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Keynote Address

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KEYNOTE ADDRESS

HONORABLE ELIOT SPITZER

I want to talk for a few minutes about securities law. It seems to be the topic of the day, and it seems to be a part of current events as well. But when I was thinking about it, it occurred to me that when I took securities law back seventeen or eighteen years ago, I don't think I had ever heard reference to the Martin Act.

As we began our endeavors, I guess it was back on April 8th, when we unveiled our first actions against Merrill Lynch, people found out that we were relying upon the Martin Act, which has been a state statute since 1921, and said, "Gee, where did this new law come from?"

In fact, it isn't a new law. It's been there. It indeed precedes many of the federal securities laws that are part and parcel of what you study when you study securities law. Yet, when in fact you practice at a firm, you rarely use it. There's always been a blue sky practice, but rarely do people pay attention to the state statutes.

I think, if nothing else has come out of this endeavor, we've changed that a little bit. People are now dusting off the Martin Act, as they refer to it in the press, and they are finding out that indeed it grants expansive jurisdiction to the New York State Attorney General. And this is not limited to New York. Analogous statutes across the nation grant similar powers to the other states' securities regulators—whether it's the attorney general or the securities commissioner depends upon the state.

But this power has really been diversified, and it has been distributed quite broadly across the nation. So I want to begin with a little discussion of federalism, which strikes me as actually having been the most important issue, other than the corporate accountability issues that we are now seeing, which is a spasm that may last beyond a year or so. Certainly if there has been a theoretical shift in our jurisprudence over the past fifteen or twenty years, it has been the shifting bounds of federalism and what we weigh. It is referred to as the new

federalism. It is what we refer to as states rights, and I think that gives you an insight into where people's political views might lie.

But I want to begin with a little story. I won't take too long on it because I do want to talk about what's actually going on out there in the world of investment banking and the dynamics between or among the investment banks, their clients, and the major players in the field.

The story begins in about 1983 or 1984, when I was in law school. This new federalism was beginning to be enunciated, and it was something that struck me back then as something that, if not abhorrent, was certainly something that I disagreed with. It struck me that it was nothing more than states rights dressed up in a different language. It was nothing more than an effort to dismember the set of statutes that had been passed in the 1970s, 1980s, and even the 1960s, statutes that we believed in deeply—civil rights laws, environmental statues, antitrust laws, or whatever the particular statute might have been.

It was an effort to say we wanted the civil rights laws to be interpreted by a state attorney general down somewhere where that attorney general may not have believed in these statutes as much as the main enforcers of justice traditionally did.

It was an effort to disburse enforcement and denigrate and diminish the powers that existed in Washington. So I was theoretically opposed to it. I believed in a uniformed aggressive application of these statues, and the new federalism struck me as an effort to dissipate all that.

Nobody cared what I thought. I was second or third year student in law school, and no one cared. It's the stuff that maybe in your study group you'd waste two minutes talking about, and then you'd go on to "Gee, what does that case really mean? We got to pass this exam."

Now the other reason that I disagreed with it is that most of the proponents—and this I think is actually the more powerful reason to oppose the new federalism—who supported it came from Yale and that, in and of itself, struck me as being a foundation of which to be skeptical.

But, nonetheless, a funny thing happened over the next couple years with respect to the new federalism. They won, and we lost. The Supreme Court's jurisprudence over the days since President Reagan's two terms, President Bush, Sr.'s term, and

even President Clinton's tenure (because he simply didn't have the faith of history—he didn't have the opportunity to appoint as many members of the supremes) has continued to follow the new federalism. One footnote that I guess we have to drop—and I guess we all know consistency is the hobgoblin of small minds—is that little case *Bush v. Gore*, which arguably seems to contradict most of the federalists principles that were being enunciated in the prior decade. But we don't expect anything more of the supremes than we expect of others. So we will put that one to the side.

Nonetheless, the new federalism won. It was manifested also in congressional actions in terms of power being shifted back to the states. It was something that just continues to be at the centerpiece of the shift. I will admit that, and here is how this becomes relevant to what's going on today.

I will admit that I woke up on a particular day and had an epiphany about the new federalism and, as you might predict, it wouldn't be hard to figure out when that was. It was when I was elected attorney general of the state. It occurred to me that power being a zero sum game, if these guys were saying we don't want it here in Washington, but you guys should exercise all these powers back at the state level, it began conceptually to become a more appealing notion.

