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THE IMPACT OF THE GLOBAL SETTLEMENT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE EFFECTS OF, AND COMPLIANCE WITH, THE TERMS OF THE GLOBAL RESEARCH ANALYST SETTLEMENT AMONG THE U.S. SECURITIES AND EXCHANGE COMMISSION, THE NEW YORK STOCK EXCHANGE, NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD), THE NEW YORK ATTORNEY GENERAL, OTHER STATE REGULATORS AND TEN WALL STREET FIRMS

MAY 7, 2003

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C O N T E N T S

WEDNESDAY, MAY 7, 2003

	Page
Opening statement of Chairman Shelby	1
Opening statements, comments, or prepared statements of:	
Senator Sarbanes	4
Senator Bennett	6
Senator Johnson	7
Senator Dole	9
Prepared statement	63
Senator Bunning	9
Senator Corzine	10
Senator Sununu	11
Senator Carper	12
Senator Enzi	13
Prepared statement	63
Senator Crapo	13
Senator Dodd	14
Senator Chafee	16
Senator Bayh	63

WITNESSES

William H. Donaldson, Chairman, U.S. Securities and Exchange Commission	16
Prepared statement	64
Response to written questions of:	
Senator Sarbanes	103
Senator Dole	109
Eliot Spitzer, Attorney General, the State of New York	37
Prepared statement	72
Richard A. Grasso, Chairman and CEO, New York Stock Exchange, Inc.	40
Prepared statement	74
Response to written questions of Senator Sarbanes	114
Robert Glauber, Chairman and CEO, National Association of Securities Dealers	44
Prepared statement	83
Response to written questions of Senator Sarbanes	124
Christine A. Bruenn, President, North American Securities Administrators Association	45
Prepared statement	87
Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission	49
Response to a written question of Senator Sarbanes	129

THE IMPACT OF THE GLOBAL SETTLEMENT

WEDNESDAY, MAY 7, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Richard C. Shelby, (Chairman of the Committee), presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

On Monday, April 28, 2002, State and Federal regulators announced the settlement of enforcement actions against 10 Wall Street firms and two individuals. This global settlement was the culmination of a year-long investigation into conflicts of interest in Wall Street research departments during the late 1990's.

The court papers that memorialize the global settlement describe how research analysts were subject to intense pressure from investment bankers that compromised their independence. The findings show that the intertwining of analysts and investment banking has led to a situation in which objectivity took a backseat to the whims of potential underwriting clients with "buy" recommendations. Research materials have become nothing more than "selling tools for investment banking."

In order to attract and retain investment banking clients, investment bankers pressured analysts to issue exaggerated reports that they knew were false or omitted crucial negative information. Analysts published recommendations that characterized stocks as "strong buys," while disparaging them as "pigs" and "dogs" in private e-mails.

To ensure that analysts remained focused on investment banking revenues, managers compensated analysts according to the amount of investment banking business that they generated. Firms were also paid at the request of a company going public, to publish research reports in order to create greater market credibility.

Former Salomon analyst Jack Grubman best described the banking environment at the time when he declared: "What used to be a conflict is now a synergy."

These cozy relationships helped drive up the stock of unworthy companies and generated vast wealth for the bankers, brokers, and their CEO clients. These insiders knew the rules of the Wall Street game and benefited handsomely. Institutional investors knew that something was rotten and ignored the hyperbole.

The only one who was not dealt in on the game was the "little guy"—that is, the ordinary retail investor.

The little guy invested his wages and retirement savings in the stock market based on the reportedly objective information and recommendations provided by brokers and research analysts. Analysts had too much to gain from inflating stock prices and issuing favorable research opinions. Therefore, the ordinary investor who was unschooled in Wall Street's ways, was misled and lost out.

The issue before this Committee today is whether the global settlement will reform the culture of Wall Street, restore the integrity of stock analysts, and regenerate investor confidence. Although the $1.4 billion settlement produced record monetary sanctions, I have serious doubts that the monetary sanctions will have a big impact on Wall Street's bottom line.

For example, Citigroup agreed to make the biggest payment of $400 million, but it received $10½ billion from investment banking revenues between 1999 and 2001, a monetary sanction of less than 4 percent of its investment banking revenues. It is questionable whether such a relatively small payment will serve as a deterrent to future improper conduct.

I fear that the cost of settlement will be seen as the cost of doing business. I fear that firms will perform a cost/benefit analysis and determine that a settlement payment is a small price to pay for the huge sums to be gained from exploiting conflicts of interest.

The consent decrees that the firms executed contain the standard legal boilerplate whereby the defendant neither admits nor denies any wrongdoing. But in this case, it is particularly telling. I believe the firms are less than contrite and simply consider the fines and penalties as a means to put the issue behind them and move on.

I am concerned that banking executives themselves have expressed a lack of contrition for their actions. In the last 3 years, we have literally seen trillions of dollars of market capitalization evaporate.

Millions of investors lost billions of dollars on investments that were influenced by the euphoric environment fostered by misleading advice. Despite the overwhelming evidence of wrongdoing presented in the findings, Morgan Stanley's CEO is quoted as saying, "I do not see anything in the settlement that will concern the retail investor about Morgan Stanley."

If executives fail to acknowledge pervasive conflicts of interest and continue to minimize the sanctions and reforms mandated by the global settlement, I do not see how the settlement can have any meaningful impact on the Wall Street culture.

I believe that the Wall Street culture must change from the top down, and I am not convinced that the global settlement has done enough to change attitudes at the top of these banks.

During the bull market, executives were praised for increasing earnings and producing higher stock prices. A "cult of the CEO" developed as certain CEO's were deemed indispensable and paid accordingly. As corporate wrongdoings have come to light, however, many of these superstar CEO's have escaped culpability for the improper actions they took to fuel market growth.

Without holding executives and CEO's personally accountable for the wrongdoing that occurred under their watch, I do not believe

that Wall Street will change its ways or that investor confidence will be restored.

The SEC enforcement staff has informed the investing public that we should "just wait" as the SEC conducts additional investigations that may possibly lead to charges against managers who supervised the research and investment banking divisions of banks. While I fully understand the need to act deliberatively and to follow the evidence, I do not believe that investors can wait too long.

The settlement seeks to minimize future conflicts of interest by establishing certain structural reforms that the banks must implement in order to further separate research and investment banking. Firms must locate research and investment banking in different offices and create separate reporting lines, budgets, and legal staffs.

These reforms attempt to better insulate analysts from intimidation and investment bankers, making it harder for bankers to pressure analysts for favorable research or to retaliate against them for unwanted negative reach. Unfortunately, I do not believe that the structural reforms can eliminate the conflicts of interest, which seem to be an inescapable part of the banking marketplace.

Because analysts do not generate their own profits, they must rely on investment banking revenues to help pay their compensation. The reforms continue to allow research and investment banking to operate as divisions within the same firm and allow analysts to consult with investment bankers on transactions in a large variety of circumstances.

While these conflicts are being minimized, they will continue to exist. This cannot be helped, because we cannot legislate morality or legislate away greed. We can, however, seek to ensure that the SEC and the self-regulatory organizations vigilantly police the firms and act to implement any necessary reforms.

This settlement is the first step in exposing conflicts, sanctioning illegal conduct and reforming the system, but it cannot be the last. As a result of the settlement, the investing public has received notice as to how the Wall Street game works. Notice, however, is insufficient to restore investor confidence.

Investors will need proof that markets are once again a place where they can safely invest their money without the fear that they are the unknowing victims of a scam.

This hearing is the beginning of the public's evaluation of the global settlement. The real value of the settlement will not be known until we see whether the penalties and reforms mandated by the settlement have changed the behavior on Wall Street.

The American public has numerous questions regarding the negotiation of the global settlement, the mechanics of the settlement, and the process for returning funds to investors who collectively lost billions of dollars as a result of the conflicts of interest on Wall Street.

I look forward to the answers to these and other questions throughout the hearing. I look forward to the testimony of each of the witnesses.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I want to thank you for scheduling this very important hearing on the global settlement in such a timely manner. This may well be one of the most significant securities settlements in history. It addresses issues at the heart of our markets and the structure of our financial system. It responds directly to the exploitation and manipulation of investor clients by stock analysts and their firms. It reveals a pattern of conduct that violates fundamental principles of a security firm's responsibilities to its clients and systemic conflict of interest within the industry.

This was not a matter of a few "bad actors," but rather, it involved major firms and was a fundamental breakdown in the system. The magnitude of the abuses disclosed in the global settlement cannot be overstated. As a press release announcing the settlement reads, "The regulators found supervisory deficiencies at every firm." Every firm.

The documents released by the Commission present a stark picture of the ways in which individual investors were given short shrift, or worse, held in contempt by the analysts and firms on whom they relied for guidance and advice in making investments. They include references of breathtaking cynicism about the "little guy" who did not understand the "nuances" of Wall Street, and "John and Mary Smith who were losing their retirement." As the *Financial Times* wrote in an editorial on April 29, "It is difficult to imagine anything worse in business than trusted professionals pushing toxic products at gullible consumers. That is the shameful picture that emerges from the evidence published yesterday behind the global settlement." Gretchen Morgenson, writing in *The New York Times,* also on the same date, April 29, said, "Wall Street firms, in pursuit of investment banking fees, put the interests of their individual clients dead last."

These are harsh assessments of our capital markets, whose high standards of market integrity and investor protection have traditionally made them the envy for the world. We enacted reform legislation last year to ensure that our markets would again adhere to high standards, and deserve the confidence of investors, and I very much hope that the global settlement will take us further in that direction. I want to commend the regulators, especially the New York State Attorney General Eliot Spitzer, and SEC Enforcement Director Stephen Cutler, for their perseverance and determination in carrying out their investigations. They have made a singular contribution to the public interest.

At the same time, however, it remains clear that much needs to be done. The issue is not closed. An editorial in *The Baltimore Sun* on April 30 observed, "Wall Street doubtless hopes this deal marks the last chapter in this debacle. Like many stock ratings, that is far from the truth."

Today's hearing gives us an opportunity to focus specifically on some of the many issues raised by the settlement, and I look forward to exploring with our witnesses some of the following questions: How is it possible that the regulators could have missed for so long the supervisory problems at 10 of the Nation's top investment firms? What steps are the SEC and the self-regulatory organizations taking to prevent a reoccurrence?

Given that supervisory deficiencies were found at every firm, why have none of the supervisors in any of those firms been held accountable in the settlement? Can we be confident that this global settlement will result in lasting change?

Does Wall Street, in fact, care about the interests of the individual investor any more? Where were the self-regulatory organizations? How adequate are the self-regulatory mechanisms on which our securities markets rely? The Director of Investor Protection at the Consumer Federation of America pointed out, that we have a whole system in place that is designed to prevent these abuses, and it is not as though there wasn't evidence of a problem. Yet, she argues, "the self-regulatory organizations took no action until pushed by this investigation."

How can the relationships between State and Federal securities regulators be strengthened so that the States are given adequate credit for and encouraged to pursue investigations wherever they may lead?

Given the magnitude of the conflicts of interest that were exposed, is further independent fact-finding needed to assess exactly what went wrong and what further needs to be done?

A number of eminent securities lawyers, including Judge Stanley Sporkin, former SEC Director of Enforcement, Irv Pollack, former SEC Commissioner and head of the Division of Enforcement and Market Regulation, and Dean Joel Seligman of the Washington University School of Law in St. Louis, have suggested a broad review of our securities markets on the model of the SEC Special Study of the markets initiated in 1961. And I urge the SEC to give serious consideration to this suggestion.

As a number of people have said, this global settlement marks the beginning and a first step toward restoring investor confidence in our markets.

Finally, while Chairman Donaldson was confirmed after most of the global settlement had already been negotiated, I want to recognize and commend him on his leadership at the Commission to date. There is a story in the morning paper, titled, "New Strength At The SEC's Helm," and describing his tenure thus far, and I commend the Chairman for the actions he has taken. One thing that I am particularly encouraged is that Chairman Donaldson seems to "get it" in terms of what the crisis of confidence is that faces us with respect to our capital markets, unlike, I regret to say, some of the leaders on Wall Street.

The New York Times on May 1 wrote an editorial, "Wall St. Revisionism." And it talked about, "There is a cynical revisionism taking hold in some Wall Street quarters. The thesis is that investors have only themselves to blame for their losses during the stock market, not duplicitous research. The thesis further holds that little will change as a result of the settlements reforms."

And it goes on to cite an op-ed piece that was written by the head of one of the major firms arguing that regulatory attempts to remove risk from the marketplace threaten the very nature of capitalism.

The *Times* goes on to say, "As a broad Economics 101 principle, we would agree, hurray for risk. But risk is not normally defined as embracing deliberate deception by brokers who twist their re-

search to curry favor with investment banking clients, thereby abusing investors' trust."

And it goes on to say, "This essay is only one of several signs that Wall Street remains in deep denial about the degree to which it betrayed investors' trust."

Chairman Donaldson wrote a very sharp letter to the head of another major Wall Street firm on that very point.

They have to get with the program. You pick up the paper every day and we see this drumbeat with respect to whether ordinary people can put their confidence in these capital markets.

A crisis of trust on Wall Street. Here's a book review, "Not Even Fuzzy." The author reveals an acute shortage of math on Wall Street.

Business Week "Sweeping Up the Street."

The internal e-mails and memos released as part of the deal show a callous disdain for individual investors that goes beyond anything revealed to date.

Those who said that Wall Street's problems stem from just a few bad apples are now confronted with proof that the corruption of the financial system was systemic and did serious harm to America's equity culture.

Many retail brokers protested that the analysts's reports on telecom and dot.com companies were deliberately misleading their clients and causing them to lose large amounts of money. These protests went to senior managers who chose to ignore them.

And finally, "If the people on Wall Street cannot be sensitized to what is happening, then obviously, the regulators are going to have to sensitize them in any event. But, surely, they need to awaken."

This is from *The New York Times* Book Review: "Business Ethics and Other Oxymorons"—business ethics and other oxymorons.

Three books about hubris, greed, corruption, and incompetence. And yet we have this denial. I just want to close this out by—sometimes the message is told effectively in these political cartoons.

This is Wall Street talking to I guess the ordinary investor. This was out of *Newsday*.

Remember how "buy" secretly meant "hold" and "hold" meant "sell?" Then he says, "Well, now 'buy' actually means 'buy' and 'sell' means 'sell.'" And then the ordinary investor says, "'Buy' means 'buy' and 'sell' means 'sell?'" Right.

And then he says, "Boy, that's confusing."

[Laughter.]

Chairman Donaldson, you have a big job ahead of you there and we wish you the very best as you pursue it and we are looking forward to hearing from you this morning and also from the panel that will follow, Attorney General Spitzer, Bob Glauber from the NASD, Richard Grasso from the New York Stock Exchange.

We also have the head of the State securities administrators, Christine Bruenn from Maine.

Thank you very much.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I won't go back over the ground that you and Senator Sarbanes have already covered. But I do have one thought which probably will not produce any testimony here today, but which Chairman Donaldson, I would hope somebody, somewhere in the bowels of the SEC can do a

study on and help me out with as you go through this rather sorry chapter in American history.

Around here, we spend a lot of time talking about the markets, and particularly about the Dow and how the Dow used to be at 12,000 and then it fell to 7,000, and whose fault that was.

And usually, we try to assign the blame, on the basis of which political party we are in and which political party the target is in, on whom we wish to put the blame.

It occurs to me as I go through this and listen to this analysis, that maybe there is a possibility of assessing where the Dow actually should have been as a measure of the value of corporate America if you can back out that portion that can be attributed to the phenomenon just described by Senator Sarbanes.

In other words, an artificial inflation. If we had not had the artificial inflation of values coming by virtue of these analysts, would the Dow in fact have been at 10,000 rather than 12,000?

I am just picking numbers out of the air. I have no empirical basis for picking those numbers.

But as we try to analyze the effect of all of this, is there any way that it can be quantified or come close to quantifying it, so that if we decide that we really are at the position that Senator Sarbanes' cartoon suggests, that buy now means buy and sell now means sell, and the market is now, we hope, responding to accurate analysis, is there any way that we can adjust for not typical inflation in the economic term, but adjust for analyst inflation, to say that the fall of the Dow is not from 12,000 to 7,000, but adjusted for analyst inflation number that was 10,000 or 11,000 or whatever?

Or if we decide that in fact, without the analyst's inflation of expectations here, the Dow would have gone to 12,000 anyway, that would be a useful piece of information to have if indeed it is discoverable.

Now in the Iraq war, we have learned from Secretary Rumsfeld's vocabulary, one of his favorite words is unknowable. We keep asking him questions in our secret briefings and very often, the answer is—that is unknowable.

And it may be that what I am asking for here falls into the category that Secretary Rumsfeld would label as unknowable. But, if anybody can come up with a study of what really happened to the overall valuation of America's listed corporations as a result of the analyst actions, I would very much like to get my hands on that number.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. First, welcome to Mr. Donaldson.

Chairman Shelby and Ranking Member Sarbanes, I want to thank you for holding today's hearing on global settlement which was finalized, of course, just this last week.

Millions of American investors relied on what they believed to be an objective investment advice from at least 10 of this Nation's largest Wall Street firms.

As we know, in far too many instances, this advice was tainted. These firms weren't looking out for their retail customers. They were looking our for themselves.

Investors who understood that investment risk is an essential part of our market assumed that that risk was going to be taken in the context of integrity, and they were wrong. The integrity was not there.

Now it is important to note that the majority of the workers on Wall Street are honest. They are honest actors, but all of whose reputations are now tarnished by association.

Time will tell whether the structural reforms and the global settlement will reduce such outrageous violations in the future. But it troubles me that an industry that is based on self-regulation was so late to the game in turning itself in.

One reason our system works is because, at least in theory, firms understand the need to maintain their reputations. Without the trust of their clients, full-service Wall Street firms have little to offer. The Sarbanes-Oxley bill, which we passed last year, is a great step forward. And I cannot let this moment pass without acknowledging the extraordinary leadership of Senator Sarbanes on that issue.

In addition, I am pleased that the agencies before us have recently increased their activity to address the lack of confidence that American and foreign investors now have in our markets.

The reality is, however, that our economy continues to falter. No matter what the White House might say, it is clear that Americans have not pulled out of the stock market because they do not like paying tax on their dividends. They are staying out of the market in large measure because they have no confidence that our system rewards honest business practices.

They believe in too many instances that the fix is on, that this is not a capitalist market. It has been too much a robber baron market.

Thanks to Attorney General Spitzer, we have proof that Wall Street firms spent far too much time trying to dupe their own clients for short-term gain. And what they have learned, I trust, is that the long-term consequences far outweigh what immediate benefit they thought they were gaining from such unethical behavior.

The Administration should take a lesson from the global settlement. Short-term greed is bad business. While some people may be fooled by slick sales tactics, eventually the truth will catch up. And when the American people realize that our problems relative to Wall Street, relative to budget strategies that we face this week will lead to dire long-term consequences, I think there will be a price to be paid.

But I thank the Chairman for this hearing. This will be a very valuable contribution to the debate, and hopefully, this will lead to still further restoration of a sense of integrity and public confidence in what once was regarded as the world's greatest market.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

COMMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. In the interest of time, I will submit my statement for the record, Mr. Chairman.

Chairman SHELBY. Without objection, it will be made part of the record.

Senator Stabenow—she's gone.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. Thank you for holding this very important hearing. I would also like to thank our witnesses for testifying today.

As we all know, there has been a great deal of uncertainty in our equity markets. The retail investor has been especially hurt by the actions of a few, greedy criminals. Some of these criminals were on Wall Street, some in Houston, some in Mississippi, and others all over the country. We have had problems on a much smaller scale in Kentucky as well. Greedy, sweetheart deals have fleeced billions out of our economy and it has not recovered from the damage.

We desperately need to restore investor confidence. Over half the households in the country own stocks. But the average investor is sitting on his money. They are keeping it in savings accounts, buying safe government bonds, and I would guess some are even hiding it in their mattresses. It is fine that Americans are putting their money in less risky investments, such as IRA's, CD's, T-bills. I would, however, caution against mattresses. It is good to diversify your investments, but we need to get people investing back in the equity markets. To achieve that, investors once again have to believe in the equity markets. I believe this global settlement, along with the passage of Sarbanes-Oxley and the aggressive—I say aggressive—prosecution of corporate criminals is another step in achieving that confidence.

I am deeply worried about this economy. We have had some growth, but no new jobs are being created. We need to increase investment. Increasing investment creates capital, capital creates jobs. This is also why we must pass a real stimulus package. We must create jobs immediately.

As my colleagues on the Committee know, I worked in the securities industry for over 25 years. I can assure you there were no Chinese walls, firewalls, stonewalls, Berlin walls, or any other kind of walls when I worked in the industry. That was in 1961 when I started.

One side knew exactly what the other side was doing at all times and there was no prosecution and there was no investigation in 1960, 1970, 1980, and finally in the year 2003, we finally got some action.

Maybe a junior associate had a copy of Pink Floyd's "The Wall," but that would be as close as we came. If someone was doing an IPO, everyone in the firm was aware of it. It is my hope that this settlement will construct real walls that keep different divisions of businesses separate. The investment banking division cannot—I say cannot—influence the analysis division.

I hope this independent research fund will truly be independent. It is critical for our investors' confidence. Investors must know that

they are getting sound advice and not just being told to buy in order to inflate the price of a stock that the other side of the firm is pushing. Confidence must be restored. If investors do not have confidence, they will not come back to the market.

I think we need this oversight hearing to see if this agreement will work. If it doesn't, we can always come back and revisit it. But I think right now, the markets need to be able to sort this agreement out and implement it. We need to see if it works. If it doesn't, there will be ample time to fix it.

We all know that firms have paid out large penalties. I am sure that some will argue too much. And I have heard some argue way too little. But the firms who have been guilty have been hurt much more by investors pulling out of their firms. The markets are punishing them. That is why we have agreed to these steps. They, more than anyone, know that confidence must be restored.

Once again, Mr. Chairman, I want to thank you for holding this important oversight hearing. We had this oversight hearing in Government Affairs last year and got the same answers from the Wall Street firms last year that I am afraid if we brought them in this year, they would give us the exact same, that they were totally separated and all of a sudden we find out now, $1.4 billion later, that they weren't totally separated.

Thank you.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and Ranking Member Sarbanes. I compliment you on holding this hearing. It is one of obvious importance, as evidenced by a terrific set of witnesses we have assembled. It is more important, though, because of the need to restore investor confidence and redress the wrongs that have obviously been revealed through the investigation.

It goes without saying that I think all of us are deeply appreciative of the focus and effort that all of the individuals here today and others and their staffs have put in to developing the global settlement and the resulting enforcement actions.

Each of the regulatory bodies represented here, the SEC, New York Stock Exchange, NASD, State securities regulators, as well as the New York State Attorney General's office, are to be commended for the serious and responsible manner with which they sought to address the failure of market participants to properly manage and disclose conflicts of interest by research analysts, a failure that led some to engage in deceptive, if not fraudulent, business practices that worked to the serious detriment of investors.

Regrettably, firms and individuals in the investment banking industry, one that I will note that I was a member of for the better part of 30 years as well, allowed themselves to step on to the slippery slope of irrational exuberance.

Ultimately, that slope led down a path where business decisions reflected infectious greed as much, if not more so, than the interest of the client.

In my life, I have met and worked with thousands of men and women employed in the financial markets and I have no doubt that

the vast majority are honorable, hard-working individuals who add value to our markets, our economy, and to our Nation.

Regrettably, this hearing is about the individuals and the organizations that chose the wrong path—those who abused the public trust, those whose missteps undermined the integrity of our markets and caused harm to unsuspecting investors.

This hearing is appropriately about the vigilance of Federal, State, and other regulators who sought to bring an end to egregious conflicts and the penalties for those who engaged in them, and it is about redressing the financial loss of those who are harmed. I compliment those who have worked on this effort.

This settlement is a very significant step in redressing the banking and securities industries' missteps of the late 1990's and restoring public investor confidence. It is an acknowledgement that investors were harmed by undisclosed conflicts and mismatches of published versus actual opinion.

Investors should be aware of the honest risks of investing. The market risks have true valuations, corrections, and business dips. Sarbanes-Oxley was, to its positive contribution, an important step in addressing those issues. But investors do not and should not, however, be forced to accept the risks of a stacked deck. That is what this settlement is about and I compliment those who have put it together.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Welcome, Mr. Chairman. I appreciate the fact that you have taken the time to put together a hearing that delves into the details of this global settlement and I will submit my written statement for the record. But I did want to highlight two points.

The first is, with regard to the settlement.

I think it is important to recognize that we are embarking on new territory in establishing an investor restitution fund. It was one of the most important pieces of the Sarbanes-Oxley legislation last year. It set up that fund to make sure that when there are fines or disgorgements, that we find a way to get that money back to investors.

And I will be interested to hear from our various panelists the ways and the mechanisms through which we intend to see that that happens.

We have the Federal fund. We are going to be providing a lot of this money back to the States. The States aren't necessarily prepared to handle these payments in a way that ensures that they get to investors. Different States have different rules and regulations. And while I think it is appropriate that there be restitutions or the fines, penalties, disgorgement paid back to the States, I think we want to look at the details of what is going to happen, not just at the Federal, but at the State level, to make sure that those investments see some return or some benefit from such an important settlement.

Second, I want to encourage a little bit of perspective here.

This is a very important settlement. It is impressive to see the level of cooperation by the SEC, the State of New York, the New York Stock Exchange, the NASD, and a lot of others to make this settlement happen.

It is a very complex settlement. It deals with important violations of the law, fraudulent behavior and ethical lapses. And I think for anyone to draw a comparison somehow for political purposes to the current budget debate, where we have legitimate differences of opinion and tax and spending issues that we are asked to deal with every day, is not just a little disingenuous. But I think it is taking a step that is unnecessary and that adds a lot of coarseness to the debate of issues other than the legal framework and the settlement that is at hand.

So, I hope we can focus on the value that has been provided through the settlement, the opportunity that exists in the settlement, and of course, focus on holding those who have broken the law, who have engaged in fraudulent behavior accountable.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. To our witness and the other witnesses who follow, we thank you for being here.

Those of you who have worked to bring us to this point today, thank you for your efforts and for your stewardship.

I do not have a long statement. I do have a couple of questions that are on my mind and perhaps on the minds of some of our colleagues. I just want to mention a few of those, starting with you, Mr. Donaldson, at the SEC.

One of the questions that I will be interested in is how will the SEC provide to make permanent the pact that has been negotiated? Do you have the resources to do so? How long is that likely to take?

I think in the global settlement, a couple of analysts have been barred from working in the securities industry for life. I am interested to know, are there likely to be others? Are there likely to be actions brought against senior officials within the companies that have been named or other companies that have not been named?

I have some interest in the after-tax costs to those that have been named in these settlements. What kind of benefit will they gain from the tax code. Is there anything that we should consider doing with respect to the tax code as a result of that?

And finally, I understand that the amounts of monies that may be involved in the class-action lawsuits brought against some of these companies are far greater than the monies that are involved in this global settlement. And I would be interested in knowing what is the likelihood that some further punitive actions will be taken in the costs incurred by the companies that have been named, or others in the industry?

Those are some of my questions that I look forward to asking and I hope we will hear some answers.

Thanks, Chairman Shelby.

Chairman SHELBY. Senator Enzi.

COMMENTS OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I appreciate your holding this very important hearing. And to expedite it, I would ask that my complete statement be a part of the record.

Chairman SHELBY. Without objection, your statement will be made a part of the record.

Senator ENZI. Thank you. And then I can concentrate on just one small part, which is the bill that you and I have introduced to streamline the process for getting certain key employees.

We have asked that there be an expedited process so that CPA's could be hired as easily as lawyers to be able to do the enforcement process that is necessary. It is held up in an extremely complicated process. We are trying to streamline that. And I hope that everyone here will help that piece of legislation to go forward or to include it in something else so that we can get that done and get some of the enforcement expedited.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I will be brief also.

A number of the Members of the Committee, both Democrat and Republican, have clearly identified the problem and indicated how strongly they feel about it, and I share their concerns.

My focus today in the hearing is going to be on whether we have solved the problem and what we need to do from here to make sure that we have.

Consumer confidence has been raised by a number of people and, clearly, that is the end result that we want to achieve here. We want to have that strong market that America is proud of and we want to make sure that Americans can really be confident in that market so that they can start making the kinds of investment decisions that will help bring us back to a strong recovery.

We all know the parade of events that have occurred over the last few years that have seemingly, repeatedly shocked the confidence of the American people in our markets. And just as we get to the point where we think, okay, maybe we are going to be able to start recovering now, we have yet once again another shock.

Last year, we dealt with the issues raised in Sarbanes-Oxley to make sure that the financial information which listed firms are reporting is accurate. And now we are dealing with the question of whether what is done by analysts and investment firms with that financial information is accurate or manipulated.

And it seems that in one context of another, we continue to have these hits, which I believe it is this Committee's responsibility and duty through these oversight hearings to evaluate and make certain that we deal with correctly.

We want to make sure that we have the correct statutory and regulatory systems and procedures in place, and the correct self-governing procedures in place to make certain that these kinds of things do not continue to happen.

I am also going to be interested as we go through the hearing to be looking at the remedy side of things. Has there been a com-

plete disgorgement of illicit profits obtained? Or is it going to turn out that after all we are doing and saying and talking about this $1.4 billion figure and so forth, that it still would be profitable to engage in the activities that are the issue of the day.

And if that is the case, and I realize that we have class action lawsuits that may be another aspect of this. But if it is the case, that it is still going to be profitable to engage in this kind of conduct when the day is done, then I do not think we have done our business and we need to pay attention to the remedy here as well.

A number of us, Senator Bunning most eloquently, have talked about the concept of independence or, as he put it, the walls that need to be established.

I am going to be looking to see whether we have truly put into place and are headed toward achieving the kind of independence and the kind of analysis of financial information and the recommendations that are made with regard to the stocks that are traded, that make it clear that that advice can be relied upon, and whether it is a Chinese wall or whatever other kind of wall, that that independence is firmly established.

There are a number of other remedy issues as well. But as I said, Mr. Chairman, my focus today is going to be on making certain that we do our part to be sure that the statutory, the regulatory, and the self-governing systems that need to be in place are in place, and they are effectively enforced, that the incentives for taking profit out of this kind of conduct are removed, and that we do everything that is necessary to restore the confidence throughout the world in our markets.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman.

First of all, let me join my collegues in thanking you, Mr. Chairman and Senator Sarbanes, for holding the hearing today.

I know that, normally, having a lot of opening statements here delays this process. But I think it is important today and I want to commend my colleagues on both sides here for their comments.

The point that Senator Sarbanes made, Senator Shelby has made, and others have made from the outset about the issue of confidence is the most critical issue for all of us here.

The fact that Democrats and Republicans here can oftentimes disagree about various things, are expressing a common sense of outrage from this side of the dais, I think is important.

And so I apologize to our witnesses for taking a little time, but I think in the interest of trying to mobilize the kind of action that you are hearing from those of us up here is critically important.

So, I appreciate, Mr. Chairman, you are giving each of us the opportunity to be heard. Although this is taking a little time, I think it is worthwhile.

Second, I want to join my collegues in thanking to those who have been involved in this settlement, putting this all together and the work that they have done.

But I want to join in expressing some deep concerns on how this is viewed and what happens now. I am still interested in the issue

of the settlement itself. I am particularly disturbed, I will tell you, when I find that about a third of this $1.4 billion is actually a penalty. Two-thirds of it may be tax-deductible or may be covered by insurance.

In a sense, we may be talking about $400 million plus that is actually a penalty and the rest of it may be subsidized by American taxpayers, in a sense, by allowing it to be written off.

And if that is the case, then there is going to be a stronger sense of outrage and this may turn out to be not quite as important as first thought.

We have lost $5 trillion in lost capitalization in the down market—$5 trillion—a lot of which was lost as a result of the point that has been made here this morning, as a result of people having no confidence in this market, whether they put it, as Senator Bunning has suggested, in a mattress or some other place.

Whether you want to attribute a half of that or a third of it, whatever else, the fact is there has been a lot more lost than even remotely comes close to the penalty we are actually talking about here, and that is a matter that I am going to be very interested in pursuing with our witnesses.

But certainly, the settlement does, as has been said by Senator Sarbanes and others, represents a failure of the Securities and Exchange Commission. It represents a failure of the State securities regulators. It certainly represents a failure as well to the self-regulatory organizations, as others have pointed out. To some extent, it represents a failure of those of us sitting on this side of this dais.

We want to point the finger of blame in a sense of who dropped the ball—part of it was dropped here, as an oversight committee. So all parties, in my view, both regulators, certainly the 10 firms involved in the settlement may want to put this chapter and ugly history behind them, and I would understand that.

However, I believe that this hearing and the testimony that we receive today is merely the start—or I hope it is, anyway—of renewed vigilance in restoring the trust that the American people have lost in the securities industry.

We should expect more from the leaders of the financial services industry. Investors certainly deserve a lot more, and the future success of our economy will depend upon it in many, many ways.

There has been much written and said about the conduct of the 10 firms who are the subject of this investigation. And while some practices may only skirt and not overtly violate securities laws, they are nevertheless fundamentally dishonest. And I, like many others, are surprised that the pervasive misconduct has yielded only a few individuals being barred from the industry.

I am hopeful that the ongoing investigations will lead to the appropriate prosecution of bad actors. Certainly removing the most egregious violators in this area is just part of the answer. We must fundamentally evaluate as well and change standards and change the codes of conduct acceptable in this industry.

In truth, this settlement may raise nearly as many questions as it answers. I certainly have concerns that the structural reforms initiated by the settlement may not go far enough. And I am concerned that the evidence of only a few clear-cut violations of our

security laws indicate that we must ask if further statutory guidance is needed to prevent against future malpractice of this kind.

Amazingly, some have tried to characterize this issue as the simple result of unhappy retail investors who have lost money in the downturn in the markets. It is my fervent hope that those in industry truly understand the depth of mistrust that their actions have caused.

This Congress and the regulators who appear before us today must be prepared, in my view, to ensure that understanding. It is during times of down markets when investors most need the protections afforded by our securities laws and regulations.

This is fundamentally why the world comes to our U.S. markets to invest—the belief that in good times or in bad, the process in the United States is fair and it is transparent.

More than ever, investors have a greater mistrust and insecurity about the advice provided to them by financial experts.

I do not blame them. Collectively, we have a difficult road before us in restoring the integrity of the marketplace. And this global settlement is the first step in that journey.

So, again, Mr. Chairman, I thank you and Senator Sarbanes for having the hearing.

Chairman SHELBY. Thank you.

Senator Chafee.

COMMENT OF SENATOR LINCOLN D. CHAFEE

Senator CHAFEE. Pass. Thank you, Mr. Chairman.

Chairman SHELBY. Chairman Donaldson, we welcome you again to the Committee. We appreciate your indulgence, but we believe that this, as has been said, is a very important oversight hearing.

Your written statement will be made a part of the record in its entirety. You can proceed as you wish.

STATEMENT OF WILLIAM H. DONALDSON
CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, thank you for inviting me to testify today concerning the recently announced global research analyst settlement among the Commission, the New York Stock Exchange, the NASD, the New York Attorney General, other State regulators, and 10 Wall Street firms. I appreciate having the opportunity to discuss this important subject with you.

Last weeks' unified actions brought to a close a period during which the once-respected research profession became nearly unrecognizable to earlier generations of investors and analysts.

As many of you may know, I helped found an investment firm that bore my name and which was originally dedicated to research. For that reason, I spoke very personally when I said last week, and I will say again today, that I am profoundly saddened and angry about the conduct that is alleged in the Commission's complaints.

There is absolutely no place for it in our markets, and it cannot be tolerated.

To impress upon the firms the seriousness with which we regard their misconduct and to help restore investors' faith in the objec-

tivity of research, the global settlement employs a multipronged approach, including both monetary and nonmonetary forms of relief.

The monetary relief is substantial, totalling, as you know, $1.4 billion. Collectively, the 10 firms will disgorge illegal proceeds of nearly $400 million and pay well in excess of $400 million in civil penalties.

I am pleased to note that the penalties alone are among the largest ever obtained in civil enforcement actions under the securities laws. The $150 million penalty imposed against one firm is the largest ever imposed in an SEC action.

I am confident this enforcement action delivers a message that the firms won't soon forget. Moreover, the Commission is continuing to investigate roles played by individual security analysts and their supervisors.

The Federal regulators—the Commission, the NASD, and the New York Stock Exchange—will place their share of the penalties and disgorgement, approximately $400 million, into a Distribution Fund for payment to harmed investors.

While there are challenges and difficulties in administering such a fund, the Commission feels strongly that those challenges and difficulties are worth taking on and that any funds paid by the settling firms should be used to compensate the investors harmed most directly by the misconduct uncovered in our investigations.

We believe this is the right thing to do, and it is consistent with the message sent by Congress when it recently authorized us to use penalties to repay investors.

Although the monetary relief secured in the settlement is substantial, unfortunately, as many of you have noted, the losses that investors suffered in the aftermath of the market bubble that burst far exceeds the ability to compensate them fully. They can never be fully repaid. Their loss was more than monetary, in my view. It is a loss in confidence and the loss of the hopes and the dreams that built up over a lifetime.

And, although the monetary relief obtained in the settlement is record-breaking, the structural reforms required by the settlement are, in my view, more significant and far-reaching.

The numerous obligations we impose on the defendants, taken altogether, will fundamentally change the role and perception of research at Wall Street's firms. Indeed, I believe these reforms will go a long way toward restoring the honorable legacy of the research profession.

Let me just take a moment to highlight a few of the most meaningful among them.

In order to eliminate the conflicts that arise when the banking function has the opportunity or means to influence the objectivity of research analysts, the settlement first requires firms to have separate reporting and supervisory structures for their research and banking operations.

Second, it requires that research analysts' compensation be totally unrelated to the investment banking business, and instead, be tied to the quality and accuracy of this research.

Third, it prohibits investment banking personnel from evaluating the performance of research analysts and requires decisions con-

cerning compensation of analysts to be documented and reviewed by an independent committee within the firm.

Fourth, it prohibits research analysts from soliciting investment banking business or participating in so-called road shows.

And, fifth, it prohibits communications between firms' research and banking operations, except as necessary for an analyst to advise the firm concerning the viability of a proposed transaction.

The settlement also imposes several disclosure requirements that will benefit investors by providing them with better information concerning the limitations of research. An additional innovative and forward-looking aspect to the agreement is the requirement that firms purchase independent, third-party research for their customers over the next 5 years.

Each firm must retain an independent research monitor, in consultation with the regulators, who will oversee this process to ensure the research is independent, of high quality, and useful to the firm's various customer bases.

To better arm investors to cope with the risks inevitably associated with participating in the capital markets, the settlement also provides for the establishment of an investor education fund of some $80 million.

The Federal portion of this fund will support educational efforts addressed to a broad range of issues associated with informed investing.

The research analyst cases reflect a sad chapter in the history of American business, a chapter in which those who reaped enormous benefits based on the trust of investors profoundly betrayed that trust.

They also are an important milestone in our ongoing effort to address these past abuses and to shore up investor confidence and public trust by making sure that these abuses do not happen again.

I cannot close without noting, however, that as significant as the global settlement is, it is but one of a broad range of activities and initiatives that the Commission is undertaking to restore investors' faith in the fairness of the markets.

We are starting to see a positive change in conduct and in attitude because of these efforts. Auditors, board members, corporate officers, and others are bringing a greater diligence and sensitivity to tasks that were previously treated as routine or insignificant.

Nevertheless, recent remarks by some business leaders and a proxy season of disclosures of compensation packages that bear little relationship to managerial performance, lead me to worry that some, as you said, Senator, just do not get it.

While I certainly hope and think that many do get it, let me say very clearly, we are not just going to assume that Wall Street or the business community gets it.

We are going to be vigilant. We are going to be watching for compliance, not only within the terms of the settlement, but also with all statutory and legal requirements. And importantly, conformity with the spirit of the need for reform. Where somebody crosses over the line, we will act swiftly and decisively to bring that person to justice.

As we persist in our efforts to restore investor confidence, be assured that the Commission will continue to move forward on mul-

tiple fronts, to aggressively combat financial fraud, to keep a close eye on practices on Wall Street, to oversee the start-up of the Public Company Accounting Oversight Board, and to implement the Sarbanes-Oxley Act, to mention just a few of our priorities.

Thank you for inviting me to speak on behalf of the Commission, and I would be happy to answer any questions you may have.

Thank you.

Chairman SHELBY. Thank you, Chairman Donaldson.

