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Monday, January 31, 2005

Mr. Jonathan G. Katz
Secretary
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
450 Fifth Street, NW
Washington, D.C. 20549-0609

RE: File No. S7-38-04

Dear Mr. Katz:

I am writing concerning newly proposed “proposing revisions to the registration, communications, and offering processes under the Securities Act that (the SEC) believe(s), while limited in scope, properly address the areas that are in need of modernization.”

We understand that the “proposal involve(s) three main areas:
• communications related to registered securities offerings;
• registration and other procedures in the offering and capital formation processes; and
• delivery of information to investors, including delivery through access and notice, and timeliness of that delivery.”

Background

William Michael Cunningham registered with the U.S. Securities and Exchange Commission as an Investment Advisor on February 2, 1990. He registered with the D.C. Public Service Commission as an Investment Advisor on January 28, 1994. Mr. Cunningham manages an investment advisory and research firm, Creative Investment Research, Inc. The firm researches and creates socially responsible investments and provides socially responsible investment advisory services.

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Mr. Cunningham's understanding of capital markets is based on first hand knowledge obtained in a number of positions at a diverse set of major financial institutions. He served as Senior Investment Analyst for an insurance company. Mr. Cunningham was an Institutional Sales Representative in the Fixed Income and Futures and Options Group for the largest investment bank on Wall Street firm. Mr. Cunningham also served as Director of Investor Relations for a New York Stock Exchange-traded firm. In 1994, his firm launched one of the first investment advisor websites.

The firm and Mr. Cunningham have long been concerned with the Commission's ability to carry out its primary mission: "to protect investors and maintain the integrity of the securities markets." We base this apprehension on the following:

- On July 9, 1993, Mr. Cunningham wrote an SEC Commissioner to notify the Commission about a certain specific investing "scam." A timely warning was not issued to the investing public.[1]

- In April 1995, following a through and objective study, Mr. Cunningham recommended investors not purchase municipal bonds issued by the District of Columbia. In retaliation, Mr. Cunningham was subject to certain "unfair regulatory practices" by the Government of the District of Columbia. He requested the Commission review this action. No review was ever conducted.

- On June 18, 1998, Creative Investment Research opposed the application, approved by the Federal Reserve Board on September 23, 1998 and endorsed by the Commission, of Travelers Group Inc. to become a bank holding company by acquiring Citicorp. One Travelers subsidiary, Salomon Smith Barney Inc., (created when Salomon, Inc. merged with Smith Barney) had a history of defrauding investors and

[1] We note that at least one U.S. citizen was murdered as a result of this scam. Certainly, the SEC failed, in the most direct and critical sense, to protect this investor.

operating schemes in restraint of trade.[2] This single fact should have rendered the proposed merger potentially injurious to the public welfare and, therefore, prohibited. *It did not.* On April 28, 2003, the merged firm, Citigroup Global Markets Inc., paid fines totaling $400 million. The firm was found, again, to be defrauding investors and operating schemes in restraint of trade.

$ In an October 1998 petition to the United States Court of Appeals[3], Mr. Cunningham cited evidence that growing financial market malfeasance greatly exacerbated risks in financial markets, reducing the safety and soundness of large financial institutions. He went on to note that:

> "The nature of financial market activities is such that significant dislocations can and do occur quickly, with great force. These dislocations strike across institutional lines. That is, they affect both banks and securities firms. The financial institution regulatory structure is not in place to effectively evaluate these risks, however. Given this, public safety is at risk."

- From October 1999 to March 2002, Mr. Cunningham served as Manager, Social Purpose Investing for a pension fund. In that role, he was responsible for proxy voting activity. In 2001, he voted on 1395 issues impacting 401 companies. In 2000, he voted on 1903 issues impacting 422 companies. On Thursday, February 14, 2002, Mr. Cunningham wrote to Ms. Linda Snyder in the Office of the General Council to inquire about his responsibility under the duty of care standard to monitor corporate events and to vote proxies, as an SEC and State-registered investment adviser who also worked for a pension fund. Mr. Cunningham noted several incidents at work that led him to be concerned about his ability to carry out his duty to exercise proper care. As a result, he questioned Ms. Snyder about his liability for negligence on the part of his employer. The Commission responded in a timely manner.

