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ISSUES AND PERSPECTIVES IN ENFORCING CORPORATE GOVERNANCE: THE EXPERIENCE OF THE STATE OF NEW YORK

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

JUNE 26, 2002

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ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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WITNESSES

ISSUES AND PERSPECTIVES IN ENFORCING CORPORATE GOVERNANCE: THE EXPERIENCE OF THE STATE OF NEW YORK

WEDNESDAY, JUNE 26, 2002

U.S. SENATE,
SUBCOMMITTEE ON CONSUMER AFFAIRS, FOREIGN COMMERCE AND TOURISM,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:30 a.m. in room SR–253, Russell Senate Office Building, Hon. Byron L. Dorgan, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. BYRON L. DORGAN, U.S. SENATOR FROM NORTH DAKOTA

Senator DORGAN. I will call the hearing to order. This is a hearing of a Subcommittee of the Commerce Committee. We are meeting today to hear from the Attorney General, Eliot Spitzer from the State of New York. I am constrained to make a few comments at the start of this hearing.

There are matters in this morning's newspaper that relate to a series of hearings we have been holding in this Subcommittee. This Subcommittee has heard over recent months from executives of the Enron Corporation and others on the issue of corporate governance, and especially issues that affect the Enron Corporation and investors and employees of the Enron Corporation.

This morning's news on the front page of the Washington Post about another company, World Com (the headlines say its books are off by $3.8 billion) raises once again, as has been raised nearly every day in recent months, the issue of corporate governance. What can investors rely upon? What is happening in corporate business in this country? We see restatements of earnings every day now. Seldom do we see statements of $3.8 billion, but the table where Mr. Spitzer sits, the person who did the Powers report, which on behalf of the board of directors looked inside the Enron Corporation, said that what the board of directors found inside the Enron Corporation was, "appalling."

In a rather short period of time they said that that corporation reported $1 billion of earnings that it did not have, and it kept off the books debt that existed as a liability to the corporation. These are the kinds of things that are going on all too often in this country now, and we see reports on them virtually every day: restatements of earnings, in some cases massive restatements of earnings, inversions where corporations have decided to renounce their citizenship and become citizens of another country so they can save on their tax bill in this country—which I think is fundamentally unpatriotic, I might say—the question of the behavior of corporate CEO's, boards of directors, the question of the accounting firms who were supposed to be involved in oversight and the enforcement of standards, and the spectacle of the people at the top of these companies getting rich while people at the bottom are losing everything.

I said some months ago that with respect to the Enron Corporation what I saw was a culture of corruption, and Mr. Lay took great umbrage at that. These stories, and especially the information unearthed by Attorney General Spitzer about security analysts who were pumping stocks that they knew to be dogs, they knew to be not of sound value, but who nonetheless were pushing these stocks and marketing these stocks to unaware consumers, show us that it was even more than a culture of corruption.

We have heard a lot about the bursting of the speculative bubble in this super-turbocharged economy of the 1990's, especially the bubble over technology firms, but we see that this was more than just a bubble whose bursting was inevitable. There was more than that. There was greed and dishonesty, and what we are reading about daily and what this Subcommittee has learned over recent months is appalling.

There must be some accountability here, and in this Subcommittee we are trying to get to that. The method by which we accumulate capital in this country requires that people have confidence, that they can rely on the people who run our corporations, that they can rely on the representations of accountants, and that they can rely on security analysts. We have learned that in many cases the fact is they cannot rely on any of those people.

Accountability and responsibility do not just apply to poor people, and they do not just apply to the bottom of the economic ladder. Let some one go buy a six-pack of beer on food stamps and you have people jumping off the buildings here trying to proclaim how awful that is. Well, let us see if the same people are willing to stand up at this point and talk about stealing in the corporate suite, or talk about misrepresentation or criminal behavior in accounting firms, or misrepresentation by security analysts. Let us see if the same people care as much about accountability and responsibility at the top as they do about accountability and responsibility among poor people.

So let me make one final point. I think all of this, including this morning's information, ought to persuade some of the regulators in the regulatory agencies to hang their head in shame. They have been AWOL, gone fishing for a long, long time. All of this has happened at a time when regulators have sat on their hands, and those who have been critical of Mr. Spitzer for using his authorities as a state regulator to do that which federal regulators should have been involved in the first place have no cause to be critical of anyone. I suggest to all of those who have been critical of Mr. Spitzer for using the reins of state government to take effective action that they spend a little more time asking hard questions of the Securities & Exchange Commission and others. Where was the SEC?

Where were these regulators? We paid them. Why didn't they do their job? I suggest they spend a little more time worrying about that, and a little less time worrying about State regulators who are in many cases digging into these issues with an aggressive approach and a vigor that I commend.

Well, I have more to say, but I will put my entire statement in the record. This morning's news is once again unnerving to this country's economy. It is simply one more piece of evidence that there is an avarice and a corruption and a greed that exists in some areas in this country that desperately cries out for effective regulatory oversight. The American people—who rely on the representations of those who run corporations, those who run accounting firms, those who are involved in security analysis—have to be able to trust those folks, and when that trust is broken (and it is) it has dramatic consequences for the methods by which we accumulate capital in our country, and will have a dramatic impact on this country's economy.

I want this economy to do well. I want it to succeed. I want it to grow again. We have the capacity to do that, but we must address these questions. These questions are basic, and very troubling to all the American people. Many of the American people have now become investors in their 401(k) program, which they now refer to as a 201(k) or a 101(k) program, as it shrinks and shrinks and shrinks virtually every single day. Then they read the stories that suggest they have lost money not because they made a bad investment, but because someone misrepresented stocks to them, or because someone in the corporate boardroom stole money, or because accountants who were paid a lot of money to look over the shoulder of the corporations that were reporting income and expenditures were enablers, enabling the corporation to misrepresent its books to the ultimate investors.

Well, I spoke longer than I intended. Let me say welcome, Mr. Spitzer, to the Committee. We have been reading of your work and want to ask some questions about it and have you testify, and then have the opportunity to ask questions.

Let me call on my colleague, Senator Wyden.

[The prepared statement of Senator Dorgan follows:]

PREPARED STATEMENT OF HON. BYRON L. DORGAN,
U.S. SENATOR FROM NORTH DAKOTA

We are in the middle of a crisis in corporate responsibility.

Almost every day we see more reports in the news media about companies restating their earnings. Sometimes these restatements go back 2, 3, 4 years and cover billions of dollars.

Not only are ordinary investors understandably outraged as they watch their life's savings disappear; they feel deceived because they know that their losses are the fault of poor corporate behavior, and a lack of oversight by federal regulators.

The ability to accumulate capital for public corporations in our economic system requires trust—trust in accounting firms, corporate financial statements, security analysts, and confidence in those who run our public corporations.

My concern is that with all that has gone on in corporate America in the past few months that this trust has been broken by a complete breakdown in corporate responsibility.

It is no wonder then that the investing public is having a hard time putting its trust in corporate America when:

Consumers now know that some of the "books were cooked" with the help of the accountants and boards of directors that were willing to look the other way;

Consumers now know that many of the so called "independent" analysts who pushed individual stocks on TV were sometimes anything but "independent" as they pumped stocks in which their firms had a financial stake, and

They have a sense that those at the top made off with millions while the ordinary investor has been taken for a ride.

The question that has to be asked is where were the public and private watch dogs that are supposed to ensure that these things do not happen? Where were the "independent" analysts? And most importantly where was the Securities and Exchange Commission (SEC) while all of this was occurring?

Today, we are going to hear from one man who has actually done something to address the problems surrounding conflicts of interest with investor analysts.

He is New York's Attorney General Eliot Spitzer. Last month, Mr. Spitzer announced a $100 million settlement with Merrill Lynch following allegations that the company's advice was tainted by conflicts of interest.

Mr. Spitzer's investigation revealed that Merrill Lynch analysts reportedly inflated their ratings on certain stocks to boost the firm's related investment banking business. He showed that even as analysts pushed individual stocks, behind the scenes they were secretly referring to some as "junk" and "dogs."

As with many industries, the regulation of securities has been a shared federal-state responsibility. Mr. Spitzer's extraordinary efforts have shown the valuable role that state authorities can play in protecting consumers.

It also shows that the fed regulators have been paper tigers in recent years, and it demonstrates how important it is for us to have federal regulators that are aggressively engaged in protecting consumers from this kind of chicanery.

While I recognize the desire for uniformity I think the solution lies in having the State Attorneys General work together with the SEC.

Reliable analysis based on a sound ethical and legal foundation is the key to a stable marketplace. Attorney General Spitzer has set the example, and it is up to the SEC to follow his lead.

I look forward to hearing from Mr. Spitzer on these important issues.

STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you, Mr. Chairman. Let me commend you for being willing to stay at this task. We have had a number of hearings on Enron, and I think what often happens in this town, somebody does one hearing and then just moves on, and you have been willing to be persistent and stay at it, and that is what it really takes and, of course, that is what Mr. Spitzer has done in the State of New York. He has been a pioneer and it is so good to know that somebody on the front lines is actually out digging and excavating the critical materials that are needed to make these cases. We are very glad that he is here, and look forward to his remarks.

Mr. Chairman, let me pick up on something that you touched on. Today, the stock market is no longer the exclusive province of the wealthy. We have got millions of working families whose hopes and aspirations are tied to the stock market, to their retirement accounts and others, and it will be devastating if the American people walk away and say, this is a rigged game, that the rules are fixed, and our country cannot afford that. We have got to make sure that there are rules on the books and that they are enforced, and that in a number of areas that the rules are strengthened.

I want to bring to the Committee's attention Fortune Magazine, not exactly a radical left-wing rag, ran a cover story just recently entitled, "In Search of the Last Honest Analyst," and it seems to me this cover story is a clear indictment of the problem and why this hearing is important as anything else.

What we have seen in recent days is what amounts to a spectacle, a spectacle of analysts snickering behind the backs of American investors as they sell them lemons, and I think that what people thought the analyst industry was all about was being an expert observer, and much of its behavior seems more typical of used car salesmen. They do an aggressive sales job, then go into the back room and snicker about how they just sold an investor a lemon, and I think we do need to examine a number of these key issues, and particularly one that I want Attorney General Spitzer to review with us is the conflict of interest laws, or lack thereof, that are on the books today.

For example, attorneys are subject to conflict of interest rules, they have to disclose conflicts, and it seems that there is little, if anything, that would in effect ensure that an investor goes into these kinds of transactions with full disclosure and a full array of the facts.

Let me wrap up by commenting on the overall business picture, Mr. Chairman, because I was going to talk about the World Com situation as well. I do not subscribe to the notion that the majority of people in this business, in American business are crooks. I just do not buy that notion. I think the majority of people are honest and sincere in their views, but what we have seen too often, as the chairman has pointed out, is what amounts to a triangle of deception involving corporate executives, audit firms, and investment analysts.

What Chairman Dorgan is doing is ensuring that today we take a look at the third leg of the triangle, the analysts. I think it is high time. I am looking forward to Mr. Spitzer, commend him for his good work on the front lines of New York State, and thank you again, Mr. Chairman, for being willing to stay at it. This is not the typical sort of approach to hearings, where you sort of do one and you hit and run. You have been willing to stay at it, and that is what it is going to take.

Senator DORGAN. Senator Wyden, thank you very much. Senator Boxer.