Mr. Chairman, in the settlement papers relating to Salomon, Smith, Barney, and I use them by way of example only here, there are references to hundreds of e-mails from the Salomon retail brokers that criticize Grubman's conflict of interest.

For example, one e-mail states, "Investment banker or research analyst? He should be fired."

And another one reads, "Grubman has made a fortune for himself personally and for the investment banking division. However, his investment recommendations have impoverished the portfolio of my clients and I have had to spend endless hours with my clients discussing the losses Grubman has caused them."

These e-mails were sent to Salomon's management as part of Grubman's annual reviews. Management knew of the dilemma produced by Grubman's involvement with investment banking.

If these abuses were so widespread, as we found out, Mr. Chairman, how is it that the regulators failed to catch them until so late in the day? How could the regulators miss such a systemic problem on Wall Street?

Chairman DONALDSON. That is a good question, Senator. I think that the bottom line is that there is enough blame to go around for all of us in terms of what is happened in the last decade, and particularly the last 5 years.

I think there has been a general erosion in ethics, and I think there has been a general erosion in——

Chairman SHELBY. There might be a lot of blame to go around, but everybody wasn't cheating and stealing.

Chairman DONALDSON. Well, I do think that the detection of some of these instances could have been sooner. And I think that I am as horrified by some of the e-mails you cite.

And I can assure you that from this day forward, the vigilance of our Commission will be there in spades.

Chairman SHELBY. Mr. Chairman, as many of us noted during your confirmation hearing, you bring a great deal of experience and knowledge of the securities markets, an industry that you now oversee. I think that that is a real plus for you.

And as a veteran of Wall Street, you built your own firm on the strength of its research. What can you tell us about the conduct sanctioned in this settlement? Do you really think that this type of behavior was a common practice? How long has this conduct been going on, in your own judgment?

I know too long.

Chairman DONALDSON. Too long is the simple answer. But I think that if you want to trace the history, I think that with the elimination of fixed minimum commissions back in 1975——

Chairman SHELBY. Is that the beginning?

Chairman DONALDSON. —the wherewithal to pay for research was substantially reduced. Research departments turned to become the handmaiden of the investment banking business.

So the beginnings of this go way, way——

Chairman SHELBY. That is the roots.

Chairman DONALDSON. I think that is the root cause. As time went on, the actual payments, if you will, for the research department becoming the handmaiden of the investment banking side of the business were considerable.

Chairman SHELBY. How can the SEC under your jurisdiction and your leadership change the examination and compliance programs in order to discover and to investigate these types of securities law violations in the future?

Chairman DONALDSON. Well, in terms of the global settlement, you can be sure that we will be monitoring according to the terms of the settlement the various devices that have been installed to separate research from the investment banking business.

My own feeling is, if I can editorialize a bit——

Chairman SHELBY. Sure.

Chairman DONALDSON. —that the quality of research, aside from the malfeasance inherent in those cables, the quality of research deteriorated over the years because it really wasn't research, as many know it. It was statistical reporting and cheerleading.

My hope is that with the research monies being put into the outside independent fund, and the return of, hopefully, research to its roots, we will see research that is really worth something.

Chairman SHELBY. Mr. Chairman, the monetary sanctions here equal a fraction, just a fraction, of the vast sums that investment banking firms generated during the late 1990's.

In light of the relatively small monetary penalties, small considering the profits, do you believe that the settlement truly punishes Wall Street for its wrongdoing?

I know it punishes it some. But Senator Dodd raised the question earlier, who's going to pay for this settlement? Is it going to be punishment or are they going to be compensated for it through insurance? Is some of it going to be deductible and so forth?

I think it was a very good observation.

Chairman DONALDSON. I think the sentiment you are expressing is on a number of people's minds. Let me give you my reaction.

Number one, I think that you cannot dismiss the fact that these are the largest fines that have ever been given.

Number two is that this is not the end. This is just the beginning. We have come against these firms and in two instances, against specific analysts. But very much on our agenda is the whole area of supervisory responsibility. And we intend to pursue that as the days and months go on.

Number three is there is considerable civil liability out there in terms of the courts and the people who have been wronged and their access to arbitration and so forth.

I suspect that you will see—this is not a prediction —but I suspect that you will see sums of money that will be attributed to this that perhaps exceed the penalties being paid.

And finally, in my view, not least, the cost in reputation that these acts have brought forth is incalculable in terms of the dam-

age done to these institutions and the years and monies that were spent to establish their reputations.

I think that is maybe the greatest cost to some of these firms.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Chairman Shelby.

Chairman Donaldson, I was struck by the phrase you just used in responding to Chairman Shelby when you said, "This is not the end, this is just the beginning," describing the settlement and so forth. I think it is extremely important that that be understood. This is in a sense a very large first step along the way of getting to where we have to go, and I wanted to ask you about just a couple of aspects of that.

First of all, the SEC, of course, is involved in putting into place a regulatory structure now that responds to the situation with which we are confronted.

You have issued a number of rules. The self-regulatory organizations are addressing the problem. Actually, the Sarbanes-Oxley Act requires that by July 30 of this year, regulations be promulgated with respect to stock analysts and their conflicts.

What is the Commission's thinking as it moves ahead in terms of harmonizing and rationalizing a comprehensive set of rules that apply in this area, which of course is, in a sense, almost the foremost responsibility of the Commission?

Chairman DONALDSON. Right. I would say two things, Senator.

Number one is that we are very much in the process of gearing up, if you will, to review the rules and the regulations already on the books, gearing up to take a look at what new rules have to be written.

I think the issue is one of where those rules reside, for example, we also have the self-regulatory rules that we oversee and the disposition of those rules as between the self-regulatory organizations and ourselves is very much on our minds.

And two, we will obviously conform to the requirements of the Sarbanes-Oxley Act. But we are clearly in for a rulemaking review looking at the settlement and based on the experience we have going forward.

Senator SARBANES. I urge the Commission to go forward. I know in your statement that accompanied the global settlement, and you said, "The Commission intends to review the implementation of the settlements, along with reforms adopted by the Commission and the NASD and New York Stock Exchange over the last 2 years to evaluate whether additional harmonizing or superceding rules are appropriate." We need to get a full comprehensive set of national rules that then become the reference point for people that are in the industry, and I urge you on in that effort.

Let me ask, coming down to the individual level, *Business Week,* on May 12, in an editorial stated, "Many who failed at this task of supervising fairly and properly were not held accountable in the settlement and remain in charge. It is now up to the SEC to follow up and ensure that Wall Street is led by people with integrity."

This is in an editoral titled, "Sweeping Up The Street."

Where are we on that issue about addressing further individuals for their conduct and holding them responsible?

Chairman DONALDSON. Well, as I said, the central thrust of the settlement was on malfeasance by the firms themselves. The ongoing actions by the SEC will be directed toward the supervisory chain of command, if you will, and by the individual malfeasors.

We have new resources thanks to all of you in terms of our additions of people and systems so that we can double our efforts, if you will, and we plan to do just that.

We will have more aggressive examinations than we have ever had. We will have continuing reviews of compliance. I think it is important to just note that we must see some of these rules in action, if you will. I think we have to be careful that we do not write rules prematurely. I think we have to see where they are working and where they are not.

But it is on our agenda.

Senator SARBANES. Over the past few years, there have been a number of cases where firms or individuals have been charged with obstruction of justice for destroying or altering evidence relating to a Government investigation. Arthur Andersen is one obvious example where a jury convicted Andersen of obstruction for shredding work papers and other documents.

As recently as April 23, a former investment banker, Frank Quattrone of Credit Suisse First Boston, was arrested and charged with obstruction of justice for reportedly telling colleagues to, "clean up," their files, despite knowing some of those documents were being sought by subpoenas or document requests from three different regulators.

Do you think that investment banking and accounting firms have gotten the message that destroying or altering evidence related to a Government investigation will not be tolerated? And do you intend to, and are you, vigorously prosecuting all cases where these issues arise?

It is fundamental that destroying evidence is a very serious matter and opens you up to serious charges. And yet, we have these instances where these high flyers making huge amounts of money, holding very responsible positions, are engaged in these practices.

Chairman DONALDSON. I think I would make just some comments on that.

We have civil enforcement capabilities, if you will. The Justice Department has criminal enforcement mandates. We work closely with the Justice Department. There are no secrets between us and the Justice Department where instances such as you cite are brought our attention. And the particular instance that you mentioned is one in which the Justice Department has moved on it.

Senator SARBANES. Well, you would agree, though, that destroying or altering evidence related to a Government investigation simply cannot be tolerated.

Chairman DONALDSON. Absolutely.

Senator SARBANES. Yes.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I want to go back to the issue that I raised in my opening statement and to which Senator Dodd also referred. And while I would

be interested historically in any kind of analysis anybody should make, I think it would be more valuable if we talked prospectively.

It is my conviction and experience that the market always gets it right. That is, the market evaluates what a company is worth. But it doesn't always get it right on time.

There can be times when it has the company vastly overpriced or vastly underpriced, and those are equally misleading. But over time, ultimately, it all shakes out and the market, whether it is the Dow or the Nasdaq or whatever, ultimately puts a fair market cap on what the company is really worth.

The problem is, of course, finding that point in time when the market has come there and not the premature time when it is overpriced or underpriced.

And what we are talking about here is the degree to which analysts have distorted that market function and caused a stock, we think, to be primarily overpriced. But it may be that current analysts are causing stocks or the appropriate market caps to be underpriced.

Is there any kind of device whereby an analyst can be tested and those test results published against any kind of measure? Or is this thing so subjective that it becomes impossible to say, well, this fellow is right most of the time?

Warren Buffet has achieved a mythic reputation of being right. And yet, you read his extremely well written reports to his shareholders and they are filled with mea culpas where he admits to being spectacularly wrong a number of times in a number of areas.

And his willingness to admit how often he is wrong frankly adds to the aura of inevitability of his being right because he gives us an honest evaluation of what he does.

I know of no way of knowing, and it may just be my ignorance, of the track record of any of these analysts. I cannot look up in a directory somewhere and say, well, Grubman was right this many times or he hit it properly that many times.

I do know, strictly anecdotal, of one analyst in a particular industry who was consistently wrong. And I wondered why her firm did not fire her because I was following a stock and following her reports on the stock, and I knew enough about the company to know that she did not get it.

Ultimately, the company's stock did go to where it belonged and she was in fact fired because she was perpetually optimistic that they finally turned the corner, they were finally going to do it. Then the firm filed for bankruptcy, and she lost her job.

As I say, I want to focus forward here because enough of my colleagues are focusing on the past and what has been done, and I share their outrage. I do not want anybody to think I am giving anybody a pass on this.

But to be as useful as possible for the future, can you respond to this plea about some measure, some track record, some way of monitoring where we go in the future with analysts?

Mr. Levitt, your predecessor, says in this morning's *Wall Street Journal*, that it doesn't really matter in a bear market because the bear market squeezes all of the excesses out. But, hopefully, in my words, we are on the threshold of a bull market.

We have had it with this bear. He's been around for more years than bears usually stay. Is it in fact that when we get back into a bull market, we are going to have no way of knowing who's being correct and who's not being correct?

Chairman DONALDSON. Senator, you ask a number of very interesting and provocative questions.

First, I would start by saying that the boom/bust, the overvaluation, the undervaluation is the nature of the beast. There is also a psychological and an emotional factor to the marketplace, and I think that is always going to be there, the swings up and swings down.

Second, I would say that we throw this word "analyst" around too loosely.

I believe that the type of work that has been done in the recent years is much more statistical reporting than it is true analysis.

I believe that true analysis is a lot closer to what a quality management consulting firm would do in terms of the long-term appraisal of the way a company is organized and so forth, much closer to that than the game that has been played for the last couple of years as to what the earnings are going to be the next quarter. Are they going to be up two pennies or down two pennies?

Third, I would say that, as a part of our settlement, there is now a new requirement for transparency and a valuation of what you are talking about within the firms. That is part of the settlement.

And then, fourth, I think that you are going to see an increased attention by the world out there, the business world, to rank analysts, independent rankings and independent followings.

Some of that has gone on in the past. I think there is going to be more attention to the educational qualifications of the people who are doing the work. They may have the chartered financial analyst designation which came in and assures a minimal level of professional competency.

I think that the bottom line, though, of your question is the stock market just a game, just a casino, or is there some fundamental value take-off point?

And there is.

Senator BENNETT. I would quickly—my time is gone—but I would quickly agree with that. I believe that the stock market does in fact, as I said in my opening comment, reflect real value.

Chairman DONALDSON. Yes, and it will centralize and adjust around, let's say, the values inherent in a risk-free investment like a short-term government bond. And then the discount rate of earnings will take off from that.

But the analytical business is not an easy business. It is an art. It is not a science. If it weren't, there would be an awful lot of very wealthy analysts around, legitimately wealthy, if you could be perfect every time.

Senator BENNETT. Thank you.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Let me begin by saying that I want to identify with the remarks that Chairman Donaldson is off to an extraordinary start. This process in selecting a new Accounting Oversight Board Chairman, both transparent and I think the conclusion, quite effective.

I feel that the testimony here today is reflective of the thoughtfulness which you bring to this effort. Now that you have the resources at the SEC, or at least significant enhanced resources, maybe some of the checks and balances that were expected will be able to be executed on an effective basis.

I want to focus on an issue of restitution. The issue, I think many people would say $1.4 billion is a lot of money and some people would say it is not enough in this instance. But I think that many would believe that the fund set up for restitution looks thin relative to the overall losses.

The first question is, was there a presumption built into this global settlement that the arbitration and court processes would perform much of that role as we go forward. That is a macroquestion. And then I have serious issues or concerns about moving forward, which I have worked with Mr. Glauber at NASD and others on, and spoken about the arbitration process and making sure that it is a fair, efficient, and effective system.

I suspect that the system is about to get into massive overload as we go forward. And therefore, needs to be attended to, that it is a fair and effective way to get to the judgments of restitution.

My second question, are you satisfied and think that the kinds of steps that the NASD board is taking with regard to dealing with public arbitrators and their independence in that process, is appropriate? Do you think we have gone far enough? Are there other things that we should be accomplishing?

I know that there has been improvement in the actual pay-outs and settlements, but it is still not everywhere anyone would want.

Are you reviewing the arbitration process consistent with what is going on in NASD?

The third question is, are you confident that, and do you understand it the way I think I do, that people can pursue arbitration outside of the restitution fund at the same time, or even legal processes for restitution, at the same time that they are applying to the fund?

And fourth and finally, maybe most importantly, how do you feel about mandatory arbitration as a part of how you sign up to do business with a broker-dealer?

Chairman DONALDSON. Well, to answer your first question, as to the size of the settlement and the adequacy or inadequacy of the monetary penalties.

I think when you step back from it and again, I was not in on the original settlement. But we have examined the processes that led us to where we are.

In the final analysis, it is a negotiation. The penalties and the size of the penalties depend upon the egregiousness of the offense. The threat is that if you do not reach an agreement, that the whole thing gets thrown into court. And thrown into court means 3, 4, or 5 years before remedies are arrived at.

So constantly, there is the thought that we have to have a settlement here. It is a reasonable settlement, one probably that dissatisfies both sides.

We maybe wanted to get more money and the firms wanted to pay less. But the overwhelming desire is to get the settlement so that we can move forward with the reform.

As far as a number of your questions on arbitration, yes, I believe that in the minds of our enforcement division and in the minds of the others who worked on this settlement, and I think the Attorney General has spoken to this point, there is a lot of information that has been released purposely by all of us that's out there. And there are mechanisms of which arbitration is a principal one, where recovery can be achieved in a court system. My suspicion is that a lot of people will go after that and do it.

And as far as the arbitration process itself, I believe it is a good process. I believe it is a fair process. I believe that the statistics show that there is not a bias one way or the other.

Although it is managed by the industry itself, the results are not skewed one way or another. It is managed by professional arbitrators who know the business and know the issues and so forth.

Senator CORZINE. A number of the arbitrators, though, are sometimes presumed to have had either economic relationships or other relationships with some of the parties, which I think is one of the big concerns for public confidence.

Chairman DONALDSON. Yes. I think that is a critique that has been made.

I think about the benefits of the arbitration system, that the people who are running the arbitrations understand the business. They are not in a courtroom where there is lack of experience. They have processed hundreds and hundreds of these cases.

I am still a great believer in the arbitration system. There has been some criticism for arbitration payments that have not been made. They have been awarded, but have not been made.

But it is important to recognize that the consequences for nonpayment in arbitration is expulsion from membership. And many of the judgments that have not been made had been by firms that went belly up.

Those statistics are a little misleading. But I think the arbitration system works well. I think there is going to be a large new caseload coming out of this settlement, and well there should be.

Senator CORZINE. The mandatory piece, mandatory arbitration.

Chairman DONALDSON. Well, until someone can convince me that there is something wrong with mandatory arbitration, I guess I still think it is the way to go. But I have an open mind on that.

I haven't thought to date that the elimination of the mandatory aspect of it was the way to go.

Senator CORZINE. I would only suggest again, as you well can understand in a practical context, this arbitration process is going to be very much one of those areas where the public is going to look for the fairness that will be tied to whether there is a restoration of public confidence in the process.

If it is not one that is both transparent and fair-minded, for those that participate, then they feel like that the process doesn't come out in aggregate with a fair response to investors' complaints.

I think we will not have had all of the benefits that were intended by the efforts of global settlement.

Chairman DONALDSON. Well, I think you make a good point.

Chairman SHELBY. Thank you, Senator.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

Chairman Donaldson, I appreciate your testimony and the additional information provided in the longer statement.

There are some more specific questions. I think the global settlement requires firms to post the results of the analysts' research on the firm's web site. Since the settlement doesn't mandate the specific criteria to evaluate the analysts' research, how do you believe that the firms will conduct these evaluations?

Do you think the evaluations will cut across industries or differ from firm to firm?

Chairman DONALDSON. Well, I think that the way the analysts are analyzed, if you will, and reported upon probably will take a number of different forms.

I suspect that good business practices will develop in certain firms where there will be a real effort to get at that evaluation a lot of different ways.

I think the free market will work there. I think a phony evaluation, in an attempt to buffer bad performance, I think that that will show through. But only time will tell how effective it is.

Senator ENZI. So you do not anticipate at this point in time any more specificity on how that report——

Chairman DONALDSON. Well, it is something new, and a new approach. And we have set it up so that there is an independence to that appraisal.

We have an oversight responsibility ourselves to look at how it is done, to make sure that it is done. And we will step in if we do not think that it is being done correctly.

Senator ENZI. Do you see any legislative changes that are necessary to implement the global settlement? And do you think the legislation will be necessary once the 5-year period on independent research has expired?

Chairman DONALDSON. I do not see the need for legislative action now. I think we need to see how the settlement plays out.

And I think that I would say to you unequivocally that we will be back to you all if we think that we see a need for legislation. I do not think we see it right now.

Senator ENZI. How has the coordination effort between the SEC and the SRO's progressed with respect to the stock research rules that are promulgated?

Chairman DONALDSON. I think we have had outstanding relationships with the SRO's. I think that our oversight responsibility is being met with a responsibility on the other side.

I think that the self-regulatory concept, even though it is under a little bit of fire right now, is still a pretty sound concept. We have had excellent cooperation with the organizations that we oversee.

Senator ENZI. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Thank you, Chairman Donaldson, for your work.

And let me also join with those who commend you for the good start you have had at the SEC, and those on your staff. You have an awful lot on your plate.

Even though you are getting additional resources and I know you are trying to staff up, there is an awful lot going on that you have to grapple with.

We have to show some patience in your ability to sort all of this out and get moving. So I appreciate that.

And let me add, too, Senator Corzine said something and I think it was important to state, because in my opening comments and those that others have made here, there are an awful lot of people who work in this industry who do a very fine job every single day.

I think part of what we are trying to say here is the message that we are sending to that younger generation of people who are choosing this as a profession and a career coming in.

I think you made the excellent point about lost reputation, trying to put a valuation on that is almost impossible. It may vastly exceed anything we have come up with or you have come up with. Those who reach this global settlement have been able to attribute a value to.

It would be unfair if we did not make that point, all of us here today. And I know that you have similar views, having worked in the industry for so many years, the literally hundreds of people that you have met who do a very good job all the time.

I want to come back to the settlement itself. I want to ask you about this. You are familiar enough with it and I just want to break it out, just based on what I know of the $1.4 billion.

You correct me where I am wrong in this, but this is what I have been told.

Of the $1.4 billion, $487.5 million is in penalties. None of that is tax-deductible or covered by any insurance at all, as I understand it. Three hundred eighty-seven million dollars in disgorgements is likely to be tax-deductible, I am told is the case. And it is unclear whether or not with respect to insurability. And $432 million for independent research and $80 million for investor education. Unclear as to both tax deductibility and insurability.

So there is some vagueness in here that I would like to get sorted out. And again, I do not argue with your point. This is a big deal. And even $487 million, I guess, although if you apportion that among 10 firms, and while I know it is not done that way, you are talking a little more than $40 million. And all of a sudden, the $1.4 billion begins to shrink down, at least potentially.

So clarify if you can for me, how much of this is tax deductible, in your mind? How much is insurable? And how much are actually penalties that are not going to be able to be written off, either borne by the taxpayer or by insurance policies, which have their own economic impact in those industries.

Chairman DONALDSON. Well, I would begin by saying that the clarity runs from very clear to not so clear in terms of the tax deductibility and the insurability of these settlements.

On the very clear, we have put into the settlement a prohibition on seeking tax deductibility on the penalty side. It is clear. It is the first time that we put that into an agreement, and that is iron-clad and black and white.

Senator DODD. The $487.5 million.

Chairman DONALDSON. Yes. The penalty payments are $487 million. There is disgorgement of $387 million. Again, that's a function

of the tax laws. And there are probably arguments as to whether that, under the tax laws, can be deducted. It probably can be.

Senator DODD. Can or cannot be?

Chairman DONALDSON. It probably can be deducted.

Senator DODD. Yes.

Chairman DONALDSON. Can be deducted.

Senator DODD. Right.

Chairman DONALDSON. And I say probably because there is some legal advice and rulings out of the IRS that cloud that a bit.

I want to assure you that the other categories here, the money going into independent research and the investor education portion of this, we have called that exactly what it is.

In other words, we have not jockeyed around the definition of those payments in order to achieve particular result—we aim for truth in what we call these things.

Now, I think that on the insurance side, it becomes a little muddier. As you know, the insurance industry, and you know is particularly well with your Connecticut background——

Senator DODD. You know it pretty well, too.

[Laughter.]

Chairman DONALDSON. The insurance industry is regulated at the State level. There are all sorts of different regulations on the kinds of policies that can be written.

There are policies that have been written that insure against some kinds of fraud. And although I might, and we might, disagree with that, nonetheless, that is not in our purview, and it is not in our purview to undo legitimate contracts that have been made.

So that, as a matter of public policy, my own personal view, and not necessarily the Commission's, my own personal view is that these kinds of things shouldn't be insurable.

Senator DODD. Should not be.

Chairman DONALDSON. Should not be. But that is a complicated question. That is a simple answer to a complicated question.

And I would leave it to the insurance regulators and to, really, the Congress of the United States to decide whether they want to write some laws that override State laws.

Senator DODD. Well, I would be interested in your comments on that. I would invite you to, over the next month or so, again, having said earlier how much of a load you have got.

But I would be very interested in the SEC's analysis of that very question. And it is an obvious one that people watching this, the idea somehow that we have talked about a $1.4 billion penalty for fraudulent, illegal, highly unethical behavior.

And then to discover that, potentially, two-thirds, in fact, certainly in one area, but potentially, two-thirds of that figure, almost a billion dollars of the $1.4 billion may be tax deductible and may be insurable, which means that others are going to end up paying one way or the other for this. And that is the point that sticks in people's craw.

Chairman DONALDSON. Right. Well, we would be glad to come back to you.

Senator DODD. I wish you would on that because I would be interested in how that might work. Obviously, there are questions for Eliot and others about how you arrived at this number and the de-

bate that went on in terms of how you proportion the penalties and disgorgement and the like, which I will pursue at a later point.

Last, maybe you answered this for Senator Enzi. Did I hear you say, and I apologize if I did not pick this up when Mike asked the question. That as I understood it, most of the violations that occurred here were not violations of fraud statutes, but, rather, were of the SRO violation types, NASD and New York Stock Exchange violations.

Is that correct, what you talked about here?

Chairman DONALDSON. I am not sure of that. I am not sure what you are referring to, Senator.

Senator DODD. I am told, other than on a relatively few violations of the fraud statutes, most of the violations were of SRO regulations.

Chairman DONALDSON. Right, which are regulations that we have overseen and continue to oversee.

Senator DODD. Yes. But they come out of the SRO's. They do not come out of the SEC.

Chairman DONALDSON. Most of them come out of the SRO's.

Senator DODD. So the question is whether or not, I do not know if there is some analysis, and Mike may have asked this question and I may have missed it, whether or not you would recommend that there be some statutory response to that or some steps that we might take up here in some way to close this gap if you perceive the necessity to do so.

Chairman DONALDSON. Yes.

Senator DODD. In light of that fact.

Chairman DONALDSON. Good point. And I think that this one that is very much on our mind now as we look at—as I said earlier, we are going to review the rules. We are going to write some new rules, I suspect. And we are going to have to make the recommendation in doing that as to whether those rules are installed at the SRO level or at the Federal level.

Senator DODD. Yes.

Chairman DONALDSON. And we haven't really determined that.

Senator DODD. No. And I would like to hear back, though, if we could because it seems to me that we are talking about future steps that we may take to avoid this kind of thing.

And just, last, I would be interested in your observations as to whether or not any of the provisions of the Sarbanes-Oxley Act, do they go far enough? Do they need refinements, in your view, in light of this particular set of circumstances?

I do not know if you are prepared to answer that at this particular moment. But if you are, I would be interested in whether or not you have made any observations about that. And if not, then we can certainly receive your answer at a later point.

Chairman DONALDSON. As to the efficacy of Sarbanes-Oxley?

Senator DODD. To the extent whether or not, in analyzing this particular situation, looking back at Sarbanes-Oxley, are there any areas where you think we could, where that Act needs to be tinkered with in any way to address this particular situation.

Chairman DONALDSON. I think we have most of the authority that we need to do the job we have been given.

And I would like to again reserve the right to reverse myself as things play out.

Senator DODD. I understand that. Thank you. And I thank you, Mr. Chairman. I took a little more time and I apologize.

I apologize to my colleague from Idaho.

Chairman SHELBY. Thank you.

Senator Crapo.

Senator CRAPO. Thank you.

Thank you, Mr. Chairman. I appreciated Senator Dodd's line of questioning. It is generally the line I wanted to pursue.

I realize that we are running very late in this hearing and we have another panel coming, but I did have a couple of questions I wanted to pursue in that line.

First of all, I understand that the analysts now are not going to be allowed to attend pitch sessions where the transactions are being pitched on road shows and the like.

I understand that the analysts' compensation is not going to be allowed to be connected to the profitability of the offerings of the investment side of the operations.

One question I have is, under the settlement agreement, and you may have gone through this, I apologize if I missed it. Who makes the decision in terms of whether to initiate research coverage on a matter? Is the analyst allowed complete freedom to do that?

Chairman DONALDSON. Well, what an analyst is going to cover, essentially, under the new scheme—and theoretically, under the old scheme, but it broke down—is the responsibility of the research department and the supervisory authority there.

That has to do with a judgment on what industry you want to cover and what analytical capabilities you want to build into your organization. But the responsibility for the analyst's work and assignment and so forth belongs in the research department, which is separate.

Now the one exception to that in our rules is that the analyst will be allowed to talk to the investment bankers about the quality of the proposed offering.

In other words, they will be allowed to consult with the investment bankers as they try to make a determination of whether they want to underwrite something.

What they won't be allowed to do is then to become a road show participant and write analytical work and so forth.

Senator CRAPO. Are the analysts going to be allowed to share their ratings and research reports with the investment bankers and issuers prior to the issuance?

Chairman DONALDSON. Absolutely not. There should be no communication and no connection, if you will, with the underwriting function and the research function.

Senator CRAPO. All right. And there is a lot more we could go through in that regard, but as we look at this entire picture, the settlement agreement only relates or only binds the firms and individuals who were part of the settlement.

Correct.

Chairman DONALDSON. At present, that is correct.

Senator CRAPO. And this gets into the area I think that Senator Dodd and several others were getting at. We want to see the consumer confidence in the entire industry following these things.

And the question comes down to, where are we going to go next from the settlement to making certain that we have the proper statutory, regulatory, and self-governing procedures and requirements in place?

Chairman DONALDSON. We have a job ahead of us in terms of formalizing the rules so that they extend to those that were not covered in the settlement, and we will be doing that.

In the interim, there is going to be a gap in time as we move to do that. And I guess my answer to that would be that, if I were running an investment banking firm today, I would be very aware of the terms of the settlement, and I would be very careful.

Senator CRAPO. I can assume that those who are not part of the settlement are paying very close attention to it.

Chairman DONALDSON. I would assume so.

Senator CRAPO. I know you have answered this question at least twice that I have heard, and so I won't ask you to answer it again. But it is my understanding that you believe that you currently have the authority at the SEC to make the necessary regulatory changes, whether they be at the regulatory level or at the self-governing level.

Chairman DONALDSON. Yes.

Senator CRAPO. And I am sure that this happens. And you will come to us if you feel that you need further authority.

Chairman DONALDSON. Absolutely.

Senator CRAPO. Mr. Chairman, I have a lot of other questions, but I believe that I will hold back. I am interested in the next panel as well, so I will finish at this point.

Thank you.

Chairman SHELBY. Thank you.

Senator Schumer.

Senator SCHUMER. Thank you. And thank you, Mr. Chairman for holding this timely hearing. I want to thank our witness. I want to thank Mr. Donaldson, and the SEC, for doing an excellent job.

We are glad you are there. I know it is a big, big job, particularly now, but I am glad you are there.

I want to praise our New York State Attorney General, Eliot Spitzer, who we will hear from on the next panel, who has really done an incredibly good job here, not only in this area, but in many areas. We just had a great settlement on electricity as well.

As well as our many New Yorkers here. We have, I see, the head of the New York Stock Exchange, Dick Grasso, Mr. Glauber, the head of NASD.

So, welcome. This is a New York industry and we have a lot of fine New Yorkers here.

Senator SARBANES. We thought it was a national industry that was just headquartered in New York.

[Laughter.]

Senator SCHUMER. That is true, Mr. Chairman. Becoming more so, I regret to say.

In any case, I have a couple of questions, Mr. Chairman and I thank you.

The first, as you know, and we talked about this once before—and I just want to say, I think the settlement was an excellent settlement. It sends a message to the investing public that their interests are going to be safeguarded and that markets can be trusted.

And we always have cycles in capitalism. And we had the 1990's, and they were a go-go-go time. There are always readjustments.

And what is happened, I guess, in the last hundred years is that Government has modulated the booms and busts some, and that is good. People are hurt less. That is why we need Government regulation. But at the same time, we cannot eliminate them.

So we go through cycles here. And I guess my question is related to some of those cycles. But first, I want to say that I think the settlement is excellent. I think that wrong-doers have to continue to be punished. I think that the best thing our markets have going for us is the faith that the rest of the world and the rest of the country has in them, and every so often, we have to polish them up and make that faith shine once again.

And you are in the process of doing it, as has Attorney General Spitzer and the others who have been involved.

But let me ask you about these cycles because sometimes the pendulum goes one way and sometimes it goes the other way. So, I want to ask you your opinion on three questions.

First, on the fractionalization of the markets, the balkanization of the markets.

I have worried, and we have talked about this before, that if we do not have one national regulator, it is very, very difficult to do any kind of financial services business.

In fact, I have been working on legislation that would create one national insurance regulator, which the State insurance regulators do not like, but that is where the business is heading.

So given the push and pull here, do you think the settlement has put aside any worries that we might have about balkanization of the markets, that there would be too many different founts and places of regulation, both between the national government and the States and among the national regulators?

Chairman DONALDSON. Well, I think that we have had amazing cooperation between the regulators at both the Federal and the State level.

I was going to say, and I will say now in answer to your question, although I am the mouthpiece here, there are people sitting behind me who were into this thing from the beginning, including, but not limited to, the NASD, the New York Stock Exchange, and the Attorney General from New York. And I think the cooperation has been terrific. They have done a great job.

And I think that, as far as the issue of balkanization, on the one hand, we need all the help we can get. We are working with the Department of Justice, we are working with State regulators. We need all the help we can get in terms of running down crime.

Having said that, I think that once the crime is run down, the solutions must fit into a national pattern. Here I think we need Federal regulation of the markets.

Senator SCHUMER. Okay. The second also relates to the idea of do not throw out the baby with the bath water kind of thing.

Senator Corzine mentioned, and I want to second that, that the vast majority—and he knows them better than I do—of the people who work on Wall Street are hard-working people, honest people, and do a great national service in creating great capital markets to allocate capital fairly. And yet, of course, we have to go after wrong-doers.

At the same time, as we go after wrong-doers, we do not want the investing public, in terms of investor confidence, to have the impression that everything that goes on on Wall Street is bad, that these are the bad apples of the bunch and not the whole bunch.

And so, given that, given the fact that we have lost hundreds of thousands of jobs in New York and then around the country in terms of financial service industries, given the fact that we always worry about competition from overseas markets, and there is always a careful balance between regulation and keeping the markets here, how would you deal with those types of issues?

And one other related issue. We want to see our markets stay entrepreneurial and vigorous. We want people to take risks and we want people to push the envelope and do new kinds of things.

How do you prevent the pendulum from swinging too far over where, instead of just going after the wrong-doers, we tar a lot of people who are doing the right thing and hurt our markets, employment, as well as the capital formation with investors here in America and around the world?

Chairman DONALDSON. Right. Well, you bring up a very interesting point. I think that the trick here is that we regulate to the point where we get at the wrong-doers, but we have to be very careful that we do not regulate to the point where we inhibit free enterprise and the entrepreneurial nature of this country. I think this is a delicate balance. It is one that we are very conscious of.

I will steal a phrase from Bill McDonough at a press conference he had, Bill McDonough, who is heading up the PCAOB. Somebody asked him, how will you measure whether you have done a good job or not at the end of the day? And he said, I will measure that by, at that point where college graduates all over the country want to go into the accounting business again.

I thought that was a pretty good answer, and I am going to paraphrase that and say that I think we will be doing a good job when people are once again proud of being part of this industry and want to get into it. That will signify that we have hit the right balance, I believe.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, is the SEC looking at other potential areas where conflicts could result in abuses, such as tying of financial services? And if not, why not?

Chairman DONALDSON. Yes. We are obviously aware of the potential for conflict in a number of different areas. We are about to have a major look at hedge funds, and in 2 weeks time, we have a major undertaking here where there could be potential——

Chairman SHELBY. And all forms of tying.

Chairman DONALDSON. Every place where the rubber hits the road in terms of conflict, we are looking at in.

Chairman SHELBY. Mr. Chairman, this global settlement that we are talking about here, this is a civil settlement.

Is that correct? It is a civil settlement. Civil. It is civil in nature. Is that correct?

Chairman DONALDSON. Yes.

Chairman SHELBY. Okay. Does this settlement in any way preclude future criminal investigations, prosecutions, should the Justice Department, or even the State, if there are State laws broken, find that the evidence or the facts lead you to such action on the merits?

In other words, people haven't been paying this fine and paying this settlement to preclude any future criminal investigations and/or prosecutions should the evidence merits that, as goes on, because you do not know what will come out in the future.

Chairman DONALDSON. Right.

Chairman SHELBY. You may have a lot of information, but you may not have it all yet, as you well know.

Chairman DONALDSON. Right.

Chairman SHELBY. Go ahead, sir.

Chairman DONALDSON. I do not believe it does prevent us from the kind of action. When I say us, I mean the Federal Government.

Chairman SHELBY. The Federal Government. Or the State.

Chairman DONALDSON. State. Justice. I am hoping at the next panel, you will talk to them.

Chairman SHELBY. We will ask that question later, too.

Chairman DONALDSON. Enforcement Director Cutler has assured me that it doesn't preclude it in any way.

Chairman SHELBY. Absolutely. I think that is an important point because if there is further investigation or further revelations, which there will be, of wrong-doing, of criminal conduct, those people should be prosecuted, whoever they are, wherever they sit.

Is that correct?

Chairman DONALDSON. Absolutely. We are totally free to do that.

Chairman SHELBY. Senator Sarbanes, do you have any other questions?

Senator SARBANES. Mr. Chairman, I will be very brief because I know we have the other panel that has been waiting quite a while.

I just wanted to make two observations.

First of all, Chairman Donaldson, this was not on your watch, but I think it is clear that there was a vacuum in addressing important issues, and Attorney General Spitzer of the State of New York and his associates in other States moved into that vacuum.

My own view is I do not think you ever would have had a settlement and we wouldn't be reviewing it here today if they had not become involved. And I think that that only underscores the point you made about you need all the help you can get. I think was the phrase you used.

We have traditionally been able to work with a cooperative system of Federal and State in addressing securities matters, recognizing, of course, the SEC's national role.

I see no reason why we cannot continue along that course, which I think, by and large, has served us well in the past.

There are some now who want to change that in a rather dramatic way. I see going around and trying to come through the back door, not being able now to get through the front door.

Chairman SHELBY. Or side doors.

Senator SARBANES. Side door, whatever, yes. We are going to be very alert to that, I think.

Chairman SHELBY. That is right.

Senator SARBANES. And I just wanted to make that point.

The other point I want to make as you depart, Senator Leahy and I have written to you about a provision that is in the bankruptcy proposal that is pending in the Congress, which would delete investment banks from the exclusion of being able to be bankruptcy trustees.

Since 1938, they have been considered not to be disinterested parties. If you were the investment banker for a firm that then went into bankruptcy, particularly in a reasonable period of time before that happened, you could not then be a trustee in bankruptcy because, obviously, there is a provision now in this legislation that somehow has entered in there quietly, as it were, which would remove this, and we are very much concerned about that.

The Dean of the University of Houston Law Center has written in opposition to this provision and made the following point. I would just quote her very quickly.

> One of the duties of the debtor in a bankruptcy case is to take a good hard look at the repetition behavior of those who dealt with or ran the debtor to see whether that behavior contributed to the downfall of the debtor.
>
> Another one of the duties is to see how the debtor can raise new post-petition funds in order to finance an effective reorganization.
>
> Both of these duties would be compromised if the same investment bankers that were involved with the pre-petition debtor were allowed to serve as the objective post-petition investment bankers.

And we have written to you asking for the views of the SEC on that. We would be anxious to receive them.

But it seems to me that, while on the one hand, we are trying to tighten these things up and eliminate these conflicts, they are coming along on the other hand and reintroducing a rather pretty raw and bold example of a conflict.

I hope the Commission will give its close attention to this matter.

Chairman DONALDSON. I am not speaking for the Commission now. We have your letter. We have talked a lot about it. We have reached no conclusions on it.

I am not an expert on bankruptcy law. However, I will stick my neck out and say that, personally, at a time like this where investor confidence is as fragile as it is, I would want to proceed very cautiously before loosening any of the conflict of interest restrictions that we have.

Senator SARBANES. All right.

Chairman DONALDSON. And that is not to say that, over the long haul, that something might be done to modify that, to enable people who are clearly not doing business with the bankrupt company or haven't done business for a long period of time, to allow them to come in and bring that expertise in.

But right now, I think that, personally, it would be a mistake to change that law.

Senator SARBANES. Yes. And I appreciate the attitude that is reflected in that response. We need to tighten the whole system up and get it working right. Then down the road, we can look at whether adjustments need to be made.

But this effort now that is going on in some areas, to make the adjustments which move in the opposite direction from the whole thrust of tightening up the system, it seems to me, are just not going to work. And they should be laid to one side.

It goes back to the point that I made in the opening statement about whether people were really getting the message in terms of what needs to be done at this particular time.

Thank you.

Chairman SHELBY. Thank you. Chairman Donaldson, we appreciate your appearance. We also appreciate the leadership you are showing as Chairman of the SEC.

We will, as a Committee, continue to work with you and we will be vigorous.

Thank you.

Chairman DONALDSON. I look forward to it. Thank you.

Chairman SHELBY. Yes, sir. We will call up the second panel. First, we have Eliot Spitzer, the Attorney General for the State of New York; Richard Grasso, Chairman of the New York Stock Exchange; Robert Glauber, Chairman and CEO, National Association of Securities Dealers; Christine Bruenn, President, North American Securities Administrators Association.

We welcome all of you to the Committee, and we look forward to your testimony.

And we also have, Mr. Stephen Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, who will accompany and be part of this panel.

Your written testimony will be made part of the record, all of it, each one in its entirety. We know this has been a protracted hearing, but it is a very important one.

