NASD

SUMMARY of TESTIMONY

Hearing on the Global Settlement

Before the Senate Banking Committee

May 7, 2003

Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD, the world's largest securities industry self regulatory organization. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

In December of 2002, federal and state securities regulators reached an agreement in principle with ten of the nation's largest investment banks to resolve issues of conflicts of interest involving research analysis and IPOs. Last week the agreement was finalized.

Under the terms of the settlement, the ten firms will pay a total of $875 million in penalties and disgorgement, consisting of $387.5 million in disgorgement and $487.5 million in penalties. Under the settlement agreements, half of the $775 million payment by the firms other than Merrill Lynch will be paid in resolution of actions brought by the SEC, NYSE and NASD, and will be put into a fund to benefit customers of the firms. The remainder of the funds will be paid to the states. In addition, the firms will make payments totaling $432.5 million to fund independent research, and payments of $80 million from seven of the firms will fund and promote investor education. The total of all payments is roughly $1.4 billion. Under the terms of the settlement, the firms will not seek reimbursement or indemnification for any penalties that they pay. In addition, the firms will not seek a tax deduction or tax credit with regard to any federal, state or local tax for any penalty amounts that they pay under the settlement.

The individual penalties include some of the highest ever imposed in civil enforcement actions under the securities laws.

The global settlement is only part of the full-court press that NASD has been pursuing to strengthen market integrity and rebuild investor confidence. We have been busier than ever in the area of enforcement -- punishing individuals, as well as firms, for breaking the rules.

NASD writes rules that govern the behavior of securities firms, examines them for compliance with NASD rules and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our market integrity responsibilities include regulation; professional training; licensing and registration; investigation and enforcement; dispute resolution; and investor education. We monitor all trading on the NASDAQ stock market -- more than 70 million orders, quotes and trades per day. NASD has a nationwide staff of over 2000.

It is important to note that while the global settlement is limited both in time and the participants it covers, NASD rules are not limited – they cover the entire brokerage industry -- and will form the basic scaffolding for a national system of rules that protect investors, whether they live in Birmingham or Baltimore, Berkeley or Brooklyn.

Beginning in 2000, NASD began aggressively investigating IPO practices and research analyst conflicts. To date, NASD has investigated and brought charges in more than a dozen important analyst and IPO allocation cases against individuals as well as firms. For example:

- NASD and the SEC brought a groundbreaking IPO case against Credit Suisse First Boston that was finally settled at the beginning of last year for $100 million in sanctions. We caught CSFB carrying out a systematic scheme whereby -- in exchange for dishing out shares of hot new IPOs to chosen customers -- it demanded and received paybacks of between 33 and 65 percent of customers' trading profits in those IPO shares, by getting vastly inflated commissions on unrelated trades.

- NASD developed substantive spinning cases -- the only federal or state regulator to do so -- against CSFB and Salomon Smith Barney. These cases were later made part of the global settlement.

- We were the first to file charges against Jack Grubman, as well as Salomon Smith Barney, for misleading research. In September 2002, the firm paid $5 million in sanctions; Grumman subsequently paid $15 million; and most important, the former telecom analyst is now barred from the securities industry for life.

- NASD likewise brought the first charges against investment banker Frank Quattrone, for failing to supervise his research analysts and improper IPO spinning to favored executives. Mr. Quattrone is contesting the charges. Soon after, he was indicted for obstruction of justice of NASD's and others' earlier investigation of IPO profit sharing.

- The individual charges against dot.com analyst Henry Blodget investigated by NASD and jointly brought with other federal regulators were wrapped into the global settlement. Blodget paid $4 million in fines and is barred from the securities industry for life as well.

  In all these enforcement efforts NASD has underscored several important principles:

  - that analyst research cannot be a servant of investment banking;

  - that hot IPOs cannot be doled out to corporate insiders as virtual commercial bribes; and

  - that since firms act through individuals, individuals, too, will be held accountable for their misdeeds.

And we are by no means done with our efforts. NASD is continuing to investigate and develop cases against those in the securities industry that have violated their supervisory or individual responsibilities to the investing public.

The global settlement will strengthen the industry's own business practices and ethical standards. And it will be enforced by NASD and the other regulators with a full range of disciplinary options – which include stiff fines and the potential for expulsion from the industry.