[2] According to published reports, "the integrity of the entire U.S. Treasury securities auction market was called into question when Salomon Inc., admitted in August 1991 to serious violations of the auction rules during 1990 and 1991." In essence, the firm attempted to "monopolize" or "corner the market" in a particular U.S. Treasury security.

[3] Case Number 98-1459.

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There have been several other incidents.[4] These concerns led Mr. Cunningham to write to the House Committee on Financial Services to suggest that the SEC create a hotline to field calls about corporate accounting practices from insiders who have concerns.

Summary Comments

The Commission is proposing new rules that “would

• facilitate greater availability of information to investors and the market with regard to all issuers;
• eliminate barriers to open communications that have been made increasingly outmoded by technological advances;
• reflect the increased importance of electronic dissemination of information, including the use of the Internet;
• make the capital formation process more efficient; and
• define more clearly both the information and the timeliness of the availability of information against which a seller’s statements are evaluated for liability purposes.”

We appreciate this effort, but note the following:

Repeatedly over the past twenty years, signal market participants abandoned ethical principles in the pursuit of material well being.[5] This

[4] From 12/5/2002 to 11/24/2003, Mr. Cunningham forwarded 118 financial market “scam” email messages to the Division of Enforcement of the SEC. It is not clear that the Division took action in any of these cases. Again, the public interest has not been served by this lack of action.

[5] We refer to the following, abbreviated list of market related ethical lapses:

- The National Association of Security Dealers was found by the U.S. Securities and Exchange Commission to be "failing to police wrongdoing the NASDAQ Stock market, the second largest stock market in the world." The Washington Post (August 8, 1996. Page A1.)
- The failure of Long-Term Capital, an investment partnership started in 1994, was “laid on the kind of capitalism .. where a closed, secretive and incestuous elite held absolute sway over politics, the economy and finance, where banks lent to cronies and crooks, and the state miraculously came to the rescue when the time

occurred in both bull and in bear markets and has taken place in the most materially advantaged country that has ever existed. By 2005, marketplace ethics reached a new low. The following are the simple, uncontestable facts:

- On September 4, 2003, a major investment bank, Goldman Sachs, admitted that it had violated anti-fraud laws. Specifically, the firm misused material, nonpublic information that the US Treasury would suspend issuance of the 30-year bond. The firm agreed to "pay over $9.3 million in penalties." On April 28, 2003, the same firm was found to have "issued research reports that were not based on principles of fair dealing and good faith .. contained exaggerated or unwarranted claims.. and/or contained opinions for which there were no reasonable bases." The firm was fined $110 million dollars, for a total of $119.3 million dollars in fines in six months.

- In May, 2003, the SEC disclosed that several "brokerage firms paid rivals that agreed to publish positive reports on companies whose shares..they issued to the public. This practice made it appear that a throng of believers were recommending these companies' shares." This was false. "From 1999 through 2001, for example, one firm paid about $2.7 million to approximately 25 other investment banks for these so-called research guarantees, regulators said. Nevertheless, the same firm boasted in its annual report to shareholders that it had come through investigations of analyst conflicts of interest with its 'reputation for integrity' maintained."

- On April 28, 2003, every major US investment bank, including Merrill Lynch, the aforementioned Goldman Sachs, Morgan Stanley, Citigroup, Credit Suisse First Boston, Lehman Brothers Holdings, J.P. Morgan Chase, UBS Warburg, and U.S. Bancorp Piper Jaffray, were found to have aided and abetted efforts to defraud investors. The firms were fined a total of $1.4 billion dollars by the SEC.

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came to balance (or cook) the books." From "LTCM, a Hedge Fund Above Suspicion," by Ibrahim Warde, *Le Monde Diplomatique*, November 1998.