We will start with Mr. Eliot Spitzer, the Attorney General, State of New York.

Welcome, Attorney General Spitzer.

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

Mr. SPITZER. Thank you, Mr. Chairman.

Let me just begin by—I think it was Senator Bunning who began with the reference to Pink Floyd and "The Wall." I was a little surprised to hear the reference to Pink Floyd, but I think maybe he got the wrong album.

I think the right album to refer to today because it refers to where the executives and most regulators were, would be "Dark Side Of The Moon."

That is where, unfortunately, they were when all this was going on and things that should have been seen and clearly observable were not.

I was taken by your opening comments, sir, because I think it sounded precisely like the comments that I was making a year ago. I think it is wonderful that we now begin with the premise that the articulation of the problem that you began with is correct.

I would like to set this in a slightly different context, though, today. I refer to Senator Dodd's comment. He said that there is a fair amount of blame to go around.

I think we need to put this in the context of an overarching effort to deregulate the financial services industry over the last 20 years. I think we may now be paying the price for that deregulation.

I think we may now be seeing that the constant refrain from financial institutions of every sort and every stripe and not just investment banks. I guarantee you that. I guarantee you it is not just investment banks, that you can trust us. We were being waylaid and led down a garden path. And those in the halls in Congress who believed that mantra are partially to blame.

For years, when Arthur Levitt came up here and said, we have problems, he was ignored. He was defunded. He fought battles. There was push back from lobbyists who simply outgunned him. I think today we are seeing the price and we are seeing a very changed attitude in the halls of Congress. But, quite frankly, sir, it is too late. It is much too late.

You should have listened years ago when people came up here and said, there is a problem. And yet, nobody wanted to pay attention. We are now paying the price for that.

And I think that much of what we are discussing now is an effort to reconstruct something that was there in the first instance. And had we enforced the rules, had we given the SEC the power, had we done what people knew should have been done, we wouldn't be sitting here.

The single most important message for the American public and for Congress is that self-regulation failed. And I say that with due apology to those people to my left who speak for the SRO's and the self-regulators.

It was a complete, abject failure.

What went on, and that is why I referred to "The Dark Side Of The Moon." You had to be on the dark side of the moon not to see it. It was there. Journalists saw it. The investment bankers saw it.

You referred to the e-mails that were sent up the chain within some of these institutions. Those who were on the front lines dealing with the retail customer knew what was going on, and nothing happened.

And yet, in that context, we repealed those limitations, tore down those walls that might have served to protect the public and we took away the authority of the SEC.

In that context, I want to, as always, applaud Senator Sarbanes, who has been such a voice of reason on these issues, when he highlighted at this moment the effort to repeal a provision in the bankruptcy code that would once again have prevented and saved the public.

As we speak, there has been an ongoing effort to repeal a provision of law that has been in place for 70 years, for good reason—to protect the public from another conflict of interest that the industry now wants to take advantage of.

When the leadership of this industry said, trust us, we know how to mediate these conflicts, they were wrong. They were dead wrong. Unfortunately, we are all now paying the price for that, and it is something we have to understand and we need to move forward aggressively to correct.

Let me make a few more points, if I could, please.

I think that there are always cycles. And I think, as Senator Schumer from New York, my senior Senator, wonderful Senator, said, there are cycles in regulation. There are cycles in our effort to back off from the industry to ensure the dynamism of the capital markets. And the settlement that we negotiated was an effort to strike just that balance.

However, the pendulum may have swung too far. It may have swung too far and that is why I think Senator Sarbanes is correct again. We should exercise incredible caution as we forward and once again deregulating those sectors that would want to move into these voids and once again take advantage of conflicts of interest.

Let me make two final points, if I could.

There has been much effort to preempt the States. I think that would be an egregious mistake. One of the first reactions on the part of the investment houses was to come down to Washington and say, we do not need them meddling in the marketplace.

In an ideal world, they would be right. This is not an ideal world. There was fraud in these investment houses. And their first reflexive response was to come down here and say, we want to get the cop off the beat.

That would be wrong. There are 100 million American investors who know it is wrong. And I will lead that fight, day-in, day-out, to prevent preemption, whether it is this year, next year, or 10 years from now. We will be there to say that you cannot keep the States out of this mandate.

We have since day one, before the Federal securities laws were there, regulated the securities markets to make sure there would not be fraud.

The concern of balkanization is a red herring. When it came time to ensure that there was consistency, that there were rules pursuant to which people could conduct business, we worked with the SEC. We made sure that there was that consistency and we said that we understand the mandate that there be uniformity to preserve the integrity of the capital markets.

However, preemption of the States would be an egregious, egregious mistake.

Let me make a point which has not been discussed so far, and that is one of the collateral consequences of the boom and bust cycle that was, to a certain extent, driven by the false and knowingly false analytical work that was generated. And that is the misallocation of capital.

If you want to talk about harm to our economy, the misallocation of capital that flowed into certain sectors that were favored because the investment banks saw that they could do underwriting, and the consequent increase in cost of capital to other sectors, some of our core economic sectors, that is an enormous cost to the competitive nature of our economy and should not be forgotten.

Many of the sectors where there were not incipient IPO's, where there were not people coming up with new paradigms, could not get the attention of the investment houses and their cost of capital increased. They could not raise the money and we lost market share.

I think anybody who wants to understand and question what is happening to our economy has to focus on that because that is a cost that is borne not just by the investors who lost the valuation

of their shares, but by the entire economy and our capacity to compete with our overseas competitors.

That is one of the collateral consequences we haven't yet focused on sufficiently. I hope, sir, that we will.

Let me make one last point. And I know that Senator Dodd in particular will focus on the tax implications, and rightfully so. But let me say this about that issue. There will be, and I am sure, I hope questions about how we determined what the appropriate fines would be and what the relative fines were and how we arrived at those numbers.

We were not going to play games with what we called these impositions of penalties, fines, or restitution.

Pursuant to various statutes that you have passed, some of these monies needed to be restitution. We were going to call it that. Pursuant to other obligations, we were going to impose fines. We were going to impose the obligation for research that we can talk about.

We were not going to play or participate in what would have been an accounting gimmick to have a tax impact.

If you rightfully believe that many of these funds that are going to be paid by the banks should not be tax-deductible, please amend the tax code. We would like that. If you believe these should not be insurable, pass a statute that forbids it.

We were deeply involved in an effort to try to see what would be insurable, what would not be insurable. We do not write the insurance policies. Many of those who are now claiming that they should not be forced to pay pursuant to those insurance policies, they took the premiums for many years without complaining. There are two sides to every contract.

So, I think if we want to examine that issue, both sides should be examined.

Thank you.

Chairman SHELBY. Our next witness is Richard Grasso, Chairman, New York Stock Exchange.

STATEMENT OF RICHARD A. GRASSO
CHAIRMAN AND CEO, NEW YORK STOCK EXCHANGE, INC.

Mr. GRASSO. Chairman Shelby, Ranking Member Sarbanes, Senator Dodd, thank you for inviting me to testify today on behalf of the New York Stock Exchange to discuss the global settlement, which addresses conflicts of interest between research and investment banking at 10 of the largest, most influential investment firms in the country.

The settlement is historic, Mr. Chairman, in many ways, in its breadth and depth, in the severity of penalties imposed, the level of cooperation among the securities regulators and, most importantly, in its impact upon the business model of integrated financial services going forward.

The last point is most significant in my view, toward restoring the public's trust and confidence, and importantly, sending a message to 85 million Americans who own the great companies that we are privileged to trade, that there have been lessons learned, that Wall Street gets it, that reform is more than just waiting for a market upturn. There were severe mistakes and egregious viola-

tions. We have to stand up, recognize that, and correct those very, very dark breaches of fiduciary responsibility to customers.

The regulators that sit before you, Mr. Chairman, conducted extensive probes of the firms' research practices, including review of hundreds of thousands of pages of documents, e-mails, interviews with employees and customers. It was extensive and, given its extraordinary size, swift.

The penalties imposed constitute some of the largest ever levied in the history of securities regulation, which sends a clear and strong message about the seriousness of the firms' misconduct.

The settlement mandates new procedures that will forever change the way analysts do their work, the way investment bankers do their work and, most importantly, maintaining a separation between the two.

In short, the settlement ushers in a new era in which the quality, integrity, and reliability of Wall Street research is protected for the benefit of investors. The settlement marks only the beginning, Mr. Chairman, of a new era. There is still more work to be done.

Firms and investors alike should be aware that the regulators, both self-regulators and those at the State and national level, will continue to take all necessary measures to protect the integrity of the marketplace and will hold accountable anyone who breaches the public's trust.

Our regulatory group is committed to making certain, Mr. Chairman, that all penalties for violations of rule, policy, practice, or law, will be swift and significant.

In the joint regulatory partnership that sits before you, an unparalled spirit of cooperation was delivered to the American public and, most importantly, delivered to those who are in the American marketplace.

The task force which was formed in April 2002, consisting of those orgainizations at this table, was designed to bring together those who were determined to make certain that our markets remain the most admired in the world.

Early in that investigation, it became apparent that all of the firms that we were looking at utilized business practices that compromised the independence of the research analysts. These conflicts were identified and our task force in a matter of months was able to uncover significant evidence that each firm under investigation had engaged in misconduct.

One of the most disturbing findings by the task force was the lack of effective supervision at each of these firms. The task force determined that each firm encouraged a culture and an environment in which research analysts were repeatedly subjected to an inappropriate influence by investment bankers and in which the objectivity and independence of their product was compromised as a result of that influence.

These supervisory deficiencies manifested themselves in numerous ways, including how research analysts were compensated, how they freely were utilized in soliciting investment banking business, and in the absence of effective review of the content of the research product, the recommendations, and ratings which were issued.

The settlement, Mr. Chairman, is one and only one element of our collective intent to continue to work and address these findings. Another important element is rulemaking.

In May 2002, the SEC approved new Exchange and NASD rules that represent an important step in insulating research analysts from conflicts of interest and improving the objectivity of their published products.

In June 2002, the Exchange initiated a special exam program in coordination with similar programs at the SEC, the NASD and the State overseers to ensure that firms were complying with the obligations and restrictions imposed in the new rules.

In October 2002, the Exchange and the NASD submitted to the SEC for comment and approval, additional rules to further expand the restriction on firms' research activities.

We are currently in the process of drafting and approving new rules pursuant to the requirements of the Sarbanes-Oxley Act of 2002. These rules, which will be submitted to the Commission shortly, will further prevent conflicts, thereby ensuring that public research will be objective.

Furthermore, these rules will require published research to contain disclosures and other information designed to help the public make informed decisions about the quality of recommendations.

It was always of paramount importance to the task force, not only to identify and punish those who had violated the public trust but also to impose a system of prospective relief that would require firms to change their business model.

As set forth in the settlement, firms that engage in investment banking services will no longer operate with the unfettered participation of research analysts. Equally important, investment bankers will not be permitted to pressure research analysts to place favorable ratings on client stocks.

Accordingly, the firms will be required to make independent research available to their customers and to make payments into an investor education fund that will be used to inform investors about the risks and opportunities available in equity investment.

Additionally, the 10 firms have entered into a voluntary agreement prohibiting "spinning." This term is used to describe the improper allocation of shares of hot IPO's to executive officers and directors of public companies in an effort to attract their investment banking business. This prohibition will promote fairness in the allocation of IPO shares.

The Exchange, in partnership with the SEC, the NASD, and the States, is currently investigating the IPO allocation process at the firms participating in the settlement to determine whether improper conduct occurred.

The Exchange and NASD formed a joint committee at the SEC's request in August 2002 to pursue such an investigation, to make recommendations to the two SRO's and, ultimately, to the Commission, on proposed rulemaking or, if needed, further legislation.

In addition, the Exchange, through its examination program, will review the 10 firms' compliance with the undertakings required by the settlement, with the new requirements of NYSE Rule 472 and with Regulation AC, which requires that analysts certify that their research reports represent and reflect their personal views.

Each firm has a responsibility to establish, maintain, and enforce a system of supervision designed to ensure compliance with applicable laws, regulations, and rules. The Exchange, the SEC, the NASD, and the States will develop joint examination programs to make certain that compliance departments of the largest broker-dealers are in a position to ensure that the violations of the past do not become practices of the future.

The Exchange will regularly examine each of its member organizations to ensure that its supervisory systems and its management are in compliance with applicable rules and securities laws and that the firms are conducting their business in accordance with the highest ethical standards.

The Exchange will bring actions that it deems warranted with respect to the management of these firms, individual supervisors of the research and banking departments, as well as individual analysts who may have engaged in improper conduct.

Mr. Chairman, let me emphasize again that the settlement's remedial sanctions are the largest ever levied in the history of the securities industry, and the prospective relief constitutes an unprecedented framework for reforming Wall Street research.

The settlement delivers a strong and clear message that the interests of the investing public will not come second to anything or anyone, including the generation of investment banking business.

We achieved the goals of the investigation with speed, hard work, and partnership at the regulatory level, both State and national. But the work is not finished. There is more to be done.

Eighty-five million investors and the entire country will watch carefully to measure and determine the answer to the question posed by the Committee earlier—does Wall Street get it?

Wall Street, from this settlement, must take a message that change, designed to return to the basic principle that the customer comes first, is the only way to build a business.

Anything less would be unacceptable for investors, for our great country, and for the efficiency of the capital market system.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Glauber.

Senator DODD. Mr. Chairman, before you proceed, I must apologize to our panel of witness who are obviously going to go longer.

I cannot stay much longer on this. I am going to submit some questions to people.

Chairman SHELBY. We will submit the questions for the record.

Senator DODD. If I can do that.

Chairman SHELBY. Absolutely.

Senator DODD. I am particularly interested in the issue about the tax-deductibility part of this. I will submit that to all of you.

I thank you for coming and I apologize again.

Thank you all, and thank you, Mr. Chairman.

Chairman SHELBY. Mr. Glauber.

STATEMENT OF ROBERT GLAUBER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. GLAUBER. Chairman Shelby, Senator Dodd, Senator Crapo, thank you for inviting me to testify about the important milestone we passed last week in finalizing the global settlement.

NASD played an important role in that historic agreement. Let me spare you repeating what has already been said and let me concentrate mainly on NASD's role.

In completing this settlement, all of the regulators took a large and necessary step on the road to renewing investor confidence. No one believes this agreement alone will reverse the effects of more than a year of scandals involving accounting that was unaccountable and corporate governance that simply did not govern, as well as the analyst and IPO abuses that were the subject of last week's announcement.

But this settlement has sent a number of important messages that we believe investors, as well as security firms, do understand and must understand.

The sanctions in this settlement are among the strongest and most substantial in the history of the securities environment and enforcement. But in addition to the $1.4 billion price tag that made the headlines around the world, we have forced meaningful change in the way Wall Street does business, and will do business in the future.

What have we done?

We have sent an unmistakable signal that analyst research cannot be a tool of investment banking. We have told Wall Street that hot IPO's cannot be doled out to corporate insiders as virtual commercial bribes. And we have demonstrated, I believe, that firms act through individuals and that individuals too will be held accountable for their misdeeds.

Underscoring these principles, NASD has investigated and brought charges in more than a dozen important analyst and IPO allocation cases against individuals, as well as firms.

Indeed, the most significant case against an individual in the global settlement, Jack Grubman, stemmed from an investigation started by NASD almost 2 years ago. Charges brought by NASD in September 2002, against Jack Grubman for misleading research were settled and wrapped into the final agreement. Mr. Grubman paid $15 million in fines and is now barred from the securities industry for life.

In addition, investigations against Salomon, Smith, Barney, Credit Suisse First Boston, Merrill Lynch and its star analyst, Henry Blodget, resulted in the largest firm and individual sanctions in the global settlement.

NASD was already policing this beat when the bubble was still a bubble. By beginning in 2000, we started building a landmark IPO profit-sharing case against CS First Boston that we, along with the SEC, finally settled at the beginning of last year—that is 2002—for $100 million in sanctions.

We caught CSFB carrying out a systematic scheme whereby, in exchange for dishing out shares of lucrative hot IPO's to chosen

customers, it demanded and received paybacks of between 33 and 65 percent of the customers' trading profits in those IPO shares.

In addition, NASD has been working with Congressional champions of analyst and IPO reforms for more than 2 years, including Members of this Committee, and we are redoubling our effort under the new agreement to ensure that the system works to protect investors.

Specifically, and in an answer to Senator Crapo's earlier question, NASD and the New York Stock Exchange have issued two sets of analyst rules to make analysts more independent and investors more informed.

These rules will apply beyond the 10 global settlement firms throughout a diverse industry of over 5,300 firms, and they will protect investors whether they live in Birmingham, Baltimore, Brooklyn, or Berkeley.

We have also issued a proposed set of rules making explicit the prohibitions against the most common IPO abuses and will soon release with the New York Stock Exchange, the results of a joint blue ribbon panel recommending additional reforms of this vital part of the capital formation process.

Finally, we are hopeful that the global settlement will make it easier for investors to recover their losses through arbitration. NASD dispute resolution is currently administering more than a hundred cases involving analyst issues. We expect this number to grow substantially, perhaps as high as 4,000, as evidence from the settlement can and does become used to make the case for recovery of investor losses.

In conclusion, if last week's global settlement proves one thing after all, it is that playing by the rules and putting investors first is more than good ethics. It is good business.

For the firms and individuals involved in this settlement, that is a hard lesson, but one I believe they surely understand well now. And that is good news for every investor who wants to participate in the most liquid and developed capital markets in the world.

Let me just add one comment if I might, Mr. Chairman. Very simply, I do not agree with Attorney General Spitzer that these events reflect the failure of self-regulation.

Of course, in hindsight, we could have, I am sure, been better focused, not gone down some blind alleys. But I think the evidence of our record, part of which I have recited, makes clear that we do have a very credible record of effectiveness as a self-regulator.

Thank you very much.

Chairman SHELBY. Ms. Bruenn.

STATEMENT OF CHRISTINE A. BRUENN PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Ms. BRUENN. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am Christine Bruenn, Maine Securities Administrator and President of NASAA.

I would like to start by acknowledging the role that this Committee and its House counterpart played in this matter. Congressional hearings shined an early light on Wall Street practices that were an important guide for regulators.

From the outset of the investigations, State securities regulators have had three goals—to fundamentally change the way business is done on Wall Street, impose meaningful penalties for illegal behavior, and to provide harmed investors with the information they need to pursue arbitration cases.

If the industry follows both the letter and the spirit of this agreement, investors, not investment banking fees, will come first. And analysts will be beholden to the truth, not the IPO business.

Let me give you a brief overview of State securities regulation. The securities administrators in your States are responsible for the licensing of firms and investment professionals, the registration of small securities offerings, branch office sales practice audits, investor education and most importantly, the enforcement of State securities laws.

Because they are closest to the investing public, State securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment-related violations. They also work closely with criminal prosecutors at the Federal, State, and local levels to punish those who violate our securities laws.

While the global settlement is most important for its impact on Wall Street and investors, it is remarkable for another reason as well. I believe it represents a model for State and Federal cooperation that will serve the best interests of investors nationwide. As we did with the penny stock fraud, with microcap fraud, day trading and other areas, the States helped to spotlight a problem and worked with national regulators on marketwide solutions. It bears repeating—the States historically and in the current cases, investigate and bring enforcement actions. They do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SRO's.

None of the regulators who are involved in this global settlement could have done this on their own. That is why there must be cooperation and division of labor among the State, Federal, and industry regulators.

Over the past several years, NASAA members have been active participants in the rulemaking and legislative process in the area of analysts' conflicts of interest. The States worked closely with the SEC and the SRO's to formulate new, marketwide rules that were needed to fix the analyst problem.

Many of our original proposals were incorporated in the final rule. Also, NASAA was strongly supportive of Title V in S. 2673, which became the Sarbanes-Oxley Act of 2002.

You have heard about the global settlement and I want to explain how the States fit in. Last spring, as the New York Attorney General was wrapping up his Merrill Lynch investigation, NASAA felt that it would be beneficial to all concerned to settle the cases simultaneously for all the States as a group. Eliot agreed and negotiated on those terms.

A few weeks before the Merrill Lynch agreement, the NASAA Board met to form the Analyst Task Force. Its Steering Committee was charged with investigating whether problems discovered at Merrill Lynch were industrywide. The Steering Committee assigned one State to lead the investigation of each firm. Many other

States signed on to assist in the investigations. Further, the Task Force agreed to work in collaboration with the other regulators.

Each firm was assigned a lead State and a Federal counterpart. The investigations continued into the fall, at which time all regulators determined to pursue a global resolution of the cases, as was described in earlier testimony.

An important question faced by State securities regulators was how best to use the penalty monies. A primary and routine objective of State securities regulators is to obtain restitution for investors as part of its enforcement actions. In reporting year 2002, restitution ordered through administrative or civil actions at the State level was $309 million. At the same time, roughly $71 million was ordered in fines and penalties.

When considering restitution, we ask ourselves, can we identify the victims? Can we quantify the loss? And can we make meaningful distribution?

As a fraud on the market, we struggled to identify the victims. We considered starting with the customers who purchased through the firms. But what about those who saw Henry Blodget on TV and purchased the stocks online? Or bought stocks from a firm that purchased research from one of the 10 firms? And what about mutual fund investors? In our view, a fraud on the market harms all investors. In light of these issues, we believe decisions regarding the funds are best made at the State level so that they can be tailored to the unique circumstances of each State.

The settlement also requires some of the firms to contribute funds over the next 5 years for investor education. The NASAA Board directed the State portion of these payments to a separate fund of the Investor Protection Trust, a public charity. The fund will be distributed pursuant to a grant process, supporting and creating financial literacy programs, with materials tailored to the needs of local communities, and conducting research.

The analysts' conflict of interest was a big story in the financial press. But it was hardly the only focus of State securities regulators. There are many types of violations that State securities regulators continue to fight.

NASAA has published a list each year of top 10 scams to highlight problem areas for investors. Attached to my written testimony is a list of some of our ongoing initiatives.

Mr. Chairman, in closing, I would like to offer you my personal opinion based upon 16 years as a securities regulator.

I believe that now is the time to strengthen, not weaken, our unique complementary regulatory system of State, Federal and industry regulation. Eighty-five million investors, many of them wary and cynical, expect us to remain vigilant, to stay the course, to make sure that Wall Street puts investors first.

I pledge the support of the NASAA membership to work with you and your Committee to provide you with any additional information or assistance you may need.

Thank you for the opportunity to testify and I look forward to continuing the NASAA's excellent working relationship with this Committee.

Chairman SHELBY. Thank you.

Attorney General Spitzer, what specific actions initially triggered your investigation into Merrill Lynch in 2001?

Mr. SPITZER. Sir, I am not sure there was a specific action. I think that, and this is why I disagree with Mr. Glauber fundamentally, and others, there was such a wealth of information out there, that this was a crisis screaming to be addressed.

It did not take a detective and, frankly, Inspector Clouseau could have seen it. It is embarrassing that those who should have seen it did not. And that is why I said, you had to be on the dark side of the moon not to understand it. There was evidence all over the place. There were articles written by superb journalists that defined the issue. And yes, there may have been isolated, atomized cases that had been brought. Nobody had asked the question, is this a structural problem? Knowledge of this problem went to the very top of the investment banks.

The compliance departments, and Bob, my criticism is not just directed at the NASD. It is also the internal compliance departments of these firms. They may ensure that things are filed in triplicate, but they did not ensure that there wasn't fraud being committed. So the internal compliance departments of these firms were a joke as well.

Chairman SHELBY. Mr. Grasso and Glauber, how is it that the blatant conflicts of interest were not detected through internal compliance procedures instituted by the SRO's?

Mr. Grasso.

Mr. GRASSO. Well, Mr. Chairman, I think that it is with the benefit of hindsight that I look back and say, you are absolutely correct in your presumption that it should have been detected.

It should have been detected at the firms. It should have been detected by the self-regulators. And it simply was not.

I think that, if you set it contextually in the period——

Chairman SHELBY. Was it because so much money was being made and everybody was exuberant?

Mr. GRASSO. I think, Mr. Chairman, I was about to go there in response to your question. You have to forgive me. I was the old economy at the time.

Chairman SHELBY. Okay.

Mr. GRASSO. But there was an enormous wealth creation in the period, 1995 through 2000, through the peak in 2000.

As you look back at the IPO process with the benefit of hindsight, or if you look back at the rising levels of equity, both in the two primary markets, the New York Stock Exchange, and the Nasdaq there was, to use Chairman Greenspan's observation, an irrational exuberance.

No one was asking the question, what is fundamental valuation of a security? People were simply asking the question—if I buy it, at what price may I sell it? And therein, I think, is the breakdown in the traditional valuation model.

I would say, finally, Mr. Chairman, that as we go forward, and I think that I am in the middle, of course, between the great Attorney General of the State of New York and my colleague in the self-regulatory community, it is unfortunate that no one can turn the clock back. We certainly can look prospectively with the benefit of

history and ask all of the tough questions that perhaps we hadn't asked in the period.

Such as, Mr. Chairman, at a time when equity values were rising just about daily, and as Chairman Donaldson observed in his commentary, there were more cheerleaders than there were analysts. Perhaps it would have been again, with the benefit of hindsight, smart to impose different levels of margin on securities, and specifically targeted margin, for those securities that literally overnight were doubling, tripling, and doing even more than that based on their initial offering prices.

So, I would say to you, Mr. Chairman, that there are lots of lessons learned, and I am not going to suggest that anyone should be proud of their record in the period, 1995 to 2000.

I can only hope and commit that, looking forward, we will be proud of how we proceed and enforce this new business paradigm.

Chairman SHELBY. Mr. Glauber.

Mr. GLAUBER. Mr. Chairman, first of all, I think your comment is spot on. The financial enticements for stepping over the line were at unprecedented levels and obviously, more people did step over the line.

Chairman SHELBY. Greed.

Mr. GLAUBER. I think you could use the word.

On the issue of self-compliance, again, I think you have put focus on the right issue. I do not believe self-compliance did the job that it should have.

Since the time I have come to the NASD, we have emphasized self-compliance. We have worked to give self-compliance officers in the firms more tools so that they can do their job better. And most recently, 2 weeks ago, our board voted to put out for comment and the SEC, a provision where we will require that the CEO and the chief compliance officer of every firm certify that the policies and procedures are in place to enforce our rules.

Chairman SHELBY. How did the Federal and State regulators organize the joint task force to investigate the wrongdoing? How were the lead Federal and State regulators paired up?

Mr. Cutler, do you want to comment on that?

COMMENTS OF STEPHEN M. CUTLER
DIRECTOR, DIVISION OF ENFORCEMENT
U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. CUTLER. Yes, Senator. Mr. Chairman, what we did on the Federal side is allocate the lead investigative position to each of the three Federal regulators.

That is, of the 12 firms, and we did start by looking at 12 firms here, there were 4 as to whom the SEC took the lead responsibility, 4 as to whom the New York Stock Exchange took the lead responsibility, and 4 as to whom the NASD took the lead responsibility.

We, all of us, worked together on these investigations, and although we designated one entity as the lead, it wasn't as though any of us abdicated our responsibility and we worked together in closely keeping each other apprised of the evidence that we were gathering and the legal analysis that we were going through.

At the same time, the States, and I will let Ms. Bruenn comment on this, and Mr. Spitzer, designated lead investigative States that

matched the Federal side. We combined our resources to conduct this investigation.

Chairman SHELBY. Do you want to comment, Ms. Bruenn?

Ms. BRUENN. Yes, Senator. The lead States on the State side were organized in the spring, and it was based upon a group of States plus the regulators who worked for those States who had some experience in doing large multistate actions.

And a lot of the leadership came from the New York AG's office. We were paired up with the Federal regulators from that point.

Chairman SHELBY. Okay. Personal accountability—we have been talking about that.

All 10 of the firms were charged with failure to supervise their research and investment banking divisions, which means that specific managers and executives failed to take the appropriate actions to eliminate the conflicts.

Several executives did more. These executives actively pressured analysts to make certain recommendations. I believe the papers regarding Citigroup and Jack Grubman are particularly instructive because they give some insight into the personal dynamics at play here.

It is apparent that Grubman himself felt enormous, enormous pressure, to write reports that pleased the head of the investment banking and Citi Chairman, Sandy Weill.

Even the head of global research expressed, "A legitimate concern with the objectivity of research with the head of Salomon, to no avail."

"Grubman was reacting to the business needs of investment bankers. It appears that he was fulfilling the wishes of those in his organization who outranked even the head of the research department."

"Yet Grubman is the only named individual."

Attorney General Spitzer——

Mr. SPITZER. Well, sir, I would——

Chairman SHELBY. Well, let me finish my question.

Mr. SPITZER. Sorry. I thought that that was the question.

Chairman SHELBY. Sure.

[Laughter.]

Why did you not name any individuals at Salomon or Merrill Lynch? Did the buck stop with Messrs. Grubman and Blodget?

Mr. SPITZER. Can I answer the first question?

Chairman SHELBY. Yes, go ahead.

Mr. SPITZER. We examined the evidence under the laws that we enforce, the Martin Act. I know that there has been a general view that the Martin Act is rubber-banded with continuous elasticity. But there is not a crime or a violation under the Martin Act for failure to supervise.

Chairman SHELBY. Okay.

Mr. SPITZER. Whether there is a possibility of having investigations under other statutory structures that would pursue that charge, I will leave to others.

I have said quite clearly that we looked at the evidence relating to Mr. Grubman and Mr. Weill and brought the charge against Mr. Grubman because we believed we could prove that charge, which is how we do things.

Chairman SHELBY. Okay.

Mr. SPITZER. There was no charge to be brought against Mr. Weill under New York State law. And that was the determination we made.

The general observation you make about failure to supervise throughout the industry, obviously is one that not only do I share, but I also imagine my colleagues share.

Chairman SHELBY. Attorney General Spitzer, your office chose not to pursue charges against Blodget. When you settled your case with Merrill Lynch, did you agree not to pursue charges against individuals at Merrill?

Mr. SPITZER. Yes, sir, and I will tell you exactly why.

Chairman SHELBY. If so, why did you make this concession?

Mr. SPITZER. I will tell you exactly why.

There was, in my mind, a concerted strategy underlying the efforts of last year. I was of the view that the problems that we diagnosed at Merrill Lynch were not unique to Merrill Lynch.

Indeed, I believed that the business model that permeated Merrill that led to the subservience of analytical work to investment banking was replicated elsewhere.

I was of the view that this issue needed to be examined elsewhere in the industry and each of the major firms. I was of the view that we needed a settlement with Merrill Lynch to define the problem, set it out in this glare of public discourse before Congress and the SEC.

Hence, I said, we will make that deal. There are other regulators who in due course will proceed against individuals. But I believed it was critical that we resolve that issue with Merrill Lynch, move on to inquiries relating to other investment houses and in due course, there will be fair opportunity for others.

And indeed, there are other prosecutorial offices that contacted me immediately after our settlement and said, we are interested.

We provided to them the information and the data. They are free to proceed as they wish.

Chairman SHELBY. What about principal violations under the Martin Act?

Are you familiar with—is it the Martin Act?

Mr. SPITZER. The Martin Act, yes, sir.

Chairman SHELBY. That takes care of investment banks.

Mr. SPITZER. But by principal violations, you mean, what?

Chairman SHELBY. Well, any of them, principal violations. In other words, were there principal violations by higher people?

Mr. SPITZER. Oh, sure. We have not given immunity, other than at Merrill Lynch to principals at any of the firms.

With respect to Sandy Weill, I have said, we examined that fact——

Chairman SHELBY. To hardly anybody.

Mr. SPITZER. Well, there are continuing investigations in my office and in other offices and it has been eminently clear since day one that these settlements with the institutions.

Chairman SHELBY. Sure.

Mr. SPITZER. Other than, as you point out, with respect to Messrs. Grubman and Sandy Weill. I investigated that case and

made a determination that there was no case under the Martin Act with respect to his dynamic with Mr. Grubman.

Chairman SHELBY. Mr. Glauber.

Mr. GLAUBER. Yes, sir.

Chairman SHELBY. In the negotiation of the settlement, there were press reports that efforts were being made to, "tone down," the wording in the orders.

Specifically, an article in *The Wall Street Journal* on January 16 of this year, suggested that Attorney General Spitzer requested that the NASD tone down its description of some of the alleged wrongdoing.

Can you describe your perspective on this? In particular, how the various regulators collectively negotiated the various documents.

Mr. GLAUBER. Certainly, Mr. Chairman.

I must say I was a bit bemused by the article. I do not want to speak for Attorney General Spitzer. The fact was, we drafted the original language and sent it to Attorney General Spitzer's office.

Chairman SHELBY. But you are familiar with the phrase, tone down, aren't you?

Mr. GLAUBER. Oh, I am.

Chairman SHELBY. Absolutely.

Mr. GLAUBER. But let me tell you the facts. The fact is that we sent it over. I never talked to the Attorney General nor, in fact, at the time that that article was written, had we heard anything back from the Attorney General's office.

So it would be hardly true to say that there was a dispute going on at that point about toning down the language. And if you look at the final language, I think it is pretty tough.

Chairman SHELBY. Senator Sarbanes, you have waited patiently.

Senator SARBANES. Thank you, Mr. Chairman.

First of all, I thank the panel. I know you have had to wait through the full morning, but we obviously had a number of things to discuss with Chairman Donaldson.

Everyone says, in retrospect or in hindsight, maybe we did not do what we should have done, but we were doing a good job all along. And it is a heightened standard to come along in retrospect and look back and say, well, you missed this or you missed that.

Of course, the Attorney General reminded us in his opening statement that we missed a lot of things here as well.

That is fair enough.

But let's not do it in retrospect. I want to take it right now. And I want to ask particularly Mr. Grasso and Mr. Glauber, what are we to make of what is happening right now by some of the leading figures on Wall Street, members, presumably, of your organizations, which lead *The New York Times* to say in an editorial, "Investors should keep a wary look along this self-denial and lack of contrition. It may suggest that the revisionists are on to something when they say that nothing will change on Wall Street."

And of course, they are referring, first of all, to an op-ed piece in *The Wall Street Journal* by the chief executive of one of the major brokerage firms, in which he says, and I am now quoting the article, "But if we attempt to eliminate risk, to legislate, regulate, or litigate it out of existence, the ultimate result will be economic stagnation, perhaps even economic failure. To teach investors that

they should be insulated from these forces, that if they lose money in the market, they are automatically entitled to be compensated for it, does both them and the economy a disservice."

That is the part of the article written by the head of one of the major brokerage firms.

Now this is what *The New York Times* says about that: "As a broad Econ 101 principle, we would agree, hurrah for risk. But 'risk' is not normally defined as embracing deliberate deception by brokers who twist their research to curry favor with investment banking clients, thereby abusing investor trust."

And then they make the point whether the head of one of these, could have forgotten these e-mail notes of one of his leading analysts ridiculing the very companies the analyst was urging the clients to invest in, from his own company.

They go on to say that, "Of course, that is not the lesson that Mr. Spitzer and other regulators are trying to teach." Namely, that, "If they lose money in the market, they are automatically entitled to be compensated."

These investors are not asserting that. I have talked to a lot of these angry investors and they know the risks they were taking. And that is not what they are arguing. They are screaming mad about being misled and deceived.

Then the *Times* goes on to say, "This essay is only one of several signs that Wall Street remains in deep denial about the degree to which it betrayed investors' trust."

And then they go on and deal with another investment house which got a very sharp retort from Chairman Donaldson just the other day.

Now what are we to make of this? It is one thing to come in and say, well, in hindsight, we would have done it differently and so forth and so on. There is no hindsight here. This thing is out here on the table. A settlement has been reached, the most far-reaching ever. These egregious practices have been detailed.

I have in here, if I can find it, the complaint that the Commission filed in the Grubman case. You read through the nature of the complaint by the SEC against Grubman.

You read through enough of this and it is just a horror story.

Mr. GRASSO. Senator.

Senator SARBANES. And yet, in the face of all of this, we are getting leading figures in Wall Street, in effect, in denial. And the *Times* says, "Investors should keep a wary eye on this self-denial and lack of contrition."

What are we to make of this?

Mr. GRASSO. Senator Sarbanes.

Senator SARBANES. Yes.

Mr. GRASSO. I think it is a tragic mistake for anyone to try to create a revisionist account of what happened.

Investors understand, in my view, the difference between risk and breach of agency responsibility. I can tell you as recently as a month and a half ago, I spent a Saturday morning with 1,600 American investors at a conference in Boston. They weren't asking for a promise of profit. They were asking for a promise of fairness.

And that is what the failure was, the fairness. The failure to adhere to the fundalmental rule that the customers' interests should

always come before the proprietary interests of a firm. I think any attempt to recast what has happened is a tragic mistake.

You saw the sharp criticism that Chairman Donaldson offered up last week. I believe that anyone in my business, any leading manager who would attempt to suggest that that is the risk of the market, when you are putting the firm's interests before the customers' interests, will have failed to have gotten the message.

The question was asked earlier, does Wall Street get it? And that type of thinking cannot ever be allowed to be in the mainstream of serving customers.

I would say to you finally, Senator, that it is difficult to separate the period from the malfeasance. But it should have been done. There is no question. There were remedies that were available.

What the global settlement does do is draw a very bright line declaration of what is the expected performance and conduct going forward. And I believe there is no ambiguity there. If people fail to get it, they won't be in the business. Nothing more complicated than that.

Senator SARBANES. Mr. Glauber.

Mr. GLAUBER. Senator Sarbanes, first of all, fraud is not risk. So there is no confusion.

I think there are some people in the industry right now who do not get it. You read statements to suggest it. I think there are many who do get it.

The ones who do not get it are going to get it. They are going to get it because of the rules that have been put in place and the enforcement of those rules. They are going to get it because of the actions that will be brought by individual investors against those firms.

I think they are going to have ample opportunities to get it. I believe they will. They have to get it, because if they do not get it, investors aren't going to trust these markets. They aren't going to come back into these markets, and that would be the greatest of all tragedies.

Senator SARBANES. Mr. Grasso, let me ask you, because both you gentlemen have to deal with boards of directors. You have to deal, in your SRO's, with the very institutions that you are regulating, by definition, which complicates your task. No question.

But now, in the New York Stock Exchange Board, do I understand you have a distinction between members of the board who represent the public and members who represent industry?

Mr. GRASSO. There are 24 nonmanagement members of the board, Senator. Twelve are from the securities industry, 12 are nonsecurities industry. They are deemed to be other than securities industry representatives and described as public representatives, but not public in the sense they may not be from the corporate community or major institutional investors in equity securities.

In fact, of that second 12, the constitution and charter of the Exchange require that one must be a representative of a large equity investment pool.

Senator SARBANES. I am interested in terms of getting it, the message. And I am not now looking back. I am dealing with where we are now, how the Exchange could have selected as one of the

nonsecurity industry representatives, Sandy Weill, especially if I read this material that has been laid out here before us.

Now how did that happen?

Mr. GRASSO. Senator, I can only say, and I will have to look back, for purposes of answering your question, at the independent nominating process at the Exchange, which is not to be confused with an independent nominating committee of a board of directors. The mechanism itself is wholly separate and apart from the Board of the Stock Exchange. Although they are similar in constituency, one may not sit on the Board of the Exchange and be a member of the nominating committee.

I think if the nominating committee chair or the entirety of that committee were here today, they would say to you, as I am about to say, it was a mistake to have offered it. I think Mr. Weill would say if he were here, it was a mistake to have accepted it.

If you look at the Martin report, not to be confused with the Martin law in the State of New York, but a refernce to William McChesney Martin, Jr., our first President at the Exchange, later to become Chairman of the Federal Reserve, and then later to come back to the New York Stock Exchange as a special advisor in the early 1970's, you will see how he structured the new composition of the board.

There is separation of the chief executive from that nominating process. But I would say to you, with the benefit of all we know now, and certainly with the good counsel of the great Attorney General of the State of New York, it never would have happened.

Senator SARBANES. Well, I have to say to you that it defies understanding, given what was out there on the record. I looked over your list. You have hardly any what I would call public directors. Panetta obviously would be a clear example.

Mr. GRASSO. Correct.

Senator SARBANES. But most of the others are all out of the industry, are they not?

Mr. GRASSO. Senator, on the nonsecurities industry side, we have a mix of CEO's of listed companies and former CEO's of listed companies.

Senator SARBANES. What kind of pressure does all of this put you under if—let's assume that you are trying to tighten things up and improve standards, and that you see problems that you want to address. But here's a board of directors that is very heavily weighted in terms of where it comes from, and presumably, what its interests are.

Now, as the Chairman and Chief Executive Officer of the New York Stock Exchange, how does that circumscribe or curtail your capacity to do what has to be done?

