a security that's  
24 offered, there's nothing to be redeemed. If you go through  
25 the nine factors that Steve West described, folio investing

1 really doesn't implicate any of them.

2           What else you can do with folio investing? It's  
3 entire baskets of folios of stocks. They can be bought  
4 quickly and easily. They can be bought obviously by an  
5 individual investor but also by advisors. They can be also  
6 managed. And each folios can be customized at any time and  
7 from time to time by whoever had authority over the account.

8           In addition, each account's completely separate.  
9 It can be opened, added to, subtracted, closed, moved to  
10 another brokerage without any impact on others. If you own  
11 half of all the accounts that would be with Foliofn and you  
12 wanted to sell them all, that's great, and it has no tax  
13 impact on the other people who continue to hold accounts with  
14 Foliofn who decide not to sell.

15           If on the other hand you had a mutual fund and  
16 half the fund were sold and liquidated it's going to have a  
17 tax impact on the other people in the fund.

18           Investors can vote the underlying securities.  
19 They can sell specific tax lots, harvest tax losses, etc.,  
20 all because they directly own the securities in the folio.

21           How does it all work? What do people do? Let me  
22 give you a quick overview. If we had an internet connection  
23 we could actually set up an account. I actually would  
24 suggest that people go home and try this on your own. You  
25 can go to foliofn.com. I actually insist that you try it and

1 use real money. Just open an account, go in and see how it  
2 works.

3 (Laughter.)

4 And you'll be amazed at how simple and easy it is  
5 to use. But what you can do is you can either start with  
6 what we call a ready-to-go folio or you can build your own or  
7 you can ask us for some assistance with regard to choosing a  
8 folio.

9 The ready-to-go folios are ones that in our case  
10 are currently all sort of modeled after other indices or  
11 otherwise objectively determines. We have, for example, a  
12 market folio which is basically the S&P 50, top 50 in the  
13 S&P. We have a conservative folio which is a slice of the  
14 S&P but made with a beta that's less than one, etc. And you  
15 can look through, we have about 100 different folios that  
16 people can browse through and examine.

17 If you click through and want to know what's in a  
18 folio not only do you get to see what the stocks are you get  
19 to see the exact percentages, the weights that each stock  
20 comprises of the folio. In addition then you can just simply  
21 decide on what you want to invest, like 1,000 bucks, and  
22 you'll then see that you can get exact, precise amounts of  
23 each of the stocks. So you will get exactly the amount in a  
24 percentage allocation that reflects how much money you put  
25 into the folio.

1           The interesting thing is that you can then go in  
2 and you can change anything you want. So, for example, if  
3 you had all those stocks and you decided you wanted to buy  
4 some additional amounts for one or the other or eliminate a  
5 stock altogether from the folio or add a new stock to the  
6 folio that we didn't have you can do any of those things. So  
7 you can add new stocks, you can buy more of something, and  
8 you can simply sell everything or not buy it at all if this  
9 is your first purchase of any stock.

10           So the folio can be basically anything you want.  
11 At the end of the day it's a collection of stocks, it's a  
12 basket of stocks. And because it's a basket of stocks you  
13 can do all sorts of fancy things with it. For example, when  
14 you decide to sell some of the stocks you can select which  
15 tax lots you want to sell and you can select the ones that  
16 will minimize your taxable gain, or depending on your tax  
17 strategy you might want to select something else.

18           In addition, you can set up automatic stock  
19 exclusions, at least in a system like ours, which shows you  
20 how customized this kind of system is. Is there anything  
21 resembling a mutual fund here? I don't think so. You can go  
22 in and you can look at this and --

23           MR. SILVER: We'll come to that, Steve.

24           (Laughter.)

25           MR. WALLMAN: Find me a fund that does this.



1                   And you can make these exclusions on your own and  
2 decide for yourselves what you want to include or what you  
3 don't want to include.

4                   You can also look at these as basket type vehicles  
5 and look at various performance measures. But you can also  
6 then, as mentioned, go back in and on any particular stock  
7 that's in a folio you get to vote it, you get to see the  
8 annual report, you can decide for yourself how a proxy will  
9 be cast, etc. In essence, you're in complete control of  
10 every security, every position that is in the portfolio and  
11 you can buy it, sell it as you wish.

12                   Investment management itself is now truly  
13 benefitted by this. Mutual funds themselves who we view as  
14 complements not competitors ultimately because review of  
15 mutual funds is really having a value add not in the delivery  
16 vehicle, I don't think most mutual funds view the delivery  
17 vehicle as their value add, it's the investment management  
18 that's embedded in the delivery vehicle. That's their value  
19 add, it's the management that goes with it. That's the value  
20 add. We just provide another delivery vehicle for that  
21 investment management.

22                   But the nice thing about this kind of a system is  
23 you can not run it across the entire spectrum of, if you  
24 will, account types from non-discretionary all the way  
25 through to completely managed. And you can now create all

1 new kinds of accounts, if you will, that can be suggested  
2 accounts, advised accounts, accounts that can be switched  
3 back and forth from managed to advised to discretionary or  
4 non-discretionary basically at the flip of a switch. And  
5 that you can't do with any of the current systems and you  
6 can't do it obviously with funds.

7           So folios are the basis for self-directed  
8 investing or advisor-assisted investing or for managed  
9 accounts. But no matter how they're used they share a couple  
10 of underlying fundamental concepts. One is that the owner  
11 owns the underlying stocks directly and has all the  
12 additional protections and benefits of that ownership or  
13 control and the protections that come from a brokerage  
14 account.

15           On to the issue of investor protection then.  
16 There are two main areas of concern that you might think of  
17 that the '40 Act as a general manner at high level tries to  
18 address. One is the whole question of pooled investments,  
19 commingling of assets. It's the notion of a fund. And all  
20 the things that happen because of the new issue of security,  
21 because of a fund itself: lack of transparency, lack of  
22 control of the assets, lack of control with regard to the tax  
23 impacts, the fact that what one investor does does in fact  
24 affect other investors, the inability of an investor to  
25 transfer the underlying securities out to someplace else,

1 etc.

2           None of those things apply, of course, to what you  
3 just saw. None of those apply to folios. There's nothing  
4 mutual in a folio. There's nothing that's a fund in a folio.

5           The second sort of broad issue is that of  
6 discretionary control or advice, the potential if you will  
7 for someone else to steer investors wrong, take advantage to  
8 create some kind of conflict of interest or some other kind  
9 of abuse. And in that case, of course, brokers and advisors  
10 as well as funds can and do all have discretion. There's  
11 nothing unique to folios that creates that. There's nothing  
12 that is specific to the notion of a non-fund that creates  
13 that. It's a question of whether or not somebody else has  
14 discretion which could be in a advised account, it can be in  
15 a fund context.

16           So the potential for abuse of course exists with  
17 regard to the exercise, whenever there is an exercise of  
18 discretion. And it has existed in connection with funds. It  
19 exists and has existed in connection with brokerage accounts.  
20 And it can occur, of course, also with the offering of folios  
21 because folios are a brokerage account. And to the extent  
22 you can have conflicts in that context it can be a conflict  
23 in our context as well.

24           But whenever there is discretion or advice applied  
25 there are rules currently on the books that address it. And

1 the proper approach if there is an abuse not covered by those  
2 roles, which doesn't appear to be the case in this instance,  
3 those regulations are the ones that should be modified.  
4 Basically address the issue if there is one instead of  
5 hypothetical issues as to what might occur if somebody did  
6 something differently and wouldn't it be nice if you put them  
7 under some other statute.

8           The concept quite simply is if there is a concern  
9 with regard to the delivery of advice or the exercise of  
10 discretion we have rules that are addressing the delivery  
11 advice and the exercise of discretion in the context,  
12 specifically for example, of brokerage accounts. Those are  
13 the rules that ought to apply, those are the rules that in  
14 fact with regard to folios do apply. And if there's an  
15 argument that says somehow or other those aren't sufficient  
16 then they should be addressed generally with regard to the  
17 issues of brokerage accounts where there is advice or  
18 discretion, not with regard to some hypothetical relating to  
19 something that happens to compete with mutual funds.

20           In addition, the benefits of folio technology can  
21 actually solve a number of other regulatory concerns and  
22 issues. For example, we just had the discussion about hedge  
23 funds. One of the issues that's come up in the context of  
24 hedge funds is the question of the commingling of funds and  
25 the fact that the assets are all put together and that that

1 has implications. And it even has implications for the way  
2 some hedge funds work.

3           Some hedge funds, for example, won't allow  
4 withdrawals except for annually or certain other time frames  
5 for two reasons. One is because of the ability to manage the  
6 fund if you will but also because of the implications that  
7 that may have with regard to other investors in the fund.  
8 With this kind of technology you can avoid a number of those  
9 kinds of issues because there isn't any impact on another  
10 from the other's actions because there's no partnership,  
11 there's no fund. But you can still manage, if you will, in  
12 an easy, seamless, synchronized and central way because of  
13 what technology permits you to do.

14           Our technology, for example, allows someone to set  
15 up a model and then have quite literally 1,000 or 10,000  
16 accounts all synchronized to that model, all run separately,  
17 all managed separately and all able to accept or not  
18 additional funds or be closed out whenever somebody wishes  
19 without having impacts on others, all of them however  
20 synchronized to the same fundamental model and master  
21 accounts.

22           Investors quite simply want this kind of new  
23 technology. They are looking for those alternatives, a  
24 separate managed account, progress and huge growth proves  
25 that. So far the Commission has focused and I think needs to

1 continue to focus as it has on protecting investors not  
2 competitors. We have other agencies out there that spend  
3 their time focusing on protecting competitors. This agency  
4 is supposed to be focusing on protecting investors. That  
5 approach has I think benefitted investors and markets and the  
6 economy overall.

7 And the issue then should be what's the  
8 appropriate form of regulation going forward. And,  
9 obviously, in my view it should be to regulate whatever the  
10 regulatory concerns are and to address those not the form of  
11 something as to who it may be competing with and by virtue of  
12 the fact that it may compete with something suggested that  
13 has to be regulated like it. And if that were to be the  
14 case, of course my view is that mutual funds should be  
15 regulated like brokerages.

16 That I think is it. And I appreciate your time.

17 MR. SILVER: Thank you.

18 MR. WALLMAN: Did I do my job ?

19 MR. SILVER: You certainly did. I admire your  
20 legal policy argumentation almost as much as I admire your  
21 product.