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- On November 4, 2004, the Securities and Exchange Commission "filed a settled civil action in the United States District Court for the District of Columbia against Wachovia Corporation (Wachovia) for violations of proxy disclosure and other reporting requirements in connection with the 2001 merger between First Union Corporation (First Union) and Old Wachovia Corporation (Old Wachovia). Under the settlement, Wachovia must pay a $37 million penalty and is to be enjoined from future violations of the federal securities laws."

- On October 8, 2004, the Securities and Exchange Commission "announced..enforcement actions against Invesco Funds Group, Inc. (IFG), AIM Advisors, Inc. (AIM Advisors), and AIM Distributors, Inc. (ADI). The Commission issued an order finding that IFG, AIM Advisors, and ADI violated the federal securities laws by facilitating widespread market timing trading in mutual funds with which each entity was affiliated. The settlements require IFG to pay $215 million in disgorgement and $110 million in civil penalties, and require AIM Advisors and ADI to pay, jointly and severally, $20 million in disgorgement and an aggregate $30 million in civil penalties."

- On October 21, 2004, the Securities and Exchange Commission "charged Qwest Communications International Inc. with securities fraud and other violations of the federal securities laws. The Commission's complaint alleges that, between 1999 and 2002, Qwest fraudulently recognized over $3.8 billion in revenue and excluded $231 million in expenses as part of a multi-faceted fraudulent scheme to meet optimistic and unsupportable revenue and earnings projections. Qwest consented to entry of a judgment enjoining it from violating the antifraud, reporting, books and records, internal control, proxy, and securities registration provisions of the federal securities laws. The judgment also directs Qwest to pay a civil penalty of $250 million."

- On December 22, 2004, "the Securities and Exchange Commission, NASD and the New York Stock Exchange announced..enforcement proceedings against Edward D. Jones & Co., L.P., a registered broker-dealer headquartered in St. Louis, Missouri." According to the announcement, "Edward Jones failed to adequately disclose revenue sharing payments that it received from a select group of mutual fund families that Edward Jones recommended to its customers." The company agreed to "pay $75 million in disgorgement and civil penalties. All of that money will be placed in a Fair Fund for distribution to Edward Jones customers."

- On November 17, 2004, the Securities and Exchange Commission announced "charges concerning undisclosed market timing against Harold J. Baxter and Gary L. Pilgrim in the Commission's pending action in federal district court in Philadelphia." Based on these charges, Baxter and Pilgrim agreed to "pay $80 million – $60 million in disgorgement and $20 million in civil penalties. This $160 million will be combined with the $90 million paid by Pilgrim, Baxter & Associates, Ltd. (PBA) in July 2004 and ultimately will be distributed to injured investors."

- On November 30, 2004, the Securities and Exchange Commission announced "the filing..of charges against American International Group, Inc. (AIG) arising out of AIG's offer and sale of an earnings management product." The company "agreed to pay a total of $126 million, consisting of a penalty of $80 million, and disgorgement and prejudgment interest of $46 million."

- On January 25, 2005, "the Securities and Exchange Commission announced the filing in federal district court of separate settled civil injunctive actions against Morgan Stanley & Co. Incorporated (Morgan Stanley) and Goldman, Sachs & Co. (Goldman Sachs) relating to the firms' allocations of stock to institutional customers in initial public offerings (IPOs) underwritten by the firms during 1999 and 2000. Under the terms of the settlements, a judgment will be entered against each firm enjoining it from violating Rule 101 of the Commission's Regulation M and ordering each firm to pay a $40 million civil penalty."

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- According to the Associated Press, on January 31, 2005, "the nation's largest insurance brokerage company, Marsh & McLennan Companies Inc., based in New York, will pay $850 million to policyholders hurt by" corporate practices that included "bid rigging, price fixing and the use of hidden incentive fees." The company will issue a public apology calling its conduct "unlawful" and "shameful," according to New York State Attorney General Elliott Spitzer. In addition, "the company will publicly promise to adopt reforms."