Mr. GRASSO. Senator, I would say that when those 24 nonmanagement directors walk into that room, they have one and only one constituency to whom they are accountable, and that is 85 million investors in this country.

Whether you come from a listed company, whether you come from a broker-dealer, whether you are the Comptroller of the State of New York, Carl McCall, as he was when elected to our board, you must take off your respective team jersey, be it a corporate team or a financial team, and recognize that the real owners of the

New York Stock Exchange, the real owners of our markets in this country are the investors and consumers who use our markets.

And if you cannot accept the fact that you put aside your own proprietary interests, just as we have said in this global settlement that the customers' interests must come before the firms' interests, then you cannot serve on that board.

Senator SARBANES. Well, have they been doing that?

Mr. GRASSO. Absolutely, in my opinion, Senator.

Senator SARBANES. Well, why have we had such a run of problems, then?

Mr. GRASSO. Senator, I would not deny what you have read. I would tell you that in my experience, and I have been a director now for longer than any person in modern history—15 years since I became President and Chief Operating Officer—there has never been a time, be it a Leon Panetta or a Carl McCall or a Juergen Schrempp, when they come into that room, where they do not understand, in my view, that they represent investors, people who use the market, and whether it is a disciplinary proceeding that we are about to hear in appellate format, or it is the institution of a new rule, policy, or practice, they measure everything against one simple test—is it right for the least sophisticated user of the market?

If we can answer that affirmatively, we will have done a good job, Senator, and I think we will have served our investors well.

Senator SARBANES. You use McCall and Panetta as examples of people who take that attitude when they, walk into this board room of yours, where other attitudes get shed away.

But I am looking at your board composition in 2002. Five of the members of your board were the head of the very companies that are part of this global settlement.

Mr. GRASSO. That is correct, Senator.

Senator SARBANES. Now, how about in that instance? How do we break through this situation?

Do you face the same problem, Mr. Glauber?

Mr. GRASSO. Let me just say, if I might, on those five individuals, Senator, that the disciplinary proceedings of the Stock Exchange are insulated from the board itself.

I believe, we have a very well balanced judicial process when we bring charges against anyone who violates rule, policy, or practice. And that whole hearing apparatus is separate from the board itself.

When an adjudication is rendered, it can be appealed to the board. But if it involves any of those board members, they clearly must recuse themselves from any action.

Senator SARBANES. No, I am concerned about the broader question of an attitude and an approach to these problems.

Have you confronted a situation in which you saw things and you said, "Well, we really should do something about that?" But then you ran into a board that said, "Well, now, wait a second. That is not the culture in which we are operating."

"What has happened to Richard Grasso here now? He's trying to cause a lot of trouble." Or maybe you did not try to cause any trouble, so you never encountered the problem.

Mr. GRASSO. Senator, if you look at the track record, particularly the Exchange's actions well before the legislation on corporate governance which came to be Sarbanes-Oxley, if you looked at the Ex-

change's actions with respect to the problems in financial services firms in the 1980's and 1990's, I do not think there has ever been an instance, certainly not in my time as a senior member of the management of the Exchange, where any board member from the industry in any way suggested that that was not what we were about to advance, was not consistent with the way they were doing business and therefore, we should not go forward.

Senator SARBANES. Let me ask the Attorney General.

What about these compliance and legal departments at these firms covered by the global settlement? Where were they through all of this?

Mr. SPITZER. I wish I knew, Senator. And I think when I speak about the failure of self-regulation and compliance, those are precisely the departments I speak of. Each one of those departments is exponentially larger than my investor protection bureau.

We have a total of 10 to 15 lawyers who work in this area. Each of the firms who is a signatory to the global settlement, certainly the bulge bracket firms at the top, have compliance departments that are vast with hundreds of lawyers, thousands of employees. And yet, at the very top, even though information was flowing up, I could not agree more with your premise that there simply was not an articulation and willingness to articulate the notion that the very business model was leading astray millions of Americans.

And that is why I say, and I began with the point that there was a failure of self-regulation, and we need to question the very premise whether or not it will work.

Senator SARBANES. Mr. Glauber, did you want to address the question I put earlier?

Mr. GLAUBER. Well, only to say that, as a self-regulatory organization, we have in our governance, properly, I think, a mixture of industry and public people. There are benefits to having industry people and benefits to self-regulation.

We have, by our charter by-laws, a requirement that the majority be nonindustry public people.

Senator SARBANES. What do you mean by public?

Because Mr. Grasso says, industry people in his case, as I understand it, are people in the securities business. Public people can be, and most of them are, as I look over the list, heads of major corporations, issuers, I take it.

And people that would meet what I think most of us would ordinarily think of as a public member are—well, we mentioned McCall, we mentioned Panetta, but not many.

Now what is your definition of public?

Mr. GLAUBER. Let me make one distinction for you.

We do not own exchanges. We do not have listed companies. Remember, we are just a regulator.

Senator SARBANES. Yes.

Mr. GLAUBER. So our public members would be what you would call public. They would include, they could include the head of a corporation, again, in our setting because we do not have listed companies. Paul O'Neill, the former Secretary of the Treasury, was a public member of our board until the Government took him away.

I believe our voice is dominated by public interest, by public members. I think there is a value in a self-regulatory organization

to having industry voice. That is the idea. That makes it different from Government.

Obviously, the dominant interest of the self-regulatory organizations has to be the public interest, and I believe it is.

Senator SARBANES. Can I ask one more question?

Chairman SHELBY. Go ahead. You go ahead. I have some more questions, too.

Senator SARBANES. Ms. Bruenn, I wanted to ask you your view from the States' level.

There are some now who are trying to preempt the States from being involved in enforcing the securities laws. Now, as I recall your testimony here earlier, you acknowledged that the framework of statute and regulation that set the standards by which business should be conducted would be essentially done at the Federal level, which would give you a national structure, but there was an important role to be played by the States in enforcing those standards.

Is that essentially your position?

Ms. BRUENN. Senator, my position is that the States are your early warning system. We are the ones that are close to your citizens in each of your States.

When Mr. and Mrs. Smith has a problem in their account, they pick up the phone and they call an office like mine, where one of my staff members says, sure, come on in and bring your grocery bag full of account statements and we will see if we can figure out what happened.

I think we are the ones that hear about problems first. I think we are a little bit of a test tube in the sense that we tend to be smaller organizations. We tend to have a little more flexibility than some of the larger Federal regulators and we have the opportunity to try different ideas out.

But we readily concede that this is a national market and that rulemaking for the whole marketplace must happen at the national level. But that should not undermine our ability to stand up and say, hey, there is something wrong here. Or here's some information, SEC or SRO's, that you should be taking account of.

We see ourselves as being a necessary piece of a complementary system where we each play our own role and are a necessary part of an integral system.

Senator SARBANES. You do not see any reason why we should make some radical change in this complementary system that has been the prevailing model now for decades and decades, do you?

Ms. BRUENN. No, I do not. I would hope that you would not make any radical changes.

I think what we have demonstrated in the past year is we are essential to the system, that we can be the ones close to the investors and stand up if we see that something is not going right.

Senator SARBANES. Mr. Glauber.

Mr. GLAUBER. Senator Sarbanes, if I just might, let me just clarify one point I made earlier.

We are in the process of divesting our ownership of Nasdaq and of the Amex. They have separate boards. And so, we are not responsible for the kinds of issues that they have to deal with, particularly the corporate governance and listing issues.

It was really that point that I would wish to make.

Senator SARBANES. All right. Attorney General Spitzer, did you want to address any of these issues that I put to Ms. Bruenn?

Mr. SPITZER. No, sir, I think she stated it perfectly. And I think that we have, as she said, a complementary relationship and I think that what proves this is that within the space of several months, we all collectively were able to generate resolution to some of the thorniest issues. Resolution that obviously is triggering substantial discussion and debate, as it should. But there was no tension or conflict between or among the various entities.

Senator SARBANES. I want to ask Mr. Cutler again on this question—you have obviously very important and substantial responsibilities as the Director of Enforcement. There is a long tradition at the SEC in that regard and some extraordinarily able people have held that post.

I asked Chairman Donaldson this question about obstruction of justice, destroying or altering evidence relating to a Government investigation.

I am very much concerned about that because if people are thumbing their nose and you come along to do an investigation—Quattrone tells his colleagues to "clean up" their files, knowing that some of these documents were being sought by subpoenas and document requests from three different regulators. That is pretty outrageous conduct.

Where do you think you are on communicating the message that destroying or altering evidence relating to Government investigations will not be tolerated? And is the Commission pursuing all instances in which that matter has arisen?

Mr. CUTLER. I think you have put your finger, Senator Sarbanes, on an issue that is critical to us.

You cannot run an effective enforcement investigative program where you cannot get the evidence you are entitled to get.

Starting I would say about 18 months ago, we made a concerted effort to talk to our counterparts in U.S. attorneys' offices around the country about the importance to us of criminally prosecuting obstruction conduct, whether it be destruction of records, whether it be false testimony, anything that goes to the heart and the integrity of the investigative process.

And we have seen not just the prosecution that you have identified, Senator, but a number of criminal prosecutions of obstruction of SEC processes. And they are, first and foremost, on the list of items that we try to bring to the attention of our counterparts at the Department of Justice around the country.

Senator SARBANES. Good.

Are you getting good cooperation from the Justice Department?

Mr. CUTLER. Absolutely. I think that they have made it a priority of theirs.

Senator SARBANES. Good.

Thank you, Mr. Chairman.

Chairman SHELBY. To the panel. Do you believe that this settlement adequately compensates the average investor for the financial damage that he or she has suffered?

We will start with you, Mr. Attorney General.

Mr. SPITZER. It was not intended to.

Chairman SHELBY. Okay. So the answer is no, then.

Mr. SPITZER. Let me be perfectly clear about this, and I have said this repeatedly. But since there has been so much questioning about it from the panelists today, I think it bears repeating.

Chairman SHELBY. Absolutely.

Mr. SPITZER. The settlement imposes the largest fines in history and provides to the investing public the information needed to obtain redress through litigation.

That is the system we have created in our judicial process. That is all we could do. That is what we designed to do.

The information is there. That information will permit them adequate redress. The deal itself cannot and was not designed to.

Chairman SHELBY. Mr. Grasso.

Mr. GRASSO. I would certainly second the Attorney General's comment. As you know, Mr. Chairman, $4 trillion has melted out of this market. There are going to be private rights of action. There are going to be arbitrations designed to take the evidence, designed to go after that money.

Chairman SHELBY. Mr. Glauber.

Mr. GLAUBER. We are gearing up for a large arbitration load. We believe there will be a lot of actions brought, as there should be.

As the Attorney General said, this settlement document spells out a roadmap to those.

Chairman SHELBY. Ms. Bruenn.

Ms. BRUENN. Thank you, Senator. I think this settlement is an important first step. I think it puts the structural changes in place.

Chairman SHELBY. But it is only a first step, isn't it?

Ms. BRUENN. I think it is just a first step. It gives the information to investors and as my colleagues have said, the arbitration process here is the next very big, important piece.

As the State securities regulators we are committed to helping investors understand how the information the regulators produced fits into their own personal situation. We will be monitoring how the arbitrations proceed and trying to help investors understand how to use it.

Chairman SHELBY. Mr. Cutler.

Mr. CUTLER. Of course, and I want to echo Chairman Donaldson in this regard, investors here have lost much more than money. They have lost their faith in the integrity of our markets. And that is why the forward-looking part of this settlement is so critical.

It is that part of the settlement that I hope and believe will ensure that research analysts do not continue to serve as cheerleaders for investment banking and are an important part of our ongoing effort. And it is an ongoing effort, to restore the faith of the investing public. We did think, Mr. Chairman, that it was important to get as much money as we could back to investors, in the context of the settlement. And no, it will not restore investor losses.

Chairman Donaldson has said there are lots of challenges and difficulties in doing that. We thought it was worth undertaking those challenges and difficulties and setting up a restitution fund. But it is only part of the restoration process and as my colleagues have said, the important part of the landscape is private litigation.

Chairman SHELBY. To the panel, do you believe that the settlement imposes the punishment and mandates the reforms that are

necessary to change the Wall Street culture and restore investor confidence in the markets? Or is it just the beginning?

Attorney General Spitzer.

Mr. SPITZER. The answer is both. It is the beginning. But the answer is yes, it puts in place the structural pieces. We will work hard. But, Senator, I think I will take a leap of faith in speaking for everybody, we all know, only time will tell.

Chairman SHELBY. Absolutely.

Mr. SPITZER. And I was as deeply distressed as the public record makes clear, that some of the evidence that some of the leadership hasn't yet internalized these values and we will be there like hawks. I stand behind the principles in this deal. We think it is right. It is the next best step. And we are going to keep pushing.

Chairman SHELBY. Does the panel agree with the Attorney General. Do you have a different view?

Mr. GLAUBER. I agree with everything that was said. I just would add that the next step, of course, is for us to write rules with the SEC that will apply to the other 5,300 firms in the industry.

Chairman SHELBY. Mr. Grasso.

Mr. GRASSO. Mr. Chairman, I agree with both Bob Glauber and Attorney General Spitzer. I would also say that anyone who doesn't get the message of a new day, just doesn't get it and won't be in this business.

Chairman SHELBY. Ms. Bruenn.

Ms. BRUENN. Yes, it is an important first step. We need to put investors, not investment banking fees, first.

Chairman SHELBY. Mr. Cutler.

Mr. CUTLER. Let me just say about people who do not get it, we are not going to assume that they do get it. And it is my job and it is the job of this agency and the job of everyone of us to ensure that they do get it over the next couple of years.

I believe most do. But I am not going to assume that.

Chairman SHELBY. And if they do not, they will, won't they?

Mr. CUTLER. They will hear from us.

Chairman SHELBY. Okay. Mr. Cutler, could you describe briefly how the Federal portion of the monetary sanctions will be distributed to investors? How long do you anticipate this process taking? And what criteria will be applied to determine which investors are entitled to restitution?

Mr. CUTLER. The final judgments in each of these cases contemplate the appointment of a Distribution Fund Administrator, to be approved by the court. That Distribution Fund Administrator will come up with a plan of distribution, will focus on investors who have invested in the securities referenced in the complaints, and will be limited to investors who lost money and were customers of the firms that are defendants in these complaints.

It will take some time to develop that plan. I believe it is 6 months before a plan would be submitted to the court. It is complicated and as I said before, there are challenges and difficulties in doing it, but we think it is worth doing.

Chairman SHELBY. Mr. Cutler, what is the scope of the ban on Mr. Grubman and Blodget? Can they still work in the capital markets in an unregistered intermediary like a hedge fund?

Mr. CUTLER. My understanding is he cannot work in any investment adviser, whether registered or unregistered. And he cannot work in a broker-dealer firm, whether registered or unregistered.

Chairman SHELBY. How permanent is the ban? Can he ask for reinstatement?

Mr. CUTLER. One of my predecessors once said about permanent bars at the SEC, that permanent means permanent.

Chairman SHELBY. Permanent means permanent. Good.

I want to thank you. This has been a long hearing. It is a very important hearing and we appreciate your patience. I want to thank you for your participation in today's hearing. I think the hearing has been extremely informative and insightful. I believe that we have all learned a great deal more about the terms of the settlement, the process for negotiating the settlement, and how regulators intend to police conflicts of interest as we move forward.

The announcement of the settlement last week and today's hearing, as we all know, is not the final chapter in this sad story. It is the beginning, hopefully, of a real end. I believe that if last Monday's roll-out was the final chapter in the effort to remedy these problems, then this has been an exercise in futility.

But I do not believe it is. I think it is the beginning. The jury is still out on the value of the settlement. Ultimately, the value of this settlement will depend on the vigilance of regulators who must make sure that Wall Street embraces the spirit of the settlement.

But I see no contrition. Perhaps most people, they are only sorry that they got caught. They are sorry they got exposed.

As a punitive measure, the settlement is relatively mild. Few individuals were named and the money payments, while unprecedented, are dwarfed by the investment banking revenues that these firms earned. In fairness to the regulators, that was no easy task. I know that, to try to punish without completely destroying institutions that play a critical role in our capital markets.

The remedial value of the settlement to the victims of the fraud that has been perpetrated upon our capital markets is likewise minimal. But there is a future there, perhaps. In all likelihood, we will never know with certainty the extent of the damage that these conflicts of interest created. And specifying the victims of the fraud will be a daunting challenge.

This settlement's primary value to date, I believe, has been one of education. By exposing the conflicts that have jaundiced so much of the research, I believe it served to put the average investor on notice—let the buyer beware. That is a phrase that comes down to us from Ancient Rome. It has survived because, basically, it is good advice. In a retail capital market like ours, notice and warnings, though, are not enough. In order to return to a bull market we would like to see, we must regain the trust of the retail investor. And to do that, there must be vigilant surveillance and enforcement of the law against all guilty parties. I believe that there has been too much greed, too much fraud, for just too long.

The hearing is adjourned.

[Whereupon, at 1:55 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

We are here today to learn more about the recent completion of enforcement actions against 10 of the Nation's top investment firms. These actions finalized the global settlement announced by regulators last December. The conflicts of interest between the investment bankers and securities analysts in these firms harmed investors who never suspected that the ratings and price targets were, to quote the words of one analyst, " . . . fairly meaningless . . . ." This analyst went on to write " . . . the little guy who is not smart about the nuances may get mislead, such is the nature of my business."

Starting with the House Financial Services hearings during the summer of 2001, case after case has revealed the largest investment firms viewed their securities analyses, not as a vehicle to attract investors, but as a tool to attract investment banking business. This has been repeatedly demonstrated through common practices such as "investment banking bonuses" and other financial compensation purely based on the amount of investment banking business an analyst could bring to the firm. Example after example has been uncovered of analysts who knew there was no truth to their reports and rarely, if ever, wrote a negative report on a company.

We are all thankful that this settlement contains strong improvements of investment firms to dramatically reform their future practices, including separating the research and investment banking departments at the firms, how research is reviewed and supervised, and making independent research available to investors. However, I am concerned that only half of the fines and disgorgements are going to compensation funds to benefit defrauded investors. For instance, though North Carolina law directs these fines toward investor education, unfortunately most other States do not ensure that such funds are used to benefit investors.

It would be my hope that more States could follow the example of North Carolina and use this money for greater investor education efforts and to assist investors who have been harmed.

I want to thank you all for the considerable time and effort it took to arrive at this settlement. I hope the fines and reforms are enough to ensure that fraud of this nature and magnitude can be prevented in the future.

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

The actions by certain Wall Street firms to use stock research to mislead investors cannot be condoned. Our public markets need faith and confidence that the system is fair. Last year, as allegations of biased stock research and abuses in the initial public offering markets were hitting the headlines we took action in the Sarbanes-Oxley Act to require new rules to cover the way research is conducted and used. It is my understanding that these rules should be finalized within the next couple of months.

The global settlement before us today sends another message that Wall Street cannot treat ethical lapses and lax supervision as everyday behavior. These firms have a moral obligation to treat investors fairly and honestly.

It also sends a message that we need to be more vigilant in the future to identify and stop practices like these before they have a chance to become accepted or tolerated worldwide.

Recently, I introduced legislation with Senator Shelby to streamline the hiring process for certain key employment positions in the SEC to assist in enforcement efforts on the oversight of publicly traded companies and the securities markets. I hope that we can move this legislation forward so that the SEC can be fully staffed to prevent future events such as those that lead up to the global settlement.

I look forward to hearing the testimony from our distinguished panel.

PREPARED STATEMENT OF SENATOR EVAN BAYH

I would like to thank Chairman Shelby and Senator Sarbanes for holding today's hearing to review the impact of the global settlement on our national economy and on investor confidence.

I congratulate SEC Chairman William Donaldson, New York State Attorney General Eliot Spitzer, New York Stock Exchange Chairman Dick Grasso, Chairman and CEO of the NASD Robert Glauber, and Christine Bruenn, who negoiated on behalf of the State Securities Adminsitrators, for their hard work in settling these cases

and protecting the financial security of millions of individual investors across the country.

The settlement embodies the very vitality of our economy—the amount of investment that will take place in the economy and the number of jobs that will be created. It involves the standing of America in the international economy—whether we will continue to be a safe haven for investments from those abroad, attracting the capital that helps us build a strong foundation for America's economy.

The reforms required under the global settlement send a loud and clear signal. Cheating will no longer be tolerated. The clear separation of reseach and investment banking divisions at firms will insulate analysts and provide investors with meaningful information. New mechanisms for providing independent research to investors at no cost to them will help them make more informed decisions. Transparent rating information, a ban on IPO spinning, independent monitors for each firm, and investor education will good a long way toward restoring investor confidence and strengthening our markets.

As the largest monetary penalty in Wall Street history, it is, more than anything else, an important step in the direction of ensuring that those Americans who have worked hard and saved their money, who have played by the rules, and are honest are able to get ahead in this society.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

MAY 7, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today concerning the recently announced global research analyst settlement among the Commission, the New York Stock Exchange (NYSE), National Association of Securities Dealers, (NASD), the New York Attorney General (NYAG), other State regulators and 10 Wall Street firms. I appreciate having the opportunity to discuss this important subject with you.

Introduction

Last week, the Commission announced enforcement actions against, and simultaneous settlements with, 10 broker-dealers and two individuals for failing to ensure that the research they provided their customers was independent and unbiased by investment banking interests.[1] The settlements of these actions, which were brought in conjunction with proceedings by the NASD, the NYSE, the NYAG, and other States extract significant monetary relief from the firms, including penalties that rank among the highest ever paid in civil securities enforcement actions. These landmark penalties reflect the serious nature of the misconduct, as well as the Commission's belief that securities firms must hold the interests of their customers paramount. The Commission is continuing to investigate the roles played by individual securities analysts and their supervisors.

Although the monetary relief secured in the settlements is substantial, unfortunately the losses that investors suffered in the aftermath of the market bubble that burst far exceed the ability to compensate them fully. They can never fully be repaid. Moreover, their loss was more than monetary. It was also a loss of confidence and a loss of the hopes and dreams they had built over a lifetime. And although the monetary relief obtained in the settlements is record-breaking, the structural reforms required are, in many ways, more significant and far-reaching. In that regard, the settlements include important requirements designed to insulate research analysts from pressures by investment banking.[2]

The research analyst settlements also require firms to provide investors with independent, third-party research whenever they solicit investors to purchase securities that are covered by a firm's own research. Certain firms will provide funding for investor education initiatives designed to arm investors with the knowledge and

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[1] The 10 firms are: Bear, Stearns & Co. Inc. (Bear Stearns), Credit Suisse First Boston LLC (CSFB), Goldman, Sachs & Co. (Goldman), Lehman Brothers Inc. (Lehman), J.P. Morgan Securities Inc. (J.P. Morgan), Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch), Morgan Stanley & Co. Incorporated (Morgan Stanley), Citigroup Global Markets Inc., f/k/a Salomon Smith Barney Inc. (SSB), UBS Warburg LLC (UBS), and U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray). The individuals are Jack B. Grubman and Henry M. Blodget.

[2] Under the terms of the settlements, injunctions will be entered against each of the firms and individuals, enjoining them from violating the statutes and rules that they are alleged to have violated. The proposed Final Judgments in the SEC actions are subject to Court approval.

skills they need to make informed investment decisions. Taken together, the numerous obligations the Commission imposes on the defendants will fundamentally change the role and perception of research at Wall Street firms. These reforms will go a long way toward restoring the honorable legacy of the research profession.

The research analyst settlements mark an important milestone in the Commission's investigation, and in its regulatory initiatives to help ensure that research provided to investors is objective. They bring to a close a period during which the once-respected research profession became nearly unrecognizable to earlier generations of investors and analysts. However, the settlements are but one component of the Commission's ongoing efforts to restore investors' faith in the fairness of the securities markets. The Commission continues to move forward aggressively in combating financial fraud, overseeing the start-up of the Public Company Accounting Oversight Board, and implementing the Sarbanes-Oxley Act, to mention just a few of the Commission's other priorities.

With that overview, I would like to use the remainder of the testimony to: (1) Review the Commission's activities in the analyst conflicts area; (2) describe the charges filed last week; (3) explain the terms of the settlements in some detail; and (4) discuss the Commission's ongoing regulatory activities in this area.

Background

The Commission's involvement in the area of research analyst conflicts, of course, predates the global settlement. The SEC began to examine this issue in 1999. The Commission staff was concerned that analysts, who had became veritable media stars, appearing ubiquitously on television financial programs, did not disclose their own conflicts of interest so that investors could evaluate their recommendations against their possible biases. Accordingly, in the summer of 1999, staff from the SEC's Division of Market Regulation began a review of industry practices regarding disclosure of research analyst's conflicts of interest. Then, the staff from the Office of Compliance Inspections and Examinations (OCIE) conducted examinations of the largest full-service firms on the Street. The examinations focused on analysts' financial interests in companies they covered, as well as analyst compensation arrangements and reporting structures, in particular whether analysts reported to investment banking personnel. The SEC reported the findings of those examinations in summer 2001 at a hearing of the House Financial Services Subcommittee on Capital Markets entitled "Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?"

The findings outlined in the Commission's testimony included:

- It was commonplace for research analysts to provide research reports on companies that the analysts' employer firm underwrote.
- Many firms paid their analysts largely based upon the profitability of the firms' investment banking units.
- Investment bankers at some firms were involved in evaluating the firm's research analysts to determine their compensation.
- Some firms maintained policies prohibiting analysts from owning stock in companies they covered. Other firms permitted analysts to own stock in companies they covered but prohibited them from executing personal trades that were contrary to the analysts' outstanding recommendations.
- Compliance with Self Regulatory Organization (SRO) rules that require firms to monitor the private equity investments of employees, including analysts, was poor. Firms did not always know whether their research analysts owned stock in companies about which their analysts issued research reports.

As a result of the Commission's examination findings, and given the serious concerns about the conflicts of interest analysts face that may taint or bias their recommendations, in fall 2001, the Commission called on the NASD and NYSE to work together to craft new rules intended to restore investor confidence in analysts' work. These rules were designed to address the conflicts of interest identified by the SEC. They were first proposed and aired for public comment in February 2002.

Then, on May 10, 2002, the Commission approved sweeping rule amendments by the NYSE and NASD addressing analyst conflicts. The amendments closed a number of regulatory gaps and took considerable steps toward promoting greater independence of research analysts by, among other things:

- prohibiting tying analyst compensation to specific investment banking transactions;
- restricting personal trading by analysts in securities of companies followed by the analyst;
- prohibiting offering favorable research to induce firm business;
- restricting investment banking review of research reports; and

• defining quiet periods on the issuance of research reports.

The Commission enacted or approved additional rules to bolster the integrity of analyst research, which are described in the Regulatory Actions to Address Analyst Conflicts and IPO Spinning section below.

The Commission was also concerned that investors were simply not aware of these conflicts of interest. To help address this problem, in 2001, the Commission issued an Investor Alert highlighting the numerous biases that may affect analyst recommendations. The Alert, called "Analyzing Analyst Recommendations," explained to investors the relationships between securities analysts and the investment banking and brokerage firms that employ them, and educated investors about potential conflicts of interest analysts may face.

On April 8, 2002, New York Attorney General Eliot Spitzer commenced an action in New York State Court pursuant to New York's Martin Act against Merrill Lynch & Co. Inc., Henry M. Blodget, and several other Merrill Lynch analysts. In papers filed with the State Court, the NYAG alleged that since late 1999, the Internet research analysts at Merrill Lynch had published ratings for Internet stocks that were misleading in that, among other things, the reports did not reflect the analysts' true opinions and Merrill Lynch did not disclose that the ratings were affected by conflicts caused by the analysts' ties to investment banking. The NYAG included with his filing dozens of exhibits, including internal Merrill Lynch e-mails demonstrating the analysts' conflicts of interest.

The NYAG reached a settlement with Merrill Lynch on May 21, 2002, pursuant to which the firm agreed to pay a penalty of $100 million and, among other things, to sever the link between compensation for analysts and investment banking, prohibit investment banking input into analysts' compensation, create a new investment review committee responsible for approving all research recommendations, establish a monitor to ensure compliance with the agreement, and disclose in Merrill Lynch's research reports whether it received or was entitled to receive any compensation from a covered company over the previous 12 months.

In the meantime, on April 25, 2002, the Commission announced that it had commenced a formal inquiry into market practices concerning research analysts and the potential conflicts that can arise from the relationship between research and investment banking. The inquiry was to be conducted jointly with the NYSE, the NASD, the NYAG, the North American Securities Administrators Association (NASAA), and the States. The purpose of the inquiry was to determine whether any laws had been violated as well as the necessity of additional rulemaking.

In October 2002, the Commission, the NYAG, the NYSE, the NASD, and NASAA announced a joint effort to bring to a speedy and coordinated conclusion the various investigations concerning research analysts and IPO allocations. The Commission and other participating regulatory entities intended, based on the evidence they had compiled, to formulate a common plan to address conflict-of-interest and other issues pertaining to research analysts and IPO allocations. The plan was to be used as a template to structure appropriate settlements with the firms that were currently under investigation and/or to provide a sound basis for proposing industry-wide rules and regulations (including structural reforms).

In December 2002, then-Chairman Harvey L. Pitt, New York Attorney General Spitzer, NASAA President Christine Bruenn, NASD Chairman and CEO Robert Glauber, NYSE Chairman Dick Grasso, and State securities regulators announced an historic settlement-in-principle with the Nation's top investment firms to resolve issues of conflict of interest at brokerage firms. Following the announcement, the Commission staff worked diligently with other regulators and the firms to finalize the settlement-in-principle. The broad principles agreed to in December are reflected in the terms of the final settlements approved by the Commission, and announced last week. The following sections describe the charges against the defendants and the terms of the settlements.

The Charges Filed Against the 12 Defendants

CHARGES AGAINST THE FIRMS

The charges against the 10 firms, which the firms neither admit nor deny, are summarized below.

The Commission's complaints charge that CSFB, Merrill Lynch, and SSB issued fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934 as well as various State statutes. For example, according to the complaint filed against CSFB, internal e-mail correspondence among research analysts regarding a particular company shows that the pressure imposed by investment bankers on research analysts to initiate or maintain favorable coverage was not an isolated problem at CSFB. In May 2001, a technology research analyst wrote an e-

mail to the Head of Technology Research, complaining of "Unwritten Rules for Tech Research: Based on the following set of specific situations that have arisen in the past, I have 'learned' to adapt to a set of rules that have been imposed by Tech Group banking so as to keep our corporate clients appeased. I believe that these unwritten rules have clearly hindered my ability to be an effective analyst in my various coverage sectors."

In another example, according to the complaint filed against SSB, on the same day that SSB and Jack Grubman published a research note rating a particular company as a 1 (Buy), Grubman e-mailed two colleagues that he believed that company should be rated a 4 (Underperform). In the e-mail, he also characterized the company as a "pig."

The Commission's complaints charge that Bear Stearns, CSFB, Goldman, Lehman, Merrill Lynch, Piper Jaffray, SSB, and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there was no reasonable basis in violation of NYSE Rules 401, 472, and 476(a)(6), NASD Rules 2110 and 2210, as well as State ethics statutes.

The Commission's complaints further charge that UBS Warburg and Piper Jaffray received payments for research without disclosing such payments in violation of Section 17(b) of the Securities Act of 1933 as well as NYSE Rules 476(a)(6), 401, and 472 and NASD Rules 2210 and 2110. Those two firms, as well as Bear Stearns, J.P. Morgan and Morgan Stanley, are charged with making undisclosed payments for research in violation of NYSE Rules 476(a)(6), 401, and 472 and NASD Rules 2210 and 2110 and State statutes.

CSFB and SSB are also charged with engaging in inappropriate spinning of hot IPO allocations in violation of SRO rules requiring adherence to high business standards and just and equitable principles of trade, and the firms' books and records relating to certain transactions violated the broker-dealer recordkeeping provisions of Section 17(a) of the Securities Exchange Act of 1934 and SRO rules (NYSE Rule 440 and NASD Rule 3110).

All 10 firms are charged with failing to maintain appropriate supervision over their research and investment banking operations in violation of NASD Rule 3010 and NYSE Rule 342.

CHARGES AGAINST THE INDIVIDUALS

The charges against the two individual defendants, Henry M. Blodget and Jack B. Grubman, which they neither admit nor deny, are summarized below.

The SEC alleges that, during 1999 through 2001, Blodget issued research reports that were materially misleading because they were contrary to his privately expressed negative views. The SEC also alleges that Blodget issued research reports that were not based on principles of fair dealing and good faith, did not provide a sound basis for evaluating facts regarding the subject companies, and contained exaggerated or unwarranted claims about those companies.

As to Grubman, the SEC alleges that, during 1999 through 2001, Grubman issued several fraudulent research reports that contained misstatements and omissions of material facts about the companies, contained recommendations contrary to his actual views regarding the companies, overlooked or minimized the risk of investing in these companies, and predicted substantial growth in the companies' revenues and earnings without a reasonable basis. The complaint against Grubman further alleges that he issued numerous research reports that were not based on principles of fair dealing and good faith, did not provide a sound basis for evaluating facts regarding the subject companies, and contained exaggerated or unwarranted claims about those companies.

Terms of the Settlements

To impress upon the firms the seriousness with which the Commission and other regulators regard their misconduct, and to help restore investors' faith in the objectivity of research, the settlements employ a multipronged approach, including both monetary and nonmonetary forms of relief.

MONETARY RELIEF

Collectively, the settling firms will pay disgorgement and civil penalties totaling $875 million, including Merrill Lynch's previous payment of $100 million in connection with its prior settlement with the States. Under the settlement agreements, half of the $775 million payment by the firms other than Merrill Lynch will be paid in resolution of actions brought by the SEC, NYSE, and NASD, and will be put into funds to benefit customers of the firms (the Distribution Funds). The remainder of the funds will be paid to the states. The Commission has invited the States to con-

tribute their portions of the civil penalties and disgorgement to the funds for investors as well.

Penalties

The civil penalties in these actions, which total $487.5 million, are among the highest—and the $150 million civil penalty against Salomon Smith Barney is the highest—ever imposed in civil securities enforcement actions. Pursuant to the settlements, the firms may not seek to treat the civil penalties as tax deductible or eligible for reimbursement under their insurance policies. In addition, the Commission intends that the Federal regulators' portion of the civil penalties be added to the Distribution Funds, pursuant to the Fair Funds provision of the Sarbanes-Oxley Act, for repayment to harmed investors.

Disgorgement

The 10 settling firms will pay $387.5 million in disgorgement. The Federal regulators' portion of these funds will be used to establish Distribution Funds to provide recompense to harmed investors.[3] While there are challenges and difficulties in administering such Funds, the Commission feels strongly that those challenges and difficulties are worth taking on and that any funds paid by the settling firms should be used to compensate the investors harmed most directly by the misconduct uncovered in the investigations. The Commission believes this is the right thing to do, and is consistent with the message sent by Congress when it recently authorized the Commission to use penalties to repay investors.

The Distribution Funds will be administered by a Court-appointed "Distribution Fund Administrator," who will distribute them in an equitable, cost-effective manner to customers who purchased equity securities of companies referenced in the complaint against the firm through which the customer bought the securities. However, the funds will not necessarily be allocated (i) with respect to purchases of stock of each company identified in the SEC's complaints; or (ii) to all purchasers of stock of a company identified in the complaints. Under the settlement agreements, it is intended that there be an equitable—but not necessarily equal—distribution of funds and that those who are allocated funds receive meaningful payments from the Distribution Funds. A recipient of funds from these settlements is not precluded from pursuing, to the extent otherwise available, any other remedy or recourse against a firm.

All of the Distribution Fund Administrator's fees, costs, and expenses, including all the fees, costs, and expenses of persons the Distribution Fund Administrator hires to assist him or her, will be paid by the settling firms and not from the Distribution Funds. Investors will not have to bear any of this expense. The only amounts from the Distribution Funds that will not be paid to investors are income taxes on the interest earned by the Distribution Funds and an additional amount, also payable from the interest earned by the Distribution Funds, to be paid to the Court. Both of these payments are required by law.

Tax and Insurance Issues Relating to the Settlement Payments

Some Members of Congress have expressed interest in and concern about the tax and insurance treatment of the settlement payments. As alluded to above, the Commission included language in these settlements that expressly prohibits the firms from taking a tax deduction or seeking to recover from an insurance carrier the penalty portions of their payments. The SEC has never imposed such requirements before, and to our knowledge, no other civil enforcement program typically does this. It was important to do this here, however, because when it comes to penalties, the public policy imperative—in the tax code and in court decisions interpreting insurance policies—is very clear: penalties should be paid by those upon whom they are imposed and should not be deductible.

With respect to the tax treatment of disgorgement payments—which are a well-accepted remedy in civil enforcement actions and whose treatment under the tax code has long been understood by Congress—we did not think it wise for us to substitute our judgment for that of Congress or the IRS. With respect to the tax treatment of the independent research and investor education payments, it did not seem appropriate to call them something that they were not in order to obtain a particular tax treatment or insurance result. In this regard, during the negotiation of the settlement, the Commission staff at no time engaged in "horse trading" by

[3] The total amount of the Distribution Funds will be $399 million, which includes the Federal regulators' share of the disgorgement and penalties paid by the firms and by the two individual defendants.

agreeing to lower penalty or disgorgement payments in return for higher independent research or investor education payments.

As for the insurability of disgorgement and the independent research and investor education payments, the issues are complicated and it likely will be up to the courts to determine, as a matter of State law, whether they are insurable.

STRUCTURAL REFORMS

Although the monetary relief obtained in the settlement is record-breaking, the structural reforms required by the settlement are, arguably, more significant and far-reaching. Specifically, the settlements include important requirements designed to insulate research analysts from pressures by investment banking. For instance, the firms will separate research and investment banking, including physical separation, completely separate reporting lines, separate legal and compliance staffs, and separate budgeting processes. In addition, under the terms of the settlement, analysts' compensation cannot be based directly or indirectly upon investment banking activities or input from investment banking personnel. Investment bankers cannot evaluate analysts, and an analyst's compensation will be based in significant part on the quality and accuracy of the analyst's research. To help ensure compliance, decisions concerning compensation of analysts will be documented.

Moreover, there will be no overlap between the jobs of investment bankers and research analysts. Investment bankers will have no role in determining what companies are covered by the analysts, and research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and road shows. Firms also will implement policies and procedures reasonably designed to assure that their personnel, including banking personnel, do not seek to influence the contents of research reports for purposes of obtaining or retaining investment banking business.

To ensure the separation between investment banking and research is comprehensive, firms will create and enforce firewalls between the two operations reasonably designed to prohibit improper communications between the two. Communications will be limited to those enabling research analysts to fulfill a "gatekeeper" role.

To ensure that these reforms are executed and implemented in a meaningful way, each firm will retain, at its own expense, an independent monitor who is acceptable to the SEC to conduct a review of the firm's compliance with the structural reforms. This review will be conducted 18 months after the date of the entry of the final judgment, and the independent monitor will submit a written report of his or her findings to the SEC, NASD, and NYSE within 6 months after the review begins.

ENHANCED DISCLOSURES

The settlements also impose a series of requirements that will benefit investors by providing them better information concerning the limitations of research. In that regard, each firm will include a disclosure on the first page of each research report stating that it "does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report." In addition, when a firm decides to terminate/coverage of an issuer, it will issue a final research report discussing the reasons for the termination. To enhance investors' power as consumers, each quarter, each firm will publish on its website a chart showing its analysts' performance, including each analyst's name, ratings, price targets, and earnings per share forecasts for each covered company.

These disclosures will fuel development of private services to transform such raw data into investor-friendly report cards on the accuracy of the firms' research, which should enable customers to comparison-shop for research.

INDEPENDENT RESEARCH

Another innovative and forward-looking aspect of the settlement agreements is the requirement that the firms purchase independent, third-party research for their customers. For a 5-year period, each of the firms will be required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers. Firms will notify customers of the availability of independent research on their customer account statements, on the first page of research reports, and on the firm's website. An independent consultant for each firm will have final authority to procure independent research, and will report annually to regulators concerning the research procured. Payments for independent research will total $432.5 million.

INVESTOR EDUCATION

To better arm investors to cope with the risks inevitably associated with participating in the capital markets, the settlement also provides for the establishment of

an Investor Education Fund of $80 million. This initiative is particularly important because it has meaning beyond the context of this investigation. The SEC, NYSE and NASD have authorized that $52.5 million of these funds be put into an Investor Education Fund to support programs designed to equip investors with the knowledge and skills necessary to make informed investment decisions. The court will appoint an SEC-recommended Investor Education Fund Administrator to establish a nonprofit grant administration program to fund worthy and cost-efficient investor education programs. The remaining $27.5 million will be paid to State securities regulators, which they will use for investor education purposes.