STATEMENT OF HON. BARBARA BOXER, U.S. SENATOR FROM CALIFORNIA

Senator BOXER. Thank you, Mr. Chairman. Thank you for inviting Attorney General Spitzer here to testify on corporate governance and investment counseling practices at Wall Street firms.

Mr. Chairman, it takes courage to do what the Attorney General is doing on a daily basis, and that is trying to weed out the corruption on Wall Street, and the reason it takes courage is, these people are very powerful and they are very wealthy, and they have a lot of people around them to protect them from the law, and so it takes courage. It also takes courage, Mr. Chairman, for you to do a lot of the things you do in this Subcommittee. I have been wanting to say that publicly for a long time. It means a great deal to me that you are willing to take on these issues, because we rub people the wrong way, and I am glad we do because they cannot get away with it, because what happens on Wall Street impacts Main Street, and we represent Main Street, or we should. We should.

Mr. Spitzer, I wanted you to know that I was a broker on Wall Street many, many years ago, when 12 million share days were overwhelmingly exciting. It was such a low volume of trades in those days, and I just want to speak to you as someone who went into that business because I wanted to help people do well, and I was quite young, and I could tell you this, we counted on the work that the people in the firms did to analyze those stocks. I felt so good, so comfortable with it, and I could tell my clients who were not very wealthy, who were just saving for their retirement, that this was real. I also counted on the big four at that time, the big four accounting firms. Boy, if they stamped their approval on it, you knew it was real.

I long for those days, and if anything good comes out of this it would be, maybe we can get back to those days where being honest and being true and being sincere, and as Senator Wyden believes a majority of the people are, if those are the people that would take the leadership we will not have headlines like this in search of the last honest analyst.

Let me close in this way. Just today's headline in the Washington Post, "Corporate Scandals Taking Toll on Markets," and it shows how the scandals track with the prices of stocks, and then even a broader statement on the next page, a headline, "Scandal's Impact Felt on Dollar and the Economy," so what we are doing here today with your leadership, Mr. Chairman, is trying to get to the bottom of why we are in such shaky times, and I think you have invited someone here today who has shown his courage, his conviction, his leadership, and it is wonderful that you are really honoring him with this invitation to come before the Senator. I thank you very much.

Senator DORGAN. Senator Boxer, thank you very much. Attorney General Spitzer, again we welcome you to the Committee. We have followed your work with interest. We think it is important work done at a very important time, and you know and I know and my colleagues know that your work has been lauded by some and criticized very significantly by others. I must say to you that I also invited Congressman Baker to be present today, who has been critical of having an Attorney General involved in the things you are involved in, and he elected not to be here. I wanted to also give him the opportunity to make a statement, but in any event, we are delighted to have you, and why don't you proceed. Your entire statement will be made a part of the permanent record; you may summarize as you wish, and then we would like to pursue some questions.

STATEMENT OF HON. ELIOT SPITZER, ATTORNEY GENERAL OF THE STATE OF NEW YORK

Mr. SPITZER. Chairman Dorgan, Senators Wyden and Boxer, thank you for your kind words. Senator Dorgan, let me simply begin by saying I am aware of the praise, and I am thankful for that and your kind words, especially this morning. I also have noted the criticism in passing over the past weeks and months, and I appreciate your commenting on it.

Thank you for the invitation to be here this morning. This morning the stock market has taken another hit. At my last beep from back home the market was down 180 points at the opening. This is because the credibility of another major corporation has been shattered. The investing public's confidence in corporate governance is dropping precipitously, and throughout this crisis of accountability there has been a void, a vacuum in leadership from federal regulators. It is time for the SEC to wake up. It is time for Congress to pass fundamental reform, and it is time for our blind faith in Wall Street's capacity to regulate itself to come to an end.

Several months ago, my office announced the results of an investigation that showed the degree to which the investing public had been fundamentally misled by one of the largest institutions on Wall Street. Unfortunately, several ongoing investigations that I am conducting have revealed similar problems in other major investment houses. It is absolutely essential that we now take steps to restore investor confidence in the marketplace. The way to do so is through true industry-wide reform that changes the way business is done at investment banks and assures individual investors that their interests are protected and that the information they are receiving is truthful.

My office's continuing investigation and my testimony today are aimed at achieving reforms that are necessary to achieve that goal. I would like to start with a very brief description of my office's findings with respect to Merrill Lynch, simply to demonstrate the nature of the infractions and the protections that are necessary to prevent similar wrongdoing in the future.

First, the evidence showed that Merrill Lynch's publicly stated assessment of stocks was often false, and did not represent the privately stated opinions of the firm's analysts. For instance, Merrill Lynch was urging customers to buy Lifeminders while Merrill Lynch's analysts were referring to the company as, "POS." Let me simply say that POS is a euphemism for an extremely poor investment.

Second, the evidence revealed that the analysts writing stock reports at times functioned essentially as sales representatives for the firm's investment bankers, using promises of positive research coverage to bring in new clients and stock offerings. Favorite investment banking clients received advance viewings of analysts' reports, and were offered an opportunity to change those reports themselves. In one revealing e-mail exchange, an investment banker said to an analyst, "we should aggressively link coverage with banking." That is what we did with go2net. If you are very bullish, they will love you.

Research could also be used to punish companies. In one instance, a company was downgraded when Merrill Lynch did not get the company's investment banking business, and in another, a stock was downgraded to please a competitor who was a client of Merrill Lynch.

Third, the evidence demonstrated that a key element of research analysts' compensations was the success of the investment banking activities they pursued, rather than the accuracy of their buy-sell recommendations to the public.

These problems were well-recognized within Merrill Lynch. Management itself acknowledged the problem, saying, "we are off-base on how we rate stocks and how much we bend backward to accommodate banking," but nothing meaningful was done. Henry Blodget, the senior Internet analyst, described the conflict in one particularly damming e-mail. Blodget, frustrated by the lack of guidance about how to handle certain investment banking situations, threatened to do the unthinkable, render an unbiased evaluation. His words are shocking, "If there is no new e-mail forthcoming on how ratings should be applied to sensitive banking clients, we are just going to start calling the stocks like we see them, no matter what the ancillary business consequences are."

Because of the conflict of interest I have described, the company's investment advice was tainted. Companies that were poor investments, companies that were disparaged internally, still received strong ratings. Even as stocks plummeted, the buy recommendations on investment banking clients remained firm. Individual investors who depended on Merrill Lynch's stock analysis and investment advice were misled, and left to rely on stock ratings skewed to please investment banking clients. In short, a major Wall Street firm exploited its massive retail client base as a tool for bringing in new business. There is no telling how much individual investors lost as a result.

On April 8, 2002, my office obtained an order in state supreme court putting in place temporary remedies to largely deal with the abuses we found. Thereafter, on May 21 of this year, we and Merrill Lynch reached a settlement involving monetary payment and permanent remedial changes in Merrill Lynch procedures. The terms of the settlement have been widely reported, and I will not burden the record by repeating them here. It included serious structural reforms in Merrill Lynch's operations, as well as the penalty of $100 million intended to emphasize to the management and shareholders of Merrill Lynch the gravity of the company's infractions.

I should add that it is to Merrill Lynch's credit that they have acknowledged the problem and implemented certain necessary reforms. We believe the settlement was a fair one, tailored to the abuses we found at Merrill Lynch, but the settlement dealt only with Merrill Lynch. We believe that the problem extends beyond Merrill, and it is our job, under New York State law, to respond to fraud in the marketplace. Further investigations and enforcement proceedings are necessary, as is industry-wide reform.

Remarkably, throughout our investigation, which has now led us to examine the documents of a significant number of companies, there is absolutely no evidence that any compliance department ever took any action to stop behavior that clearly violated internal rules, state and federal law. The failure of the industry's much-vaunted compliance structure is appalling.

A few critics, however, as the Chairman mentioned, are alarmed that a state prosecutor conducted the investigation and obtained the settlement. For example, Congressman Baker, in a letter to each of the 50 State Attorneys General, criticized the action of New York, saying it would produce confusion in the market, and harm the interests of investors. Congressman Oxley, Chairman of the House Financial Services Committee, went further, writing in a May 31 letter to the New York Times that the settlement with Merrill was, "a State regulatory coup."

These allegations are wholly without basis, and reflect a flawed understanding of the necessary role that the states have played in protecting the integrity of the securities markets. The Merrill investigation and settlement was not a state excursion into rulemaking. My office became aware of possible fraud by Merrill. We investigated it. We exposed Merrill's practices to public view. We commenced a proceeding, and we reached a settlement with Merrill which provided for both a monetary penalty and substantive relief.

As Attorney General of New York, I have legal duty to enforce the Martin Act, a law that predates the federal securities acts, and that has been integral to protecting investors for over 80 years. Unlike rulemaking, which is the province of the SEC and the securities SRO's, the settlement we reached with Merrill was a resolution of an enforcement proceeding against the firm. It imposed no rule on the securities industry as a whole. Indeed, it imposed no change on a firm other than the firm investigated, Merrill Lynch.

The settlement required specific remedial actions to be undertaken by Merrill and no one else. It was tailored to deal with the specific abuses we had evidence of at Merrill. It was negotiated with Merrill, and it is binding on Merrill and Merrill alone.

It is quite true that after we reached our settlement with Merrill Lynch, I said I hoped the industry as a whole would adopt the reforms Merrill Lynch was undertaking. That is because that I believed then, and believe now, that the reforms represented good practices that could well be adopted by other firms or imposed by the SEC. I am gratified that several large Wall Street firms apparently agree, and have voluntarily adopted the Merrill reforms. I hope other firms follow their lead, and that they do even more to address the potential conflict of interest that exists.

Critics of state action overlook the absence of federal action that made the Merrill investigation and reforms necessary. The analysts' conflict of interest we investigated had been widely reported in the press for years, but until we published the Merrill Lynch emails, virtually nothing had been done about it. There was no meaningful new SEC regulation to address the problem, no legislation to correct the abuses, no serious enforcement actions against those who were defrauding the public. During the period of this federal enforcement vacuum, untold millions of individual investors lost vast sums of money.

Congressman Baker held hearings on the issue of analysts' conflict of interest, but those hearings utterly failed to uncover the damning evidence revealed by our investigation. Indeed, those hearings failed to include testimony from industry insiders, even though those are the individuals with the most extensive knowledge of the conflicts, and his hearings produced no proposal for reform, even though such reforms were desperately needed.

The NASD proposed new regulations on analysts which were accepted by the SEC at its June 8 meeting, but those regulations are simply inadequate. Indeed, if those rules had been in effect, the abuses we discovered at Merrill Lynch all would have been perfectly within the bounds of federal regulations. With respect to analysts' compensation, the only restriction imposed by the new regulations is a ban on compensating an analyst on a per-transaction basis, i.e., a flat fee per transaction, or percentage of the investment banking fee from each transaction. All other methodologies and procedures to compensate analysts for generating investment banking revenue, including those ended at Merrill by the settlement, are permitted to continue.

The new regulations disclosure requirements are also inadequate in several respects. They totally fail to address clear disclosure upon termination of coverage, serious abuse we found at Merrill, and also failed to require firms to disclose whether analysts authoring research reports solicited investment banking business in the past year, something we feel strongly investors should be told.