22 (Laughter.)

23 MR. SILVER: I have to say in 19 --

24 MR. WALLMAN: We appreciate all of your  
25 investments in our services.

1           MR. SILVER: They're coming. I've looked at that  
2 website and I'll be one of your big salesmen in the future.  
3 Well, you're not supposed to have salesmen. Well, perhaps  
4 as a broker/dealer you can have salesmen.

5           Back though in 1972 when the Commission was first  
6 tinkering with mini-accounts under the Advisors Act the  
7 question of status came up and I remember debating this with  
8 Allen Mostoff I think at a conference, and I said, Allen,  
9 someday, someday some genius -- and I thought it was going to  
10 be Jack Bogel, I said Jack Bogel in '72 -- is going to figure  
11 out how to disaggregate a mutual fund and you'll find out  
12 that you aren't regulating anything. I thought it going to  
13 be Bogel. I was wrong. It was Wallman. And I guess Steve  
14 Steve wasn't even thinking of this back in '72. But I guess  
15 an idea in itself is not patentable anymore.

16           MR. WALLMAN: Hold it. Hold it, hold it. We're  
17 not sure of that. Certainly not our position.

18           MR. SILVER: I would say though, Steve, that this  
19 conference happily is not the usually meat and potatoes  
20 conference to figure out whether you can do something  
21 and how should you do it and everyone takes notes and goes  
22 home and files the appropriate papers. We're kind of forward  
23 looking at this conference. And I can see that in ten years  
24 you and your competitors are going to have \$20, \$40, \$60, \$80  
25 billion in your accounts. So let's talk about your industry

1 as it will be and not as it is today in its inception.

2 I agree with you if we were sticking to present  
3 law and the whole question is are you an investment company,  
4 since 3(c)(4) says you have to have an organized group of  
5 persons to be an investment company, you have a very good  
6 argument and end of case. But should that be the end of  
7 case, as Steve West pointed out this morning there are  
8 nine identifiable areas of investor protection under the  
9 Investment Company Act. There is a constellation of  
10 investor protection under the Securities Exchange Act.

11 Now, let me just take one protection which I said  
12 before was perhaps non-controversial but it can rapidly  
13 become controversial I suppose, custody of securities.  
14 Under the Investment Company Act the fund's assets are not  
15 only segregated from the manager's assets but any profit,  
16 ancillary profit that comes from use of an investment company  
17 securities, say security lending programs, etc., must enure  
18 to the benefit of the fund.

19 Under the Exchange Act, if I recall Exchange Act  
20 regulation, broker/dealers can use customers' assets in the  
21 conduct of their own business. They can lend it out, etc.,  
22 etc., etc. So you have protection under the Exchange Act  
23 against misappropriation, theft and all the rest of it.  
24 But you have a custodial regime very different than that  
25 under the Investment Company Act.



1                   What is different, my first question would be,  
2                   between your arrangement and mutual funds from the point of  
3                   view of how that \$20 or \$40 or \$60 billion should be  
4                   protected? Who should be able to profit from the use of  
5                   customers' or investors' securities?

6                   The second question I have is, again, you have a  
7                   prospectus delivery requirements and liability flowing from  
8                   prospectus abuse. In the registered investment company  
9                   context broker/dealers don't have that.

10                  Third, you have, changing the flow a little, the  
11                  empirical questions which I think have to be looked at. I'm  
12                  not sure where they lead you. But the question is how many  
13                  of your investors really do change the portfolios which you  
14                  offer to them or how many just accept them and go on with  
15                  them as if from their point of view they have a mutual fund  
16                  and from their point of view it may turn out that they really  
17                  just have legally a virtual mutual fund but they haven't got  
18                  a mutual fund at all. From that investor's point of view why  
19                  shouldn't that investor receive at least some of the investor  
20                  protections under the Investment Company Act rather than the  
21                  far looser kind of regulation never meant for asset  
22                  administration under the Exchange Act?

23                  Now, I buy large portions of your basic argument.  
24                  The governance system that applies to registered mutual funds  
25                  really has no bearing I think on what you do. But I suspect

1 and I suggest that this may be a defect in current law where  
2 you are in the Investment Company Act or you're out of the  
3 Investment Company Act. If you had a more modular regulatory  
4 structure available to the Commission you might have elements  
5 of the Advisors Act, elements of the Investment Company Act  
6 and broker/dealer regulation,  
7 applying to products that were never even thought  
8 of when the Exchange Act was drafted in '34 and when the  
9 Investment Company and Advisors Act were drafted in 1940.

10 So I think under present law your arguments are  
11 very, very good, make sense. But the question is what do you  
12 have going forward?

13 MR. WALLMAN: Yes.

14 I think the question you're raising is the one  
15 that I think of interest given that I think the rest of the  
16 panel has currently conceded the fact that we're not a mutual  
17 fund. So I will stipulate to that and move forward.

18 Looking at what we ought to do going forward then  
19 I think really is quite simple. If you take the '40 Act,  
20 just as you described, it didn't contemplate this. The  
21 notion of, therefore, taking its provisions as if somehow or  
22 the other and for some reason they should be what applies,  
23 even if you do it in a modular piecemeal form, doesn't really  
24 answer the question. The question is what are the abuses  
25 that might exist that ought to be taken into account and that

1 ought to be regulated appropriately?

2 I'm a former regulator. I clearly believe that  
3 regulation makes a lot of sense. We wouldn't be here today  
4 as a small company but for regulations because nobody would  
5 send their money to us, nobody would give us money if this  
6 weren't a highly regulated industry and people could feel  
7 that they could trust a brokerage company to not steal their  
8 money. So we need regulation. We think appropriate  
9 regulation is of course the right thing to have. We  
10 subscribe to that.

11 So then the issue is what is the appropriate  
12 regulation going forward? And I don't think this is a really  
13 difficult question. I think you've got two sets of issues.  
14 One is there are things that happen when you have a fund or a  
15 commingled pool of assets. And the inability for people to  
16 know what is precisely in there, the lack of transparency,  
17 the other kinds of things we discussed are things that have  
18 needs to be addressed, that have to be addressed through  
19 other means. And some of the things you suggested are ways  
20 to address those.

21 On the other hand, there are also things that have  
22 to be addressed if somebody has discretion or the ability to  
23 manage or advise an account. And we have a series of rules  
24 with regard to those. If the view is that brokerage  
25 regulation isn't sufficient because brokers today in an

1 account can take the securities and actually with the  
2 permission of the customer and the customer agreement lend  
3 out those securities and you don't like that split, then  
4 let's address that split. But that's a market regulation  
5 issue that should apply to brokerages generally. It's got  
6 nothing to do with regard to folios, it's got to do with  
7 brokerage accounts and who's got the custody over the assets  
8 and where that split ought to be.

9           And one can argue whether or not it's better or  
10 worse and whether or not if the money can go to the firm who  
11 is then using it that that helps reduce other fees that the  
12 firm otherwise would be imposing on the customer, etc., etc.  
13 But I think it makes sense to address the issues instead of  
14 making the mistake going forward that we sometimes make in  
15 the past which is to address labels and then try to force  
16 things into a label formed regulatory structure.

17           So look at the issues and, you know, if the view  
18 is that we need to have special rules that apply to what you  
19 can do with customer assets whether they're held in the fund  
20 or held in a brokerage account, let's have rules.

21           If the view is that we need to worry about  
22 conflicts of interest with regard to people who are advising  
23 or managing an account, let's have rules.

24           But let's not make the mistake that says if this  
25 thing has too many people who are all doing the same thing

1 and somehow or other it needs to be regulated like a mutual  
2 fund whereas if we have a wire house who sends out the same  
3 recommendation to 15,000 brokers and all those 15,000 brokers  
4 put their customers generally into the same security that  
5 somehow or other that's a different issue. And it's not.

6           If you've got somebody who is advising or managing  
7 an account, especially on a discretionary basis, then you  
8 have issues with regard to the management of that account.  
9 But it, again, isn't a question of whether or not that  
10 account can be diversified or not or whether or not there is  
11 a cost effective way for someone to be able to buy 50 stocks  
12 at once or not, it's a question of what are you doing that  
13 creates the regulatory concern and then address that as  
14 opposed to trying to create a new kind of form or label that  
15 puts in place something that will address perhaps your view  
16 of us today but again in five years or ten years that's going  
17 to be outmoded because somebody else is going to come along  
18 with something that we can't think of today that's going to  
19 get you into the same position.

20           So look at the regulatory concern and just simply  
21 address the concern. It's basically sort of goal oriented  
22 regulation. The Commission called it at one point functional  
23 regulation on a broader scale when it was looking at this  
24 with regard to financial services regulation more generally.  
25 It's the right general approach as opposed to a more label

1 type of approach.

2 MR. SILVER: Well, as far as the labels are  
3 concerned, you're the one who has brilliantly argued yourself  
4 out of being in a mutual fund and argued yourself into being  
5 a broker/dealer. So --

6 MR. WALLMAN: That's under current law.

7 MR. SILVER: -- the exercise in labels go both  
8 ways. But I'm impartial. I would say that broker/dealer wrap  
9 accounts should be looked upon the same way as far as the use  
10 of assets are concerned. Perhaps what you really --

11 MR. WALLMAN: But why wrap accounts? Why keep  
12 drawing that distinction? Why not look at it and say the  
13 question is if there is customer money do we need rules to  
14 protect customer money and customer assets? It's got nothing  
15 to do that it's a wrap account or a non-wrap account or a  
16 discretionary account or a non-discretionary account.

17 MR. SILVER: I would say, I would suggest that at  
18 least a possibility that '34 and '40 the Congress looked at  
19 these issues, never thought of broker/dealers as being -- as  
20 holding a vast reservoir of assets. The only customers'  
21 assets they had were in trading accounts. In 1940 when they  
22 came to look at a pool of assets they made the decision that  
23 the pool of assets should belong to the people who own them  
24 for all purposes.

25 So at least as far as you can see what choices the

1 Congress made I think it can be argued that the '40 Act model  
2 is more apposite. But we can go on arguing that forever.  
3 But one thing I think it shows or might show is that the  
4 bifurcation within the Commission between a group that  
5 regulates broker/dealers and is concerned with questions of  
6 market structure and another group concerned with investment  
7 management issues really allows at least intellectually a  
8 whole group of questions such as this to fall between the  
9 cracks.

