The Costs of Compliance

In the U.S. Securities Industry

Survey Report

February 2006

Securities Industry Association

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Introduction

Nothing is more central to firms in the securities industry than maintaining the confidence of their clients and complying with myriad regulatory and legislative mandates that govern the industry. This study has estimated that the securities industry spent $23.2 billion on compliance-related activities in 2004 and will spend a projected $25.5 billion for 2005.

This survey was conducted for several reasons, including: (1) to obtain feedback from SIA members about the cost they incur related to complying with the full range of federal and state regulations and legislative mandates; (2) to better understand the "day-to-day" impact the regulatory and legislative mandates have on industry firms; (3) to solicit ideas on how the regulatory process could be made more efficient, while maintaining high standards of oversight and investor protection.

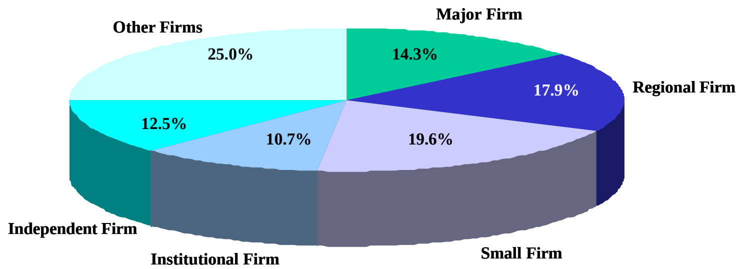
For the purposes of this study, compliance is defined as "the firm's general efforts designed to achieve compliance with applicable laws, rules, and regulations." The compliance functions may reside in several locations within a securities firm in addition to the compliance department; including, for example: the risk management department; the internal audit department; the office of the comptroller, treasurer, or chief financial officer; the legal department; the branch network; Operations; Sales; Marketing; and, in many firms, the Human Resources Department. The essence of compliance is embedded in the concept of "supervision," where business management, not the compliance department, has ultimate responsibility to ensure that every element of the firm adheres to all regulatory and legislative mandates.

The survey questionnaire was sent to all SIA member firms; fifty-six firms participated in the study and returned a completed questionnaire. Those firms account for 40% of industry employment and 28% of total industry net revenue. The chart below shows the percentage that firms in each category represent of total survey participants. The survey questionnaire, which is included at the end of this report, contains a description for each of the categories.

For the purposes of analysis, firms were organized into three firm-size categories: Large Firms; Mid-sized Firms; and, Small Firms. The Large Firm category includes the major firms as well as some of the largest firms from other categories; the Mid-sized Firm Category includes the remainder of the regional firms as well the larger firms in other segments. Small Firms comprised the remainder. A combination of revenue and employment were used to classify each firm.

Figure 1

Cost of Compliance Survey Participants



Key Findings

- Firms in the securities industry place a very high premium on compliance, having spent an estimated $23.2 billion in 2004 and a projected $25.5 billion for 2005;

- The vast majority of compliance-related spending (93.9%) is staff-related (base salary, variable compensation, employee benefits, and overhead), with the greatest impact in recent years on management positions;

- Out-of-pocket and capital expenditures accounted for 2.8% and 3.3% of compliance spending, respectively; these categories each experienced double- and triple-digit increases since 2002;

- When all regulators are taken into account, firms reported receiving an average of 231 inquiries per firm over the past twelve months; the SEC and NASD accounted for nearly three-quarters (72.8%) of that total;

- State regulators accounted for only 7.2% of the inquiries reported by survey participants, but virtually every state was mentioned at least once; some states were mentioned as many as 13 times;

- The extent to which duplicative examinations were a concern for survey participants varied considerably, depending on the size and complexity of the firm; overall, 44% of respondents reported that duplicative exams were a significant problem: 62% for Large Firms, 55% for Mid-sized Firms, and 36% for Small Firms;

- Firms identified a number of legislative and regulatory initiatives that presented significant burdens, including:

    - SEC Books and Records (36 month rule)
    - Sarbanes-Oxley (especially section 404)
    - Patriot Act (AML requirements and Customer Identification)
    - Supervisory Procedures and CEO Certification (NASD Rules 3010, 3012, 3013)
    - Breakpoints
    - Email review and archiving
    - Investment Advisory Regulations

- Participating firms reported that over the past five years, regulatory and legislative mandates have had a material, adverse impact on overall compliance spending levels;

- The costs incurred by firms in the securities industry to comply with the increasing volume of regulatory and legislative initiatives may ultimately be passed on to investors through higher prices and fewer choices.

- There are an increasing number of U.S. firms that operate in jurisdictions outside the United States. Many of these firms believe that they operate at a competitive disadvantage because they have to apply U.S. rules globally.

Recommendations

Participating firms made a number of constructive suggestions for how to maintain high standards of oversight and investor protection in a more efficient way, including:

- Consolidate, or at least better coordinate, federal and state regulators to remove unnecessary duplication of effort and make rules / regulations more consistent;

- Implement a better process for evaluating the impact of new rules / regulations on the industry, including meaningful input from the industry at the very beginning and an assessment of the cumulative effects;

- Give more consideration to how new rules / regulations impact firms in different segments of the industry (e.g., a full service retail firm vs. a firm that deals exclusively with government bonds);

- Provide clearer guidance, in plain English, to avoid unnecessary and wasteful guesswork by industry firms;

- Develop a better mechanism for scheduling new regulations, regulatory requests, sweeps, inquiries, and examinations focusing more on core issues rather than broad requests so industry firms can meet their regulatory obligations and continue to conduct business effectively;

- Reduce the pace and volume of new rules and regulations, which are now putting enormous pressure on industry firms to keep pace;

- Expand and strengthen collaborative education programs whereby regulators can develop a deeper understanding for the day-to-day workings of industry firms and securities firms can gain a deeper appreciation for issues facing regulators.

Spending on Compliance

Overview

- To develop a more comprehensive estimate of the total spending on compliance-related activities by firms within the securities industry, survey participants were asked to report their total compliance-related costs within three categories: Staff-related costs; Out-of-Pocket costs; and Capital costs. The staff-related costs from the survey were adjusted to account for employee benefit costs and overhead. Staff-related, out-of-pocket and capital costs were aggregated and indexed to net revenue (gross revenue minus interest expense). The percentage of net revenue devoted to compliance-related expense derived from the survey was then applied to industry-wide net revenue data to produce an overall estimate of industry compliance costs. The Methodology section provides greater detail on how compliance spending was estimated.

- In addition to the "hard" data on compliance costs, firms were also asked to describe significant Opportunity Costs, which, although not quantified in financial terms, may represent one of the greatest burdens on securities firms.

- Overall, this study estimates that firms in the Securities Industry spent $23.2 billion on compliance-related activities during 2004. That is projected to grow to at least $25.5 billion for 2005.

- Overall, firms in the securities industry are spending 13.1% of net revenue (gross revenue less interest expense) on compliance-related activities. While that may seem like a large percentage, the activities included comprise the broadest definition of compliance, encompassing all compliance-related expenditures by industry firms, including staff-related, out-of-pocket, and capital. Staff-related expenditures include personnel in the traditional compliance, internal audit, risk management, and legal departments. However, it also includes the increasing amount of time spent by senior executives on compliance-related issues, and time spent on compliance by employees in many other functions, including: Retail and Institutional businesses; IT departments; Finance & Accounting; Human Resources; Training & Education; Research; and other business areas. The study also takes into account estimated employee benefit costs and overhead in the total staff-related expense. Furthermore, this study measures out-of-pocket costs for compliance-related activities such as accounting, legal, and audit services; IT suppliers and vendors; and other compliance-related activities. The study also measures capital spending on compliance, which is largely related to the purchase of IT software and hardware.

Figure 2

Percent of Net Revenue Spent on Compliance

Type of Firm	Percent of Net Revenue
All Firms	13.1%
Large Firms	14.9%
Mid-sized Firms	17.5%
Small Firms	8.6%

- Among the three categories of compliance-related spending, expenditures on staff were by far the greatest, accounting for 93.9% of the total. This was especially true for Large and Mid-sized Firms. In contrast, Small Firms tend to outsource many compliance-related activities that are routinely handled by larger firms with internal staff. As a result, staff-related costs are smaller and out-of-pocket costs increase significantly.

Figure 3b

Percent of Total Compliance-Related Spending

	Staff-Related[1]	Out-of-Pocket	Capital	Total
All Firms	93.9	2.8	3.3	100.0
Large Firms	94.3	2.1	3.6	100.0
Mid-sized Firms	96.1	3.1	0.8	100.0
Small Firms	81.5	13.4	5.1	100.0

[1] Staff costs include total compensation plus employee benefits and overhead

- In addition to the "hard data" on compliance spending, firms were asked to provide a qualitative measure of the impact that regulatory and legislative initiatives have on compliance-related spending at their firm. Overall, 92% of survey participants indicated that over the past five years, regulatory and legislative initiatives have resulted in a very significant increase in total compliance-related spending (responding either "5" or "4" on a scale where "5" equals "Major Increase" and "1" equals "No Increase").

Figure 4a

Impact of Regulatory and Legislative Mandates on Compliance-Related Spending
All Firms

(Over the past five years)

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
Staff-related Spending	54.9	25.5	17.6	-	2.0
Out-of-Pocket Costs	51.0	37.3	5.9	5.9	-
Capital Costs	36.7	26.5	22.4	8.2	6.1
Opportunity Costs	46.9	34.7	14.3	4.1	-
Total Compliance Expenditures	58.8	33.3	5.9	2.0	-

Figure 4b

Impact of Regulatory and Legislative Mandates on Compliance-Related Spending
Large Firms
(Over the past five years)

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
Staff-related Spending	75.0	25.0	-	-	-
Out-of-Pocket Costs	75.0	25.0	-	-	-
Capital Costs	50.0	37.5	12.5	-	-
Opportunity Costs	50.0	50.0	-	-	-
Total Compliance Expenditures	87.5	12.5	-	-	-

Figure 4c

Impact of Regulatory and Legislative Mandates on Compliance-Related Spending
Mid-sized Firms
(Over the past five years)

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
Staff-related Spending	27.3	27.3	45.5	-	-
Out-of-Pocket Costs	45.5	27.3	9.1	18.2	-
Capital Costs	27.3	18.2	27.3	18.2	9.1
Opportunity Costs	27.3	36.4	27.3	9.1	-
Total Compliance Expenditures	36.4	54.5	-	9.1	-

Figure 4d

Impact of Regulatory and Legislative Mandates on Compliance-Related Spending
Small Firms
(Over the past five years)

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
Staff-related Spending	59.4	25.0	12.5	-	3.1
Out-of-Pocket Costs	46.9	43.8	6.3	3.1	-
Capital Costs	36.7	26.7	23.3	6.7	6.7
Opportunity Costs	53.3	30.0	13.3	3.3	-
Total Compliance Expenditures	59.4	31.3	9.4	-	-

Staff-Related Spending

- As noted above, staff-related expenditures account for the single largest component of compliance spending by firms within the securities industry – 93.9% of the total. When asked how recent regulatory and legislative initiatives have affected industry firms, the survey shows that management positions have seen the greatest impact. This is especially true for Small Firms whose management ranks are more compact. Many firms reported that the wave of new regulatory and legislative initiatives that have come forth since 2002 required much more management time to interpret, design systems to implement, and to assure overall adherence. The greater involvement of management in day-to-day compliance activities has had a tangible, adverse impact on opportunity costs, as the same management personnel are responsible for developing new products and growing the business.

Figure 5

Extent to Which Regulatory and Legislative Initiatives Have Impacted The Amount of Time Devoted to Compliance Since 2002

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
			(percent of responses)		
All Firms					
Staff	58.5	34.0	5.7	1.9	-
Management	65.5	30.9	3.6	-	-
Large Firms					
Staff	50.0	50.0	-	-	-
Management	75.0	25.0	-	-	-
Mid-sized Firms					
Staff	54.5	27.3	18.2	-	-
Management	36.4	54.5	9.1	-	-
Small Firms					
Staff	61.8	32.4	2.9	2.9	-
Management	72.2	25.0	2.8	-	-

- Participants were asked to identify those aspects of the legislative and regulatory process that have had the most adverse impact on staff-related compliance spending at their firm. Excerpts from their verbatim responses are included in Appendix I. The major themes are summarized below.

    - The sheer volume of new rules, rule changes, examinations, sweeps, and inquiries is putting enormous strain on staff at many firms. Firms reported that senior management is now spending substantially more time on compliance-related activities, reaching as much as 30% - 40% of their time in many instances. In addition, the retail sales force and many other non-compliance staff are spending as much as 25% of their time on compliance-related activity.

- Overlap and duplication of effort by regulators has contributed greatly to rapidly rising compliance-related staff expenditures at industry firms. Firms cite the lack of coordination among regulators as resulting in overlap and duplication of staff effort. This is true across regulators and among home and regional offices of the same regulator. Firms report separate requests for similar or nearly identical information by multiple regulators with no coordination among them.

- The depth and breadth of many regulatory and legislative initiatives is consuming ever-increasing amounts of staff time to comply. This is especially true when regulators request that the firm perform specialized tabulations of the requested data.

- Having to keep track of regulatory initiatives from the SEC, NASD, NYSE, and others is very time consuming; keeping track of initiatives from 50 states can be very challenging.

Out-of-Pocket Expenses

- Although out-of-pocket expenditures accounted for only 2.8% of total compliance spending overall (as shown in Figure 3b), this proportion was significantly larger for some firm categories. For example, Small Firms reported that 13.4% of their compliance spending was for out-of-pocket services; across the board, however, firms reported experiencing very substantial increases in their out-of-pocket expenditures. With few exceptions, out-of-pocket expenses have doubled or tripled since 2002. The following table shows average expenditures and percent increase for each out-of-pocket expense category.