In considering the attacks made by critics of state action, one must consider the alternatives they support. A case in point is H.R. 3763, a bill that originated in Chairman Oxley's and Representative Baker's committee, which on the issue of analyst conflicts requires absolutely no action from anyone. Its sole directive is to the SEC to study and report back to Congress on any final rules a self-regulatory organization may in the future deliver to the SEC. It is difficult to conceive of a more passive or inadequate response to the problem.

The Merrill investigation and settlement has spawned another movement, one that is very dangerous to investors. I am referring here to the behind-the-scenes effort to pass legislation that would eviscerate the ability of states to effectively prosecute securities fraud. The threat is very real. Representative Baker, in a letter to all of the Nation's Attorneys General, has threatened that he would introduce legislation which would supersede state efforts in this area. Two weeks ago, an amendment to the Sarbanes bill was circulated. It would have stripped state prosecutors of their power to obtain substantive relief from analysts who have conflicts of interest.

This is no time to curtail the powers of state regulators to pursue securities fraud. Continued state enforcement is essential if individual investors are to receive the continued protection they need and deserve. The state security regulators are the cops on the beat to ensure that the investing public is protected from fraud, whether that fraud is perpetrated by a small bucket shop or one of the biggest investment institutions in the world.

For years, many in Congress have aggressively promoted the concept of increased federalism, a belief that the Federal Government should scale back its involvement in our Nation's affairs. I opposed that effort when it began, and I still oppose it now. However, I believe that the Congress and the Federal Government cannot have it both ways. If Congress and the Executive Branch decide to curtail federal oversight of areas such as securities, they must recognize it is the responsibility of state securities regulators such as myself to step in to protect the investing public.

Several Members of Congress and some leaders of the financial industry have said that what is truly needed is a uniform national standard. Let me be very clear. I agree it would be best for the SEC to use its powers to impose nation-wide rules to regulate analysts to prevent the sort of abuses we discovered in the Merrill Lynch cases, but so far that has not happened, and when and if it does, the enforcement of those regulations and actions to curtail abuses will be of paramount importance. It will be incumbent on federal and state regulators to continue our efforts to vigorously pursue enforcement actions and obtain significant relief when it is necessary to protect the investing public.

Finally, I want to be very clear what this case is about. Wall Street spends millions of dollars each year to convince individual investors to put their life savings in the hands of the large investment houses and the brokers. What they have not told investors is that their investment advice has been compromised by a desire to win investment banking clients. Regular people, not Wall Street professionals, have lost a collective fortune by relying on the tainted advice of the biggest and most trusted names in the world of finance.

Do not take it from me. Listen to the words of one investment analysts at Merrill Lynch who wrote, "we are losing people's money and I do not like it. John and Mary Smith are losing their retirement because we do not want an investment banking client to be mad at us."

I do not like it either, and neither should anyone who has the power and responsibility to regulate or prosecute this industry. As I said at the beginning of my testimony, one of my primary goals is to restore the confidence of the investing public in Wall Street. Unfortunately, as a result of the abuses that have occurred, including those we see on the front pages of the papers today, the American people simply do not believe the advice they are being given by the Wall Street securities firms. We need to change that perception, and let me list quickly several of the reforms that are absolutely necessary.

First, we need to rebuild the wall between research analysts and investment bankers, to eliminate pressure from the investment bankers for more favorable research reports. This must include careful thought to the precise aspects of every interaction with investment banking clients that analysts are permitted to participate in.

Second, we need to ensure that analysts' compensation is not based on investment banking revenue so that analysts are considering the interests of the investing public and not their own wallets.

Third, we need to provide greater disclosure to the public. For example, investors should be told how frequently a firm issues buy or sell recommendations on stocks in particular sectors. All research reports should reveal whether the investment banking firm has received compensation from the subject company, and firms must state when and why they have discontinued research coverage of a company.

Finally, every firm should have an independent committee that reviews all research recommendations to confirm that the research recommendations are based upon sound objective analysis.

Implementation of these four fundamental reforms will give confidence to the Mr. and Mrs. Smith mentioned in the Merrill Lynch e-mail that the recommendations provided by Wall Street firms are objective and honest.

I thank you for giving me the opportunity to testify today, and I look forward to answering your questions.

[The prepared statement of Mr. Spitzer follows:]

PREPARED STATEMENT OF HON. ELIOT SPITZER, ATTORNEY GENERAL OF THE STATE OF NEW YORK

Chairman Dorgan and distinguished Members of the Subcommittee, thank you for inviting me to testify before you today on the important issue of investment banking reform.

There is no question that the investing public has diminished faith in Wall Street. We have seen that not only in public opinion polls, but also in the performance of the stock market over the past year. Several months ago, my office announced the results of an investigation that showed the degree to which the investing public had been misled by one of the largest institutions on Wall Street. Unfortunately, several ongoing investigations have revealed similar problems elsewhere. Those deceptions—Enron, Global Crossing, and other scandals—have led many small investors to withdraw from the markets. It is absolutely essential that we now take steps to restore investor confidence in the marketplace. The way to do so is through true industry-wide reform that changes the way business is done at investment banks and assures individual investors that their interests are protected and that the information they are receiving is truthful. My office's continuing investigation and my testimony today are aimed at achieving reforms that are necessary to achieve that goal.

I would like to start with a brief description of my office's findings with respect to Merrill Lynch, simply to demonstrate the nature of the infractions and the protections that are necessary to prevent similar wrongdoing in the future.

First, the evidence showed that Merrill Lynch's publicly stated assessment of stocks was often false, and did not represent the privately stated opinions of the firm's analysts.

For example, while Merrill Lynch publicly was giving the company Infospace its highest rating in the fall of 2000, the firm's analysts privately were branding said InfoSpace "a powder keg" and "a piece of junk." This particular stock remained on Merrill Lynch's list of highest recommended stocks for many months even after these internal warnings. In the same vein, Merrill Lynch was urging customers to buy "Lifeminders" while Merrill Lynch analysts privately were referring to the company as a "POS" Let me simply say that POS is a euphemism for an extremely poor investment.

Second, the evidence revealed that the analysts writing stock reports at times functioned essentially as sales representatives for the firm's investment bankers, using promises of positive research coverage to bring in new clients and stock offerings.

Individual mandates for investment banking services are worth millions of dollars, and are the major income stream of a securities firm. As a result, there is incredible pressure to win investment banking deals and to secure and retain investment banking clients.

Because of the risk that research conclusions relied upon by the general public could be manipulated to assist in obtaining investment banking clients, the two realms must remain independent. Merrill Lynch's internal policy manual stated "opinions expressed by analysts must be objective. Any indication that a research opinion is less than totally objective, or that it may have been influenced by a business relationship of the firm, could seriously damage the firm's reputation and lead to potential legal liability."

Yet the reality was very different. Research was openly and largely used as a sales hook for investment banking clients. Indeed, the internet unit never recommended that investors sell any stock and rather than recommend a "sell" on a given stock Merrill Lynch would simply drop coverage. Favored investment banking clients received advanced viewings of analyst reports and were offered an opportunity to offer changes. In one revealing e-mail exchange, an investment banker said to an analyst: "we should aggressively link coverage with banking—that is what we did with go2net . . . if you are very bullish they will love you . . . " This was a situation in which Merrill Lynch was trying to win a new client. In another example, an institutional investor e-mailed Henry Blodget asking, "What's so interesting about GOTO except banking fees???" Blodget responded, "nothin." Blodget's candid opinion was not reflected in the initiation research report, nor did the report disclose that Merrill Lynch had promised research coverage in exchange for GoTo's investment banking business.

Research could also be used to punish companies. In one instance a company was downgraded when Merrill Lynch did not get the company's investment banking business and, in another example, a stock was downgraded to please a competitor.

Third, the evidence demonstrated that a key element of research analyst's compensation was the success of the investment banking activities rather than the accuracy of their buy-sell recommendations to the public. For example, the head of equity research wrote to analysts soliciting information on their involvement in investment banking so compensation could be calculated: He said:

> We are once again surveying your contributions to investment banking during the year . . . please complete details on your involvement in the transaction, paying particular attention to the degree your research coverage played a role in origination, execution and follow-up. Please note as well, your involvement in advisory work on mergers or acquisitions, especially where your coverage played a role in securing the assignment and you made follow up marketing calls to clients. Please indicate where your research coverage was pivotal in securing participation in high yield offerings.

These problems were well recognized within Merrill Lynch. Management itself acknowledged the problem—saying "we are off base on how we rate stocks and how much we bend backwards to accommodate banking." But nothing meaningful was done. Henry Blodget, the senior internet analyst, described the conflict in one particularly damning e-mail. Blodget, frustrated by the lack of guidance about how to handle investment banking situations, threatened to do the unthinkable—render an unbiased evaluation. His words are shocking: "If there is no new e-mail forthcoming on how 'ratings' should be applied to sensitive banking clients, we are just going to start calling the stocks like we see them, no matter what the ancillary business consequences are".

Because of the conflict of interest I have described, the company's investment advice was tainted. Companies that were poor investments—companies that were disparaged internally—still received strong buy ratings. Even as stocks plummeted, the buy recommendations on investment banking clients remained firm. Individual investors who depended on Merrill Lynch's stock analysis and investment advice were misled, and left to rely on stock ratings skewed to please investment banking clients. In short, a major Wall Street firm exploited its massive retail client base as a tool for bringing in new business. There is no telling how much individual investors lost as a result.

On April 8, 2002 my office obtained an order in State Supreme Court putting in place temporary remedies to partially deal with the abuses we had found. Thereafter, on May 21, 2002, we and Merrill Lynch reached a settlement involving a monetary payment and permanent remedial changes in Merrill Lynch procedures.

The terms of the settlement have been widely reported, and I will not burden the record by repeating them here. It included very serious structural reforms in Merrill Lynch's operation, as well as a penalty of $100 million, intended to emphasize to the management and shareholders of Merrill Lynch the gravity of the company's infractions. I should add that it is to Merrill Lynch's credit that they have acknowledged the problem and implemented necessary reforms. We believe the settlement was a fair one, tailored to the abuses we found at Merrill Lynch. But the settlement dealt only with Merrill Lynch. We believe that the problem extends beyond Merrill Lynch, and it is our job under New York State law to respond to fraud in the marketplace. Further investigations and enforcement proceedings are necessary as is industry-wide reform.

Remarkably, throughout our investigation, which has now led us to examine the documents of a significant number of companies, there is absolutely no evidence that any compliance department ever took action to stop behavior that clearly violated internal rules and state and federal law. The failure of the industry's much vaunted compliance structure is appalling.

Beyond Merrill Lynch

A few critics, however, are alarmed that a state prosecutor conducted the investigation and obtained the settlement.

For example, Congressman Richard Baker (Chairman of the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises) in a letter to each of the 50 state attorneys general, criticized the action New York took as an improper attempt to impose state rules on a national marketplace which, if emulated by other states, would produce confusion in the market and harm the interests of investors. Congressman Michael Oxley, Chairman of the House Financial Services Committee, went further, writing in a May 31 letter to the New York Times that the settlement with Merrill was a state "regulatory coup" which would lead to a "balkanization" of rulemaking and oversight.

