

**Securities and Exchange Commission Historical Society**  
**Interview with John Pinto**  
**Conducted on March 12, 2010, by Kenneth Durr**

**KD:** Interview with John Pinto, March 12<sup>th</sup>, 2010, in Washington, D.C., by Kenneth Durr. A little bit of background. You went to Rutgers. Is that right?

**JP:** Rutgers in Newark is where I, ultimately, graduated from.

**KD:** Undergrad?

**JP:** Yes. I went to high school in Newark, New Jersey, Essex Catholic High School. I graduated in 1961. From there, I went to Newark College of Engineering. After a period of a couple years, realized clearly that engineering was not what I wanted to do, or could do, and it's probably thankful for people driving over bridges that I wasn't involved in engineering. I left there after a couple of years, and my first real job was with Household Finance, mainly in Newark, although I worked in a number of their offices. I was there about four years.

**KD:** What were you doing?

**JP:** You go in making loans, collections. I had gone through the qualification program that they had to be a manager, and I was qualified as a manager, and I managed a couple of their offices in Orange and Newark for a period of time as a fill-in for the manager. I left

there. But there, I was involved in retail credit. I was in the Newark office during the riots in Newark, so it was interesting getting back to work during that time with the gentleman sitting on the door with a shotgun.

I left there and went to work for Worthington Pump in Harrison, New Jersey. There it was in the industrial credit area. That was mainly, if not exclusively, on the collections side. I wasn't there for very long. I went there sometime in 1968 and left there probably very beginning of '69. On January 27<sup>th</sup> of 1969, I joined the NASD.

**KD:** Was Richard Walbert the president at that point?

**JP:** Back then I was still walking around looking at the big skyscrapers, but I think Walbert was the president then.

**KD:** Gordon Macklin wasn't.

**JP:** Gordon came on after I was there. Dick Walbert was the head of the NASD back at that time.

**KD:** What was your title when you came in?

**JP:** I joined what was at that time District 12, which is the New York district office, and I started there as an examiner trainee. The director there was George Bergen, another

name who's got history that really would get you back to where you want to go. There's a couple of names of guys that were around that were pioneers back when the NASD was almost getting started, and George is one of them. George was the director and, ultimately, became vice president. But that's who ran the New York office. I started as an examiner trainee, which was an entry-level position for the examining ranks. I was there a week, and then we went to a training class down here in D.C. Actually, part of the training was in this building. The NASD executive office used to be at 888 17<sup>th</sup> Street before Gordon bought the other building on K Street.

**KD:** Tell me about your first big assignment, going in and examining.

**JP:** The big assignment for me was, once you get to go through the training process, you go out with folks, and you kind of get a flavor for it. I did a number of examinations, as I recall, on my own in the South Jersey area, down the Jersey Shore. We had a number of firms. Let me step back. The period of time I joined was '69, so it was right after what was then the '68 period where the market, the volume picked up.

The first big major thing that I recall us doing was control examinations, meaning we would go in because of the concern over the sharp increase in daily volume. I think they even closed on Wednesday to try to get everything up to date: but the sharp increase in volume plus the fact that you had firms—because the NASD's membership is very broad, a wide range of different businesses that fall under the mantra of over-the-counter, and NASD regulates all of the over-the-counter markets, mutual funds and what have you.

Because of the activity, many firms would either start selling securities, where before maybe they were doing just mutual funds or other kinds of products that weren't the sale of securities, or their business increased in volume, and there was a concern about the ability for them to maintain accurate books and records and to keep that information up to date.

We would go in and do control examinations, meaning you'd go in and look at the stock record as far as what information they say they have, and stock records tell you who owns it and where it is. There's a number of categories in both of those, but who owns it and where it is. Then you would go back to the subsidiary record. If it said on the stock record, for example, they're long 3,000 shares in the trading account, you go back to the subsidiary record and find out that they're long 9,000 shares. So you'd have a difference, and there's discrepancies. The whole idea there was to see if the firm was in control of its records and had accurate books and records and information. In conjunction with that also was the computation of net capital. That was a very big part. It was really financial, operational.

You would get the financial statement for whatever period of time you were going in, and you would prepare a trial balance off of their financial documents, off of their general ledger information, prepare a trial balance and do a computation of net capital under the SEC's net capital rule and see whether they're in compliance or not. Then also, in conjunction with the control exam, on the operations side, if there were discrepancies, oftentimes discrepancies led to additional charges for net capital because if they said they

had \$8,000 and they really had \$3,000, you got a \$5,000 difference, and you got to take that somewhere as a charge, so you would include that.

The bottom line was to see whether the firm had controls on the operations side, whether their books and records were accurate and whether they were in compliance with the net capital rule, all of which was considered extremely important, and still is, actually.

**KD:** Did you find a lot of problems at this point?

**JP:** There were a lot of problems, yes. I forget how long of a period we did that, but that was sort of a special program of going in doing control exams for a good period of time.

**KD:** What was the next step after you identified a firm that was not in compliance?

**JP:** It depends. As an example, if the computation of net capital showed that they had an excess net capital of \$100,000, and by going through all of this, in reality it was only \$70,000, you'd prepare a report because there were discrepancies, and that information would be reviewed for disposition. I'll tell you about that part of it in a second. If you found that a firm didn't have adequate net capital in order to stay open, which means that they were under what their minimum requirement was, that was serious. They violated net capital. The violation is to continue doing a business while you're in violation. That caused us to require the firm to stop doing business. You'd actually cease doing the

business. You'd permit them to liquidate long positions because liquidating long positions reduces haircut charges, so we let them do that.

You didn't want to lock up customers if they wanted to sell, so if a customer had a long position at the firm and they wanted to sell it, you'd permit that to be done, but nothing that would take on additional liabilities, nothing that would take on additional commitments. It was allowing liquidations along those lines.

**KD:** Did you get the national office involved at this point?

**JP:** No.

**KD:** So this was just something the districts would handle on their own.

**JP:** New York was a different district. Because of its location, because of the scope of the membership that was there, and because of the size of the staff and the level of experience and expertise of the people on the staff, many, many programs were developed and initiated in New York that, ultimately, got adopted nationally. The national folks didn't want to accept that, but that's what happened. When I became national, then I realized that. This control examination, this whole thing ultimately became a program that all the districts did, they basically took our procedures.

I was involved in establishing what we did, and we get further into the process. But the New York district, you always had a centralized control out of Washington. But in my earlier times at the NASD, I didn't really deal with that very much. I was out examining in the beginning, and I'd be bringing these reports back to my supervisor.

I started out as a trainee, and then there are levels within the examiner ranks. Trainee, examiner, senior examiner, up the line. I was promoted to examiner, and then I was promoted to a senior examiner, and then I was promoted to supervisor. The examiners all work for a supervisor. The supervisor manages the group, assigns the exams, makes sure it's all being done. The examiners go out and do the work, prepare the report. The supervisor reviews all the reports that come in, including whatever documentation that's been there to see whether—if there's problems, whether it's supported by documentation.

When you say what happens after, the exam would come in and it would be reviewed by the supervisor. For most of my career at the NASD, the final adjudication and review and disposition of every examination report was done by the District Business Conduct Committee. The district committees were locally-elected officials that came from the members within the district. In New York, you had from New York, New Jersey. They changed the districting as well. They're locally-elected officials, so there's a vote that takes place and these people are elected. There was the district committee that dealt with general matters—then the District Business Conduct Committee—when they sat reviewing examination reports in disposition, and when they heard enforcement matters, they served as the District Business Conduct Committee. The supervisor would review

the report and get it ready. They all got presented, even the exams that had no action, and ones that did have an action.

The disposition of an exam could be a file with that action, it could be a letter of caution, which is minor violations, but nothing of great substance, a staff interview, which is now called the compliance interview. It was a little bit more serious, but not serious enough to fall under the Code of Procedure for formal action. You'd have the firms come in, and you'd sit down and go over the issues, and they'd have to tell you how they were going to fix it. The next level would be a formal disciplinary action, which is the most serious action that NASD could take against its members. That's the filing of charges, and they're entitled to a hearing, there could be fines, they could be expelled, thrown out of business.