10 I'm willing to bet --

11 MR. WALLMAN: I think that you need to clarify  
12 that because it doesn't fall between the cracks, it falls in  
13 another division. I think it's quite important because the  
14 argument keeps getting made that somehow or the other there's  
15 lesser regulation here. There's not, there's different  
16 regulation.

17 MR. SILVER: It's different regulation. But I'm  
18 willing to bet, and I will ask Paul this question. He  
19 probably won't answer it. But I'm willing to bet that it has  
20 never been discussed on the staff whether the holding of the  
21 billions dollars worth of investors' assets receive different  
22 treatment under the '40 Act where all of the ancillary  
23 benefits, economic benefits flow to the investor as against  
24 the broker/dealer model where broker/dealers can use those  
25 assets in the course of their own business activities. I'm

1 willing to bet this has never been a subject of regulatory  
2 discussion.

3 Perhaps the division is logical and should take  
4 place but it is certainly something that somewhere along the  
5 way should be on the regulatory agenda for discussion and  
6 analysis. And I'm willing to bet it never has been.

7 Paul, you can take the fifth or anything else.

8 MR. ROYE: In the Division of Investment  
9 Management we discuss the custody of investment company  
10 assets.

11 MR. SILVER: Right. Well, go ahead.

12 MS. MORIARTY: I was wondering whether the real  
13 focus should be more the way Steve is focusing it which is  
14 the first question is whether the investor has control or  
15 not, and I mean real control as opposed to imaginary control?

16 And then the second question is assuming that he  
17 or she does have control and it's not a pooled situation is  
18 the person making their own decisions or are they being  
19 advised?

20 So the real question is whether, and not  
21 necessarily Steve's product but other similar folio type  
22 products which are all lumped together which are not really  
23 similar entirely, whether they're providing brokerage service  
24 and/or advice? And should not they then be regulated as  
25 advisors under the Advisor Act as well? Not necessarily



1 folios because I'm not sure that I'm convinced that you're  
2 providing advice. But I know there are certain programs  
3 where virtually you have no control or customization over the  
4 basket so in effect you're being given a variety of  
5 recommended strategies. And so my question would be, you  
6 know, really '40 A Act and '34 Act versus '40 Act.

7 MR. SILVER: Steve, are you a registered  
8 investment advisor?

9 MR. WALLMAN: We actually are a registered  
10 investment advisor. But we are not applying that  
11 registration, we're not at this point giving advice. We  
12 provide some assistance and help but we don't provide advice  
13 as legally defined under the current labels.

14 Again, if your question is what should the law be?  
15 We are reasonably astute with regard to regulatory issues so  
16 we understand some of these distinctions within the company.  
17 The question of what should the law be is a different issue.  
18 And there I actually agree with Kathleen that the general  
19 notion has to be ultimately and ought to be ultimately if  
20 people are basically providing advice or exercising  
21 discretion over somebody else's account what are the rules  
22 that apply to that action, not whether or not that makes  
23 something a mutual fund or not?

24 If I have the ability to manage on a discretionary  
25 basis 1,000 accounts or 10,000 accounts or two accounts, the

1 fact that it's more than two shouldn't make it a mutual fund.  
2 And what you ought to do is care about the one and the two as  
3 much as the 20, the 50, the 100, the 1,000. And those are  
4 rules that can be put in place. I think it's not hard to  
5 craft protections to ensure that the exercise of that kind of  
6 discretion whether it's over 50 accounts or 5,000 accounts is  
7 appropriate exercised without having to then say somehow or  
8 other because you've gone over some number of accounts you've  
9 now created a mutual fund when there's no commingling of  
10 assets, there's no pool, there's nothing mutual, there's no  
11 fund.

12 MR. SILVER: Bob, I think you wanted to go first?

13 MR. POZEN: Steve, I was trying to understand your  
14 business model about --

15 MR. WALLMAN: Well, we're trying to do that  
16 sometimes too.

17 MR. POZEN: -- about how it is that this modest  
18 fee that you charge supplies enough profit. And --

19 MR. WALLMAN: I've been asking that question also.

20 MR. POZEN: And I guess one question I have is: do  
21 you accept payment for order flow? And if you do, is that  
22 disclosed?

23 MR. WALLMAN: It is and we do. Or we do and it  
24 is. So we actually have gone out of our way to disclose it.  
25 We disclosed it before the SEC's rules required us to

1 disclose it. We lamented at the fact that we are in fact  
2 accepting payment for order flow. But as a broker we were  
3 given two choices when we routed to our market makers who we  
4 thought were providing us the best execution at the lowest  
5 cost for our customers which was either they can keep the  
6 payment for order flow or they can give it to us. Between  
7 those two choices we thought they were wealthier at the  
8 moment than we were and we decided to accept it.

9 My hope and my view based on the first panel is  
10 that the innovation of decimal pricing, including getting  
11 down to the penny, will in fact over time eliminate the  
12 payment for order flow payments entirely. And when that  
13 occurs we'll be very willing to applaud the fact that we no  
14 longer accept payment for order flow.

15 MR. POZEN: The other thing I couldn't help but  
16 comment on is that I don't know exactly which survey it is  
17 that showed that the mutual fund investors don't understand  
18 that they're being charged expenses. But of course, there's  
19 the prospectus that shows all expenses very clearly. It's  
20 probably true, Steve, if we did a survey of almost any group  
21 of investors, whether they were brokerage or mutual  
22 customers, there would be some portion that wouldn't fully  
23 understand that they were paying expenses or how much.

24 And I would actually be surprised if your  
25 investors understood the significance of payment for

1 order flow in your system. I don't think it's necessarily  
2 wrong. But I think we all do the best job we can to disclose  
3 these things. And I think both on your side and the mutual  
4 fund side, we do a pretty good job. The fact that people  
5 choose not to read, or not to understand, is something that  
6 it's unfortunate. But I think we've tried hard to use plain  
7 English, etc. So I'm not sure how much further we can go  
8 in this area.

9           It seems that payment for order flow  
10 is a significant item for you, so it is perfectly reasonable  
11 for you to disclose it. I just bet that if I took a survey  
12 of your customers on payment for order flow, they  
13 wouldn't understand that subject.

14           MR. WALLMAN: Just to clarify, actually payment  
15 for order flow is almost imma -- it's immaterial.

16           MR. POZEN: Yes?

17           MR. WALLMAN: It's completely immaterial to us.  
18 And payment for order flow now has become so reduced because  
19 of decimals thankfully that it's increasingly immaterial to  
20 most people out there. But that's not a charge to the  
21 investor itself. We can't get a better execution than what  
22 our brokers or market makers are providing.

23           What we do know is that investors read a  
24 percentage disclosure. What they don't understand is that if  
25 they've got \$46,000 sitting in a fund what that means to them

1 each month in terms of the charge to them because of the  
2 investment in the fund. And it was surprising to me as well.  
3 I mean I was shocked having been a regulator thinking that  
4 the regulatory disclosure was certainly sufficient and in  
5 reasonably good plain English. And I think the fund  
6 companies have done a very good job of disclosing that in a  
7 prospectus. But what isn't there is the monthly disclosure  
8 on the statement that says you've got 27,000 or \$47,000 in  
9 this fund, your charge for being in this fund this month was  
10 \$163.26.

11 So I mean relatively easy to do. We'd be happy to  
12 do it if you'd like. You can give us the data, we'd be happy  
13 to send it out to customers.

14 MR. POZEN: There is already a disclosure  
15 quantifying the annual expenses for a \$10,000 investment in 16  
each mutual fund.

17 MR. WALLMAN: Right, but it's not --

18 MR. SILVER: Before you yield to temptation even  
19 further, seizing upon every possible segue, you used the word  
20 "English" and so I'm going to exercise the chairman's  
21 prerogative at the moment. We do have with us a  
22 representative from the Financial Services Authority of the  
23 United Kingdom. And let me just say one word further about  
24 Stuart Willey.

25 We met on a mission to China where we both had our

26 portfolios filled with the regulatory notions of the

1 jurisdiction from which we came. The Chinese, as many of you  
2 know, have been trying to start a mutual fund industry and  
3 adopt appropriate regulations. And it was, it really kind of  
4 proved something that I thought of for a long time having  
5 been in sort of this international consulting arena, that the  
6 regulations that get adopted in emerging markets seem to  
7 depend upon who the consultants were.

8 I even found when I first started in the mutual  
9 fund industry in 1960 that New South Wales in Australia was  
10 using Ohio's Q-3 regulation that dated from 1938. There must  
11 have been an itinerant younger son who found his way to New  
12 South Wales.

13 But the Chinese situation, the Chinese like to get  
14 everybody's advice. So we found ourselves as you might say,  
15 regulatory salesmen, with our portfolios filled  
16 with our regulations, the English approach, the American  
17 approach. Of course I had independent directors. I thought  
18 that was the way they should really go. And we also had the  
19 German approach - the Germans are very, very influential in  
20 advising on revision of the commercial laws of China. And  
21 so when the Chinese mutual funds end up with German  
22 supervisory boards over the Board of Directors, you'll  
23 know where that came from.

24 When last seen, the last draft that I saw of the  
25 Chinese law is that they have indeed independent directors

26 but they do give the same broad authority to the custodians



1 that the Europeans give to oversee fund operations. They  
2 have a supervisory board on top of the directors. And, of  
3 course, a residual of their recent heritage is they have a  
4 shareholders' committee which also has plenary jurisdiction  
5 over all fund activities. It's going to be a long time  
6 before we really see a large Chinese mutual fund industry.

7 But that isn't the reason that Stuart Willey is  
8 here. You've heard us talk and you've heard me talk about  
9 modular kind of regulation and are all these differences  
10 simply an accident of history that you have an Exchange Act  
11 over here, you have a '40 Act over here, you have an Advisors  
12 Act, the '33 Act passed even before that. What flows from  
13 that is you get separate divisions within the SEC with  
14 different jurisdictions, "not on my turf", or "not my  
15 problem", which is the other side of the coin. And if we  
16 have a problem that doesn't fall on anybody's turf, there is  
17 no problem.

