Beware the new cops on the block

New York Attorney General Eliot Spitzer, is already notorious for his assaults on the investment banks, mutual funds and ratings agencies based in the US financial capital. But there is more in store for the international business community, because attorneys general in other states are now on the warpath, warn **David Martin** and **Alan Vinegrad**

The SEC has long been regarded as the pre-eminent regulator for the national securities industry, but recent events have called its position into question. Eliot Spitzer, the Attorney General of the State of New York (NYAG), has opined that where power is not being exercised in Washington, state regulators have an opportunity to "flex [their] muscles." And flex those muscles he has. The Wall Street Journal has referred to Mr Spitzer as "a *de facto* federal regulator of the securities markets."[1] In October, he was chosen as 'European Personality of the Year' by the UK asset-management industry. While often playing the lead role, he has been joined in his efforts to ferret out wrongdoing in the securities industry by regulators from a number of other states.

State regulation of the securities industry is not a new phenomenon. But where the traditional role of state regulators was in protecting the small investor and addressing local misconduct, increasingly active state regulators are now demanding a seat at the table of national policymaking. Aggressive steps by state regulators have been something of an embarrassment for federal regulators, the Securities and Exchange Commission (SEC) in particular, which has by some accounts lost ground and been fighting to keep up. These are worrisome results.

Although depression-era federal securities laws notably broadened the scope of federal regulatory authority of the securities industry, these statutes were in some ways no match for state-level regulatory statutes codified years before. In the 1920s, more than 40 states passed so-called Blue Sky laws in response to securities fraud scandals that were damaging investors nationwide. New York's Blue Sky Law – the Martin Act – is widely viewed as the most expansive regulatory authority in the country, giving the NYAG civil and criminal jurisdiction over fraudulent activity in securities. The law defines security and the fraudulent sales thereof broadly – according to some, more broadly than any other statute.[2] It bestows upon the NYAG unusually broad investigative powers and permits the NYAG to establish a violation of the Act's criminal provisions without proving criminal intent. The Act has been used sparingly in recent decades, though Mr Spitzer has referred to a 'dusting off' of the Martin Act in recent years.

Mr Spitzer forced Wall Street to abandon decades-old conflicts between analyst recommendations and investment banking after he disclosed e-mail messages from top analysts who disparaged the stocks that they praised publicly, in part to curry favour with companies and win banking business. Mr Spitzer's investigation began in mid-2001, and by the time it was finished, Wall Street's leading investment banks had paid a $1.4 billion settlement. It was this investigation that first raised questions about the effectiveness of the SEC's enforcement group, with investors wondering where the feds had been.

Mr Spitzer is not alone among state actors in his policing efforts. When telecommunications giant WorldCom became embroiled in a massive accounting fraud that allegedly hid costs and inflated profits to the tune of $11 billion, criminal charges against the head of the company were filed in late August not by the US Attorney's Office in Manhattan, which was engaged in an extensive investigation, but by the Attorney General of Oklahoma, Drew Edmondson.

And Mr Spitzer has been at it again in recent months. Both the NYAG and the Massachusetts Secretary of the Commonwealth, William Galvin, who heads the state's Securities Division, have taken aggressive steps to combat certain trading practices in the mutual fund industry. Mr Spitzer's investigation commenced this spring, and on September 3, 2003, he announced a settlement with Canary Capital Partners LLP, a New Jersey hedge fund alleged to have engaged in late trading and market timing. Late trading occurs when investors who place their orders to buy and sell mutual funds after the US market closes get that day's price instead of the price set for the next day.[3] Market timing occurs when investors rapidly buy and sell shares in mutual funds, attempting to take advantage of share prices that are out of sync with the value of their underlying portfolios. Though not illegal, in a number of cases regulators have expressed concerns that the practice has involved preferential treatment for some investors, particularly where fund policies provide that rapid trading either is not permitted or is actively discouraged.

The SEC responded to the disclosure of the Canary settlement by commencing its own review of mutual fund practices and announcing plans to consider rules directed at trading practices. SEC Chairman William Donaldson has acknowledged that "we were not there first," and has indicated that the SEC is reviewing how it handles tips and conducts routine inspections of fund companies and brokerage firms.[4] Mr Spitzer's response to the SEC's action was to accuse the SEC of having been "asleep at the switch."[5] And when a reporter asked Mr Spitzer who regulates the mutual fund industry's intermediaries, he swiftly responded: "That's easy. We do." Only after pausing did the NYAG add, "with the SEC, of course."[6]

At a November 3, 2003, Senate hearing on the mutual fund industry, Senators criticised the SEC for failing to act sooner. For example, the SEC's Boston office failed to pursue a tip about problems at Putnam Investments, prompting the informant to take the case to Massachusetts securities regulators, who have since filed an action against the company. The head of the SEC's New England regional office announced that he would step down amid criticism that his office failed to properly investigate the accusations.