**KD:** How often would that happen, the formal discipline?

**JP:** New York had a very active docket. When I got into a more senior position, I split handling the docket with our counsel. The counsel handled the normal formal disciplinary where the complaints are filed, etcetera, and then there was an alternate way of settling formal matters, which we actually created in New York. I don't know if you've heard the term "acceptance, waiver, and consent." Back then it was called "admission, waiver and consent, AWC." What that was, we realized that often times when you file a complaint, the respondent says, "Look, I know I did this."

We said, "We ought to have a document where you can roll it all into one." An AWC is, basically, the allegations, any mitigation the respondent wants to say and an agreed-upon fine, settlement, censure, whatever the sanction would be. They're supposed to be remedial sanctions, not punitive. We had a document that was all in one. I controlled that document. I think I had a hundred items, give or take, and there were about the same number on the legal side. Overall, when I came to Washington, there was probably, on average, over 1,000 formal actions between formal and AWC a year, give or take. Sometimes more.

**KD:** Out of those, we're talking about the 1970s, how many of these would have been small brokerage firms and folks like that versus the big guys?

**JP:** In the early-70s period while I'm still in New York, the New York Stock Exchange was still very active in examining its members, which are also NASD members. We would examine those firms for, basically, sales practice issues. New York was mainly focused on financial and operational. Of our disciplinary actions, a good number were against sole NASD members, but we brought disciplinary action against the largest of the large; whether it was for free riding, withholding violations or other violations involving mutual funds, markups. The New York Stock Exchange exerted, but they don't have any jurisdiction over municipal bonds, they don't have jurisdiction over mutual funds, they don't have any jurisdiction over tax shelters. These are all over-the-counter areas. There were disciplinary actions taken against the larger firms as well. I guess on a percentage

basis, there would be more against the mid- and smaller firms that were NASD members only, but it really didn't matter.

**KD:** At what point did you start seeing more involvement from the national level at the NASD?

**JP:** I would say that was probably around '72-73. When SIPC came into being, which I think was '71-72, SIPC's purpose was to be there to provide funds and securities for customers of firms who were closed up because of financial problems, not for other sales-related, but if they had financial failings, SIPC was there. The New York Stock Exchange had a fund that I remember because Merrill Lynch took over somebody back then, but part of the New York Stock Exchange funds were used to help facilitate that, and that concept was adopted when SIPC came in. There was a period of time in there were a number of smaller-type firms with customer exposure that were running into financial problems. That was '72-73, the economy probably wasn't so hot back there. There were a lot of financial and operational problems.

There were a number of SIPC trustee firms. There were a number of the SIPC trustee firms that came out of New York. There was a coordinator in D.C. that was the coordinator between, and I'm assuming all the districts. When you're in New York district, you just figure it's me and the world. There were reports that had to be made as far as what we were doing on some of these firms and the like.

**KD:** So NASD is working with SIPC to liquidate?

**JP:** No. SIPC doesn't have any regulatory authority as far as examiners or anybody to go out and detect any of this stuff. SIPC is there really as a fund that's there to support in case a firm goes out of business. They rely on the self-regulatory organizations and the SEC to enforce the financial and operational rules, and where there's early warning signs or whatever, to be able to go out and try to do something to try to prevent these things from occurring. SIPC liquidation was not anything you were proud of. You would try whatever you can do within reason. Sometimes you just couldn't do anything. Sometimes these firms did stupid things that caused them to go out of business.

There was a requirement to report to SIPC, so that SIPC could know what's on the horizon. We used to call them SIPC reds and greens. The reds put them on. How elementary. The memo we sent had a red border on it. There was a person or group in D.C. that was supposed to coordinate these. I don't think that was, at that point, done as well as the organization would have liked.

**KD:** Okay. But that was NASD staff.

**JP:** That was NASD staff. In '73, the gentleman who was the associate director in New York, the second highest position in the district, the first is the director, vice president that I told you earlier, George Bergen. The second in line was the associate director that, basically, ran the examination and compliance programs in the district, all the routine

exams. We had a special group that did customer complaints and registered rep. terminations for cause, it was the whole special investigations as well as the routine examinations. He was promoted and came to Washington in 1973, and he took over that whole area. It was more than just SIPC. It was a stronger voice in Washington to oversee the districts.

When he left New York, I was promoted into his job. So in 1973, and in between, I was made assistant director. I became the associate director in March of 1973, and then I had responsibility for all the folks in New York. He came to Washington, and he was in charge of overseeing all the districts.

**KD:** Is this regulatory he's overseeing, compliance?

**JP:** Yes. NASD back then was a regulatory agency. That's all we were. At that point, NASDAQ was only like two years old. It started, I think, in '71, and it was just a little thing. It was to oversee the regulatory programs. He had people working under him, but it was to oversee the financial and operational monitoring, the relations and reporting to SIPC, it was to oversee the examination program. It was, at that point, a little turning point because of his involvement in New York.

He was there when we were doing all these things that a lot of what we were doing got implemented around the country. There was more standardization and more similar use

of modules that we had developed and special programs that we had developed were starting to be adopted at all the district offices around the country.

There were a couple times a year where there were meetings in D.C. with all of the district management and the management of D.C. It wasn't like there was never any interplay. There were always a couple of times a year where this took place. I wasn't involved in those in the earlier days because I wasn't high enough up, but in my associate days on from '73 on, I was. During a lot of these, I used to run some of the workshops to tell other folks what we're doing and how to do it, so it was really to try to educate other people. This is John Wall I'm talking about. John Wall had come down.

**KD:** I'm getting the sense that at this point, early 70s, maybe enforcement wasn't so even all across the country.

**JP:** I wouldn't say not even. I couldn't tell you.

**KD:** But it was left up to the districts.

**JP:** There were folks in charge in D.C. I really didn't deal so much, and I knew them, but I think there was more autonomy allowed than happened later on. I think everybody was sort of left—they all had exams to do, they all had programs, but I think they were more or less left to their own initiative as to how they did it. They all had district committees

so they all had industry input and what have you. I wouldn't say it was less, it was just more autonomous and maybe not as uniform.

**KD:** You've talked about the internals going on. How about externals, like the '75 Act Amendments and things like that where the overall playing field is changing considerably?

**JP:** I still have the book inside in the other room—that was a big deal. I don't remember all the specifics of that. All I know is if I went in and got that book, it's the only one that the binding is starting to come apart on. I probably still have tabs on it, the '75 Act Amendments. There's a lot of stuff that happened there. I don't remember all the stuff. All I know is a lot of times you'd rely on our legal department to do something, but that was something that I'd personally got very involved in because, among other reasons, I was in the New York office from '73 to '75, and then in 1975, I was promoted, and I came to Washington, and I was promoted by John Wall, and I came down and took over his position because he moved up to another position.

I used to kid him because he would move up and I'd move into his spot. He would move up and I'd move into his old job. I told him to keep going because it was good stuff. I came down to Washington in 1975, and I think my title was Director of Enforcement. In that role now—when I was in New York, I had responsibility for all of the regulatory programs in New York. Now I had responsibility for all of the fourteen district offices. Everything they did, including the dealing with the committees and stuff like that.

In '75, we had a small group that we used as our antifraud group. And these were folks that weren't involved in the day-to-day examinations or review of financial reports or customer complaints that were in the districts, which they had to do, they had routine assignments to do, these were specialized, really qualified people who, when we ran across something that we thought was a manipulation or a fraud and it was going to take two months to investigate, and you've got to be onsite in Cleveland, these guys would go because they didn't have to worry about fifteen financial reports coming in. I had responsibility for that group. That was in '75. In '76, I got promoted to vice president of surveillance, and my job, as I remember, stayed pretty much the same, I just was made an officer at that point.

**KD:** Name keeps changing, though. Compliance comes in at some point.

**JP:** All the way through. We kept changing. It was vice president of surveillance, later on it was compliance. We kept changing. There was a debate. Sometimes you went from compliance to regulation because one is a little broader than the other. I think I was executive vice president regulation because regulation is broader than just compliance. We thought, at that job, since I had more than just compliance, which I'll get to later on, regulation was the better term.

**KD:** Was examinations part of what you were responsible for?

**JP:** I had responsibility for examinations. If you count my days in New York, clearly for that whole period of time. From the time I came to Washington in '75 until I retired in September of 1997, throughout that entire period of time, no matter what you called me and no matter what organization, I had responsibility for all of the district offices, all of the examination programs, the special cause examinations throughout that entire period. Depending what period you're in, I had other responsibilities, in some cases many others, but I always had the district offices throughout that whole time.

