

REMARKS BY ARTHUR LEVITT TO NASD BOARD

I know many of the people in this room and I've sat where you sit. I've held the positions you hold at both a small and a large firm.

I requested this meeting because we -- the NASD and the SEC -- are at a point where we should move forward with a constructive solution to what I feel is a very serious problem, one that goes to the heart of our system of self-regulation. I'm here today in the role of Chairman of the SEC, your chief regulator. But you should also see in me someone who has had the experience I spoke of before, someone who has served on boards of public companies, as well as on an SRO board. I well understand the responsibilities you have, as well as the difficulties you face in carrying them out. I want to be sure you personally receive a message that would have prompted me to act, had I heard it when I was in your position.

I will state it simply and up-front. Although our investigation is ongoing, the evidence shows that the NASD has not fulfilled its most basic responsibility -- to provide a fair and open market, and to protect the interests of investors. As an SRO you undertake quasi-public responsibilities. That calls for a strict adherence to your charter's commitment to "promote full and equitable principals of trade for the protection of investors". Anything less and you are a trade organization -- not an SRO. Instead of maintaining the delicate balance between commercial interests and the public interest, the NASD has tilted the scale in favor of the commercial side. Together, you and I must rectify that imbalance.

The Enforcement Division has met with the staff of the NASD several times, beginning last July, to discuss this record and the changes we believe will be necessary for the NASD to make in its organization and operation and I gather that you've been informed

of the substance of these discussions. From our very first meeting, we've laid out much of the information I will present to you today. While we believe that our recent meetings have been constructive, we've been perplexed by the disconnect between what we've been telling your staff and the stories we've seen in the newspaper. We feel it is now time for the Board of this institution to hear directly what our concerns are, and what we, and the public interest, require this institution to undertake.

For most of the past year, we have been treated to the spectacle of economists, the press, lawyers, and various self-styled experts debating whether there is "collusion" in the Nasdaq market, whether the SOES system is responsible for numerous problems, and whether I have a personal vendetta against the dealer markets. None of those debating has been privy to the information that the Commission has, and many of them have had a personal interest in the outcome of the debate. While this has continued, the Commission has been unable to speak publicly about the issues. I am here today to tell you that these speculations have been distractions from the real issues.

This inquiry and the solutions we seek have nothing to do with anything but my responsibility, and your responsibility, to address very real problems involving regulation of the Nasdaq market. We are motivated by our concern for the integrity of your market and the public interest. Period.

We are not interested in proving or disproving exotic economic theories. Let's leave that to the highly paid consultants. We are concerned with the old-fashioned nuts and bolts of regulating a securities market: Does the market have the capacity, and the will, to enforce its rules? Has evidence of problems in the market been appropriately pursued? Have the

rules been administered fairly? In short, is the SRO operating in compliance with its statutory responsibilities as a regulator? Should the answer to any of these questions be in the negative, the public must hold both the NASD and the SEC accountable, since we both have the responsibility to assure that you meet your obligations. If you fail, we have failed. I understand that and am fully prepared to deal with it.

However I might see my public responsibility as Chairman of the SEC, each of you has perhaps a more sobering fiduciary obligation. Your duties eclipse even those which board members of a public company owe to shareholders -- they run to the public. You are required to hold the public interest above that of any issuer, any dealer, or even the competitive interest of the NASD itself.

While the Commission's investigation is continuing, I cannot lay evidence before you as such. But I believe you as Board members should know as much as I am at liberty to tell you about the facts that the Enforcement Division has given me. Like a hidden illness, one underlying problem of the NASD has surfaced in many ways. Although I will recite a few of these symptoms, my real hope today is to address the fundamental imbalance from which they spring. Remember that these are rough highlights -- but together they paint a picture of significant regulatory deficiencies.