18 I thought in a certain sense, and I'll tread  
19 delicately, but I'm overstating the point for the purpose of  
20 making it, that two of the more innovative operations at the  
21 Commission in recent years have been the Enforcement Division  
22 and the new Inspection Division.  
23 These are the two divisions at the Commission which cross  
24 freely their various regulatory boundaries between the

25 various operating divisions and can take a macro

1 look and say, oh, this is happening here because it comes  
2 from the broker/dealer side. Or how does this thing really  
3 operate? Follow the money. And they can follow it all the  
4 way through the various regulatory statutes.

5 MR. ROYE: David, they do cross with Investment  
6 Management, too, both Enforcement and OC.

7 MR. SILVER: In any event, I thought that it might  
8 be interesting to us all to see how a universal securities  
9 regulatory statute worked, indeed broader than a  
10 securities regulatory statute, you might say a financial  
11 regulatory statute where under the recently adopted revision  
12 of the English laws you now have one agency and one statute  
13 regulating activities as diverse as banking, insurance and  
14 all aspects of the investment management business.

15 Has there been a kind of modular approach to  
16 regulation? And how are some of these problems handled under  
17 a law which is, to paraphrase and adopt, are we further apart  
18 than we think because we speak a common language?

19 In any event, I will turn this over to Stuart  
20 Willey.

21 MR. WILLEY: David, thank you very much. And it's  
22 a great honor and pleasure to be participating in your panel  
23 this afternoon.

24 As David has mentioned, the financial services  
25 legislation in the U.K. has just, literally just completed a

1 major reform program which has lasted some four-and-a-half  
2 years. This has brought together banking, insurance and  
3 investment business regulation into a single act and has  
4 conferred the supervisory functions for all of these  
5 businesses upon a single regulator, the FSA.

6 The legislation confers extensive powers on the  
7 FSA to make rules and regulations for each of these kinds of  
8 business. And in doing so it contains the statutory  
9 stipulation that the FSA must do what is most appropriate for  
10 meeting its statutory objectives. And there are four  
11 statutory objectives. And it's just worth mentioning and I  
12 think very briefly.

13 The first one is maintaining market confidence.  
14 The second statutory objective is increasing public awareness  
15 of the financial system. The third one is the protection of  
16 consumers. And the fourth objective is the reduction of  
17 financial crime.

18 The act requires the FSA to follow disciplines of  
19 open consultation and subjecting proposals to cost/benefit  
20 analysis but subject to these quite onerous but important  
21 disciplines the FSA is given a fairly free hand to fashion  
22 its rules as it thinks will be most appropriate to meeting  
23 the statutory objectives. The process is not tied to the  
24 government's legislative program and ought to allow the FSA  
25 to be more responsive to short-term changes in market

1 behavior.

2           One important qualification to this is that the  
3 FSA must act in accordance with the U.K.'s international  
4 obligations including in particular the single market  
5 directives of the European Community. The European financial  
6 services directors have some significant effects on the shape  
7 and content of our regulation and beyond this the government  
8 still contains control through secondary legislation over the  
9 broad scope of the activities which are regulated under the  
10 act.

11           So I think that the having a single legislative  
12 construct ought to provide the FSA with the ability to  
13 fashion appropriate regulation for all forms of financial  
14 services covering banking, insurance and investment business.  
15 And it has a program designed to bring about, for example,  
16 convergence of the capital requirements for businesses.  
17 That's going to take some time but it's one of the early  
18 parts of this program to reassess, for example, the capital  
19 requirements for insurance business, banking business and  
20 investment businesses and to see what degree of convergence  
21 could be brought about and what might be desirable.

22           But at the generic level there will continue to be  
23 differences in the substance, style and intensity of  
24 regulation applied to those three sectors.

25           I now want to move on to make some specific

1 comments about investment funds. The U.K. regulation, the  
2 U.K. legislation continues to present complexities in the  
3 definition and treatment of investment funds and of  
4 discretionary portfolio management activities. The  
5 legislation is built around two regulated activities: the  
6 activity of managing a portfolio of investments with  
7 discretion and operating or managing a collective investment  
8 scheme.

9 To put this another way, a distinction is drawn  
10 between a pool of assets which is to be regulated as an  
11 investment vehicle, in U.S. terms an investment company, and  
12 a separately managed segregated account, portfolio management  
13 for an individual.

14 The regulated activity of managing assets  
15 belonging to another person describes and covers, for  
16 example, discretionary portfolio management where an investor  
17 entrusts his money or assets to an investment management firm  
18 which will manage them on an individual and discretionary  
19 basis. The assets, including if held in a nominee account by  
20 the discretionary manager, will continue to be treated as  
21 belonging to the customer. The customer in this case will at  
22 least have a beneficial interest in the money and assets held  
23 in the discretionary manager's nominee accounts. 24

This activity also covers much larger

25 institutional fund management activity such as pension fund

1 activities. The trustees of an occupational pension scheme  
2 have legal ownership of the assets of the pension fund but  
3 they are treated as carrying on the activity of investment  
4 management. In this case the employees who are interested in  
5 the occupational scheme have beneficial interests under the  
6 trusts of the pension scheme and hence the assets are being  
7 managed by the trustees and they fall to be treated in  
8 regulatory terms as assets belonging to another person.

9 A firm which carries on portfolio management for  
10 individuals must be authorized by the FSA, must be fit and  
11 proper and have adequate financial resources. Such a firm is  
12 subject to conduct of business rules which require it to  
13 maintain a customer agreement which specifies the investment  
14 objectives which the manager will pursue. The manager's  
15 transactions with the customers must not be excessive, must  
16 be suitable to meet the disclosed objectives and must comply  
17 with the fair dealing rules, including the requirement for  
18 best execution. And the firm must avoid or suitably manage  
19 conflicts of interest.

20 All of the manager's marketing literature must  
21 comply with the FSA's financial promotion or advertising  
22 rules. The material must be fair, clear and not misleading.  
23 The discretionary portfolio manager is required to arrange  
24 for the safe custody of the customer's assets. If the assets  
25 are not entrusted to a separate custodian the managing firm

1 must ensure that it's client's assets are segregated from its  
2 own and must not use its client's assets for its own  
3 purposes.

4 In the case of a segregated managed account the  
5 individual bears tax on the income and capital gains arising  
6 from the acquisition, holding and disposal of assets managed  
7 for him.

8 The second concept prescribed in the U.K.  
9 legislation is the activity of establishing, operating or  
10 winding up a collective investment scheme. The collective  
11 investment scheme is an arrangement in relation to property  
12 of any kind where broadly speaking there is a pooling of  
13 contributions from several contributing participants or the  
14 collective and common management of property in which several  
15 participants have an interest. In both cases the purpose  
16 must be to share in the profits or income arising from the  
17 management of the property.

18 A person who manages a collective investment  
19 scheme must be authorized and is subject to regulation by the  
20 FSA as an operator of a collective investment scheme. The  
21 operator may be an externally appointed firm or may be -- or  
22 the management may be undertaken by the directors of the  
23 collective investment scheme itself if there is no third  
24 party manager.

25 The FSA applies a more intrusive and intense form



1 of regulation to collective investment schemes which can be  
2 freely promoted to the public. These are the so-called  
3 regulated collective investment schemes which include unit  
4 trust schemes which, particularly in respect to their  
5 investment borrowing powers are, if they are to be freely  
6 promoted to the public, required to conform with detailed  
7 product regulation, valuation and pricing requirements.

8 In the case of a regulated unit trust or open-  
9 ended investment company the scheme or company must be  
10 authorized also as meeting the product regulation  
11 requirements and the manager of the scheme must also be  
12 authorized and is responsible for ensuring that the scheme is  
13 managed and administered in accordance with the FSA's  
14 regulations.

15 So I'll just pause there and stress that it's a  
16 sort of dual authorization. The scheme itself if it is to be  
17 regulated and freely promoted to the public must itself be  
18 authorized as conforming with the product regulation  
19 requirements and the manager, if there is a separate manager,  
20 he too must be authorized.

21 The manager of an authorized unit trust or open-  
22 ended company cannot engage in transactions with associates  
23 or affiliates unless the transaction is at arms length and of  
24 full commercial value. The trustee or depository must  
25 exercise a degree of oversight of the manager's transactions.

1 And if of the opinion that a particular acquisition or  
2 disposal of assets by the manager exceeds the powers of the  
3 manager, the trustee or the depository may require the  
4 manager to cancel the transaction or to make a corresponding  
5 acquisition or disposal to restore the fund's position.

6 The operator of an unregulated collective  
7 investment scheme, this is a scheme which cannot be freely  
8 promoted to the public, is also subject to regulation by the  
9 FSA. Unlike its regulated counterpart there is no  
10 requirement that the unregulated scheme itself is registered  
11 or authorized.

12 The distinction may be drawn here between the U.S.  
13 Investment Companies Act of 1940 and the U.K. approach. If I  
14 understand the position correctly, a fund with fewer than 100  
15 beneficial owners or whose investors can only be qualified  
16 purchasers are exempted by Section 3(c) of the 1940 Act and  
17 are not regulated as investment companies as such.

18 The U.K. legislation also draws on a distinction  
19 between funds which can be freely promoted to the public and  
20 those which do not involve a public offer. However, both  
21 remain classified as collective investment schemes but with a  
22 much more intrusive degree of regulation applied to the so-  
23 called regulated public funds. The unregulated schemes even  
24 if operated only for professional or sophisticated investors  
25 provided the operator is based in the United Kingdom does not

1 fall, as it were, below the FSA's radar.

2           One further structural point is relevant. I think  
3 this is particularly relevant to the issue of rep funds that  
4 have been discussed. The definition of a collective  
5 investment scheme includes what may be termed parallel or  
6 common investment schemes in which the participants do retain  
7 legal or beneficial interest in the property under management  
8 but where the expectation is that the scheme manager will  
9 apply formulaic, uniform or programmed investment management  
10 decisions to each of the participant's property in the  
11 scheme. This is analogous to the manner in which rep funds  
12 and mini-accounts described in the issues paper are managed.

13           Now, prima facie such arrangements would fall to  
14 be treated as collective investment schemes because they at  
15 least involve the common management of property. Since they  
16 would not and probably could not qualify as regulated schemes  
17 they could not on that basis be freely marketed in the United  
18 Kingdom. However, the legislation has since 1988 provided an  
19 important exclusion for parallel or common investment  
20 management arrangements where the property of the  
21 participants is restricted to securities other than  
22 derivatives. Each participant owns an identifiable share of  
23 the property under management and is entitled to withdraw it  
24 at any time. And the participants' contributions are not  
25 pooled such as to convert the contributions into an interest

1 in the pool.

