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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, DC 20510-6200

KOLAN DAVIS, STAFF DIRECTOR AND CHIEF COUNSEL
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November 28, 2006

Via Facsimile (202) 293-6260
Via Electronic Transmission

Ms. Mary L. Schapiro
Chairman & CEO
National Association of Securities Dealers
1735 K Street, NW
Washington, DC 20006-1500

Dear Ms. Schapiro:

As a senior member of the United States Senate and as Chairman of the Committee on Finance (Committee), it is my duty under the Constitution to conduct oversight into the activities of executive branch agencies and entities that are regulated by these government agencies. Over the past year, I have been conducting oversight into the Securities and Exchange Commission (SEC) and its role in protecting investors. Various questions have arisen from a number of sources, regarding the procedures and safeguards that exist to ensure the integrity of financial markets.

NASD is the largest regulator of the financial markets, overseeing every securities firm that does business in the country. As such, NASD has a responsibility to all investors, in addition to the brokerage firms and registered agents that are its members. Moreover, as a 501(c)(6) not-for-profit organization, NASD has a duty to all investors, taxpayers, and Congress to ensure that its core mission of protecting market integrity merits its tax-exempt status.

One of the most important components of the SEC's oversight of financial marketplace is reliance on Self-Regulatory Organizations (SROs), such as the NASD, as the front line of defense against fraud and manipulation in the financial markets. This complex partnership between the SEC and the SROs creates a situation where the government agency tasked with regulating the market relies, in part, on third parties to enforce market integrity.

The current system of industry self-regulation via the SROs, with federal oversight, as opposed to federal regulation, was established at a time when only a small minority of Americans invested with brokerages. Today, the majority of American households have at least one brokerage account. Industry self-regulation was designed to prevent excessive government involvement in market operations. However, for this system to work effectively, the SEC must vigilantly ensure that SROs continue to meet their responsibilities to regulate, among other things, member conduct, market activity, and trading practices. Additionally, the SEC must actively oversee SROs.

In order to address these concerns, I recently requested a review of all SROs to be conducted by the Government Accountability Office (GAO). The GAO will conduct this review over the course of the next year. Cooperation on the part of NASD will be critical in ensuring that the GAO obtains access to all necessary information leading to a complete and accurate final report. Accordingly, I request that NASD provide complete cooperation to GAO during the course of the review.

Additionally, and as an integral part of my oversight of both the SEC and SROs, I request that NASD provide detailed, written answers to the following questions. In the event that NASD has written information, including policies and procedures that are responsive to any of the questions set forth below, please attach that material also. Finally, in responding to the questions below, please respond for the period of January 1, 2002 through November 1, 2006.

- (1) Please describe in detail the mechanisms used by NASD to conduct oversight of the financial markets, including but not limited to, details regarding automated monitoring systems, such as the INSITE monitoring system, Advanced Detection System (ADS), SONAR, and any other market surveillance tools utilized by NASD.
- (2) Please describe in detail the types of enforcement actions available to the NASD. Additionally, please provide statistical information regarding the frequency of enforcement actions, information regarding the utilization of various enforcement mechanisms, as well as information regarding the number of enforcement actions sought by NASD that are not accepted or overruled by the SEC.
- (3) Please describe the oversight conducted by the SEC to ensure that NASD remains in compliance with SEC rules and regulations for SROs. When preparing this material please identify specifically each effort including the date(s), finding(s) and current status.
- (4) Please describe the requirements that NASD must meet to maintain its good standing with the SEC. Identify any and all audits, evaluations, and investigations or other reviews conducted by SEC where NASD was found to be deficient in any matter. More specifically, describe all instances where NASD has been found in violation of Section 19(g) of the Securities Exchange Act and what actions, if any were taken to address the identified deficiencies.
- (5) Please describe the mechanisms in place at NASD to ensure that NASD casts a wide net during market surveillance and oversight. For instance, how does NASD ensure that it provides equal coverage for both buy side and sell side transactions?
- (6) Please describe NASD's sampling patterns for capturing "aberrational" or "serendipitous" trades preceding or following a "material" event. (E.g. Does NASD focus on specific timeframes in the weeks immediately preceding material announcements, or does it take a more holistic snapshot? How rigorous are NASD's surveillance systems in catching aberrational trading that far predates a "material" announcement?).