These allegations are wholly without basis and reflect a flawed understanding of the necessary role the states have historically played in protecting the integrity of the securities markets. The Merrill investigation and settlement was not a state excursion into rulemaking. My office became aware of possible fraud by Merrill; we investigated it; we exposed Merrill's practices to public view; we commenced a proceeding; and we reached a settlement with Merrill which provided for both a monetary penalty and substantive relief. As Attorney General of New York, I have a legal duty to enforce the Martin Act—a law that predates the federal securities acts—and that has been integral to protecting investors for over eighty years.

Unlike rulemaking, which is the province of the SEC and the securities SROs, the settlement we reached with Merrill was a resolution of an enforcement proceeding against a firm. It imposed no rule on the securities industry as a whole. Indeed, it imposed no change on any firm other than the firm investigated, Merrill Lynch. The settlement required specific remedial actions to be undertaken by Merrill and no one else. It was tailored to deal with the specific abuses we had evidence of at Merrill, it was negotiated with Merrill, and it is binding on Merrill and Merrill alone.

It is quite true that after we reached our settlement with Merrill I said I hoped the industry as a whole would adopt the reforms Merrill was undertaking. That is because I believed then, and believe now, that the reforms represented good practices that could well be adopted by other firms or imposed by SEC rule. I am gratified that several large Wall Street firms apparently agree, and have voluntarily adopted the Merrill reforms. I hope other firms follow their lead, and that they do even more to address the potential conflicts of interest that exist.

Critics of state action overlook the absence of federal action that made the Merrill investigation and reforms necessary. The analyst conflicts of interest we investigated had been widely reported in the press for years. But until we published the Merrill Lynch e-mails virtually nothing had been done about it—there were no meaningful new SEC regulations to address the problem, no legislation to correct abuses, and no serious enforcement actions against those who defrauded the public. During the period of this federal enforcement vacuum, untold millions of individual investors lost vast sums of money.

Congressman Baker held hearings on the issue of analyst conflicts of interest but those hearings utterly failed to uncover the damning evidence revealed by our investigation. Indeed, those hearings failed to include testimony from industry insiders—even though those are the individuals with the most extensive knowledge of the conflicts—and his hearings produced no proposals for reform, even though such reforms were desperately needed.

The NASD proposed new regulations on analysts, which were accepted by the SEC at its June 8th meeting, but those regulations are simply inadequate. Indeed if those rules had been in effect, the abuses we discovered at Merrill Lynch all would have been perfectly within the bounds of federal regulations. With respect to analyst compensation, the only restriction imposed by the new regulations is a ban on compensating an analyst on a per transaction basis—i.e., a flat fee per transaction or a percentage of the investment banking fee from each transaction. All other methodologies and procedures to compensate analysts for generating investment banking revenue, including those ended at Merrill by the settlement, are permitted to continue. The new regulations' disclosure requirements are also inadequate in several respects. They totally fail to address clearer disclosure upon termination of coverage, a serious abuse we found at Merrill, and also fail to require firms to disclose whether analysts authoring research reports solicited investment banking business in the past year, something we feel strongly investors should be told.

In considering the attacks made by critics of state action, one must consider the alternatives they support. A case in point is HR 3763, a bill that originated in Chairman Oxley's and Representative Baker's committee, which on the issue of analyst conflicts requires absolutely no action from anyone. Its sole directive is to the SEC to study and report back to Congress on any final rules a self-regulatory organization may in the future deliver to the SEC. It is difficult to conceive of a more passive—or inadequate—response to the problem.

The Merrill investigation and settlement has spawned another movement, that is very dangerous to investors. I am referring here to the behind-the-scenes effort to pass legislation that would eviscerate the ability of the states to effectively prosecute securities fraud.

The threat is very real. Representative Baker—in a letter to all of the nation's attorneys general—has threatened that he would "introduce legislation which would supercede" state efforts in this area. Two weeks ago, an amendment to the Sarbanes bill was circulated. It would have stripped state prosecutors of their power to obtain substantive relief from analysts who have conflicts of interest.

This is no time to curtail the powers of state regulators to pursue securities fraud. Continued state enforcement is essential if individual investors are to receive the protection they need and deserve. The state security regulators are the "cops on the beat" who insure that the investing public is protected from fraud—whether that fraud is perpetrated by a small bucket shop or by one of the biggest investment institutions in the world.

For years, many in Congress have aggressively promoted the concept of increased federalism—a belief that the Federal Government should scale back its involvement in our nation's affairs. I opposed that effort when it began and I still oppose it now.

However, I believe that the Congress and the Federal Government cannot have it both ways. If Congress and the Executive Branch decide to curtail federal oversight of areas such as securities, they must recognize it is the responsibility of state securities regulators such as myself to step in to protect the investing public.

Several Members of Congress and some leaders of the financial industry have said that what truly is needed is a uniform national standard. Let me say very clearly here: I agree. It would be best for the SEC to use its power to impose nationwide rules to regulate analysts to prevent the sort of abuses we discovered in the Merrill Lynch case. But so far that has not happened, and when and if it does, the enforcement of those regulations and actions to curtail abuses will be of paramount importance. It will be incumbent on federal *and* state regulators to continue our efforts to vigorously pursue enforcement actions and obtain significant relief where such relief is necessary to protect the investing public from continued abuses.

Finally, I want to be very clear what this case is about. Wall Street spends millions of dollars each year to convince individual investors to put their life savings in the hands of the large investment houses and their brokers. What they have not told investors is that their investment advice has been compromised by a desire to win investment banking clients. Regular people—not Wall Street professionals—have lost a collective fortune by relying on the tainted advice of the biggest and most trusted names in the world of finance. Don't take it from me. Listen to the words of one investment analyst of Merrill Lynch who wrote, "We are losing people's money and I don't like it. John and Mary Smith are losing their retirement because we don't want . . . [an investment banking client—the cfo of goto.com] to be mad at us." I don't like it either, and neither should anyone who has the power and responsibility to regulate or prosecute this industry.

As I said at the beginning of my testimony, one of my primary goals is to restore the confidence of the investing public in Wall Street. Unfortunately, as a result of the abuses that have occurred, the American people simply do not believe the advice that they are being given by the Wall Street firms. We need to change that perception, and here are the reforms that need to be implemented:

First, we need to rebuild the wall between research analysts and investment bankers, to eliminate pressure from the investment bankers for more favorable research reports. This must include careful thought to the precise aspects of every interaction with investment banking clients that analysts are permitted to participate in.

Second, we need to ensure that analyst compensation is not based on investment banking revenue, so that analysts are considering the interests of the investing public, and not their own wallets.

Third, we need to provide greater disclosure to the public. For example, investors should be told how frequently a firm issues "buy" or "sell" recommendations on stocks in particular sectors; all research reports should reveal whether the investment banking firm has received compensation from the subject company; and firms must state when and why they have discontinued research coverage of a company.

Finally, every firm should have an independent committee that reviews all research recommendations, to confirm that the research recommendations are based upon sound, objective analysis.

Implementation of these four fundamental reforms will give confidence to the Mr. and Mrs. Smith mentioned in the Merrill Lynch e-mail that the recommendations provided by Wall Street firms are objective, honest, and can be relied upon as they decide how to invest their life savings.

Again, I thank you for giving me this opportunity to address you today on these important issues. If you have any questions I would be happy to answer them.

Senator DORGAN. Attorney General Spitzer, thank you very much. We have been joined by the Ranking Member of the Full Committee and the Ranking Member of the Subcommittee, as well as Senator Edwards. Let me call on Senator McCain for an opening statement.

STATEMENT OF HON. JOHN McCAIN, U.S. SENATOR FROM ARIZONA

Senator McCAIN. Thank you. I will be brief. Thank you, Mr. Spitzer. Mr. Chairman, I was just informed by staff that Congressman Baker called over and said he was never formally asked to testify. We can rectify that, I am sure, in the future.

Mr. Spitzer, I applaud what you have done. The only encounter I ever had with Attorney General Spitzer was an effort to clean up boxing, so far, at which we have been significant failures, but I still appreciate your effort enormously. Anybody who says that you should not have done what you did does not have the interest of the investors all over the country as their primary motive. I do not believe that we would be finding out the things we are finding out today in light of a $3.8 billion misstatement on the part of WorldCom. I think Enron was only $1.-something billion. So Mr. Spitzer, I applaud your efforts, and I believe a majority of the United States Senate would oppose any endeavor to curtail your efforts on behalf of the average citizens of this country. Mr. Spitzer, I hope you will do more, and I wish you would put somebody in jail. I will tell you, Mr. Spitzer, until somebody goes to jail I am not sure that these people are going to get the message. I hope that the next time, and obviously there will be a next time, that criminal charges are referred, because I do not think that a $100 million fee is that big. I mean, it is a pretty big deal in most places in America, but I am not sure how big a deal it is with Merrill Lynch.

So Congressmen and Senators are free to write letters to anybody they want to, and I applaud that right, but I believe a majority of the United States Senate would oppose curtailing your investigatory activities, which I think are carried out on behalf not only of the people of New York but the people of Arizona and every other state in America.

Why did you decide not to refer criminal charges?

Mr. SPITZER. Senator, let me explain it this way. The objective number one for me was to reform the industry and to articulate a new set of rules that desperately needed to be articulated so that others who have the power to mandate industry-wide reform could do so.

As we proceeded with the Merrill Lynch investigation, I have stated this publicly, we could have indicted and convicted Merrill Lynch. That would have destroyed 60,000 jobs. It would have destroyed an entity, but it would not have led to the sort of reforms that we believe are necessary to protect the American public.

Senator McCAIN. Is not there some individual responsibility?

Mr. SPITZER. Absolutely, Senator, and there are individuals who still face the possibility of criminal charges, not from my office but from other offices, and indeed, let me explain this in the context of timing. I believed it was critical for Wall Street, the investment world to see what the parameters were of the Merrill Lynch deal to be awakened quickly to the realities of what was there, and to protect the investing public, and we took a first step at that.

I have spoken to the leadership on Wall Street and said to them, it is now incumbent upon you to step into this breach, because as I said in my opening statement, we have had an absolute void at the SEC. There has been absolutely no meaningful——

Senator MCCAIN. An absolute void, and the fox is guarding the hen house.

Mr. SPITZER. And that is why I said to the industry, gentlemen and ladies, it is up to you now to work with me and with others who have the interest of the investing public at heart.

Senator MCCAIN. What do you think of what the SEC has proposed so far?

Mr. SPITZER. Inadequate, and I have said that privately and publicly, and I have made it very clear to the SEC that although I am proud to be in a partnership with them to continue to investigate the underlying abuses, they are indeed the primary regulator of this industry. Their actions so far have been inadequate for a year now. It has been a year now, Senator, that this has been brewing. We have seen nothing meaningful from them.

Senator MCCAIN. For the record, and soon, would you provide this Committee and me with your recommendations as to what they should be doing?

Mr. SPITZER. Yes, sir, I will do that.

Senator MCCAIN. I appreciate the generosity of the Chairman here. I was supposed to be making an opening statement, but I think all Americans are terribly disturbed, particularly in light of today's news. People's life savings are being wiped out today as we speak. The last time I looked, the market was down 140 points. By the way, we do have a banking expert here to my right who will probably be able to ask much more coherent and temperate questions than I am asking.

I thank you, Mr. Chairman.