2 Now, in practice this exclusion in the legislation  
3 has provided a significant opportunity for firms providing  
4 common or uniform managed portfolios for which investors  
5 enjoy tax advantages under the U.K.'s PEP and individual  
6 savings account legislation. A condition of the exclusion is  
7 that the arrangements for parallel portfolio management must  
8 be liquid, i.e., it must allow the investor to withdraw his  
9 share of the property at any time. And as I have said, there  
10 must be no pooling of the customers' assets which in practice  
11 means that each customer must have his or her own individual  
12 account on the books of the fund manager or the relevant  
13 custodian and this must identify the property to which he is  
14 entitled.

15 Otherwise, however, the manager may in practice  
16 manager all of the property held in the PEP or ISA managed  
17 account in the same way and with the same objectives,  
18 although this will be subject to individual transactions to  
19 accommodate customers as they enter or leave the individual  
20 accounts. In theory, each individual will be subject to tax  
21 on the income and gains on the assets which are allocated to  
22 his account, although in practice this is not an issue for  
23 PEPs and ISAs because they enjoy tax exemptions provided the  
24 investors' contributions do not exceed the revenue limits.

25 I'd just like to make finally a few comments about

1 the degree of regulation which the FSA applies to those  
2 managing unregulated collective investment schemes. The  
3 operator of an unregulated collective investment scheme is  
4 required to be authorized by the FSA, must manage the scheme  
5 in a way which provides the participants with certain  
6 protections. Unregulated schemes can only be promoted on a  
7 relatively restricted basis. The manager, if there is no  
8 separate custodian or depository, is required to comply with  
9 the rules on safe custody of assets, fair dealing and  
10 transactions for the scheme and must provide the investor  
11 with information about the performance of the scheme on at  
12 least a biannual basis.

13 Rules which require fair dealing and safe  
14 custody -- Did I say biannual? A semi-annual basis.

15 Rules which require fair dealing and safe custody  
16 do not, however, preclude an unregulated scheme from  
17 borrowing heavily and adopting investment strategies of a  
18 hedge fund manager. The protection for the fund investor is  
19 secured through disclosure and the requirements that the  
20 scheme or fund should be operated in accordance with its  
21 disclosed objectives.

22 The U.K. regulatory approach seeks to draw a  
23 distinction between firms which manager individual accounts  
24 and firms which manage a pool of assets in which the  
25 contributors have interests as unit or share holders. The

1     latter are subject to regulation as collective investment  
2     schemes and if they are to be freely promoted to the public  
3     they are subject to a more intrusive degree of regulation  
4     which involves regulating the product itself so that it has  
5     an acceptable risk profile.

6             The U.K. law also recognizes a form of collective  
7     fund management which is very close to pooled management,  
8     this is the so-called parallel or common fund management  
9     operation, in which there may be no actual pooling of assets.  
10    However, the U.K. legislation carves these out of the  
11    classification of collective investment schemes where the  
12    arrangements enable a liquidity and where the property under  
13    management is restricted to certain prescribed forms of  
14    asset.

15            One final comment. This exclusion of parallel or  
16    common fund portfolio management from the collective  
17    investment scheme regulation does not appear to have aroused  
18    any opposition among U.K. fund managers. And I would suggest  
19    there might be the following reasons for this:

20            First, individual account managers or portfolio  
21    manages are nonetheless subject to regulation, and in  
22    practice, by the same regulatory agency as for pooled managed  
23    funds.

24            Second, most U.K. fund managers have come to be  
25    owned by groups which are also -- which also conduct

1 portfolio management for individuals so there may be no  
2 obvious commercial incentive to playing some form of  
3 regulatory arbitrage.

4 Third, the tax treatment of individuals with  
5 investments outside the favorable PEP and ISA arrangements  
6 may make programmed or parallel management of assets less  
7 attractive.

8 The issues paper refers to the classification of  
9 web based portfolio services which may also involve parallel  
10 and programmed investment management such that there may be  
11 little personalized control of individual accounts. The  
12 principals of classification I have described would apply  
13 equally to these form of web based services. It could be  
14 conceivable that such a service could fall within the  
15 collective investment scheme regime but the likelihood is  
16 that most services will fall within the exclusion which  
17 applies where the arrangements offer liquidity and where the  
18 type of investments held meet the prescribed criteria.

19 MR. WALLMAN: I think we're going to move to the  
20 U.K.

21 MR. SILVER: Yeah, till you got to the exclusion I  
22 though that Steve Wallman was going to march up to Bunker  
23 Hill, and rally the troops.

24 But one thing I'd like you to clarify, I think you  
25 said it, arrangements that fall within the exclusion, let's

1       assume a firm does nothing but offer a sort of web based  
2       service, that's the only product it has, and it falls within  
3       the exclusion, to what regulation is the sponsor of that  
4       arrangement subjected?

5               MR. WILLEY: They would fall within the regime for  
6       investment managers, the managers of individual accounts.

7               MR. SILVER: Not a broker/dealer?

8               MR. WILLEY: Well, I think it would be in effect a  
9       broker/dealer regime that applies here, yeah.

10              MR. WALLMAN: We're moving to the U.K.

11              MR. SILVER: Paul, do you see any virtues in the  
12       U.K. approach and do you wish that you were able to bestride  
13       the world like a Colossus the way the FSA can? And if you do  
14       not aspire to such, to those heights, whether you are  
15       Hercules or not what do you aspire to and what are we in for  
16       in the future as you enter your fourth year as Director of  
17       the Division of Investment Management?

18              MR. ROYE: Yeah, I think you should probably have  
19       directed the first part of that question to Senator Sarbanes  
20       in terms of structure. I mean I think we're stuck with what  
21       we have at the SEC and what our authority is.

22              What I thought I would do, David, is just kind of  
23       react to maybe an order to each of our speakers and just give  
24       some thoughts and observations about where the Commission is  
25       on some of these issues. And since this is a program for



1 ideas maybe throw out some ideas that are my own and the  
2 Commission very well may not take to. But I'll mention them  
3 anyway.

4 I think, David, you started out by saying that,  
5 you know, maybe the statute needed a workover. And I think  
6 you were suggesting, I think you were suggesting maybe a  
7 legislative fix to the statute to deal with some of the  
8 products and some of the issues that have been raised in the  
9 conference. And I guess my view is that a legislative fix is  
10 really not called for. I think that as has been discussed,  
11 you know, this afternoon the statute and the framers of the  
12 statute gave the Commission broad exemptive authority to  
13 accommodate change and innovation.

14 And I think the Commission, you know, has as  
15 decent record in that regard in terms of reacting to new  
16 products and new circumstances. You would not have money  
17 market funds, for example, but for the exemptive authority.  
18 The exchange traded funds that Kathleen talked about exist  
19 because of the exemptive authority that the Commission has.  
20 Certainly if you look at the statute and you would, you know,  
21 make changes here and there but in terms of fundamental type  
22 changes I guess I don't really see it. And I see the  
23 Commission as having the ability, you know, to react and  
24 respond to some of the developments that we've discussed.

25 When you move to affiliated transactions it is an

1 issue that the Commission is focused on. The prohibitions  
2 apply in a way, as Bob pointed out, that create a number of  
3 technical issues which the Commission has tried to deal with  
4 through rulemaking and continues to try to deal with through  
5 rulemaking and through the exemptive process and even through  
6 the no action letter and interpretative process.

7           This is certainly an area where, you know, we  
8 should look to being more efficient and speeding up the  
9 process in terms of dealing with those issues. The  
10 Commission recently proposed amendments to Rule 17(a)(8)  
11 which deals with merges among affiliated funds trying to get  
12 out of the way of those kinds of transactions. And, indeed,  
13 it's an area where we've seen a number of exemptive  
14 applications. Maybe the highest number of exemptive  
15 applications have been mergers of funds as a result of  
16 consolidation going on in the industry.

17           And so as we can codify some of these kinds of  
18 issues into rules we can focus on more of the novel issues,  
19 the ETF type exemptive applications and speed up that  
20 process.

21           But it does raise some interesting questions when  
22 you get into trying to resolve some of these issues. And it  
23 touches on some of the issues raised in your paper. For  
24 example, when you look at Rule 17(a)(8) and what the  
25 Commission was doing there and getting the Commission out of

1 the way of those kinds of transactions we rely very heavily  
2 on the board of directors to scrutinize the fairness of the  
3 transaction. But the rule proposal also would require that  
4 shareholders of the acquired fund in a merger vote on the  
5 transaction, whether or not they're satisfied the transaction  
6 is fair from their standpoint.

7 In your paper you raise the issue of how should we  
8 look at funds, is the model of a corporation with shareholder  
9 owners having a stake in the enterprise and participating in  
10 that, is that the model that we should have going forward or  
11 should it be more like a commodity? You know, should it be  
12 more like a product with a customer? And I think that, how  
13 you view that determines how you structure some of these  
14 rules. Because if you say it's more like a product than a  
15 customer why do you need a shareholder vote in that kind of  
16 context?

17 And those are the kinds of issues that the  
18 Commission is wrestling with and I think is keyed up in a  
19 rule like that. So, you know, even when you get into some of  
20 these issues like affiliated transactions you get into  
21 fundamental questions of, you know, how should the statute  
22 work, how should we view it going forward?

23 Again, a number of rules, 10(f)(3) Bob mentioned,  
24 we have an affiliated underwriter, we have a rule proposal to  
25 expand the scope of that rule. We've tried to through a no

1 action letter process eliminate the need for exemptive  
2 applications where we can, do that interpretively or through  
3 the no action letter process. So it's an area that the  
4 Commission is really focused on and it's an area that like to  
5 figure out a way how we can speed up dealing with the  
6 individual exemptions. Certainly we can probably do more on  
7 our end to like speed through the routine exemptions and  
8 focus on the more novel issues. Certainly codifications of  
9 the rulemaking process is one way to do it.

