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UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON CORPORATE GOVERNANCE

TESTIMONY OF

NEW YORK STATE ATTORNEY GENERAL

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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 SROs, but 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 that 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.