Senator DORGAN. Senator McCain, thank you. Let me ask Senator Fitzgerald for an opening statement, then Senator Edwards, and then we will get to the questions. As always, Senator McCain got right to the bull's eye of the target.

Senator MCCAIN. I thank you for your forbearance, Mr. Chairman.

Senator DORGAN. Senator Fitzgerald. Before you start, let me just make this point. When we announced this hearing, Senator McCain, Congressman Baker's staff called and asked about the opportunity to testify. I told our staff to call them back and say he was invited to testify. They then said he was unavailable, so that is the way that worked. I do not want to misrepresent it, but they did inquire. I said, "you are welcome, we would love to have you," and then they indicated he was not able to, so just for the record.

STATEMENT OF HON. PETER G. FITZGERALD, U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. Thank you, Mr. Chairman, and Mr. Attorney General, thank you for being here, and I want to compliment the Chairman for the series of hearings we did. I think it was back in December when we first had a bunch of employees from Enron testify right where you are today, and these were the folks who lost most or all of their life savings in their Enron 401(k) account. At that time I asked all of those employees if they had seen any of the research reports coming out on Enron stock from some of the analysts and the Wall Street investment banking houses, and every member at that panel raised their hand, and I said, did you rely on that research, did you think that was good, independent, objective advice, and they said, oh, yes. That is why we kept holding onto our stock, buying more of it in some cases.

This Committee later looked into what the analysts had been doing with respect to Enron. We found that there were 17 analysts following Enron stock, and up through September of last year, 16 of them had a buy or strong buy recommendation on the stock, and of those, half kept a buy recommendation on Enron right up to the time they filed bankruptcy on December 2, and there have been empirical studies that have looked into this before.

As you know, the prior Chairman of the SEC, Arthur Levitt, was very interested in this issue, and I think he attempted a reform but either got bludgeoned back by Congress or the investment banks or both, but there was a study of stock analyst recommendations from 1996 through 2000 conducted by Dartmouth Professor Kent Womack that found that 71 percent of all analysts' recommendations were buy or strong buy, while less than 2 percent were sell or strong sell recommendations. It is very clear that there is an overwhelmingly optimistic bias on the part of analysts, and when you combine that with concerns about the influence of the enormous investment banking fees that are often generated by the clients that are being analyzed, you really have the worry about the independence of analysts' judgment.

Now, I have myself concluded that analysts' reports are merely advertisements in most cases for the firms being analyzed. They are paying for that advertising via their investment banking fees. That is what was going on in the case of Enron. They paid hundreds of millions of dollars to Wall Street investment banks, and I think there are two ways we can deal with it.

We could seek to stamp out the conflicts of interest, and I applaud you for your efforts with respect to the Merrill Lynch settlement, or we could simply require disclosure of those conflicts of interest, and I think with disclosure of those conflicts of interest, most average investors would then have a better idea that when they are reading one of these analyst reports it really does not have much more credibility, in most cases, than an advertisement for diapers, or cereal, or something they see on TV.

I introduced a bill that would require disclosure of all the investment banking fees, any positions that companies, the investment houses, have in the company being analyzed. I think that would help in clearing up people's understanding that they may have an agenda, but on the other hand, to stamp out the conflicts entirely, or to have complete disclosure of them, is very, very difficult when you are dealing with sell-side analysts, so I will be interested in your perspective on how we should go about handling this situation.

I do commend you for what you have done in New York, and I will have some more questions when we get to the question and answer session.

Senator DORGAN. Senator Fitzgerald, thank you very much. Next, we will call on Senator Edwards.

STATEMENT OF HON. JOHN EDWARDS, U.S. SENATOR FROM NORTH CAROLINA

Senator EDWARDS. Good morning, Mr. Attorney General, very good to see you again, and thank you for what you are doing on behalf of the people of North Carolina, because I think you are protecting investors not only in the State of New York but all over this country, including people I represent in North Carolina.

As others have said, this hearing could not be more timely, given the news on WorldCom. This I think has been focused on businesses and investors and employees, but the reality is, as the Washington Post reported today, it is also about the economy as a whole, because there is no question that what is happening with these various firms is having a real impact on slowing down the recovery that all of us need, and the key, I think, to restoring investor confidence, which I think is a huge component of what we are trying to accomplish here, is to have aggressive watch-dogs like you, and the truth of the matter is that while the federal regulators have been sitting on their hands and fiddling around, you have actually been doing something, so thank you for what you are doing.

To those who would say that what you are doing should be stopped, they are wrong. What you are doing is important, and instead of trying to stand in your way, what we ought to be doing is applauding you for what you are doing and pushing you forward.

I want to change subjects, though, just briefly. There has been a lot of focus on the investment firms, which you have been focused on, on the accounting firms, on the actions of the top-level executives at these various companies. I also think there is another component that has gotten little attention thus far, which is the role of the lawyers in these various problems.

I have many years of experience as a lawyer, as I know you do, and you are the top lawyer in the State of New York, but the truth of the matter is, a lot of these things could not have happened without some lawyer either allowing it to happen, or giving an opinion that it was okay, and one of the problems that I think happens is, the lawyers develop relationships with the people they deal with on a day-to-day basis, the CEOs. You know, they go to lunch with them, they play golf with them, they are their friends, but that is not who the lawyers work for.

They work for the corporation. They work for the investors. They work for the shareholders, and it is my belief that they have, we, as lawyers, have a responsibility to those shareholders first of all. If they see something about to happen that is wrong/illegal, they have a responsibility to say it and to stop it.

Number two, if it goes forward over their objection, I think they also have a responsibility to go up the chain, to go to the chairman of the board, to go to the board of directors, because oftentimes they are in a position to actually stop this stuff, as you well know, and I have written a letter to Harvey Pitt asking him whether he agrees with this, and whether this is something we can do something about. For years, this sort of regulation occurred, but unfortunately it stopped over the course of the last decade or so, and it is my belief that we need to reinstate it at the national level.

I have also written a letter to the ABA, and unfortunately the ABA, even though they agree with the substance of what I have just said, is taking somewhat of a hands-off approach to this, which I think is wrong. I think we have to be willing to police our own profession, and I just wanted to get—Senator Corzine and I are working on a bill to do something about this issue, because I think it is another place where we can have a really meaningful and positive impact in restoring investor confidence, and I do not want to ask you questions now, but let me just ask you briefly, is that something you would agree with?

Mr. SPITZER. Absolutely, Senator, and I will be brief in my answer. I know this is not the Q&A.

I referred to Enron as the perfect storm of corporate governance failure, by which I mean, you not only had a failure on the part of the board, the audit committee, the outside auditors, the peer review, which is an area I think has gotten insufficient attention, but also, as per your point, the outside lawyers.

I think the outside lawyers and the lawyers who work within a company have an ethical obligation to report those actions, those steps that they believe are wrong, violate law, and as you suggest, because their fiduciary duty goes to the shareholders, not to the CEO, not to the executive, it goes to the shareholders, they have to report up the chain to the board when their advice is not followed on ethical matters.

Senator EDWARDS. Thank you for your leadership, Mr. Attorney General. I look forward to working with you, and thank you, Mr. Chairman.

Senator DORGAN. Senator Nelson.

STATEMENT OF HON. BILL NELSON, U.S. SENATOR FROM FLORIDA

Senator NELSON. Mr. Chairman, I was somewhat jolted into reality in a conversation with the Chairman of the Banking Committee last evening, the very distinguished Senator from Maryland, Senator Sarbanes. When asking him about the reform legislation, which is the part that Senator Carnahan and I have added to that particular bill on corporate reform, and on accounting reform, Senator Sarbanes said that there was an all-out effort, and they may succeed in defeating his bill. If this environment that we have just witnessed of corporate greed and skullduggery and accounting firms being in bed with the corporate managers, if this environment cannot create the political environment in which we can move legislation, that is a sad commentary, and I hope that further exposing to the clear light of day what you are doing in this hearing will help give us the momentum to try to be able to be successful in passing legislation for corporate reform.

Thank you, Mr. Chairman.

Senator DORGAN. Senator Nelson, thank you very much.

Mr. Spitzer, again thank you for being here, and thank you for your testimony. I want to ask you about the Securities and Exchange Commission just a bit.

The Securities and Exchange Commission was appropriated $514 million last year. The President's budget request suggests a cut to $466 million this year, a rather strange recommendation at this point in time, of course, but I said when I started that the SEC ought to hang its head in shame, because this has gone on around them. It is as if there is this carnival of greed and they have a front-row seat, and they are eating popcorn, and nothing is happening there.

Can you tell me—and again, in your investigation, you investigated one piece of this. You are not investigating the things I referred to in the newspaper this morning that deal with restatements and so on, but tell me about the Securities and Exchange Commission and your contacts with them. What were they doing? Were they active in this area?

Mr. SPITZER. I will try to be deft but make my point persuasively, and I will try to be deft because I have a partnership with the SEC and look forward to working with them as we march forward. Having said that, I have been sorely disappointed in what we have seen from the SEC over the past year. In an environment, as Senator Nelson said, when the public and all investors are crying out for leadership we have not seen it.

It is not merely a matter of the budget. I hate to say this publicly, because some may get comfort from it. We have only 15 lawyers in my Investor Protection Bureau, although I am constantly asked for more by the Bureau Chief, and we have managed rather easily, I should say, to reveal the evidence that verified an underlying theory that had been floating out there for years, and so it is not that the SEC lacks resources.

I think they need more resources so they can be more affirmative and more aggressive, but it is a matter of will, it is a matter of desire, it is a matter of aggressiveness, it is a matter of leadership, and I think it is very clear that after a year this SEC is not where it should be.

Senator DORGAN. Well, in your judgment, what has failed? Is it, you say a lack of will at the top of the SEC? For how long, and is there a culture here at the SEC that says, well, we have got $½ billion so let us decide what to do with it, let us sit around and do nothing?

Mr. SPITZER. Senator, I do not wish to personalize this with respect to Chairman Pitt. Having said that, there are many professionals at the SEC who wish to be vigorous. I think that I will without recounting the details of my first meeting with the SEC, I would say that when I first sat down with senior lawyers at the SEC and proposed some of the ideas that I thought they could embody, since they have rulemaking authority that would begin to address the analysts' problems, they were dismissive of the ideas.

The SEC and the SIA were the same. The SEC and the Securities Industries Association saw eye-to-eye. It was absolutely a failure on the part of the SEC to be inquisitive, to be aggressive, to understand that as the evidence was unfolding the much-vaunted self-regulatory world that had been relied upon was failing the public, and I think that is what is clear, whether it is Senator Edward's comments about lawyers, where self-regulation there also has been insufficient, or more palpably, as the American public has seen on the front page of every newspaper and every business page for the past year, in the context of our financial reporting systems, there has been a failure of self-governance, and hence, it was obligatory upon the SEC to step in, and they have not.

Senator DORGAN. Mr. Spitzer, Senator McCain made the point that a lot of folks out there have just lost their shirts, lost their life savings. You turn on television, and if you have cable television you have 100 channels, and you go through the channels and you see all kinds of programs these days with investor analysts talking about this stock or that stock. They seem authoritative, they sound informed, and they are making recommendations here and there, but what you have discovered is that in many cases these recommendations are not objective at all. In some cases, recommendations are made by security analysts or stock analysts who privately are telling their firm, "this is a dog, this stock is worthless," and yet they are saying to the public, "buy this stock, buy this stock," and it has to do with money, does it not?