So suddenly I began to reevaluate this, and I said, "Huh, maybe all those environmental statutes, the antitrust laws, the civil rights laws, even the securities laws, will present us with an opportunity to begin to flex our muscles." I didn't want to say have some fun as though this is a game, but rather begin to do what we think the law should be doing, even if it is not being done in Washington.

Now, I began to articulate this concept a little bit and we got involved in a few litigations, which I won't run through, that began to rattle a few cages. After that, I got invited down to a federalism society meeting in Washington. I said, "Wow, either they really think I believe this, in which case I've got to examine my own principles, or there's something more sophisticated afoot here. These guys, you need to understand, are very sophisticated, very smart, and they had invited me down to a meeting of their major donors. It was a room several times larger than this, filled by people who paid probably several times your annual tuition just to be there for the lunch.

It was a fundraiser for the federalism society. So I understood what the game was. They were holding me out as Exhibit A. They were kind of holding me out there to the side, pointing to me saying, "If you are not careful, you will get him."

I think it scared them. I think it succeeded in raising a fair bit of money for the federalism society. The next time I am invited, I am going to be smarter, and I'm going to say, "Okay, I will show up, but I want ten percent."

See, I wasn't quick enough last time to throw that in the negotiations. But I challenged them at one point and I said, "Wait a minute guys. You have given all this power back to the states and yet you are now objecting to the Microsoft litigation, to the tobacco litigation, to the environmental litigation we had begun against the mid-western power companies whose emissions were polluting our air"—a series of litigation that I think are wonderful examples of state attorney generals flexing their muscles.

I said to them, "Isn't this directly contrary to what you've been enunciating for a number of years? Aren't you lacking in intellectual integrity when you now want to handcuff the very parties who you thought should be at the center of this?" Somebody put up his hand in the back and said, "Who cares about intellectual integrity?"

You know, so I said, "Well, at least the terms of the debate are now being clear, and I have a prediction for you. Now that state attorney generals and others at the state level are beginning to enforce these statutes in a more aggressive manner, you will see not necessarily the academics, who really believe in federalism as a theory of decision making and where decision making should be, but you will see those on the political side of it, who are more interested in outcomes than the underlying decision process, begin to rearticulate the notion that "gee, decisions being made in Washington which parenthetically we control right now don't look so bad."

Did this happen in the securities context? Yes. I will give you Exhibit A in my argument on this matter. Soon after we began with Merrill—not after we began the investigation but after we announced the results of the first stage of the filing of the affidavit that laid bare the emails—an amendment was floated in the House and passed by those representatives who had supported federalism principles.

What did this amendment say? It stripped state attorneys general of jurisdiction over securities issues. Now how do you like that for the ultimate, you know, turn of events that shows the fallacy in their thinking? Anyway, all of that is the backdrop, which I think is curious and interesting in terms of how the new federalism will or will not emerge.

But now let me just turn directly to securities issues which have captivated a little bit of my time recently, probably much to the consternation of the professor I had in law school who didn't think I spent a lot of time studying the issue when I was there. But that's a separate issue. I had a good outline for the exam. That was the saving grace.

Let me say this about the world of securities law. I hear you had a stupendous presentation this morning about Enron and its rise and fall. I won't get into Enron per se. Let me begin by saying that there has been, by and large, a breakdown in corporate governments. It extends to non-private sector governance as well, but I won't get into that today. I mean, just parenthetically, I think it affects government, elected government, and the not-for-profit world.

But let's today, for the purposes of this, keep our discussion to the for-profit world. There has been historically in the corporate world—forget private entities for now—a series of checks and balances that have been in place to ensure that no one decision maker in the corporate world wields too much power. Just as there has been a series of checks and balances in our public government that are designed to ensure that there is not an imbalance, there has been a structure in the private sector to do the same thing. Just as in the public sector, where there have been moments when that balance was knocked out of kilter—for example, when we had and imperial presidency that many people felt took us down a path that was unsatisfactory—we have now just passed through a period of the imperial CEO.