**KD:** At this point, to go back to that question I asked before, when you came into Washington, you must have had the opportunity then to look at this big picture, to look at these fourteen districts and sort of assess how people are performing out there. What did you find as far as strengths and weaknesses?

**JP:** I found what John Wall had found, that you had varying degrees. Most of the folks that were out there we were extremely happy with. As you got into working closely with them and have them adopt improved ways of doing things or better ways of doing things or more comprehensive ways, you may find that some, perhaps, weren't able to handle that as well as others, both from receptivity as well as just carrying it out. There were some personnel issues. Not many.

The biggest thing, I think, was that it was adapting a more uniform and consistent way of doing the work across the country. Whether you're in Seattle, or whether you're in Cleveland, or whether you're in Kansas City, the NASD's responsibilities are the same in

all those areas. The members, they're broker dealers, they may have different areas of focus and different areas of concentration, but they're broker dealers. If you're going to examine a broker dealer that's doing mutual funds or tax shelters in Cleveland, there's no reason that it should be done differently in L.A. What I found was the fact that there was a need to just keep proceeding with ensuring that, first of all, we had something that was uniform and consistent.

Importantly, always working to improve and enhance. One of the departments I had in Washington that was right down the hall from me were the guys that wrote the exam procedures. Constantly trying to refine the exam procedures. As the years went on, trying to get them to be a little bit more risk-oriented, where it's not just a check-the-box kind of an approach, but more or less that there's some creative thinking going on in an examination in order to try to deal with the areas where the firm is making most of its money and, therefore, most apt to have problems. That was part of what we found.

There was always a constant effort to revise the procedures. Conceptually, what we wanted to capture, you tried to capture the thinking of your most experienced best investigator when they go out to do an exam, and what they do to try to get that process that they go through somehow into a format where a less-experienced person doesn't have to work like five years to get there and can use that in doing a better exam. We had what I would call an examination module. It had questions and you had to answer yes and no with checks. You had to do that so that you had at least a safety net of a minimum of what was going to be done.

You wanted people, though, if they got an answer on something without having to say if you get a yes, but you wanted them to be able to have a minimum amount of information but then think out of the box. That's where we tried to capture some of this other thinking. If you look at the modules, they really got to be much, much more sophisticated.

At one point in time when I started, we had a five-page exam report, five pages was the whole thing. A couple of guys that started before me had two pages. We went from two to five. Then we had a much more comprehensive exam. Then we decided that you really can't do that with a single exam, so we developed modules. You had a municipal module, you had an options module, you had a financial and operations module. When you went in to do an exam, if you were going to focus on certain areas, you took those modules. Then you had a background interview module.

You took the modules that you were going to be working on. When you do that, if you have five pages, and you have three questions on municipals, when you go have a municipal module, you're going to have fifty-five questions. By its nature, you got very, very much more detailed, but it led to a much more comprehensive examination in each of those areas.

**KD:** At some point, I know you were working with the New York Stock Exchange on exams, and then later taking over for the regionals. Is that right?

**JP:** Going back, yes. We worked at the very early stages to come up with a joint examination with the New York Stock Exchange because there were New York Stock Exchange members who were also NASD members. As I said, they focused on financial and operational. We looked at non-financial operational, all the over-the-counter. The first joint exam, a gentleman by the name of Joe Kasparack at the New York Stock Exchange, a nice gentleman, and I sat down. They had an examination procedure and module, and I had the five-page thing. We went through theirs and ours and said, "Okay, we'll do this. Cut it out and put it here. You do that."

And we developed, basically, what turned out to be a cut and paste exam report, this is going to be your area, and this will be our area, so that at least when we went in, we kind of knew the division of labor. That became sort of the first joint exam module that we did. That was back when I was still in the district, so I'll bet you that goes back to '73. Over the years, I was still involved in meeting with the New York Stock Exchange probably through the nineties. We'd go up, and what we did was we allowed the New York district office to coordinate the examinations directly with the New York Stock Exchange since they were in New York.

I would go up, and I would have the exams that we were required to do for that year for all the other districts, and I'd sit down with Sal Pallante and his folks. Sal was EVP and in charge of their exam program, and we would go through and pick out the required exams for the year. The NYSE, they had to fly somewhere from New York. When

they're doing a Kansas City exam, I got to know, "When are you going to Kansas City?" They'd say, "We're going in June." We'd look at the June exam, we'd look at the exams that Kansas City had to do for New York Stock Exchange firms, try to get a general coordinated program for the year. We'd go up, I think, in the middle of the year and sort of check it out.

The idea was I'd let our guys know that New York is going to go in, schedule it in June for these firms. They would tell their people. Before the exam, the examiners would talk so that we'd know exactly when they were going in, and we would meet at the firm, and we would do our exams and, hopefully, cut down on the overlap and duplication at the firm. That was the genesis, and it worked pretty well for twenty-something years.

The regional exchanges, we entered into what was called 17d-2 agreements. 17d-2 is a provision of the Securities Act. 17d-1 was the designation for financial responsibility of an SRO so that you didn't have everybody looking at the same thing. In essence, the New York Stock Exchange was the 17d-1 designee for New York Stock Exchange firms, financial and operational, and NASD was the DEA, 17d-1, all the rest, for financial. 17d-2 allowed for an allocation of other examination responsibilities among SROs pursuant to an agreement that had to be filed with the SEC for their okay. We entered into 17d-2 agreements with, I'd say, all the regional exchanges, Philadelphia, Boston, Midwest, Pacific, Cincinnati.

**KD:** Were they all happy to sort of get rid of this extra task?

**JP:** Generally, yes. Once you have one or two—they didn't all have robust exam programs. Let's put it that way. Some were delighted not to have to do this stuff anymore. There was a lot over overlap. What we did was we created a Midwest Stock Exchange exam module. We created a Philadelphia module, because they all have their own rules. We eliminated all of the rules that overlapped because a lot of theirs were like ours, so when we examined ours, we would do theirs. Where there were unique rules that were regulatory in nature on the part of the regions, we incorporated them and we would examine for them.

Our examiners had training and we had the material, so we knew what the rules were. We would fill out our modules, and we would conduct the examinations with our modules, and we would provide that over to the regional exchanges. The important thing with that is that all of the regional exchanges at the point in time delegated to us their examination responsibility for members, but they retained the responsibilities to oversee conduct in their respective marketplaces. So the Phil-Ex still had floor monitoring, etcetera. We did not get into that. But we did examine the joint members.

I think we also examined sole members; the exchanges gave us authority to go in and examine so that they didn't have to do that either. We did that in the mid-70s. I was involved in many of those discussions.

**KD:** To round out the overview of broad responsibilities, how much involvement did your people have in proposing new rules and coming up with suggestions on that?

**JP:** My people, you mean as far as the scope of people that I had?

**KD:** Yes, in your office in enforcement compliance.

**JP:** Are we still in the seventies? That will change as we go forward.

**KD:** Tell me when it changed.

**JP:** As I moved up the chain, I added departments and responsibilities, which gave me a broader responsibility over other areas that involved rulemaking and the like. Eventually, I had everything, so it was a lot greater in '95 than it was in '78 or '80 or '85.

**KD:** But that capacity was there in the seventies.

**JP:** The capacity was always there because of a number of things. One, our folks are out doing the examinations, reviewing the findings, perhaps seeing areas where either clarifications are necessary, or perhaps new rulemaking is necessary. NASD publishes notices to members. That goes back to before my days. Certainly, during my days, we issued a lot of notices to members. Notices to members, often times, came to, one, clarify certain rules. You'll see in a number of our members that the district offices are

noting during examinations that there are many instances where reps are selling away from their firm. They're not advising the firm, etcetera. Probably ten notices that talk about that.

The input that we got from our compliance work, our examination work, you see notices that say that the NASD has issued a hundred formal disciplinary actions over the last year for failing to do this or this. As a result, members should look at their procedures and make sure they're doing this. The feedback that we got from the examination program, from customer complaints, from enforcement, led to notices going out to advise members. It led to recommendations for amendments to rules. It led to recommendations for new rules. In conjunction with that, I mentioned earlier about the locally-elected officials in the districts.