10 The other issue that I would throw out is that  
11 Chairman Pitt is very much emphasizing that the Commission  
12 should be a service agency, that we're here to help and  
13 assist. Well, when an applicant files an exemptive  
14 application and you've identified two of the ten issues that  
15 are raised by the application we're going to have to spend a  
16 lot of time working with you to work through those issues.  
17 And so to the extent that applicants can upfront identify the  
18 issues and identify solutions to those issues we can speed  
19 the process.

20 On the exchange traded funds upfront, as Kathleen  
21 mentioned, the Commission recently published a concept  
22 release. It's principally focused on the actively managed  
23 exchange trade fund issues and the questions focused on that.  
24 But, again, it does go to some basic questions about ETFs,  
25 how they operate, benefits, risks and other issues raised by

1 those products. And we're hoping to get comments on those  
2 issues as these products evolve and develop.

3 The types of products that you're likely to see  
4 come out next we have equity index based ETFs. We have  
5 applications for fixed income index based EFTs. And those  
6 are likely the products that you will see emerging next. And  
7 then we move to actively managed funds where we do have  
8 applications on file. And at the direction of the Commission  
9 we will continue working on resolving issues in those  
10 products while we elicit comment through the concept release.  
11 So we're not going to stop working on these issues, we're  
12 going to continue to work through them even though we're  
13 asking for comment on those issues.

14 With regard to hedge funds, I agree with James  
15 that there is this notion that hedge funds are unregulated.  
16 Indeed, they're subject to, the managers are subject to the  
17 antifraud provisions. And with those antifraud provisions  
18 come fiduciary obligations and fiduciary duties. And I guess  
19 the question is whether or not hedge fund managers recognize  
20 that and whether or not that translates into procedures and  
21 courses of doing business.

22 The questions I have in the hedge fund area really  
23 go to I guess the fundamental assumption that underlies the  
24 exemptions and that is that the investors in those products  
25 are sophisticated. And I guess I have questions as to when

1 you look at some of the fund to fund arrangements where you  
2 have a fund investing in hedge funds, you look at the  
3 minimums to get into some of those funds, indeed whether or  
4 not the investors in these funds are sophisticated. I mean I  
5 think that's a fundamental question.

6 And then as James pointed out, we brought a number  
7 of hedge fund fraud cases very recently. And, you know, we  
8 have seen some problems in the area. And I think that where  
9 Stuart talks about these unregulated funds not being under  
10 the U.K. regulators' radar screen, to some extent they are  
11 under our radar screen at the SEC. And I think one of the  
12 issues is that we don't have the ability where the advisor is  
13 not registered really to go in and look at books and records  
14 and inspect the managers of the fund. So by the time we hear  
15 about a problem it's too late, the money's gone. And it's an  
16 issue that I think needs some focus.

17 And I know how to, I know how to gain jurisdiction  
18 over these without going to Congress. There's a rule that  
19 under the Advisors Act that allows you to count a limited  
20 partner as one client. Now, the Commission can rescind that  
21 rule, and I don't know if James would like this, but we can  
22 rescind that rule and essentially I think gain jurisdiction  
23 over a number of the hedge fund advisors who aren't  
24 registered as investment advisors.

25 MR. SILVER: I think he's sorry he came.

1           MR. ROYE:  Indeed, you know, we do have a number  
2 of investment advisors who are registered and run hedge  
3 funds.  And I guess one of the questions is really whether or  
4 not the investment advisor regulatory regime would be all  
5 that burdensome from the standpoint of a hedge fund manager.  
6 I think, David, you put it in the guise of, you know, should  
7 investment company regulation be kind of the model here?  And  
8 I guess what I'm seeing is the problem is not so much  
9 overlaying, you know, independent directors and the other  
10 protections but at least the ability for the Commission to go  
11 and inspect, identify problems and try to correct them before  
12 they become, you know, huge problems.

13           MR. SILVER:  You have a pretty fair complex of  
14 disclosure rules under the Advisors Act.

15           MR. ROYE:  Well, I mean it's just a thought.

16           With regard to the web based portfolio investment  
17 programs, I'm sure most of you know the Commission did deny a  
18 rulemaking petition that was filed by the Investment Company  
19 Institute with regard to those products.  And I'd just let  
20 that rulemaking petition speak for itself.

21           Would point out that the Commission did emphasize  
22 in that rulemaking petition that the Commission would  
23 continue to monitor these products and the development and  
24 evolution of these products.  Unfortunately, some of these  
25 products don't exist anymore.  But we will continue to

1 monitor those products going forward.

2           One issue that's mentioned in the materials that  
3 was alluded to in part was the issue of many accounts and wrap  
4 accounts. And there is an exemptive rule under the  
5 Investment Company Act 3(a)(4), the whole premise of that  
6 rule is that if somehow these accounts managed in a very  
7 similar format discretionary management get individualized  
8 advice and you comply with the conditions of the rule that  
9 you avoid investment company status.

10           And I guess at least one of the issues in my mind  
11 is whether or not those conditions in the rule really lead to  
12 individualized investment advice. And this is a very  
13 controversial area. The rule was proposed in the '80's and  
14 lay dormant for 15 years. And then in 1995 the Commission I  
15 guess adopted the rule. And, you know, technology has been  
16 discussed is allowing, you know, more and more capability in  
17 terms of managing accounts. But I guess the question is  
18 whether or not again in these kinds of accounts are you  
19 really seeing individualized treatment and does the basis for  
20 this rule really hold up, you know, in today's environment?

21           There were ideas that were thrown out when the  
22 rule was proposed that were rejected where, you know, you set  
23 minimums that had to be met in terms of accounts that would  
24 qualify for the exemption. That was rejected. There were  
25 suitability requirements that I think were thrown out. There



1 were notions of advisors having to make judgments about each  
2 transaction vis-a-vis each advisory client as a way to assure  
3 individualized treatment. But I think it's an area that I  
4 don't have the answers but at least I wonder whether or not  
5 that rule as it's structured really gets you to  
6 individualized advice and, therefore, distinguishes you from  
7 indeed an investment company when these accounts are managed  
8 on the same basis.

9           And then, finally, I don't think anybody's  
10 discussed it but I think the materials keyed up the issue of  
11 self-regulation in the investment company area. And my own  
12 view is that this is not an area that lends itself to self-  
13 regulation in the investment company area, although I think  
14 you see sort of tidbits of it when you look at what the  
15 Investment Company Institute has done in terms of best  
16 practices with the personal trading guidelines they put out,  
17 the fund governance guidelines. And then when you look at  
18 some of the things they've done in the valuation area with  
19 the White Paper in that area. So you do see the industry,  
20 you know, trying to establish standards or best practices  
21 which is in the nature of self-regulation.

22           You know, Senator Sarbanes talked about, you know,  
23 resources of the Commission and the Commission having the  
24 resources to do the job. And if we don't get additional  
25 resources, you know, we're going to have to figure out how to

1 leverage what we have better. And I know in the inspections  
2 area they're looking at ways to leverage resources, make  
3 better use of technology, different ways to do inspections  
4 that you may see emerge in the future. But if we don't get  
5 resources we're clearly going to have to think creatively  
6 about where to go.

7           You know, ideas in the past that have been floated  
8 as sort of alternatives of self-regulation have been, you  
9 know, notions of fund auditors playing a greater role in  
10 terms of reviewing fund operations, the issue of having a  
11 compliance officer, designated compliance officer in the fund  
12 group who maybe perhaps could report to the board of  
13 directors, be hired by the board, work for the fund, only  
14 accountable to the directors to oversee compliance or to  
15 monitor compliance, issues like that which would not get you  
16 to self-regulation but might be ways to ensure, you know,  
17 efficient and compliant operations of investment companies.

18           MR. SILVER: Thank you, Paul.

19           Bob Pozen who has had to hold his tongue for all  
20 these years, which is a fiction, who had to bite his tongue  
21 all these years that he was directly associated with the  
22 industry now about to leave for the halls of academe and  
23 other things, now, Bob, you can take the gloves off and tell  
24 Paul and everybody else on the panel what we've been doing  
25 wrong all these years and how to do it right?

1                   MR. POZEN: I think in the interest of time  
2 I'm not going to do that. I think Paul has done a very good  
3 summary of the issues.

4                   I do want to emphasize two points. One is that in  
5 thinking about the future of mutual funds, we haven't talked  
6 very much about tax. But I believe a  
7 lot of the issues  
8 that are evolving about new products competing with  
9 mutual funds are essentially tax driven. And this, of  
10 course, was driven home last year with the  
11 capital gains distribution. In general, mutual funds  
12 are pass-through vehicles, treated like individual investors.  
13 But it seems to me, at least if investors are reinvesting  
14 their capital gain dividends in their funds, they ought to  
15 be allowed, as they are in many countries in Europe, not to  
16 pay a capital gains tax on such dividends.  
17

18                   And I think that this will be a major issue  
19 looking over the next ten years for the mutual fund  
20 industry. Because it may be the case  
21 that Steve's folios and all these new products are  
22 very good, but I think that tax is a disadvantage that  
23 mutual funds have relative to many new products. So tax  
24 must be high  
25 on the legislative priorities of the mutual fund industry.

1           Of course, mutual funds still have a lot of money  
2           from 401(k)'s, IRA's, and other tax sheltered vehicles. But 3  
          tax is an increasing issue for mutual funds and  
4           it really should be dealt with.

5           The second thing I will say on the international  
6           front with respect to asset gathering is that we have  
7           had very few examples of true harmonization. I wouldn't  
8           want to take a quiz on Paul's explication of the there,  
9           although I think I understood the general outlines. But  
10          what's baffling to me is: while the EU is supposed to be a  
11          harmonized system, if you go and try to do business there,  
12          I can assure you it doesn't feel like a harmonized system  
13          because Germany and France and all these countries have  
14          different rules. Given this experience, I don't believe  
15          we can hope to have harmonized rules across the whole world.  
16          I think it's a holy grail that we ought to give up. But  
17          what we can hope for is to have large regions --  
18          maybe an Asian region, a European region, a North  
19          American region -- where you can use one set of funds  
20          for all countries in the region.

21          Besides regional harmonization, what will  
22          be the most critical question in the next ten years  
23          for the U.S. mutual fund industry going abroad?  
24          How the transition from defined benefit to defined  
25          contribution is structured. In Europe, will the new

1 defined contribution plans be structured on an EU-wide basis,  
2 or will this be a means by which some countries revert, as  
3 they have somewhat in Germany and France, to local pension  
4 requirements? There are now proposals before the European  
5 Parliament to establish more of a "prudent person" rule than  
6 quantitative limits on pensions. But we still have the  
7 unusual situation where you can't manage a German pension  
8 fund from London.