Figure 6

Compliance-Related Out-of-Pocket Expenditures
Average Expenditures and Percent Increase Since 2002

Type of Firm / Expense	Average Expenditure Per Firm	Average* Percent Increase
All Firms		
Accounting Services	$441,081	135.7
Legal Services	$1,313,895	140.2
Audit Services	$362,781	88.2
IT Suppliers & Vendors	$771,918	144.6
Other Services	$996,355	473.7
Large Firms		
Accounting Services	$2,867,500[1]	147.2[1]
Legal Services	$5,350,077	91.1
Audit Services	$1,670,600	104.0
IT Suppliers & Vendors	$3,027,289	160.0
Other Services	$5,526,000[1]	601.7[1]
Mid-sized Firms		
Accounting Services	$281,520	93.9
Legal Services	$741,592	31.6
Audit Services	$215,294	81.1
IT Suppliers & Vendors	$503,851	66.1
Other Services	$372,133	42.2
Small Firms		
Accounting Services	$74,808	129.2
Legal Services	$639,000	283.8
Audit Services	$73,242	36.8
IT Suppliers & Vendors	$135,014	166.3
Other Services	$373,726	181.1

** Weighted averages* [1]*Small sample*

- Participants were asked to identify those aspects of the legislative and regulatory process that have had the most adverse impact on their firm's compliance-related out-of-pocket expenditures. Excerpts from their verbatim responses are included in Exhibit II. Major themes are summarized below.

  - As internal staff becomes fully occupied with compliance-related activities, firms increasingly turn to external resources for accounting, audit, IT, and legal support services. Firms report that outside legal services are often engaged to help interpret and respond to regulatory requests and mandates.

  - The reporting requirements of many rules and regulations have forced firms to use outside vendors for the development of software and other systems in order to comply.

- Many, if not most, Small and Mid-sized firms lack sufficient internal resources to implement many of the changes required by new or updated rules and regulations. Therefore, their only recourse is the use of outside support services, which are increasingly expensive.

- Some of the specific regulatory and legislative initiatives having the most adverse impact on out-of-pocket expenditures include: USA Patriot Act; SEC Books & Records; Sarbanes-Oxley (particularly section 404); e-mail retention requirements; policies and procedures governing investment advisors; Best Execution / Order Routing.

Capital Expenditures

- Although a relatively small percentage of overall compliance spending (3.3%), capital costs are, nevertheless, quite significant. As regulations become increasingly complex they require individual firms to implement sophisticated systems to meet the regulatory requirements and to monitor / manage ongoing compliance. Many firms purchase specially designed IT systems to meet these challenges.

- Since 2002, participating firms reported an average increase in their compliance-related Capital Expenditures of 366%.

Figure 7

Compliance-Related Capital Expenditures
Average 2005 Expenditure and Percent Increase Since 2002

Type of Firm	Average Expenditure Per Firm	Average* Percent Increase
All Firms	$3,959,543	366.1
Large Firms	$21,316,151	331.8
Mid-sized Firms	$511,500	144.7
Small Firms	$481,324	347.1

* Weighted averages

- Firms reported Capital Expenditures that ranged from virtually nothing to tens of million of dollars. The average expenditure was reported to be nearly $4 million per firm in 2005.

- Participants were asked to identify those aspects of the legislative and regulatory process that have had the most adverse impact on their firm's compliance-related Capital Expenditures. Excerpts from verbatim responses are included in Appendix III. Major themes are summarized below.

    - Capital expenditures are largely driven by regulatory and legislative mandates that require firms to purchase specialized software / hardware systems designed to achieve compliance with reporting and other requirements.

    - Mandates cited by participating firms include: email monitoring and retention; data encryption requirements; Anti-Money Laundering / OFAC compliance; OATS; OTS; TRACE; MSRB; Reg. SHO; CEO Certification and Books and Records; among others.

- Looking ahead, firms generally reported that they saw a continuation and expansion of current trends in compliance-related capital spending.

Opportunity Costs

- Opportunity costs (*the cost of something in terms of an opportunity foregone*) arise when limited resources are utilized for one activity when they could be productively employed in another. Although these costs are difficult to quantify, they are, nevertheless, very significant and real. Firms that participated in this research provided many illustrative examples of how increasing compliance requirements have created opportunity costs at their firms. Excerpts from verbatim responses are shown in Appendix V. Major themes are summarized below.

    - Central to the concept of Opportunity Costs is the fact that resources are limited. Therefore, committing a larger share of available human and financial resources to compliance-related activities necessitates that other priorities be deferred or cancelled.

    - Firms reported that the increased need to devote resources at all levels of the firm to fulfilling compliance mandates has meant fewer resources are available for business development and expansion. This is particularly true among senior management, who now spend significantly more of their time on regulatory matters than three years ago.

    - Regulatory and legislative mandates have reduced innovation and slowed the development of new financial products and services for investors. In addition, some firms report being more wary of regulatory challenges related to new products and increasingly use outside counsel, at high cost, in the product review process.

- In some instances, beneficial IT projects are being deferred or cancelled because IT staff are overloaded with ongoing compliance reporting and system development.

Inquiries from Regulators

- Firms were asked to indicate, by regulator, the number of inquiries they received during the preceding twelve-month period segmented into four categories: Regulatory, Supervisory, Investigative, and "Other." For all firms, Regulatory inquiries accounted for 40.7% of the total; Investigative and "Other" accounted for 27.5% and 30.9%, respectively. Nearly all of the "Other" category related to Bluesheets. Supervisory inquiries only totaled 0.8% of the total.

- In total, firms participating in this survey received an average of 231 inquiries per firm during the past twelve months, slightly less than one inquiry per business day. Among the four inquiry categories, Regulatory had the highest average of 94 per firm in the preceding twelve months, followed by Investigative (64 per firm) and Other (71 per firm). Supervisory Inquiries averaged only 1.9 per firm.

Figure 8a

Reported Inquiries by Type and Regulator - All Firms

(percent distribution)

	Total	Regulatory	Supervisory	Investigative	Other
SEC	41.6	10.1	0.2	11.9	19.5
NASD	31.2	14.0	0.4	8.5	8.4
NYSE	12.3	8.6	0.0	2.1	1.6
AMEX	0.8	0.4	0.0	0.3	0.1
CBOE	1.9	1.0	0.0	0.6	0.4
State Regulators	7.2	4.4	0.1	2.2	0.4
Other	4.8	2.3	0.1	2.0	0.4
Total	100.0	40.7	0.8	27.5	30.9

Note: may not add due to rounding

Figure 8b

Reported Inquiries by Type and Regulator - Large Firms

(percent distribution)

	Total	Regulatory	Supervisory	Investigative	Other
SEC	33.3	14.7	-	17.7	0.9
NASD	28.9	19.0	-	9.4	1.4
NYSE	17.7	15.2	-	1.8	0.6
AMEX	1.0	0.8	-	0.2	-
CBOE	3.2	1.9	-	0.8	0.5
State Regulators	8.5	7.6	-	0.7	0.1
Other	6.6	4.1	0.1	1.9	0.4
Total	100.0	63.4	0.2	32.5	3.8

Note: may not add due to rounding

Figure 8c

Reported Inquiries by Type and Regulator – Mid-sized Firms

(percent distribution)

	Total	Regulatory	Supervisory	Investigative	Other
SEC	49.1	7.4	0.2	6.5	34.9
NASD	31.6	8.1	0.6	8.5	14.5
NYSE	11.3	3.3	0.1	4.4	3.5
AMEX	0.2	0.1	-	-	0.1
CBOE	0.7	-	-	0.1	0.6
State Regulators	4.7	0.4	0.3	2.5	1.5
Other	2.3	0.4	0.2	1.0	0.7
Total	100.0	19.8	1.4	23.1	55.8

Note: may not add due to rounding

Figure 8d

Reported Inquiries by Type and Regulator - Small Firms

(percent distribution)

	Total	Regulatory	Supervisory	Investigative	Other
SEC	51.0	3.5	0.4	5.6	41.5
NASD	33.6	9.5	0.9	6.7	16.5
NYSE	3.3	0.6	-	0.7	2.0
AMEX	1.1	-	-	0.7	0.4
CBOE	0.7	-	-	0.7	-
State Regulators	6.7	1.8	-	4.9	-
Other	3.7	0.5	0.1	2.8	0.3
Total	100.0	15.9	1.4	22.0	60.7

Note: may not add due to rounding

- Overall, firms reported receiving an average of 231 inquiries per firm during the past twelve months. This varied considerably by firm size category averaging 772, 248, and 98 for Large Firms, Mid-sized Firms, and Small Firms, respectively.

Figure 9a

Average Number of Inquiries per Firm – All Firms

	Total	Regulatory	Supervisory	Investigative	Other
SEC	94.3	23.2	0.4	27.5	45.0
NASD	73.5	32.9	0.9	19.9	19.8
NYSE	29.0	20.2	0.1	4.9	3.8
AMEX	2.0	1.0	-	0.7	0.3
CBOE	4.6	2.3	-	1.4	0.9
State Regulators	16.8	10.4	0.2	5.3	0.9
Other	11.4	5.4	0.3	4.6	1.0
Total	230.7	94.0	1.9	63.5	71.2

Note: may not add due to rounding

Figure 9b

Average Number of Inquiries per Firm – Large Firms

	Total	Regulatory	Supervisory	Investigative	Other
SEC	256.9	113.6	0.3	136.4	6.6
NASD	230.0	146.8	0.3	72.5	10.5
NYSE	136.4	117.6	0.3	13.9	4.6
AMEX	7.8	6.3	-	1.4	0.1
CBOE	24.6	14.8	-	6.1	3.8
State Regulators	65.5	58.8	0.3	5.6	0.9
Other	50.6	31.9	0.9	14.9	3.0
Total	771.8	489.6	1.9	250.8	29.5

Note: may not add due to rounding

Figure 9c

Average Number of Inquiries per Firm – Mid-sized Firms

	Total	Regulatory	Supervisory	Investigative	Other
SEC	121.6	18.4	0.5	16.2	86.5
NASD	78.4	20.1	1.4	21.1	35.8
NYSE	28.0	8.3	0.3	10.9	8.5
AMEX	0.5	0.2	-	0.1	0.2
CBOE	1.7	-	-	0.4	1.4
State Regulators	12.8	1.0	0.9	6.7	4.2
Other	5.8	1.1	0.5	2.4	1.8
Total	247.6	48.9	3.5	57.1	138.1

Note: may not add due to rounding

Figure 9d

Average Number of Inquiries per Firm –Small Firms

	Total	Regulatory	Supervisory	Investigative	Other
SEC	49.9	3.5	0.4	5.5	40.6
NASD	33.9	9.5	0.9	6.8	16.6
NYSE	3.4	0.6	-	0.7	2.0
AMEX	1.1	-	-	0.7	0.4
CBOE	0.7	-	-	0.7	-
State Regulators	6.6	1.7	-	4.8	-
Other	3.7	0.5	0.1	2.8	0.3
Total	97.9	15.5	1.4	21.6	59.4

Note: may not add due to rounding

- "Other" regulators reported by survey participants included: Commodity Futures Trading Commission; International Securities Exchange; National Futures Association; Pacific Exchange; Philadelphia Exchange; Chicago Mercantile Exchange; U.S. Department of Treasury; U.S. Department of Justice; U.S. Department of Labor.

- Although State Regulators accounted for only 7.2% of the reported inquiries, virtually every state was noted, as illustrated below.

Figure 10

State Regulators – Number of Mentions by State

State	Number of Mentions	State	Number of Mentions
Alabama	10	Montana	4
Alaska	3	Nebraska	6
Arizona	8	Nevada	6
Arkansas	3	New Hampshire	7
California	8	New Jersey	10
Colorado	8	New Mexico	7
Connecticut	8	New York	10
Delaware	3	North Carolina	4
Florida	13	North Dakota	4
Georgia	7	Ohio	7
Hawaii	6	Oklahoma	6
Idaho	4	Oregon	4
Illinois	12	Pennsylvania	9
Indiana	6	Rhode Island	3
Iowa	4	South Carolina	7
Kansas	4	South Dakota	3
Kentucky	5	Tennessee	6
Louisiana	2	Texas	9
Maine	10	Utah	8
Maryland	4	Vermont	5
Massachusetts	7	Virginia	8
Michigan	10	Washington	4
Minnesota	3	West Virginia	1
Mississippi	6	Wisconsin	13
Missouri	9	Wyoming	-

- Almost half (44.2%) of the firms that participated in this survey reported that they experienced duplicative examinations to a significant extent (answering "4" or "5" on a scale where "5" = Considerable Extent and "1" = Minimal Extent). Large Firms were the most impacted, Small Firms the least.

Figure 11
Extent to Which Regulators Conduct Duplicative Examinations

	Considerable Extent (5)	(4)	Modest Extent (3)	(2)	Minimal Extent (1)
			(percent of responses)		
All Firms	17.3	26.9	30.8	3.8	21.2
Large Firms	12.5	50.0	37.5	-	-
Mid-sized Firms	18.2	36.4	36.4	-	9.1
Small Firms	18.2	18.2	27.3	6.1	30.3

- Firms that reported having duplicative examinations were asked to provide specific examples to illustrate the scope and nature of these exams. Excerpts from those verbatim responses are included in Appendix VI. Major themes are summarized below.

  - Firms reported that duplicative examinations could occur in several different ways. For example,

    - Different regulators reviewing the same or similar issues;
    - The same regulator reviewing the same or similar issues through different offices (e.g., home office and district office)
    - A federal regulator and a state regulator reviewing the same or similar issues;
    - Regulators conducting different examinations, but much of the substantive information is the same or similar (e.g., each regulator looking at AML and Disaster Recovery as part of a broader examination).