Each of the district committees would elect a chairman. The committee members used to serve three-year terms. Usually, it was somebody that was in their third year, but it was somebody that had sort of stood out as kind of a leader of the group, and they would be elected by the committee. Twice a year, the chairman of the district committees would come to Washington and meet with the senior NASD staff and representatives of the board of governors. The overriding purpose of the meeting was for the district chairman to be able to have the opportunity of speaking to the board to discuss issues and matters within their respective districts that were giving them concern, giving them the ability to suggest rulemaking, giving them ideas of enhancing rules, changing rules.

What it was was senior industry people that were on the district committees speaking to the board. From '75 on, I was the person in Washington that had responsibility for chairing these meetings, for spending a day listening to, often times, complaints about what was going on, maybe things that I needed to deal with, but not things that rose to the level of the board. I would prepare reports twice a year that would be a summary of these recommendations to the board. We would present them to the board, and then at the next meeting, I would prepare, again to the board, a report describing what steps had been taken in order to address those recommendations. It wasn't that they just made them it was like, "Okay, thanks, guys," and it went on.

We had to provide updates as to what was happening with these things. Often times, the result was that new rules were recommended or new procedures were adopted. It gave the opportunity to take somebody from Seattle, who's not going to meet with the board, to come in, talk to their fellow district chairman to see, "Yes, we're having that problem too." You come to a consensus of what's more of a national issue versus something that I had to deal with in one district. That was other input.

In addition to that, there always was standing committees of the board. You had the Board of Governors, but then you had a corporate financing committee, you had an investment company committee. You're familiar with that. These folks would meet a couple of times a year, and it was for the purpose of talking about the same thing, what's going on in their respective areas, where do we need rulemaking, where do we have a rule that doesn't work, and it's not effective, or it's not in place. Those committees

would issue reports that would be discussed at the six board meetings. The Board of Governors met six times a year.

The National Business Conduct Committee, which was the board level that reviewed all of the district disciplinary actions, they would all come up to the National Business Conduct Committee for review. Again, they're looking for consistency, uniformity across the country. You didn't want somebody in Seattle being thrown out for three Reg. T violations and somebody in New York getting a \$400 fine. They're looking at it for consistency and that sort of thing. All of these matters that would come in from the standing committees of the board, that were appointed each year by the board, all funneled their way up to the board for deliberation at the board meeting about whether rulemaking was required, or whatever action was necessary.

**KD:** Moving on a little bit, you've been talking about dealing with the broker dealers, first in New York and then in the national level, the firms. You said early on that NASDAQ was just this little thing. Well, getting into the eighties and it's not a little thing anymore and you've got, more or less, a market to worry about as well, tell me how that changed the enforcement task, and how you dealt with that.

**JP:** One of the areas that I had responsibility for, I think starting in the seventies, we had a very small market surveillance department. If I remember, it was four or five people. In the seventies, there wasn't trade reporting. They oversaw the market as best they could back in that time, and I had that group. I maintained responsibility for market

surveillance. It used to be called market surveillance. The name has changed to market regulation. I had responsibility for market surveillance from probably the mid-seventies up through 1996. Whenever NASD Regulation came into being, I had responsibility for market surveillance throughout that whole transitional period.

As NASDAQ evolved, we had reporting rules. I don't even remember what the rules required back then, but they weren't transaction reporting. You were reporting representative prices and that sort of thing. We had information that the market surveillance folks monitored. I think it wasn't until 1981 or '83 where trade reporting was required for the first time in the NASDAQ stock market. Trade reporting was required only for the national market stocks, NMS stocks. If I remember right, you had national market system stocks, NMS stocks, and then you had other NASDAQ stocks. You had trade reporting for NMS stocks. Eventually, later in the eighties, trade reporting became effective for all of NASDAQ.

**KD:** What does that mean? Does that mean you have a better look at what's going on?

**JP:** What it meant was, under the trade reporting rule, and I think it was this way from inception, the details of the transaction were required to be reported within ninety seconds of execution. That meant that you had a buy of one hundred shares of Microsoft at 17 7/8 at such-and-such a time, and that had to be reported. That information was reported electronically, and we maintained information of that electronically. It,

therefore, gave us far more real time information for us to be able to utilize in looking at what was happening in the marketplace. We had a Stockwatch Group which was there.

There were three people that ran Market Surveillance while I was there. Molly Bayley, Chris Franke and Jim Cangiano. Most of the more advanced technology changes came under Jim Cangiano's realm. Molly was on in the earlier stages, and Chris Franke was there during the earlier days of the technology. If you wanted to get into more detail about, specifically, what and where, those would be people. All three of those people reported to me in my role over the years. As the technology evolved and as the information became more real-time, we had a group that was in stock watch that took care of quote halts, quotation halts. Back then, I don't think we had trading halts. We had quotation halts. But we told folks, "If we have a quote halt, you're not supposed to be trading during that time."

Basically, what that was is issuers had a responsibility to call the stock watch area when they were about to release material news. Not after they released it, but prior to, which gave us the opportunity to consider what the news was, make a determination of whether it was material, and then if we felt it was, to halt quotations in the security in anticipation of material news.

The analysts who got the calls, I was the primary officer who they called for quotation halts. Anyplace I went anywhere, they always had to know where I was and how I could be reached by phone, and if I couldn't be, who was my backup.

**KD:** What was the purpose of the quotation halt?

**JP:** The quotation halt was in order to put the market on notice that material news was about to be released, so that you didn't have serious disruptions in the marketplace because somebody who is particularly astute knew news that somebody else didn't know. If you had your finger on the newswires, you'd know immediately, whereas somebody who didn't wouldn't. You had a lot of disruptive conduct. It continues today. You see trading halts that take place on the exchanges. It's so that you don't have these explosions, especially now, but the idea was that you wouldn't have these incredible disruptions in the marketplace where you had uneven distribution of information that caused some investors to be disadvantaged because they weren't sitting at a terminal or they weren't sitting at a newswire.

**KD:** Did insider trading factor into that?

**JP:** Sure. Sure. It could, of course. Especially because that's part of the kinds of investigations we would look at. Let's say you had material news, or let's say that some issuer didn't, and you call up and say, "What's going on?" and they say, "Oh, well, we just put out release we're being taken over." We might halt quotations at that point so that at least we can get that news out. One of the things you would look at is what kind of trading took place before the news came out. This is easy kind of stuff. I can't believe

people didn't realize this. We would look and see what kind of trading activity took place before either the news came out or before the stock broke.

It was pretty easy because we had all the trading information, so you'd look and see who was doing all the trading, and you'd look to see whether you had readily-identifiable names. Often times, the trading activity, you'd find that it was actually taking place by customers or issuer insiders, over whom the NASD didn't have jurisdiction. A good number of our insider trading cases were referrals to the SEC because they involved trading by individuals who we didn't have jurisdiction over. The sum and substance of it is that as the information became more refined and became a broader applicability across broader markets, the automated systems that were in place got greatly more sophisticated, got greatly more expanded over a wider range of issues and caused our procedures and policies within market surveillance to be much more sophisticated in what we could do in order to monitor what was going on in the marketplace.

As you carry the evolution to today, a good portion of the examinations that we would do at market surveillance where you sent examiners out with some information, today there's so much information that the examiners, in many cases, don't require on site exams. There are reports that are sent to firms, basically, with all of the information already there because you got it. You're looking for, "Can you explain any of this? Because otherwise, you've got a problem." That's how a lot of the sweeps are done today. We didn't really do the sweeps. We probably called them special exams back then. As market surveillance evolved, the scope of their reviews got larger. We

established in the mid-eighties a Market Surveillance Committee similar in concept to the district committees.

The Market Surveillance Committee charter was to look at the reviews that were done by market surveillance and to adjudicate and make a determination about what do we do with these. How do we deal with them? I didn't want it to be a staff decision of what to do with these things. It had gotten to the point where we were doing a lot of these and we said, "We don't do this in the district; we shouldn't be doing this here." We established a Market Surveillance Committee. The first chairman of the Market Surveillance Committee was Carl Sherr, he's with Carl Sherr & Company up in Worcester, Massachusetts.

Carl was the chairman for the first couple of years. Carl had been the chairman of the NASD board in '83 and became the first chairman. He was sort of like Mr. Market Surveillance Committee.