Let's begin with the primary focus of public attention. I have said before that the word "collusion" has been a diversion. But let me be clear -- we have found that there is a widespread course of conduct among market makers to coordinate their quotes. We have testimony, taped conversations, and data to support the fact that this is market-wide -- not just a few rogue traders. Individual market maker and firm conduct in this regard is serious and

egregious. This behavior certainly violates the securities laws. It may or may not be collusion in an anti-trust context. We are not concerned with the Christie-Shultz study, the academic rhetoric, and images of smoke-filled rooms. But Nasdaq has a problem. And what is most serious is that the NASD knew that there was a problem, and failed to take effective action to address it.

In 1992 an NASD staff memo received by senior management reporting research analyzing the fact and causes of widening spreads, stated the following (I'm quoting):

"Dealer spreads are arbitrarily established at the time of an IPO and after initially set, there is no incentive to reduce them. . [when] attempts are made by individual dealers to do so, peer pressure is brought to bear to reverse any narrowing of the spreads. "

This candid appraisal rings true. It is supported by other evidence, as well as our own economic analysis, which by the way, is the only such analysis based on complete market data. The magnitude of the spreads on Nasdaq supports this conclusion. The Enforcement Division believes that spreads are kept unreasonably wide to benefit market makers, to the detriment of retail investors.

You should also know that our analysis shows that there is no basis for the argument that these stocks are somehow different, or that this type of pricing is normal for a dealer market. For some stocks in Nasdaq, we see an extraordinary degree of clustering on even eighths. However, market makers routinely quote odd eighths in other systems, such as Instinet. When we combine the Nasdaq quotes with the market maker quotes on Instinet, the distribution of quoted prices looks like every other market. Market makers coordinate their quotes in Nasdaq.

Even if you dispute these observations, it's hard to deny that the NASD should have reacted to this issue when it was posed in 1992. Yet as the issue was raised by the press and others with increasing frequency, and as the SOES controversies intensified, we do not find the NASD investigating or ventilating this issue. What we find is a public relations campaign, conducted at great expense, and aimed at appearances. Even in dealing with its regulator on issues as important as the SOES rules, we find the NASD continuing to assert that SOES was an overriding cause of spread width, and that there simply was no discrimination or harassment.

Instead of facing the facts, the NASD has been managing the message. The focus on shoring up an image of the market appears to be carried to extremes with respect to academic research as well. Let me quote again from a 1994 in-house memo:

"At recent meetings to deal with the bad press it has been suggested that what the NASD needs is a program to generate more positive studies that would be available to counter the damage to Nasdaq's image from negative occurrences. "

As Board members, you are aware that the NASD is a major supporter of academic research on market issues, as are other markets. But are you aware that the NASD, through financial incentives and other means, exercises control over material that is otherwise purported to be independent? You can see the potential for misleading the industry and the public.

The same overriding concern for appearances is evidenced in the reaction to our initial inquiries. We have obtained a 20-page crisis management plan prepared by the NASD staff in conjunction with an outside consultant. The plan recommends an extensive public relations campaign designed solely to influence public opinion, both through staff efforts and through

such surrogates as high-profile economists and lawyers. This is like a football team trying to turn around a losing streak by taking sports writers to lunch. Nowhere in this plan is there any call for candid review and analysis of the problems of the Nasdaq stock market.

The concerns over appearances went so far as to influence at least one executive's compensation arrangement. His 1995 incentive goals provide that one of the performance standards he will strive to meet is "effectively manage our response to the SEC's investigation and our ongoing relationship with the SEC staff and the Chairman's office with the result that no formal action is brought against the NASD." I ask you whether it would not be much more appropriate to base incentive compensation on "consulting and cooperating with government agencies in finding solutions for problems affecting investors and the securities business," a phrase that comes from the NASD's own charter. For the system to work, it is as inappropriate to incent an executive of an SRO to keep its regulator at bay as to incent the head of a hospital to fend off the inquiries of health authorities.

These are but a few examples of what the Enforcement Division is finding with respect to the underlying problem and the NASD's reaction to it, but they are troubling. As Board members you must ask whether all the energy and money and time that have gone into the response should instead have gone into a bona fide effort to ensure the integrity of the market.