  - Often, the duplication results from minor differences in the criteria used by each regulator (e.g., the time period covered), yet neither regulator will share or accept the findings of the other. The net result is unnecessary and burdensome duplication of effort.

Most Burdensome Legislative/Regulatory Initiatives

- Numerous legislative and regulatory initiatives were identified as being particularly burdensome. Each firm was asked to identify up to five examples. Excerpts from the verbatim responses provided by participating firms are shown in Appendix VII. A short list of the most burdensome initiatives is included below.

  - SEC Books and Records (36 month rule)
  - Mutual Fund Breakpoints
  - The sheer volume of examinations / inspections / sweeps
  - Sarbanes-Oxley, particularly section 404
  - USA Patriot Act / AML
  - Supervisory Procedures and CEO Certification (NASD rules 3010, 3012, 3013)
  - Email review / retention
  - Investment Advisory Regulations
  - Inconsistency among regulators
  - Lack of clarity in rules and guidance

- Firms do not seem to be questioning the underlying value or justification for the initiatives identified as most burdensome, they simply would like to see a less burdensome approach to their implementation.

Recommended Changes to the Regulatory Process

- Firms in the securities industry are firmly committed to achieving effective regulation, but are frustrated by a range of perceived inefficiencies in the current regulatory environment. Some of those inefficiencies include duplicate examinations, lack of clarity in new regulations, a "one size fits all" regulatory structure, and many more. Detailed verbatim comments are included in Appendix VIII. Several general themes are presented below.

  - Consolidate, or at least better coordinate, federal and state regulators to remove unnecessary duplication of effort and make rules / regulations more consistent;

  - Implement a better process for evaluating the impact of new rules / regulations on the industry, including meaningful input from the industry at the very beginning and an assessment of the cumulative effects;

  - Give more consideration to how new rules / regulations impact firms in different segments of the industry (e.g., a full service retail firm vs. a firm that deals exclusively with government bonds);

  - Provide clearer guidance, in plain English, to avoid unnecessary and wasteful guesswork by industry firms;

- Develop a better mechanism for scheduling new regulations, regulatory requests, sweeps, inquiries, and examinations focusing on core issues rather than broad requests so industry firms can meet their regulatory obligations and continue to conduct business effectively;

- Reduce the pace and volume of rules and regulations, which are now putting enormous pressure on industry firms to keep pace.

- Expand and strengthen collaborative education programs whereby regulators can develop a deeper understanding for the day-to-day workings of industry firms and securities firms can gain a deeper appreciation for issues facing regulators.

Study Methodology

The regulatory environment in which the securities industry operates has undergone a dramatic transformation in the last few years reflecting both long-run trends (such as the dismantling of depression-era regulations which separated securities from commercial banking and insurance activities, increasing globalization and a revolution in communication and information technology) as well as the impact of a series of unique events (including heightened security concerns following September 11, 2001, massive corporate governance failures and the deflation of a speculative "bubble" in equity markets). Each event added new or revised regulatory or legislative initiatives to an already robust regulatory program.

A year ago the Securities Industry Association (SIA) began this study with three objectives in mind: (1) developing a deeper understanding of how various regulatory and legislative mandates impact compliance-related activities at securities firms; (2) measuring compliance-related costs; and, (3) obtaining recommendations from industry firms on how to achieve the same high standard of oversight and investor protection, but accomplish it more efficiently.

Frustration with the current regulatory process by industry firms, particularly with the pace and scope of new regulatory and legislative initiatives over the past three years, underscored the need for this survey. Although industry firms wholeheartedly support efficient and effective industry regulation, expressions of concern began to surface about the current regulatory system being out of alignment, with multiple regulators initiating new rules and regulations at a rapid pace, with firms being examined by multiple organizations, with increasing human and financial resources being required to keep pace with compliance, and with investors paying a high price through increased costs, fewer choices, and more paperwork.

At the same time, many changes are taking place within the regulatory environment. Therefore, this is the perfect time to consider new alternatives that can maintain the high level of oversight in place today, but accomplish that most efficiently. This report serves as a platform for discussion.

The concept of the study and the details of the survey questionnaire were developed in collaboration with many groups at SIA, including the following: Federal Regulation Committee; Self Regulation Committee; Small Firms Committee; Regional Firms Committee; Independent Firms Committee; State Regulation and Legislation Committee; Compliance and Legal Division. In addition, many individual discussions were held with senior executives at member firms. Some of those discussions were held at firms' headquarters while others were conducted by phone.

In October 2005, the survey was finalized and distributed to all SIA member firms by e-mail. In most instances, several individuals at each firm were sent the questionnaire. SIA coordinated with each firm to make sure only one response was prepared for each firm. The goal was to develop a representative sample of large, mid-sized, and small firms. The questionnaire solicited both quantitative information (e.g., compliance-related costs and number of regulatory inquiries) and qualitative information (e.g., the degree to which duplicative examinations are conducted) in an effort to get a complete picture. Gathering reliable "hard" data on compliance spending presented some significant challenges. After numerous discussions with senior compliance executives, CFOs, and senior accounting management, an effective methodology was developed. The survey questionnaire was pre-tested with several firms to be sure it was clear and easy to complete.

Essentially, the decision was made to obtain compliance cost data in three categories: Staff-related; Out-of-Pocket; and Capital. Officials familiar with accounting practices at industry firms felt the latter two categories would be reasonably straightforward to obtain from accounting records. However, the staff-related element presented a more significant challenge. To get reliable staff costs, firms were asked to look at various functions within their firm (see questionnaire for more detail) and provide data on the number of employees in each function, the average amount of time those employees spend on compliance-related activities, and the average total compensation per employee. It was felt that this approach would provide the most accurate and complete estimate of staff costs.

By December 2005, fifty-six firms had completed and returned questionnaires. Those firms represented a good cross-section of the industry both in terms of firm type and size. These firms were grouped into three categories for the purpose of analysis: Large Firms; Mid-sized Firms; and, Small Firms. A combination of revenue and employment were the criteria used to classify each firm into the appropriate category as shown below:

Firm Category	Net Revenue	Employees
Large Firms	Over $500,000,000	More than 1,000 employees
Mid-sized Firms	$50,000,00 to $500,000,000	100 to 1,000 employees
Small Firms	Less than $50,000,000	Fewer than 100 employees

Note: Net Revenue = Gross Revenue less interest expense

The following table illustrates the number of SIA member firms that fall into each of the three groups defined above and the survey response rate for each group. Although the percent of SIA's membership that responded is relatively small (13.5%), the participating firms in each group appear quite representative of the overall universe, with one possible exception. Although several very large and complex firms participated in the survey, several others did not. This segment of the "Large Firm" category, however, includes relatively few firms.

Firm Category	Number of SIA Members[1]	Percent Responding
Large Firms	56	14.3%
Mid-sized Firms	101	11.0%
Small Firms	257	14.4%
Total	414	13.5%

[1] *Does not include members firms that did not report their total employment in the SIA Yearbook*

The data were subsequently aggregated and analyzed and estimates were made for industry-wide spending on compliance. Those estimates were developed using the following approach:

1. Using the survey data, metrics were developed for the percent of net revenue spent on compliance-related activities by firm. This involved combining staff-related, out-of-pocket and capital costs for each firm and dividing by net revenue. The staff-related compensation data was expanded to reflect both employee benefit costs and overhead using a methodology developed for the SEC. That methodology is shown in the box below.
2. The percent of net revenue spent on compliance-related activities from the survey was aggregated and then applied to industry-wide net revenue data from SIA's DataBank. The same industry groupings were used.

In addition, qualitative information on "Opportunity Costs" was obtained from the survey participants. Opportunity costs, which are difficult to quantify, can be described much more easily. Although not quantified, opportunity costs are no less real than staff-related, out-of-pocket, and capital costs. In fact, opportunity costs may have a more significant impact than any of the more quantifiable costs.

Process Used To Expand Direct Compensation
To Include Employee Benefit Costs and Overhead

Step 1: Earlier research conducted in 2005 indicated that a reasonable overall estimate of an industry-wide "employee benefits factor" was in the range of 1.3 times base salary. Therefore, the first step taken was to expand the base salary component of total compensation provided in the survey to reflect employee benefits costs. Based on industry data, base salary represents 71.4% of total compensation, on average. The employee benefit factor was applied to base salary and then added to total compensation.

Step 2: The second step was to include overhead in total staff-related costs. Overhead expenses are included because they are a necessary expense for employees to perform their various functions. As such they become an integral part of total staff-related expense. For this estimate, data from SIA's DataBank was used to develop a ratio that expanded total compensation to reflect overhead. Several deductions were made from total expense to arrive at an appropriate estimate of overhead expense, including: Floor Costs; Promotional Costs; Interest Expense; Error Account & Bad Debt Losses; and, Non-Recurring Charges. The resulting factor to expand total compensation to include overhead was 1.68.

Appendix I: Staff-Related Costs

What aspects of the legislative and regulatory process have had the most adverse impact on staff-related compliance costs at your firm? *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *The large number and timing of regulatory rule proposals and rule changes that in many instances have been made hastily and without regard to the impact and cost to the firm.*
- *The sheer volume. For every legislative and regulatory process disseminated, we must read, discuss, interpret, apply, develop processes, document, train, refine … And then still get written up for failing to apply some obscure aspect of the regulation, to what seemed to be an irrelevant application to our lines of business. Now, multiply all of this times the number of releases rolling out from the NASD, NYSE, SEC and MSRB and you get an idea of the drain this is having on the small broker-dealer.*
- *NASD 3012, 3013 and NYSE 342; Reg. SHO; Research disclosures; implementation of requirements of research settlements with regulators; registration requirements for Equity research analysts; OATS; SOX 404; AML/USA PATRIOT Act; Privacy Legislation; Basel II; Business Continuity; FSA (UK) Arrow process; CSE; Industry Sweeps; E-mail archiving and retrieval.*
- *Volume and breadth of regulatory inquiries/examinations requires additional internal and external staffing. Requires hiring of increasingly specialized legal/compliance expertise – competition for talent raises market. Due to the increase in the number of new and revised regulations, additional staff is needed to provide adequate compliance coverage. The following specific regulatory matters have significantly impacted staff/resource requirements: NASD 3012, 3013 and NYSE 342; Reg. SHO; OATS; SOX 404; AML/USA PATRIOT Act; Privacy Legislation; Basel II; Business Continuity; CSE; Industry Sweeps; E-mail archiving and retrieval.*
- *Within a two-year period, the SEC alone promulgated over 25 new rules applicable to investment companies - a level of activity unmatched in the history of U.S. investment regulation. Little regulatory guidance was provided on the implementation of these requirements. Other regulators followed suit, often addressing many of the same issues from a different perspective…In addition, a pattern has emerged where multiple SEC offices have made similar but not identical information and data requests. This has resulted in multiple overlapping research and compilation projects involving essentially the same data configured and organized differently.*
- *As the result of market decline, political turmoil or even economic difficulties, it seems that our industry reacts frantically pushing through more regulation instead of enforcing or even revising current regulation. This creates a cacophony of processes and technology that must be implemented immediately. Not only costs, but (also) manpower resources are impossible to control.*
- *A continuous flow of proposed and final regulations from the SEC, NYSE, NASD and others have made it difficult to keep up. It seems that the NYSE and NASD are in direct competition and (are) often duplicative with each other. Although we hear of their cooperation efforts it does not seem evident from our perspective.*

Verbatim responses about Staff-related Costs *(continued)*

- *The lack of meaningful cost-benefit analysis in the rulemaking process means there are no effective checks on the amount firms must spend for staff-related compliance costs. Moreover, there is no effort to examine cumulative compliance costs in connection with new initiatives; each new initiative is considered in a vacuum. This leaves regulators immune from having to prioritize regulatory initiatives and leaves firms unable to plan and budget for staffing and other compliance resources that carry significant costs.*

- *The never-ending regulatory process requires that our firm constantly be reviewing websites and publications for proposed rule making, updates and/or changes to existing rules, and SEC securities releases. SEC securities releases are often unnecessarily dense and obtuse, requiring extra time to read, reread, and then interpret. Despite SEC/SRO mandates that industry communications with the public be in plain English, the regulators' communications to the industry, final rules as published in the Federal Register and Code of Federal Regulations, and so-called interpretative guidance are often anything but plain English.*

- *The sheer volume of rules and rule changes have forced us to increase staff so that we can respond during the comment period. Special sweeps, audits, unique requests for data, have also impacted the staff's time. New regs. requiring testing and certification of compliance procedures.*

- *The requirements of Rules 3010 and 3012 to enhance the firm's supervisory systems and controls and provide independent review of producing managers activities, including the required two-year rotation, has resulted in an increase in the compliance staff.*

- *Transparency, Mutual Fund Breakpoint review, TAMMS, Level of inquiries, multiple inquiries from SROS - Responding - Ongoing responses, Sweeps- Inquiries-follow-ups.*

- *Supervisory procedures that monitor Mutual Fund sales charges, Anti-Money Laundering regulations, creating a meaningful Business Continuity Plan, reviewing e-mail correspondence and finally the evolving 3010,3012 and 3013 rules.*

- *Informal investigations, sweeps, and requests for granular data in formal investigations have had a tremendous impact on the compliance costs of the firm. Many inquiries come not with a simple request for books and records but a demand that the firm perform manipulations and forensic analysis of that data to regulator-prescribed standards with no view for the increased costs of such work.*

- *Two aspects have had the most adverse impact on staff-related compliance costs: 1) Regulation by enforcement (break-points, share class sweeps, variable product sweeps, advertising, market-timing; 2) New regulations including Patriot Act, 3012 supervisory controls, books and records, branch office rules, Sarbanes Oxley.*