- (7) Does NASD limit referrals to SEC based upon the size of the referral? If so, what is the determining factor? (E.g. Dollar value involved? Size of the trade compared to daily volume of a particular security? Size of the broker/dealer involved?).
- (8) What types of statistical information does NASD retain regarding referrals made to SEC? Provide any statistical analysis or reports that outline the types of referrals made to SEC from NASD.
- (9) How vigorous is NASD in identifying and tracking potential repeat offenders? What safeguards are in place at NASD for determining if a past referral to SEC corresponds with a current unusual activity file (UAF)?
- (10) What level of coordination exists between NASD and other SROs for monitoring insider trading and market manipulation? Are regular channels of communication available to discuss unusual activity? To what extent are the computer systems between various SROs compatible to exchange information regarding suspect activity?
- (11) How secure is information at NASD? What internal safeguards are in place to ensure that sensitive information is secure from contacts with entities and individuals that are regulated by NASD? Has NASD ever had a security breach and/or situation where non-public information was left vulnerable? If so, please describe each instance in detail.
- (12) What procedures are in place to detect and prevent internal conflicts of interest at the NASD? Does NASD have a system designed to recuse individuals who have a conflict of interest that is direct or indirect? If so, what are the procedures and how often are they implemented?
- (13) Discuss the delegation of any regulatory responsibilities to subsidiaries that operate under the umbrella of NASD, such as NASDR. Please describe the relationship between NASD and NASDR, as well as any other subsidiaries, including but not limited to, the tax status of the subsidiary, board structure, governance, fire walls between the two organizations, and any shared board members between NASD and a subsidiary thereof.
- (14) How does NASD conduct oversight over any subsidiary entities that are responsible for regulatory matters? What mechanisms are in place to ensure that any delegation is done in a manner consistent with federal law? What rules or procedures are in place to ensure the integrity and fairness of any delegated regulatory authority? What, if any, role does SEC play in approving such delegation of authority?
- (15) What tools does NASD, or any delegated subsidiary thereof, have in place to detect and investigate “wash trades”? Does NASD have any tools designed to identify “wash trades” conducted by institutional investors?
- (16) Has NASD conducted any internal reviews of its regulatory responsibilities? Please provide copies of all final reports including those prepared by third party contractors or other outside entities or individuals.

- (17) Please describe any protections that may exist for any registered member, or employee thereof, who brings forth allegations of wrongdoing, waste, fraud, and/or abuse of laws, rules, or regulations. Does the NASD have any internal whistleblower protections for its own employees who are aware of potential wrongdoing? How does NASD handle any internal complaints regarding its oversight activities?
- (18) What procedures are in place with NASD to prevent employer retaliation against registered analysts, brokers, or dealers that are regulated by NASD? For example, does NASD have an appeal process to investigate negative reports filed by an employer in an employee's U-4, U-5, and/or other similar registration forms? If not, why not?
- (19) What procedures does the NASD have in place to ensure that the information it provides to the public regarding the disciplinary records of its member firms and their registered representatives through its Brokercheck program are accurate? What efforts has the NASD made to upgrade this program in light of technological advances? What has the NASD's response been to private sector initiatives aimed at improving investor awareness of brokerage wrongdoing? Is the NASD of the opinion that it is the sole party entitled to deliver such information to the investing public?
- (20) Provide a specific list of all funds received by NASD, or any subsidiary thereof, from the United States federal government or any affiliated agency or organization of the federal government and for each, specify the amount(s), date(s) or such funds, the source of the funds, and the stated purpose of those funds.

Thank you in advance for your prompt attention to this matter. Please provide your written response by December 18, 2006. Additionally, I request that you provide an in-depth briefing to the Committee staff following the submission of your written response. Should you have any questions regarding this matter, please contact Nick Podsiadly or Jason Foster of my staff at (202) 224-4515.

Sincerely,



Charles E. Grassley
Chairman

Attachment

GENERAL INSTRUCTIONS

1. Please note that, for purposes of responding to this document request, the term “document” should be interpreted in accordance with the general definitions attached to this letter.
2. In complying with this document request, produce all responsive documents that are in your possession, custody, or control, whether held by you or your past or present agents, employees, and representatives acting on your behalf. In addition, produce documents that you have a legal right to obtain, documents that you have a right to copy or have access to, and documents that you have placed in the temporary possession, custody, or control of any third party.
3. No documents, records, data or information requested by the Committee shall be destroyed, modified, removed or otherwise made inaccessible to the Committee.
4. If the document request cannot be complied with in full, it shall be complied with to the extent possible, which shall include an explanation of why full compliance is not possible.
5. In complying with this document request, respond to each enumerated request by repeating the enumerated request and identifying the responsive document(s).
6. In the event that a document is withheld on the basis of privilege, provide the following information concerning any such document: (a) the privilege asserted; (b) the type of document; (c) the general subject matter; (d) the date, author and addressee; and (e) the relationship of the author and addressee to each other.
7. Each document produced shall be produced in a form that renders the document susceptible of copying.
8. It shall not be a basis for refusal to produce documents that any other person or entity also possesses non-identical or identical copies of the same document.
9. If any document responsive to this request was, but no longer is, in your possession, custody, or control, identify the document (stating its date, author, subject and recipients) and explain the circumstances by which the document ceased to be in your possession, or control.
10. This request is continuing in nature. Any document, record, compilation of data or information, not produced because it has not been located or discovered by the return date, shall be produced immediately upon location or discovery subsequent thereto.