Testimony

of

Robert Glauber

Chairman and CEO

Before
the
United States Senate
Committee on Banking, Housing and Urban Affairs

May 7, 2003

In December of 2002, the Securities and Exchange Commission (SEC), New York Attorney General, the North American Securities Administrators Association (NASAA), the New York Stock Exchange (NYSE), and NASD reached an agreement in principle with ten of the nation's largest investment banks to resolve issues of conflicts of interest involving research analysis and initial public offerings (IPOs). On April 28, 2003, regulators announced that the agreement had been finalized. This "global settlement" concludes a joint investigation begun in April by regulators into the undue influence of investment banking interests on securities research at brokerage firms. NASD will continue to investigate and bring cases against individuals who have neglected their personal or supervisory responsibilities to the investing public.

The settlement, along with new rules and enforcement cases that are in force or being developed, will go a long way toward ensuring that these problems are effectively addressed -- not only at the large investment houses that are party to this settlement, but throughout a diverse industry.

NASD

This global settlement is only part of the full-court press that NASD has been pursuing to strengthen market integrity and rebuild investor confidence. We have been busier than ever in the area of enforcement -- punishing individuals, as well as firms, for breaking the rules. We have been working with the NYSE on writing and preparing new rules on analyst research and initial public offerings -- and carefully studying what additional measures are needed. We have stepped up our investor education efforts across the board. Our dispute resolution services have been more heavily used than ever -- with almost 75 percent of cases resulting in a monetary recovery for the investor. And we are devoting unprecedented attention to strengthening the securities industry's own compliance mechanisms and efforts -- both with a targeted new certification proposal and with new tools that will help brokerage firms meet their self-compliance responsibilities.

NASD, the world's largest securities self-regulatory organization, was established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines them for compliance with NASD rules and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our market integrity responsibilities include regulation; professional training; licensing and registration; investigation and enforcement; dispute resolution; and investor education. We monitor all trading on The NASDAQ Stock Market -- more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2000 and is governed by a Board of Governors – at least half of whom are unaffiliated with the securities industry.

NASD Rules

Tough enforcement is only part of the equation. To prevent these kinds of abuses in the future, it is necessary not only to punish those who violated existing NASD rules and securities laws, but also to lay down a comprehensive framework of rules and laws that will protect investors and the integrity of our markets. It is important to note that while the global settlement is limited both in time and the participants it covers, NASD rules are not limited – they cover the entire brokerage industry -- and will form the basic scaffolding for a national system of rules that protect investors, whether they live in Birmingham or Baltimore, Berkeley or Brooklyn.

NASD and the NYSE have written two sets of analyst rules toward exactly that end. Our rules use a combination of disclosure and outright prohibitions to assure that investors are more informed and analysts are more independent. These rules were the model for several global settlement provisions -- including those declaring that analyst compensation cannot be influenced by any input from investment bankers. NASD has already begun examining for compliance with these new rules.

NASD rule-writers have been active on the IPO front as well. Last year, NASD issued proposed rules to make even more explicit the prohibitions against such practices as "spinning," "laddering," and quid pro quo arrangements. These practices were the most common IPO abuses during the bubble of 1999 and 2000 -- and they are among the most likely to pose a temptation when the IPO market heats up again.

Spinning is when an investment bank parcels out oversubscribed IPO shares so as to induce future investment banking business. Laddering is when an IPO underwriter requires the commitment to purchase IPO shares in the aftermarket, in order to be allocated some shares of the initial offering. Quid pro quo arrangements are the kinds of dealings where investment banks work out kickbacks to share in the profits of hot IPOs with their favored customers.

The SEC has held these new IPO rules in abeyance for the time being. In the meantime, it asked NASD and the NYSE to convene a blue-ribbon panel to take an even more comprehensive look at the process by which IPOs are priced, brought to market, and purchased by investors. We have brought together a truly eminent panel of experts to do so, and its analysis has been penetrating. The panel's report is not yet public, but its recommendations are due soon. The SEC will then take those recommendations, as well as NASD's proposed rules, into account in deciding what rules to issue in this vital area of capital formation. The global settlement explicitly contemplates that its provisions limiting the distribution of hot IPOs will be superceded by more comprehensive SEC rules.

NASD Enforcement Efforts

The U.S. capital markets are not only the most liquid and developed, but overall the best run in the world. In the past decade, more than 5,600 domestic and foreign enterprises have raised a total of over $500 billion through initial public offerings in U.S. markets. For companies seeking to raise capital, go public, or find a partner, the U.S. capital-formation environment remains the most attractive anywhere. Healthy capital markets are an engine of the U.S. economy -- and as such, nothing less than a national security asset. That is another reason why we take our responsibility to police IPO practices so seriously.