- *It is difficult to track and monitor proposed rule changes at the state level. There is no one-stop resource whereby firms become aware of proposals directly impacting the business. The SEC and NASD proposals are fairly easy to track yet, with 50 state jurisdictions each posting notices within designated sites, firms are required to allocate staff resources to this monitoring function or rely upon various trade associations. One specific, recent rule change regarding the NASD change to the branch office definition whereby nearly all locations are now required to register as branches has resulted in significant expenses in terms of: signage, increase in the number of internal inspections, and other home office compliance and licensing functions. In addition, inconsistent approaches between regulators increase the expense and time of Compliance.*

Appendix II: Out-of-Pocket Expenditures

What aspects of the legislative and regulatory process have had the most adverse impact on compliance-related out-of-pocket costs at your firm? *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *Dollar costs are not necessarily that large of a burden. It is the opportunity cost of time spent on regulatory burdens rather than business development that really hurts.*
- *Out-of-pocket costs are minimal. Time is the largest cost.*
- *The overly complex and often difficult to interpret rules, releases, and guidance often require the assistance of outside counsel. Even as a rule or interpretation evolves or is revised it is still often necessary to go back to outside counsel to ensure that such changes have not created conflicts or unintended consequences for the Firm. The Firm has had to obtain the services of a third-party vendor in order to fulfill its AML responsibilities. The Firm has also had to devote considerable time, money, and human resources to working with its parent company's AML unit and audit/compliance groups to educate them in the differences between bank and broker-dealer responsibilities under the various rules and regulations.*
- *Retrieval and review of information in response to regulatory inquiries and industry sweeps (outside legal fees, consulting firms, support staff, etc.). Also, compliance with [SOX 404; Reg. SHO; Data/e-mail archiving and retrieval; USA PATRIOT Act – in particular Section 312 requirements (due diligence on client info); Business Continuity; OATS; Books & Records; Surveillance Tools; NASD 3013/NYSE 312]. CSE – inquiries re oversight/governance, etc. Increased resources to assist in testing of controls required by NASD 3012. Research disclosures – new systems/enhancements to existing systems have been required in order to administer disclosure requirements. Also, businesses areas have incurred significant costs to build and maintain systems to provide Research with information required for identification and disclosure of potential conflicts of interest on research reports.*
- *Outside counsel retention: The Firm has increased the use of outside counsel to assist in the management of regulatory matters in response to regulatory inquiries, examinations, and initiatives. As the application of rules and fines for not being in compliance with the rules reach unprecedented levels, the Firm feels the need to seek advice of these professionals when matters are identified. Through the use of outside counsel, they are utilized in such manner that they can potentially minimize the Firm's exposure based upon their subject matter knowledge and reputation, recommend a course of action to avoid similar issues in the future, as well as ease tensions during resolution discussions/efforts.*
- *Regulatory sweeps - primarily the breakpoint exercise - have been very expensive to our firm. Also, the vast amount of rule making has often caused a need at our firm to employ the advice of outside counsel during implementation. In addition, on occasion, we have hired outside counsel to aid in our drafting of comment letters to more effectively voice our concern over the nature of some of the rules that have been proposed.*
- *We receive extensive document requests as part of sweep investigations initiated by regulators in response to perceived new areas of risk. These requests often require significant assistance from outside counsel for the production and review of responsive documents.*

Verbatim responses about Out-of-Pocket Expenditures *(continued)*

- *The SOX 404 audit has been the most expensive out-of-pocket expense for our firm. Compliance with e-mail review and retention requirements. Compliance with AML requirements.*
- *We have seen a number of matters where the regulators acknowledged there was no rule violation under standards in place at that time but nonetheless an enforcement action was sought. Several proposed and passed rules appear to be devoid of any true weighing of the costs of rulemaking versus the perceived benefits of that rule change. Significant and expensive systems changes are a direct result of rulemaking, and perfect examples of those costs are found in changes needed to comply with Rule 401 and Reg. SHO. Regulatory action seems to violate constantly the rule of unintended consequences, to the detriment of firms and their customers. Some regulatory requirements have outstripped available technology to meet the standards, and regulators have turned a deaf ear to the concerns about these IT limitations.*
- *Although not yet reflected, my audit cost will increase substantially as I will likely outsource the secondary audits required for producing branch offices. E-mail retention requirements are absurd and enormously expensive. Requests from regulators related to e-mail production are extremely broad and unduly burdensome. Required notifications mailed to clients - POSTAGE is ridiculous for mailings our clients most often never even open. (This would include order flow disclosure, margin disclosure, certification letters (SEC Books & Records Rule), privacy mailing, disaster recovery disclosure…who knows if I remembered them all?) Quarterly Best Execution reports on our website. Although I have never had a client ask me where their order was routed in 17 years, we no longer route our orders to avoid the extra $3 - $5,000 it would cost to have our website updated quarterly with best execution reports.*
- *The nature of a small firm is that it must rely more on vendors and third parties than in-house personnel for support in complying with legislative and regulatory initiatives. As a result, concurrent compliance-related out-of-pocket costs have risen substantially. An example would be the new requirement that brokerage firms have in place a full set of policies and procedures to govern their investment advisory business. We are working with a vendor to purchase a template set of procedures that will include ongoing updates.*
- *Whether making the decision to purchase or internally develop research analysis CE, we had to incur additional out-of-pocket costs to meet this CE requirement. In addition, out-of-pocket costs include Continuing Education (commodity and/or securities), state registration (general securities and/or investment advisor), fingerprints, any filing made to the NASD (address change, billing code change, disclosure update, etc.) .*
- *Mutual fund supervision, email archiving, 11a-C6, legal costs.*
- *AML/CIP changes have necessitated additional staff, additional programming and have resulted in the loss of accounts due to burdensome and conservative processes. The firm feels these changes are appropriate; however, the industry's reactions to them and the inconsistencies in approach have been costly and unnecessary.*

Appendix III: Capital Expenditures

What aspects of the legislative and regulatory process have had the most adverse impact on total compliance-related capital expenditures at your firm? *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *All of it! Until the regulators and the politicians recognize that you cannot regulate or legislate away risk, they will burden firms and drive the small firms out of business. Focus on existing regs and rules and enforce. Get the bad advisors out.*
- *Similar to the firm's out-of-pocket expenses, the capital expenditures related to the firm's compliance efforts are a direct result of regulations that necessitate the firm to contract with outside sources to achieve compliance. Software and other technological expenditures related to email monitoring and archiving, data encryption software related to privacy protection and systems for Anti Money Laundering/OFAC compliance have had a significant impact on the firm's capital expenditures.*
- *Electronic reporting requirements continue to have the most adverse effect on capital expenditures of the firm. Such initiatives as OATS, OTS, TRACE, MSRB, Reg SHO and other reporting requirements continue to be introduced or amended at a record pace. The programming costs on these types of initiatives have grown over the last two years. In addition, many firms have utilized outside vendors for software solutions to meet these deadlines. The costs associated to these software solutions can and have had a definite impact on compliance-related capital expenditures.*
- *Books and records, emphasis on supervisory controls, branch-office rule.*
- *USA PATRIOT Act; Electronic Communications storage and retrieval; Business Continuity; Surveillance; Space and hardware for additional resources hired due to increased regulatory scrutiny/inquiries; Books and records; Registration; Bluesheet reporting; OATS, TRACE reporting.*
- *The New Books & Records Requirements pursuant to SEC Rule 17a-3 and 17a-4, which went into effect May 2003.*
- *Informal investigations, sweeps, and requests for granular data in formal investigations have had a tremendous impact on the compliance costs of the firm. Many inquiries come not with a simple request for books and records but a demand that the firm perform manipulations and forensic analysis of that data to regulator prescribed standards with no view for the increased costs of such work. We have also experienced regulators with no role-claiming jurisdiction over brokerage activities. We have noticed that the Federal Reserve and OCC are increasingly pressing for brokerage information outside of the "functional regulation" standard.*
- *The volume is the most difficult aspect. With the large number of regulations introduced over the past 36 months, it is difficult to keep up - in terms of man-hours, technology, and cost. Another difficult aspect contributing to large expenditures is the regulators' increased attention to documentation of supervisory activities.*
- *For a small firm, it is becoming increasingly costly to comply with all new rules/regulations.*
- *Breakpoint Sweeps, AML/Patriot Act and the CEO Certification.*

Verbatim responses about Capital Expenditures *(continued)*

- ❖ *While the federal government's reaction to September 11 is understandable, the requirement to acquire secondary customer identification has proved quite costly in tangible and intangible ways. It is apparent that the regulators and legislators either 1) spend little time considering or 2) don't care about the cost impact in dollars and human resources spent in implementing compliance mandates.*

- ❖ *Email solutions that required changes in technology.*

- ❖ *The regulations that made us decide that all registered personnel in the field need to hold either the Series 65 or 66 was a significant capital expenditure. New systems will be purchased for annuity processing and suitability; web page monitoring and disclosures will require new systems.*

- ❖ *Firm has had to evaluate capital cost vs. staff cost in order to keep pace with regulatory compliance requirements. The firm believes it has been able to keep pace with limited capital and out-of-pocket costs. But it is becoming increasingly difficult to meet increasing regulatory requirements without adding full- or part-time compliance staff.*

Appendix IV: Future Plans for Capital Expenditures

Please describe any major changes you anticipate to your compliance-related capital expenditures over the next year or two. *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *We fully anticipate having to change systems, software and other technology to meet new rule requirements in the point of sale and trade reporting areas. These costs plus other needs could cause a two-fold to four-fold increase in capital expenditures.*
- *Electronic communications storage and retrieval requirements will result in further investment in technology solutions. Development of enhanced supervisory and surveillance tools (software) to comply with new/revised regulations (e.g. gifts & entertainment, NASD 3012/3013, etc.). Implementation of Section 312 of the USA PATRIOT Act.*
- *We will adopt a new reporting system that will allow all reviews to be performed online, eliminating paper-based reports. The expected cost of implementation is $350K.*
- *Firm has budgeted for technology initiatives. These initiatives include software to assist the Compliance Department in the area of supervision with exception reports, office inspections.*
- *The Firm will potentially invest in a new supervisory and surveillance tool.*
- *Acquisition of front-end surveillance program, enhancements to our broker audit program, acquisition of program for research disclosure, enhancements due to NYSE risk-based examination program.*
- *E-mail retention, red flag monitoring for AML and OFAC.*
- *New systems dealing with emails review and retention, review of employee trading and a compliance workflow application.*
- *Email filter system.*
- *We anticipate that we will make a substantial investment in compliance software in 2005. It is estimated that this investment could range between $125,000 and $175,000.*
- *Increased systems costs associated to automated controls related to process management. Anticipated changes to the advisory and variable annuity product regulations as well as possible changes to the Patriot Act will require additional systems to gather, distribute and supervise activities related to these initiatives. Archiving of required books and records continues to be a major concern as guidelines vary between SROs and other jurisdictions. Archiving methods and systems will have to be evaluated and enhanced to meet the demands of regulators and others who seek this information in regard to investigations, reviews, examinations or other legal actions.*
- *Technology and systems to comply with Books and Records requirements.*
- *While we are currently self-clearing, we are now considering going fully disclosed to capitalize on the compliance resources of a larger clearing entity.*

Appendix V: Opportunity Costs

Please describe the most significant compliance-related opportunity costs at your firm and discuss how the legislative and regulatory process impacts them. *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *By far the most significant opportunity cost is at the senior management level. CEO, CMO and VP Operations spend considerably more time dealing with rule changes, implementing new procedures, and visiting and servicing existing production sources rather than building new relationships and finding new opportunities.*
- *Employees at all levels spend more time in meetings and in education-related activities with respect to compliance. A significant amount of CFO/CCO's time and the CEO's time is spent on compliance topics that could be better spent on business development, sales etc.*
- *Limited staff and capital resources, in reality, mean that less of CFO/CCO's time is devoted to finance/accounting and operations as compliance requirements have increased.*
- *Management and staff and legal personnel time is spent primarily on managing examination requests and implementing processes for new regulatory requirements. New products, new business relationships, improved processes and savings for investors have slowed because of the strain on resources. Routine compliance work may be affected by the immediate need to meet new regulatory demands.*
- *District advisors and Regional Advisors are now spending approximately 7.5 hours per week on compliance-related issues as opposed to sales issues. This approximate annual opportunity costs equals $5.6 million for our firm alone.*
- *Compliance resources – busy reacting to inquiries/exams, etc. and not available to provide proactive advice and conduct training; frequency and breadth of compliance reviews also potentially compromised due to resource constraints.   Supervisors/senior management spending increasing amounts of time monitoring and reviewing daily activity, conducting administrative tasks (pre-approvals, following up on training, etc.) and participating in the development and review of responses to regulatory inquiries, rather than meeting with clients, developing business, etc. Major business technology and out-of-pocket spending is increasingly related to compliance initiatives rather than business support and development. Competitive disadvantage for U.S. firms in jurisdictions outside the U.S. resulting from need to apply U.S. rules globally – sometimes in direct conflict with or more restrictive than local requirements.*
- *The amount of time executives other than compliance must spend on Compliance issues is taking time away from being able to run the firm. This includes daily conference calls, meetings and other time spent solely on compliance-related issues. It probably consumes at least 30% of executives' time versus about 10% in the past. This is time taken away from running the firm, recruiting and sales.*
- *In short, management, production, and operations are spending a disproportionate amount of time on regulatory matters (and on the interpretations thereof), than in the areas of revenue development.*

Verbatim responses about Opportunity Costs *(continued)*

- *Across the board, all employees are spending more and more time on compliance-related issues. Most employees seem "afraid" of moving forward. There is an increased need to check with compliance and/or immediate supervisor.*

- *The firm has had to expend significant capital on the compliance infrastructure and as a result thereof has missed several key opportunities to increase the volume and quality of the day-to-day broker-dealer operations.*