All documents shall be Bates stamped sequentially and produced sequentially.

GENERAL DEFINITIONS

1. The term “NASD” means the National Association of Securities Dealers, Inc., a 501(c)(6) non-profit corporation, its board of directors, or one or more of its divisions, subsidiaries or affiliates, or related entities, including, but not limited to, NASD Regulation, Inc (NASDR), NASD Dispute Resolution, Inc, Securities Dealers Risk Purchasing Group, Inc., and NASD Investor Education Foundation.
2. The term “document” means any written, recorded, or graphic matter of any nature whatsoever, regardless of how recorded, and whether original or copy, including, but not limited to the following: memoranda, reports, statistical or analytical reports, books, manuals, instructions, financial reports, working papers, records notes, letters, notices, confirmations, telegrams, receipts, appraisals, pamphlets, magazines, newspapers, prospectuses, interoffice and intra office communications, electronic mail (E-mail), contracts, cables, notations of any type of conversation, telephone call, meeting or other communication, bulletins, printed matter, computer printouts, teletypes, invoices, transcripts, diaries, analyses, returns, summaries, minutes, bills, accounts, estimates, projections, comparisons, messages, correspondence, press releases, circulars, financial statements, reviews, opinions, offers, studies and investigations, questionnaires and surveys, and work sheets (and all drafts, preliminary versions, alterations, modifications, revisions, changes, and amendments of any of the foregoing, as well as any attachments or appendices thereto), and graphic or oral records or representations of any kind (including without limitation, photographs, charts, graphs, microfiche, microfilm, videotape, recordings and motion pictures), and electronic, mechanical, and electric records or representations of any kind (including, without limitation, tapes, cassettes, discs, and recordings) and other written, printed, typed, or other graphic or recorded matter of any kind or nature, however produced or reproduced, and whether preserved in writing, film, tape, disc, or videotape. A document bearing any notation not a part of the original text is to be considered a separate document. A draft or non-identical copy is a separate document within the meaning of this term.
3. The term “records” is to be construed in the broadest sense and shall mean any written or graphic material, however produced or reproduced, of any kind or description, consisting of the original and any non-identical copy (whether different from the original because of notes made on or attached to such copy or otherwise) and drafts and both sides thereof, whether printed or recorded electronically or magnetically or stored in any type of data bank, including, but not limited to, the following: correspondence, memoranda, records, summaries of personal conversations or interviews, minutes or records of meetings or conferences, opinions or reports of consultants, projections, statistical statements, drafts, contracts, agreements, purchase orders, invoices, confirmations, telegraphs, telexes, agendas, books, notes, pamphlets, periodicals, reports, studies, evaluations, opinions, logs, diaries, desk calendars, appointment books, tape recordings, video recordings, e-mails, voice mails, computer tapes, or other computer stored matter, magnetic tapes, microfilm, microfiche, punch cards, all other records kept by electronic, photographic, or mechanical means, charts,

photographs, notebooks, drawings, plans, inter-office communications, intra-office and intra-departmental communications, transcripts, checks and canceled checks, bank statements, ledgers, books, records or statements of accounts, and papers and things similar to any of the foregoing, however denominated.

4. The terms “relate,” “related,” “relating,” or “regarding” as to any given subject means anything that discusses, concerns, reflects, constitutes, contains, embodies, identifies, deals with, or is any manner whatsoever pertinent to that subject, including but not limited to documents concerning the preparation of other documents.
5. The terms “and” and “or” shall be construed broadly and either conjunctively or disjunctively to bring within the scope of this document request any information which might otherwise be construed to be outside its scope. The singular includes plural number, and vice versa to bring within the scope of this document request any information which might otherwise be construed to be outside its scope. The masculine includes the feminine and neuter genders to bring within the scope of this document request any information that might otherwise be construed to be outside its scope.
6. The term “communication” means each manner or means of disclosure or exchange of information, regardless of means utilized, whether oral, written, electronic, by document or otherwise, and whether face to face, in a meeting, by telephone, mail, telexes, discussions, releases, personal delivery, or otherwise. Documents that typically reflect a “communication” include handwritten notes, telephone memoranda slips, daily appointment books and diaries, bills, checks, correspondence and memoranda, and includes all drafts of such documents.