So what does this mean for businesses? It makes sense for regulation of national markets and the major segments of the securities industry to be undertaken at the national level. To be sure, competition between different regulators can lead to aggressive enforcement and creative ideas for reform. However, the fact remains that dispersing regulatory authority to the 50 states will increase the cost of doing business, as businesses are forced to comply with competing regulatory systems, undercutting the economies of scale of a national presence. As an example, at least 20 states have passed or are considering their own versions of the Sarbanes-Oxley law approved by Congress more than a year ago, creating the potential for contradictory policies and a tough road to navigate for national companies.[7] The SEC has made it clear, however, that while it wants to work more closely with the states, it should remain the nation's standards-setter.[8]

As far as regulators are concerned, the involvement of federal and state actors in regulating the financial industry can lead to coordination difficulties, particularly where different statutory or regulatory provisions mandate variable results or where state and federal regulators do not agree on what the overarching national policy should be. Competition also may make prosecution in securities cases with broad national import more difficult. For example, when Oklahoma State Attorney General Edmondson charged five former officers of WorldCom, four had already pleaded guilty in the federal case and were awaiting sentencing. Mr Edmondson's move may cause witnesses to hesitate to cooperate in investigations for fear of how their statements will be used in different enforcement contexts.

> Active state regulators are increasingly demanding a seat at the table of national policymaking

Some have suggested that the SEC's apparent failure to keep up with the states in discovering and pursuing misconduct in the securities industry is the result of chronic understaffing and an inability to move swiftly. Recent budgetary allotments should address this issue and enable the SEC to beef up its regulatory efforts. While state regulators view themselves as filling a void left by federal regulators, SEC defenders would argue that in taking enforcement action, it is wielding a mighty sword and must first think about broader market impacts. Being in the business of securities regulation on a permanent and full-time basis, federal regulators have seen the impact that their actions can have on investor confidence and market stability. State actors, in turn, have their own pressures to contend with. They unquestionably have local and particularised constituencies that they must serve, which can lead to policies and viewpoints that may not be nationally oriented.

The SEC's recent settlement of its case against Putnam presents this inter-agency tension in stark relief. Massachusetts and New York regulators have been deeply critical of the deal, with Mr Spitzer warning that the agreement should not be viewed as a template for settlements with his office, and Mr Galvin of Massachusetts criticising the SEC for setting the bar too low and "papering over wrongdoing [rather] than uncovering it."[9] On the other hand, Stephen Cutler, the SEC's Director of Enforcement, has countered that "[w]e don't think an enforcement issue X should be the forum for a wish list people are considering for the industry at large."[10]

In September, federal and state securities officials announced that they have been discussing ways to find common ground. It was expected that protocols would be developed to dictate which regulator should take the lead in certain cases, and when it is appropriate to notify other regulators of ongoing investigations in which they may share an interest. We should hope that this comes to pass.

Whether state or federal, all government actors should be focused on investor protection. Commenting on recent turf wars between federal and state actors, former SEC Chairman Arthur Levitt stated: "What's tragic is that there is no philosophical difference between the two of them. These two organisations could do so much by working together." The regulatory environment is one of enormous responsibility and scope, but also one of limited resources. The challenge for regulators now is to make their work cooperative and complementary and thereby best serve the interests of the investing public. ■

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[1] Charles Gasparino & Michael Schroeder, Pitt & Spitzer Butt Heads to Overhaul Wall Street Research, The Wall Street Journal, Oct. 31, 2002.
[2] New York v. 7040 Colonial Rd. Assocs. Co., 671 N.Y.S.2d 938, 941-42 (N.Y. Sup. Ct. 1998) ("The Martin Act provides the Attorney General with what one commentator has characterised as 'the broadest and most easily triggered investigative and prosecutorial powers of any securities regulator, state or federal.'") (quoting David J. Kaufmann, Introduction and Commentary Overview, in 19 McKinney's Consolidated Laws of New York Annotated 8, 9 (1996)).
[3] An SEC rule forbids this practice. See 17 C.F.R. § 270.22c-1(a).
[4] Judith Burns, SEC Chief Pledges Action on Funds, The Wall Street Journal, Nov. 10, 2003.
[5] Jonathan Fuerbringer, The Mysterious World of Mutual Fund Costs, The New York Times, Nov. 9, 2003.
[6] Diana B. Henriques, Spitzer Casting a Very Wide Net, The New York Times, Oct. 12, 2003. How to strike the appropriate balance between federal and state regulation is a complex question that has even caught the attention of the US Congress. A provision of a bill under consideration this past summer threatened to curtail the ability of state regulators to include industry-level reforms in striking settlements with potential defendants. However, the provision was later set aside by its sponsor to permit state and federal regulators to try working together.
[7] Deborah Solomon, Zealous States Shake up Legal Status Quo, The Wall Street Journal, Aug. 28, 2003.
[8] Mr. Donaldson stated, in a speech to the North American Securities Administrators Association meeting, "One of the cornerstones of our current regulatory system – a system that I believe works in the best interests of investors – is that national regulatory policies are set at the federal level." Deborah Solomon, Regulators to Seek Common Ground, The Wall Street Journal, Sept. 15, 2003.
[9] Gretchen Morgenson, 2 Mutual Funds Move to Assure Wary Investors, The New York Times, Nov. 14, 2003.
[10] Brooke A. Masters and Kathleen Day, Morgan Stanley Settles With SEC, NASD, The Washington Post, Nov. 18, 2003.