- *The aggregate cost of the firm's compliance efforts amount to 30%, or more, of the total operating profit/loss. The opportunity costs associated with regulatory initiatives have been tremendous. Senior management of the firm is required to spend considerably more time on compliance-related and administrative matters rather than revenue generating endeavors. Similarly, registered representatives are likewise also spending much more time on paperwork rather than generating sales. In addition, compliance is often diverted from their day to day compliance duties when, in the case of mutual funds, they are required to focus solely on a particular product or sales practice.*

- *The increased regulatory burden, both in the planning and implementation stage, has resulted in numerous lost opportunities for the Firm. Senior management must devote time and resources that could be used for strategic purposes to reviewing reports and addressing issues that could be more appropriately handled at a lower level. Business unit supervisors must devote time and effort to fulfilling regulatory responsibilities, which are often not directly related to production, client service, or direct supervision of securities business and activities. Registered representatives and sales assistants have more forms to complete and more rules to explain to clients, which can lead to frustration (on the part of the sales force and the client).*

- *Sales force is spending a greater amount of time on compliance and related matters daily, monthly and periodically moving away from client sales and service. Branch Management and Executive Sales Management has increased significantly their time spent on compliance and related issues and in dealing with response to regulatory inquiries causing a widening gap in the time spent managing sales, products and sales personnel. Investment Advisory Management is spending a large and increased amount of time on compliance with new and existing rules and regulations.*

- *1. The amount of resources being diverted from the retail sales force in complying with the myriad regulatory requirements. 2. The risk in approving new products. 3. E and O. Overall a tremendous amount of time in labor and FTE redeployment has severely cramped our ability to expand education and training. Between 03' and 05' thousands of hours have been diverted from much-needed surveillance and supervisory training to the specific issues in answering the many audit requests from the regulators.*

- *The primary compliance-related opportunity cost is related to lost employee productivity and innovation resulting from the time spent on complying with legislative and regulatory requirements. Many noncompliance related employees are spending up to 25% of their time on compliance related issues. We would estimate that this amount has doubled over the past 5 years. The increased regulatory burden has resulted in fewer products being delivered to the market in a less efficient manner resulting in a reduction in profits and revenue growth opportunities. Instead of spending time creating efficient products for the market, employees are spending time determining the correct process needed to comply with vague regulatory rules. Also, the fear of noncompliance inhibits employees' innovation of new ideas and products that would create a more efficient securities market.*

Verbatim responses about Opportunity Costs *(continued)*

- *…The product development group has been forced to spend extraordinary amounts of time on compliance matters to the measurable detriment of their marketing and training responsibilities. Branch office managers are spending far more time on compliance issues rather than training and management.*

- *As margins and staffing remain tight in our business, the largest opportunity costs are in the compliance department itself. A very high percentage of compliance department resources are spent responding to regulatory inquiries - which thankfully in most cases lead to no action. Sweeps and inquiries are very expensive and result in compliance staff spending more time on responses than on preventive compliance. Opportunity cost is also high in the branch network where high producing managers are producing much less due to the increased demands of compliance and regulation.*

- *…the greatest loss has been experienced in our IT Department. They have spent a substantial amount of their time gathering data to respond to regulatory inquiries. That precious time could have been spent developing ways to improve our systems, processes and procedures for the benefit of our registered representatives and our customers. We have several IT projects (e.g., paperless platform for direct way business; fully electronic records retention; automated audit program; more user friendly email system; fully electronic 24/7 U-4, U-5 and amendments) that have been delayed months if not more than a year because already overworked resources are devoted to regulatory inquiries.*

- *We do not believe that those individuals responsible for sales and development of products and services have spent less time on those responsibilities. Rather, those individuals have been forced to increase the hours in their overall workday by as much as 15% to achieve the Firm's compliance objectives.*

- *We opened a second office in 2004 (late) and would like to open more. However, we can't free up the capital because of increased compliance costs along with other increases.*

Appendix VI: Duplicative Examinations

If you indicated that duplicative examinations are conducted to a significant extent (4 or 5), please describe. *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *SEC, NASD and NFA are all duplicative. NASD should be able to report findings to other regulatory bodies.*
- *There is a fair amount of regulatory overlap among regulators, which is exacerbated by what sometimes appears to be a lack of communication between them. In addition to overlap among federal regulators and SROs, another area of concern relates to overlap between inquiries by state regulators among themselves and also with federal/SRO inquiries/oversight. Also, it is not always clear at the state level which governmental arm has jurisdiction over securities regulation. For large firms, this same theme may be played out in the international context.*
- *One branch of the SEC sent two overlapping information requests for extensive materials and information. The letters asked for much of the same information, but in slightly different terms and with slightly different criteria. This resulted in two simultaneous projects to gather massive amounts of data, with confusingly similar, yet different, parameters. We also received regulatory requests from three other SEC offices and the NASD with no coordination as to timing.*
- *While there has been increased coordination of exams by the NYSE and NASD, the SEC continues to perform duplicative and overlapping exams.*
- *The same regulators doing routine exams are also doing the sweeps. Different regulators (NASD, SEC, States) examine the same functions and make the same requests.*
- *There appears to be duplication in the following areas (between the NASD and SEC): net capital and financial statement reviews, customer complaints, and mutual fund sales practices. Also, the IRS and SEC are duplicating each other extensively with respect to tax and securities laws relating to the issuance of tax-exempt bonds.*
- *Our firm has experienced a great deal of duplication related to examinations by regulators. In 2005, the firm has been the subject of numerous home office and branch office regulatory exams by the NASD, SEC and various states. NASD Enforcement, as well as the NASD District office, recently started an examination on our firm. NASD Enforcement asked for a great deal of information that was reviewed by the NASD District staff during their routine examination of our home office. We had two NASD examinations of our home office that were being conducted concurrently and are both still ongoing. The SEC also conducted an examination of our home office during the same time period, and a great deal of the same information was provided to each regulatory agency. Our firm had three examinations of our home office going on at the same time by two separate regulators. The District office of the NASD also conducted a Breakpoint Follow-Up Review at our home office prior to completing the routine. Our firm has spent thousands of man-hours and produced tens of thousands of documents for these examinations and they have been a tremendous burden.*

Verbatim responses about Duplicative Examinations *(continued)*

- *This mainly occurs with scheduled cycle examinations by NASD and the SEC. These two exams generally cover the same territory and occur within one to two months of each other. Outside of these, our firm has not been subject to many duplicative exams by regulators.*

- *In 2004, our firm was examined 8 times - 3 times by the SEC, 2 times by the NYSE, twice by the NASD and once by the NFA. There were many duplicative areas covered by these exams; e.g., they all looked at AML procedures and disaster recovery. Both NASD and NYSE looked at complaints and active accounts.*

- *We have encountered duplicative sweeps by SROs and the SEC; while we have sometimes been able to get those coordinated, we have had situations where different offices of the SAME SRO (or of the SEC) will look at similar areas, and require slightly different but overlapping documentation. When we pointed this out, we were specifically told that the two offices did not coordinate with each other, and we had to respond to each. In the case of for cause investigations triggered by a regulatory filing or complaint, we find parallel inquires are conducted by SROs and the States for the same matter.*

- *Sales Practice examinations as well as market regulatory examinations many times are duplicative in nature. A joint anti-money laundering examination was conducted in which each SRO (there were three) asked for information related to specific processes, policies and procedures. Each asked for similar if not duplicative information but approached it from unique perspectives and interpretations of specific rules or regulations. Even though the NASD conducts a very comprehensive and thorough examination of the trading and market making area of the firm, other SROs continually send market regulatory inquiries, which are duplicative of what was reviewed and commented on previously. The time periods for review are many times the only difference in inquiry or examination.*

- *NASD and NYSE conducted duplicative examinations in 2005 in the following areas: AML, Reg. SHO and customer complaints. The SEC and NYSE conducted duplicative Fin/Op examinations in 2002. The SEC and NYSE conducted duplicative supervisory examinations in 2003. NASD conducted examinations in 2005 in the following areas that the NFA plans to duplicate: Trading accounts and AML.*

Appendix VII: Most Burdensome Legislative and Regulatory Initiatives

Please identify up to five key legislative / regulatory initiatives that have particularly burdensome direct impacts on your firm / business and briefly describe how each impacts your firm. *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *SEC Books & Records mandate - contacting all clients every 36 month for changes of circumstances. We will expend untold man-hours and resources to trace, mail and document.*

- *Amended and new NASD compliance policy and procedure rules. Increased focus on documentation of compliance policies and procedures. In response to NASD exams, firm has made minor, technical revisions to existing WSP. Amended rules have increased documentation requirements with no significant change in firms' method of doing business (i.e., firm has not substantially changed its business over past 5 years, but increased compliance requirements have caused reallocation of resources, increased out-of-pocket costs, and non-revenue producing capital expenditures.*

- *(1) 3012/3013 – Requires significant resources to conduct review of controls and documentation and address findings. Large firms using a Sox 404 type approach has resulted in Compliance personnel conducting audit type activities (risk analysis, documentation of controls, etc.) resulting in already strained resources trying to complete the exercise in a compressed time frame. (2) The volume, scope, and complexity of inquiries from regulators have increased significantly. In addition, as discussed above, there is frequently overlap in these requests and it appears that there is little communication/coordination among the regulators. Also, regulators continue to ask for information in a format that is not strictly from already maintained "books and records," but rather, requires analysis/preparation of custom information prior to production. This puts a significant strain on existing resources. This has created a "war for talent," making it difficult to identify, hire and train qualified personnel required to support these requests in the time frame required. (3) The requirements of the USA PATRIOT Act, together with similar requirements in jurisdictions outside the U.S. result in significant increased capital and out of pocket expenditures to conduct client identity verification, and develop monitoring and surveillance tools. Also, it requires the implementation and maintenance of complex systems across jurisdictions. (4) The hardware and software solutions required for large global firms to meet many "core" compliance requirements, such as e-mail retention/storage, review and retrieval requirements, results in significant capital and out-of-pocket spending. Also, off-the shelf products that are suited to large-scale complex businesses are not always available – this results in the need to develop complex, custom-designed systems and procedures, requiring significant time, staff and other resources to build. (5) State regulatory schemes (such as in regard to privacy, registration requirements for entities, representatives, and securities, etc.) are not uniform, resulting in the need for complex policies, procedures and systems. Also, in some cases, there is overlap among states and SRO requirements. The varied rules require significant efforts to ensure required filings are made and payment of significant filing fees.*

- *Breakpoint self-assessment - costly assessment. Broker/Dealer had additional software programming, staffing and office expenses in order to comply with this requirement.*

Verbatim responses about Burdensome Regulatory and Legislative Initiatives *(continued)*

- *Merrill Rule - The majority of our RRs are Series 6 registered and only 30% are registered as RIAs. All do financial planning in some form or another with their clients. The Merrill rule will impact the firm and these RRs greatly by increasing supervision of financial planning activities that may be deemed to be investment advisory under the new rule and by limiting the RRs ability to put a financial plan in front of their clients.*

- *New SEC Books and Records Rule*

- *Breakpoint self-assessment - costly assessment. Broker/Dealer had additional software programming, staffing and office expenses in order to comply with this requirement.*

- *Examination/inspection frenzy (sweep letters) – as noted above. Very resource intensive and disruptive. No incentive for regulators to limit costs or extent of their requests, as the expense is borne solely by brokers, advisors and ultimately investors. The cost determination and benefit determination of whether and how much to engage in investigatory sweeps should not be divorced from one another, or wasteful resource decisions will continue. The effect on our firm is a skyrocketing and uncontrollable expense of performing regulatory driven investigations, as well as the opportunity costs that arise by having to devote resources to investigations rather than providing value to investors.*

- *The mutual fund breakpoint initiative. The scope of this review was entirely too extensive (i.e. all transaction for a five year period), and the cost of resources was outrageous relative to the overall findings. We did not have the resources to program for this review, therefore, we had to sort through thousands of transactions on two internal systems (yes, we went through a conversion during that five year period) and a shopping cart full of transaction tapes provided by the mutual fund companies (surprise, some of them were not entirely accurate) and then we had to manually compile and detail test hundreds of transactions by combining all of this data. This literally took months.*

- *Reviews required for the 3012 compliance are redundant with the daily review of our ongoing compliance duties.*

- *Annual AML certifications. This is a ridiculous requirement since all broker/dealers are subject to same regulation. It takes up people's time to mail certifications, do the follow up and also wastes the cost of mailing.*

- *Sarbanes-Oxley especially section 404 requiring documenting and attesting of internal control structures.*

- *NASD breakpoint review and reimbursement process of 2003-2004: To handle this matter, the Firm had to reallocate existing staff, hire temporary staff, and hire an outside vendor to handle the mass client mailings. The staff spent countless hours for weeks analyzing historic trading data, establishing households per individual prospectus requirements, trying to determine if other fund holdings existed outside of the Firm, developing an internal client reporting system, calculating reimbursement figures down to one cent, and responding directly to customer inquiries in the time frames prescribed by the NASD. The Firm incurred significant compliance-related out-of-pocket expenses as well as opportunity costs as development work on other product related items were halted.*

- *Mutual Fund Breakpoints. The time, effort and expense of keeping track of so many different breakpoint issues greatly increase staff costs. i.e., householding, shares held away, related accounts.*

- *Merrill Rule - many of our top executives have spent exhaustive hours trying to interpret the rule and determine how to implement the rule. Has a direct impact on our rep force and how they are going to be able to conduct business in the future.*

Verbatim responses about Burdensome Regulatory and Legislative Initiatives *(continued)*

- *NASD Rule 3012 - Tremendous amount of work to comply with these requirements on an annual basis.*

- *SEC Books and Records 36-Month Rule. Requires development of new update system for account records and mailing process. Will require extensive amount of representative sales force time and effort to update account records to meet the data requirement format for these new mailings to clients.*

