Summary of the
Statement of Richard A. Grasso, Chairman and CEO of the New York Stock Exchange, Inc., to the United States Senate Committee on Banking, Housing and Urban Affairs on Wednesday, May 7, 2003

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 ten of the largest and most influential investment firms in the country.

This historic investigation and its results resulted from the tireless efforts of a Joint Task Force comprised of individuals from the Exchange, the Securities and Exchange Commission (the "SEC,"), NASD Inc. (the "NASD"), the North American Securities Administrators Association, or NASAA, the New York Attorney General's Office, and other state securities regulators (the "Task Force"). Prior to that time, the Exchange and the NASD began to work in conjunction with the SEC and the House Financial Services Committee to draft amendments to the existing self-regulatory organization ("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. The first phase of new rulemaking was completed and approved by the SEC in May 2002, and additional amendments are pending. All of the amendments are designed to better insulate research analysts from conflicts of interest and thereby improve the objectivity of published research. In addition, the Exchange is continuing to work with the SEC and the NASD to draft additional rules pursuant to the requirements of Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and Regulation Analyst Certification ("Regulation AC").

Rulemaking relating to research analyst conflicts of interest is far from complete, and the Exchange is unwavering in its commitment to develop rules that are rational, comprehensive, and serve the public interest. 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 Task Force identified three goals to be achieved by the investigation: (1) identify problematic conduct; (2) create a system to ensure that such conduct would not occur in the future; and (3) impose sanctions on those who were responsible. Those goals have been accomplished. First, the Task Force determined that all of the firms utilized practices that compromised the independence of their research analysts. In a matter of months, the Task Force uncovered significant evidence that each firm engaged in misconduct, and this misconduct is described in detail in the settlement documents released on April 28, 2003. Second, the Task Force created, as a component of the settlement, a set of restrictions limiting the activities of research analysts, and these restrictions are set forth in "Addendum A" to the settlement documents. Third, each firm was subject to significant sanctions, including a substantial monetary payment, a censure, and the imposition of the undertakings contained in Addendum A, which exceed the requirements of the current SRO rules.

In addition, the Task Force determined that each firm encouraged an environment in which research analysts were repeatedly subject to inappropriate influence by investment bankers, and the analysts' objectivity and independence was compromised as a result of that influence. The firms' policies and procedures failed to protect research analysts from the significant investment banking influences and conflicts of interest. By restructuring the way that research analysts and investment bankers interact—both through the undertakings in Addendum A and through the new rules—it is intended that the supervisory deficiencies at these firms will be corrected.

The $1.4 billion settlement includes a payment by the ten firms of $387.5 million as restitution, which will be returned to harmed investors, and a payment of $487.5 million in penalties. The penalties constitute some of the largest ever levied in the history of securities regulation and thereby send a strong message regarding the seriousness of the firms' misconduct. In addition to the monetary sanctions, the settlement includes funds earmarked for investor education and for the procurement of independent research.

Finally, all of the firms entered into a voluntary agreement prohibiting "spinning," or the allocation of shares of "hot" initial public offerings ("IPOs") to executive officers and directors of public companies to attract investment banking business. This will promote fairness in the allocation of IPO shares.

The Exchange is committed to ensuring that the terms of the settlement are strictly enforced through regular monitoring by the Exchange's Division of Member Firm Regulation. This monitoring includes regular annual examinations of the Exchange's member firms, and these examinations will now include a review of compliance with the undertakings required by Addendum A and new Exchange Rules, a review of improper spinning, and a review of compliance with the requirements of Sarbanes-Oxley and Regulation AC. In addition, the Exchange, the SEC, and the NASD recently completed examinations of the IPO allocation practices at the firms subject to the settlement, and the federal regulators 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. Also, 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.

The Exchange will continue to work in conjunction with the SEC and other regulators to address research analyst conflicts of interest, IPO allocations, and related areas of misconduct through rulemaking and enforcement action where appropriate.

The Exchange is confident that great strides have been made during the past year to effect wide-scale reforms that will have a dramatic impact on this industry and that will serve the public interest. However, our work is not finished. The Exchange's commitment to additional necessary reforms, and to continuing the investigation of related areas of misconduct, is unwavering.

Statement of Richard A. Grasso, Chairman and CEO of the New York Stock Exchange, Inc., to the United States Senate Committee on Banking, Housing and Urban Affairs on Wednesday, May 7, 2003

I. 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 ten 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 lastly 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

---

[1] In 2002, these ten 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.

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.

II. 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 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 re-emphasize 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 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 of 2002.

III. The Exchange's Role in Investigation of Research Analyst Conflicts of Interest

A. 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 "SROs"), in consultation with the SEC and the House Financial Services Committee, were working towards 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 SROs, pursuant to discussions with the SEC, began to consider ways to enhance the rules in this area. New rules were drafted by the SROs 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.

B. 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 that 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.

C. 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.

D. Enforcement Actions Relating to Failure to Retain Electronic Communications

During the course of the investigation, the Exchange, the SEC, and the NASD determined that five 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 three years and/or, to the extent they did retain electronic communications, failed to keep those communications in an accessible place for two 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 to 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.

E. 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 co-workers. 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

---

[4] As noted above, the investigations of Deutsche Bank Securities, Inc. and Thomas Weisel Partners LLC are continuing.

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, research 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 three 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. Furthermore, 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.

F. 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, seven out of the ten 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 conflicts 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 five-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 five 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 five 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 ten firms have collectively entered into a voluntary agreement prohibiting spinning. Specifically, firms will not allocate securities in hot IPOs 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.

V. The Exchange's Role Moving Forward

This settlement represents a significant step towards 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 towards 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 the 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.

A. 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.

B. 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.

C. 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.

D. 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.

E. 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 the current Exchange listing standards, along with proposals for reform, with the goal of enhancing the accountability, integrity, and transparency of the Exchange's listed companies.

F. 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.

VI. 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.