When the high-tech bubble burst and stock prices began to fall dramatically in the second half of 2000, many people began to wonder why the analyst recommendations sounded strangely the same as during the bull market. In fact, during the excruciating slide from the top of the market in 2000 to the low after 9/11, "strong buy" or "buy" recommendations outnumbered "sells" by a ratio of more than 50 to 1.

Beginning in 2000, NASD began aggressively investigating IPO practices and research analyst conflicts. To date, NASD has investigated and brought charges in more than a dozen important analyst and IPO allocation cases against individuals as well as firms. For example:

- NASD and the SEC brought a groundbreaking IPO case against Credit Suisse First Boston that was finally settled at the beginning of last year for $100 million in sanctions. We caught CSFB carrying out a systematic scheme whereby -- in exchange for dishing out shares of hot new IPOs to chosen customers -- it demanded and received paybacks of between 33 and 65 percent of customers' trading profits in those IPO shares, by getting vastly inflated commissions on unrelated trades.

- We have successfully reached settlements with Robertson Stephens and two other firms, against which NASD has levied more than $20 million in fines for IPO profit-sharing violations.

- NASD developed substantive spinning cases -- the only federal or state regulator to do so -- against CSFB and Salomon Smith Barney. These cases were later made part of the global settlement.

- We were the first to file charges against Jack Grubman, as well as Salomon Smith Barney, for misleading research. In September 2002, the firm paid $5 million in sanctions; Grubman subsequently paid $15 million; and most important, the former telecom analyst is now barred from the securities industry for life.

- NASD likewise brought the first charges against investment banker Frank Quattrone, for failing to supervise his research analysts and improper IPO spinning to favored executives. Mr. Quattrone is contesting the charges. Soon after, he was indicted for obstruction of justice of NASD's and others' earlier investigation of IPO profit sharing.

- The individual charges against dot.com analyst Henry Blodget investigated by NASD and jointly brought with other federal regulators were wrapped into the global settlement. Blodget paid $4 million in fines and is barred from the securities industry for life as well.

In all these enforcement efforts NASD has underscored several important principles:

- that analyst research cannot be a servant of investment banking;

- that hot IPOs cannot be doled out to corporate insiders as virtual commercial bribes; and

- that since firms act through individuals, individuals, too, will be held accountable for their misdeeds.

And we are by no means done with our efforts. NASD is continuing to investigate and develop cases against those in the securities industry who have violated their supervisory or individual responsibilities to the investing public.

Global Settlement Terms

The "global settlement" concludes a joint investigation begun in April 2002 by regulators into the undue influence of investment banking interests on securities research at brokerage firms. The settlement will bring about balanced reform in the industry and bolster confidence in the integrity of equity research.

Terms of the agreement include:

- The insulation of research analysts from investment banking pressure. Firms will be required to sever the links between research and investment banking, including the direct or indirect influence of banking on analyst compensation, and the practice of analysts accompanying investment banking personnel on pitches and road shows. This will help ensure that stock recommendations are not tainted by efforts to obtain investment banking fees and that research analysts will be insulated from investment banking pressure. Among the more important reforms:

    - The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups.

    - The firms' senior management will determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking.

    - Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance.

    - Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions.

- Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows. During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction.

- The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances.

- A complete ban on the spinning of Initial Public Offerings (IPOs). Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.

- An obligation to furnish independent research. For a five-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers. An independent consultant ("monitor") for each firm, with final authority to procure independent research from independent providers, will be approved by regulators. This will ensure that individual investors get access to objective investment advice.

To ensure that individual investors get access to objective investment advice, the firms will be obligated to furnish independent research. For a five-year period, each of the firms will be required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers. An independent consultant for each firm will have final authority to procure independent research.

- Disclosure of analyst recommendations. Each firm will make publicly available its ratings and price target forecasts. This will allow for evaluation and comparison of performance of analysts. To enable investors to evaluate and compare the performance of analysts, research analysts' historical ratings will be disclosed. Each firm will make its analysts' historical ratings and price target forecasts publicly available.

