TESTIMONY OF CHRISTINE A. BRUENN

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And
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Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

"Wall Street Analyst Conflicts of Interest Global Settlement"

May 7, 2003

SUMMARY OF NASAA'S TESTIMONY

- 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 five 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. 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.

- 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 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. And analysts will be beholden to the truth, not the IPO business.

- While the global settlement is most important for its impact on Wall Street and investors, it is remarkable for another reason as well– it represents a model for state-federal cooperation that will serve the best interests of investors nationwide.

- Investors were harmed by unwarranted and exaggerated research reports. The research reports resulted in a "fraud on the market" in that they caused specific stocks and stocks in the affected sectors to rise out of proportion to their true value. Investors who purchased the specific securities or securities in those sectors experienced losses when the market crashed. Investors purchased through the nine firms named, discount firms, other firms who purchased the research, and online. For these reasons identifying the investors for restitution is very difficult.

- Some of investor losses were due to the inflated research reports, but not all of their losses. It's difficult to determine how much of investor losses are attributable to the exaggerated and unwarranted research reports and how much was due to other market factors.

- The analyst conflicts of interest settlements requires six of the firms to contribute a total of $27.5 million over the next five 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).

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee,

I'm 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 ten 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.

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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 five 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.

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[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.

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 market-wide 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 SROs.

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 can't 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 SROs both to leverage limited investigative resources and to formulate new, market-wide 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.

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[2] See State/Federal Dynamic Chart Attached

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 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 and 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 one percent of the total.[5] An important question is how best to use that money?

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[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

A primary and routine objective of state securities regulators is to obtain restitution for investors as part of enforcement actions. For example, in FY 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 eighteen 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 ten 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 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 five 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 ten 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, non-commercial website dedicated to serving the individual consumer who invests online or is considering doing so, and a non-commercial 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'll mention just 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

[6] See "Top 10" Investment Scams Listed by State Securities Regulators Attached

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 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 (CGAs) in Maine through an agent and other unlicensed financial professionals who expected to receive at least a 6% commission. (Such commission-based sales of CGAs are rare and disfavored by most charities.) Solicitations for these CGAs 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.