**KD:** They're making policy.

**JP:** Well, they got to do the same thing that we did in the districts. The Market Surveillance Committee would meet. Mainly, initially, the concept was to review the results of our exams. They did a lot of reviews. They would look at a lot of issues and find no problems, so those were to be filed without action. We had a lot where we found some minor things, so you'd issue letters of caution and the like. They found things that rose to

the level of serious violations. We needed a body to say, "This should be a formal complaint."

We needed a body, as we did with the districts, when the districts had a complaint that wasn't handled through an AWC because you had AWC's in market surveillance as well, where there was a hearing necessary, you would have a subcommittee of the District Business Conduct Committee, which are three individuals that sat, listened to both sides, listened to the evidence, would deliberate and come down to a decision. Market Surveillance, we established the same thing. When we issued a complaint, they respond, whatever. If there was a hearing, we would have three members of the Market Surveillance Committee, because it's more specialized.

You didn't want to bring in somebody that was a mutual fund expert, because you're dealing with trading activity and market activity, and these three individuals with industry experience would listen to the evidence, listen to both sides, look at the documents and issue decisions. We had, basically, the Fifteenth District Committee, but it was the Market Surveillance Committee, focused on market surveillance issues.

**KD:** Because the governance of the NASD revolved around these committees, that's why you had to have a committee do it.

**JP:** Because of the governance back then, until there was a change, only a district committee, and now a Market Surveillance Committee. You had to adopt all the bylaws and other

stuff that established the Market Surveillance Committee the same way the bylaws and what have you established the district business conduct committees. It sets out what they can do and what have you. Now you have the same support to establish the Market Surveillance Committee, but in those days, self-regulation really meant that it was the business conduct function, whether it's at the district level or the market surveillance level, that reviewed these and applied their businessman's judgment in conjunction with input about what the rules and regulations are to make a determination about filing complaints.

The staff just couldn't do it. It didn't have the authority, so it had to come through the committee. I was involved going back to 1973 through 1996 in differing levels. When I was in New York, I was preparing this stuff to go into the district committee in New York to make the presentation to say, "What do you guys think?" Subsequently, I oversaw all of that happening in all of the fourteen district offices by all the district people that were charged with the responsibility to do that. I went around to every single district committee at least once a year, and I attended these meetings, and I would sit in and listen to what was going on, and oversaw all of that. In addition, at the district committee, the first part of it, I would give a little overview of what's going on and that sort of thing, and they would ask questions.

Then the district business committee would sit and I would listen to what was going on. Back then, that's how it was done. That's how the responsibility was charged. It was in

the hands of the District Business Conduct Committee and the Market Surveillance Committee.

**KD:** It's interesting. Everything worked through the district committee, so when you got NASDAQ and you had to regulate NASDAQ, you, essentially treated it like another district.

**JP:** In essence. I guess if there were no NASDAQ, I'm not sure how much a pink sheet market would've led to the establishment of a Market Surveillance Committee. I think the evolution and the growth of the market—when you think about it, it's pretty remarkable. When I was in the training class in 1969, John Hodges, who was the guy that was a senior vice president, came in and gave us a slide presentation of this new thing called NASDAQ that they were developing. It was NASD Automated Quotations. That's what NASDAQ is. He was giving us this little slide show on the little Bunker Ramo terminal and what it was going to be. So in '71, it came onboard.

I don't think even Gordon envisioned—conceptually, it was smart. You have all these market makers all over the country. Now you were going to, for the first time, connect all of them electronically so that you didn't have to go to the floor of the Exchange to find all the people willing to trade these stocks. You had this terminal where everybody that was involved would have some way to input. That evolved. In the beginning, you had representative bids and asks. You really didn't even have a real quote. Eventually,

you got real quotes. You got on a level two—you showed every market maker that was quoting.

Whether you were in Boise, Idaho, or New York City, when you punched up on your terminal level two, you saw Merrill Lynch, you saw Dean Witter, but you also saw Janney Montgomery in Philadelphia, you saw Mesirow in Chicago, you saw all these firms competing on a screen to get business. It wasn't like, okay, you go to Merrill. You looked, and you saw the best market and you went there. That grew, and we grew with it. I think because of the growth and popularity of the market, it mandated more robust regulation, more robust systems, and that mandated that you have a mechanism to regulate that market through the district committees and through the Market Surveillance Committee.

**KD:** You mentioned pink sheets. Those hung on for a while. You also had the over-the-counter bulletin board. What was the idea behind that?

**JP:** The Penny Stock Reform Act, 1990, when you're talking about stages of stuff, you had the NASDAQ in the eighties, but you then had penny stock issues. That was the late eighties. It was a big deal. Penny stock was a big deal. I remember being on a panel in Denver with David Ruder, who was then the chairman of the SEC. We were in Denver. Talk about being in the home of penny stock. It was at the annual conference that the director out there of the SEC regional office, Bob Davenport, would hold of the state and federal regulators, and I would go out and speak at that thing every year. David and I are

on a panel, and I remember the question was, "What do you think is going to be the big issue going forward?" and mine was penny stocks.

I remember this was '88, because he basically said we're declaring a war on penny stocks, penny stock fraud. We're going to be working with the NASD and we're going to be doing this stuff. Going forward from there we put together task forces, we put together strike forces. I remember going out there early one morning. We had like forty-some odd examiners from the states, the SEC, maybe more. NASD. In a room, we gave them the old go-get-them, and we gave them firms to go examine.

We kept track of it. It was like a battle station, but we went out *en masse* looking at firms for purposes of net capital, purposes of operations, and purposes of fraud. Penny stock fraud became a very big regulatory compliance, financial and operational issue in the late eighties. We worked very, very closely and very, very well with the SEC in dealing with that.

The Penny Stock Reform Act, I'm sure, came out as a result of all of that. It called for the establishment of some centralized system. It just so happened that we had already, we at NASD, if my chronology remembers correctly, had already established an OTC Bulletin Board whereby we would gather information into this bulletin board. I don't think it was quotes. I don't remember exactly, but it gathered information about what was going on. It didn't replace the pink sheets, because they still continued. It became the more viable recognized entities for broker dealers to input quotations. I think that

was the genesis. There's a Form 211 that firms had to file when they wanted to have additional stocks put on the bulletin board that went through.

Originally, it was in the antifraud department, moved over to the market surveillance department. They had to provide a lot of information about what the company was, "Where are you getting these quotes from?" You couldn't just come in and say, "I want to quote Pinto Aeronautics at seven." You had to give some information before we'd give you the approval. In fact, Ken Worm still does that for market regulation at the NASD today, probably for pink sheet stocks.

**KD:** So at this point, market surveillance has got to be pretty big.

**JP:** Market surveillance grew pretty significantly. Absolutely. I think there are over 200 people now. You can verify that with Tom Gira who runs it now. Tom Gira's the EVP that runs Market Reg for FINRA right now. It grew dramatically. To show you, I was on the sixth floor at the NASD. I had my group, which were the guys that provided financial and operational support to all the district offices, the compliance department that wrote the modules. I had some folks that did some other stuff. In the back of our floor was the market surveillance department. So it fit on my floor.

We used to do demos back there and all that stuff, but they were all back there. Then it grew to the point where they couldn't fit there anymore, and eventually, market surveillance moved to the Rockville site and took up a floor or whatever, and they grew

there as well because we picked up additional responsibilities. You've got more information, so now you could look at trade reporting. You got a group that focuses on trade reporting. We got information. Now you have to disclose when you're having a short sale.

Now we've got a group that's looking at short sales, and another group that focuses on potential fraudulent type of activity. It grew because as information developed, as systems developed to take care of that, as people's expertise grew, your ability to oversee the market grew, so the department grew. And it got to be a pretty big department. So it did grow.

**KD:** Newspapers say that, around early 1990s or so, they're saying that NASD is toughening up. New rules, fines are going up, you're collecting more fines every year. Does that square with what you recall? I wondered if the '87 market break was behind that, penny stocks.

**JP:** I don't know what you're citing as far as what the papers are saying. One of the things I find now is I'm trying to keep up, so I look at what's in the newspaper. I remember when I was at the NASD, I never relied on the newspaper because they were never right. If you think about what we were talking about there, you had NASD evolving with more information and, therefore, more regulatory capability on the part of market surveillance and more systems to look at things. You had the penny stock fraud era whereby you had

a lot of stuff going on with investigations that will lead to enforcement actions. They don't always happen the next day.