The reason for this is that each of the links in the chain that is designed to constrain the CEO broke. Every one of those links failed. What are those links?—Boards of directors, audit committees, outside auditors, outside lawyers—which is perhaps where we in this room have a greater role—, institutional shareholders—which is something that has gotten too little attention, and investment banks—which have always been a critical check and a critical part of the corporate governing

system because they are the critical intermediary between the public company and the financial markets.

Now the good news is that when you have a catastrophic failure of this sort, there tends to be a reaction. Sometimes the reaction is excessive. Sometimes it lacks subtlety. Nonetheless, there has been a reaction. There has not, however, been a sufficient reaction with respect to each one of these critical links.

Let's take them and go through them bit by bit. Board behavior will change prospectively. Why? To a certain extent it will change because the New York Stock Exchange in its listing requirements is now mandating that boards be constituted differently, that there be greater independence, and that there be greater involvement. Board behavior will change because if you sit on the board of a public company right now, let me put it plainly, you are scared. You are terrified. You don't know what is going on inside that company, and you are deathly afraid that your name is going to be in the headline in a way that will make you very unhappy.

Imagine if you are the chairman of an audit committee right now. Frankly, I am not sure why people would want that position, given the enormous difficulty of fulfilling the mandate the way it has to be fulfilled. But board behavior will change. I say this based on many conversations I've had with people who sit on many boards, from General Motors down to the smallest company that's listed, but you've never heard of. Their aggressiveness, their understanding that they were asleep at the switch for too many years, and their understanding that they were all too happy just to raise their hands and vote in the affirmative because the numbers looked good, will no longer outweigh their understanding that they'd better ask the hard questions or else they are going to be there with potential personal liability. The listing requirement from the stock exchange and the exposure that board inattentiveness has had will change board committees.

Audit committees likewise. Audit committees are now asking the hard questions. Whereas the reports of auditors—who we will get to in a second—used to be adopted anonymously without any hard questions, now committees are saying, "We have got to ask the hard questions."

Now let me drop a footnote here—I only talk about footnotes when I am in front of lawyers. There is a fare debate whether

what Dick Rasso did with respect to board membership is right or wrong. I happen to have enormous, enormous respect for Dick Rasso. I think he is a wonderful guy who stepped into the breach and is trying to do the right thing.

Having said that, there is a theoretical discussion about how you define your perfect board participant. When Dick Rasso set up as sort of the paragon of good board membership, the independence that we think leads to neutrality and aggressive judgment calls and aggressive inquiry, just as we want an independent judiciary, what he sacrificed—and I have heard this from people on both sides of the debate—was the sort of in-depth knowledge of a company that comes from having lived inside the company for many years. Sometimes—and of course I am setting up a little bit of a straw man here—you don't need these two to be in opposition to each other. You can have boards that have both.

But there is a very interesting debate out there going on in the world of corporate governance about whether or not you want independent board members who only know the company from a distance, from their contact through the CEO, and perhaps from their inquiry of other individuals. But they haven't lived inside the company. They haven't been compensated by it for many years, evolved with the company, and actually built the widget that the company makes over many years. Therefore, they don't understand the day-to-day problems. They don't understand the market better. They don't understand the competition better.

What you get in the more antiseptic participation of a neutral outsider is perhaps the greater distance and willingness to ask hard questions. But sometimes they don't know the questions to ask. So this is a debate that I think should be played through at academic institutions, such as this one, among those who are studying issues of corporate governance.

But let me go back down the chain part of this to the auditors—one of the other critical links. The auditors clearly have been in for and will continue to be in for a rocky period. It's not only that we've gone from the "big eight" a couple years ago, down to the "big four." There has been this diminution, either through bankruptcy, indictment, or shredding. They are sort of disappearing. It's not a pretty picture, and it leads to perhaps excessive concentration.

But the auditors clearly misdefined their role over the past decade, just as lawyers did, and we'll get to them in a second. The auditors, instead of saying to the world at large, "Our duty is to you and to the financial community to paint the most accurate picture of the finances of this company that we can paint," they began to view themselves as part of management of the company whose job it was to push the boundaries and push the envelope of gap and say, "What can we get away with."

Again, not to simplify this—the analysis of Enron that you got this morning was much more sophisticated than what I know—but certainly what might have begun as one off balance sheet partnership that was innocent enough and not material, exploded in a way so that the entire company was being described in the footnotes.