There are further issues. We have found that the NASD suspended surveillance of its audit trail, the primary means of surveilling this market, for a period of 14 months -- without notifying the Commission. This occurred during the height of the controversies about backing away and SOES. The hiatus began shortly after the first critical Forbes magazine article, and

continued until after the first reports of the Department of Justice investigation. During that period of time, the NASD represented publicly and to the Commission that there was no pattern of abuse by market makers, and that the NASD's surveillance procedures were state of the art.

I am also informed that the NASD has an unacceptably low level of compliance with its own trade reporting rules, resulting in the largest proportion of late trades of any major market. Late trades affect the integrity of pricing, and afford opportunity for manipulation and self-dealing. When this issue was publicly exposed by the press and academics, the NASD represented that these levels were caused by systems problems at some firms. I think that this is only partially correct. The Enforcement Division has found that the NASD conducts little effective surveillance of trade reporting compliance by its firms. They have found market making firms that had late trade rates of 20% or more. They also found the problems are much broader than "sold sales," which are trades marked as late. Simple comparison of clearing records, which NASD does not routinely do, revealed large numbers of trades reported late without being marked sold.

The Enforcement Division has found similar problems in connection with surveillance and enforcement of the firm quote rule, as well as other critical market rules. Instead of routine and vigilant surveillance, they find that NASD staff have a customer service orientation, which can distort the SRO function. Staffers have been instructed to routinely approve requests by market makers to be readmitted to market making after an unexcused withdrawal. Requests for exemption are granted as a matter of course, recordkeeping is sparse, and there is no mechanism to refer such matters to enforcement, because these are not

considered to be matters for enforcement.

Significantly, while I am informed that the NASD has failed to surveil and enforce basic market protection rules, I am also informed that enforcement efforts have been disproportionately, even discriminatorily, directed at disfavored market participants. I am told there is evidence of marketmakers providing lists of firms who use SOES actively to the NASD staff to be targeted for inspection and enforcement. The business of the NASD is regulation, not retaliation.

This type of conduct has extended to the membership application process. We've seen flatly discriminatory behavior practiced against applicants for market maker status, with the knowledge and approval of the NASD staff.

Set against the background of the NASD's failure to enforce rules routinely violated by market makers, the focus on market makers', or the market's, competitive interest is especially egregious. I don't have to tell you that the NASD is a regulatory body. It may not enforce economic discrimination. The evidence that this kind of thinking affects the NASD's enforcement agenda is clear. Any conclusion that this is appropriate is totally unacceptable.

I submit to you that any responsible corporate official reviewing the facts I've just presented would conclude that change is required -- change that is not cosmetic, but fundamental.

I've talked so far about the Board's supervisory responsibilities. Now I would like to turn to the Board's priorities.

I am concerned with the priorities expressed by the allocation of resources within the NASD. The Rudman Committee has ably identified some of them for you. In particular, the

extraordinary amounts of money spent on advertising in relation to enforcement, surveillance, and systems. I would go so far as to say that all of the problems I have addressed today are really reflected in your spending priorities. I urge you to consider this carefully. This market is absolutely critical to capital formation in our country. It is in fact, or potentially is, the largest market in the United States. I fully believe that when its problems are resolved, the Nasdaq market will continue to grow and prosper. But it's not going to get there on advertising. You must actually be able to meet your statutory responsibilities -- otherwise, you risk discredit and mistrust that will cripple you. Your market must actually perform as represented, or better. Your systems must work. As Board members, you must ask whether your resources have been allocated and used in a way that will achieve that.

No one can be more keenly aware of the importance of the effective functioning of the Nasdaq system than this Board. It is your market's lifeblood. The consequences of this market being unavailable to provide liquidity when the public demands it because of technical failure or capacity limitations haunts me. I hope you are equally concerned.