You mentioned the '87 market break. What a thing that was. Back in those days, our senior management group was three EVPs: John Wall, Frank Wilson and Dick Justice, Senior VPs and Joe Hardiman. We had our "senior management meeting" every Monday, and we sat around a round table with six people. That was the senior management group. We handled everything that happened at the NASD. That was the senior management. HR, whatever it was, that was our group. Each of the guys around that place had a responsibility. Mine was all the stuff I talked to you about. John Wall was something else. Dick Justice was technology. Frank Wilson was the general counsel.

The Friday when there was a 190-something point drop, I was out in Denver at that conference. Maybe the year before, but I think it was the year before the one I mentioned that I was out with Dave Ruder. I went out every year in October. That's when it was held. Joe Hardiman was there, and Joe gave the speech on Friday, and he was talking about the 190-something point drop, and I remember him saying, "I wouldn't be surprised if Monday we see this turn around."

Monday we're at the senior management meeting, and we're listening to all the stuff going on. It was a scary time. We meet at 8:30, and all the sudden, you got all the stuff that you're hearing is going on on the squawks and stuff that this thing is going to hell in

a hand basket very quickly. It was a scary day. We listened to stuff going on. We had people going out. Examiners were going out to firms, finding out what's going on, what kind of positions. You've got to look at this stuff not, "Send me your report the end of the week." We're looking at, "Holy shit's going on right now. Let's get out and see what's going on."

It was a scary time. We had a lot of stuff going on. I can't even remember all of the things that were done during that time and after it because you had a lot of settlement and clearance problems at NSCC. You had a lot of DK's, you had a lot of unknown trades, you had price discovery, because markets were moving so fast. A lot of that was going on.

**KD:** Did you start thinking about how this was going to change your agenda? You must have.

**JP:** Yes. Whatever you might've been doing, you couldn't drop everything because you had other stuff that was important. Yes. You had to refocus and deal with this because you had to be able to get through all of this, and from a regulatory side, you had your districts. We tried not to make it like every time there was something, you jumped and you had them run, but they had to go out on a lot of special things. We had a lot going on, and I don't remember exactly all the detail, but I can tell you, we had directives going out all the time asking for districts to go out and gather this information, gather that information, bring this back, let us know what's going on throughout that whole period.

It wasn't only the Monday and Tuesday, because Tuesday something happened, probably late morning, which all of the sudden turned a lot of that around and the market, thank God, came back. You didn't have what we got two years ago where it was like the end of the world. It was the end of the world for a day and a half, and stuff came back. I know that you got data that showed how quickly. That didn't end it for us, because you had a lot of difficult problems dealing with these issues in NSCC, the National Securities Clearing Corporation, to settle all this stuff.

**KD:** But as far as not just dealing with the mess and cleaning up the mess, but going ahead and making sure it doesn't happen again, certainly a lot of it was technology. Your guy who was doing technology certainly had a lot to think about after that. As far as enforcement was concerned, how did '87 change the way you approached enforcement?

**JP:** Because of the way the responsibilities were separated within NASD, you did have the technology guys that had to deal with technology, speed of the systems, being able to handle volume, that sort of thing. John was in the area of the market side—John Wall—in his area. I forget what his title was. Probably EVP market, something. John had to deal with the issues that related to "You guys aren't answering." That was part of the other stuff that we had to deal with too. Not answering the calls, not answering the phones. I got involved with some of that about trying to discern who wasn't answering because they weren't answering, and who wasn't answering because you only have so many hands. A lot of that was shaken out. John had responsibility on the market side. Rick Ketchum came in '91.

It was mainly on John's side of the ledger about dealing with all of that. I do remember some of the meetings that were held that were around in Rick's time, so a lot of that flopped over. A lot of that was still working in the couple of years that followed. Like SOES. I don't think you would've ever gotten the automatic 1,000-share SOES. SOES may have been an outshoot of this because of this inability to get an order executed. I think the Small Order Execution System, SOES, came up. This came out of the market side of it.

**KD:** Get rid of the telephones.

**JP:** Have a mechanism where if I've got a small trade for a customer, I don't have to go to get on the phone with Knight trading and say I want to order a hundred shares of Microsoft for my customer. There were very strict rules that were written for SOES where the market said, "If you have small orders, and we're going to define that as 1,000 shares or less, and it's for a client, we're not going to be here as the basket for your trading account." If Knight trading wants to sell 1,000 shares of its own position in Microsoft and they're going to call Mayer & Schweitzer and say, "I want to sell," SOES was not going to do that.

We will, if you have a true customer order, we'll have an automatic execution system where you go in through SOES and it gets done. You can't break up big orders. You can't come in with a 5,000-share order and give me five 1,000-share orders because that's

going to be a violation of the SOES rules. You can't come in with a professional order for your own account because that's going to be a violation for the SOES rules. SOES came into being, and obviously, that gave us a whole new set of rules to look at, a whole new set of rules which mainly were out of the Market Surveillance Department, but I think we also had the districts involved with that.

Then you had folks who found a way, they thought, to circumvent that by violating the SOES rules, and were doing proprietary trading, but they would call it customer trading. They would break up large orders and say that they weren't breaking up large orders. You had a whole new set of rules to enforce, and you had a whole new set of enforcement actions for those who thought that they could violate the rules by working around them. That came up in that '87-'91 time when that all came into being.

I remember Rick being involved in some of the meetings with the market makers to try to deal with some of the issues, and I'm trying to remember what the events were. But to answer your question, you had all this happening. You had penny stocks, you had SOES rules, the OTC bulletin board, and you had trade reporting. You had a much broader spectrum of our ability to see what was going on out there in broader areas.

**KD:** So you're doing a whole lot more. Your staff is increasing greatly.

**JP:** Our staff—that was always a challenge for us. It was always a challenge for us. Now market surveillance increased, but it was a challenge for us under the financial regime at

the time to get additional people all the time as much as we thought we needed. We would do these manpower studies, and we would say, given this and this, we need X. But we had to operate within a much, much smaller budget than FINRA deals with today.

**KD:** This is because the members are, essentially, paying for this out of dues?

**JP:** Clearly, it was a member-funded organization. That's where the dues came from. That expanded a little bit because you've got fees. Back then, NASDAQ was part of NASD. It was in the same corporate entity. There were some fees and what have you. You had fines and assessments, much smaller than they are today, that would be revenue. You had annual membership fees that folks had to pay. You had assessments that members had to pay based on a percentage of their gross revenue. You had registered rep, RR, every year they had to renew their registration. That brought in fees. All these fees came in, sort of made the pot that you had to deal with, and you had to work within that pot. You didn't have unlimited funds to spend.

**KD:** The pot wasn't growing the way the market or your needs were growing.

**JP:** Any compliance person you'll talk to will tell you that they don't have enough resources. As a regulatory compliance person, I couldn't honestly tell you that we always got the resources that we thought we needed in order to do the job, but you had to do the job. You made do with what you had.

**KD:** Something else that comes up in this period is you get this new thing called an expedited remedial proceeding. Tell me a little bit about the reasoning behind that and its reception.

**JP:** When these chairmen that I talked about used to come in for these two meetings a year, it used to be called the advisory council, and it was called the advisory council, basically. I still have a folder in here of the guys that used to be on the advisory council for a lot of the period of time I was there. They're really heavy-hitter folks, when you look back on them. The advisory council would always come in and say, "We got this firm. We know that First Jersey, we know they're doing this, we know they're doing that. But by the time we do the investigation, it takes forever." Or, "We got a firm that's got these financial issues. We know that there's an issue there, and we don't have a mechanism for being able to deal with it on a timely basis."

My recollection is the first leg of the expedited remedial proceeding was for financial and operational matters. It was for situations where the firm was in such dire financial and operational status that we needed to have a mechanism to immediately be able to deal with it and not have to go through a disciplinary process whereby we said, "Look, this firm's in capital deficiency, but he won't stop and what are we going to do," so there was this immediacy of doing that.

I think our board understood that there was a good reason for it. The Commission approved the rule. There was, as I recall, some safety nets in there to make sure that it

wasn't us going wild. There might've even been a committee or some people that we had to go through when it was expedited that had to get approvals before it was done. I think, ultimately, there were some "due process" things put into there where if a firm was notified that they were going to be subject to this, they had a certain amount of time to respond and react. I don't think it got used as much as we thought it might get used, but that was the whole genesis behind why that got done. Later on, it even got expanded to sales practice matters. There, if I recall right, the safeguards and safety nets got to be even more so where it almost became unusable because you had to provide a hearing and it dragged on.