We all know it—you put in the footnotes that which you don't really want people to read. Is that right? I mean that's what we did in law review articles. That's where all the "but sees" go, you know, the things that really don't support your case.

So the auditors began to play games. If it wasn't criminal, which in 99.9% of the cases it wasn't of course, it strayed from the fundamental purpose of having the outside auditors report for the benefit of the investing community. That will be changed.

What we have then is the Sarbanes Bill. I still choke whenever it's called the Sarbanes-Oxley Bill, given my own little dynamic with Congressman Oxley. But nonetheless, if they call it the Sarbanes-Oxley Bill, I'll defer to them. The Sarbanes Bill will begin to address some of the needs in the accounting world.

Lawyers, let me tell you, we fell down on the job. I don't think there is any question about it. We did not go to the prosecutors. We did not even go to the boards even though perhaps we were ethically required to say, "There is criminal conduct afoot here. There has been straying. There are sham transactions that we are papering that are designed to be nothing more than tax games, and we should not be part of this."

We fell down on the job. There will be a debate likewise about the ethical obligations that we have as lawyers and the old inevitable question that we all study in legal ethics—who is the client?

I think it does reveal so many of the issues. Is the client the

CEO? No, it's the shareholder as represented by the board. We have to remember that. Therefore, in terms of disclosure issues and how we report problems that we see, we have to be cognizant of that, which is an issue the bar associations nationally and otherwise are beginning to look at.

Now let me focus on two last groups, and let me look at institutional shareholders first.

Some of the institutional shareholders forgot during the 1980s and the 1990s, when everybody was looking great, that it was their money that was being played with. They became the ubiquitous passive institutional investors. Everybody bought into that model, that of the major pension funds. Everybody said, "Well, it isn't our job to manage the companies. Sure we own eighty-three percent of the marketplace, but we don't want to be there in a position making day-to-day management decisions."

There is a lot of power to that argument. But they went so far to the other end of the spectrum that they really lost their capacity to understand what was going on inside the companies. It was their money that was being played with, the option packages that were being approved by compensation committees—where you can just see a picture of everybody standing around in circles and scratching each other's back. The compensation committees completely lost their grounding and their bearing, and it was because the people whose money was being given away—even if it was only by dilution of their stock interest—simply weren't being heard from.

Think about the enormous loss of equity ownership that is reflected in these enormous grants of stock options. Right now there are many who are going to make a very powerful and at times persuasive argument in sectors that deal with new technologies or start up ventures, that you need to use stock options as a way of compensating those whose ideas are being grown over a long term. That powerful argument, which has a lot of merit to it, doesn't apply as much when you are dealing with established companies that are essentially industrial companies where production is the day-in-day-out business. I just don't think the argument applies, and I think you will see the whole issue of CEO compensation and option packages revisited because of it.

Institutional investors have to come back to life. Long term,

it's their money. No amount of regulation will ever be as successful or as powerful as shareholders whose money is at risk pounding the door of the CEO saying, "Don't do that. You are going to be voted out next week if you make that decision. I'm going to vote against you in the next proxy round," or whatever it may be.

That has got to start happening. We are trying to organize that because I think that market discipline is ultimately going to be what solves this problem. The market discipline of having the pension funds stand up to be heard from is critical. Phil Angelides, who is the treasurer of California; Richard Moore, who is the treasurer of North Carolina; Carl McCall, who is the comptroller here in New York; and about seventeen states together whose public pension funds control in excess of one trillion dollars in equity—when they all begin to think through how they can use their pension fund assets to begin to exercise management control in a way that will be meaningful, that is what will restore the moral groundings of what the CEOs are doing.

Now let me focus for the next couple of minutes on the group that I have been learning probably more about than I want and certainly more than they want over the last couple of years—the investment banking world.

They are, as I said, the critical intermediary between the public companies and the markets. Let me discuss the incestuous relationship that existed with the investment bankers over the past couple years. Analysts would write reports that would generate enormous sell pressure—selling if you are doing the underwriting, buying if you are doing the pubic offering. Obviously, they were usually sell-side guys. They would write these reports that were essentially just puff pieces for the stock. Why would they do it? Because the analysts were being compensated not for the quality of their research, but for bringing in investment banking clients. This is now something that no investment bankers with a straight face can deny. Six months ago, they would all stand up sanctimoniously and say, "Well we don't compensate our analysts based on the investment banking work they bring in. We compensate them because they are good."