Envy and greed have flourished in certain capital market institutions, propelling ethical standards of behavior downward. Without meaningful reform, including reform of the securities issuance process, there is a small (but significant and growing) risk that our economic system will simply cease functioning.

Fully identifiable entities and individuals (corporate officers, investment banks, mutual fund managers, and investment analysts) engaged in criminal activities. They have, for the most part, evaded civil and criminal prosecution. We note that the aforementioned Goldman Sachs, fined $159.3 million by the Commission for various efforts to defraud investors, subsequently received $75 million in Federal Government tax credits.[6]

We understand that, given any proposed rule, crimes will continue to be committed.[7] These facts lead some to suggest that regulatory authorities may have been "captured" by the entities they regulate.[8] We note that under the "regulatory capture" market structure regime, the public interest is not protected.

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[6] The tax credits were awarded under the U.S. Department of the Treasury New Markets Tax Credit (NMTC) Program. (See: http://www.cdfifund.gov/programs/nmtc/).

[7] We assume that "employees are 'rational cheaters,' who anticipate the consequences of their actions and (engage in illegal behavior) when the marginal benefits exceed costs." See Nagin, Daniel, James Rebitzer, Seth Sanders and Lowell Taylor, "Monitoring, Motivation, and Management: The Determinants of Opportunistic Behavior in a Field Experiment, *The American Economic Review*, vol. 92 (September, 2002), pp 850-873.

[8] See George J. Stigler, "The Theory of Economic Regulation," in *The Bell Journal of Economics and Management Science*, vol. II (Spring 1971), pp. 3-21.

Any effort to modernize securities issuance rules and regulations must specifically protect the public interest.

Summary Comments on the Proposed Rules

We appreciate the time and effort the Commission has devoted to this task. Our comments are structured in two-parts. Our public comments focus on the proposal in general. In Appendix A, submitted separately, we respond to the Commission's specific questions.

We support the Commission's efforts to modernize capital access. We are, however, concerned that the proposal does not go far enough. The suggested rule changes are incremental modifications in an environment where more significant action is required. We note such action can be constructive, especially in light of market malfeasance cited above.

We suggest using a fairness-enhanced, Dutch-auction style system to allocate and price securities.[9] We further suggest using on-line, Internet-based and enhanced tools to significantly reduce securities issuance costs.

Prior to the creation and adoption of high speed, massively networked public computer systems, allowing companies to issue securities using on-line, Internet-based Dutch auctions was a costly proposition, unfair to investors and to public companies, since this would mean having to incur substantial costs (time and monetary) to insure investor access. This is, however, no longer the case.

Public companies should be given the option of issuing securities on-line, via the Internet. Candidate companies could be screened by potential investors on-line and a fair, efficient securities issuance procedure could be established.

[9] We have developed a fairness-enhanced Dutch-auction style system to allocate and price securities, our Fully Adjusted Return[tm] Auction System. The system is proprietary and a trade secret. As such, it is beyond the scope of this comment.

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Securities could be issued using a secure, tamper resistant, management-independent website. Security prices could be tabulated in real time. The proposed securities issuance system could be tied to an investor accounting system. Once purchased, securities could be easily transferred to investors. Many shareholders currently use websites like www.proxyvote.com to vote proxies. Internet technology was specifically designed for this type of problem.

Initial Public Offerings

On average, investment banks appropriate seven percent (7%) of the capital raised via traditional Initial Public Offerings. An Internet based, on-line system, allowing for the dissemination of corporate data, pricing information and securities, will significantly lower the cost of raising capital.[10] The network of prescreened buyers, already well known to Wall Street, could easily be moved to this system. The system would be designed to meet certain security and performance standards.

Currently, members of the public pay, unfairly, for the privilege of purchasing IPO shares: they can only purchase shares at an excessively high price in the after issuance market. We believe a non-proprietary, SEC-owned and managed IPO Dutch auction system will eliminate the short term run up observed in the after issuance market.[11]

We suggest this system be phased in over a six year period. In the first two years, IPO issuers would simply be offered the option of issuing securities via on-line Dutch auction. After two years, companies seeking capital in the IPO market would be required to describe why they chose to use or not to use the system. They would have to report certain information to shareholders. As noted, we expect a Dutch auction system to be cheaper (resulting in lower stock issuance cost) than the current non-auction system.