- *Sarbanes-Oxley Act. This has placed additional reporting burdens on the Firm's accounting department and certification burdens on senior management, the former being driven by the later. These additional reporting requirements take time away from the responsibilities of maintaining the Firm's books and records. This also requires additional use of independent auditors to test and report on the reporting and certification required by the act. While the legislative intent of the rule may have been to bring about even greater "transparency" in financial reporting and corporate activities the actual, potentially unintended result, will be to give a regulator, or class-action bar firm, the thin end of the wedge, provided by some minute oversight or procedural reporting error, to drive into an otherwise sound, responsible company.*

- *Sarbanes-Oxley/SOX 404 – compliance with the requirements and the required audit to comply with the rule.*

- *Relatively new SEC books and records requirements impose costly burdens on broker/dealers. The last major revision of SEC Rule 17a-3 requires that broker dealers send certain information to clients within 30 days of the client opening an account and to also update certain customer information at least once every 36 months. These additional requirements are responsible for adding to the obligations that are already imposed upon broker/dealers whose staffs are already burdened by an increase in regulatory requests. These new requirements cost more for broker/dealers in terms of financial capital and human resources.*

- *NYSE Rule 342 and NASD Rules 3012/3013 - staffing, third party software, outside counsel.*

- *AML / CIP - different requirements for different clearing firms has created cost beyond what is necessary to assure compliance.*

- *Sarbanes-Oxley, CEO Certification --- With these initiatives, the Firm has been required to impose an additional layer of internal controls, as well as testing procedures. This has caused us to hire specialized compliance staff, increase our audit processes and involve significant amount of senior executive time to assess and certify the control processes at the Firm.*

- *Anti-Money Laundering - staff increase to review transactions, development costs for technology, management time diverted to respond to examination issues and IT development costs for correspondents.*

- *Customer Identification Program (CIP) requirements have been costly and burdensome and have otherwise had no positive, meaningful impact on screening potential clients. Consumer databases available for this purpose are inherently inaccurate and incomplete. We find ourselves in the position of requiring additional information at the expense of our clients for zero benefit but to record it on a new account form and file it away.*

- *Revocation of discretionary brokerage accounts by the elimination of the exemption afforded broker dealers to manage a clients' account without registering as an IA. Regulation NMS. Sarbanes-Oxley. NASD Rule 3013/NYSE Rule 342 on internal controls. SEC Books and Records.*

- *SEC Books and Records, Patriot Act, SOX, Supervisory Internal Controls.*

- *Supervisory Controls - Compliance with NASD Rules 3010, 3012 and 3013 require a significant amount of capital both in terms of personnel and time taken away from other duties. Our firm has added 5 full-time mid level positions for compliance with these rules only. A significant amount of time is required of our CEO and other Executive Team members to comply with just these rules.*

- *The monitoring of municipal markups is a difficult endeavor and cannot be fairly enforced with the regulatory mindset that municipal bonds can be commoditized and, therefore, easily segmented into like groups and values and prices measured accordingly. In order to monitor the municipal market fairly, regulators need a more complete understanding of how the market really functions. The current reporting mechanics do not appear to distinguish the difference between wholesale trades and retail trades. Reporting the prices of wholesale trades between dealers only confuses the general public.*

- *SEC compliance policy and procedures rules, including annual review requirement. Firm had to revise its documented IA compliance procedures. Prior procedures were sufficient based on results of past 2 SEC IA examinations. Firm has significantly changed its method business. But regulatory burdens have increased greatly in past 5 years. Annual review requirement will result in more CCO/CFO time spent on compliance related activities and less on other responsibilities (finance/accounting and operations).*

- *Repetitive branch office examinations. Several branch offices reported regulatory staff present for periods exceeding 4 months.*

- *New Account verifications - letters required to be sent to customer when there is an address change, investment information update, etc. Software needed to comply with this new requirement.*

- *NASD Rule 3010 requiring controls, policies and procedures over supervisory activities.*

- *Privacy Rule- mailings are costly and are burdensome to staff resources.*

- *Reg. NMS - Extensive system enhancements are needed in this area*

- *Breakpoint Surveillance and Required Refunds. Ongoing efforts to keep reps informed of breakpoint rules for specific fund families, development of front-end breakpoint tools and back-end exception reports to identify potential breakpoint violations. Each potential violation has to be manually reviewed due to complexity of fund family breakpoint rules. Refunds to clients may cost several times more to process than actual refund amount.*

- *Trade Reporting and trade reporting inquiries. These require a significant amount of resources to complete and rarely result in negative findings against our firm.*

- *E-Mail – the amount of time necessary to filter the spam checker/ and then review 20% of the e-mail takes at least 1 – 2 hours per day. Then, at month end someone has to spend an additional 30 minutes or more burning two sets of the data – one for me and one for a third party. This process eats up about 20% of a person's day – each and every day.*

- *Email Retention: Today technology is being utilized more than ever before to contact existing clients and potential clients. All of these email communications must be retained and easily retrievable. In order to do this a firm must have a system in place that allows for the retention, review and retrieval of email communications. Our firm has such a system in place. As you can imagine, the number of email communications increases every day and with several thousand representatives sending and receiving emails, maintaining this system can be a burdensome and costly task. In order to properly maintain this system we must retain qualified IT professionals, purchase hardware and software, storage "platters" and train new employees on the retrieval of messages should a request be received.*

- *Ever-changing market structure initiatives in equity and fixed income trading markets, including Regulation NMS, Mark-ups, order audit trail and trade reporting - I/T infrastructure for trading markets and client interfaces, training of employees, development and revision of compliance tools, including exception and surveillance, staffing.*

- *Patriot Act --- The requirements of the Act with its AML procedural aspects have increased the time and costs of our operational and compliance departments, as well as those of our branch office managers. This has occurred even with the Firm having minimal foreign business.*

- *The constant re-visiting of mutual fund sales practices after the original NASD mandate, specifically following up on the breakpoint project. This review has gone on over 24 months and we continue to get additional follow-up questions from regulators about single breakpoint claims we received.*

- *The required mutual fund breakpoint review was overly broad in scope and involved significant time and expense for little customer benefit. The industry is held to high standards by regulators for being aware of and monitoring direct business and yet no efficient means exist to do so.*

- *Books and Records: Significant systems costs, mailing costs, data clean-up effort requiring additional resources.*

- *Branch Office Definitions - NASD BrokerCheck program. In spite of strong industry objection, the NASD finalized a rule that will disclose an agent's entire justified and unjustified compliant history to the public in the event the agent has 3 customer complaints within 5 years. Currently, only complaints filed within the past 2 years is made available to the public. Most troublesome is the retroactive application of the rule.*

- *Rule 3010/3012/3013 - more management involvement.*

- *State Attorneys' General have noted the significant revenue generation by NY AG Eliot Spitzer and are initiating their own examinations to produce fine/penalty income for their own jurisdiction(s).*

- *Investment Company Act Rule 38a-1 and Investment Advisors Act Rule 206(4)-7 require investment companies and investment advisors to adopt and maintain written procedures designed to ensure compliance with applicable laws and regulations. As a practical result, significant resources must be dedicated to drafting and tracking documentation of compliance policies and procedures. Moreover, the rules requirement that firms appoint a chief compliance officer, who must be a senior officer, serves to shift compliance responsibility away from the firm's CEO, who ultimately should be responsible for compliance matters.*

- *E-mail review and archiving. If a firm is large enough to throw money at this problem, it's no longer much of a problem. We, on the other hand, spend thousands of dollars continually upgrading server and storage capacity, upgrading filter software (that still allows about 9 items of junk e-mail for every 1 valid communication to get through), and then spending hours each month trying to wade through the resulting mess in a meaningful effort to review customer communications.*

- *The full impact of SEC Rule 17a-3, Books and Records, in particular the 36 month customer confirmation requirements will be realized May 2006. To meet the May compliance deadline the firm has spent a significant amount of time and money preparing customer mailings and updating accounts. To send the customer confirmation letters it is anticipated that the firm will have significant programming expenditures to extract and format the data for customer presentation.*

- *CEO CERTIFICATION The SEC and self-regulatory agencies believe many firms have not "reasonably designed" their supervisory procedures or that the procedure in place are not effective. Regulators want the securities industry to meaningfully self-regulate. Consequently, NASD rules 3010, 3012 and 3013 have been promulgated to require the development of new and stringent supervisory control processes that are rigorous and demanding their execution, review, and testing on a ongoing bases. This mandate requires the building of new compliance programs, added burdens on documentation and a "ramping" up of qualified and trained staff to accomplish and open-ended review process.*

- *Competing and sometimes contradictory point of sale rule proposals by SEC, NASD, and MSRB . The effort to comply through systems and procedures becomes confusing and burdensome as many requirements differ.*

- *NASD gifts, gratuities, travel and entertainment self-assessment: This initiative was particularly burdensome for the Firm due to a number of factors including the Firm's use of decentralized systems which capture these items/events, the NASD requesting specific data elements never identified elsewhere prior to the directive, and the expansive time frame which entailed a thirty four month period. Additionally, each item/event identified was to be verified by the Firm, which required each employee to take action in response to this matter even if they had never given or received any business related gifts, gratuities, travel or entertainment items/events. Due to the complexity of the situation, the Firm engaged outside counsel to advise on how to best structure the self-assessment and manage the regulatory contact and response efforts. In addition to incurring outside counsel expenses, the Firm hired temporary staff to assist with various aspects of the assessment and secured internal IT support to build an on-line review tool to facilitate an electronic review by all employees. After countless NASD direction changes and extensions, the Firm ultimately had to focus response efforts on a group of employees only representing approximately 13% of the current employee population. At the present time, the Firm is waiting to hear what action the NASD will take as a result of self-assessment reports submitted by our firm as well as any other firms.*

- *B Share Sweep. Analysis to perform B Share expense calculations, as documented in recent enforcement actions against three major firms is overly complex and beyond the system and resource capabilities of small to mid-sized firms. Such firms do not possess fund performance, dividend and capital gains data, let alone systems than can account for redemptions, exchanges, etc to compare comparable A Shares to B Shares.*

- *Research analyst rules. This area continues to be one of gray rather than black and white. As such, more resources, both internal human and external professional fees, have been devoted to understanding and complying with the rules. One concern is that often times the spirit of the rule and the activity caused by the rule are at conflict. More clarity and guidance from the SROs would be beneficial.*

- *Investment Advisory Regulations - "Merrill Lynch Rule" - although the total impact is yet unknown, this rule fragments many aspects of traditional brokerage and has nothing but negative impact on already confused clients.*

- *OATS - the technicality and specificity of the rules, along with the aggressive enforcement of it have created an unreasonable burden on technology*

- *Sweep letters - risk assessment inquiries --- The scope of many of the sweep letters have necessitated the involvement of outside counsel as well as outside technology resources and senior management involvement. The regulators have provided very little guidance to the industry as a result of the sweep letter responses.*

- *SEC 34-50980. Certain Broker-Dealers deemed not to be Investment Advisors, SEC Rule 405, IA Code of Ethics.*

Verbatim responses about Burdensome Regulatory and Legislative Initiatives *(continued)*

- *There is a dramatic disparity of regulatory depth and breath of exams varying by regulator, department and or region. This can have the effect of exacting fines on some firms and not others despite their having identical compliance issues.*

- *NASD/NYSE fears of absorption into the SEC suggested "Super -SRO" are creating overzealous examinations to "prove we are doing our job" and forestall the inevitable modernization of the regulatory environment.*

- *Equity Indexed Annuities - determining how broker/dealer is going to handle EIA transactions per the guidance given from the NASD. Depending on outcome could be costly - staffing, RRs leaving B/D.*

- *The new requirement to test all supervisory procedures, and then certify their accuracy. Those who take supervision seriously, now have a heavier workload. Those who do not take supervision seriously (and who no doubt caused the perceived need for this new requirement), now have one more regulation they will not take seriously.*

- *Regulations enacted pursuant to the USA PATRIOT Act have also had an impact on the firm. Despite the fact that the majority of our representatives have personal relationships with their clients and are not located in high-risk geographical areas the firm must still meet all of the AML requirements. In order to meet the Customer Identification Program and OFAC requirements necessitated that the firm contract with outside vendors.*

- *Various trade reporting rules (i.e. OATS, TRACE) that require order information to be submitted almost on a real-time basis. This is burdensome especially considering the number of transactions we effect on a daily basis.*

- *NYSE Risk Assessment Unit: In our experience, the questions precipitating from this newly created unit have been poorly written (i.e., "if not, why not"), contain duplicative questions, and at times appears that they may not understand they request themselves or the scope of the information requested. When clarification has been requested, we have not received guidance to be of assistance, which would allow the Firm to address their question. There was an instance in which the NYSE contact simply stated that the Firm was to give everything we had on the topic, including the kitchen sink. While the unit may be charged with identifying future risks, it remains unclear as to how the NYSE may use the information provided and if they believe that the Firm requires enhancements to current practices to better comply with the rules and regulations. As there has not been many articles about this unit and the actions they have taken, it can be a bit unsettling for Firms as we do not know how information is shared between the risk assessment, surveillance, regulation and enforcement units as they are all ultimately under the same control.*

- *Supervisory Rules. Unfortunately, these Rules are poorly written and defined (e.g., heightened supervision of producing managers). Beyond the subjective interpretation needed to implement these rules, the requirements to produce the written report for senior management is simply a large drain on resources.*

- *Advertising / Communications regulation has been inconsistent between enforcement entities and between different members. As an options oriented firm, this has been especially difficult for us.*

- *The State Securities Division routinely requires branch office reviews to be conducted by independent parties. This is in addition to the firm's own internal review which is a timely and costly duplication of efforts resulting in a perfunctory, written report that must be filed with the state.*

Verbatim responses about Burdensome Regulatory and Legislative Initiatives *(continued)*