VOLUNTARY INITIATIVE REGARDING INITIAL PUBLIC OFFERINGS

In addition to the terms imposed by the regulators, the firms have collectively entered into a voluntary agreement restricting allocations of securities in "hot" IPO's—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors, a practice known as "spinning." The Commission intends to evaluate the need for specific rulemaking in this area, in light of these and other recent Commission enforcement actions that indicate abuses in the IPO allocation process.

INDIVIDUAL SETTLEMENTS

The terms of the settlements with the individual defendants are as follows:

Former Merrill Lynch analyst Henry M. Blodget, in settlement of the charges against him,[4] which he neither admits nor denies, has agreed to pay $2 million in penalties (which he may not treat as tax deductible or seek to recover from an insurance carrier or other third party) and an additional $2 million in disgorgement (all of which will be placed in the Distribution Funds). Blodget also has agreed to a Federal court order that will enjoin him from future violations of the Federal securities laws and NASD and NYSE rules. Blodget also will be censured and permanently barred from associating with any broker, dealer, or investment adviser.

Former SSB analyst Jack B. Grubman, in settlement of the charges against him,[5] which he neither admits nor denies, has agreed to pay $7.5 million as disgorgement and an additional $7.5 million in penalties (which he may not treat as tax deductible or seek to recover from an insurance carrier or other third party). One-half of these amounts will be placed in the Distribution Funds. Grubman also has agreed to a Federal court order that will enjoin him from future violations of the Federal securities laws and NASD and NYSE rules. Grubman also will be censured and permanently barred from associating with a broker, dealer, or investment adviser.

Regulatory Actions to Address Analyst Conflicts and IPO Spinning

In addition to its enforcement activities, the Commission and the self-regulatory organizations have taken action through rulemaking to require securities firms to better minimize, manage, and disclose analyst conflicts. These rules are designed to improve the objectivity and independence of research analysis and ensure that conflicts of interest that may affect research are disclosed to investors.

REGULATORY INITIATIVES RELATING TO RESEARCH ANALYSTS

As described in Section II, in May 2002, the Commission approved sweeping rule amendments by the NYSE and NASD addressing analyst conflicts. Early this year, the Commission published a second set of proposed rule changes filed by the NYSE and NASD to further strengthen their analyst conflicts rules. The Commission expects to act on those proposed amendments by the end of July.

The proposed amendments would, among other things:

- further reduce the influence of investment banking on analyst compensation;
- prohibit the issuance of research reports by the manager or co-manager of a securities offering for 15 days prior to and after the expiration of lock-up agreements (booster shots).
- restrict analyst involvement in solicitation activities with issuers (pitch meetings); and
- provide investors with notice of a firm's intention to terminate coverage of a company.

As you know, on July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act directs the Commission to implement rules designed to further address research analyst conflicts of interest. The Act re-

[4] The action against Henry Blodget is being brought in conjunction with actions by the NASD and NYSE.

[5] The action against Jack Grubman is being brought in conjunction with actions by the NASD, NYSE, and NYAG.

quires that such rules must be adopted by the end of July. The Commission has been working with the SRO's to meet the directives of the Act.

In addition to SRO rule changes, the Commission adopted its own rule, Regulation Analyst Certification, which became effective on April 14 of this year.

Regulation AC requires that broker-dealers, and certain associated persons who distribute research reports, obtain certifications from their research analysts that the views expressed in research reports and public appearances accurately reflect the analyst's personal views and whether the analyst received compensation for their recommendations or views.

REGULATORY INITIATIVES RELATING TO IPO SPINNING

As you are aware, the IPO underwriting process has come under considerable scrutiny during the past year—especially with regard to perceived abuses in the allocation of IPO shares. During the technology-stock boom of the late 1990's, it was not uncommon for a "hot IPO" to quadruple in value on its first day of trading (in some cases increasing by as much as 700 percent). These IPO's were typically heavily oversubscribed and participation in these IPO's became immensely valuable for both underwriters and customers.

This hot commodity produced not only huge first-day returns for those who received allocations in the IPO's, but also led to abusive conduct, including a practice known as "spinning." Spinning involves the allocation of "hot" IPO shares to senior executives in the belief or expectation of receiving future investment banking business from their companies. The problem with IPO spinning is that the broker-dealer is not distributing all the shares of hot IPO's into the market, but is using some shares to entice investment banking business from insiders of other corporations. Spinning increases the public perception that IPO allocations are an insiders' game. Spinning also raises serious questions about whether the corporate insiders who take hot IPO shares in exchange for their firms' investment banking business are breaching their fiduciary duties to their shareholders.

The global settlement includes a voluntary ban on the allocation of "hot" IPO's to executive officers and directors of public companies. The Commission is reviewing industry practices regarding the allocation of IPO shares with the goal of restoring investor confidence and public trust.

In addition, last fall, at former Chairman Pitt's request, the NYSE and NASD convened a blue ribbon panel of business and academic leaders to conduct a broad review of the IPO process, including the role of issuers and underwriters in the pricing and allocation process, and recommend ways to improve the underwriting process. We understand that the panel hopes to report on its findings shortly.

The NASD recently sought comment from its members on its proposed new rules regarding the regulation of IPO allocations and distributions.

These rules are intended to better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPO's. Among other things, the rules would prohibit allocations to company CEO's and directors on the condition that they send their companies' investment banking business to the NASD member.

In the months ahead, the Commission will continue to examine the IPO practices of the industry to determine whether further Commission or SRO action is necessary, including the possibility of revising existing rules or proposing new rulemaking.

Conclusion

In conclusion, let me assure you throughout the research analyst investigation and the process of negotiating the global settlement, the goals of the Commission and its staff have been to protect investors and restore confidence in our securities markets. The Commission will monitor carefully the effects of, and compliance with, the terms of the settlement, and take actions as appropriate to ensure that these objectives are achieved.

In addition, the Commission intends to review the implementation of the settlement, along with reforms adopted by the Commission and the NASD and NYSE over the last 2 years, to evaluate whether additional harmonizing, or superseding rules are appropriate.

Thank you again for inviting me to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

PREPARED STATEMENT OF ELIOT SPITZER

ATTORNEY GENERAL, THE STATE OF NEW YORK

MAY 7, 2003

Thank you Chairman Shelby, Senator Sarbanes, and distinguished Members of the Committee, it has been almost a year since I last testified on Capitol Hill about issues of great concern to the investing public. At that time, my office had just revealed in court documents the raw reality of Wall Street research, and imposed a previously unimaginable $100 million dollar fine on Merrill Lynch for promoting its investment banking clients by touting stocks to the public that it internally had labeled "junk" and even less flattering 4-letter words. In negotiating the Merrill Lynch settlement, I was frequently told by members of the investment banking community and shockingly, even by some members of the securities regulation community that (1) "all investment banks raise capital like this;" (2) "there's nothing wrong with it;" and, most astounding, (3) "there is no other way."

Well, they were right on the first point. We now know that Merrill Lynch was not alone amongst investment banks that would go to the ends of the earth to produce favorable research for investment banking clients—regardless of underlying realities—whether the bank wrote the research itself or paid another bank to do so. But we also now know that this practice IS wrong. It is illegal. It yielded research that was fraudulent at worst and misleading at best. It cost individual investors their mortgages, their college funds, and their retirement money, and it had to stop. There IS another way—and that is what the global resolution we announced last week is all about.

The global settlement resulted from a productive collaboration between State and Federal regulators. I entered into this collaboration with three goals, and I was gratified to learn that my co-regulators shared them. Those goals were (1) structural reform, (2) availability of restitution to investors, and (3) individualized liability.

The first and third goals, while not mutually exclusive, had to be dealt with in order. In other words, it was crucial to change the rules of the game and not merely substitute players. These players were operating in a system that allowed investment bankers to determine what purportedly "objective" research analysts said, and when the analysts' research would be initiated and terminated (without notice to investors) with the same favorable rating in place. These players were operating in a system where the most significant component of a purportedly "objective" research analyst's evaluation and compensation was the amount of investment banking revenue attributable to that analyst. The players were operating in a system where analysts were expected to accompany bankers on pitches and roadshows, and yet did not have to disclose prominently on their research reports that they were trying to satisfy and woo investment banking fees from the very same companies about which they were writing.

To allow the system that I just described to remain in place while merely ousting its current participants would have been a fruitless endeavor. So our foremost goal was to reform the system to remove investment banking concerns from the research analyst's paycheck and ultimate work product, and to require meaningful disclosures that will better equip investors to evaluate both the objectivity of a particular piece of research, as well as the track record of an individual analyst over time. Finally, the mandate that each settling firm provide research that is not only independent, but also not produced by yet another conflicted investment bank, should ensure that individual investors have at least one piece of research available to them that is not written by someone who stands to gain—directly or indirectly—from an investment banking mandate. It is, as my colleague Steve Cutler described it last week, a necessary "belt and suspenders" approach.

That being said, I do not wish to imply that individual wrongdoers have not been or will not be held responsible for their actions. We simply first had to remove some of the systemic flaws that enabled improper conduct to flourish. As you know, a number of individuals have been charged—both civilly and criminally—and I suspect that examinations of individuals will increase in the coming months. Individual wrongdoing was not covered by the global settlement—rendering individual conduct fair game not only for the SEC and the SRO's, but also for State and local prosecutors as well. Obviously, it is improper to discuss the status of ongoing individual investigations, or to name individuals for whom a charging decision is still pending.

Much attention and criticism has been directed to the settlement's monetary relief: Specifically, the amount and the purposes to which the penalties and disgorgement are being directed. There are those who feel that the penalties were not high enough that the banks "felt no pain," and there are also those who feel that more of the settlement money should have gone to restitution. With respect to

this, it is important to keep in mind that if more of the settlement money had been designated "restitution," it would be that much less a "penalty" to the extent that the banks are already obligated to make restitution to investors who prevail in court and in arbitrations. Penalties are an additional obligation to be paid by the banks on top of their pre-existing obligation to make investors whole. In resolving these cases, it was important to us that both penalties and restitution be components of the settlement. And as we stated last week, we were not about to engage in "accounting gimmickry" by calling a particular payment something that it is not.

Even though not all monies paid by the banks will go to restitution, the settlement will nonetheless facilitate restitution by making the evidence readily available to anyone who can show reliance on tainted research and who wishes to pursue a claim against a bank in court or through arbitration. Judges and arbitrators presiding in these fora have been resolving securities claims for years—with Congress' blessing. Individual States are simply ill-equipped to mete out restitution in any other manner.

With respect to where we go from here, two thoughts come to mind. First, as a lawyer, it remains astounding to me and to many of my colleagues the investment banks ever got into the position that they were in when we began investigating. Where were the legal and compliance departments? Where was the leadership at each bank? We know from the evidence uncovered at more than one bank that senior levels of management were cognizant of the conflicts of interest that permeated these institutions at every level. Indeed, if they didn't know from their personal experience, they could have read about it in the Nation's leading newspapers and periodicals. Yet, no bank was willing to do anything about it until, in essence, the first subpoena issued. Indeed, it was not until I aired the Merrill Lynch e-mails that any other bank stepped up to the plate and recognized that their internal workings may not be so flawless, either. It should not take the threat of direct legal action to do the right thing.

Second, I hope that this extraordinary collaboration between State and Federal regulators has put to rest any notion that States need to be "preempted" from enforcing securities laws. To the contrary, this settlement demonstrates that Federal and State governments are capable of pursuing common goals in record-breaking time to achieve unparalleled relief. The States played an important role in uncovering the misdeeds recited in the charging documents released last week, and will continue to play an important role in policing against such misdeeds in the future.

When I appeared before Congress less than a year ago, State "balkanization" of the securities laws was of concern to many lawmakers. As we now know, no such "balkanization" among States occurred. Indeed, the only danger of "balkanization" remaining is that the settling banks will be alone amongst financial institutions required to operate under the principles of fair dealing that informed the global settlement. The ten investment banks that settled last week should not be the only institutions required to separate research from investment banking, provide meaningful disclosure, or make available independent research. Nor should they be the only institutions that must stop the pernicious practice of "spinning" whereby banks award lucrative IPO shares to officers and directors of current and potential investment banking clients in hopes of winning even more lucrative investment banking business. There is simply no reason why any individual should profit personally from the opportunity to direct his or her corporation's business to a particular investment bank. To that end, I urge Congress and the regulators to do all in their power to promote and direct broader applicability of the provisions of the global settlement to similarly-situated financial institutions. I urged Congress to include the type of reforms contained the global settlement prior to passage of Sarbanes-Oxley; it is even more important now. Only when the rules are fair, and fairly applied to everyone can investor confidence return to the marketplace.

I would note parenthetically in this regard that an immediate stop must be made to the effort to amend the definition of "disinterested person" under the Bankruptcy Code such that investment banks that underwrote securities of debtor companies would subsequently be allowed to advise those companies in bankruptcy. The inherent conflict of interest in and perverse incentives created by such an arrangement ought to be clear to all by now.

I am extraordinarily proud of the concrete reforms that State and Federal regulators were able to achieve through joint efforts in less than a year. I look forward to future fruitful collaboration, and thank the Members of this Committee for affording me the opportunity to expound on this process today. I will be happy to answer any of your questions.

PREPARED STATEMENT OF RICHARD A. GRASSO

CHAIRMAN AND CEO, NEW YORK STOCK EXCHANGE, INC.

MAY 7, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am pleased to testify today on behalf of the New York Stock Exchange, Inc. (the Exchange) to discuss this historic $1.4 billion settlement that addresses the conflicts of interest between the research and investment banking departments at 10 of the largest and most influential investment firms in the country (settlement).[1]

The firms that participated in the settlement are Bear, Stearns & Co. Inc. (Bear Stearns), Credit Suisse First Boston LLC (CSFB), Goldman, Sachs & Co. (Goldman), Lehman Brothers Inc. (Lehman), J.P. Morgan Securities Inc. (J.P. Morgan), Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch), Morgan Stanley & Co. Incorporated (Morgan Stanley), Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (Salomon Smith Barney), UBS Warburg LLC (UBS), and U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray).[2] These firms settled enforcement actions by the Exchange (enforcement actions) without admitting or denying the allegations, facts, conclusions or findings contained in the settlement documents.[3]

The settlement is historic in many ways, including in its breadth and depth, in the severity of the penalties imposed, in the level of cooperation between Federal and State securities regulators, and finally but perhaps most importantly, in its impact on the way that securities firms will do business in the future.

This investigation leading to the settlement was unmatched in terms of its magnitude. The regulators conducted simultaneous, extensive probes of the firms' research practices, which included taking the testimony of numerous firm employees and reviewing hundreds of thousands of pages of documents and e-mail. In addition, the investigation was unparalleled in terms of the speed in which a resolution was reached. Barely a year has passed since the investigation was initiated.

The $1.4 billion settlement, which includes penalties of $487.5 million, disgorgement of $387.5 million, $432.5 million for independent research, and $80 million for investor education, is the largest in the history of securities regulation. In addition, the firms have agreed to far-reaching new procedures that will forever change the way that research analysts and investment bankers do their jobs.

In short, this settlement ushers in a new era in which the quality, integrity, and reliability of Wall Street research will be protected for the benefit of investors. Securities firms and investors alike should be aware that the Exchange and the other regulators will take all necessary measures to ensure the integrity of the marketplace and to hold responsible any firm or individual who breaks the rules or violates the law.

The Exchange's Role in Regulating the Securities Industry

Prior to my discussing the Exchange's role in this historic settlement, I would like to emphasize the Exchange's well-established commitment to the vigorous and the effective regulation of the securities industry to protect investors, the health of the financial system, and the integrity of the capital formation process. I have cited this commitment by the Exchange many times. However, I believe that it is important to reemphasize the depth of this commitment and to describe the resources that the Exchange has dedicated to policing the securities industry.

The Exchange is one of the most active self-regulators in the securities industry and is the designated examining authority for its more than 400 member firms, 250 of which do business with the public. These firms include all of the major securities firms in the United States, which hold more than 93 million customer accounts, or 85 percent of all public customer accounts handled by broker-dealers. In addition, these firms operate more than 21,000 branch offices around the world and employ approximately 157,000 registered personnel.

Within the Exchange, the responsibility for regulating its member firms falls upon the Regulatory Group, which consists of the Divisions of Member Firm Regulation, Market Surveillance, and Enforcement. The Division of Member Firm Regulation, with a staff of approximately 265, conducts ongoing surveillance and annual examinations of firms' financial, operational, and sales-practice compliance. The Division

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[1] In 2002, these 10 firms generated more than 70 percent of the total investment banking revenue generated by the Exchange's member firms.

[2] The investigations of Deutsche Bank Securities, Inc. and Thomas Weisel Partners LLC are continuing.

[3] At the Exchange, the firms executed a "Stipulation and Consent," which is a settlement document that is approved by an Exchange Hearing Panel.

of Market Surveillance, with a staff of approximately 155, is responsible for the oversight of all trading activities on the Exchange floor, ensures that auction-market principles are maintained, and monitors for abusive or manipulative trading practices, including insider trading. The Division of Enforcement is the prosecutorial arm of the Exchange and employs approximately 140 people, most of whom are attorneys. Enforcement typically carries a caseload of approximately 700 matters and initiates over 200 enforcement actions a year to enforce Exchange rules and the Federal securities laws.

To meet its regulatory obligation, the Exchange commits substantial resources to the Regulatory Group. Approximately one third of the Exchange's staff works in the Regulatory Group, which has an operating budget of approximately $142 million. In addition, the Regulatory Group places a high priority on working with other securities regulators, including the Securities and Exchange Commission (the SEC) and NASD Inc. (the NASD), in investigating violations of securities laws and in creating new rules to govern the industry. It is this spirit of cooperation, along with a high commitment to protecting investors, which led to the joint investigation into research analyst conflicts of interest in April 2002.

The Exchange's Role in Investigation of Research Analyst Conflicts of Interest

RULEMAKING

The $1.4 billion settlement resulted from the efforts of the Exchange, the SEC, the NASD, the North American Securities Administrators Association (NASAA), the New York Attorney General's Office, and State securities regulators (collectively, the Task Force) pursuant to a joint investigation into the market practices of research analysts and the conflicts of interests between the research and investment banking departments at certain securities firms.

Prior to the creation of the Task Force, the Exchange and the NASD (the self-regulatory organizations or SRO's), in consultation with the SEC and the House Financial Services Committee, were working toward modifying the SRO rules to create a comprehensive regulatory scheme to address the activities of research analysts and to increase the level of disclosure in research reports. As early as March 2000, the SRO's, pursuant to discussions with the SEC, began to consider ways to enhance the rules in this area. New rules were drafted by the SRO's and approved by the SEC in May 2002, and these rules represented an important step in insulating research analysts from conflicts of interest and in improving the objectivity of published research.

Exchange Rule 472 governs the content of research reports and communications with the public generally. The May 2002 amendments to Rule 472 impose significant restrictions on research analysts and require additional disclosures in research reports. These amendments prohibit the investment banking department from supervising research analysts and approving research reports; prohibit the linking of analyst compensation to specific investment banking transactions; restrict personal trading by analysts in the stock of covered companies; and require additional disclosures in research reports. These disclosures include a disclosure of relationships with and ownership interests in subject companies; data relating to the firm's stock ratings, such as the percentage of ratings issued in each of the "buy," "hold," and "sell" categories; and a price chart comparing the rated security's closing price to the rating or price target over time.

In June 2002, the Exchange's Division of Member Firm Regulation initiated a special examination program, in conjunction with similar programs at the SEC and the NASD, to ensure that firms were complying with the obligations and restrictions imposed by the new rules. As set forth more fully below, the Division of Member Firm Regulation will continue to conduct examinations of member firms to ensure that the new rules are followed.

In addition, the Exchange continues to work closely with the SEC and the NASD to further develop the rules governing research analysts. In October 2002, the Exchange and the NASD submitted to the SEC, for comment and approval, additional rules that further expand the restrictions on firms' research activities. These proposed rules provide restrictions on the compensation of research analysts and research analyst solicitation of investment banking business; require notification to customers when research coverage is terminated; impose registration and qualification requirements on analysts, broaden the application of quiet periods, during which research may not be issued; and require continuing education and ethics training for research analysts.

The Exchange is in the process of drafting and approving new rules pursuant to the requirements of Sarbanes-Oxley Act of 2002 (the Act). The Exchange, in conjunction with the SEC and the NASD, has analyzed the differences between the Act

and the SRO rules and has determined that further amendments are warranted. These amendments, which will be submitted to the SEC shortly, represent yet another step in the direction of insulating research analysts from conflicts of interest and ensuring that published research is objective and contains disclosures and other information to help the public make informed investment decisions.

Rulemaking in this area is far from complete, and the Exchange is unwavering in its commitment to develop rules that are rational, effective, and comprehensive. The Exchange will continue to work closely with the SEC and the NASD to ensure that the resulting regulatory framework protects both investors and the functioning of the securities markets.

THE INVESTIGATION

In April 2002, the Office of the New York State Attorney General (NY AG's Office) announced a court order against Merrill Lynch relating to research analyst conflicts of interest, which was followed by a $100 million settlement with the firm in May 2002. The NY AG's Office uncovered evidence of improper conduct by certain research analysts in e-mail produced by Merrill Lynch. Following the announcement of this settlement, the Exchange, the SEC, and the NASD (collectively, the Federal regulators) initiated an investigation of the research practices at twelve of Wall Street's top securities firms. In addition, State securities regulators began an independent review of these practices.

The Federal regulators' goals in this investigation were to identify any problematic conduct, create a system to ensure that such conduct would not occur in the future, and impose sanctions on those who were responsible. As I sit before you today, I believe that those goals were accomplished.

The Exchange recognized the importance of conducting this investigation both expeditiously and effectively, and thus committed significant resources to the task. From April to December 2002, 50 Exchange staff members and managers from the Divisions of Enforcement, Market Surveillance, and Member Firm Regulation participated in the investigation. Collectively, these individuals devoted more than 40,000 hours reviewing approximately 765,000 e-mails and 187,000 pages of documents, and interviewing or deposing dozens of firm employees. In addition, Exchange technical staff built from the ground up, an electronic system to review, search, and catalog e-mail.

The Task Force met regularly to discuss the progress of the investigations at each firm, to share information and findings, and to evaluate the many ways in which the conflicts of interest were manifested at the firms. Early on, it became apparent that all of the firms utilized business practices and unwritten procedures that compromised the independence of their research analysts. In a matter of months, the Task Force uncovered significant evidence that each firm had engaged in misconduct, and this misconduct is described in detail in the settlement documents released on April 28, 2003.

While the investigations of the firms were ongoing, senior officials from the Exchange, in conjunction with the other members of the Task Force, discussed structural reforms that would address the conflicts of interest and insulate research analysts from investment banking pressures. During this lengthy process, the regulators created a new system that would protect investors while maintaining the research analyst's traditional role as a "gatekeeper" in screening companies for underwriting purposes. The result of this process is specified "Addendum A" to the settlement documents. Addendum A contains strict limitations on the activities of research analysts. As discussed below, these limitations exceed the requirements of the current SRO rules. While it is anticipated that there will be uniform rules that govern the activities of research analysts at all securities firms, the Task Force believed it was imperative that the firms under investigation make immediate changes in the way that they conduct their business, for the sake of protecting investors.

COOPERATION WITH STATE REGULATORS

Shortly after the Exchange, the SEC, and the NASD commenced its investigation, these Federal regulators coordinated their investigative efforts with NASAA and individual State regulators. Since that time, the Federal and State regulators worked closely by comparing and sharing evidence, consulting on findings against the firms, and negotiating the final settlement agreements. During settlement negotiations with the firms, the Federal and State regulators spoke with one voice and presented the firms with an opportunity to resolve the State and Federal claims simultaneously. The level of communication and cooperation among the Federal and State regulators was noteworthy.

ENFORCEMENT ACTIONS RELATING TO FAILURE TO RETAIN ELECTRONIC COMMUNICATIONS

During the course of the investigation, the Exchange, the SEC, and the NASD determined that 5 of the 12 firms under investigation—Deutsche Bank, Goldman Sachs, Morgan Stanley, Salomon Smith Barney, and Piper Jaffray—did not preserve electronic communications in a manner consistent with the recordkeeping and supervisory requirements of Section 17(a) of the Securities Exchange Act of 1934, Rule 17a–4 thereunder, and Exchange Rules 440 and 342.

Between 1999 and 2001, the firms failed to retain electronic communications related to their business for 3 years and/or, to the extent they did retain electronic communications, failed to keep those communications in an accessible place for 2 years. In addition, these firms failed to have systems and procedures to ensure that the electronic communications were preserved for the requisite period of time, and this failure amounted to supervisory deficiencies in violation of Exchange Rule 342.

In December 2002, the firms agreed to settle the enforcement actions by the regulators and paid a fine of $1.65 million per firm, for a total payment of $8.25 million. The fines were paid jointly to the Exchange, the NASD, and the SEC. In addition, the firms agreed to an undertaking to establish a system to properly retain electronic communications. Presently, the firms have upgraded their systems and have attested to their compliance with Federal law and the SRO rules relating to the retention of electronic communications. Equally important, securities firms have been placed on notice that they may not disregard the requirement to maintain electronic communications relating to their business.

It is important to note that the firms participating in the $1.4 billion settlement are required to pay substantial monetary penalties, notwithstanding the absence of certain electronic communications.[4] Each firm under investigation produced e-mails, research reports, notes, and other documents, all of which provided evidence of conflicts of interest and other violative conduct. The enforcement actions against Salomon Smith Barney and CSFB contained fraud charges, despite the fact that those firms did not have appropriate systems to mechanisms or preserve electronic communications. Contrary to reports in the press, no firm "escaped" from the $1.4 billion settlement because it failed to preserve certain electronic communications as described in the $8.25 million e-mail case.

THE ENFORCEMENT ACTIONS

Issuance of Fraudulent Research

At several of the firms participating in the settlement, the evidence revealed that certain analysts, including Henry Blodget of Merrill Lynch and Jack Grubman of Salomon Smith Barney, drafted research reports that contradicted their privately held views of those companies, as those views were expressed to others in e-mail.

Issuance of Exaggerated and/or Unwarranted Research

The Task Force's review of e-mail uncovered numerous instances in which research analysts issued research reports that appeared to be more positive than the analysts' views expressed in e-mails to friends, family, preferred customers, and coworkers. In certain instances, this overly positive research was attributable to direct pressure from investment banking personnel. In addition, certain research analysts acknowledged that the covered company's status as a current or prospective investment banking client was as a factor in drafting the positive research.

Compensation of Research Analysts

The Task Force determined that each firm compensated its research analysts in a manner that created a conflict of interest between receiving high levels of compensation, often linked to investment banking business, and the responsibility to issue objective research. Research analysts at these firms were paid base salaries that ranged from $125,000 to $200,000, and bonus compensation often totaled millions of dollars. Bonus compensation was based, in varying degrees, on the level of investment banking business generated by companies and/or sectors covered by the analysts. In some instances, research analysts were paid a percentage of investment banking fees generated by companies in covered sectors. By linking research analysts' compensation to the generation of investment banking business, the firms utilized a compensation system that created an improper incentive for analysts to issue research that was overly positive, inaccurate, or otherwise lacked objectivity.

Furthermore, it was a common practice at all of the firms for research analysts' performance reviews to include input from investment bankers. As a result, re-

[4] As noted above, the investigations of Deutsche Bank Securities, Inc. and Thomas Weisel Partners LLC are continuing.

search analysts understood that their contribution to the firms' investment banking business was a factor in their compensation.

Research Analysts' Participation in Soliciting Investment Banking Business

At all of the firms, research analysts typically assisted investment bankers in preparing "pitch" materials for presentation to prospective investment banking clients. The pitch materials frequently identified the analyst who would provide research coverage of the company after the investment banking transaction and described the research coverage that would be provided. Research analysts frequently attended pitch meetings with investment bankers, and during these meetings, analysts discussed their view of the company and the research coverage they intended to issue. In some instances, firms touted their research analysts' "voice" in the marketplace by showing the increase in covered companies' stock price in response to favorable research issued by the analysts. Participation by research analysts in the pitch process created a conflict of interest for the analysts who, early in the process, expressed their support of investment banking clients.

Initiation and Dropping of Coverage

In general, research coverage was issued on companies for which a firm acted as a lead- or co-manager in an underwriting. The firms considered research coverage to be a service to the companies as well as a service to the firm's customers who purchased shares of the companies. However, in some instances, firms gave their investment banking clients a durational "warranty" of research coverage for periods ranging from 18 months to 3 years.

In addition, the investigation revealed that research analysts frequently initiated research coverage, in conjunction with input from investment banking personnel, to generate investment banking business from the covered companies. At many of the firms, research analysts were pressured to refrain from dropping coverage on investment banking clients unless approval was received from the investment banking department. Also, there was evidence that research analysts dropped research coverage in retaliation against companies that engaged an outside firm for an investment banking transaction.

Maintenance of Positive Coverage

The investigation revealed that the firms maintained favorable ratings on the majority of all stocks covered research. Even as the dot.com bubble began to burst and stock prices began to fall in 2000 and 2001, research analysts maintained their positive ratings on investment banking clients. Further, the investigation uncovered numerous instances in which investment banking personnel pressured research analysts to issue positive research and/or to raise price targets and recommendations.

Payments for Research

The evidence revealed that some firms made payments to and/or received payments from outside firms for published research. These "research payments" were typically made in connection with an underwriting transaction in which the lead underwriter made payments to firms that did not participate in the transaction. The receiving firms failed to disclose these payments in the published research reports.

Spinning

The evidence revealed that at least two of the firms, Salomon Smith Barney and CSFB, engaged in "spinning," which is the improper allocation of "hot" IPO shares to executives of investment banking clients with the expectation that these executives would steer investment banking business to the firm.

Supervision and Bad Business Practices

Another significant component of the Task Force's investigation was scrutiny of the firms' supervisory policies and practices. The Task Force determined that each firm encouraged a culture and environment in which research analysts were repeatedly subjected to inappropriate influence by investment bankers, and the analysts' objectivity and independence was compromised as a result of that influence. These supervisory deficiencies manifested themselves in numerous ways, including the following:

- Certain firms did not adequately supervise the work of their research analysts, the content of research reports, and the reasonableness of published ratings and recommendations;
- Certain firms failed to establish policies and procedures sufficient to prevent investment bankers from pressuring research analysts to initiate or drop coverage and/or to upgrade recommendations and raise price targets;

- Certain firms failed to establish policies and procedures reasonably designed to ensure that "pitch" materials did not to implicitly suggest that favorable research would be provided if the firm were selected for an investment banking transaction;
- Certain firms failed to establish policies and procedures sufficient to prevent or detect instances in which research analysts provided drafts of research reports to covered companies for review, including research reports that contained price targets and ratings or recommendations;
- Supervisors at certain firms failed to detect that some research analysts held private views that differed from their published research, even though these analysts communicated these private views to others, and failure led to the publication of exaggerated, unwarranted and, in some cases, fraudulent research; and
- Supervisors at the firms knew that the research analysts' contribution to the firms' investment banking business was a significant factor in determining the analysts' bonus compensation and, in some instances, research analysts were guaranteed by contract a certain percentage of the investment banking fees generated by the transactions on which they worked.

Supervisors at the firms encouraged research analysts to assist in the solicitation of investment banking business and did so without systems and procedures in place to ensure the independence and objectivity of the research product. The firms' policies and procedures failed to address the significant investment banking influences that developed, and more importantly, the firms failed to manage the conflicts of interest that existed between the research and investment banking departments.

The Task Force determined that the lack of adequate supervision constituted a structural deficiency that was best addressed by including supervision violations in the enforcement actions against each of the firms. By restructuring the way that research analysts and investment bankers are permitted to interact—both through the undertakings specified in Addendum A and through the new rules—it is intended that the supervisory deficiencies at these firms will be corrected.

The Exchange, as a member of the Task Force, will continue to monitor and review evidence of misconduct in this area and will bring actions, as warranted, against the management of these firms, individual supervisors of the research and investment banking departments, and individual research analysts who engaged in improper conduct. As set forth more fully below, the Exchange's Division of Member Firm Regulation will conduct periodic examinations to ensure compliance with the settlement's undertakings and the new rules in this area.

THE TERMS OF THE SETTLEMENT

Restitution

The $1.4 billion settlement includes a restitution payment of $387.5 million, which will be returned to harmed investors. This $387.5 million payment represents the entire amount attributed to the Exchange, the SEC, and the NASD. No funds paid by the firms will be directly held or received by the Federal regulators. An administrator appointed by the SEC will administer the restitution fund.

Furthermore, while the $387.5 million in restitution is not intended to fully reimburse the losses of investors, the detailed description of the evidence uncovered by the investigations will assist individual investors in recovering some of their losses through civil remedies such as arbitration and class action suits.

Penalties

The $1.4 billion settlement also includes a collective payment of $487.5 million in penalties. These penalties constitute some of the largest fines ever levied in the securities industry and thereby send a strong message about the seriousness of the firms' misconduct. These penalties constitute the collective payment that will be made by the firms to the States, and no members of the Task Force will receive any payment of penalties.

Investor Education

As part of the settlement, 7 out of the 10 firms will also pay a total of $80 million for investor education, as described in more detail below.

Prospective Relief

As discussed above, it was always of paramount importance that the Task Force not only identify and punish past misconduct, but impose a system of "prospective relief" that would require the firms to change the way they did business in order to provide immediate protection to the investing public. This goal was accomplished through the inclusion of "Addendum A" to each of the firm settlement documents. Addendum A addresses the complicated problem of how to manage the inherent con-

flicts of interest between research analysts and investment bankers in a manner adequate to protect individual investors while still allowing research analysts to continue their essential role in the capital formation process.

Under this aspect of the settlement, the firms are required to sever the links between research and investment banking, including prohibiting analysts from receiving compensation for investment banking activities, and prohibiting analysts' involvement in investment banking "pitches." In order to ensure the feasibility of promptly implanting the new system, the firms participated in discussions pertaining to the design of this new model for research and investment banking. In sum, the firms have agreed to curtail certain acts and practices that called into question the credibility of published research and to safeguard research analysts' role in the capital formation process and in providing services to their clients.

Significant Changes to the Firms' Business Models

The impact of the settlement, and particularly Addendum A, will be significant. No longer will firms that engage in investment banking services be able to operate with the unfettered participation of research analysts. Equally important, those firms will not be permitted to pressure research analysts to place a favorable ratings or recommendations on stocks. Specifically, Addendum A requires the following:

- The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups.
- The firms' senior management will determine research department budgets without input from investment banking and without regard to specific revenues derived from investment banking.
- Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance.
- Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions.
- Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows. During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction.
- The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances.
- Each firm will make its analysts' historical ratings and price target forecasts publicly available.

Independent Research

To ensure that individual investors get access to objective investment advice, the firms will be obligated to make independent research available. For a 5-year period, each of the firms will be required to contract with no fewer than three independent research firms. Customers will be given notice on account statements and trade confirmations that independent research is available at no cost. An independent consultant for each firm will have final authority to procure independent research. Under the terms of the final judgments, the firms will individually incur the cost associated with retaining an independent consultant.

Independent Monitors

Each firm is required to retain an independent monitor, acceptable to the Task Force, for a period of 5 years. Under the terms of the final judgments, the firms will individually incur the cost associated with retaining an independent monitor. The independent monitor's function is to conduct a review to provide reasonable assurance of the implementation and effectiveness of each firm's policies and procedures designed to achieve compliance with the terms of Addendum A. The independent monitor will provide a written report concerning each firm's compliance and will continue to monitor the firm's conduct over the 5-year period. The appointment of an independent monitor is the first step in having the firm's compliance with the new requirements evaluated, which is essential to be sure that the conflicts of interest that flourished at the firms are eliminated.

Prohibition of Spinning

In addition to the other restrictions and requirements imposed by the enforcement actions, the 10 firms have collectively entered into a voluntary agreement prohibiting spinning. Specifically, firms will not allocate securities in hot IPO's to executive officers and directors of public companies in order to attract investment banking business. This will promote fairness in the allocation of IPO shares.

The Exchange's Role Moving Forward

This settlement represents a significant step toward ensuring that published research is untainted by conflicts of interest and that the firms effectively manage their research and investment banking departments. This settlement is also a significant step toward guaranteeing that pre-IPO shares are allocated fairly and not used as a tool for firms to generate investment banking business.

In addition to the payment of penalties and disgorgement, and creation of a mechanism for independent research, this settlement contains other important components that, moving forward, will help ensure the protection of investors in this area.

INVESTOR EDUCATION FUND

The investor education component of the settlement is particularly important to the Exchange. The settlement requires payment of $80 million into a fund for investor education. The objective of the fund is to support programs to provide investors with the knowledge necessary to make informed investment decisions. Under the terms of the final judgments entered by the SEC, the investor education funds will be paid out in five equal installments based on the various amounts that firm has agreed to pay.

The Exchange has been active in educating investors for decades and sponsors several full-time programs. One such program is a teacher workshop, which is in its 16th year. The workshop has educated more than 2,500 teachers about investing in the stock market, so that they can return to the classroom and pass this knowledge to their students. The Exchange is committed to continuing these programs and working with the SEC and NASD to make certain that the investor education funds paid pursuant to the settlement are used productively and with the goal of enhancing investor understanding of investing in the global securities markets.

COMPLIANCE WITH THE SETTLEMENT'S UNDERTAKINGS AND EXCHANGE RULES

Pursuant to the settlement, the firms will make significant changes to their business operations in ways that will forever impact the securities industry. The changes are detailed in Addendum A in the settlement documents. No longer will it be permissible for the research department to work with the investment banking department to solicit and generate investment banking business. Research analysts will not report to investment bankers, will not be compensated or evaluated based upon banking business, will not solicit investment banking business, and will not communicate freely with investment bankers about the companies upon which they are issuing research. The goal is to ensure that the research and investment banking departments are indeed separate and that research personnel publish research that is objective and free from investment banking influence.

The Exchange, through the Division of Member Firm Regulation, conducts regular annual examinations of the sales practice and financial operations of member firms. Pursuant to these examinations, Member Firm Regulation will review compliance with the undertakings required by Addendum A. A detailed examination "scope"—which is listing of the operational areas that will be reviewed and the questions that will be answered by representatives of the firm—is being prepared that will be used to review each firm's compliance with the undertakings required by the settlement.

In addition, the Exchange will continue to review its member firms' compliance with Exchange Rule 472 and its amendments, which govern the content of research reports and the activities of research analysts. The Exchange is also reviewing its member firms' compliance with the requirements of Regulation Analyst Certification (Reg. AC), which requires that analysts certify that the content of research reports represent their personal views.

The Committee should be aware that the Exchange is committed to making sure that the firms adhere to the Exchange Rules governing research analysts, as well as the structural requirements required by the settlement's undertakings. Violations of Exchange Rules or the undertakings' requirements will be referred to the Exchange's Division of Enforcement, which will investigate and pursue formal and informal disciplinary actions when appropriate.

REVIEW OF COMPLIANCE DEPARTMENTS

Our member firms have a responsibility to establish, maintain, and enforce a system of supervision reasonably designed to ensure compliance with applicable laws, regulations, and rules. An integral component of such a system would be an effective and proactive compliance department. The Exchange, the SEC, and the NASD are developing a joint examination program that will review the largest broker-dealers on Wall Street to determine whether those firms are sufficiently committed to compliance. The examinations will review the structure of the compliance department, the qualifications of its employees, the department's staffing and budget, and

most importantly, whether the department has the tools to effectively monitor the firm's operations.

INVESTIGATION OF "SPINNING" AND OTHER IMPROPER IPO SHARE ALLOCATION PRACTICES

The Exchange is very concerned with "spinning" and other abusive initial public offering (IPO) share allocation practices that not only disadvantage small investors but also impair the capital formation process. Pursuant to the global settlement, the participating firms entered into an agreement that prohibits improper practices such as "spinning," which is the allocation of IPO shares to the account of an executive officer or director of certain public companies as an incentive to direct investment banking business to the firm.

The Exchange, in conjunction with the SEC and the NASD, is currently investigating the pre-IPO allocation practices at the firms participating in the settlement to determine whether any improper conduct occurred. These investigations were commenced a year ago, and the Exchange will review the findings and pursue enforcement actions based upon preliminary findings. It is anticipated that enforcement actions will be brought against certain firms when these investigations are completed. Enforcement actions involving two firms participating in the settlement—Salomon Smith Barney and Credit Suisse—contained violations of Exchange and NASD rules by engaging in improper IPO share allocation practices. The Exchange, through regular examinations conducted by the Division of Member Firm Regulation, will continue to review the IPO share allocation practices of all member firms to ensure that spinning and other improper conduct does not occur.