[10] We estimate the cost will, over six years, fall from 7% to 1%.
[11] This run-up was, according to one source, 16 percent (for IPO stocks issued between 1960 and 1987).

Corporate management would be required to report the cost differential between the Dutch auction system and other methods. Over time, say, after six years, all IPO's would be issued through the on-line Dutch auction system.[12]

Revised security issuance system as a community development tool

One of the goals of a revised securities issuance system, we believe, should be to allocate capital in a fairer, broader, less discriminatory manner. The development of an on-line security issuance system, combined with the resulting reduction in issuance fees, will spur investment banks to expand solicitation efforts to communities, individuals and companies previously excluded from consideration.

Thus, we see an expanded, fairer security issuance system as a community development tool.[13] An expanded market will serve:

> "to provide a market for the buying and selling of shares that is both liquid and open. In particular, stock market listings will provide (neglected) companies with a potentially long-term source of funds for investment requirements.
>
> Therefore, from an economic development perspective this should be an efficient means of circulating wealth and allowing business development opportunities to be fulfilled."

To facilitate this effort, we suggest the Commission carefully review the experience of the Federal Financial Institution Examination Council (FFIEC) with respect to the implementation of the Home Mortgage Disclosure Act. HMDA requires banks and other financial institutions to report statistics on

[12] If Ebay can successfully implement this technology, so can Wall Street.

[13] The firm has designed several community development and Empowerment Zone stock market exchanges.

every home mortgage loan application received.[14] The law requires the FFIEC collect millions of records, and has resulted in no appreciable damage to banking operations. In fact, the law, by encouraging financial institutions to make loans to previously underserved but credit worthy borrowers, opened a new market, resulted in increased profitability.[15] By doing so, we believe prospects for domestic economic growth have been greatly enhanced.

Conclusion

We believe any changes to rules regarding the ability of investors to “participate meaningfully in the securities issuance process” should be fair, just and efficient, designed to “protect investors and maintain the integrity of the securities markets.”

We also believe the SEC has the responsibility to facilitate the ability of investors and shareholders to participate in market activities by creating and sponsoring Internet based market tools. This includes sponsoring a public company board election website. This public company board election website could be part of a securities issuance website.

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[14] According to the FFIEC, “In 2002, there were approximately 28 million loan records for calendar year (CY) 2001 reported by 7,631 financial institutions. In 2001, 7,713 financial institutions reported approximately 19 million loan records for CY 2000. In 2000, 7,829 financial institutions reported approximately 23 million loan records for CY 1999. In 1999, 7,836 financial institutions reported approximately 24.7 million loan records for CY 1998. In 1998, 7,925 financial institutions reported approximately 16.4 million loan records for CY 1997.” See: http://www.ffiec.gov/hmda/history.htm.

[15] This is our view. For a detailed review of the law’s impact, see: *“The Impact of the Community Reinvestment Act on Bank and Thrift Home Mortgage Lending.”* March, 2001. Eric Belsky, Gary Fauth, Michael Schill, Anthony Yezer, presented at **Changing Financial Markets and Community Development: The Federal Reserve System's Second Community Affairs Research Conference.** Available on-line at: http://www.chicagofed.org/cedric/2001/Aprilconference.cfm.

We favor efforts to strengthen the property rights of investors and shareholders and to increase fairness in our capital markets, in general, while opposing reform for reform's sake. Efforts to enhance the securities issuance process should also boost the ability of investors and the public to efficiently make informed investment decisions. The current proposal moves in that direction.

We appreciate the time and effort the Commission has devoted to this task. Thank you for your leadership. Please contact me with any questions or comments.

Sincerely,

William Michael Cunningham
Social Investment Adviser
for William Michael Cunningham and Creative Investment Research, Inc.