Now, let me ask the question. Some say that there ought to be some kind of federal standard governing independence of investor analysis, or investor analysts. Even if we develop a federal standard, something, incidentally, I support, that does not mean that there is not going to be a role for Attorneys General in enforcing state and federal laws, is that not correct?

Mr. SPITZER. Absolutely, Senator. I could not agree with you more. I said in my testimony and I said it for months, I am in favor of the SEC articulating a standard. They are the rulemaking entity that is supposed to define the behavior in the securities environment. I have been encouraging them to do so, to do it aggressively. Once they do so, there still will be a need for state enforcement.

I have the Martin Act, which has generalized antifraud provisions. It will be obligatory and important for the investing public that we continue to enforce those provisions as we do from the smallest Ponzi scheme and bucket shop up to the Merrill Lynch inquiry. Those two work together.

Senator DORGAN. Mr. Spitzer, what led you to the investigation? The reason I ask that question is that today in the Wall Street Journal—I suspect it is coincidence that it appears today. It is a two-page advertisement by Merrill Lynch with a picture of the president and CEO and chairman and CEO, and it says, "lately you have been hearing a lot about Merrill Lynch, now you are going to hear from us," and it describes the reforms and so on.

Look this is not, to me, about this company. It is about the people inside this company and other companies that have not been honest with analysts or with the American public, and as a result people have lost a fortune. Tell me what led you to this investigation? Were there whistleblowers some place? Where did you find the hints and the information to go forward?

Mr. SPITZER. There were, Senator, over time there were people who came forward and spoke to us, but the instigation for this was very simple, and this is what is, I think, most unfortunate about it. Everybody on Wall Street knew. In the past year I have spoken to hundreds of investment bankers. Everybody agrees with the premise of our investigation. Everybody agrees that there was a fundamental tension and conflict, and yet nobody was doing anything about it. It was because of the void in enforcement that I felt there was an obligation to protect the investor.

We stepped in precisely because every investment banker, every analyst understood what was going on. Mr. and Mrs. Smith were losing their shirts and nobody was doing anything.

Senator DORGAN. Is there a connection, in your judgment—this is my last question, and it kind of goes far afield in terms of what you have done—with the Enron hearings? We saw a string from the law firms, high-paid, big law firms that were enablers, to accounting firms that were enablers, to CEOs who in this turbocharged economy think you ought to make hundreds of millions of dollars and perhaps even get hundreds of millions of dollars as you exit, to stock analysts whose connection to the firm and to the investment bank that they serve relates to the fees, and therefore the requirement that they give good reports on the company. Is there a thread that connects all of this with respect to a culture, do you think?

Mr. SPITZER. Senator, I think it is a harder question to answer, but I do think there is a thread there, and there has been I think a crisis of accountability that has gripped Wall Street, perhaps other sectors of our society as well, but there has been a more generalized dissipation of standards, a dissipation of the recognition on Wall Street to abide by the ethics that the investment bankers and lawyers and accountants understand. Not a failure of understanding. There is a failure of will in terms of their willingness to abide by their standards.

Senator DORGAN. Just one final point. Do you have other cases underway?

Mr. SPITZER. Unfortunately we do, and unfortunately, as I have said, the evidence at other houses replicates what we have seen at Merrill, and I say unfortunately because I wish this were isolated, but it is not, and that is a problem.

Senator DORGAN. Senator McCain.

Senator MCCAIN. Mr. Spitzer, what is it that motivated you to begin your investigation?

Mr. SPITZER. Senator, we have in New York a statute, the Martin Act, that has been on the books since 1921, it predates the federal securities laws, that obligates the State Attorneys General to enforce the antifraud provisions of the statute to ensure integrity on Wall Street. We have had historically through Attorneys General of both parties, I am proud to say, aggressive enforcement with respect to fraud on Wall Street.

Most often the cases do not receive the notoriety of our investigation of Merrill, of course, because they relate to Ponzi schemes, bucket shops, fraud that does not go to the core of what has gone on, but our Merrill Lynch investigation is the same kind of inquiry that we conduct day-in and day-out, where we get evidence, or have a theory of wrongdoing on Wall Street, where investors are the losers, and we then pursue it.

Senator MCCAIN. Did you work with Mr. Morganthal?

Mr. SPITZER. Yes, sir. I am proud to say I was in his office as an Assistant DA for 6 years, and I am glad you raised him, because I think the BCCI inquiry is another example of—it was the largest bank fraud in history—another example where state prosecutors stepped in to make an important case.

Senator MCCAIN. The agreement you reached with Merrill Lynch includes an enforcement provision which allows the firm to appoint its own monitor, subject to your approval.

Mr. SPITZER. Yes, sir.

Senator MCCAIN. When will this appointment occur?

Mr. SPITZER. It will occur shortly, and I have every confidence that Merrill now understands the problem and will act appropriately, if only out of a sense of self-preservation.

Senator MCCAIN. Well, I want to ask you one question that is pretty tough, and that is, under its present leadership, do you believe the SEC can be effective?

Mr. SPITZER. I believe that Chairman Pitt understands the problems. I look forward to the evidence that the SEC is willing to take the steps that are needed. I have not seen that evidence yet. I have seen them proffer proposed rules with respect to accounting, with respect to analysts, that are insufficient, that do not reflect an understanding of the vacuum that exists and, quite frankly, Senator, in a year in which there has been a crisis of corporate governance unlike any we have ever seen we have seen a failure of leadership at the SEC.

Senator MCCAIN. The hour grows late. I thank you, Mr. Spitzer, and I congratulate you for your singular public service.

Mr. SPITZER. Thank you, sir.

Senator DORGAN. Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Spitzer, one of the things I did in preparation for this hearing is, I went out and picked up all the financial magazines, the money magazines, Kiplinger's and the like, and they are just filled with articles about this, and particularly the need for more independence at the various firms, and as I go through these my sense is that even now, after your good work, the firms still do not get it. They do not get it in terms of how serious these conflicts are.

For example, in Money Magazine of this month, where there was considerable discussion about the need for firewalls that would separate, for example, investment banking from research, the Merrill CEO told Money Magazine that research plays a critical role in the capital-raising process.

Now, when I hear a statement like that, that suggests again that they still do not see how important these firewalls are that separate out these various kinds of functions. Tell me what your sense is. Is this message now finally starting to sink in, because to see these kinds of quotes after all of this attention suggests to me there is still a long way to go.

Mr. SPITZER. Senator, I agree with you there is a long way to go. I think there are different camps within the investment banking world, and I think that we saw from Hank Paulson, the chairman of Goldman, a very important speech, now 2 weeks ago, in which he addressed these issues. I have spoken with many of the leaders in the investment banking world, the business community, who understand what is at stake, who understand the revenues that are needed. They understand the magnitude of what is at issue here.

I think that the precise parsing of where the analysts, and as I said in my testimony, how the analysts interact with each aspect of the investment banking function of the firms and the houses that are full-service investment houses need to be parsed very carefully, and that is where we need leadership from the SEC.

Early on in our inquiry, I floated publicly the notion that theoretically one could remove the research function entirely from the investment banking side, the capital formation side, because they serve different customers, one the retail public that was buying, the other the capital formation side with investment banking fees. It was an idea that garnered absolutely no support. It is not a concept I can impose unilaterally. It is not a concept that can be the product of a settlement with one company. It is a concept that could result only from an SEC directive, or legislation, and as a consequence, I think that is why, as I said in my testimony, this issue of how the analysts interact with investment banking needs to be carefully thought through, carefully parsed. That has not yet happened sufficiently.

Senator WYDEN. Is it your sense that there are no rules on conflicts of interest, or is it a problem that the rules are not being enforced?

Mr. SPITZER. The rules are not being enforced. There are platitudinous statements in most of the manuals that are issued to analysts by the investment houses. Merrill Lynch had some wonderful language in its firm manual, but there was absolutely no effort to enforce. As I have said, there was absolutely no evidence of compliance ever raising a hand, compliance sending a letter to the chairman, to the director of research, to anybody, to signal that there was a problem, and this was in a context where the abuses were brazen and not subtle, a context where, for instance, an analyst would send a report to an outside company to get the company's approval before it was issued. That is inconceivable, and yet compliance never did anything.

Senator WYDEN. Let me ask you about this matter of buy and sell recommendations. John Coffey of the Columbia Law School makes the point that in 1990 analysts issued six buy recommendations for every sell, and by the year 2000 the ratio was nearly 100 to 1. You get the sense as you look at this that for some analysts—and again, I want to make clear I think there are many, many honest people in this field, but for some analysts it seems that the word sell is a four-letter word, and I would like to have you give us your sense about whether you examined whether the percentage with respect to these issues varied greatly on whether or not a company was a client in the analyst's firm for banking purposes.

Obviously, to have this information on something resembling a firm-by-firm basis would be helpful. Did you look at that?

Mr. SPITZER. Yes, Senator. As a matter of fact, we have obligated Merrill as part of our settlement to disclose that very information to investors. What we have required is that each analyst statement include not only an array within the sector of buy-sell recommendations that Merrill has issued, but also then a second chart that says, with respect to those companies that are clients of Merrill Lynch, what is the distribution of buy-sell recommendations, and that will permit us, and we have begun to do this, to examine any skew, any differentiation there may be between the distribution of buy-sells across a sector where people are not clients, and then buy-sell recommendations when you do have a client relationship, and the evidence so far is that there is a skew, so we have been focusing precisely on that issue.

Senator WYDEN. If nothing was done, what do you think would happen in 5 years? Would we just be back to business as usual, because again, as I talk to someone on Wall Street, and I want to stress that I think there are many honest people there, I get the sense that people think conflicts are just inevitable.

They say, you know, we are going to have this attention now, and Spitzer is out there digging up our e-mails, and they are running around in Washington all lathered up about this, but conflicts are always going to be with us. We are always going to have these, and I am interested in your judgment about what would happen 5 years from now if this is just allowed to go by the boards after a few more hearings.

Mr. SPITZER. I think you are correct that—whether it is 5 years, 4 years, or 10 years I, of course, do not know, but your point that there will be a cycle that will bring us back to this problem is absolutely correct, I think, which is precisely why we need vigilance on the part of the SEC, on the part of the state regulators to ensure that the attention that now has properly shone the light on the abuses, that that attention continues.

If this is spasmodic, if this is not a continuing effort to ensure that those on Wall Street abide by the ethical rules that they understand, then we will see a dissipation of standards once again, and we have seen this historically. There was a period where insider trading cases were made about 10 years ago. For a period, people on the street believed that the ethic changed, but now here we are a number of years later, and again we are seeing the same sorts of problems, so I think you are correct, Senator, we need continuing attention to this issue.

Senator WYDEN. My time is up, Mr. Chairman. I just wanted to wrap up with one point. This morning's story about WorldCom 10, 15 years ago would be a big deal at the typical country club in America, because that is where you would have so many people concerned, and they would be anxious about their stockholdings. Today's story, though, is of tremendous interest to millions of working families, because the stock market is no longer just the province of the wealthy, and I think there is no more important issue in this Congress at this point, and no more important domestic issue in this Congress than making sure that working families see that the rules are not rigged against them, and that is what is important about continuing these hearings.