In addition, the Exchange and the NASD have created a joint committee to review the IPO underwriting process at broker-dealers, with a focus on IPO price-setting and share allocation, and to recommend appropriate changes. The joint committee, which was formed pursuant to a request by former SEC Chairman Harvey L. Pitt in August 2002, includes some of the most respected leaders in business and academia in the country. The joint committee's recommendations, which will be submitted to the SEC shortly, will highlight the need for transparency in IPO pricing and prohibitions against abusive allocation practices. The joint committee will also recommend that the code of business conduct and ethics of listed companies should include a policy restricting the receipt of pre-IPO shares by the company's directors and executive officers.

RULEMAKING

The Exchange will continue to review the pre-IPO allocation and research and investment banking practices of its member firms to determine whether additional rulemaking is required. As described above, the Exchange is also in the process of drafting and approving additional rules pursuant to the Sarbanes-Oxley Act.

In addition, the Exchange is at the forefront of creating and implementing rigid corporate governance requirements that also place much of the responsibility for ethical practices upon listed companies. In June 2002, the Exchange created the Corporate Accountability and Listing Standards Committee to review current Exchange listing standards, along with proposals for reform, with the goal of enhancing accountability, integrity, and transparency of the Exchange's listed companies.

FORUM FOR ARBITRATION CASES

A critical component of the global settlement is the disclosure of facts and information to the public to assist aggrieved investors in recovering through civil litigation the losses that resulted from conflicted and fraudulent research. The Exchange provides an arbitration forum for investors to bring actions against firms for violations of Exchange Rules and Federal securities laws. Presently, there are more than 50 arbitration cases pending that involve allegations against Jack Grubman, Henry Blodget, Salomon Smith Barney, Merrill Lynch, and the other firms participating in the global settlement. It is estimated that, during the next few months, the number of arbitration cases involving conduct identified in the global settlement will increase to 1,500.

The Exchange takes seriously its role in providing a convenient, fair, and accessible place for investors to bring their claims against these firms, and will continue to guarantee that aggrieved investors have the opportunity to have such claims heard in a prompt and fair-minded way.

Conclusion

The Exchange played an active and significant role in every aspect of the Task Force's work and has demonstrated a strong commitment throughout the past year to accomplishing the goals of the Task Force in an effective and expeditious manner. The Exchange is confident that great strides have been made as a result of our

efforts over the past year to effect wide-scale reforms that will have a dramatic impact on this industry and serve the public interest. We will work vigorously to pursue any other indications of conflicts, by firms, individuals, or supervisors and to accomplish our goal of a fair, unbiased system of research coverage. The remedial sanctions are the largest ever levied, the prospective relief constitutes a highly specific and unprecedented framework for inclusion in a settlement of this magnitude. By placing responsibility squarely, and appropriately, at the feet of the largest firms on Wall Street the Exchange has delivered a strong and clear message that the prioritization of the firms' interests over those of the investing public will not be tolerated. The prohibitions imposed upon analysts' activities restores the role of the analyst to one of careful analysis and objectivity and removes analysts from their previous role in investment banking. An analyst is an analyst and a banker is a banker. And the two shall never cross.

The monumental changes that have already been effected in the industry as a result of this agreement achieved the goals that we set for ourselves when the Task Force was initially conceived just a year ago. We achieved those goals with great speed, with hard work and dedication. But our work is not finished, and there is more to be done. The Exchange's commitment to other necessary reforms and to continuing the investigations of related areas of misconduct is unwavering.

PREPARED STATEMENT OF ROBERT GLAUBER

CHAIRMAN AND CEO, NATIONAL ASSOCIATION OF SECURITIES DEALERS

MAY 7, 2003

In December 2002, the Securities and Exchange Commission (SEC), New York Attorney General, the North American Securities Administrators Association (NASAA), the New York Stock Exchange (NYSE), and NASD reached an agreement in principle with 10 of the Nation's largest investment banks to resolve issues of conflicts of interest involving research analysis and initial public offerings (IPO's). On April 28, 2003, regulators announced that the agreement had been finalized. This global settlement concludes a joint investigation begun in April by regulators into the undue influence of investment banking interests on securities research at brokerage firms. NASD will continue to investigate and bring cases against individuals who have neglected their personal or supervisory responsibilities to the investing public.

The settlement, along with new rules and enforcement cases that are in force or being developed, will go a long way toward ensuring that these problems are effectively addressed—not only at the large investment houses that are party to this settlement, but also throughout a diverse industry.

NASD

This global settlement is only part of the full-court press that NASD has been pursuing to strengthen market integrity and rebuild investor confidence. We have been busier than ever in the area of enforcement—punishing individuals, as well as firms, for breaking the rules. We have been working with the NYSE on writing and preparing new rules on analyst research and initial public offerings—and carefully studying what additional measures are needed. We have stepped up our investor education efforts across the board. Our dispute resolution services have been more heavily used than ever—with almost 75 percent of cases resulting in a monetary recovery for the investor. And we are devoting unprecedented attention to strengthening the securities industry's own compliance mechanisms and efforts—both with a targeted new certification proposal and with new tools that will help brokerage firms meet their self-compliance responsibilities.

NASD, the world's largest securities self-regulatory organization, was established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the United States that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines them for compliance with NASD rules and the Federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our market integrity responsibilities include regulation; professional training; licensing and registration; investigation and enforcement; dispute resolution; and investor education. We monitor all trading on

The Nasdaq Stock Market—more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors—at least half of whom are unaffiliated with the securities industry.

NASD Rules

Tough enforcement is only part of the equation. To prevent these kinds of abuses in the future, it is necessary not only to punish those who violated existing NASD rules and securities laws, but also to lay down a comprehensive framework of rules and laws that will protect investors and the integrity of our markets. It is important to note that while the global settlement is limited both in time and the participants it covers, NASD rules are not limited—they cover the entire brokerage industry—and will form the basic scaffolding for a national system of rules that protect investors, whether they live in Birmingham, Baltimore, Berkeley, or Brooklyn.

NASD and the NYSE have written two sets of analyst rules toward exactly that end. Our rules use a combination of disclosure and outright prohibitions to assure that investors are more informed and analysts are more independent. These rules were the model for several global settlement provisions—including those declaring analyst compensation cannot be influenced by any input from investment bankers. NASD has already begun examining for compliance with these new rules.

NASD rule-writers have been active on the IPO front as well. Last year, NASD issued proposed rules to make even more explicit the prohibitions against such practices as "spinning," "laddering," and quid pro quo arrangements. These practices were the most common IPO abuses during the bubble of 1999– 2000—and they are among the most likely to pose a temptation when the IPO market heats up again.

Spinning is when an investment bank parcels out oversubscribed IPO shares so as to induce future investment banking business. Laddering is when an IPO underwriter requires the commitment to purchase IPO shares in the aftermarket, in order to be allocated some shares of the initial offering. Quid pro quo arrangements are the kinds of dealings where investment banks work out kickbacks to share in the profits of hot IPO's with their favored customers.

The SEC has held these new IPO rules in abeyance for the time being. In the meantime, it asked NASD and the NYSE to convene a blue-ribbon panel to take an even more comprehensive look at the process by which IPO's are priced, brought to market, and purchased by investors. We have brought together a truly eminent panel of experts to do so, and its analysis has been penetrating. The panel's report is not yet public, but its recommendations are due soon. The SEC will then take those recommendations, as well as NASD's proposed rules, into account in deciding what rules to issue in this vital area of capital formation. The global settlement explicitly contemplates that its provisions limiting the distribution of hot IPO's will be superceded by more comprehensive SEC rules.

NASD Enforcement Efforts

The U.S. capital markets are not only the most liquid and developed, but overall the best run in the world. In the past decade, more than 5,600 domestic and foreign enterprises have raised a total of over $500 billion through initial public offerings in U.S. markets. For companies seeking to raise capital, go public, or find a partner, the U.S. capital-formation environment remains the most attractive anywhere. Healthy capital markets are an engine of the U.S. economy—and as such, nothing less than a national security asset. That is another reason why we take our responsibility to police IPO practices so seriously.

When the high-tech bubble burst and stock prices began to fall dramatically in the second half of 2000, many people began to wonder why the analyst recommendations sounded strangely the same as during the bull market. In fact, during the excruciating slide from the top of the market in 2000 to the low after September 11, "strong buy" or "buy" recommendations outnumbered "sells" by a ratio of more than 50 to 1.

Beginning in 2000, NASD began aggressively investigating IPO practices and research analyst conflicts. To date, NASD has investigated and brought charges in more than a dozen important analyst and IPO allocation cases against individuals as well as firms. For example:

- NASD and the SEC brought a groundbreaking IPO case against Credit Suisse First Boston that was finally settled at the beginning of last year for $100 million in sanctions. We caught CSFB carrying out a systematic scheme whereby—in exchange for dishing out shares of hot new IPO's to chosen customers—it demanded and received paybacks of between 33 and 65 percent of customers' trading profits in those IPO shares, by getting vastly inflated commissions on unrelated trades.

- We have successfully reached settlements with Robertson Stephens and two other firms, against which NASD has levied more than $20 million in fines for IPO profitsharing violations.
- NASD developed substantive spinning cases—the only Federal or State regulator to do so—against CSFB and Salomon Smith Barney. These cases were later made part of the global settlement.
- We were the first to file charges against Jack Grubman, as well as Salomon Smith Barney, for misleading research. In September 2002, the firm paid $5 million in sanctions; Grubman subsequently paid $15 million; and most important, the former telecom analyst is now barred from the securities industry for life.
- NASD likewise brought the first charges against investment banker Frank Quattrone, for failing to supervise his research analysts and improper IPO spinning to favored executives. Mr. Quattrone is contesting the charges. Soon after, he was indicted for obstruction of justice of NASD's and others' earlier investigation of IPO profit sharing.
- The individual charges against dot.com analyst Henry Blodget investigated by NASD and jointly brought with other Federal regulators were wrapped into the global settlement. Blodget paid $4 million in fines and is barred from the securities industry for life as well.

In all these enforcement efforts NASD has underscored several important principles:

- that analyst research cannot be a servant of investment banking;
- that hot IPO's cannot be doled out to corporate insiders as virtual commercial bribes; and
- that since firms act through individuals, individuals, too, will be held accountable for their misdeeds.

And we are by no means done with our efforts. NASD is continuing to investigate and develop cases against those in the securities industry who have violated their supervisory or individual responsibilities to the investing public.

Global Settlement Terms

The global settlement concludes a joint investigation begun in April 2002 by regulators into the undue influence of investment banking interests on securities research at brokerage firms. The settlement will bring about balanced reform in the industry and bolster confidence in the integrity of equity research.

Terms of the agreement include the insulation of research analysts from investment banking pressure. Firms will be required to sever the links between research and investment banking, including the direct or indirect influence of banking on analyst compensation, and the practice of analysts accompanying investment banking personnel on pitches and road shows. This will help ensure that stock recommendations are not tainted by efforts to obtain investment banking fees and that research analysts will be insulated from investment banking pressure. Among the more important reforms:

- The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups.
- The firms' senior management will determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking.
- Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance.
- Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions.
- Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and road shows. During the offering period for an investment banking transaction, research analysts may not participate in road shows or other efforts to market the transaction.
- The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances.
- A complete ban on the spinning of Initial Public Offerings (IPO's). Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.
- An obligation to furnish independent research. For a 5-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers. An independent consultant (monitor) for each firm, with final authority to procure

independent research from independent providers, will be approved by regulators. This will ensure individual investors get access to objective investment advice.

To ensure that individual investors get access to objective investment advice, the firms will be obligated to furnish independent research. For a 5-year period, each of the firms will be required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers. An independent consultant for each firm will have final authority to procure independent research.

- Disclosure of analyst recommendations. Each firm will make publicly available its ratings and price target forecasts. This will allow for evaluation and comparison of performance of analysts. To enable investors to evaluate and compare the performance of analysts, research analysts' historical ratings will be disclosed. Each firm will make its analysts' historical ratings and price target forecasts publicly available.

The 10 firms against which enforcement actions were taken as part of the global settlements include:

- Bear, Stearns & Co. Inc. (Bear Stearns)
- Credit Suisse First Boston LLC (CSFB)
- Goldman, Sachs & Co. (Goldman)
- Lehman Brothers Inc. (Lehman)
- J.P. Morgan Securities Inc. (J.P. Morgan)
- Merrill Lynch, Pierce, Fenner & Smith, Incorporated (Merrill Lynch)
- Morgan Stanley & Co. Incorporated (Morgan Stanley)
- Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc. (SSB)
- UBS Warburg LLC (UBS Warburg)
- U.S. Bancorp Piper Jaffray Inc. (Piper Jaffray)

Penalties, Disgorgement, and Funds for Independent Research and Investor Education

Pursuant to the enforcement actions, the 10 firms will pay a total of $875 million in penalties and disgorgement, consisting of $387.5 million in disgorgement and $487.5 million in penalties (which includes Merrill Lynch's previous payment of $100 million in connection with its prior settlement with the States relating to research analyst conflicts of interest). Under the settlement agreements, half of the $775 million payment by the firms other than Merrill Lynch will be paid in resolution of actions brought by the SEC, NYSE, and NASD, and will be put into a fund to benefit customers of the firms. The remainder of the funds will be paid to the States. In addition, the firms will make payments totaling $432.5 million to fund independent research, and payments of $80 million from seven of the firms will fund and promote investor education. The total of all payments is roughly $1.4 billion.

An issue that has been under close scrutiny by Members of the Senate and that this Committee is especially interesting in includes a provision that the firms will not seek reimbursement or indemnification for any penalties that they pay. In addition, the firms will not seek a tax deduction or tax credit with regard to any Federal, State, or local tax for any penalty amounts that they pay under the settlement.

The individual penalties include some of the highest ever imposed in civil enforcement actions under the securities laws.

Enforcement Actions

The enforcement actions allege that, from approximately mid-1999 through mid-2001 or later, all of the firms engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on research analysts that the firms failed to manage in an adequate or appropriate manner. In addition, the regulators found supervisory deficiencies at every firm. The enforcement actions, the allegations of which were neither admitted nor denied by the firms, also included additional charges:

- CSFB, Merrill Lynch, and SSB issued fraudulent research reports in violation of Section 15(c) of the Securities Exchange Act of 1934 as well as various State statutes;
- Bear Stearns, CSFB, Goldman, Lehman, Merrill Lynch, Piper Jaffray, SSB, and UBS Warburg issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts; contained exaggerated or unwarranted claims about the covered companies; and/or contained opinions for which there were no reasonable bases in violation of NYSE Rules 401, 472, and 476(a)(6), and NASD Rules 2110 and 2210 as well as State ethics statutes;

- UBS Warburg and Piper Jaffray received payments for research without disclosing such payments in violation of Section 17(b) of the Securities Act of 1933, as well as NYSE Rules 476(a)(6), 401, and 472 and NASD Rules 2210 and 2110. Those two firms, as well as Bear Stearns, J.P. Morgan, and Morgan Stanley, made undisclosed payments for research in violation of NYSE Rules 476(a)(6), 401, and 472 and NASD Rules 2210 and 2110 and State statutes; and
- CSFB and SSB engaged in inappropriate spinning of "hot" initial public offering (IPO) allocations in violation of SRO rules requiring adherence to high business standards and just and equitable principles of trade, and the firms' books and records relating to certain transactions violated the broker/dealer recordkeeping provisions of Section 17(a) of the Securities Exchange Act of 1934 and SRO rules (NYSE Rule 440 and NASD Rule 3110).

Under the terms of the settlement, an injunction will be entered against each of the firms, enjoining it from violating the statutes and rules that it is alleged to have violated.

Investor Education

Further, seven of the firms will collectively pay $80 million for investor education. The SEC, NYSE, and NASD have authorized that $52.5 million of these funds be put into an Investor Education Fund that will develop and support programs designed to equip investors with the knowledge and skills necessary to make informed decisions. The remaining $27.5 million will be paid to State securities regulators and will be used by them for investor education purposes.

In addition to the other restrictions and requirements imposed by the enforcement actions, the 10 firms have collectively entered into a voluntary agreement restricting allocations of securities in hot IPO's—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors, a practice known as "spinning." This will promote fairness in the allocation of IPO shares and prevent investment banking firms from steering these shares to executive's personal accounts to attract investment banking business.

Conclusion

The global settlement will strengthen the industry's own business practices and ethical standards. And it will be enforced by NASD and the other regulators with a full range of disciplinary options—which include stiff fines and the potential for expulsion from the industry. While the settlement does not solve all the problems revealed in recent months, it is an important step in restoring investor confidence in the markets.

The work of your Committee and the Congress will be vital in addressing the myriad other issues that will arise in the wake of the settlement. I look forward to working with you as Congress examines the range of suitable remedies to address these issues.

PREPARED STATEMENT OF CHRISTINE A. BRUENN

PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

MAINE SECURITIES ADMINISTRATOR

MAY 7, 2003

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee, I am Christine Bruenn, Maine's Securities Administrator and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I commend you for holding this timely hearing, and thank you for the opportunity to appear before your Committee to present the States' views on the global settlement with 10 Wall Street firms.

I would like to start by acknowledging the role that this Committee and its House counterpart played in this matter. Congressional hearings shined an early light on Wall Street practices that were an important guide for regulators.

From the outset of the investigations, State securities regulators have had three goals: To fundamentally change the way business is done on Wall Street, by putting

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was founded in 1919. Its membership consists of the securities administrators in the 50 States, the District of Columbia, Canada, Mexico, and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

investors, not investment banking, first; impose meaningful penalties for illegal behavior; and to provide harmed investors with the information they need to pursue arbitration cases and legal actions against their brokerage firms.

If the industry follows both the letter and spirit of this agreement, it has the potential to change the culture on Wall Street. Investors—not investment banking fees—will come first. Analysts will be beholden to the truth, not the IPO business.

Overview

Let me give you a brief overview of State securities regulation, which actually predates the creation of the SEC and the NASD by almost two decades. The securities administrators in your States are responsible for the licensing of firms and investment professionals, the registration of some securities offerings, branch office sales practice audits, investor education and, most importantly, the enforcement of State securities laws. Some of my colleagues are appointed by their Governors or Secretaries of State, others are career State government employees. Notably, only 5 come under the jurisdiction of their States' Attorneys General. We have been called the "local cops on the securities beat," and I believe that is an accurate characterization.

Securities regulatory offices are located in all 50 States and the District of Columbia, and Puerto Rico. We respond to investors who typically call us first with complaints, or request information about securities firms or individuals. State securities regulators work on the front lines, investigating potentially fraudulent activity and alerting the public to problems. Because they are closest to the investing public, State securities regulators are often first to identify new investment scams and to bring enforcement actions to halt and remedy a wide variety of investment related violations. They also work closely with criminal prosecutors at the Federal, State, and local levels to punish those who violate our securities laws.

The role of State securities regulators has become increasingly important as Americans rely on the securities markets to prepare for their financial futures. Today, we are indeed a "nation of investors." Over half of all American households are now investing in the securities markets.

Investigation and Settlement Process

The investigation of the Wall Street firms was a massive undertaking and involved the coordination of 35 States. These States provided the staff and resources to analyze and review millions of documents, depose and interview witnesses, and draft nine comprehensive settlement orders, all in coordination with their Federal counterparts.

While the global settlement is most important for its impact on Wall Street and investors, it is remarkable for another reason as well—I believe it represents a model for State-Federal cooperation that will serve the best interests of investors nationwide. As they did with penny stock fraud, microcap fraud, day trading and other areas,[2] the States helped to spotlight a problem and worked with national regulators on marketwide solutions. It bears repeating: The States historically and in the current cases, investigate and bring enforcement actions—they do not engage in rulemaking for the national markets. That is rightly the purview of the SEC and the SRO's.

None of the regulators who were involved in this global settlement could have done this on its own. Even with the funding increase Congress allocated for the SEC, the Commission cannot go it alone. That is why there must be cooperation and division of labor among State, industry, and Federal regulators.

Over the last several years, NASAA members have been active participants in the rulemaking and legislative process in the area of analysts' conflicts of interest. The States worked closely with the SEC and the SRO's both to leverage limited investigative resources and to formulate new, marketwide rules that were needed to fix this problem. In 2001, we commented on the NASD's original rulemaking regarding analysts' communications to the public. We followed that with a letter to Chairman Richard Baker during his subcommittee's public hearing process regarding analysts' practices.

In addition, we commented on the NASD/NYSE's proposed rules relating to research analysts. We complimented the NASD and NYSE on their work, offered general support and made suggestions that we felt could make the rule stronger in some areas. Many of our original proposals were incorporated in the final rule. Also, NASAA was strongly supportive of Title V in S. 2763 which became the Sarbanes-Oxley Act of 2002.

Last spring, as the New York Attorney General was wrapping up its Merrill Lynch investigation, NASAA suggested to Attorney General Spitzer that it would

[2] *See* State/Federal Dynamic Chart Attached.

be beneficial to all concerned to settle the case simultaneously for all the States as a group. He agreed, and negotiated on those terms. The case was concluded with all 50 States, the District of Columbia, and Puerto Rico joining in the settlement.[3]

In late April, a few weeks before the Merrill Lynch agreement, the NASAA Board of Directors met to form the NASAA Analysts Task Force. Its Steering Committee was charged with investigating whether problems discovered at Merrill Lynch were industry wide. The Steering Committee assigned one State to lead the investigation of each firm; many other States signed on to assist in the investigations. Further, the Task Force agreed to work collaboratively on the analyst investigation with the SEC, the NYSE, and the NASD.

The State investigations continued into November, at which time, in conjunction with the SEC, NYSE, and the NASD a determination was made to pursue the resolution of the cases in a global manner. Each firm investigation included a lead State and a Federal counterpart. Last December, an agreement in principle was reached with 11 firms; it took intensive negotiations with the firms to reach the final global settlement announced last week.[4]

The Deutsche Bank investigation was not included in the global settlement because the California Department of Corporations discovered the failure of Deustche Bank to produce documents as requested by the Department during its analyst investigation. The reasons for Deutsche Bank's failure to produce documents and whether Deutsche Bank has, in fact, produced all requested documents at this time remains under investigation by the Department (and other State securities regulators such as the District of Columbia and Maryland) in conjunction with the SEC.

Penalties/Restitution

The $487.5 million in penalty monies to the States includes the prior settlement between Merrill Lynch and State securities regulators. Attached to this testimony is a State-by-State chart that lists the distribution of the global settlement penalties based on a population formula with a minimum allocation of 1 percent of the total.[5] An important question is how best to use that money?

A primary and routine objective of State securities regulators is to obtain restitution for investors as part of enforcement actions. For example, in fiscal year 2002, restitution ordered through administrative or civil actions was $309 million. At the same time, roughly $71 million was ordered in fines and penalties.

In a recent case involving the illegal sale of unregistered products, the Arizona Corporation Commission ordered the defendants to pay over $16 million in restitution to investors. It also assessed administrative penalties in the amount of $133,100. In another case announced last week by the Alabama Securities Commission, the former President of Fabtec Inc. pled guilty to two counts of fraud in connection with the sale of securities and two counts of theft of property in the first degree. A sentencing hearing is scheduled for June. The former president faces up to 60 years imprisonment and the State is seeking restitution in the amount of $1,690,000.

Throughout the 18 months of the analysts' investigations, State securities regulators wrestled with how best to compensate investors injured by the wrongdoing. Restitution is a viable remedy where victims can be readily identified, where the fraud is direct and person-to-person and where damages are subject to straightforward calculation. In order to satisfy the expectations of the victims, there also needs to be enough money to distribute through restitution so that the recipients receive a sum that represents a meaningful portion of their losses. Unfortunately, we do not believe the analyst cases readily lend themselves to restitution.

One of the reasons we have struggled is because it is very difficult to identify the victims of any fraud on the market. We could start with the customers who purchased the stocks through the firms, but what about those who saw Henry Blodget on CNBC and then purchased the stocks online or bought stocks from a firm that purchased research from one of the 10 firms? And what about mutual fund shareholders? In our view, in a fraud on the market, all investors are harmed. If restitution is available to all investors, it would be an insignificant amount of their losses. If restitution is available to only a subset of investors, it is arbitrary and unfair. In light of these problems, we believe decisions regarding the funds are best made at the State level so they can be tailored to the unique circumstances of each State.

These monies will be allocated according to the governing law in each jurisdiction. For example, in North Carolina, it will go to an investor education fund; in Mississippi, new investigators will be hired for future enforcement efforts; in my State

[3] *See* NASAA Analyst Investigations Chronology Attached.
[4] *See* Chart of Investigated Firms and State/Federal Partnership Attached.
[5] *See* Analysts Conflicts settlements Chart Attached.

of Maine and in Maryland, the money will go into the general fund and be used for State legislative priorities such as education, prescription drugs, and other State provided services. We expect the combination of monetary penalties, injunctive provisions and the release of evidence that can be used in private actions will deter similar conduct in the future.

Investor Education Funds

The final component of the analyst conflicts of interest settlements requires six of the firms to contribute a total of $27.5 million over the next 5 years for investor education on the State level. The NASAA Board of Directors determined these payments will be directed to the Investor Protection Trust (IPT).

The IPT is a Wisconsin charitable trust, classified by the IRS as a public charity. The IPT was created 10 years ago with $2 million as part of a multistate securities settlement. The Trust's primary focus in recent years has been Financial Literacy 2010 (FL2010), a program designed to increase the amount and quality of personal finance classroom instruction in America's high schools. This initiative gives teachers across America the tools they need to introduce a personal finance curriculum in the high schools. Money from the Trust has been used to provide customized teaching guides and to train thousands of teachers on how to use the guides in their classrooms. FL2010 has also reached teachers through direct mail, exhibits, a quarterly newsletter, and a website (*www.fl2010.org*).

In addition to FL2010, the Trust has undertaken an extensive investor education mission, including public service announcements, distribution of educational videos on investor preparedness and investment fraud awareness, the Investing Online Resource Center (*www.onlineinvesting.org*), an independent, noncommercial website dedicated to serving the individual consumer who invests online or is considering doing so, and a noncommercial investor education website (*www.investorprotection.org*).

The payments from the analyst conflicts of interest settlement will be maintained in a separate, designated fund of the IPT, the Investor Education Fund (the Fund). The Fund will be distributed pursuant to a grant process and used to support and create financial literacy programs and materials tailored to the needs of local communities and to conduct research. The goal of the Trust is to equip investors with the knowledge and skills necessary to make informed investment decisions and to increase personal financial literacy. No principal or income from the Fund shall inure to the general fund or treasury of any State. The Fund will be held in a subaccount, with provisions for fund accounting, annual audited financial statements, and regular reporting on items such as grant applications, expenses and fees incurred.

Ongoing Enforcement Initiatives

The analyst conflict of interest case was a big story in the financial press over the past year. But it was hardly the only focus of State securities regulators. As always, State securities regulators continue to vigorously pursue sales practice abuses and a variety of scams and frauds against unsuspecting investors. There are many types of violations that State securities regulators continue to fight. NASAA has published a list of the "Top 10 Investment Scams" the past several years to highlight problem areas for investors.[6] I will mention a few of our ongoing initiatives.

Unregistered Securities—We are continuing to address, in cooperation with the National Association of Insurance Commissioners (NAIC), the chronic problem of insurance agents selling unregistered and fraudulent securities. In hundreds of cases, scam artists are using high commissions to entice insurance agents into selling investments they may know little about to investors for whom they are unsuitable.

On April 17, the Indiana Secretary of State announced the sentencing of a convicted Securities Act violator to 42 years in prison and $110,931 in restitution. This conviction was the culmination of an investigation initiated by the Secretary's office regarding a firm that operated to sell unlicensed securities. The Secretary of State referred the case to the County Prosecuting Attorney to file the criminal charges. These offices worked together to utilize their specialized resources and expertise to sentence a violator to jail.

Examples Unregistered Products

Viatical settlements—In the wake of a 1996 decision holding that interests in certain viatical settlement policies sold were not "securities" under Federal law, there has been a proliferation of these viatical investments sold to investors nationwide

[6] *See* "Top 10" Investment Scams Listed by State Securities Regulators Attached.

in violation of State securities laws. A viatical settlement contract allows an investor to purchase an interest in the life insurance of a terminally ill person.

Almost all State securities regulators take the position that viatical investments are "securities" under their respective laws. Last fall, the NASAA membership approved guidelines for States to adopt that apply to the offer and sale of viatical investments. Meaningful regulation is essential to ensure that neither the lawful viators nor investors are defrauded.

Many States have vigorously pursued enforcement actions due to occurrences of deceptive marketing practices and numerous instances of fraud.

Recently, the Arizona Corporation Commission revoked the registration of a Tucson securities salesman, assessed a penalty of $66,000 and ordered him to repay six investors over $430,000 plus interest in a case dealing with unregistered viatical contracts.

Charitable Gift Annuities—In February 2003, the Securities Administrator issued a Cease and Desist Order against a Tennessee-based company, the New Life Corporation of America, and a Maine insurance agent. The company had offered charitable gift annuities (CGA's) in Maine through an agent and other unlicensed financial professionals who expected to receive at least a 6 percent commission. (Such commission-based sales of CGA's are rare and disfavored by most charities.) Solicitations for these CGA's allegedly misrepresented that they were guaranteed, no-risk investments. The action prevented consummation of pending sales to Maine consumers, one of whom, a very elderly man, was about to part with over $1 million.

Local Enforcement

The States also continue to play an important enforcement role with respect to the conduct of licensed broker-dealers and their registered representatives. State securities regulators are often the first place that investors turn when they feel they have not been treated fairly by a broker. One reason for this is our proximity to everyday investors. Each NASAA member has one or more offices within their State, with contact information readily available on the web. Many investors understandably feel that the logical place to start with a grievance is their local State securities regulator.

And our members are quick to respond, even to individual complaints that may not signal the type of widespread abuse of interest to our fellow regulators at the Federal and SRO levels. Often, our members will reach out to the firm with an informal inquiry, leading to quick resolution of the investor's concerns without the need for an enforcement action. In other cases, a "for cause" examination prompted by the customer complaint will reveal systemic problems that must be dealt with through more formal enforcement proceedings. These exams complement the routine broker-dealer exams that a significant number of our members conduct.

Closing

Mr. Chairman and Members of this Committee, in closing, I would like to offer you my personal opinion based on 18 years as a securities regulator. I believe that now is the time to strengthen, not weaken our unique complementary regulatory system of State, industry, and Federal regulation. Eighty-five million investors—many of them wary and cynical expect us to remain vigilant, to stay the course—to make sure, that Wall Street puts investors first. We can not and we will not let these millions of investors down. I pledge the support of the NASAA membership to work with you and your Committee to provide you with any additional information or assistance you may need. Thank you for the opportunity to testify and I look forward to continuing NASAA's excellent working relationship with this Committee.

STATE/FEDERAL DYNAMIC:
HOW STATE DETECTION OF INVESTOR PROTECTION ISSUES LEADS TO NATIONAL RESPONSE

Issues Identified by State Securities Regulators	Problem	National Response
1989 - States determined Penny Stock offerings by newly formed shell companies to be per se fraudulent.[1] These "blank check" companies had no business plan except a future merger with an unidentified company.	**$2 billion/yr. Losses in Penny Stocks**[2]	1990- Congress passed Penny Stock Reform Act which mandated SEC to adopt special rules governing sale of Penny Stocks (<$5.00 per share) and public offerings of of shares in Blank Check companies (SEC Rule 419).[3]
1991 - States found that rollups of poorly performing public limited partnerships disadvantaged individual investors by not providing meaningful dissenters' rights.	**Lack of dissenters' rights**	1993- Congress passed the Limited Partnership Rollup Act which mandated that NASD adopt rules containing specific provisions to protect dissenters' rights.[4]
1996-97 - 33 States participated in sweep of 15 broker-dealer firms that specialized in aggressively retailing low-priced securities to individual investors. States found massive fraud in firms' manipulation of shares of start-up companies, most of which had no operating history.	**$6 billion/yr. Losses in Micro-cap Stocks**[5]	1997-98- Congress held hearings on fraud in the micro-cap securities markets (shares selling between $5-10). 2002 - Congress passed Sarbanes-Oxley Act which made certain state actions a basis for federal statutory disqualification from the securities industry.[6]

[1] *Resolution of the North American Securities Administrators Association Declaring Blank Check Blind Pool Offerings to be Fraudulent Practices* (4 April 1989), NASAA Reports (CCH) ¶7028.

[2] *NASAA Investor Alert*: Penny Stock Fraud (December 1989).

[3] 15 U.S.C. §78o(g); 15 U.S.C. §77g(b)(1).

[4] 15 U.S.C. §78o(b)(12) and (13).

[5] Opening Statement of Senator Susan Collins, Chair, Senate Permanent Subcommittee on Investigations (22 September 1997).

[6] U.S. Senate Permanent Subcommittee on Investigations (22 September 1997 and 10 February 1998); 15 U.S.C. §78o(b)(4)(H); 15 U.S.C. §80b-3(e).

1996-97 - States were the first regulators anywhere to issue uniform interpretative guidance on use of Internet for legitimate securities offerings and dissemination of product information by licensed financial services professionals.[7]	**Risks of Securities offerings on The Internet**	1998- SEC issued interpretative guidance based on the States' Model on the use of Internet for securities offerings and dissemination of services and product information by licensed financial services professionals.[8]
1999 - In a report on trading of securities on the Internet, States found that investors did not appreciate certain risks, including buying on margin and submitting market orders.[9]	**Risks of Online Trading**	2001- SEC approved a new NASD rule requiring brokers to provide individual investors with a written disclosure statement on the risks of buying securities on margin.[10]
1999 - In a first-ever report on individuals engaged in day trading, States found that day trading firms failed to tell prospective investors that 70% of day traders would lose their investment while the firm earned large trading commissions.[12]	**Risks of Day Trading**	2000- SEC approved new NASD rules making day trading firms give written risk disclosure to individual investors.[11] 2001 - SEC approved new NASD and NYSE rules governing margin extended to day traders.[13]

[7] *Resolution of the North American Securities Administrators Association Regarding Securities Offering on the Internet* (7 January 1996), NASAA Reports (CCH) ¶7040; *Resolution of the North American Securities Administrators Association Regarding Internet Advertising of Information on Products and Services* (27 April 1997), NASAA Reports (CCH) ¶2191.

[8] *Statement of the Commission Regarding use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore,* U.S. Securities and Exchange Commission, Release No. 33-7516 (23 March 1998).

[9] *From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry*, Office of the New York Attorney General (22 November 1999).

[10] *Delivery Requirement of a Margin Disclosure Document to Non-Institutional Customers*, U.S. Securities and Exchange Commission, Release No. 34-44223 (26 April 2001).

[11] NASD Rules 2360 and 2361.

[12] *Report of the NASAA Project Group on Day Trading*, North American Securities Administrators Association (August 1999).

[13] NASD Rule 431; NYSE Rule 2520.

NASAA Analyst Investigations Chronology

Date	Event
7/2001	NY Attorney General starts probe into Merrill Lynch.
8/15/2001	NASAA files letter with the NASD in response to the NASD's request for comment on proposed changes to NASD rules governing analysts communication with public.
4/12/2002*	Attorney General Spitzer sends subpoenas to 12 investment banks with significant research and investment banking revenues requesting that they supply documents that will address analyst's roles in investment banking. (*Not all subpoenas sent out on same date).
4/18/2002	NASAA files letter with SEC in response to SROs' proposed rules addressing analyst conflicts of interest. NASAA suggests that while the rules are a good start, they need to be more expansive.
4/18/2002	NASAA Board of Directors meets to form NASAA Analysts Task Force to be charged with investigating whether problems discovered at Merrill Lynch are industry wide.
4/25/2002	NASAA/SEC/NASD/NYSE agree to work collaboratively on analyst investigation.
4/26/2002	NASAA Analyst Task Force assigns a lead state to investigate each target firm identified by the NYAG in its subpoenas and asks other states to volunteer to assist in the investigation under the management of the lead state.
5/14/2002	NASAA Board approves $2.5 million budget for analyst investigation.
5/21/2002	NYAG settles with ML to agree to terms of settlement. Settlement contains proposed settlement provisions with other states.
6/18/2002	NASAA Board endorses sending settlements to all the states.
6/20/2002	NASAA sends states template to be used in ML settlement.
9/20/2002	NASAA signs contract with Case Central, an electronic discovery company, to assist the states in search, organizing and sharing discovery documents.

9/24/2002	NASAA files letter with SEC in response to proposed rule for Analyst Certification.
10/03/2002	NASAA/SEC/NYAG/NASD/NYSE agree to work together in an attempt to conclude the investigations in a speedy fashion.
12/20/2002	Tentative settlement agreement reached among almost all target firms among states, SEC, NASD, NYSE for $1.4 billion in fines and other payments.
03/10/2003	NASAA submits comment letter to SEC in response to SROs' amendments to rules filed in 2002 noting that the SROs for picked up most of NASAA's suggestions from its 4/18/2002 letter.
4/28/2003	Reach final agreement among almost all target firms, lead states, SEC, NYSE and NASD.
5/1/2003	Draft settlement documents distributed to non-lead states for execution.