**KD:** This idea of needing some mechanism to do things more quickly, the fact that you had to go out to the districts and you didn't have the budget, it all sort of gets to the idea that you've still got this old model of the NASD that's very decentralized. On the other hand, you've got NASDAQ that's going gangbusters and is the face of the future stock market. Was there a sense that the two things didn't match? I guess that's what I'm getting at.

**JP:** There is no way that the district operation—of course they're located in different parts of the country. That was one of the advantages that we thought we had as a national organization. If we had a problem in Seattle, I didn't have to fly somebody five hours to get there. I'd call the guy in Seattle and say, "Send the guy down the street." We had geographically-dispersed offices. By no means would it have been decentralized, at all.

**KD:** Well, I'm thinking of decision making rather than enforcement. I'm really thinking of governance here and the ability to bring all of these different power centers together to make decisions. That's maybe a bigger picture than just running enforcement, having to get everybody on the same page, if you want to do something new or advance the organization.

**JP:** If you were decentralized, you wouldn't be worried about that because they'd be doing whatever. That's my interpretation of decentralized. That's the way it was in '69, '70. It was decentralized. They all had exam programs, but everyone was different. In my era there, if you went out to a district office, we had a binder of educational circulars. Those were designed for the examiners. Everybody had one. We sent them out. Everybody had the same binder. When we thought there was something that everybody should know, it went out. We had binders of district staff memos, which were more policy issue things.

Mostly, when you look in those, my signature's on those, those were policy-related matters that were a little above examiners checking on bank reconciliations, including dealing with committees that went out that every district had. Everybody was operating under the same sort of things. Every district had the same examination modules. They all had the same policies and procedures to work under.

Were they in different parts of the country? Sure. But everybody had the same cycle.

They all had the same programs to operate under. They reported their information

centrally to us in Washington. Every month, I had a report that showed what every district was doing. I knew that the district in New Orleans was ahead of their program. I knew where they were on aged matters, and aged customer complaints, I knew where they were on aged docket items. I had a central control. If I saw something that looked to me like somebody was getting behind, I could find out and send them some help. It was anything but decentralized.

Did the district committees meet where I wasn't involved? Sure. But they met on matters that were centrally-established in Washington, and applied uniformly around the country. I was a pain in the neck in reviewing what they sent in. Every summary of a complaint that went out I reviewed because those summaries were prepared by somebody in my office because it was captured on CRD. I reviewed every summary of a decision. If I saw something that struck me as odd, I would get a copy of it and review it. I would review district committee minutes. Not every single one, but I'd review them.

**KD:** So the enforcement mechanism worked pretty well in that setup.

**JP:** Not only enforcement. It was the whole compliance program as it related to the district operation. Enforcement was just the complaints and decisions. All of the other things that I talked about, customer complaints, that was all the compliance, the examination, all of the other things that they did. Plus, I would not only meet with the district committees at least once a year, but I'd go out and meet with the district staff at least once a year with my guys, the financial guys and stuff, and we'd talk about compliance, about the

programs that we're doing, get some input and all that. It was centrally administered and carried out geographically.

**KD:** You didn't see any tension between the two, between Washington and the districts.

**JP:** If you asked them, they might. I had a very good rapport with the district directors. I think they'll tell you to a person, do they agree with me all of the time? No. Some of the people that I still am closest to as friends that I communicate with are the district directors. I just had dinner with one of the fellows two weeks ago when I was out in Denver for an arbitration that I was testifying at as an expert witness. I communicate with probably 80 percent of them.

**KD:** From the district back to the NASDAQ then and the odd eights.

**JP:** From market surveillance side of it—which was the other part of the big enforcement sort of thing, but oversight—that was Rockville. I was in constant contact with, whether it was Chris Franke or more as it evolved, Jim Cangiano. I'm still close to Cangiano even though he's retired. I was out there a heck of a lot more than I was out to the district offices. I was much more involved in what they were doing, and I attended their committee meetings as well. I was able to do more of those because, usually, they were local.

I want to dispel this decentralized thing. When I had my two meetings a year with my direct reports, one of them was just the directors, and the other one was every supervisor and above would come in, so that was like 200 people coming in for that. The other was forty. I expanded that. In the beginning when I used to come to those from the district in New York, it was just the district offices. I took over enforcement, I took over market surveillance, I took over corporate financing, which is the department that looked over all of the filings of new issues and other corporate offerings.

I took over advertising regulation, which is the department that looks over all of the sales literature, etcetera. I had responsibility for the regional attorneys, which were the attorneys in all the districts that wrote the complaints. I had financial responsibility, I had compliance. When I had these meetings, I included the department heads and their senior folks for all of those groups as well. We'd meet with everybody there. We'd talk about district things, we'd talk about market surveillance things, we talked about advertising things, we talked about corporate financing things, we talked about the legal things. They were all together.

Everybody knew what page everybody was on. When we're talking about a program, the corporate financing people kind of know what we're talking about. Not the detail that these other folks do. Then I had special meetings. Bill Schief used to be the head of the regional attorneys. Bill reported to me. Bill then would break off and have a separate meeting with the regional attorneys with an incredibly detailed agenda about what to go over for there. There was a lot of communication, and there was buy-in.

**KD:** I think Hardiman's perspective, as president, was that on the governance side he had to deal with the power centers. What you're saying makes sense, is that the NASD really was coming together, operationally. On the other hand, he was really thinking about, you know, how do I get these individual power centers to work together.

**JP:** I had considerable autonomy. We had our senior management meetings when Joe became the president and CEO when we would report in, but Joe didn't ask me the details of where I was. He knew. We reported to the board. There were six meetings a year. My information was part of what was reported into the board. The NBCC work, the National Business Conduct Committee work was the culmination of all of my direct reports. It was the districts, it was market surveillance. Everything where there was a disciplinary action came from something that I had responsibility for, so it all funneled up to the National Business Conduct Committee level, which funneled to the board level.

Joe saw, indirectly, the culmination of what I always viewed as our most serious output, which is our formal disciplinary actions. He knew from his level, but he had other stuff to do. He's the president and CEO. He had to work with NASDAQ, he had to work with issuers, he had to work with the board. He had broader responsibilities.

**KD:** I think he was thinking more on the board level.

**JP:** Yes, but I didn't want it to be misstated because that was far from decentralized.

**KD:** Well, you mentioned market surveillance, and we're getting into the big things in the nineties, and I want to touch on the odd-eights and get a sense—we know about the professors who wrote the paper. What was the immediate reaction within your market surveillance people, what did you put in place to deal with that in the short term, and then the long term?

**JP:** The paper from the professors. By this time, there were more people involved in our "senior management" than the little group that I told you about earlier. There were others. John still had responsibility, but there were many others under him that had responsibility to deal with the market. Not the regulatory stuff, but the market. There was a division of labor, so many of the issues raised by that report, although NASD was a regulatory agency, really were more of the market side of it. Whether somebody's putting in quotes, some of the folks there had responsibility for trying to narrow quotes. That was in a different division. We knew what it was.

We had on the market surveillance, there was a rule that was the excess spread quote rule. All that was was if you had a bid of X, the ask couldn't be broader, couldn't be more than whatever the parameter was of Y. That was enforced by market surveillance. Frankly, the initial reaction, I'm going to put it in two camps. I don't want to speak for them because Joe was on the other camp. Joe was NASDAQ and worked with those guys. I think it was that the professors misunderstood the workings of the market. What they were looking at was quotes, but they really should be looking at executions because,

often times, transactions go off, trades go off between the quotes, and that's really more representative of what the market is. I think the belief was that they were misguided in what they were saying because of what they were looking at.

From my side of it, they weren't saying that the market makers are violating a rule. We had an excess spread quote rule. I'm sure I talked to Cangiano in Market Surveillance about are we seeing any violations of the excess quote rule? That had a parameter, whatever it was, but it was very confined. You didn't have much of that because the quote that was up on the level ones was the inside bid and ask. Even if you had a market maker that was outside the parameters, that quote never got into the inside bid and ask because it was the high bid, low ask, which usually was the quotes of two different market makers.