I look forward to working with you, and the willingness of Senator McCain and Senator Fitzgerald to constantly come to these hearings and to make sure that these issues with respect to corporate governance are going to be bipartisan, Senator McCain, Senator Fitzgerald, I think you do a great service by being so extensively involved, and I look forward to working with you and them.

Senator DORGAN. Senator Wyden, thank you very much. Senator Fitzgerald.

Senator FITZGERALD. Mr. Spitzer, I wanted to ask you some questions about the Martin Act. It is my understanding the Martin law is kind of a strict liability statute, and you said you have had it on the books since 1921, that it only requires evidence of a conflict of interest that hurt investors, but it does not require proof of criminal intent. Is that correct?

Mr. SPITZER. It is correct, Senator, that to establish certain types of violations, that it is not necessary to establish intent, that is correct.

Senator FITZGERALD. In the case of your use of the Martin law against Merrill Lynch, was proof of criminal intent required?

Mr. SPITZER. Well, we did not reach that point, and I think that—let me say this, since I have said this before. We could have established intent had we needed to.

Senator FITZGERALD. But it sounds to me that that statute is stronger than any statutory tool that the SEC may have at its disposal, is that not correct, because the SEC would have to show criminal intent?

Mr. SPITZER. I believe it is correct, Senator, that for the SEC to enforce most of its provisions, other than bookkeeping provisions, certainly in the criminal context the SEC would have to establish intent, that is correct. I should indicate, it is only in the context of misdemeanors, the criminal context, that the Martin Act does not require a demonstration of intent.

Senator FITZGERALD. Say that again.

Mr. SPITZER. In other words, if you want to indict somebody for a felony as opposed to charge him or her with a misdemeanor, then it is obligatory that you demonstrate intent under the Martin Act.

Senator FITZGERALD. Okay, and that comports with what I learned in law school. You have to have criminal intent for a felony.

Mr. SPITZER. We usually believe that.

Senator DORGAN. Senator Fitzgerald, would you yield on that point just for a moment, so I can understand this? You are not saying, however, that the SEC lacks the authority to issue some kind of cease-and-desist orders if they see practices in a company by which security analysts are providing information that is at odds with information the company has because there is a conflict. You are not saying they do not have the authority to be active and involved and engaged, right?

Senator FITZGERALD. By no means am I saying that.

Senator DORGAN. I think that is important, because you were asking, I think, Senator Fitzgerald, what authority does the SEC have, or what do they not have. My view has been that they have had the authority to do certain things but largely have been——

Senator FITZGERALD. Well, what could the SEC do in the case of analysts giving overly optimistic research reports that misled investors? Say they could not establish, they could not show criminal intent, what could the SEC do?

Mr. SPITZER. Senator, there is absolutely nothing we have done that the SEC could not have done, absolutely nothing.

Senator FITZGERALD. So it is not the difference in the Martin law.

Mr. SPITZER. No, sir. I think many people have focused on this, and it is an intriguing, perhaps, issue for a law school law review article, but I think in terms of its practical import as we have pursued this investigation, there is absolutely nothing we did the SEC could not have done under the myriad of statutory powers they have.

Senator FITZGERALD. Now, both the National Association of Securities Dealers, the NASD, and the SEC have proposed rules to force disclosure of some conflicts such as whether a firm or its affiliate owned 1 percent of more of the examined company's securities, whether the firm had a banking relationship with the issuer over the past 12 months. I notice that you did not require specific disclosure along these lines in the agreement that you made with Merrill Lynch. Was there a particular reason for that, and is it your opinion that making information of this type available to potential investors is important?

Mr. SPITZER. We actually did require that disclosure. We did require disclosure of an investment banking relationship that generated any revenues in the past 12 months, because we thought that was an absolutely critical piece.

Senator FITZGERALD. How about ownership?

Mr. SPITZER. Ownership, I do not believe we got to the issue of ownership, because I think that was already covered elsewhere, but let me say this. We even tried to be more expansive than that, because it is the pitch, and this is why there is so much work to be done. It is really at the point where the solicitation is being made that there is the moment of greatest vulnerability.

It is even prior to the existence of the investment banking relationship, when the analyst and the investment bankers are going to the prospective client, where the real nefarious deals are cut, where the statements are made either explicitly or implicitly, if you bring your business to us, we will give you a strong buy, and I have heard from CEOs and analysts from both sides of this.

Senator FITZGERALD. So it is really hard to cover that situation with disclosure, is it not?

Mr. SPITZER. It is hard to craft it properly, and we have been struggling on how one might do it, but it can be done, because it gets into the area of where there is an ongoing effort to solicit business, which is, of course, then an area where there is some interaction.

Senator FITZGERALD. Well, do you think that our government should try to cover all those potential conflicts with disclosures, or should we try to educate the public that hey, these are just advertisements, like as you see on TV? People are conditioned to know that an ad that they see on TV, they do not necessarily believe that it is true, but I believe the way analysts' reports come out, people think that they are credible and objective.

Mr. SPITZER. Senator, I suppose—first of all I have to say, I was intrigued by your metaphor, your comparison of diapers to analysts' reports. I thought, there is probably some work we could do with that metaphor, but I am not sure we should pursue it too much here, but I think there is a utility to having the public rely upon analysts' reports, so I do not want to be so dismissive that we say that the capital formation purpose that results from dissemination of information to the public should be discarded and we should remove these and relieve these.

Senator FITZGERALD. But can we ever require disclosure of all the potential conflicts? Don't you think that is really hard? For example, Citibank, they loaned $1.5 billion to Enron. I am not sure that the disclosures that the NASD and the SEC want to require would have required Citibank to disclose the indebtedness owed to them, because it is not an ownership interest, they were a creditor. Citibank actually wound up losing nothing, even though they had lent $1.5 billion to Enron because they sold securities to the general public, or maybe in a private placement, that had the effect of hedging their position. They did not have to pay back the securities if Enron did not pay back its debt to Enron. They ended up losing nothing.

Mr. SPITZER. Senator, I agree with you that the complexity of the web of interrelationships among the full service entities and their client, Citigroup, perhaps being the largest of them, makes it difficult to figure out how to do it, but we must try, because if we throw up our hands in despair and say there is no possibility, there is no mechanism, then we will be dooming the capital markets to the increasing decline of participation by the American public.

And as Senator Wyden said, and has observed several times, the increasing participation by the American public in capital formation is critical. It has been one of the great successes of our economy over the past 15 years, and I am concerned that if we do not make every reasoned effort to ensure disclosure, to ensure that the conflicts—you drew a dichotomy, I am not sure it is real, between disclosure versus eliminating the conflict.

I think we can do both. I think we can attack this from several angles. If we do not address this problem from each of these perspectives, then I think the public confidence will continue to dissipate, and we will see the public exiting the capital markets.

Senator FITZGERALD. I know my time is up. Can I do one or two followups here? Just, if you really extend that far, we cannot limit our disclosure requirements to analysts. There were apparently members of the news media that appear to have been on Enron's payroll, some of whom were out writing puff pieces in various publications, pumping Enron. They would not be subject to these regulations. People are conditioned to believe that everything they read in the newspaper is independent and objective, but there are, in fact, no disclosure requirements for members in the news media. It gets very hard to stamp all that out. I just want to make that comment.

One other thing is, there is a whole industry of buy-side analysts who do emphasize that they are representing just the buyers, that they do not work for investment banks, that are trying to sell stock for issuers, and you can pay them for their research. A lot of the big institutional investors like TIAA–CREF will buy some of this research. The problem is that research costs money. It is more objective.

Our system in this country is that the investment banking fees pay for research at the investment banking houses, but then it is just so intermingled with conflicts that I wonder how we can ever really change it.

Mr. SPITZER. Senator, let me pick up on one of the things you said. I agree with you, there are the other houses, Sanford Bernstein, others—I do not mean to promote any one—which are merely—are not involved in the sell side, they are merely buy-side, and they are advertising these days. If you turn on the TV, you will see advertising that focuses on the fact that they do not participate on the sell side, and therefore their research should have more credibility.

You are correct, unfortunately it has been TIA–CREF, the major pension funds, the sophisticated investors who have been able historically to draw these distinctions to tap into that research. It has been the small investors, the Mr. and Mrs. Smith referred to in the e-mails, who have been brought into the retail network of the sell-side houses, the Merrill Lynch, Salomon Smith Barney retail networks that are out there who have been, then, the recipients of this research, and hence I would argue the victims of the conflicts and the tainted advice.

Senator FITZGERALD. Thank you very much.

Mr. SPITZER. Thank you, sir.

Senator DORGAN. Senator Fitzgerald, thank you very much.

Senator Nelson.

Senator NELSON. Mr. Chairman, I want to thank you and Senator McCain for just like a pit bull hanging onto this, because it is a responsibility. It is a unique constitutional responsibility that we have in the Senate, when something is out of kilter, when something is wrong, when something is out of balance, as it clearly was in the decade of the nineties, and it starts coming to light, that we bore in and we keep boring.

I appreciate the witness. I am curious, when you found out about the Merrill Lynch analysts who were promoting the technology stock based upon decisions on the investment banking side instead of on the research side, how did you get tipped to this?

Mr. SPITZER. Well, Senator, it was an unfortunately easy investigation to conduct. We served a few subpoenas. Merrill Lynch, to its credit, did not destroy any documents. They turned over all of their material, and it was there clear as day. We did not have at that moment anybody who directed us to a particular stock or a particular transaction. It was a matter of good, diligent work by the lawyers in my bureau, and I am enormously proud of them.

I say it was unfortunately easy, because it shows how brazen this behavior was.

Senator NELSON. Why would Merrill Lynch agree in a settlement not to admit guilt?

Mr. SPITZER. Well, Senator, there is the entire issue of the restitution. They paid $100 million as a penalty, or fine. They are subject, and there have been a significant number of class action and individual lawsuits filed on behalf of individual investors who are seeking restitution.

I have no individual opinion about the magnitude of the settlements or verdicts that will result from those litigations, but analysts, if we can rely upon them, have suggested that could range over a billion to $2 billion, and so they did not want to make a statement that would then, from a lawyer's perspective, be an admission of liability that would necessarily lead to that payment. They wanted to put the individual plaintiffs to the proof, and that is what I think will happen in the hundreds if not thousands of lawsuits that are now pending.

Senator NELSON. Well, thank you for you work. I appreciate it. In my former life as the elected State Insurance Commissioner, I had to go after a number of big companies, and if you do not go with—as we say in the south, put your head down and go forward with an intention that you are going to prevail you will get thrown off-course by the dilatory tactics and the nuanced answers and the incredible resources that are at a number of these companies, and we just need to ferret it out and get people on the straight and narrow, and get people heading in the right direction as to what they are supposed to be, which is protecting their customers and their stockholders.

Let me summarize here portions of the bill that Senator Carnahan and I have filed, and which have been incorporated in the Banking Committee bill, the Banking Committee bill to which I referred earlier that I was shocked last night when Senator Sarbanes thought it is going to be very difficult to pass this bill. It sounds like motherhood and apple pie to me, but for the record, I wish you would comment on portions of this bill prohibiting auditors from providing any nonaudit services to their audit clients, the separation of the auditing function from the consulting function. That is in our bill and in the banking bill as well.

Mr. SPITZER. I am firmly in support of that. What I have referred to, I apologize, until now the Sarbanes bill. I will now call it the Sarbanes-Nelson-Carnahan bill.

