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TESTIMONY OF

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Beyond Merrill Lynch

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

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

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

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

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

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

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

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

In considering the attacks made by critics of state action, one must consider the alternatives they support. A case in point is HR 3763, a bill that originated in Chairman Oxley's and Representative Baker's committee, which on the issue of analyst conflicts requires absolutely no action from anyone. Its sole directive is to the SEC to study and report back to

Congress on any final rules a self-regulatory organization may in the future deliver to the SEC. It is difficult to conceive of a more passive - - or inadequate - - response to the problem.

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

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

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

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

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

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

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

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

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

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

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

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

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

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