ANALYST CONFLICTS OF INTEREST TASK FORCE INVESTIGATORS

FIRM	LEAD STATE	OTHER PARTICIPATING STATES	FEDERAL REGULATOR
Bear Stearns	New Jersey	Delaware, Hawaii, Maine, Pennsylvania, and Vermont.	NYSE
Credit Suisse First Boston	Massachusetts	Virginia	NASD
Goldman Sachs	Utah	Kansas	NYSE
J.P. Morgan Chase	Texas	Arkansas, Idaho, Missouri,	NYSE
Lehman Brothers	Alabama	Georgia, Indiana, Mississippi	SEC
Morgan Stanley	New York		SEC
Piper Jaffray	Washington	Iowa, Minnesota, and Wisconsin	NASD
Salomon Smith Barney	New York	Alaska	NASD
Deutsche Bank*	California	Maryland and District of Columbia	SEC
UBS Paine Webber	Arizona, Illinois	Connecticut, Nevada, Oklahoma	NYSE

*Settlement in Principle

Analyst Conflicts Settlement

	State	Population	% US Pop	Bear Stearns Settlement	CSFB Settlement	Deutsche Bank Settlement	Goldman Sachs Settlement	JP Morgan Settlement	Lehman Brothers Settlement	Morgan Stanley Settlement	Salomon Smith Barney Settlement	UBS Warburg Settlement	Piper Jaffray Settlement	TOTAL SETTLEMENT
1	California	33,871,648	11.88%	2,609,851	7,829,548	2,609,851	2,609,851	2,609,851	2,609,851	2,609,851	15,659,096	2,609,851	1,304,926	43,062,527
2	Texas	20,851,820	7.31%	1,606,657	4,819,970	1,606,657	1,606,657	1,606,657	1,606,657	1,606,657	9,639,939	1,606,657	803,329	26,509,837
3	New York	18,976,457	6.65%	1,462,158	4,386,473	1,462,158	1,462,158	1,462,158	1,462,158	1,462,158	8,772,946	1,462,158	731,079	24,125,604
4	Florida	15,982,378	5.60%	1,231,461	3,694,382	1,231,461	1,231,461	1,231,461	1,231,461	1,231,461	7,388,763	1,231,461	615,731	20,319,103
5	Illinois	12,419,293	4.35%	956,921	2,870,762	956,921	956,921	956,921	956,921	956,921	5,741,524	956,921	478,461	15,789,194
6	Pennsylvania	12,281,054	4.31%	946,269	2,838,808	946,269	946,269	946,269	946,269	946,269	5,677,615	946,269	473,135	15,613,441
7	Ohio	11,353,140	3.98%	874,773	2,624,317	874,773	874,773	874,773	874,773	874,773	5,248,634	874,773	437,386	14,433,748
8	Michigan	9,938,444	3.48%	765,768	2,297,305	765,768	765,768	765,768	765,768	765,768	4,594,611	765,768	382,884	12,635,176
9	New Jersey	8,414,350	2.95%	648,335	1,945,006	648,335	648,335	648,335	648,335	648,335	3,890,011	648,335	324,168	10,697,530
10	Georgia	8,186,453	2.87%	630,775	1,892,326	630,775	630,775	630,775	630,775	630,775	3,784,653	630,775	315,388	10,407,792
11	North Carolina	8,049,313	2.82%	620,209	1,860,626	620,209	620,209	620,209	620,209	620,209	3,721,252	620,209	310,104	10,233,445
12	Virginia	7,078,515	2.48%	545,408	1,636,223	545,408	545,408	545,408	545,408	545,408	3,272,446	545,408	272,704	8,999,229
13	Massachusetts	6,349,097	2.23%	489,205	1,467,615	489,205	489,205	489,205	489,205	489,205	2,935,231	489,205	244,602	8,071,883
14	Indiana	6,080,485	2.13%	468,508	1,405,525	468,508	468,508	468,508	468,508	468,508	2,811,050	468,508	234,254	7,730,385
15	Washington	5,894,121	2.07%	454,149	1,362,446	454,149	454,149	454,149	454,149	454,149	2,724,892	454,149	227,074	7,493,455
16	Tennessee	5,689,283	1.99%	438,366	1,315,097	438,366	438,366	438,366	438,366	438,366	2,630,194	438,366	219,183	7,233,036
17	Missouri	5,595,211	1.96%	431,117	1,293,352	431,117	431,117	431,117	431,117	431,117	2,586,704	431,117	215,558	7,113,433
18	Wisconsin	5,363,675	1.88%	413,277	1,239,832	413,277	413,277	413,277	413,277	413,277	2,479,663	413,277	206,638	6,819,072
19	Maryland	5,296,486	1.86%	408,100	1,224,301	408,100	408,100	408,100	408,100	408,100	2,448,601	408,100	204,050	6,733,652
20	Arizona	5,130,632	1.80%	395,321	1,185,963	395,321	395,321	395,321	395,321	395,321	2,371,926	395,321	197,660	6,522,796
21	Minnesota	4,919,479	1.72%	379,051	1,137,154	379,051	379,051	379,051	379,051	379,051	2,274,309	379,051	189,526	6,254,346
22	Louisiana	4,468,976	1.57%	344,339	1,033,019	344,339	344,339	344,339	344,339	344,339	2,066,038	344,339	172,170	5,681,600
23	Alabama	4,447,100	1.56%	342,654	1,027,962	342,654	342,654	342,654	342,654	342,654	2,055,924	342,654	171,327	5,653,791
24	Colorado	4,301,261	1.51%	331,417	994,251	331,417	331,417	331,417	331,417	331,417	1,988,502	331,417	165,708	5,468,380
25	Kentucky	4,041,769	1.42%	311,423	934,268	311,423	311,423	311,423	311,423	311,423	1,868,537	311,423	155,711	5,138,477
26	South Carolina	4,012,012	1.41%	309,130	927,390	309,130	309,130	309,130	309,130	309,130	1,854,780	309,130	154,565	5,100,645
27	Puerto Rico	3,808,610	1.34%	293,457	880,373	293,457	293,457	293,457	293,457	293,457	1,760,746	293,457	146,729	4,842,047
28	Oklahoma	3,450,654	1.21%	265,877	797,630	265,877	265,877	265,877	265,877	265,877	1,595,261	265,877	132,938	4,386,968
29	Oregon	3,421,399	1.20%	263,622	790,868	263,622	263,622	263,622	263,622	263,622	1,581,736	263,622	131,811	4,349,769
30	Connecticut	3,405,565	1.19%	262,402	787,208	262,402	262,402	262,402	262,402	262,402	1,574,416	262,402	131,201	4,329,639
31	Iowa	2,926,324	1.03%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
32	Mississippi	2,844,658	1.00%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
33	Kansas	2,688,418	0.94%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
34	Arkansas	2,673,400	0.94%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
35	Utah	2,233,169	0.78%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
36	Nevada	1,998,257	0.70%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
37	New Mexico	1,819,046	0.64%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
38	West Virginia	1,808,344	0.63%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
39	Nebraska	1,711,263	0.60%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
40	Idaho	1,293,953	0.45%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
41	Maine	1,274,923	0.45%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
42	New Hampshire	1,235,786	0.43%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
43	Hawaii	1,211,537	0.42%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
44	Rhode Island	1,048,319	0.37%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
45	Montana	902,195	0.32%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
46	Delaware	783,600	0.27%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
47	South Dakota	754,844	0.26%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
48	North Dakota	642,200	0.23%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
49	Alaska	626,932	0.22%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
50	Vermont	608,827	0.21%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
51	District of Columl	572,059	0.20%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
52	Wyoming	493,782	0.17%	250,000	750,000	250,000	250,000	250,000	250,000	250,000	1,500,000	250,000	125,000	4,125,000
	State Total	285,230,516		25,000,000	75,000,000	25,000,000	25,000,000	25,000,000	25,000,000	25,000,000	150,000,000	25,000,000	12,500,000	412,500,000
	Total Settlement			50,000,000	150,000,000	50,000,000	50,000,000	50,000,000	50,000,000	50,000,000	300,000,000	50,000,000	25,000,000	825,000,000
	State Settlement			**25,000,000**	**75,000,000**	**25,000,000**	**25,000,000**	**25,000,000**	**25,000,000**	**25,000,000**	**150,000,000**	**25,000,000**	**12,500,000**	412,500,000
	Minimum			**250,000**	**750,000**	**250,000**	**250,000**	**250,000**	**250,000**	**250,000**	**1,500,000**	**250,000**	**125,000**	4,125,000
	Maximum			25,000,000	75,000,000	25,000,000	25,000,000	25,000,000	25,000,000	25,000,000	150,000,000	25,000,000	12,500,000	412,500,000
	Max/Min Adj Factor			0.8790940995	0.8790936300	0.8790940995	0.8790940995	0.8790940995	0.8790940995	0.8790940995	0.8790935400	0.8790940995	0.8790947000	

Payments in Global Settlement Relating to
Firm Research and Investment Banking Conflicts of Interest

Firm	Penalty ($ Millions)	Disgorgement ($ Millions)	Independent Research ($ Millions)	Investors Education ($ Millions)	Total ($ Millions)
Bear Stearns	25	25	25	5	**80**
CSFB	75	75	50	0	**200**
Goldman	25	25	50	10	**110**
J.P. Morgan	25	25	25	5	**80**
Lehman	25	25	25	5	**80**
Merrill Lynch	100*	0	75	**	**200**
Morgan Stanley	25	25	75	0	**125**
Piper Jaffray	12.5	12.5	7.5	0	**32.5**
SSB	150	150	75	25	**400**
UBS Warburg	25	25	25	5	**80**
Total ($ millions)	**487.5**	**387.5**	**432.5**	**55**	**$1,387.5**

*Payment made in prior settlement of research analyst conflicts of interest with the states securities
**Payment of $25 million to Federal investor education fund only.

NEWS AND PUBLIC AFFAIRS
PRESS RELEASES

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"Top 10" Investment Scams Listed by State Securities Regulators

WASHINGTON (August 26, 2002) - State securities regulators today released a list of the "Top 10" scams, risky investments or sales practice abuses they're fighting. New to the third annual list are unscrupulous brokers, conflicts of interest in analyst research, charitable gift annuities, and oil and natural gas scams.

"Record-low interest rates and a bear market on Wall Street have created a bull market in fraud on Main Street," said Joseph Borg, president of the North American Securities Administrators Association (NASAA)[1] and director of the Alabama Securities Commission. "Con artists know investors are concerned about the volatile stock market and low yields on bonds and bank deposits, so they pitch their scams as safe alternatives and promise high returns - an impossible combination."

The 2002 list was again topped by independent insurance agents selling risky or fraudulent securities. Borg said that while most independent insurance agents are honest professionals, too many are letting high commissions lure them into selling high risk or fraudulent investments.

The federal war on terror and large budget deficits at the state level are diverting or pinching resources to fight investment fraud, Borg warned.

"Putting people in jail gives investors the biggest bang for their regulatory buck," said Borg. "So legislators at all levels need to ensure that regulators and prosecutors have sufficient resources to successfully bring securities fraud cases."

Here are the "Top 10" investment scams, ranked roughly in order of prevalence or seriousness:

1. Unlicensed individuals, such as independent insurance agents, selling securities. In hundreds of cases from Washington state to Florida, scam artists are using high commissions to entice independent insurance agents into selling investments they may know little about. The person running the scam instructs the independent sales force - usually insurance agents but sometimes investment advisers and accountants - to promise high returns with little or no risk. For example:

· In an alleged scam sold almost entirely by independent insurance agents, investors in at least 14 states lost close to $30 million. According to Ohio securities regulators, money raised from the sale of fictitious limited partnerships was used to make interest payments to another group of promissory note investors. Both groups were promised double-digit returns. In April a court issued a preliminary injunction and appointed a receiver in connection with the allegations.

· Earlier this month, an Arizona insurance agent was sentenced to 10 years in prison for selling $1.8 million in worthless stock and bogus promissory notes to investors. Another Arizona insurance agent was sentenced in May to five years in prison for scamming 32 elderly investors out of nearly $2 million by first soliciting them to purchase 'living trusts' and then switching them into annuities and finally into bogus promissory notes. A third Arizona insurance agent, working with his two sons, scammed $16.2 million by selling high risk brokered CDs, viatical contracts, real estate deals and equipment leases. They were ordered to repay all $16.2 million and fined another $133,000.

To verify that a person is licensed or registered to sell securities, call your state securities regulator. If the person is not registered, don't invest.

2. **Unscrupulous stockbrokers.** The declining stock market has caused some brokers to cut corners or resort to outright fraud, say state securities regulators. At the same time, some investors have grown more cautious and are scrutinizing their brokerage statements for unexplained fees, unauthorized trades or other irregularities. In North Dakota, regulators investigated a complaint from an investor who received conflicting account statements. They discovered that two brokers working for H.D. Vest Investment Securities Inc. issued phony account statements to cover up losses from hundreds of unauthorized trades. The brokers had also made unsuitable recommendations such as risky options contracts. Under a settlement with state securities regulators, H.D. Vest agreed to repay clients' out-of-pocket losses plus 6 percent, totaling over $3.2 million.

In New York, the attorney general's office took action against seven brokers and two firms for bilking hundreds of elderly investors out of more than $12.5 million through a pay telephone scam. The brokers pressured investors into liquidating their CDs, annuities and IRAs, sometimes at significant penalty, and promised them "risk-free" 14 percent returns. So far one firm has agreed to pay $5.9 million in restitution.

3. **Analyst research conflicts.** In May, the New York Attorney General's office concluded a 10-month investigation into whether Merrill Lynch had issued misleading research reports by entering into a settlement agreement with the firm. Under the agreement, Merrill Lynch agreed to pay a $100 million fine and make significant changes to way it does business. NASAA is assisting a multi-state task force investigating conflict of interest issues at Wall Street firms. The primary focus of the ongoing investigation is to determine whether analysts issued glowing research reports and made "buy" recommendations in order to win investment-banking business. State investigators are now reviewing materials provided by a dozen firms for possible securities law violations.

In June NASAA learned of an attempt by Morgan Stanley Dean Witter to amend an early version of the Sarbanes-Oxley Act with language that would have ended the states' probe into whether Wall Street analysts intentionally misled investors. NASAA held a press conference and met with lawmakers; the draft amendment was ultimately not included in the bill.

4. **Promissory notes.** These are short-term debt instruments often sold by independent insurance agents and issued by little known or non-existent companies promising high returns – upwards of 15 percent monthly – with little or no risk.

In June, four Georgia-based scam artists were each sentenced to 17 ½ years in prison for recruiting independent insurance agents to sell millions of dollars worth of bogus promissory notes. While investors were promised nine-month returns as high as 21 percent, half of each investment went straight to commissions that were divided among company principals and sales agents. Acting on a tip from the Better Business Bureau, Georgia securities regulators seized nearly $5 million of the $8 million stolen from local investors and, together with federal investigators, used the evidence uncovered to broaden their investigation and prepare criminal charges. In the end, the Federal Bureau of Investigation, working with Georgia regulators, found the ringleader – Virgil Womack – had scammed over $150 million from investors nationwide. Of the $150 million, nearly $90 million was seized and returned to investors. The average age of the victims was 68.

In another case, a Maine court sentenced an insurance agent to seven years in prison for running a promissory note scam that took 25 investors for more than $1 million. The agent, who was sentenced in June, told investors the notes were "better than certificates of deposit and life insurance policies," regulators said, and that they would yield 10 percent to 12 percent returns annually.

"A 12 percent return may not seem over-the-top by bull market standards, but it's far more than banks are offering now for insured deposits," said Chris Bruenn, administrator for the Maine Office of Securities and NASAA's president-elect.

5. **"Prime bank" schemes.** Scammers promise investors triple-digit returns through access to the investment portfolios of the world's elite banks. Purveyors of these schemes often target conspiracy theorists, promising access to the

"secret" investments used by the Rothschilds or Saudi royalty.

In Texas, a Harlingen-based con artist promised returns of 6 percent to 8 percent a month through a secretive web of money dealers supposedly set up by a coalition of governments in 1914 to pay for World War I debt. In videotape shown at Monday's press conference, the promoter claimed that seven "world traders" control the entire global money supply. In the end, the scam took over 300 investors for roughly $6 million.

6. **Viatical settlements.** Originated as a way to help the gravely ill pay their bills, these interests in the death benefits of terminally ill patients are always risky and sometimes fraudulent. The insured gets a percentage of the death benefit in cash and investors get a share of the death benefit when the insured dies. Because of uncertainties predicting when someone will die, these investments are extremely speculative. In a new twist, Pennsylvania regulators say "senior settlements" – interests in the death benefits of healthy older people – are now being offered to investors.

In June, 15 individuals were indicted in connection with a scam that cost hundreds of investors nationwide at least $100 million. State securities and insurance regulators, together with federal regulators, allege the individuals, employed by Liberte Capital Group, were involved in a scheme to buy life insurance policies from terminally ill individuals who lied to insurance companies about their medical conditions. Liberte managers used investor funds to support lavish lifestyles, including investments and the purchase of large homes and dozens of boats and cars. A receiver has been appointed in the case.

7. **Affinity fraud.** Many scammers use their victim's religious or ethnic identity to gain their trust – knowing that it's human nature to trust people who are like you – and then steal their life savings. From "gifting" programs at some churches to foreign exchange scams targeted at Asian Americans, no group seems to be without con artists who seek to take advantage of the trust of others.

In Alabama, nine individuals have been charged with scamming parishioners at the Daystar Assembly of God church in Prattville out of more than $3 million. Investors were told their money would be used to purchase retirement properties in Florida. The income generated by the Florida properties would be used to payoff the mortgage of the Prattville church and build a religious theme park, investors were told. In reality, state securities regulators allege, the money went to pay off investors in a previous scam and to purchase equipment for unrelated businesses.

8. **Charitable gift annuities.** These annuities are transfers of cash or property to a charitable organization. The value of the annuity is less than the value of the cash or property, with the difference constituting a charitable donation. While most annuities offered by charitable organizations are legitimate investments, investors should be cautious of little-known organizations or those that provide only sketchy information.

In Arizona, regulators uncovered a scam that took 430 investors nationwide for an average of $133,000. The scam involved the purchase of charitable gift annuities from the Mid-America Foundation. According to regulators, Robert Dillie, founder of Mid-America, ran what amounted to a $54 million Ponzi scheme through a network of independent insurance agents, financial planners and accountants. Dillie used investors' funds to purchase three homes in Las Vegas, a ranch in South Dakota, pay child support, book charter flights and support his extensive gambling.

Magdalena Scheller, 68, of Phoenix, invested more than $400,000 in Mid-America. A life insurance agent approached her after her husband died.

"It makes you wonder if there are any honest people out there," Scheller said at Monday's press conference.

"Unfortunately, Mid-America is not an isolated scam," Mark Sendrow, director of securities for the Arizona Corporation Commission told reporters Monday. "We are looking at two more foundations in the Phoenix area which have issued millions of dollars of charitable gift annuities in the last few years, and both were basically penniless before they began issuing them."

9. **Oil and gas schemes.** These scams follow the headlines, rising in frequency with predictions of oil shortages or a rise in natural gas prices. In Arkansas, securities regulators forced Energy Consultants and Ark-La-Tex Consulting Co.,

L.L.C. to discontinue their marketing efforts after finding a natural gas well touted to investors as a 'can't lose' opportunity hadn't produced in years.

10. **Equipment leasing.** While the majority of equipment leasing deals are legitimate, thousands of investors have been scammed by individuals selling interests in payphones, ATMs or Internet kiosks. In a typical equipment leasing scam, a company sells a piece of equipment through a middleman. As part of the sale, the company agrees to lease back and service the equipment for a fee. Investors are promised high returns with little or no risk. But state regulators say high commissions paid to salesmen and promised returns that are unrealistically high doom many projects. In North Carolina, regulators took action against an individual who sold an Internet kiosk to an investor for $24,950, promising a 17 percent return. The individual had previously sold payphone leases to investors from a company that later filed for bankruptcy.

Before investing, state securities regulators urge investors to call their offices and ask if the individual selling the investment is licensed to do so. Regulators say investors can also save themselves a lot of grief by asking a second question – whether the investment itself is registered. To check out an investment or salesperson, contact your state securities regulator. Their phone number is in the white pages of your phone book under "government" or available online at www.nasaa.org.

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[1] NASAA, the oldest international organization devoted to investor protection, was organized in 1919. It is a voluntary association with a membership consisting of the 66 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM WILLIAM H. DONALDSON

Supervisory Deficiencies at Every Firm—Compliance Failures

Q.1. In your press release announcing the global settlement, you said that, "the regulators found supervisory deficiencies at every firm" covered by the settlement. Where were the compliance breakdowns? What is being done by the firms to fix their compliance programs?

A.1. The most significant compliance breakdown found at the firms was the failure to manage the conflicts of interest between the provision of investment banking services and the integrity of the research product. Companies routinely selected a broker-dealer to provide investment banking services based on the promise, whether explicit or implicit, of favorable research coverage. The companies wanted that research to reflect positively on the companies' prospects. In addition, research analysts were frequently compensated directly for contributions to investment banking business. This business dynamic created a conflict of interest that needed to be managed to ensure the integrity of the research product. The firms failed to recognize and address this conflict.

As a result of the global settlement, firms are severing the links between investment banking and research, including establishing firewalls between these departments, ceasing the practice of compensating research analysts directly or indirectly based upon investment banking revenue, prohibiting analysts' involvement in "road shows" or "pitch" meetings, and requiring all decisions regarding the initiation and termination of research coverage to be made by senior firm management. In addition, the firms are required to procure independent research from outside sources and to make it available to the firms' clients. The intent of these changes is to cause firms to provide investors more accurate and reliable information to assist them in making investment decisions.

Q.2. How is the SEC improving its examination and oversight function of broker-dealer compliance programs in light of the problems discovered in the investigation of the 10 broker-dealers to ensure that such a breakdown does not happen again?

A.2. SEC staff is in the process of conducting an examination sweep focused solely on broker-dealer compliance and supervisory programs. In particular, each firm has a responsibility to establish, maintain, and enforce a system to properly supervise the activities of its employees to achieve compliance with the Federal securities laws. The staff is examining not only whether the firms have implemented effective procedures required under the securities laws, but also the extent to which the firms have systems in place that encourage new issues to be identified, concerns to be communicated to management, and responses to issues to be developed prior to discovery by a regulator. This review includes an evaluation of the Board's and senior management's involvement in compliance-related functions.

As a result of the increased funding Congress has directed to the Commission, it is expanding the number of examiners. These

increases will allow for an increased number of targeted examinations of broker-dealers as well as more frequent inspections of oversight programs at the self-regulatory organizations.

Q.3. Has the SEC identified "red flags" or facts that should have signaled to the SEC that a violation of the Federal securities laws might be occurring?

A.3. In 2000, prior to the joint investigation that led to the global settlement, Commission staff began examining research analysts conflicts of interest. These findings were reported in July 2001 by then-Chairman Unger during her testimony before the House Financial Services Subcommittee on Capital Markets. Pursuant to these findings and SEC recommendations, the NASD and NYSE crafted significant amendments to their analyst rules. The SRO rule amendments were initially filed in February 2002 and approved by the Commission on May 10, 2002. The Commission launched its joint investigation into research analyst conflicts of interest on April 25, 2002.

The Commission staff's examinations in 2000 exposed a number of conflicts of interest such as research analyst compensation being significantly linked to investment banking revenue, research analysts owning securities in companies they covered, and research analysts executing trades that were contrary to the recommendations published in their research reports. Several specific instances were referred to the Commission's Division of Enforcement for further investigation.

Q.4. What lessons has the SEC learned in this investigation that will prompt it to act more quickly and effectively in addressing securities violations and protecting investors in the future?

A.4. The findings in these investigations have reinforced the need to focus resources on areas of conflicts of interest. As outlined below in response to question 5, the staff is currently conducting examinations of broker-dealers targeting other areas of conflicts of interest. In addition, the research analyst investigation has demonstrated the investigative value of e-mail. As a result, examination and enforcement staff are increasingly requesting e-mail as part of examinations and investigations of broker-dealers.

Q.5. Mr. Glauber at the hearing testified that, "two weeks ago, our board voted to put out for comment and the SEC [is reviewing], a provision where we will require that the CEO and chief compliance officer of every firm certify the policies and procedures are in place to enforce our rules." What is your reaction to this recommendation and do you believe it should be applied more broadly?

A.5. On June 4, 2003, the NASD published Notice to Members 03–29, which requested comment from its members on a proposal to require each NASD member to designate a Chief Compliance Officer, who, jointly with the member's Chief Executive Officer, must certify annually that the member has in place adequate compliance and supervisory policies and procedures. The NASD has not filed the proposal with the Commission for review. The Commission staff will carefully review this certification proposal for consistency with the Exchange Act when the NASD files it with the Commission.

Self-Regulation

Q.6. In his testimony, New York State Attorney General Spitzer said, "The single most important message for the American public and for Congress is that self-regulation failed." He went on, "It was a complete, abject failure." Do you agree with Mr. Spitzer's characterization that "self-regulation failed?" What can be done to improve our self-regulatory apparatus—by the SEC; by the SRO's?

A.6. It is a fair criticism to say that the oversight system for broker-dealers regulators, self-regulators, and the internal firm compliance structures—did not do enough. Nonetheless, I do not believe that their failure to act sooner represents a total failure of the self-regulatory system. In fact, it is important to note that the investigation resulting in the global settlement reflected the efforts of not only the Commission and the States, but also the NASD and the NYSE.

The Commission maintains an inspection program that oversees SRO's, through which Commission staff seek to ensure that regulatory programs are adequately staffed, funded, and independent of SRO members' business interests. The Commission's recent increase in funding will assist Commission staff, through additional staff resources and technological enhancements, to provide additional oversight of SRO's and broker-dealers.

NYSE Investigation

Q.7. On April 17, 2003, the New York Stock Exchange announced that it is conducting an investigation "of trading practices at several specialist firms." What is the SEC's role in the NYSE's current investigation of its specialists?

A.7. As has been reported in the media, the NYSE is currently investigating numerous individual specialists for allegedly engaging in conduct known as "interpositioning," which is the practice of a specialist trading for his own account with customer buy and sell orders that could be matched at a single price, thereby allowing the specialist to illegally profit from the spread. Commission staff is actively overseeing the NYSE's investigation into interpositioning. In addition, the staff is examining the NYSE's overall regulatory program as it pertains to specialist trading.

New York Stock Exchange Rule 342

Q.8. New York Stock Exchange Rule 342 requires each Exchange member to submit to its Chief Executive Officer or Managing Partner an annual report that discusses compliance efforts regarding antifraud and trading practices, sales practices and other matters, significant compliance problems and plans to prevent violations and problems, and complaints and internal investigations. After the Exchange's examinations of its members that were parties to the global settlement, did the Exchange bring possible misconduct to the attention of the SEC staff?

A.8. With respect to the global settlement, the Commission's staff jointly conducted the investigations with the NYSE and NASD and was, therefore, fully apprised of all potential regulatory concerns. In addition, shortly after the NYSE's May 2002 enhancements to Rule 472 regarding research analyst conflicts of interest, the NYSE

conducted examinations of the firms that were parties to the global settlement to assess their compliance with these rule enhancements. Commission staff participated in some of these examinations and, therefore, was apprised of any potential regulatory concerns at those firms. With respect to the remaining firms, NYSE examiners presented Commission staff with their findings at the conclusion of the examinations.

Q.9. Has the SEC staff conducted its own review of the Exchange's enforcement of Rule 342 or of the Exchange members' compliance with Rule 342? Has the SEC reviewed the New York Stock Exchange's examination procedures or use of information contained in the reports prepared pursuant to Exchange Rule 342? What action has the Commission taken as a result of any such reviews?

A.9. SEC staff routinely inspect the NYSE's examination programs. In this regard, the staff intends to conduct an inspection focusing on the Exchange's review and enforcement of members' compliance with NYSE Rule 342.

Conflicts of Interest

Q.10. In addition to the research analyst-underwriting conflict of interest, what other conflicts, if any, within the securities industry concern you?

A.10. Currently, the Commission is focusing examination resources on additional areas of conflicts of interest. For example, the staff is examining broker-dealers to determine whether conflicts of interests exist in the way brokerage firms are compensated when selling mutual funds. The examinations focus on the various types, amounts, and sources of remuneration that broker-dealers receive for selling mutual funds, the manner in which broker-dealers pay their registered representatives who sell mutual funds, and the extent these payments are disclosed to investors. As demonstrated by the Commission's recent enforcement action against Deutsche Asset Management Inc., Deutsche Bank AG's investment advisory arm, conflicts of interest also may arise in the proxy-voting process.

Research

Q.11. A number of commentators have observed that research has historically been subsidized and have expressed concern that delinking banking from research [as required by the global settlement] may create a problem in terms of the funding of research generally. These observers, as well as representatives of smaller companies, have raised the concern that the proposed changes may result in these companies losing access to research coverage entirely. Do you believe these are valid concerns and, if so, how do you plan to address them?

A.11. The settlement's imposition of structural and institutional separation between research and investment banking personnel is designed to prevent promises of favorable research coverage for companies that are banking clients of the firm and to protect analysts from inappropriate influences. Companies will likely continue to consider the ability to provide research coverage as a significant factor in selecting firms for investment banking services.

While there has been a recent decrease in research coverage by investment banks, it is unclear how much this decrease should be attributed to the settlement (which is not yet in force), and how much this decrease is caused by the poor investment banking climate. In addition, there are heartening signs of an increase in independent research being provided to institutional investors.

Moreover, similar to the global settlement's approach, in the Sarbanes-Oxley Act of 2002 (the Act), Congress concluded the best way to restore confidence in our markets is to ensure that investors receive independent and objective research, as opposed to allowing investment banking influenced research reports to continue to provide investors with biased research, particularly where conflicts of interest remained undisclosed. The Commission has approved SRO rule amendments that implement the requirements of the Act (and impose additional requirements). We believe that these protections for the integrity of research will provide incentives for firms to fund research according to its value to the firm's customers, rather than base funding of the production of research on inappropriate influences within the firm.

Scope of Investigation

Q.12. In the context of the global settlement, I understand that the regulators looked into only a sample of the analysts and a sample of the stock recommendations at these firms. What was the scope of your investigation and will the SEC examine additional research reports to determine whether there are other instances of misconduct?

A.12. The staff's investigation focused on the extent to which research analysts: (1) Published research reports and recommendations that did not reflect the analysts true beliefs; (2) reported to, or had their work reviewed by, investment banking personnel; and (3) received compensation from revenue derived from investment banking activities. The staff selected for investigation firms that underwrote a significant number of technology and Internet-related IPO's. In addition, the staff focused on IPO's (and the underwriters of those IPO's) that rapidly increased in price and then decreased in a relatively short period.

The staff does not currently plan to review additional research reports in that it believes that the sampling used during the investigations was appropriate. The staff is, however, continuing to investigate the conduct of senior management at these broker-dealers to determine whether it is appropriate to sanction individuals for failing to supervise the conduct of their employees.

Deutsche Bank

Q.13. According to press reports, Deutsche Bank admits that it failed to produce all its e-mail to the SEC and the lead State investigating agency, the California Department of Corporations. What steps did the SEC take before, and what steps is the SEC taking after, Deutsche Bank's admission to ensure that Deutsche Bank was and is, in fact, producing all of its e-mail and documents?

A.13. As a matter of Commission policy, I am unable to comment on actions taken by the Commission or its staff in connection with an ongoing investigation. However, I can assure you that the Com-

mission and its staff take very seriously the obligations of parties who receive Commission subpoenas for documents, whether the recipient is an individual or an entity. The staff routinely obtains assurances from witnesses under oath that they have complied fully with subpoenas, including probing the manner in which the individual conducted the search for relevant documents. The staff seeks similar representations from counsel for entities concerning how and whether their clients have complied with Commission document subpoenas. Moreover, in instances when the staff believes that a subpoenaed party's compliance has been inadequate, the Commission may seek a Federal court order that the party comply fully with the Commission's subpoena. In fiscal year 2002, the Commission filed 19 such subpoena enforcement actions, and in the first three-quarters of fiscal year 2003 the Commission has brought 6 such actions.

Obstruction of Justice

Q.14. You and Mr. Cutler each underscored the importance of criminally prosecuting obstruction of justice conduct and the Commission's close working relationship with the Justice Department. What is the Commission doing from a civil perspective to deter future obstructive conduct or conduct that, as Mr. Cutler says, "goes to the heart and the integrity of the investigative process" and, in that context, is the Commission vigorously prosecuting all matters in front of it that involve obstructive conduct by accountants or investment bankers?

A.14. Criminal prosecution of those who obstruct Commission investigative processes by destroying documents or lying to the staff is the most effective means of deterring such conduct by others. Accordingly, the Division of Enforcement has worked closely with the criminal authorities to make them aware of such occurrences and facilitate the prosecution of these offenders. We have been very pleased with the cooperation of the Department of Justice in this regard.

Because the Commission does not have the authority to bring actions for obstruction of justice, we employ a different strategy to help ensure the integrity of the Commission's processes. As noted above (in response to question 8), in instances when the staff believes that a party is seeking to delay or divert an investigation by refusing to comply with a Commission subpoena, the Commission has been aggressive in seeking Federal court enforcement of its subpoenas. Indeed, last year, the Commission sought and obtained $1.2 million in damages against a Dallas law firm for violating a court order in a pending SEC civil lawsuit against one of the law firm's former clients. The law firm had failed to produce for 18 months 27 boxes of its client's records that the court had ordered produced to the SEC. This case illustrates the SEC's commitment to seeking sanctions against those who interfere with its law enforcement processes.

Similarly, the Commission has created strong incentives for subjects of its investigations not only to comply with its investigative processes, but also affirmatively to cooperate with the staff to facilitate thorough and expeditious investigations. In an October 2001 Section 21(a) Report, the Commission articulated the benefits to

parties who provide meaningful cooperation, which includes self-policing prior to discovery of misconduct (such as developing effective compliance procedures and an appropriate "tone at the top"); self-reporting misconduct upon discovery to the public and regulators; remediation, such as dismissing or appropriately disciplining wrongdoers, improving internal controls and procedures to prevent recurrence, and compensating those adversely affected, and; cooperation with law enforcement authorities' investigations. Those benefits may include lesser charges or lighter sanctions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM WILLIAM H. DONALDSON

Q.1. Chairman Donaldson, I am hoping you will share with us your view of the mechanism to return a portion of these fines to defrauded investors. Please explain how the Fair fund established under Sarbanes-Oxley will enable the Commission to return this money to investors. I understand that the Commission invited the States to contribute their portion of their penalties to the Fair fund—have any agreed or declined to do so?

A.1. The Fair Fund provision of the Sarbanes-Oxley Act was a groundbreaking measure to help the Commission return more funds to defrauded investors. It did so by changing the law to permit penalty amounts collected to be added to disgorgement funds in certain circumstances. The Commission has made ample use of this new authority, including in the global analyst research settlement filed with the Court. Collectively, the settling firms will pay disgorgement and civil penalties totaling $875 million, including Merrill Lynch's previous payment of $100 million in connection with its prior settlement with the States. Under the settlement agreements, half of the $775 million payment by the firms other than Merrill Lynch will be paid in resolution of actions brought by the SEC, NYSE, and NASD, and will be put into funds to benefit customers of the firms (the Distribution Funds). The remainder of the funds will be paid to the States. The settlement has not yet been approved by the Court so the process of establishing the Distribution Funds has yet to commence. To date, we have received an indication of interest from only a single State—Missouri—in distributing its share of settlement proceeds to investors.

Q.2. Chairman Donaldson, it is my understanding that, as part of this global settlement, a restitution fund will be established with an administrator to allocate funds to individual customers based primarily on whether each customer purchased any of a limited universe of securities identified in the Commission's complaint. Can you please discuss the methodology for how these funds will be distributed? Does questionable analyst research make it hard to determine who was harmed? How much reimbursement would the average defrauded customer receive? Would it be based on the number of shares the individual purchased? Will mutual funds which purchased these stocks have access to restitution?

A.2. The monetary relief included in the analyst research settlement is substantial. Collectively, the 10 firms will disgorge illegal proceeds of nearly $400 million, and will pay well in excess of $400 million in civil penalties. As discussed above, the Federal regu-

lators—the Commission, the NASD, and the New York Stock Exchange—will place their share of the penalties and disgorgement (approximately $400 million) into Distribution Funds for payment to harmed investors if authorized by the Court. While there are challenges and difficulties in establishing such Funds, the Commission feels strongly that those challenges and difficulties are worth taking on and that any monies paid by the settling firms should be used to compensate the investors harmed most directly by the misconduct uncovered in our investigations. We believe that this is the right thing to do, and is consistent with the message sent by Congress when it recently authorized us to use penalties to repay investors.

If approved by the Court, all told, there will be 9 Distribution Funds, one for each of the 9 settling firms other than Merrill Lynch. Merrill Lynch will not have its own Distribution Fund because it previously paid $100 million in penalties to the States. The amounts to be paid by Henry Blodget, who formerly worked for Merrill Lynch, will be placed in a separate court-administered fund for distribution to investors. The money that Jack Grubman pays to the Court will be put into the Distribution Fund for Citigroup Global Markets Inc., formerly known as Salomon Smith Barney Inc., for which Grubman previously worked.

For the firm Distribution Funds, the settlement provides that the Commission will recommend to the Court, and the Court will appoint, a Distribution Fund Administrator. The Distribution Fund Administrator will devise Distribution Fund Plans and Distribution Fund Reports that contain the complete and final terms for distribution of funds to investors. There will be a separate Plan and Report for each of the Distribution Funds. These Plans and Reports will identify those who are to receive payments from the Distribution Funds, the amount each person will receive, and the procedures for distributing funds to the recipients. The Distribution Fund Administrator will initially submit his/her Distribution Fund Plans and Reports to the SEC staff and then to the Court. The Court must approve all the Distribution Fund Plans and Reports.

The methodology for determining which investors receive recompense will be developed, in the first instance, by the Distribution Fund Administrator. Although the Fund Administrator may exercise significant discretion and judgment in designing the Distribution Fund Plans, the settlement filed with the Court articulates certain broad requirements and guidelines to which the Distribution Fund Administrator must adhere. The overarching objectives of the Distribution Fund Plans are to provide for "the equitable, cost-effective distribution of funds" to eligible recipients, and to attempt, "to ensure an equitable (though not necessarily equal) distribution of funds and that those who are allocated funds receive meaningful payments from the Distribution Fund[s]."

In addition to identifying broad objectives of the Distribution Fund Plans, the settlement provides more specific guidelines for allocation of the funds. For each defendant, the Distribution Fund Administrator is required to formulate a Distribution Fund Plan "that, to the extent practicable, allocates funds to persons who purchased the equity securities of companies referenced in the complaint" against that defendant. The settlement also specifies that

eligible investors *must* have purchased the equity securities in question through a defendant firm during the relevant period identified in the complaint, and *must* have suffered a net loss on his equity securities purchases in question. The settlement also states that the Distribution Fund Administrator may consider (1) whether the person was a retail or institutional customer; and (2) the proximity in time between the person's purchase of a company's equity securities and the applicable defendant's publication of pertinent research regarding that company.

Under the settlement, a mutual fund would *not* be excluded simply because it is an institution. It will be eligible provided it "purchased the equity securities in question through [a defendant firm] during the relevant period identified in the complaint" against that defendant, met all the other requirements described above, and was not affiliated with a defendant firm. A shareholder of such a mutual fund would not be able to receive a *direct* payment from the Distribution Funds but might be able to receive a payment *indirectly* through the mutual fund if the Court-approved Distribution Fund Plan in question provides for payments to the mutual fund. As mentioned above, in identifying eligible investors the Distribution Fund Administrator may consider whether the person in question was a retail or institutional customer.

Q.3. Chairman Donaldson, has there been any time frame set for when investors can apply for restitution and do you have any idea how long it might take for an investor with a good claim to receive their money? If the answer is no possible follow up: When will such time frames be set?

A.3. Potential recipients of settlement funds need not take any action at this time in order to be eligible. Under the terms of the settlements, the firms are obligated to provide the Distribution Fund Administrator with all the documents and information necessary to enable the Distribution Fund Administrator to identify those who may be eligible to receive a payment from the Distribution Funds. The time frame for distributing funds is as follows:

- Six months after being appointed by the Court, the Distribution Fund Administrator will provide Distribution Fund Plans to the SEC staff for review and comment. These Plans will describe the process for (i) identifying and categorizing those who may receive payments from the Distribution Funds, (ii) determining the amount that each of those persons shall receive, and (iii) distributing monies to such people.
- Two months after submitting the Distribution Fund Plans to the SEC staff, the Distribution Fund Administrator will present the Plans, with any revisions (s)he deems appropriate, to the Court for its approval.
- Within 9 months after the Court approves the Distribution Fund Plans, the Distribution Fund Administrator will submit Distribution Fund Reports to the SEC staff. These Reports will identify (i) those who are to receive payments from the Distribution Funds, (ii) the amount that each person will receive, and (iii) the procedures for distributing funds to the recipients.

- One week after submission of the Distribution Fund Reports to the SEC staff, the Distribution Fund Administrator will present the Reports to the Court for its approval.
- Following Court approval, the Distribution Funds will be distributed to investors in accordance with the procedures set forth in the Distribution Fund Reports.

Note that because the Court has yet to approve the settlement, this process has not yet begun.

Investors should be aware, however, that the global settlement papers expressly provide that those who are eligible to receive payments from the Distribution Funds are not precluded from pursuing, to the extent otherwise available, any other remedy or recourse they may have. To take advantage of the legal rights that investors may have to pursue any other remedy, individuals must take legal action promptly or they may lose the right to seek a remedy or recover funds. Statutes of limitations will apply and can vary in length depending upon the claim involved and the forum (court or arbitration) in which a claim is pursued.

Q.4. Chairman Donaldson, according to the SEC's summary of the settlement, the practice known as "spinning," the restricting of allocations of securities in "hot" initial public offerings (IPO's) to certain company executive officers in a potential bid for future investment banking business, has been addressed. However, I am not certain what reforms this settlement contains to address this problem. Can you discuss the antispinning reforms in the settlement and if you are considering any further action on this issue?

A.4. The IPO underwriting process has come under considerable scrutiny during the past year—especially with regard to perceived abuses in the allocation of IPO shares. Separate and apart from the global settlement to be imposed by the Court, the firms have collectively entered into a *voluntary* agreement banning allocations of securities in "hot" initial public offerings (IPO's)—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors, a practice known as "spinning." Pursuant to this voluntary initiative, the firms have agreed to implement policies and procedures reasonably designed to ensure that: (1) The firms will, not allocate securities in a hot IPO to an account of an executive officer or director of a U.S. public company or a public company for which a U.S. market is the principle equity trading market; (2) in connection with any IPO transaction in which they are seeking to become the lead or co-lead managing underwriter, the firms will take reasonable steps, prior to the aware of the formal mandate, to notify the company in writing that they may have allocated hot IPO's to the company's executive officers and directors and/or their immediate family members; (3) the firms will not allocate securities in an IPO in exchange for or for the purpose of obtaining investment banking business; and (4) the firms will not permit investment banking personnel to have input into their allocation of securities in an IPO to a specific individual customer. The requirements of the voluntary initiative will sunset in the earlier of 5 years or at the time that the Commission or the SRO's adopt rules concerning IPO spinning.

At the same time, the Commission is reviewing the industry practices regarding the allocation of IPO shares with the goal of restoring investor confidence and public trust. Last fall, at former Chairman Pitt's request, the NYSE and NASD convened a blue ribbon Panel of business and academic leaders to conduct a broad review of the IPO process, including the role of issuers and underwriters in the pricing and allocation process, and recommend ways to improve the underwriting process. The Blue Ribbon panel completed its report in May. The panel recommended prohibiting the allocation of IPO shares (1) to executive officers and directors (and their immediate families) of companies that have an investment banking relationship with the underwriter, or (2) as a quid pro quo for investment banking business. The Commission will work with the SRO's to consider changes to the rules governing the initial public offering process, including the recommendations of the blue ribbon panel.

