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Introduction

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THE TENTH ABRAHAM L. POMERANTZ PROGRAM

Wall Street in Turmoil: Who Is Protecting the Investor?

Introduction*

Norman S. Poser†

This issue contains the proceedings of the Tenth Annual Abraham L. Pomerantz Program, a Symposium held at Brooklyn Law School on February 6, 2004. I began the Symposium by stating a premise: the purpose of federal and state securities regulation is to protect investors. When we look at the conduct of investment bankers, research analysts, stock exchange specialists, or mutual fund advisers, it cannot be denied that the regulatory system has failed to do its job. Again and again, investors have been betrayed by the professionals in whom they placed their trust.

This regulatory failure is largely a result of the failure to deal effectively with conflicts of interest. Most bankers and brokers wear several hats, and one of these hats is their own self-interest.[1] The distinguished regulators, attorneys and academics who participated in the Symposium have provided answers to two questions: first, how should our legal and

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[1] *See* Norman S. Poser, *Conflicts of Interest within Securities Firms*, 16 BROOK. J. INT'L L. 111, 111–15 (1990) (describing the conflicting interests created by multiple roles of industry personnel).

regulatory systems deal with these conflicts of interest; and, second, what role should the states play in regulating the securities markets?

Conflicts of interest in the securities industry did not arise just yesterday. It would be wise to heed George Santayana's warning that "[t]hose who cannot remember the past are condemned to repeat it."[2] In the 1930s, when the banking laws were revised and the securities laws were enacted, Congress attempted to deal with the issue of conflicts of interest. When it came to the securities activities of banks, Congress confronted the problem head-on. The Glass-Steagall Act separated commercial banking from investment banking.[3] Over the years, that bold, radical step was steadily eroded by judicial and administrative decisions, and was finally repealed by the Gramm-Leach-Bliley Act of 1999.[4] The question, however, remains: was Glass-Steagall a costly mistake like Prohibition, or did Congress get it right the first time?

In September 2003, the Securities and Exchange Commission (SEC) and the New York Attorney General charged that Bank of America provided $300 million in credit to a hedge fund to finance its illegal late trading and market timing in the bank's own family of mutual funds.[5] And in February 2004, the same two regulators accused a former director of another large bank, CIBC, with facilitating late trading by the same hedge fund.[6] These charges suggest that

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[2] GEORGE SANTAYANA, THE LIFE OF REASON 284 (2d ed. 1936).

[3] Banking (Glass-Steagall) Act of 1933, ch. 89, § 20, 48 Stat. 162, 188 (separating banks and investment brokers, codified at 12 U.S.C. § 377, then repealed by Gramm-Leach-Bliley Act of 1999); Glass-Steagall Act § 32, 48 Stat. 162, 194 (proscribing securities transactions on behalf of banks or their officers, codified at 12 U.S.C. § 78, then repealed by Gramm-Leach-Bliley Act of 1999).

[4] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999) (repealing 12 U.S.C. §§ 377, 78).

[5] *See* Press Release, Office of New York State Attorney General Eliot Spitzer, Attorney General Spitzer and Securities and Exchange Commission File Charges Against Bank of America Broker (Sept. 16, 2003), *available at* http://www.oag.state.ny.us/press/2003/sep/sep16a_03.html (last visited October 14, 2004); *see also* Complaint at 18, New York v. Canary Capital Partners, L.L.C. (N.Y. Sup. Ct. 2003) (alleging, *inter alia*, that Bank of America facilitated defendant's unlawful trading by making available approximately $300 million in credit), *available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf (last visited October 14, 2004).

[6] *See* Press Release 2004-12, U.S. Sec. and Exch. Comm'n, SEC Charges Former CIBC Managing Director With Fraud for Role in Financing Unlawful Mutual Fund Trading (Feb. 3, 2004), *available at* http://www.sec.gov/news/press/2004-12.htm; *see also* Press Release, Office of New York State Attorney General Eliot Spitzer, Banker Charged with Late Trading (Feb. 3, 2004), *available at* http://www.oag.state.ny.us/press/2004/feb/feb03b_04.html.

the subtle hazards created by allowing banks to underwrite and advise mutual funds, which the Supreme Court wrote about thirty years ago in the seminal case of *Investment Co. Institute v. Camp*,[7] really exist and may not be so subtle after all.

The first two articles in this issue discuss the impact on investors and on the securities industry of ending the separation of commercial banking from the investment banking and brokerage business, a process that culminated in the Gramm-Leach-Bliley Act. My colleague, James A. Fanto, argues that combining commercial and investment banking creates a risk that is different from the "subtle hazards" that the Supreme Court envisioned in *Camp*.[8] Professor Fanto believes the risk is that investment bankers will participate in improper transactions of their corporate clients, to the detriment of shareholders and other constituencies.

Professor Samuel L. Hayes III of the Harvard Business School presents the view that while investors are better protected than before Glass-Steagall, regulatory changes are still needed. Professor Hayes acknowledges that it is not feasible to dismantle existing regulatory structures and to build a new system from scratch, but he suggests that in today's world of financial conglomerates, a functional approach to regulation would be more appropriate than the present institution-focused regulatory system.

On the issue of conflicts of interest within the securities industry, Congress passed the ball (or the buck) to the SEC. The SEC decided that segregating the functions of broker and dealer was neither practical nor desirable.[9] The 1963 SEC Special Study facetiously pointed out that, in order completely to avoid all conflicts of interest, each investor would have to have his own broker, who would not be permitted to act for any other customer or for himself.[10] Obviously, this was not done. Instead, the SEC thought that the conflicts of interest created by brokerage firms' multiple roles could be regulated.