- *Books & Records – the absurd amount of information required to be entered on an "order" prior to it being able to be sent to the floor for execution. (Time taken, time entered, who accepted it -who entered it – it takes so long to get the order in, I have to believe the client gets the short end of this rule) The three-year update rule. Although I don't have a problem with doing a routine update with my clients – the requirement to send them information that we currently have on file is going to require us to pull the new account forms out of each client file manually to prepare our mailing. I'm estimating the cost of this mailing at over $10,000 by the time you consider all the man-hours involved. A blank form requesting the client to complete and provide any information that may have changed since they opened the account would have been much less expensive and burden-some – and would probably have produced a similar response rate. AML - although I understand the reason for the effort - it's an enormous burden on small firms to run the verifications, check against OFAC, keep current on countries that are on the watch list, have an annual audit (another one) extra steps on wires, third party checks, etc.... I wonder how many small firms that have performed all these steps for 4 years now have every even so much as filed a SAR form?*

- *The unintended consequences of Sarbanes Oxley legislation applying standards relevant to operating company financial statements to investment companies are ill founded. Unlike public operating companies, whose shareholders rely on financial statements to make investment decisions, investment company shareholders rely on daily valuation processes and prospectus disclosures for the investment company's continuously offered shares. As a result of this legislation, a large amount of compliance and administrative resources have been misdirected toward investment company financial statements, with no benefit to shareholders and high risk (i.e., criminal sanctions) to individual firm officers.*

- *Maintaining compliance with the best execution/order routing disclosure requirements has been very costly for the firm. This is by far the single largest recurring annual compliance expense. Given our relatively low volumes a single instance of an error can often reflect poorly on the overall percentages. Larger firms tend to look "better" in absolute terms despite higher number of errors.*

- *CEO Certification: Similar to many firms, the Firm is approaching this matter both by documenting the processes by which compliance and supervisory procedures are established and by conducting a comprehensive review of the businesses in which it engages and the compliance policies and supervisory procedures pertaining to these businesses. While the Firm expects this process to pay dividends in the future, in the short term it has caused a significant resource issue, particularly in the compliance department as compliance employees have taken a leadership role in the process.*

- *Electronic communication costs --- The need to apply books and records, supervision and overnight requirements to all electronic and web-based communications has resulted in significant IT costs and taxed the resources available to the Firm.*

- *Reg. SHO*

Appendix VIII: Recommended Changes to the Regulatory Process

In your opinion, what changes would you recommend to the regulatory process to achieve the same high standards of oversight, but accomplish it more efficiently from your firm's perspective. *(In some instances, minor edits were made to verbatim responses to protect the identity of respondents, to shorten the comment, or to conform to a more consistent format)*

Excerpts From Verbatim Responses

- *Several changes come to mind when answering this question. First and foremost better coordination between regulatory bodies both from their auditing arms, as well as their policy issuance arena would eliminate the duplication of effort that currently occurs when answering the "sweep of the week", or trying to reconcile several slightly different regulations aimed at curing the same potential abuse. In a similar vein, getting more industry input as the very beginning stages of policy drafting would give the regulators a good "reality check" from the people who will actually have to implement the rules once they are enacted. After the fact comment periods are less effective, as the drafters of a proposed regulation are married to an approach to address the perceived problem and may have already ruled out (or failed to consider) other, less drastic alternatives. Lastly, more consideration must be given to how a particular regulation fits into the "big picture." Most regulators focus on fixing a particular perceived problem, but in the process may create other, equally disturbing potential problems. A recent example would be the proposed point of sale disclosures on mutual funds. While the intent is admirable, anyone who has spent anytime with a commissioned salesperson (aka broker) would know to put such extraordinary requirements on the sale of such a product will only drive the sales person to sell a less "regulatory burden" product. (UITs perhaps). The net effect is that an appropriate, suitable product, mutual funds, will be overlooked in favor of a product that is easier to sell. Seems to be a bigger issue than the one the regulators was meant to cure. The bottom line is, the regulators must view the industry as an ally as opposed to an adversary, and must partner with us accordingly.*

- *The rules have to make consideration of the size of the organization being dealt with. For example, I have been told that 65% of all firms registered as BD's with the NASD have 5 or fewer employees. Yet, it is clear that the effort is to push these firms out. The small firms have the same burden as large firms, yet the costs make it difficult to comply.*

- *Consolidation of regulatory oversight/ better coordinated efforts by regulators. Risk-based/rotational based testing approach by examiners. Flexibility on the time permitted to respond to inquiries/narrowing of scope. More targeted inquiries – focus on core issue rather than broad requests. Federalize insurance and other state-driven regulatory schemes (e.g. registrations). Adopt regulations for standardizing client asset portability. Regulators should provide/encourage development of "best practice" guidelines. More reliance by regulators on findings by independent control functions like internal audit. Increased standardization of rules/requirements and interpretive guidance across regulatory schemes. Revise regulatory standards to consider the prevalent use of the Internet (e.g. in context of delivery, notice, etc.).*

- *Combine regulators in to one "super regulatory body" that could oversee exchange and SRO rules. Also, recognize that all firms are not the same and make certain that examiners understand the differences between institutional and retail business.*

- *Consolidation of SRO examination and regulatory staff into or under the management of the SEC's OCIE. This would eliminate the duplication and disjointed coordination, as it currently exists.*

Verbatim responses about Changes to the Regulatory Process *(continued)*

- *There are too many regulatory bodies. We feel a high standard of oversight could be maintained, and a lot of duplicative efforts be eliminated, by combining the regulatory efforts of the SEC, the NASD and NYSE (possibly even state authorities with respect to issues that are not state specific). We are a relatively small firm with fewer than 50 employees generating less than $10million gross annually. In April 2004, the SEC sent four examiners for six weeks. In July 2004 the NYSE and NASD conducted a joint regulatory exam, sending a total of six examiners for four weeks. About seven months later, in April 2005, the NYSE returned for a joint Financial / Operational and Sales Practice exam with a total of six examiners over a total of six weeks. All of these examinations were classified as routine, and resulted in no findings of an unusual or significant nature. That dead horse was beat once too often.*

- *One size fits all regulations place undue burden on small firms. More flexibility should be built into the regulations that would enable all firms to achieve compliance without the enormous, almost punitive, impact on the firm. A recent example can be found in the changes to the supervisory control system, Rule 3010 and 3012. These rules have a number of threshold calculations that seem to have been arbitrarily selected. Based on the results of the calculations the firm must continually revise the supervisory format. In addition, the rules require "independence" in all areas of review. The testing of supervisory controls places yet another requirement on the annual internal review process, each with their own distinct focus. To meet the "independence" requirement and accomplish the scope of the reviews small firms have little choice but to divert already strained resources to the process, hire additional staff, or outsource.*

- *There simply needs to be more emphasis on cost/benefit analyses of not only proposed rules but enforcement matters and examination sweeps. Until this standard comes into balance, the brokerage component of our capital formation regime will be in peril. Additionally, multiple exams in one calendar year have such an impact in terms of costs and lost personnel hours that serious consideration needs to be given to having one super regulator who conducts one exam per year. In addition, given the rapid and continuing consolidation of the financial services industry, particularly banking, insurance and securities, there is a compelling need for one regulator to govern all aspects of these financial sectors. Insurance is particularly troublesome where today there is no federal oversight as there exists in banking and securities.*

- *Regulatory entities could respond to firms in a more timely manner so that matters do not become dated and due to attrition, firms may loose the individuals handling the matters or those employees who may be the subject matter experts.*

- *We would recommend that the different regulators work together to more effectively audit the compliance process. There is too much duplication in requests from different regulatory bodies. It would be nice if regulators were more pro-active with their rulings on what is acceptable and not acceptable in regards to broker-dealer practices. Many fines and sweeps that take place are a result of past practices, which at the time were considered acceptable and industry wide practice (revenue sharing, breakpoints, etc).*

- *Believe there is a real conflict of interest when the fines collected by the regulators are used to fund SRO operations. If the Hybrid model comes into existence, the industry needs to ensure that a single SRO budget does not spiral out of control. Budgets should be voted-on by the members and approve by the SEC. NASD TMMS examination procedures appeal dysfunctional where all reports regardless of the immaterial nature of the finding are sent to Rockville for review. The current system slows down the process of receiving a final report and also does not provide for an environment where members can receive timely feedback of any issues.*

- *More effort from regulators in providing clear and well thought out guidance to firms before implementing new rules. When final rules are ready for publication, work with a cross-set of firms – sort of a focus group – to discuss the rules; their clarity, understanding of what is required to implement, etc. The regulators should also work with vendors, other firm, etc. in developing proper automation to assist firms when new rules (or enforcement actions, sweeps, etc) require analysis of activities (i.e., b shares, breakpoints, VA sweep). Two years after the breakpoint actions began, we are just now receiving breakpoint data on funds from the NASD and unfortunately, the data is deficient (one example – ROA data does not include what share classes are eligible). Also, the revised mutual fund expense calculator does not allow you to account for clients with current holdings in a fund family.*

- *The highest recommendation would be unified broker-dealer rules between NASD, NYSE, and SEC. The Firm is routinely subjected to three broker-dealer examinations. This situation creates diverts energies and resources from everyday compliance matters and Firm operations. It adds to the cost of doing business as the Firm is often required to gather and deliver duplicate information to three different sets of regulators, as well as providing staff assistance to three different sets of regulators during their time on site and in the post-site visit process. The SEC and SRO rule making process should have a more rigorous and thorough review of costs to the industry. The process should more clearly address the actual or perceived condition which needs correcting, the reason(s) why it needs correcting, why enforcement or interpretation of existing laws and/or rules and regulations is inadequate to correct the situation, and clearly spell out the intent, scope, and application of the proposed rule. Too often the industry has had to refer to SEC securities releases, which, as stated above, can be unnecessarily complicated for scope, intent, and application of proposed and enacted rules. Similar documentation from SRO's is often as inadequate as SEC releases in explaining the intent, scope, and application of proposed and enacted rules. SEC should make it clear to SRO's that they may not engage in rule making by notice, i.e., NYSE Information Memos and NASD Notices to Members. In the past firms have been cited during SRO examinations for deficiencies that were related to a violation of a notice, not a rule that had been put out for public comment and review.*

- *Have federal regulatory oversight only of the brokerage industry and eliminate the states from the equation. Along with that, have the regulators avoid the duplication of investigations/examinations, especially at the cycle examination level. Make it mandatory that all registration forms and fees are filed through CRD. We recently found out that the state of Illinois requires a separate form to open a branch in that state.*

- *With respect to examinations, sweeps and inquiries, we would recommend that the various regulators exercise more coordination amongst themselves and within themselves to avoid duplication. Also, while a routine exam should consider many if not all aspects of a broker-dealer, other exams should be more focused rather than broad-sweeping fishing expeditions. Regulators should agree to select samples rather than requesting all documentation for all trades or all complaints. In addition, regulators should be more flexible on time frames, especially if a firm is the subject of simultaneous exams. Finally, District Offices should return to serving as a valuable resource for the firms in their district rather than the adversaries they have become, resulting in less communication and, therefore, more misinterpretations and less efficiencies and effectiveness. With respect to rule proposals, the regulators should work more with broker-dealers and customers in crafting rules that meet the need reasonably and practically yet do not overburden the industry and, thus, increase the costs to customers. The NASD should work more with their membership committees, rather than view them as an unnecessary part of the rule development process. Finally, the regulators should impose reasonable and practical time frames for implementing new rules, based on current technology and the costs to the firm, and the customers.*

Verbatim responses about Changes to the Regulatory Process *(continued)*

- *One SRO. Fewer regulatory inquiries. Impact - cost/benefit studies done with each new proposed regulation. Enforcement of existing regulations over creation of new ones.*

- *Recognition of cumulative compliance costs in cost-benefit analyses and requirements that regulators prioritize; regulation of member firm activity by a single self-regulatory organization; rational rules for supervision, retention and storage of electronic records; substitution of consultative approach between regulators and firms to address new areas of risk instead of burdensome sweep examination and document requests by examiners;*

- *The SEC, along with the SROs, need to simplify and streamline the regulations so by following one set of rules you are complying simultaneously with all regulatory agencies.*

- *A single regulator with consistent approach would be helpful to create an even footing amongst members. The increase in attention on the regulatory environment is a good thing, it is being handled in different ways right now by both exchanges and regulatory entities and that is a bad thing.*

- *A hybrid regulator would result in a greater efficiency to the regulatory process. Currently being regulated by the significant regulators (SEC, NYSE, and NASD) creates inherent inefficiencies simply with multiple sets of regulations and oversight review.*

- *Other than dispute resolution, the NASD's mission and purpose seems to be identical to the SEC, resulting in duplicative work for broker/dealers. NASD ought to consider reevaluating its original mission.*

- *Create one SRO by consolidating NYSE and NASD. Have that SRO take over all branch office exams and get the SEC out of that process. Encourage meaningful industry communication before adopting (unworkable) rules. Have SROs (or SRO) provide more guidance and best practices, and eliminate rule-making by enforcement.*

- *Many times initiatives are designed as a one rule fits all solution. In many cases, the small firms are given exemptive relief from meeting the requirements imposed by the new rule or imitative. As the industry is comprised predominately of small firms, this seems to be counter productive and places an undue burden on larger more complex firms. In addition, clearing firms are being required to produce solutions for the smaller introducing firms, placing a financial burden of cost of development and maintenance as well as the regulatory scrutiny upon the larger firm. Oversight solutions should be designed for the current marketplace with specific guidance provided for different types of firms. Many initiatives are written without full knowledge of changes related to the target business or process, which inhibits firm's ability to achieve compliance.*

- *Investor education is a crucial part of investor protection. There should be more focus in this area. In addition to investor education, regulators should be well educated on products that firms offer prior to conducting examinations.*