It was only when you got to the level two where you could see somebody whose individual quote might be out of the spread, and that was something that we would follow up on. The initial was more dealing with the market side of it than the regulatory side of it—initial. I remember telling the directors, I said, "Guys, we're a regulatory agency. I have a bad feeling this is going to come back as a regulatory issue," even though, at the time, it was more of a market side of it than it was a regulatory.

**KD:** There must've been some sense of, well, if there is this consistency of only quoting odd-eights, or not quoting odd-eights –

**JP:** It was quoting evens, no odds.

**KD:** Only quoting evens, why didn't we detect this? I mean, that question must've been asked inside.

**JP:** Well, at the time—we talked about that after. I remember the first meeting we had after it. I think what I expressed to you was the view that was expressed at the first meeting. Much of the discussion was with the market side, with the market makers about that. We all had our responsibilities. The trading committee, let's say we had a trading committee. I would attend that once in a while, but I was not the liaison. The market side would attend that.

**KD:** Is there a sense that that's not the kind of thing market surveillance would've been thinking about?

**JP:** That's not the kind of thing market surveillance would've been expected to pick up. People knew what the quotes were, but there was no "rule violation" that was visible. Despite what people said, there were people that quoted eights. There were people that quoted sixteenths. The spreads were wider. There's no question about that. I remember that whole concept just dealing from the markup issue, you would look and you'd see spreads and you'd know that there was spreads. Market surveillance was charged with enforcing the rule that we had that dealt with quotes, which was the excess bid quote rule. Market surveillance is looking for violations of things like insider trading, they're

looking for violations of not trade reporting, they're looking for violations of other market conduct. The concept of what the quote was was more on the market side of our area of the division within the NASD.

**KD:** How about once the SEC and the Rudman committee start getting involved? Were you brought in to participate in that process?

**JP:** The Rudman committee was a committee that was self-appointed within the NASD. We brought in Rudman to take a look at all the different areas and what have you. I'm sure I got involved in that because Rudman was there for a long time with a lot of people talking to a lot of people.

**KD:** Did he come in and talk to you?

**JP:** I talked to a group of his people. I don't think he was there a lot. I think it was his firm that was there, and I remember talking to at least three of them. I remember three of their people sitting out in the audience at one of my district director meetings that I was telling you about where we talk about what's going on, all taking notes. The Rudman committee wrote a report. The Rudman committee came out with a report. The Rudman committee made some recommendations.

Remember I said that the disciplinary committees were always consisting of three members of the committee that were industry people? They came out with a

recommendation that they thought that there should be some staff person that sat on there that was a lawyer that could counsel the other members of the panel that were going to continue to be industry people on what the rules and regulations are. A lot of times, the committee would say, what is Article III, Section 20, what is that?

They said, however, that person should not have a vote. It should be still a member of the industry because this is a self-regulatory organization, it should be the industry, which made sense. Ultimately, the SEC determined otherwise, but that was one of the things that came out of the Rudman Committee. I do remember the presentation of the Rudman Committee report was very confidential.

It was made at a board of governors meeting, and we didn't get a copy of it until we all got there. I think I remember one of the recommendations was that the NASD ought to establish a separate corporation called NASD Regulation. All of the regulatory functions now in the NASD should funnel down to NASD Regulation. I'm pretty sure that that was one of the recommendations. I remember reading it, and basically, the functions were what I was doing. By that time, I had everything that I described to you.

Everything of a regulatory, compliance and enforcement nature I had. The only thing I didn't have was the membership department.

That was a big topic of discussion, a big topic of discussion at the board meeting was NASD Regulation, it was where we are with this SEC thing, and that was the whole discussion. That was probably the beginning of '96. If I remember correctly, Mary

Schapiro was there. It was first announced in December of 1995. I'd met with the directors in June and December, so I was at the directors' meeting for December. There was an article in the *Wall Street Journal* on the morning that I was going down to talk with these folks about Mary being selected as the president of NASD Regulation. I went down.

The prior *Wall Street Journal* had two names that were potential, Mary Schapiro and me. I called Mary. At that time, she was the chairman of the CFTC, and I went over and met with Mary in December to kind of just introduce and kind of talk to her. Mary came over to the NASD, I believe, in January of 1996. NASD Regulation didn't get officially approved until sometime in '96, maybe April of '96, but I do remember Mary being at the board meeting where this was discussed. There was a period of time there when Mary was there and Joe Hardiman was still there in '96.

**KD:** Right. He hung on for a little while.

**JP:** Yes. I don't remember exactly when, but there was an overlap. Then Mary took over as president of NASD Regulation.

**KD:** Then you stayed with NASD for a while.

**JP:** No. When NASD Regulation was formed, I was one of the folks that moved over to NASD Regulation because that was my job.

**KD:** You were doing member firms?

**JP:** When Mary took over NASD Regulation, this was the first time we had this new entity. It was a brand new entity, and Mary came over and she had with her three people that she had worked with at the SEC, Steve Luparello who is now vice chair over at FINRA, Elisse Walter who is one of the Commissioners at the SEC, and Susie Bowman who came over. Mary reorganized NASD Regulation. She separated out enforcement, and Barry Goldsmith came over as the EVP in charge of enforcement. She separated market surveillance. Jim Cangiano was still in charge of market surveillance, although Steve Luparello later went over there. She basically reorganized what had been NASD, and separated a number of the functions. One of the departments that she set up was Member Regulation.

I became executive vice president of member regulation working under Mary, reporting directly to Mary, and my charge at that point were still the fourteen district offices, but I also then picked up the responsibility for the licensing and registration area, which were the folks in Rockville that wrote the Series examinations. That was my area of responsibility under the new NASD Regulation structure working for Mary.

**KD:** How long did you do that?

**JP:** I was in that position from 1996 through September 30<sup>th</sup> of 1997 when I retired at that point.

**KD:** Great. You made it all the way through. Is there anything we haven't talked about that we missed?

**JP:** I'd have to think of the history, but when I left, I began working in the consulting area with a number of different consulting firms, ultimately now with Renaissance Regulatory Services, which sort of is a successor to a number of the other consulting firms that I worked for. I started to work for a firm called Dover International that was actually started by two former examiners that had worked for me back in the old NASD days, and that was bought out by BISYS, and that was bought out by Citi, and then Citi rolled it out. Renaissance was started several years ago by two individuals, Louis Dempsey and Bart McDonald, both of whom I work with at BISYS and both of which had worked with the SEC in the Miami office of the SEC and the other two folks that I work with now at Renaissance Regulatory Services. That's where we do broker-dealer consulting on the compliance and regulatory side as well as on the investment advisor side.

**KD:** So you're helping them deal with the SROs?

**JP:** Everything that we did as a regulator, go in and do sales practice exams, go in and do supervisory procedures, we do now basically from a preventive compliance side. We'll go in and do some of the same things and say, "You really need to fix this, or your

procedures are deficient here and you've got to improve this." We'll give them a report. The only thing we don't do that's different is at the end, we don't take any kind of an action. We tell them, "Look, you guys got to fix this," and we do everything. We do BD startups, we do IA startups, we do independent consulting work. Regulators today, even back in those days when they have an enforcement action, part of the sanction will be that the firm has to hire an independent consultant to come in and review the areas that were found to be deficient and then write a report that gets provided. We've been named as the independent consultant in a number of FINRA and state matters.

We do expert witness work. Anything that relates to what NASD/FINRA on the broker-dealer side, and SEC on the advisor's side, from a regulatory and compliance perspective we do, including registrations and the like, basically from the point of view of preventive. Trying to work with firms to help them avoid problems or enhance ways they're doing things to try to do a better job from a regulatory and compliance perspective.

**KD:** Makes a lot of sense, actually.

**JP:** All of our folks, myself, Louis, Bart, all of our people at one time or another worked either for the NASD, for FINRA, a state or the SEC, but we all have regulatory background, which gives us an advantage to be able to go in. Since I was one, I can say this. Regulators think differently sometimes, so it's good kind of to know that when you're looking at something not only how the firm looks at it, but that's not the way the regulators are going to look at what you're doing. Here's what they're going to see, so

you have to do such and such in order to deal with that. It's worked out really well. It's twelve years I've been doing that.

**KD:** Well, I appreciate your taking me through your career as a regulator and thinking differently. Thank you very much.

**JP:** Well, thank you for your time.

[End of Interview]