Prior to the establishment of the Blue Ribbon panel, the NASD had sought comment from its members on a proposed rule that would prohibit allocations to company CEO's and directors on the condition that they send their companies' investment banking business to the NASD member. The Commission staff expects that the NASD will revise its rule proposal in light of the report of the blue ribbon panel and the voluntary initiative.

Q.5. The settlement requires for securities firms to include a disclosure on the first page of their research report a note making it clear that the reports are produced by firms that do investment banking business with the companies they cover. This disclosure must acknowledge that such a relationship may affect the objectivity of their firms' research. Is this disclosure an acknowledgement that it may be impossible for investment banking business in a firm not to affect firms' analysts?

A.5. As with many types of corporate disclosure, the purpose is to make available to the public, to shareholders, or, in this case, to consumers of research, information that they may find relevant to their investment decisions. It is up to individual readers of the disclosure to afford such information appropriate weight in their decisionmaking process based on their own preferences, risk tolerance, and judgment. Thus, requiring disclosure of an investment banking relationship on the first page of a firm's research report simply acknowledges that investors may find that factor relevant in evaluating their investment alternatives. It does not necessarily suggest that it is impossible for investment banking business in a firm not to affect a firm's analysts.

Q.6. How do the reforms in this settlement interact and differ from the reforms that have been instituted since 2001—such as the industry's own best practices that were adopted in 2001 and the rules that were adopted by the New York Stock Exchange during the public outcry about analyst's conflicts?

A.6. The global settlement marks the conclusion of a joint investigation by regulators aimed at undue influence on research exerted by investment banking interests at brokerage firms. The settlement includes structural and institutional safeguards designed to protect analysts from inappropriate influences and pre-

vent promises of favorable research. These reforms are consistent with continuing initiatives by Congress, the Commission, the SRO's, and the industry to restore investor confidence by attempting to reduce conflicts of interest and increase disclosure of such conflicts.

The thrust of the global settlement and the SRO rules is quite similar and certain of the global settlement's structural elements are already incorporated in those rules. Key similarities between the settlement and the SRO rules (including recent amendments to those rules that implemented the Sarbanes-Oxley Act of 2002) include the following: Structural separation between investment banking and research personnel; prohibitions on investment banking involvement in determining analyst compensation; notification of a decision to terminate research coverage; and prohibition on involvement by research analysts in solicitation of investment banking business for their firms, including participating in "sales pitches." The global settlement goes further than the SRO rules in some respects by prohibiting analyst involvement in "road shows," obligating firms to provide customers with "independent research" for 5 years, and mandating the creation of a research oversight/monitoring committee. The Commission and the NYSE and NASD will consider what, if any, of these additional elements of the global settlement should be incorporated into rules applicable for the entire industry.

The global settlement's reforms do not conflict in any way with the SIA's "Best Practices for Research," which are a series of guidelines that urge higher ethical and professional standards for research analysts.

Q.7. In reading accounts of conflicts uncovered one thought frequently came to mind. These analysts did not operate in a vacuum. There must be some accountability in the executive suites as well. Accordingly, can you discuss whether the SEC will hold any Wall Street executives accountable for their failure to properly supervise their employees?

A.7. The Commission is continuing to investigate the roles played by individual securities analysts and their supervisors in the conduct described in the Commission's settlement papers. I am unable to comment further on this ongoing Commission investigation.

Q.8. What was the role of the self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers in reaching the agreement and hammering out the settlement?

A.8. The NASD and the New York Stock Exchange played important roles in the investigation and settlement of the analyst research cases. As the first-level regulators of the firms under investigation, they brought valuable expertise and experience to the process. These SRO's were full partners in negotiating the settlement with the firms.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM RICHARD A. GRASSO

Q.1. In analyzing the misconduct discovered through the investigation, has the New York Stock Exchange (NYSE) identified, red

flags' or facts that should have triggered an earlier look into whether a violation of the securities laws was occurring?

A.1. Initially, when the New York Stock Exchange, Inc. (the Exchange), the Securities and Exchange Commission (the Commission), NASD Inc. (the NASD), (the Federal regulators) recognized that there were problems stemming from the potential conflicts of interest resulting from research and investment banking operating under one roof, the focus was to establish industry-wide standards in this area through rulemaking. In 1999, the Commission, the Exchange and the NASD determined that refinements to the self-regulatory organization (SRO) rules governing firms' research practices were necessary. After discussion with the SEC, the Exchange, and the NASD began the process of drafting new rules governing research analysts and the disclosure of the conflicts of interest. In February 2002, the Exchange's Board of Directors approved new amendments to Exchange Rules 472 and 351, which govern research analysts and published research.[1] However, it was not until the recent Joint Task Force investigation conducted by the Exchange, the Commission, the NASD, the North American Securities Administrators Association, the New York Attorney General's Office (NY AG's Office), and State securities regulators (collectively, the Joint Task Force), that the regulators discovered the extent[2] to which the actual conflicts of interest had compromised the integrity of the research process. The "red flags" that revealed this misconduct were uncovered after the regulators scrutinized hundreds of thousands of internal and external e-mail communications of analysts and other personnel at the firms under investigation. These e-mails provided evidence of the interrelatedness of the research and investment banking departments, the investment banking pressures placed on research analysts, and the interactions of research analysts with the companies that they covered. In addition, the e-mails provided the strongest evidence of exaggerated, unwarranted, and fraudulent research.

Although the Federal regulators were working to develop industry-wide rules governing firms' research practices, an earlier review of e-mail sent and received by research analysts and investment bankers may have revealed the extent to which investment banking pressures and conflicts of interests affected the firms' published research. The Exchange now utilizes e-mail review as an important regulatory tool. As explained below, the Exchange is committed to using e-mail review, along with rulemaking and member firm examinations, to ensure the firms' compliance with the terms of the settlement and to uncover and punish violations of Exchange rules and the Federal securities laws.

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[1] The Commission approved these amendments in May 2002. In October 2002 and May 2003, the Exchange and the NASD submitted to the Commission, for comment and approval, rule amendments that place even greater restrictions on firms' research activities, including amendments made pursuant to the Sarbanes-Oxley Act of 2002.

[2] The firms that participated in the settlement are Bear, Stearns & Co., Inc., Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc., J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith, Incorporated, Morgan Stanley & Co. Incorporated, Citigroup Global Markets Inc., f/k/a Salomon Smith Barney Inc., UBS Warburg LLC, and U.S. Bancorp Piper Jaffray. The investigations of Deutsche Bank Securities, Inc., and Thomas Weisel Partners LLC are continuing.

Q.2. What lessons has the NYSE learned as a result of this investigation that will make it act more quickly and effectively to address securities violations and protect investors in the future?

A.2. As discussed above, the investigation demonstrated the importance of enhanced e-mail review as a regulatory tool. Exchange rules require member firms to retain e-mail, to provide reasonable supervision of e-mail communications, and to develop written policies and procedures for the review of communications with the public.[3] Prior to the investigation, the Exchange ensured compliance with these requirements by, among other things, sampling and reviewing external email sent and received by registered representatives during annual and periodic examinations of member firms. In 2002, the Exchange expanded its examination program to include a sampling and review of internal and external e-mail sent and received by other categories of employees, including research analysts and investment bankers. In addition, as part of its investigative program, the Exchange's Division of Enforcement will conduct more extensive reviews of e-mail when appropriate based upon the nature of the alleged misconduct under investigation. In fact, the Exchange is currently conducting such e-mail reviews in several on-going investigations.

The Exchange has committed significant resources to facilitate this expanded e-mail review. The Exchange's Division of Regulatory Technology has developed a sophisticated computer system to review and catalog e-mail. Exchange employees in the Divisions of Member Firm Regulation, Market Surveillance, and Enforcement have received training in this system, which will be used regularly in Exchange examinations and investigations.

In addition to the above changes, the Exchange has undertaken new regulatory initiatives to target problems in the industry. The Exchange, in conjunction with the Commission and the NASD, are presently investigating the improper "spinning" of initial public offering (IPO) shares.[4] The Federal regulators will also be examining the operation of compliance departments at major broker-dealers. These examinations will review the structure of the department, the qualifications of its employees, the department's staffing and budget, and most importantly, whether the department has the tools to effectively monitor the firm's operations.

Q.3. The joint agency press release announcing the global settlement said that, "the regulators found supervisory deficiencies at every firm." That means "every" major investment bank on Wall Street covered by the settlement had supervisory deficiencies. What

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[3] *See New Rules-Supervision and Review of Communications with the Public,* Exchange Information Memo 98–03 (Jan. 16, 1998) (announcing the requirements adopted in amended Exchange Rules 342.16 and 342.17 requiring member firms to provide reasonable supervision of e-mail communications and to develop written policies and procedures for review of communications with the public). In November 2000, the Exchange, in conjunction with the Commission and the NASD, fined five firms under investigation by the Joint Task Force $8.25 million for failing to retain electronic communications. *See Deutsche Bank Securities, Inc.,* Exchange Hearing Panel Decision (HPD) 02–223 (Nov. 15, 2002); *Goldman, Sachs & Co.,* HPD 02–224 (Nov. 15, 2002); *Morgan Stanley & Co. Incorporated,* HPD 02–225 (Nov. 15, 2002); *Salomon Smith Barney Inc.,* HPD 02–226 (Nov. 15, 2002); and *U.S. Bancorp Piper Jaffray Inc.,* HPD 02–227 (Nov. 15, 2002).

[4] Spinning is generally known as the allocation of shares of a "hot" IPO to the account of an employee of a public company for the purpose of obtaining, or in exchange for, investment banking business.

is the responsibility of the heads of these firms to supervise their personnel?

A.3. The supervisory responsibilities of Exchange member firms are set forth in Exchange Rule 342, entitled "Offices—Approval, Supervision and Control." This rule mandates that every Exchange member firm provide—through designated supervisory personnel and systems of follow-up and review—appropriate supervisory control over its employees and business activities to ensure compliance with all Exchange Rules and the Federal securities laws. This obligation extends to the heads of these firms, who are ultimately responsible for compliance with Exchange Rules and the Federal securities laws.

Q.4. Where were the compliance breakdowns? What is being done to fix them?

A.4. The "compliance breakdowns" uncovered by the Joint Task Force are described in great detail in the settlement documents, which include, among other things, the finding that the firms failed to adequately manage the conflicts of interests and address their impact on published research.

A key focus of the investigation was a review of the supervisory practices and procedures at the firms. This review revealed that each firm failed to maintain supervisory control over its business activities to ensure compliance with the SRO rules and the Federal securities laws. In the Exchange hearing panel decisions formalizing the settlement, each firm consented to a finding that it violated Exchange Rule 342 for "failing to establish and maintain adequate policies, systems, and procedures for supervision and control of the research and investment banking departments reasonably designed to detect and prevent the . . . [specified] investment banking influences and manage the conflicts of interest, including a separate system of follow-up and review to ensure compliance with applicable Exchange Rules and Federal securities law."[5] This finding resulted from the firms' failure to monitor research analyst participation in pitches, road shows, and other investment banking activities; failure to monitor e-mail communications for evidence of investment banking pressure to change the content of, or the recommendations contained in, published research; failure to monitor communications with issuers; and failure to ensure that research analyst compensation was not linked to investment banking activities or the profitability of the investment banking department. As detailed in the settlement documents, each firm fostered a culture that subjected research analysts to significant investment banking pressures and conflicts of interests.

To "fix" the compliance breakdowns, the settlement imposes a detailed framework of requirements to ensure that published research is the product of independent, objective analysis by research analysts. These requirements, which are contained in "Addendum

[5] *Bear, Stearns & Co., Inc.,* BPD 03–63 (Apr. 22, 2003); *Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc.,* HPD 03–72 (Apr. 22, 2003); *Credit Suisse First Boston LLC,* HPD 03–64 (Apr. 22, 2003); *Goldman, Sachs & Co.,* HPD 03–65 (Apr. 22, 2003); *JP Morgan Securities Inc.,* HPD 03–68 (Apr. 22, 2003); *Lehman Bothers Inc.,* HPD 03–66 (Apr. 22, 2003); *Merrill Lynch, Pierce, Fenner & Smith Incorporated,* HPD 03–67 (Apr. 22, 2003); *Morgan Stanley & Co. Incorporated,* HPD 03–69 (Apr. 22, 2003); *UBS Warburg LLC,* HPD 03–70 (Apr. 22, 2003); and *U.S. Bancorp Piper Jaffray Inc.,* HPD 03–71 (Apr. 22, 2003).

A" to the settlement documents, will forever change the way that these firms conduct business. For example, it is no longer permissible for research analysts to participate in pitches or otherwise solicit investment banking business. Also, research analysts may not report to investment bankers, may not be compensated or evaluated based upon investment banking considerations, and are restricted in their communications with investment bankers. In addition, the firms are required to retain an independent monitor to conduct a review of the policies and procedures implemented to comply with the requirements of Addendum A. As discussed in response to Question 1, the Exchange and the NASD have imposed additional requirements governing research analysts and published research through rulemaking. The new rules and the requirements of Addendum A are intended to ensure that the research and investment banking departments are physically and operationally separate and that published research is free from investment banking influences.

In addition, the Exchange is continuing to investigate the role that supervisors at all levels played in both creating and perpetuating the "culture of conflicts" that was present at all of the firms. Additional enforcement actions in this area are expected.

Q.5. Are you satisfied with the compliance programs at these broker-dealers? [If not, what are you going to do to improve them?]

A.5. It is a well-established tenet of securities industry regulation that broker-dealer compliance is the first line of defense against securities law violations. The size and complexity of the industry make it critical that firms maintain effective compliance programs to ensure adherence to SRO rules and the Federal securities laws. This compliance obligation arises out of Federal and SRO requirements that firms reasonably supervise their employees and business activities. The Commission has referred to this obligation as "a critical component of the Federal regulatory scheme."[6] In particular, the heads of these firms "are responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient.[7]

In leveraging regulatory resources, the Exchange and the other securities regulators require that firms implement effective systems and procedures to ensure adherence to securities rules and laws. To ensure that broker-dealers comply with this requirement, the Exchange conducts regular examinations of firms and initiates disciplinary actions if these firms fall short of their compliance responsibilities.

As a result of the investigation, the Exchange, the Commission and the NASD have initiated a joint examination program to determine whether the largest broker-dealers are sufficiently committed to compliance. These examinations will review the structure of each firm's compliance department, the qualifications of its employees, the department's staffing and budget, and most importantly,

[6] *In the Matter of John H. Gutfreund, et al,* Exchange Act Release No. 31554, 51 S.E.C. 93, 108. (Dec. 3, 1992).
[7] *Id.* at 112.

whether the department has the tools to effectively monitor the firm's operations. The Federal regulators will closely examine the results of these examinations to determine the appropriate regulatory response.

Q.6. How are you improving your own surveillance of the broker-dealer community?

A.6. The Exchange is committed to improving its surveillance of member firms to ensure that they are in compliance with Exchange rules and the Federal securities laws. The Exchange has long-standing and effective examination and investigation programs designed to uncover and address misconduct in the broker-dealer community. The Exchange will enhance its review of member firms through new initiatives in its examination program and through rigorous investigations of firms and their employees which will include a review of e-mail when appropriate.

One immediate change that the Exchange has made to its the examination program is a review of the settling firms' compliance with the significant undertakings required by Addendum A. With respect to all other broker-dealers, the Exchange will continue to review for compliance with Exchange rules governing research analysts, research reports, and communications with the public. The Exchange completed a special examination program, conducted in coordination with the Commission and the NASD, that reviewed firms' compliance with the requirements imposed by the new SRO rules approved in May 2002. The Exchange will also review for compliance with the requirements of Regulation Analyst Certification, or "Reg. AC," which requires that research analysts certify the content of published research represents their personal views. As described above, the Exchange is working with the Commission and the NASD on coordinated examinations of the operations of compliance departments at major broker-dealers. The purpose of these examinations is to ensure that these firms are sufficiently equipped to execute their compliance responsibilities.

It is noteworthy that an integral component of every investigation conducted by the Exchange's Division of Enforcement is a review of the adequacy of supervision, and this will continue to be a focus of the Exchange's regulatory program. As a result, the Division of Enforcement has a demonstrated record of disciplinary actions against firms and individuals, including chief executive officers (CEO's), floor brokers, high-level managers, and branch office managers for failing to adequately supervise a firm's operations and/or for failing to implement adequate supervisory policies and procedures to prevent misconduct.

Exchange member firms have an obligation to ensure that their operations adhere to securities rules and regulations. The Exchange will continue to require that member firms provide effective compliance programs, will conduct examinations and investigations to ensure that those responsibilities are upheld, and will sanction firms and individuals as warranted.

Q.7. On April 17, 2003, the NYSE announced that it is conducting an investigating [sic] "of trading practices at several specialist firms." The press reports on the investigation stated that it arose because the Exchange received customer complaints and that the

NYSE is examining activity in dozens of stocks" and that "legal and compliance officers at six of the NYSE's seven 'specialist' firms . . . met to discuss concerns about 'front-running,' or trading ahead of clients in the stocks that the specialists are in charge of trading.' The Exchange issued a press release on April 22, 2003 stating that the press accounts contained errors.

The Wall Street Journal on April 23, 2003, wrote, "We believe our coverage has been accurate and fair . . . As for the Exchange's criticism of our semantics, we will happily defer to its experts on whether the proper description of the possible misbehavior under investigation is running in front of public investors or failing to stand out of their way. Meanwhile, we hope that the Exchange can tell us and the public soon the extent of the problem and what, if anything, it thinks should be done about it.

How would the NYSE respond to the *Journal* saying that the April 22 release is about a "criticism of our semantics?" What is the extent of the problem and what, if anything, needs to be done about it?

A.7. In statements issued on April 17 and 22, 2003, the Exchange made an exception to its longstanding policy not to comment on regulatory matters in progress and confirmed the existence of an investigation of trading at several specialist firms. The Exchange issued these statements on the investigation because some of the press coverage mischaracterized the conduct under investigation and contained inaccuracies.

The investigation was initiated pursuant to the Exchange's ongoing program of examination and surveillance of the activities of its specialist members. The Exchange's Division of Market Surveillance detected suspicious trading by a specialist in an individual stock. The Exchange then undertook a full-scale review of trading by all of the specialist firms to determine if other specialists were engaging in inappropriate trading.

The Exchange's investigation involves a review of the specialists' discharge of their responsibilities to agency orders and their failure to comply with their "negative obligations." A specialist may appropriately act as a dealer with respect to some orders and as an agent with respect to other orders.[8] A specialist has an "affirmative obligation" to buy and sell securities as a principal when such transactions are necessary to minimize an actual or reasonably anticipated, short-term imbalance between supply and demand to avoid an unreasonable lack of continuity and/or depth in the market. Alternatively, a specialist has a negative obligation to permit public orders to be executed against each other, within the current market and without undue specialist intervention, when there are sufficient public orders.

The Exchange will bring appropriate disciplinary action if the current investigation establishes that any specialist firm or individual specialist engaged in violative conduct.

Q.8. Has the NYSE received increasing numbers of complaints about specialists? What is the nature of these complaints?

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[8] *See* Exchange Rule 104.10 (delineating the functions of specialists).

A.8. As an SRO, the Exchange carefully reviews all inquiries and complaints from the public, institutional investors, professional market participants, and listed companies. Complaints from the public involving specialists relate to a variety of issues, including order execution, market maintenance, general inquiries about the auction market process, and the publication of stock prices. Inquiries and complaints have not increased from 2002 to the present. In 2001, the first full year of trading in decimals, complaints and inquiries increased from 2000. This was likely due to several factors, including increased trading volume, decimalization, and the general downturn in the securities markets.

Of course, inquiries from the public represent just one source of the matters subject to review and investigation by the Exchange. Every transaction effected on the Exchange is under continuous surveillance during the trading day. Various surveillance programs monitor for irregular or exceptional trading and price movement by specialists and floor brokers, insider trading abuses, and other manipulative and prohibited trading practices. In addition, annual and periodic examinations of specialists are conducted to detect violations of floor-related trading rules.

Q.9. Is "penny jumping" permissible under NYSE rules? What is the difference between "penny jumping" and front running?

A.9. Penny jumping is generally known as trading in front of existing orders at a penny better than those orders. It is a term that disparages the concept of price improvement by implying that market participants are more concerned with making the trade than with the price paid. Brokers for certain customers may outbid orders for other customers. Penny jumping primarily involves trading by individuals other than specialists. Under certain circumstances, penny jumping by specialists may be impermissible under Exchange rules, although the practice, unlike front running, is not illegal per se. Specialists are not permitted to trade when there are sufficient public buyers and sellers. They are obligated to commit capital to trade and participate as necessary to minimize temporary disparities between supply and demand.

In an auction market, buyers compete for available supply to arrive at an appropriate price at the confluence of supply and demand. In some circumstances, specialists have an affirmative obligation to intervene with public trading to maintain fair, orderly, and continuous trading. A specialist in possession of executable buy and sell orders must represent those orders by crossing them at an appropriate price within the current market by participating as a dealer only when there is an imbalance between supply and demand. On the other hand, in a dealer market, it is always acceptable for the dealer to interact with customer orders and to profit by pennies or more on such transactions.

Penny jumping may be distinguished from the generally accepted definition of front running, which occurs when a person is in possession of a large customer order and purchases on the same side of the market and ahead of the order at a more favorable price, with the expectation that execution of the customer order will increase the price of the stock. After the execution of the customer

order, the fiduciary sells the stock at a profit when the stock price increases, in violation of his or her fiduciary duty.

The Exchange has reviewed the issue of penny jumping in connection with its evaluation of the impact of decimalization.[9]

Q.10. As a self-regulatory organization, the NYSE is investigating the conduct of its own specialists. You have done this historically but given the current environment how do you respond to those who raise the conflict of interest issue?

A.10. It is important to note the Exchange does not own the specialist firms. It regulates them as it does any other member firm.

As an auction market, the Exchange has the greatest expertise and experience in policing its market and in ensuring compliance with its rules, all of which have been approved by the Commission after review, publication in the *Federal Register,* and public comment. In the regulation of its market, the Exchange operates within a system of Federal regulatory oversight, shared jurisdiction, and regulatory cooperation, to protect the public interest. This system has made the U.S. securities markets the world model of liquidity, depth, and investor protection.

The Commission has emphasized the importance of the SRO's in enforcing the securities laws and has stated the following with respect to the advantages of self-regulation:

> Industry participants bring to bear expertise and intimate knowledge of the complexities of the securities industry and thereby should be able to respond quickly to regulatory problems. Self-regulation supplements the resources of the Government and reduces the need for large governmental bureaucracies. In addition, SRO's can adopt and enforce compliance with ethical standards beyond those required by law.[10]

Historically, the Exchange has consistently and effectively regulated its membership, including its specialist members, and has always responded decisively to evidence of misconduct in any form. Furthermore, the Exchange has a demonstrated record of disciplinary actions against specialist firms and individual specialists. The effectiveness of the Exchange's regulatory program is predicated upon the Exchange's ability to recognize changes in the marketplace and to adapt its regulatory program in response to those changes. To accomplish this, more than one third of the Exchange's employees are engaged in regulatory activity, which is supported by state-of-the-art technology and surveillance programs. Protecting investors has always been and continues to be, the Exchange's highest priority.

There is nothing about today's "current environment" that prevents the Exchange from carrying out its regulatory responsibilities with respect to specialist firms and individual specialists. To the contrary, it was the Exchange's own surveillance program that uncovered the problematic trading that prompted the current in-

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[9] *See, e.g.,* Robert Jennings, *Getting 'ennied: 'The Effect of Decimalization on Traders' Willingness to Lean on the Limit Order Book at the New York Stock Exchange,* NYSE Working Paper 2001–01 (Jun. 2001).

[10] *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market,* Securities Exchange Act of 1934 Release No. 34–37542, 52 S.E.C. 882 (Aug. 8, 1996).

vestigation of specialist firms. The Exchange will take appropriate regulatory action if this investigation establishes any incidents or patterns of wrongdoing.

Q.11. Without disclosing specific details, can you describe with some specificity what the NYSE is doing to investigate misconduct by the supervisors of the analysts at the organizations involved in the global settlement?

A.11. The Exchange, the Commission, and the NASD are continuing to review for supervisory deficiencies of individual supervisors that were employed by the firms involved in the investigation by using a variety of methods and tools of investigation. After a careful review of materials obtained, and after taking testimony as needed, the Federal regulators will determine whether disciplinary action is warranted. The Exchange ordinarily does not discuss the nature of an on-going investigation until and unless there is a determination to initiate disciplinary action. Upon the conclusion of this investigation, the Exchange will report on the investigative steps taken and any findings, as well as any disciplinary action taken.

Q.12. *The New York Times* has reported that foremost among the unresolved questions for investors and the securities industry is what long-term impact the settlement will have on the culture of Wall Street, the integrity of stock analysts, and the confidence of investors. What long-term effects do you think this scandal will have on investor confidence and the industry?

A.12. The misconduct uncovered by the Joint Task Force investigation has been addressed decisively by the global settlement. The various components of the settlement serve a multipurpose of addressing structural problems that led to the conflicts of interest and providing a framework for making independent research available to customers. Some of the more significant components of the settlement include the following:

First, the settling firms are required to institute significant safeguards to ensure that published research is independent, objective, and not tainted by investment banking influences. These safeguards are set forth fully in Addendum A to the settlement documents, and described above.

Second, the firms are required to provide independent, third-party research, in conjunction with the published research, for a period of 5 years.

Third, the firms are required to pay $80 million for an investor education fund, which will be used to ensure public understanding of these requirements and other important investor-related issues.

In addition, as discussed in response to Question 1, the Exchange and the NASD have imposed additional requirements governing research analysts and published research through rulemaking.

In sum, the result of the global settlement and the new SRO rules is a new regulatory framework that will undoubtedly have a positive long-term impact on the culture of Wall Street, the integrity of published research, and investor confidence.

Q.13. NYSE Rule 342 requires each NYSE member to submit to its Chief Executive Officer or Managing Partner an annual report

that discusses compliance efforts regarding antifraud and trading practices, sales practices and other matters, significant compliance problems and plans to prevent violations and problems, and complaints and internal investigations. Did all firms covered by the global settlement submit their required reports over the time period covered by the global settlement? Did the NYSE review the examination reports of the firms covered by the global settlement? What did the NYSE discover in the review of these reports? What allegations of improper conduct were made in these reports? How are you enforcing Rule 342 and the "Annual Report" provisions?

A.13. Exchange Rule 342.30 requires that each member firm submit an annual report to its chief executive officer or managing partner that details the firm's compliance efforts during the preceding year. The Exchange's Division of Member Firm Regulation reviews for compliance with this rule during its annual and periodic examinations of member firms. These reviews ensure that the annual reports contain the required information and are submitted to the appropriate firm personnel in a timely manner. One purpose of the annual report is for firms to communicate compliance problems to senior management and for management to take action to resolve those problems. Another purpose of the annual report is to notify the Exchange when member firms discover misconduct, and this enables the Exchange to explore the extent of the wrongdoing and to determine whether the firm sufficiently corrected the problem. Thus, the annual report submitted pursuant to Exchange Rule 342.30 serves as a basis for the Exchange to conduct further inquiry when firms uncover serious problems or otherwise raise compliance "red flags."

From 1999 to 2001, each of the firms under investigation submitted annual reports as required by Rule 342.30. During that time, the Exchange's Division of Member Firm Regulation noted one exception involving this rule. In 1999, during a financial and operational examination by the Exchange, a firm was found to have failed to provide a copy of the annual report to the appropriate individual at the parent company. Exchange examiners followed-up on this exception during the 2000 examination and determined that the deficiency was corrected. The Exchange will continue to review its member firms' compliance with Rule 342.30 and will take appropriate action when that rule is violated.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES FROM ROBERT GLAUBER

Q.1. In analyzing the misconduct discovered through the investigation, has NASD identified "red flags" or facts that should have triggered an earlier look into whether a violation of the securities laws was occurring?

A.1. I believe that in hindsight, all of the regulators, Federal and State, could have more quickly identified and addressed the issues of research analyst conflicts of interest. We have not identified any specific red flags or facts that would have or should have triggered an earlier look into whether a violation of the securities laws was occurring. Much of the evidence that was developed in these investigations was found among many hundreds of thousands of internal e-mails reviewed, as well as through sworn investigative testimony.

Nonetheless, in general, mapping out the conflicts of interest that exist in large integrated investment banks is enabling us to think more precisely about other conflicted conduct that may warrant regulatory attention. For example, we are currently undergoing a review of the Fairness Opinions that are issued in conjunction with mergers.

NASD was at the forefront of the effort to address IPO abuses and research analyst conflicts of interest. In addition to rulemaking that was largely completed before the settlement, NASD was investigating IPO abuses and research analyst conflicts of interest as far back as mid-2000. In January 2002, NASD, along with the SEC, fined CSFB a total of $100 million for improper IPO profit sharing. In the summer of 2001, NASD commenced a series of research analyst investigations separate from the global settlement investigations that have resulted thus far in charges of misleading research and improper conduct being made against more than 20 firms and individuals. NASD has been and remains active in investigating supervisors and other individuals who may be responsible for certain of the conduct discovered during the global settlement investigations.

NASD was also the first regulator to bring charges against Solomon Smith Barney and Jack Grubman, filing an action in September 2002 alleging, among other things, that Mr. Grubman and his firm published misleading research on Winstar Communications, in violation of NASD advertising rules.

NASD was the principal investigator among the Federal regulators responsible for the matters involving Salomon Smith Barney, Jack Grubman, Merrill Lynch, Henry Blodget, CSFB, Frank Quattrone, and US Bancorp Piper Jaffray. NASD responded appropriately and aggressively to the evidence it uncovered at these firms relating to structural conflicts of interest and specific examples of pressure by investment banking on research analysts or fraudulent or misleading research. As a result of this investigation, and as part of the global settlement, SSB, CSFB, and Merrill were the only firms charged with fraud. Messrs. Grubman and Blodget were charged with, among other things, aiding and abetting SSB's and Merrill's fraud (respectively), and the firms and these two individuals paid some of the most substantial fines on record. NASD was also the first regulator to file an action against Mr. Quattrone, and recently filed an action against another Merrill Lynch research analyst, Phua Young, based on an investigation begun independently from the joint investigation of Merrill Lynch.

Q.2. What lessons has the NASD learned as a result of this investigation that will prompt it to act more quickly and more effectively in addressing securities violations and protecting investors in the future?

A.2. Investor protection can best be achieved through quick and decisive enforcement action and effective rules and regulations. It is clear from this group of cases, as well as others, that the review of internal e-mail can provide regulators with a contemporaneous record of potential volatile conduct. In this regard, NASD, along with the SEC and the NYSE, brought charges against five

brokerages and imposed aggregate fines of $8.25 million for the failure to retain e-mails.

NASD has also further focused its commitment to identifying nascent investor protection issues. In this regard, NASD has implemented its "Ahead of the Curve" program and provides periodic updates to investors of potential problem areas through our Investor Alerts. While we cannot anticipate all problems, we learned that we need to look ahead in a more systematic way.

Q.3. The joint agency release announcing the global settlement said that "the regulators found supervisory deficiencies at every firm." That means "every" major investment bank on Wall Street covered by the settlement had supervisory deficiencies. What is the responsibility of the heads of these firms to supervise their personnel?

A.3. The chief executive officer or president of each brokerage firm has the legal responsibility to either supervise each employee or reasonably delegate that supervision responsibility to others. In most brokerage firms, and certainly of those of the size involved in the global settlement, there are systems in place to delegate' responsibility to appropriate managers. The question in each case is whether that supervision was appropriately carried out, and whether the president was on notice that it was not being appropriately carried out. This general supervisory responsibility is found in both the Federal securities laws and NASD rules.

Thus, the head of each firm is responsible for compliance with all of the requirements imposed on his firm, unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient. When alerted to "red flags" of possible wrongdoing, a supervisor or the head of a firm has the responsibility to take appropriate action.

In addition, NASD Rule 3010 requires each member firm to establish, maintain, and enforce a system to supervise the activities of each registered representative and associated persons and to maintain adequate written supervisory procedures. These procedures must state who is responsible for the supervision of each area of the firm, what that person does to supervise that area and how such supervision is evidenced in writing.

NASD recently proposed rules that would require the chief executive officer and chief compliance officer of each member firm to jointly certify annually that the firm has adequate compliance and supervisory policies and procedures in place. This certification is intended to enhance investor protection by ensuring that senior management focuses increased attention on their firm's compliance and supervisory systems and by fostering regular interaction between business and compliance officers.

Q.4. Where were the compliance breakdowns? What is being done to fix them?

A.4. Each firm's system and business practices fostered inappropriate contact and coordination between research and investment banking. The firms essentially failed to properly manage these conflicts and, in fact, encouraged, through their compensation systems, conflicted conduct. For example, investment banker evaluations

and investment banking revenues were significant factors in promoting and compensating research analysts. In addition, investment banking influenced the initiation, rating, and the coverage of issuers. The new NASD research analyst rules, and the undertakings imposed in the settlement, provide for the separation of these two functions and seek to insulate research analysts from any improper influence by investment bankers.

The research analyst rules that I discussed in my testimony, and that we jointly wrote with the NYSE, use a combination of disclosure and outright prohibitions to assure that investors are more informed and analysts are more independent. NASD has already begun examining for compliance with these new rules.

Q.5. Are you satisfied with the compliance programs at these broker-dealers? (If not, what are you going to do to improve them?)

A.5. In conjunction with the SEC, we are engaged in a series of top-to-bottom reviews of the compliance department of major firms. We will require the firms to address through remedial actions, any shortcomings identified either through these specialized exams or in the course of the cycle exam program. In addition, through the proposal for CEO and chief compliance officer certification, we will have a very focused and direct tool for requiring firms to identify and fix any gaps or failures in their compliance programs. Finally, we will continue to bring enforcement actions wherever there have been breakdowns in compliance.

Q.6. How is the NASD improving the surveillance of the broker-dealer community?

A.6. NASD broker/dealer examinations include a review for IPO abuses and research analyst conflicts of interest. The following is a brief outline of certain aspects of our examination protocol that specifically address these issues.

Review of Supervision—To determine the adequacy of the firm's supervisory system in detecting and preventing insider trading our examiners review the firm's written supervisory procedures to ensure that they address items such as: (1) Monitoring of accounts (proprietary accounts, employee accounts at the firm and at other broker/dealers, family and related accounts); and (2) information barriers; and employee education and certification.

Review of the Firm's Information Barriers—Here, examinations focus on the adequacy of policies and procedures and assessment of whether they are reasonably designed to limit or contain the flow of material, nonpublic information to employees who have a "need-to-know." Among other things, examiners review a firm's information barriers to verify that they include: (1) Physical separation of the trading and sales department from investment banking or other departments that regularly receive confidential information; (2) supervision of interdepartmental communications involving material, nonpublic information; (3) investigations for possible misuse of material, nonpublic information that includes maintaining documentation sufficient to recreate investigations made by the firm in connection with its information barrier procedures; (4) standards and criteria for placing securities on Restricted/Watch Lists; and (5) a process for employee education and certification to impart an understanding of Federal and State laws, SRO require-

ments and the firm's policies and procedures regarding the use of material, nonpublic information.

Examiner Independent Review for Insider Trading—To detect the possible occurrence of improper trading by the firm, employees, or customers, our review is an examiner-conducted, independent test of the application of the firm's own supervisory system for information barriers.

Examiner Review for Research Analyst Conflicts of Interest—To address the conflicts of interest that arise when research analysts recommend equity securities in public communications examiners conduct a review to determine whether: (1) The firm's written supervisory procedures are adequate with respect to conflicts of interest and related disclosures in research reports and during public appearances; (2) there is a relationship between the investment banking department, the subject company, and the research department (such as whether research analysts are under separate control and supervision from the investment banking department; whether the firm complies with applicable restrictions regarding submitting research report information to subject companies; whether favorable research, ratings, or price targets are used as an inducement for the receipt of business); (3) analyst compensation is tied to investment banking services transactions; (4) an analyst's stock ownership and personal trading is in the securities he/she covers and whether he/she complies with required restrictions; (5) required disclosures of potential conflicts of interest in research reports and public appearances are made; and (6) the firm and its research analysts comply with the requirements of Regulation AC regarding the inclusion of required certifications in research reports.

Examiner Review of Initial Public Offerings—To determine that firms did not engage in any manipulative practices during an underwriting period or in the immediate aftermarket, as well as to assess that a bona fide public distribution of securities occurred examiners focus on whether the firm: (1) Made any "quid pro quo" agreements (such as the receipt of excessive commissions in exchange for IPO allocations and sharing in customer profits, undisclosed compensation paid to the firm, to finders, to consultants, to promoters, or to any other party; or deal paybacks); (2) solicited aftermarket orders for the allocation of IPO shares, often referred to as "laddering" or "tie-in" agreements; and (3) allocated hot issues to the personal brokerage accounts of corporate officers, directors, and venture capitalists in the hopes of attracting future underwriting or other types of corporate financing business, often referred to as "spinning.

Q.7. Without disclosing specific details, can you describe with some specificity what the NASD is doing to investigate misconduct by the supervisors of the analysts at the organizations involved in the global settlement?

A.7. The NASD, along with the SEC and the NYSE, are investigating the actions of the most senior supervisory personnel in each of the firms involved in the global settlement. The NASD has committed significant resources to this effort, which will include the review of thousands of e-mails and documents and the sworn testimony of numerous individuals. In addition, NASD has been in-

vestigating several immediate and second-level supervisors of those found in the global settlement and elsewhere to have been engaged in significant misconduct.

Last month, NASD, along with the SEC and NYSE, requested additional e-mails from the 10 settling firms relating to more than fifty of their senior level officials and supervisors for a 3-year period. Over the coming months, we will be reviewing hundreds of thousands of e-mails relating to supervisory structures, responsibilities and potential culpability of persons in the firms.

Q.8. *The New York Times* has reported that foremost among the unresolved questions for investors and the securities industry is "what long-term impact the settlement will have on the culture of Wall street, the integrity of stock analysts, and the confidence of investors." What long-term effects do you think this scandal will have on investor confidence and the industry?

A.8. While it is clear that investor confidence has been shaken badly, I believe that it will rebound. I truly hope that the industry has learned a hard lesson from its misconduct and the consequences that have flowed from it. If they cannot demonstrate by their conduct that they have learned these lessons, then I believe they will not reclaim investor faith and they will earn regulators' quick and unforgiving response.

RESPONSE TO A WRITTEN QUESTION OF SENATOR SARBANES FROM STEPHEN M. CUTLER

Q.1. You and Chairman Donaldson each underscored the importance of criminally prosecuting obstruction of justice conduct and the Commission's close working relationship with the Justice Department. What is the Enforcement Division doing from a civil perspective to deter future obstructive conduct or conduct that, as you say, "goes to the heart and the integrity of the investigative process" and, in that context, is the Enforcement Division vigorously prosecuting all matters in front of it that involve obstructive conduct by accountants or investment bankers?

A.1. Criminal prosecution of those who obstruct Commission investigative processes by destroying documents or lying to the staff is the most effective means of deterring such conduct by others. Accordingly, the Division of Enforcement has worked closely with the criminal authorities to make them aware of such occurrences and facilitate the prosecution of these offenders. We have been very pleased with the cooperation of the Department of Justice in this regard.

Because the Commission does not have the authority to bring actions for obstruction of justice, we employ a different strategy to help ensure the integrity of the Commission's processes. As noted above (in Chairman Donaldson's response), in instances when the staff believes that a party is seeking to delay or divert an investigation by refusing to comply with a Commission subpoena, the Commission has been aggressive in seeking Federal court enforcement of its subpoenas. Indeed, last year, the Commission sought and obtained $1.2 million in damages against a Dallas law firm for violating a court order in a pending SEC civil lawsuit against one of the law firm's former clients. The law firm had failed to produce

for 18 months 27 boxes of its client's records that the court had ordered produced to the SEC. This case illustrates the SEC's commitment to seeking sanctions against those who interfere with its law enforcement processes.

Similarly, the Commission created strong incentives for subjects of its investigations not only to comply with its investigative processes, but also affirmatively to cooperate with the staff to facilitate thorough and expeditious investigations. In an October 2001 Section 21(a) Report, the Commission articulated the benefits to parties who provide meaningful cooperation, which includes self-policing prior to discovery of misconduct (such as developing effective compliance procedures and an appropriate "tone at the top"); self-reporting misconduct upon discovery to the public and regulators; remediation, such as dismissing or appropriately disciplining wrongdoers, improving internal controls and procedures to prevent recurrence, and compensating those adversely affected, and; cooperation with law enforcement authorities' investigations. Those benefits may include lesser charges or lighter sanctions.