This has been a rough year for your systems. The SEC has been assured that when Workstation II is installed, capacity will be increased to close to a billion shares. We've asked the NASD to provide us with an independent assessment of those claims as well as whether the current system is configured to grow further as needed. I am concerned that we are running out of time. I ask you as the Board to assure yourselves that enough resources are being devoted to systems capacity and reliability, to planning for the future, and that you have internal and external expertise that is second to none. Find out what other markets are investing in infrastructure; find out whether your technology is the best possible; find out

whether you are doing the best possible job.

I've talked at length about the problems. What are the solutions?

One is for the public representation on the organization's boards to rise to 50%. The Rudman Committee has recommended a particular structure. I understand you will be considering some modification of that today. We have not seen the specifics of the proposal before you, so I will not comment on it, beyond saying that at least half of your directors should have no affiliation with broker dealers, or with the NASD itself. These governors should be a significant presence on key committees that have public responsibilities. They as well as those who head these boards should represent the most distinguished leaders in our industry and our community. If I can be of any help in recruiting such leaders, I commit to you today to do so. The restoration of public confidence will require not only the perception of excellence in every aspect of your management and governance, but also the reality of excellence. This is the first step.

We have presented the NASD staff with a list of changes that we feel must be made in the organization. Let me briefly summarize them for you. This is not a negotiation, these are not bargaining chips to be traded away. The values, the standards, the very soul of this organization is at stake.

The NASD must establish an autonomous and independent regulatory staff with sole discretion as to what matters to investigate and prosecute, and as to membership issues. The staff must prepare rule proposals and policy matters with evenhanded consultation with all of NASD's constituencies. These should be structural as well as procedural changes.

Membership involvement in the initiation of investigations and disciplinary proceedings should be eliminated, although we would expect a continued role for peer review in the hearing process. We would expect professional hearing officers to chair disciplinary cases.

There is more:

A substantial, independent internal audit staff, which reviews all aspects of the NASD, and reports directly to a committee that has a majority of public directors, one of whom serves as Chairman.

An improved audit trail, sufficient to enable the NASD to effectively surveil and enforce its rules. This clearly requires a significant financial commitment.

Substantially upgraded capacity to enforce late trade reporting and the firm quote rule.

Improved surveillance and examination of order handling.

We have asked that you adopt a rule specifically making it unlawful for market makers to coordinate quotes or trade reports, and which prohibits retribution and retaliation for competitive conduct.

We have asked for an undertaking that the NASD enforce its rules of fair practice to eliminate pricing conventions and coordination of trades and quotes, and to protect market participants from unfair discrimination and refusals to deal.

As I mentioned at the outset, we feel we have made progress in discussing these issues with your staff in recent weeks. But we are a long way from being done. You will have to see this to completion. It is far better for the NASD to make these changes than for the Commission to force them.

Most important of all is one thing that cannot be reduced to paper or rules. We ask you to abandon the fortress mentality that has colored all of our discussions since these issues first began to emerge. The result has been slow torture for this market. It is personally appalling to me that we have found ourselves in an adversarial posture. Let's end the sparring. We all have to do our jobs now. Mine is to assure that this market is as good as it can be; that it fulfills its statutory requirements; that public confidence in its fairness is restored. Your job is the same. You are not spectators at a play. These are your decisions, your responsibility and you are accountable to the public. There need to be structural changes, and they need to be the right ones. There needs to be a demonstrated will to address the problems, ventilate them, get them out in the sunlight, and so get rid of them. I want this to play out in substantive changes, not in the press. I want this market to move on, and become the great market it can be. But it is up to you.

There is much at stake here -- for your market, and for your firms. I think you have a choice.

You can go down in history as the Board that turned its eyes away. Or you can be the Board that saved one of our nation's most important and productive markets.

You can be remembered as a country club. Or you can be remembered as a fearless advocate for the public interest -- which is really your own interest.

You can be the Board that stalled the SEC, made cosmetic changes, and ate up time in the hope of avoiding the tough choices. Or you can be remembered as the Board that confronted this market's problems head-on and took the NASD into the next century as a strong and vibrant force.

For your sake, and for the sake of your market, I hope you will make the right choice
now.

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