9           So just finishing up, David, I would say these  
10 are two of the macro issues that we haven't talked about  
11 that are really going to have a big effect on the mutual  
12 fund industry. Both of them are a little outside the SEC's  
13 jurisdiction. But these are two very large issues which are  
14 going to have a huge impact in ten years on the  
15 strength of the U.S. mutual fund industry.

16           MR. SILVER: Thank you, Bob. And with that let me  
17 exercise sort of a McLaughlin approach of taking something  
18 from totally left field for the final comment.

19           In ten years we will have a pan-European SEC. The  
20 Committee of Wise Men Report last February is the first step  
21 in that direction. And with that Delphic cryptic comment,  
22 thank you all for attending and listening very patiently.

23           (Applause.)

24           MR. PHILLIPS: Thank you, Dave, and thanks to your  
25 panel for a truly stimulating, though-provoking discussion.



## 1 E V E N I N G S E S S I O N

## 2 DINNER AND KEYNOTE ADDRESS

3 MR. RUDER: It's my pleasure to welcome all of you  
4 to the dinner at this SEC Major Issues Conference. I think  
5 we've had a successful first day. And I've been asked  
6 whether this is the first in a series of conferences of this  
7 type and the answer is this is an unique conference. We will  
8 never again have the opportunity in the near future at least  
9 to have a conference like this in the first days of a  
10 chairman's tenure at the Commission. So the answer has to be  
11 there will never be a conference like this again.

12 It's my pleasure to introduce to you someone who  
13 really needs no introduction, particularly to most of you in  
14 this room. And nevertheless I feel compelled to say some  
15 things about Harvey Pitt.

16 It's very seldom that I have a chance to introduce  
17 someone whom I admire so much and I've had so much contact  
18 with over the years. So you will forgive me, Harvey, if I  
19 tell about you as I know you.

20 Harvey L. Pitt is the 26th Chairman of the United  
21 States Securities and Exchange Commission and without doubt  
22 is one of the very best qualified persons to hold  
23 this position. He brings extensive knowledge regarding the  
24 inner workings of the Commission. Senator Sarbanes read his  
25 various capacities to you this noon, but as I read them I

1 found that he had managed in a brief, fairly brief time to  
2 insinuate himself into every possible working cranny of the  
3 Commission. He served as General Counsel but he also served  
4 as Executive Assistant to Chairman Ray Garrett and  
5 therefore got to know about the entire workings of the  
6 Commission.

7 He was Chief Counsel to the Division of Market  
8 Regulation and therefore knows all about the markets.

9 He was editor of the SEC's Institutional Investors  
10 Study Report which makes him an expert in the investment  
11 management area.

12 And he was Legal Assistant to Commission Frank  
13 Wheat whom as you know wrote the Wheat Report which was not  
14 the accounting Wheat Report but the Wheat Report which was  
15 the basis for the revision of our exemptions to the  
16 securities laws.

17 Together I think these experiences provide Harvey  
18 with a complete picture of the Securities and Exchange  
19 Commission. Of course, in his subsequent activities he got  
20 to know the Commission from the outside and therefore has  
21 another perspective on how the Commission works.

22 Harvey brings enormous intellect to his job.  
23 During the past 25 years I've had the pleasure of listening  
24 to Harvey at numerous securities law conferences and the  
25 pleasure of reading his encyclopedic outlines of the law.



1 Sometimes we thought he didn't write all of them but we knew  
2 he'd read all of them and critiqued all of them. His  
3 analysis has always been insightful and his articulations  
4 excellent.

5 Harvey knows Congress. He has testified on  
6 numerous occasions and has served as informal advisor to  
7 Congressional committees. For instance, when I became  
8 Chairman I was confronted with insider trading legislation  
9 that had been drafted by what I thought was the staff of  
10 Senator Riegle's office. But I later found out that who had  
11 drafted it was Harvey Pitt. And I had to deal with Harvey's  
12 intellect and knowledge of how the Congress worked. It was a  
13 formidable task.

14 Harvey brings a strong record of public service.  
15 In my world alone I have had the pleasure of listening to  
16 Harvey in numerous COE programs throughout the country. I  
17 observed him as co-chairman of the PLI's Securities Law  
18 Institute. I served with him when he was chairman of the San  
19 Diego Securities Regulation Institute. And I read and was  
20 appreciative of his great work as a member of numerous  
21 committees at the American Bar Association Section of  
22 Business Law. And finally, of course, he served as  
23 President and one of the founding trustees of the great  
24 organization of the Securities and Exchange Commission  
25 Historical Society.

1 Harvey is a fine administrator. As chairman of  
2 his law firm he dealt with the most difficult of  
3 administrative tasks, dealing with lawyers. As Ray Garrett's  
4 Executive Assistant, Harvey observed the qualities of great  
5 leadership and has learned how to use those qualities when  
6 dealing with others. As President of the Historical Society,  
7 Harvey knew how to accomplish administrative tasks in a  
8 wonderful way. And it was always my great pleasure when  
9 Harvey said "I'll call him."

10 Harvey's personal qualities are wonderful. He's  
11 thoughtful, he listens, he's loyal, he's pragmatic, he's  
12 tough, and he values his family and friends. I believe we  
13 are all extremely lucky to have Harvey Pitt as Chairman of  
14 the Commission in these difficult times. His actions  
15 following the September 11 tragedy were sensitive and  
16 forceful. His early days as Chairman have demonstrated  
17 that he knows how to be effective. I look forward to a  
18 highly successful SEC under Harvey Pitt's leadership.

19 Harvey.

20 (Applause.)

21 CHAIRMAN PITT: You know, it's very difficult to  
22 speak after an introduction like that. So I think maybe I'll  
23 just throw it open to questions.

24 (Laughter.)

25 Actually, David reflects the wisdom of the old

1 saying when I used to practice law, which I no longer do,  
2 that it was always better to be introduced by friends rather  
3 than clients because friends could overlook some of the  
4 details that at least my clients were never able to forego.

5 I do think I need a little bit of a rebuttal.  
6 David is correct that I am the 26th Chairman of the SEC. But  
7 the difference between me and my predecessors is that the  
8 first 25 were all adults. In addition, any attribution to me  
9 of knowledge about the Investment Company Act not only is  
10 something I deny, in fact I remember on my first day working  
11 in the General Counsel's Office reading that statute and  
12 calling my wife and saying, It appears to be written in  
13 English but I haven't got the foggiest idea what it's talking  
14 about. I'm never going to make it here.

15 Many years later when I was in private practice I  
16 was very fortunate among other clients to represent the  
17 Investment Company Institute. And Matt Fink who at that time  
18 was the general counsel would call me with the standard  
19 mantra when he wanted to retain us, he would say, I know you  
20 don't know anything about the '40 Act, but perhaps you can  
21 help us on this problem.

22 So take some of what David said with a grain of  
23 salt. It's very flattering and I appreciate it but I'm not  
24 sure it's deserved. In any event, let's hope that this being  
25 the third time it's a charm.

1           Before being elevated to my current lofty status I  
2 understood that the cost of enjoying a wonderful meal like  
3 this one with bright and interesting colleagues was the need  
4 to sit through some pompous after dinner speaker's not so  
5 terribly fascinating reminiscences or war stories. And,  
6 frankly, it was a tradeoff I was never willing to make. For  
7 that reason since there are still some of you in the room I  
8 can honestly say that I am honored to be with you this  
9 evening. And I consider it a privilege to share some  
10 thoughts with you.

11           We stand on the threshold of remarkable changes in  
12 our capital markets. If there ever was a time when we could  
13 view U.S. capital markets as if they existed in a vacuum that  
14 time is long past. We live in a global economy with global  
15 markets engaged in fierce global competition with boundaries  
16 that are expanding exponentially given the internet and  
17 changing technology.

18           If there ever was a time we could view the world  
19 solely through the prism of U.S. securities regulation that  
20 time is also long past. Major financial markets operate  
21 around the globe governed by local securities regulators  
22 under local rules. No one regulator's experiences can or  
23 should dictate the responses that others take. We can and  
24 must learn from each other, especially in circumstances where  
25 we are attempting to expand the universe of securities traded

1 in our markets. We need to recognize that we in the U.S.  
2 will have to make appropriate accommodations to differing  
3 regulatory and accounting standards worldwide.

4 Now, I wish that I could dramatically unveil for  
5 you this evening a framework for global regulation in the  
6 21st Century, how the global community could regulate the  
7 marketplace and create a veritable seamless web of  
8 interconnectedness with logic that would be obvious to all.  
9 Now, it has been said of me in the past that he is seldom  
10 right but never in doubt. But I have to say I cannot lay  
11 claim to such prophetic vision. And realistically the forces  
12 at work in today's marketplace belie a simple solution or  
13 easy fix.

14 So even as we discuss these issues we cannot and  
15 must not lose sight of our limitations. It sort of reminds  
16 me of the trio of revolutionaries sipping coffee in Boston on  
17 the day of the Boston Tea Party. And as they sat at a cafe  
18 the mob filled the street moving toward the harbor. The  
19 rebels watched with great interest. And eventually one said,  
20 We can't just sit here and watch. We are their leaders, we  
21 must follow them.

22 This is also the ineluctable fate of regulators.  
23 We see ourselves as leaders but in fact we are almost always  
24 in the position of following the markets and trying to catch  
25 up.

1           Now, during the past 70 years the Securities and  
2 Exchange Commission has been guided by certain fundamental  
3 regulatory objectives: protecting investors, maintaining  
4 market integrity, liquidity and transparency, and promoting  
5 capital formation. While our commitment to these principles  
6 has not wavered the means of accomplishing them must change  
7 along with markets. Securities regulators around the globe  
8 must regularly reexamine the purpose and efficacy of  
9 regulation and the methods chosen to accomplish their goals.

10           And integral part of this examination and  
11 reexamination must be the recognition that every nation's  
12 regulatory authority has limits but the markets we regulate  
13 transcend those limits. We must also acknowledge our  
14 inherent shortcomings. The changes in our markets are so  
15 dynamic that the more specific the regulatory approach we  
16 adopt the more likely it is to become obsolete unless we  
17 craft flexible approaches that permit and foster innovative  
18 methods of regulation and compliance that are fully capable  
19 of evolving with the markets.