Well funny things happen when you subpoena documents and read what actually goes on. They were being compensated

directly and overwhelmingly for bringing in investment banking business. Take Jack Grubman. Jack Grubman was not being paid twenty million dollars because his research was good. Now I don't want to tell you what he would have been paid based upon the quality of research, but I can tell you it wasn't twenty million dollars.

We have the documents bank-to-bank-to-bank that show that the analysts would send the memos to the compensation committee saying, "Here are the deals we brought in." They didn't bring those deals in because they were going to write a report that would say, "This stock is a dog. This stock shouldn't be in your portfolio. It's worthless." Now, they may have said that in the emails internally, but the public reports were strong buy, strong buy, strong buy.

So that's the analysts. Now, the investment bankers of course are being compensated for bringing the deals. They had to bring in the deals. Now what did they say to the CEOs? When the analysts and investment bankers went to the CEOs they said, "If you bring your underwriting business to us, what are we going to do for you? Two things. One, the analyst will write the strong buy recommendation and two—and here is the candy we are really talking about—we will give you IPO allocations."

What does that mean? We know that in the hot stocks, the hot IPO allocations—hot IPOs that were brought into the marketplace couple years ago—had such a demand that a stock that went out at thirty-five would be trading at seventy within two minutes. There was just excess demand. There are question whether they were under pricing the stock in the first place, but that's a more complicated discussion. By giving somebody access to those IPO allocations, you give them straight out money—cash in their pockets.

Now, on a first year law school exam, say criminal law, imagine the fact pattern said, "The store manager of a Wal-Mart is having a meeting with a vendor, and the vendor walks in and says, 'Gee, if you put my sneakers on the shelf up front, I'll give you $5,000 cash, and here it is.' "

We would say, "You can't do that. That's commercial bribery." Wal-Mart to its credit—I don't pick them for any reason—is enormously strict. They won't let the vendor buy a cup of coffee for the store manager.

Now let's change the facts a little bit. The exam instead says "CEO of a company walks in the door to the investment bank with of course plush carpets and nice mahogany walls." It looks and sounds a little different. But they say to him, "you bring your underwriting to us, but we will give you, not the company, but individually IPO allocations to the tune of a few million bucks." Is that legal?

I'm not going to answer the question, yet. But I don't think so. Maybe. Anyway, the point is you had this incestuous ring from analyst to investment banker to CEO. Now who is left out in this? Who's left out is the shareholder—folks like you and I who go out there and buy shares because the analyst says buy the stock. Folks who don't know that internally the analyst is saying, "This stock isn't worth it. I wouldn't want my grandmother buying this stock."

We end up holding the stock. The analyst got his salary. The CEO cashed out on the IPO allocations. The investment bank got its fees up front. They used to have a name for that, a Ponzi Scheme, right? Isn't that what it was? They get their money up front, and you and I are stuck holding something. It's a con game. It may be a little more subtle than that in terms of what was going on, but that is the essence of this dynamic and, it's not right.

Now, here is the good news. The game is over. The investment bankers know it. It is beginning to end, whether or not people are let off, you know, the proverbial perp walks, which I happen to think are not a good idea. I mean I don't think we operate that way, you know, waiting until there is a conviction to humiliate people that way.

But nonetheless, the game is over because as somebody said about the securities markets many years ago, "Sunlight is the best disinfectant." The fact that there has now been scrutiny applied to these various dynamics means that things are changing. The investment banks know they have to change what has been going on.

How that will happen is going to be a long tedious process. I can't tell you that I can see down the road where the changes will take us exactly or what the mechanism will be. Will it be by virtue of individual enforcement actions that other officers bring or by actions my office brings? Will it be by rule making out of the SEC or by a congressional enactment? Who knows? That

crystal ball we can all read equally well or poorly.

But there will be change because I think now there has been enough light shed on the problem so that no investment banker will seriously contend to you that the system was fundamentally different than what I just outlined. They know it, and they know that the game is up. So there will be change. That is the good news.

Thank you for your patience. It's an honor to be here. Thank you.