



Testimony

of

Mary L. Schapiro

**NASD Vice Chairman and President
Regulatory Policy and Oversight**

On H.R. 2179

Before

the

**Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises**

United States House of Representatives

June 5, 2003

Mr. Chairman and Members of the Subcommittee:

NASD would like to thank the committee for the invitation to submit this written statement for the record in support of H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act.

NASD

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 those firms 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 examination; rulewriting and interpretation; 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 2,000 and is governed by a Board of Governors -- at least half of whom are unaffiliated with the securities industry.

NASD supports H.R. 2179. These amendments to the federal securities laws will strengthen the hand of the Securities and Exchange Commission (SEC) in a number of important ways. At a time when more than 80 million American investors and many others are looking to regulators, legislators, and industry leaders to meet our collective responsibilities to protect investors and strengthen market integrity, we endorse the bill's twin goals of maximizing the restitution returned to injured investors and strengthening the tools available to our nation's federal securities regulator.

Role of the FAIR Fund in the Global Settlement

On April 28, 2003, the SEC, the North American Securities Administrators Association (NASAA), the New York Attorney General, the New York Stock Exchange (NYSE), and NASD reached an agreement with ten of the nation's largest investment banks to resolve issues of conflicts of interest involving research analysts and investment banking. This "global settlement" concluded a joint investigation by the regulators into the undue influence of investment banking interests on securities research at brokerage firms. The settlement, along with new rules and other enforcement cases that already have been filed or are being investigated, will go a long way toward ensuring that these problems are

effectively addressed -- not only at the large investment houses that are party to the settlement, but throughout a diverse industry.

During the negotiations on the global settlement, the federal regulators were able to use the FAIR Fund (Federal Account for Investor Restitution Fund), established in the Sarbanes-Oxley legislation last year at the urging of Chairman Baker, as the mechanism to return civil penalty funds to injured investors. Under the terms of the settlement, the firms agreed to pay a total of \$1.4 billion. Of this amount, \$387.5 million in penalties and disgorgement will be paid to the FAIR fund to benefit injured customers of the firms. The states will receive an equal amount, \$487.5 million, to use as they deem appropriate. The firms will also 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.

Of the \$80 million that will be paid for investor education, the SEC, NYSE and NASD have authorized that \$52.5 million will be placed in 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.

The global settlement demonstrated extraordinary cooperation among our nation's securities regulators. Each of the regulators involved play an important role in policing our securities markets: the SEC has overall responsibility for setting the structure of securities regulation; self-regulatory organizations like NASD oversee day-to-day operations of the market and enforce the rules; and the state securities regulators are our partners in enforcement, adding more "cops on the beat" to securities regulation in this country.

Those of us who played a role in the settlement wanted to underscore four basic principles:

- One, to change the way Wall Street does business.
- Two, to get maximum recovery to investors by using the FAIR fund.
- Three, to fund investor education in innovative and effective ways.
- And last but not least, to make certain that the evidence we uncovered would be made available to investors so that they would be able to seek recovery of their losses through meritorious arbitrations and court proceedings.

H.R. 2179

The changes to the FAIR fund included in H.R. 2179 are important for our shared goals of maximizing recovery to investors.

One way to rebuild investor confidence is by assuring investors that when they have been defrauded and a firm is forced to pay penalties, the money that is paid will go to restitution or, more generally, for investor protection, through securities enforcement or education. Money collected by government regulators in securities enforcement actions should go back to those who were victimized by the wrongdoing or, where the injured are not readily identifiable or if the case involves a matter where there are no discernable or identifiable victims, the money should be used for investor protection or securities regulatory purposes. A centralized fund such as that envisioned in Section 8 of the bill is a highly effective tool for this purpose.

And Section 8 will not diminish the effectiveness of federal or state regulators in pursuing wrongdoing.

Another provision that investors will find helpful as they attempt to collect from those who have defrauded them is the elimination of the homestead exemption contained in the bill. By authorizing the SEC to foreclose on homes to satisfy judgments in securities cases, the bill helps prevent situations where illicit profits wind up in the pockets of wrongdoers, while investors' pockets remain empty. This is an important provision for solving the classic problem of crooks building massive homes to shelter ill-gotten gains and keep from paying judgments to injured investors.

Other provisions in the bill will significantly change the calculus made by some companies and individuals, who currently reason that paying SEC penalties is simply a cost of doing business and not a public recognition that they violated investor protection laws. Giving the SEC authority to impose monetary penalties in cease and desist proceedings, and significantly increasing the maximum fines that courts can impose for violations of the securities laws, sends a strong signal to companies and individuals. We support the greater efficiency provided by allowing the SEC to seek civil monetary penalties from non-regulatees in an administrative proceeding, without having to go to federal court. Facilitating the SEC's collection of financial records will be helpful and the requirement that a formal order be in effect before a subpoena for such records is issued without notice will protect against possible abuse.

Expanding the SEC's existing authority for nationwide service of process to include subpoenas issued in federal court actions removes an impediment to the SEC's efficiency, speed, and ability to build compelling cases through the use of live testimony. In terms of litigating securities fraud cases, there is nothing more compelling than live witnesses. With this provision in effect, the SEC will be able to present stronger cases that will have more impact with judicial fact finders.

Likewise, Section 4, authorizing the SEC to accept voluntary production of otherwise-privileged information to assist in an investigation without the provider waiving the privilege should expand the SEC's access to internally directed reports and analysis, thus speeding a fair resolution to SEC investigations by eliminating time-consuming negotiations and discussions over privilege.

NASD can attest to the difficulty of debt collection resulting from securities litigation. Granting the SEC the authority to hire private lawyers for debt collection means that scarce government resources will not have to be diverted to collection activities.

All these provisions will result in aiding investors as they seek to recover their losses.

NASD Dispute Resolution

NASD helps investors recover losses through our arbitration forum, in which we strive to ensure that there is a fair and cost-effective process for resolving disputes between investors and brokerage firms. NASD has administered securities arbitration cases for more than 30 years, and today we administer more than 90 percent of all securities arbitrations in the U.S. If a firm fails to pay arbitration awards, it is suspended from membership in NASD and thus from the securities industry.

Arbitration is a faster, more convenient and less costly alternative to court litigation. NASD's mediation forum successfully reaches a settlement in nearly eighty percent of cases, with an averaged elapsed time of just four months. The bottom line – including settlement, as well as decisions – is that in all of the customer arbitration and mediation cases filed with NASD, almost seventy-five per cent result in compensation to investors.

Any claim that an investor believes he or she has against his or her broker or the broker's employer may be brought in the NASD arbitration forum. In 2002, the most widespread complaint was for breach of fiduciary duty. Other common complaints were unsuitable recommendations, failure to supervise and misrepresentation.

NASD also manages a mediation program, which is an informal, voluntary process in which an impartial person, trained in negotiation and facilitating settlements, helps parties reach a mutually acceptable resolution. Mediation is non-binding, and during the last seven years nearly eighty percent of NASD-managed mediation cases reached a settlement.

Conclusion

At NASD, we believe that, in addition to crafting tailored enforcement remedies and effective regulatory changes, an important part of restoring investor trust is to ensure and demonstrate very publicly that, where wrongdoing is uncovered and proven, significant fines will be collected and channeled to greater enforcement efforts, enhanced regulation and, through restitution, to investors. H.R. 2179 furthers the goals of maximizing restitution to investors and arming the SEC with additional tools to quickly and

effectively combat securities law violations and we thank the Subcommittee for this to chance to testify in support of the bill.