20           Let me take a few moments to highlight some of the  
21 marketplace developments at home and abroad that require us  
22 to rethink our approaches to regulation.

23           In our national marketplace a confluence of events  
24 has resulted in the blurring of more than just geographic  
25 distinctions. The elimination of clear boundaries separating

1 categories of investment intermediaries and types of  
2 investment products has created an environment ripe for  
3 regulatory inconsistencies and, worse, regulatory arbitrage.  
4 Here in the U.S. the passage of the groundbreaking Graham-  
5 Leach-White Financial Modernization Act eliminated barriers  
6 that traditionally separated U.S. financial industry  
7 professionals into discrete regulatory segments. In this  
8 regard we have trailed most of the rest of the world which  
9 seems to have gotten along just fine without the harsh  
10 separate walls we used to impose between commercial and investment  
11 banking.

12           Similarly, the distinctions between banking,  
13 insurance, commodity and securities regulation have been  
14 shifting. Because of this the financial services industry  
15 has seen firms consolidate while watching the services these  
16 firms offer expand. And the growth of for-profit electronic  
17 trading networks has put a new spin on old issues like market  
18 fragmentation and competition.

19           At the international level investors in any nation  
20 can now access foreign markets more easily than ever before.  
21 This in turn has profound implications for an issuer's need  
22 to list on foreign markets in order to raise capital there  
23 and on the ability of the regulator to oversee the markets in  
24 which its investors operate.

25           Investors too are in many ways very different from

1 investors of days past. Today's investors have new and  
2 greater expectations as their investment needs have evolved.  
3 The transition from defined benefit retirement plans to  
4 defined contribution retirement accounts has brought more  
5 investors into our markets and imposed greater demands on  
6 these investors to understand investment risk theory,  
7 portfolio management and asset allocation. Recent studies,  
8 as Senator Sarbanes indicated, show that roughly one out of  
9 every two households now has an investment in securities.

10           While retail investors today have greater access  
11 via electronic technology to financial information and  
12 execution systems it is an open question whether these same  
13 investors have sufficient training and adequate time to  
14 utilize those tools. Just as investors' needs are changing,  
15 market professionals are rethinking and reinventing the  
16 services they provide, their role and their compensation  
17 structure. For example, a proposed Commission rule would  
18 permit brokers who provide portfolio advice to receive asset  
19 based compensation rather than commissions. Broker and  
20 investment advisors are offering financial services that seem  
21 more and more alike.

22           Similarly, collective investment vehicles like  
23 hedge funds, mutual funds and online investment portfolios  
24 are given very different regulatory treatment, although  
25 increasingly they appear to be providing comparable services



1 to similar types of investors. We must ascertain whether or  
2 regulations continue to keep pace with the new and evolving  
3 products, changes in the roles played by financial  
4 intermediaries or changes in our markets' structures. If we  
5 conclude that they do not, then it is our challenge as  
6 regulators to find new approaches to keep pace with  
7 innovation and the increasing importance of technology.

8 For this reason I have already announced that we  
9 are rethinking our approach to one of the fundamental  
10 contributions of the federal securities laws, full and fair  
11 disclosure. In my view we need to supplement the static,  
12 periodic disclosure model that has long served investors well  
13 but in today's world results in the delivery of information  
14 that is often stale upon arrival and impenetrable to many of  
15 those who receive it. I believe we need to move toward a  
16 dynamic model of current disclosure of unquestionably  
17 material information. We need to clarify and sharpen  
18 financial disclosure so that every investor can readily  
19 understand the company's true financial picture.

20 In short, we need to come up with an approach that  
21 is less burdensome but more meaningful than the current  
22 system we have. We must also be frank in recognizing that  
23 reconciling the dichotomy between the '33 Act and the '34 Act  
24 disclosure requirements necessarily will require addressing  
25 in an intelligent fashion the thorny issue of liability

1 standards.

2 We also need to recognize that the issuer  
3 population subject to our standards is increasingly a global  
4 issuer community. Consider that in 1981 we had 173 foreign  
5 companies registered with the SEC. By 1991 that number had  
6 increased to 439. And today by the end of 2001 we expect to  
7 have 1,400 foreign companies registered with the SEC.

8 Although U.S. markets have had success in  
9 attracting foreign companies to our public markets we cannot  
10 rest on our laurels. U.S. investors already invest around  
11 the globe and, therefore, their interest will be best served  
12 if foreign companies can be brought into our markets which  
13 offer the protections of fair trading and full and fair  
14 disclosure by the companies whose securities trade in those  
15 markets. We must make it inviting for global businesses to  
16 offer and trade their securities in our markets but without  
17 sacrificing necessary investor protections. This is a  
18 consistent Commission message but sometimes it has been  
19 obscured. So I want to make it unequivocally clear, we are  
20 determined to find a way to make our markets as hospitable as  
21 possible to issuers around the world while adhering to our  
22 mandate of investor protection.

23 We also must note that our past regulatory  
24 successes in facilitating the private offering process now  
25 compel us to reexamine regulations that are causing seasoned

1 public companies to opt for private offerings over public  
2 offerings. Entities raising capital in a private offering  
3 have far fewer regulatory hurdles than those that access  
4 public markets. We need to ask whether these discrepancies  
5 are in keeping with our regulatory objectives. Should we  
6 treat new issuers differently from seasoned issuers?  
7 Conversely, if we make changes in the offering process the  
8 seasoned issuers can we foresee how they will then affect the  
9 attractiveness of the private offering process? These are  
10 just some of the many issues we must face as we move forward.

11           What is key in my view is that we address these  
12 issues and issuers, foreign versus domestic, public versus  
13 private, seasoned versus unseasoned in a comprehensive manner  
14 so that our regulatory fixes do not have unintended  
15 consequences. While the area is of enormous importance, the  
16 solution we choose should be consistent with our overarching  
17 goal, certainly not more regulation and not necessarily less  
18 regulation but smarter regulation, regulation that allows  
19 markets the greatest amount of flexibility to innovate and  
20 create while still preserving and meriting investors'  
21 confidence.

22           Not surprisingly, foreign markets also are  
23 experiencing dynamic change. Domestic and foreign investors  
24 alike are showing considerable interest in other  
25 marketplaces. To put this growth in perspective considering

1 the following numbers from the Securities Industry  
2 Association: U.S. holdings of foreign securities reached  
3 nearly \$2.5 trillion by year-end 2000, up 692 percent from  
4 1991. Foreign holdings of U.S. securities were approximately  
5 \$4.2 trillion, up 340 percent over the same period.

6           Given the sheer size of these numbers we want to  
7 encourage and facilitate access by foreign issuers to our  
8 markets. As we embark on our own modernization of our  
9 offering and disclosure processes we will need to consider  
10 how any changes we make to our procedures will affect foreign  
11 as well as domestic issuers and investors. In this way we  
12 can certainly work to break down all non-essential access  
13 barriers to our markets.

14           At the same time we must examine and expand the  
15 areas in which we can work together with our foreign  
16 regulatory counterparts to come to common approaches to  
17 address issues of mutual interests. The growth of foreign  
18 markets forces us to recognize that the days when we could  
19 establish policy without considering the competitive  
20 implications of our policies on our markets have also long  
21 since passed.

22           Many of our efforts to date in the international  
23 arena have involved working with foreign regulators in a  
24 systematic and coordinated way to craft comprehensive  
25 policies that make sense for us all. Regulators around the

1 globe have worked cooperatively to forge excellent working  
2 relationships. These relationships have proved invaluable  
3 but they need to be expanded to cover the entire gamut of  
4 securities regulation and capital raising.

5           Similarly, we are inspired and encouraged by all  
6 of the cooperative efforts aimed at crafting high quality  
7 international accounting standards. While work remains to be  
8 done we are certainly well on the road toward creating the  
9 type of standards in which investors can have confidence.  
10 Looking into the future we also must appreciate that  
11 compatible core accounting standards will lose some of their  
12 value unless we work together toward consistency among  
13 nations in interpretation and application of these standards.

14           There are, of course, numerous other subjects  
15 worthy of future international efforts. Some have suggested  
16 the possibility of examining the development of multinational  
17 positions on subjects such as minority shareholder rights and  
18 the use of audit committees. I'm confident that many  
19 similarly provocative thoughts will percolate out of this  
20 conference.

21           Over the years our international successes have  
22 been achieved in a variety of ways, through unilateral  
23 efforts by us or by other regulators, through bilateral  
24 agreements such as MOUs, and through multilateral projects  
25 such as those sponsored by IASCO. Each approach has merits



1 and may be successful depending upon the nature of the issuer  
2 or goal and we will continue to use all three approaches in  
3 the future. Underlying each approach is a foundation of  
4 longstanding informal and close working relationships among  
5 regulators. It will continue to be the key to our own  
6 efforts and to the success of what I hope will be an  
7 increasing number of joint projects.

8           This is the first conference in two decades  
9 devoted to a broad examination of fundamental securities  
10 regulation issues. It could not be more timely. At the  
11 start of my stewardship of the SEC we recognize the need for  
12 a fundamental reexamination of our regulatory framework. And  
13 we would be naive if we believe that we could conduct this  
14 examination in isolation. All of us must consider changes in  
15 our markets in a global context. While we will not and  
16 cannot always share the same vision on every issue, there is  
17 much we can learn from one another and much that requires us  
18 to work together.

19           The cooperative spirit that has served us so well  
20 in the past must be our guiding principle as we marshall our  
21 collective resources to meet the challenges that lie ahead.  
22 Today and here and now we begin that process anew. The  
23 challenges that lie ahead are exciting. Together public and  
24 private sectors, domestic and foreign regulators, we can

25     reshape the very essence of our capital markets, our



1 disclosure system and the rules governing both of them with  
2 thoughtfulness, care and creativity. It is an enormous  
3 challenge but who could ask for any more?

4 Thank you.

5 (Applause.)

6 MR. RUDER: Thank you, Mr. Chairman.

7 We are adjourned until tomorrow morning at 8:30.

8 (Whereupon, at 8:45 p.m., the conference was  
9 adjourned, to reconvene at 8:30 a.m., Thursday, November 15,  
10 2001.)

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