The ten firms against which enforcement actions were taken as part of the global settlements include:

- Bear, Stearns & Co. Inc. (Bear Stearns)
- Credit Suisse First Boston LLC (CSFB)
- Goldman, Sachs & Co. (Goldman)
- Lehman Brothers Inc. (Lehman)
- J.P. Morgan Securities Inc. (J.P. Morgan)
- Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch)
- Morgan Stanley & Co. Incorporated (Morgan Stanley)
- Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (SSB)
- UBS Warburg LLC (UBS Warburg)
- U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray)

Penalties, Disgorgement and Funds for Independent Research and Investor Education

Pursuant to the enforcement actions, the ten firms will pay a total of $875 million in penalties and disgorgement, consisting of $387.5 million in disgorgement and $487.5 million in penalties (which includes Merrill Lynch's previous payment of $100 million in connection with its prior settlement with the states relating to research analyst conflicts of interest). Under the settlement agreements, half of the $775 million payment by the firms other than Merrill Lynch will be paid in resolution of actions brought by the SEC, NYSE, and NASD, and will be put into a fund to benefit customers of the firms. The remainder of the funds will be paid to the states. In addition, the firms will make payments totaling $432.5 million to fund independent research, and payments of $80 million from seven of the firms will fund and promote investor education. The total of all payments is roughly $1.4 billion.

An issue that has been under close scrutiny by members of the Senate and that this Committee is especially interesting in includes a provision that the firms will not seek reimbursement or indemnification for any penalties that they pay. In addition, the firms will not seek a tax deduction or tax credit with regard to any federal, state, or local tax for any penalty amounts that they pay under the settlement.

The individual penalties include some of the highest ever imposed in civil enforcement actions under the securities laws.

Enforcement Actions

The enforcement actions allege that, from approximately mid-1999 through mid-2001 or later, all of the firms engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on research analysts that the firms failed to manage in an adequate or appropriate manner. In addition, the regulators found supervisory deficiencies at every firm. The enforcement actions, the allegations of which were neither admitted nor denied by the firms, also included additional charges:

- CSFB, Merrill Lynch, and SSB issued fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934 as well as various state statutes;

- Bear Stearns, CSFB, Goldman, Lehman, Merrill Lynch, Piper Jaffray, SSB, and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts; contained exaggerated or unwarranted claims about the covered companies; and/or contained opinions for which there were no reasonable bases in violation of NYSE Rules 401, 472 and 476(a)(6), and NASD Rules 2110 and 2210 as well as state ethics statutes;

- UBS Warburg and Piper Jaffray received payments for research without disclosing such payments in violation of Section 17(b) of the Securities Act of 1933, as well as NYSE Rules 476(a)(6), 401 and 472 and NASD Rules 2210 and 2110. Those two firms, as well as Bear Stearns, J.P. Morgan, and Morgan Stanley, made undisclosed payments for research in violation of NYSE Rules 476(a)(6), 401, and 472 and NASD Rules 2210 and 2110 and state statutes; and

- CSFB and SSB engaged in inappropriate spinning of "hot" Initial Public Offering (IPO) allocations in violation of SRO rules requiring adherence to high business standards and just and equitable principles of trade, and the firms' books and records relating to certain transactions violated the broker/dealer record-keeping provisions of Section 17(a) of the Securities Exchange Act of 1934 and SRO rules (NYSE Rule 440 and NASD Rule 3110).

Under the terms of the settlement, an injunction will be entered against each of the firms, enjoining it from violating the statutes and rules that it is alleged to have violated.

Investor Education

Further, seven of the firms will collectively pay $80 million for investor education. The SEC, NYSE, and NASD have authorized that $52.5 million of these funds be put into an Investor Education Fund that will develop and support programs designed to equip investors with the knowledge and skills necessary to make informed decisions. The remaining $27.5 million will be paid to state securities regulators and will be used by them for investor education purposes.

In addition to the other restrictions and requirements imposed by the enforcement actions, the ten firms have collectively entered into a voluntary agreement restricting allocations of securities in hot IPOs -- offerings that begin trading in the aftermarket at a premium -- to certain company executive officers and directors, a practice known as "spinning." This will promote fairness in the allocation of IPO shares and prevent investment banking firms from steering these shares to executive's personal accounts to attract investment banking business.

Conclusion

The global settlement will strengthen the industry's own business practices and ethical standards. And it will be enforced by NASD and the other regulators with a full range of disciplinary options – which include stiff fines and the potential for expulsion from the industry. While the settlement does not solve all the problems revealed in recent months, it is an important step in restoring investor confidence in the markets.

The work of your Committee and the Congress will be vital in addressing the myriad other issues that will arise in the wake of the settlement. I look forward to working with you as Congress examines the range of suitable remedies to address these issues.