- *Better coordination amongst regulatory bodies to reduce duplicative examinations. More resources devoted by regulatory bodies to interpretation of rules and regulations. Faster and appropriate guidance to member firms requesting help relating to rule interpretation. More training for examiners.*

- *More regulatory attention should be paid to the size and nature of a firm's business before a one-size-fits-all approach is required of all industry participants. If not, additional, clear guidance should be published as to acceptable levels of compliance for small firms.*

- *Specific and concerted recognition of the expense of rule making upon broker dealers. The hybrid model for one SRO examination process stopping duplicative examinations. Limit broad based regulatory inquiries recognizing that firms do not maintain their records all in the same manner and that many requests are for reports or formats that firms do not maintain nor are required to.*

- *Consistent rule making among all regulators. Focus on enforcing existing rules rather than creating new ones.*

- *The elimination of duplicative regulators and regulation would certainly assist the industry in its efforts to build strong compliance infrastructures. Time is sometimes spent performing research to determine the common denominator among regulations in order to determine how to comply. Oftentimes that research leads to additional confusion when overlapping regulatory schemes are inconsistent or contradict one another. A uniform scheme among the regulators or the creation of one regulatory body would solve these problems. A more global consideration by the regulators of the timing of new regulations, regulatory requests, sweeps, inquiries and examinations would aid the compliance effort considerably. Oftentimes, the need to meet the requirements of new rules is competing with the need to respond to seemingly unlimited regulatory inquiries and/or examinations for compliance, technology and legal resources that are inherently limited. Some comprehensive consideration of the requests already outstanding in the industry, and at particular firms, would greatly alleviate the need to divert or stretch resources from equally important projects in order to attempt to meet them all. The overextension of industry resources only leads to incomplete or inaccurate responses that increase the time and manpower that must be allocated by both the industry and the regulators. We need to move to an environment of regulation by rule and detailed guidance rather than regulation by enforcement. The use of enforcement to change the regulatory landscape only taxes limited industry resources further by creating the need for the "emergency" allocation of resources to address issues immediately and avoid being the next regulatory target. This makes for haphazard compliance determined by what can be done the fastest rather than what is the best approach. A return to regulation with timed implementation would give firms the opportunity to have input on upcoming changes, plan their approach to the regulators requirements and address things correctly the first time. Publication of guidance on interpretive issues relating to existing rules which regulators feel are being improperly applied would also allow firms the ability to address the issues from a comprehensive standpoint rather than the "finger in the dyke" approach that enforcement tends to bring about. Given the considerable regulatory focus on the development of comprehensive systems of supervisory procedures and controls, it would seem in the regulators best interest to allow firms the ability to plan the use of their time and resources in order to address these requirements rather than spending their time fighting fires and expending valuable resources and time that could be better allocated to address the needs of the future.*

- *Regulators should work more closely to better define new rules and/or regulations. State regulators should strive to be more uniform with regard to their individual state rules and regulations. For instance, states vary on their requirements for investment adviser agent registrations. Combine the various regulatory bodies into one "super-regulatory" body; or coordinate inquiry efforts among SROs to ease the burden on member firms. The relationship between the regulators and the industry is too adversarial. The investing public is bearing the brunt of the new regulations in paperwork, unwanted communications, and increased costs.*

- *Greater use of interpretive releases rather than regulation through enforcement. Greater exercise of jurisdiction by the SEC over the states. Prohibition against multiple regulatory actions based on the same underlying facts. An industry advisory board to both the states and NASD. Minimum experience requirements for examiners. Legislative fining/penalty guidelines. More realistic comment periods on new legislation. Revamp the process for determining burden and cost on the industry as part of the SEC rule-making process. Needs to be more realistic.*

Questionnaire

COST OF COMPLIANCE STUDY

Confidential Questionnaire

To obtain a copy of this questionnaire in Excel,
Please contact Claire McKenna at cmckenna@sia.com.

120 Broadway, 35th Floor
New York, NY 10271
(212) 608-1500

Securities Industry Association

October 2005

Dear Colleague:

Securities firms have long made it a priority to adopt and implement robust compliance programs as part of their self-regulatory efforts and good business practices. Over the past five years, in the wake of massive corporate governance failures and the deflation of a speculative "bubble" in equity markets, new laws, regulatory requirements and enforcement settlements have placed increased demands for specific supervisory procedures and systems and reshaped the structure of compliance programs in securities firms.

The Securities Industry Association has developed this survey with two objectives in mind: (1) developing a deeper understanding of how various regulatory and legislative mandates impact compliance-related activities at industry firms; and, (2) measuring total compliance-related costs.

The **compliance function** can be **defined** as the firm's general efforts designed to achieve compliance with applicable laws, rules, and regulations. These compliance functions may reside in several locations within a securities firm in addition to the compliance department, including, for example: the risk management department; the internal audit department; the office of the comptroller, treasurer or chief financial officer; the legal department; the branch network; and, in many firms, the human resources department. The essence of compliance is embedded in the concept of "supervision," where business management, not the compliance department, has ultimate responsibility to ensure that every element of the firm adheres to all regulatory and legislative mandates.

As you complete the questions on the following pages, please use your best judgment to make appropriate estimates wherever necessary. Your responses to this survey will remain strictly confidential. No individual firm information will be made available.

Best regards,

Frank Fernandez
Senior Vice President,
Chief Economist and
Director of Research

Please complete the following information about the person who is responsible for completing the survey questionnaire so we can contact you about your responses if necessary.

Your Name:		Title:	
Your Firm:			
Telephone:	( )	Fax:	( )
E-mail Address:			

I. GENERAL INFORMATION

1. Please indicate which of the following categories best describes your firm. (check only one)

❑	**Major**	*These firms or parent firms usually have thousands of employees, an international presence and generate many hundreds of millions and even billions in revenue from investment banking, capital markets and/or from diverse securities product lines both retail and institutional.*
❑	**Regional**	*These firms are often full service, retail and institutional broker-dealers operating in a single or in several geographically significant areas. They have many securities product lines and can generate several hundreds of millions in revenue.*
❑	**Small Firm**	*These firms are primarily retail-oriented but some are small institutional firms. They operate in a limited geographical area with few branch offices and employees.*
❑	**Boutique**	*These firms generate their revenue from a single or a limited number of securities product lines, such as M&A activities and payment for order flow. They usually operate in one location and can generate a significant amount of revenue.*
❑	**Institutional**	*These firms primarily derive all or at least a significant part of their revenue from institutional products and services. These firms are smaller than the major firms.*
❑	**Independent Contractor**	*The majority of RRs in these firms are independent contractors, usually retail.*
❑	**E-Broker**	*These firms usually generate their revenue from electronic commerce; either retail online trading or institutional online including capital markets activities.*
❑	**Clearing**	*These firms primarily perform clearing and execution services for other brokerage firms. This does not include other firm categories, which integrate clearing as one of their business lines.*
❑	**Investment Management**	*These firms are primarily mutual fund wholesalers and/or retailers, asset managers and are sometimes subsidiaries of banks, insurers, etc. Some also provide major clearing services.*
❑	**Other**	______________________ *(Please describe)*

2. Please indicate your firm's 2004 Net Revenue *(Gross Revenue less interest expense)* $ ____________

2a. Please indicate your firm's projected 2005 Net Revenue $ ____________

3. Please indicate your firm's current employment for each of the following.

3a. Total Employment ________ as of ___/___/___

3b. Number of Retail RRs ________ as of ___/___/___

3c. Number of Independent Contractors ________ as of ___/___/___

4. Please indicate, by regulator, the total number of inquiries received by your firm during the past 12 months.

	Type of Inquiry			
Regulator	Regulatory	Supervisory	Investigative	Other
SEC	______	______	______	______
NASD	______	______	______	______
NYSE	______	______	______	______
AMEX	______	______	______	______
CBOE	______	______	______	______
State Regulators	______	______	______	______
Other ____________ *(please specify)*	______	______	______	______

If you indicated "State Regulators" above, please indicate which states. ______________________

II. STAFF-RELATED COSTS

5. **For each of the departments/functions listed below that applies to your firm, please indicate the total number of employees (exempt and non-exempt full-time equivalents FTEs) in that department/function, the average percent of time spent by those employees on compliance-related activities, and the average total compensation per employee.** *The ability to provide the data requested below might vary by firm size. Therefore, firms can respond at whatever level is appropriate for them, (e.g., by line item within each group, on the total line for each group, or for the overall total line, which might be appropriate for very small firms).*

	Total Number of Employees	Average Percent of Time Spent on Compliance	Average Total Compensation per Employee
Legal & Compliance			
Legal	______	______ %	$ ______
Compliance	______	______ %	$ ______
Risk Management	______	______ %	$ ______
Training & Education	______	______ %	$ ______
Other ______	______	______ %	$ ______
Total	______	______ %	$ ______
Management & Administration	______	______ %	$ ______
Executive Management	______	______ %	$ ______
Exec. Mgt. Support Staff	______	______ %	$ ______
Finance & Accounting	______	______ %	$ ______
Human Resources	______	______ %	$ ______
IT/Systems Technology	______	______ %	$ ______
Other ______	______	______ %	$ ______
Total	______	______ %	$ ______
Retail Activities	______	______ %	$ ______
Sales	______	______ %	$ ______
Retail Products *(e.g., Mutual Funds; Retirement Products; Insurance and Annuity products; Estate Planning; Asset Management Accounts; etc.)*	______	______ %	$ ______
Other ______	______	______ %	$ ______
Total	______	______ %	$ ______
Institutional (Equity & Fixed Income)	______	______ %	$ ______
Sales	______	______ %	$ ______
Trading	______	______ %	$ ______
Investment Banking	______	______ %	$ ______
Syndicate	______	______ %	$ ______
Other ______	______	______ %	$ ______
Total	______	______ %	$ ______
Research	______	______ %	$ ______
Other ______	______	______ %	$ ______
Other ______	______	______ %	$ ______
All Other Employees	______	______ %	$ ______
Total	______	______ %	$ ______

Please note any key assumptions you made for your responses to question 5: ______________________

____

____

6. **Since 2002, how have regulatory and legislative initiatives impacted the amount of time staff and management spend on compliance-related activities?**

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
Staff	❑	❑	❑	❑	❑
Management	❑	❑	❑	❑	❑

7. **Since 2002, what is the approximate increase in (1) the number of total employees and (2) employee compensation costs at your firm?**

	Approximate % increase vs. 2002
Number of total employees	%
Average Employee Compensation	%

8. **What aspects of the legislative and regulatory process have had the most adverse impact on staff-related compliance costs at your firm?** ***(please provide as much detail as possible)***

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III. OUT-OF-POCKET COSTS

9. **Please indicate your firm's total compliance-related out-of-pocket expenditures during 2005 for each expense category and how that has changed since 2002.**

	2005 Expenditures	**Approximate % change vs. 2002**
Accounting services	$	%
Legal services	$	%
Audit services	$	%
IT suppliers & vendors	$	%
Other ________	$	%
Other ________	$	%
Other ________	$	%
Total out-of-pocket	$	%

10. **What aspects of the legislative and regulatory process have had the most adverse impact on compliance-related out-of-pocket costs at your firm?** ***(please provide as much detail as possible)***

IV. CAPITAL COSTS

11a. **Please indicate your firm's total compliance-related capital expenditures during 2005 for each of the following expense categories and how that has changed since 2002.**

	2005 Expenditures	Approximate % increase vs. 2002
IT systems/software/hardware	$	%
Other capital costs	$	%
Total capital costs	$	%

11b. **Please describe any major changes you anticipate in the next year or two.**

12. **What aspects of the legislative and regulatory process have had the most adverse impact on total compliance-related capital expenditures at your firm?** ***(please provide as much detail as possible)***

IV. OPPORTUNITY COSTS

13. **Please describe the most significant compliance-related opportunity costs at your firm and discuss how the legislative and regulatory process impacts them.** Please be as specific as possible. Opportunity Costs occur when a resource is employed in one way when it might be more productively used in another. (*e.g., the increased amount of time spent by the sales force on compliance instead of production; the amount of time spent by executive management on compliance instead of developing new products and services, etc.*)

V. IMPACT OF REGULATORY AND LEGISLATIVE INITIATIVES

14. **To what extent do regulators conduct duplicative examinations at your firm?** *(e.g., SEC and NASD conducting examinations covering the same areas; the home office and a branch office of the same regulator conducting examinations covering the same areas; multiple State Regulators conducting examinations covering the same areas)*

	Considerable Extent (5)	(4)	Modest Extent (3)	(2)	Minimal Extent (1)
Extent to which regulators conduct duplicative examinations	❑	❑	❑	❑	❑

If you indicated that duplicative examinations are conducted to a significant extent (4 or 5), please describe.

15. **Please identify <u>up to five</u> key legislative/regulatory initiatives that have particularly burdensome direct impacts on your firm/business and briefly describe how each impacts your firm.**

a. ______________________________

b. ______________________________

c. ______________________________

d.

e.

16. Over the past five years, what has been the overall impact of regulatory and legislative initiatives on compliance-related costs at your firm?

	Major Increase (5)	(4)	Modest Increase (3)	(2)	No Increase (1)
Staff-related costs	❑	❑	❑	❑	❑
Out-of-pocket costs	❑	❑	❑	❑	❑
Capital costs	❑	❑	❑	❑	❑
Opportunity costs	❑	❑	❑	❑	❑
Total compliance costs	❑	❑	❑	❑	❑

17. In your opinion, what changes would you recommend to the regulatory process to achieve the same high standard of oversight, but accomplish it more efficiently from your firm's perspective?

Please return your completed questionnaire no later than October 28th to:

Stephen L. Carlson
Vice President and Director of Surveys
Securities Industry Association
surveys@sia.com
212-618-0572
FAX: 212-968-0658