Regulation, however, failed to protect investors from the conflicts of interest of research analysts. Despite this failure,

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[7] 401 U.S. 617, 630 (1971).

[8] *Id.*

[9] Segregation of the Functions of Broker and Dealer, Exchange Act Release No. 739 (June 22, 1936), 1936 SEC LEXIS 263, at *1–2, *8–9.

[10] U.S. SEC. AND EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 1, at 440 (1963).

neither the Sarbanes-Oxley Act[11] nor the global settlement[12] requires complete separation of investment banking from research. As in the past, the preferred solution is to regulate, not eliminate, the conflicts of interest.[13]

The second two articles in this issue discuss the legal and economic issues raised by the multiple services offered by brokerage firms, with particular emphasis on the conflicts of interest of the research analyst. Professor H. D. Vinod of Fordham University provides a detailed economic analysis of these conflicts. He argues that regulation, principally in the form of a "Chinese Wall" between the various departments and activities of a securities firm, has not worked, and that following the Glass-Steagall example of complete divestiture of brokerage from investment banking would create enormous difficulties. Instead, Professor Vinod proposes a novel solution: that penalties for violating fiduciary duties caused by the conflicts of interest should include divestiture. Thus, separation of functions would be used as a club to punish "bad boys."

Barbara Moses, a partner of a prominent New York law firm that specializes in criminal defense work, provides a legal perspective on the conflicts of interest of research analysts. Ms. Moses points out that the conflicts were well known to regulators – and in fact were described in the press – throughout the past decade. As a result, class action plaintiffs face significant hurdles in getting past the pleading stage in lawsuits against investment banking firms. In this connection, she discusses the relevant issues of statute of limitations and causation, and offers some cautious predictions as to how these issues may be resolved as the cases move through the courts.

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[11] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.).

[12] In April 2003, the SEC, National Association of Securities Dealers, New York Stock Exchange, and several state regulators reached a settlement of enforcement actions against ten investment banking firms and two research analysts. The settlement included monetary penalties and structural reforms requiring the firms to separate their research from their investment banking operations. *See* Joint Press Release, U.S. Sec. and Exch. Comm'n, New York Attorney General, N. Am. Sec. Adm'rs. Ass'n, Nat'l Ass'n Sec. Dealers, and New York Stock Exch., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm; *see also* NORMAN S. POSER, BROKER-DEALER LAW & REGULATION § 1.02[C][4] (3d ed. 2000 & Supp. 2004).

[13] *See, e.g.*, Sarbanes-Oxley Act § 501 (showing regulation without separation of roles).

The federal securities laws expressly preserve state regulation of the securities industry, so long as it does not conflict with federal law.[14] Over the years, state securities regulators have supplemented the SEC's enforcement efforts. The North American Securities Administrators Association (the other NASAA) is a highly regarded organization of state regulators, whose members have been at the forefront of investor protection. For example, a few years ago the Idaho Securities Bureau played a key role in exposing Prudential-Bache's fraudulent and unsuitable sale of limited partnership interests to thousands of investors.[15]

Views differ on what is the proper role of the states in regulating the securities markets. I do not think it is open to serious dispute, however, that recent investigations and enforcement actions by state regulators have served the interests of investors. These actions support the continued validity of Justice Brandeis's view that one of the "happy incidents" of our federal system is "that a single courageous state may . . . serve as a laboratory [for] novel social and economic experiments . . . ."[16]

On the other hand, requiring national brokerage firms to comply with fifty different standards of conduct creates obvious costs and other difficulties. Indeed, one former SEC chairman is reported to have said in jest that he would like to have everyone involved in state securities regulation lumped together in a boat, hauled out to sea, and sunk.[17] Although it is unlikely that this extreme solution to the SEC's problem with state regulation will be implemented in the foreseeable future, the proposal does provide insight into the opposition that state regulators can expect to face, not only from the SEC but also from Congress.

It is ironic that some of the conservatives who have traditionally upheld states' rights would today like to abolish state securities regulation, while liberals have become born-again states-righters. It should be noted, however, that the global settlement of the research analyst cases, which

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[14] *See, e.g.*, Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78dd(a) (2000).

[15] *See* KURT EICHENWALD, SERPENT ON THE ROCK 192, 355–60 (1995).

[16] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

[17] The author believes that this statement has been attributed to SEC Chairman Richard C. Breeden.

represented a joint regulatory effort by the SEC, the states, and the self-regulatory organizations, shows that regulatory cooperation, as well as regulatory conflict, is possible.[18]

The final article discusses a subject of greatly renewed interest, the respective roles of federal and state regulators in protecting investors, including the benefits, as well as the drawbacks, of state regulation of the securities markets. Professor Jonathan R. Macey of Yale Law School makes two principal points: first, that regulators utilize opportunities created by crisis, such as the research analyst scandals, to increase their own political power; and, second, that the various governmental responses to crisis reflect the nature of the competition between federal and state regulators. Professor Macey predicts that the increased activity by state regulators will lead to more preemption of state securities law.

The exchange of views reflected in this Symposium is a valuable addition to a debate whose conclusion is still in doubt. The three issues considered here – the desirability of allowing commercial and investment banks to operate under one roof; how to deal with the conflicts of interest within securities firms; and the proper role of the states in securities regulation – need to be resolved with one ultimate goal in mind: how best to protect investors.

[18] *See* Press Release 2002-179, U.S. Sec. and Exch. Comm'n, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement To Reform Investment Practices (Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm (last visited Oct. 14, 2004).