[Laughter.]

Senator NELSON. No, around here you give all kinds of deference to the senior Senators. You bow and scrape to the chairmen of committees, the Ranking Members of committees, and I do that with great deference. It is the Sarbanes bill.

[Laughter.]

Mr. SPITZER. Yes, sir. I think the Sarbanes bill is an absolutely essential step. I think it is a wonderful beginning at clarifying not only in the context of accountants, which is not the area we have investigated, but I am familiar with those provisions, but also in the contexts of analysts and other areas where Congress should be moving.

I have spoken to Senator Sarbanes, and am fully supportive of his bill.

Senator NELSON. All right. A comment about closing the revolving door, where accountants that have been performing the audit function and all of a sudden get hired in by the company.

Mr. SPITZER. I think that is highly problematic. Just as we have revolving door concerns in government, because of the conflicts that emerge and the concerns about the independence of decisionmaking that results, likewise we have to have that concern in that context as well.

Senator NELSON. Mr. Chairman, oh boy, is the revolving door a problem that I see, for example, in the regulation of the insurance industry, for most of the insurance commissioners in the country are appointed instead of being elected, and as such they are appointed out of the insurance industry. They are appointed Insurance Commissioner by the governor, or whatever the appointing authority in the state is, and usually they are less than a year in office, and the revolving door continues, and they go right back out, back into the industry that they are supposed to be regulating.

All right, here is another component. Requiring the rotation of auditors every 7 years, and what the Sarbanes bill did was require the leading auditor partner to be rotated every 5 years.

Mr. SPITZER. I think that makes perfect sense, and I have spoken to not only Senator Sarbanes to this and his staff, but also to Arthur Levitt, the prior Chair of the SEC, with whom I have had a number of conversations about the issues we are discussing this morning, and I think that is a very important proposal.

Senator NELSON. Another component is that the board of directors must disclose with every filing any director relationships, such as familial, professional, or financial, to the company. The banking bill did not go quite that far. It did require enhanced disclosure, particularly of loans from the companies to directors and transactions between the management and the principal stockholders. What do you think about that?

Mr. SPITZER. Absolutely essential, and I would also add that I think that Dick Grasso's and the New York Stock Exchange's recommendations about board independence have been critically important, and I think were a powerful and useful reaffirmation of how independence should be defined, and how we need a much more sophisticated interaction between independent board members and CEOs.

Senator NELSON. All right, here is another interesting component, that the audit and compensation committee members must be independent directors instead of inside directors. The banking bill did not go that far. They did it for—the audit committee would have to be an independent director. It did not address the compensation committees.

Mr. SPITZER. I think we need to do more in the area of compensation. I think one of the things we saw during the Roaring Nineties was the explosion of option packages that, while one can theoretically argue in favor of options as an incentive device for CEOs, they grew so wildly disproportionate to the return to shareholders that one wonders what was going on, and there were also options that were, heads I win, tails you lose, from a shareholder's perspective, so I think a critical reevaluation of compensation decisionmaking is also necessary as Dick Grasso argued, and as the Sarbanes bill and as your proposal called for.

Senator NELSON. Boy, we sure learned that in the Enron case, and then there is the sense of the Senate that the commission should take a tough enforcement approach. The actual committee bill ends up having, the commission has the authority to take legal, administrative, or disciplinary action. It does not specifically encourage the tough enforcement approach.

Mr. SPITZER. Well, Senator, as I have said, I think we would all benefit from a strengthening of the resolve at the SEC.

Senator NELSON. Well, Mr. Chairman, thank you for indulging me as I got the expert testimony of our expert witness, which is all the more testimony that corroborates why a bill that has been produced by Senator Sarbanes ought not to be heavy lifting. I mean, we ought to pass this, and yet the hard reality is, it is going to be difficult to do it. With my Chairman's help, we are certainly going to try to help the other Chairman, Senator Sarbanes.

Senator DORGAN. Senator Nelson, thank you. Those were interesting observations, and I agree with you with respect to the Sarbanes bill. Let me make a couple of additional comments and ask a couple of additional questions, Mr. Spitzer, and then we will adjourn the hearing.

The point that was made by my colleague, Senator Fitzgerald, is an important one. I think this is complex; it is difficult to root out all conflicts, there is no question about that. The issue of advertising, for example, consumers beware. Advertising that is patently deceptive is illegal, and we have a Federal Trade Commission that is supposed to be taking action against it.

If someone is advertising a product that they in their internal memorandum are saying this product does not work, but we are out here on TV advertising that it works to cure hiccoughs or the gout or acne, but internally they are saying it does not work, that is perpetrating a fraud on the public.

The same is true with respect to securities analysts working for a firm who are receiving fees from their investment banking activities, who are internally saying this stock is a dog, it is not worth anything, but who are on television or in print saying, "We recommend as a matter of course, our firm recommends that this stock has high earnings potential, has high upside potential, we recommend you buy it." That also is perpetrating a fraud, and so I wanted to make the point that I think, while this is a difficult area, it is an important area to be involved in.

I want to go back to testimony last December that was received by our Subcommittee by Scott Cleland, the CEO of The Precursor Group, some of the most interesting testimony we have received. This was last December. I want to read to you what he says. The Precursor Group is an independent research broker-dealer which provides investment research to institutional investors. That is essentially what they are doing, so they are in a different position than perpetrating sales, but here is what he says.

"Systemic conflicts of interest are more pervasive and corrosive than either Congress, regulators, investors, or the press appreciate. Conflicts of interest are eroding the integrity and resilience of our capital markets because they undermine the objectivity, integrity, and accountability of the watch dogs and the early warning systems that markets depend on to prevent Enron-type situations from escalating into disasters.

Millions of trusting American investors have lost big in the markets in recent years in part because the system has become so conflict-ridden that the system no longer effectively serves investor interests but primarily serves company interests. It appears that the oversight mood has now shifted," and "more than ever," he says, "we need the internal controls capital markets rely on—auditors, research analysts, and boards of directors—to function with integrity to ensure the protections of investors' financial security."

When Mr. Cleland testified, I thought it was pretty remarkable testimony. With 6-months age it appears to be even more prescient, and I wanted to make that point.

Let me also say again that accountability and responsibility does not just apply to poor people in America. We have seen a decade or two here in Congress where people point fingers at something that has happened that is ugly on the side of someone who did not have anything, who was abusing the system. Well, we ought to point fingers at that, but it does not just apply to poor people when you talk about accountability and responsibility. It also applies to people at the top, and there was an insider trading issue that has arisen.

I mean, we are so surrounded by issues of corporate governance and swashbuckling behavior in these financial areas that it is hard to know where to start. I was reading the other day about an inside trading scandal—I shall not mention the participants in this, but it is under active investigation—but this is a case where a large investor is on a private jet to a foreign land to take a vacation, stops for fuel some place, and calls the broker back in New York.

Well, you know my point. People take a look at that and say, well, is this how the system works, and the answer is no, it does not work for everybody that way. The broad bulk of people in this country who invest and have a 401(k) think that everything is on the up-and-up. Everything is honest. Everything is something they can rely on.

I think it is important to say that there are wonderful companies out there, wonderful CEO's that run these companies that produce great products, do a great service to our country and to the stockholders and shareholders, and we should not tarnish all of them with these hearings. By the same token, there are some that are greedy, that take advantage of people, that are committing criminal acts, that are replete with conflicts of interest, and we have a responsibility, all of us, to do something about it.

I want to make one point clear at this hearing. There ought not be a conflict between federal and state regulators. We have enough work for both to do, and both ought to work in harmony and together. I said when I started I feel terrible that I think our regulators at the federal level have let the American people down, and to some extent the Congress as well, but we spend a lot of money creating regulatory systems and funding agencies, and it is very hard to see that they have been aggressive or interested or active in what is going on.

As the souped up, turbocharged economy surged forward and we began to read about the excesses, we have some of these agencies that are on the sidelines, and I regret that. I think that is shameful. Let me just ask two additional questions, and then we will let you go.

In the standards you have suggested, you talk about a wall between the analysts and the investment bank side. Can you describe how could one construct that wall? What are the developments that would lead you to create that?

Mr. SPITZER. There are several issues that one has to think about in constructing that wall. As I said, it is a subtle issue that is difficult and has to be parsed, but first and foremost is compensation. We have promoted and have encouraged Merrill and the other firms with whom we have been talking to devise a compensation system for the analyst that disengages analysts from investment banking, that absolutely prohibits any factor in the compensation of analysts from being dependent on deal flow, from the ability of an analyst to get a client in the door, or any favorable treatment of that client. That is the rigid, absolute rule that must be followed.

We have also had discussions with the investment banks about the necessity of ensuring that investment bankers do not in any way, shape, or form call or excerpt pressure upon the analysts in any subtle or overt way to change or alter an evaluation that the analyst might render because the client has perhaps a conflicting interest, and we also, of course, have had lengthy conversations about the degree to which the analyst can in any way, or should interact with the potential client or an ongoing client in an effort to solicit business from the outside entity. That is an area where I think, quite frankly, I wish we could do more.

What we did with Merrill was a first shot at articulating that boundary line. There is discussion, I believe, amongst some of those who were thoughtful in this area about prohibiting analysts from in any way participating in what they call the pitch, the effort to generate new clients. I think that would be a very important and positive step forward. It was not something that we could unilaterally do, but I think it would be an important step forward.

Senator DORGAN. And finally, in the investigations that you have been doing, does the culture you describe, the development of the conflicts that have occurred over time, extend to the top of these companies, in your judgment? Where does the knowledge of this practice reach in a corporation, in your judgment?

Mr. SPITZER. That is a hard question to answer in a sweeping manner. Part of the problem is that the documentary evidence does not always establish that information flows to the very top, but as I have said, I have spoken to hundreds, literally hundreds of investment bankers, from CEOs down to line analysts who are straight out of college or B school, and at every point, every individual, man or woman, has acknowledged an understanding of this problem, and so yes, I think there was an understanding to the very top that this was a problem that was festering, but it was a problem that led to enormous fee-generations, and as a consequence there was a failure of will to address it in the ways that leadership understood that they should have been pursuing.

Senator DORGAN. Mr. Spitzer, let me say for the record that we also invited the Securities Industry Association to testify today, but those who would testify on their behalf were not available today so they declined. I think, had the schedule been such that we were able to match yours and theirs, they would have testified. Let me again go back to the question of Congressman Baker.

It is not my intention at all to cast aspersions here. He certainly has a right to his opinion. He is a thoughtful legislator. I would disagree with the publicly stated opinions of his with respect to what has happened in New York, but his office did call and inquire of the Subcommittee of the opportunity to testify. We then called back and indicated we would invite him to do so, and then apparently his schedule did not allow him to do that, but I wanted to make clear for the record that was the case.

Let me again say I think your work is very helpful. I, for one, appreciate the work you do. Having served in a state capital for a good number of years, I think much of what goes on in state government is refreshing and interesting, and you were able to take effective action where in some cases federal agencies with far greater resources than you had available to you either refused to or failed to. I do not know which at this point, but I commend you for your work, and we will have additional hearings on this general subject.

Attorney General Spitzer, thank you for being here. This hearing is adjourned.

[Whereupon, at 11:10 a.m., the Subcommittee adjourned.]

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