Eliot Spitzer, the SEC, and Research Analyst Conflicts of Interest: Assessing the “Balkanization” Criticism of Eliot Spitzer’s Analyst Conflict of Interest Case

Introduction

In the wake of numerous corporate scandals over the past few years, state attorneys general have played an increasing role in protecting the general public from corporate fraud. From exposing corporate fraud through their investigations, to settling with potential corporate defendants, state regulators have added an extra layer of protection to the general public, on top of what protections the SEC has already provided. Such actions have not been met without their share of criticism, however. Critics contend that by enforcing their own state rules, state regulators have created a discontinuity in the national market. For example, House Financial Services Committee Chairman Michael Oxley, R.-Ohio, criticized Elliot Spitzer’s action against Merrill Lynch and other investment banks as duplicative regulation that threatened to “balkanize” regulation of the securities industry. Such “balkanization” theoretically arises from federal regulators enforcing federal law on the one hand, and state regulators enforcing state law on the other hand. There is a fear that a lack of uniformity in national securities law will ultimately have negative consequences in the national market, as corporations will struggle to determine what exactly the law is and what regulations must be followed, not to mention facing the costs associated with compliance.

The debate over the states’ roles in regulating the securities markets is not a new one. State blue sky laws preceded the federal securities acts, which were not passed until the early 1930’s, after the great

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4 See, e.g., id.
The stock market crash of 1929, when the federal government finally realized that the states could not police the securities markets by themselves.\(^6\) The federal securities acts, however, were not intended to preempt the state blue sky laws, as is made clear by the express savings language in the federal securities statutes.\(^7\) In drafting the federal securities laws, Congress believed it could create a system that would allow the state and federal securities regulatory regimes to co-exist.\(^8\) The regulatory roles to be allocated to the state and federal governments were never clearly defined, however, and a poorly coordinated regulatory regime has ensued as a direct consequence. The question of what is the proper role for state governments in securities regulation remains to this day.

Despite confusion over their appropriate role in securities regulation, the utility of state attorneys general in securities regulations should not be understated. The SEC and the Department of Justice are too overburdened to address every instance of corporate fraud, thus creating a void that needs to be filled by some alternate enforcement body.\(^9\) During the 1980’s, the Reagan Administration severely cut funding to several regulatory agencies, as part of its self-regulating market theory. In addition to the deregulation, a series of legislative acts during the 1990’s eroded both the ability of states to regulate the securities industry, and the ability of harmed investors to bring class action suits.\(^10\) State attorneys general have attempted to fill the void left by the deregulation of the 1980’s and ’90’s, and as a result have unearthed some of the most substantial cases of corporate fraud in America’s history, have assisted federal regulators in numerous investigations, and have successfully reached settlements with corporate defendants. The utility of state attorneys general and other state regulatory bodies in enforcing securities laws is apparent. The question that must be asked, though, is whether the role of state regulators in securities enforcement

\(^{6}\text{Id.}\)


\(^{8}\text{[See Report on State Merit Regulation of Securities Offerings, supra note 6.]}\)

\(^{9}\text{See, e.g., Coffee, supra note 2.}\)
A fair critique of state securities regulation and the enforcement activities of state attorneys general cannot take place before inquiring as to the merit of criticisms that state regulations and enforcement actions “balkanize” the national market. To accomplish this, state actions must be analyzed to determine how they affect the federal securities regulatory system. Once this question is answered, the debate can then proceed to ask what improvements can be made to the interplay of the state and federal regulatory regimes.

This paper proposes to examine New York Attorney General Eliot Spitzer’s investigation of Merrill Lynch, and assess how his use of the Martin Act\textsuperscript{10} to address the financial analyst conflicts affected federal regulation of financial analysts. Through this analysis, this paper will show that when individuals criticize Eliot Spitzer for enforcing state law that “balkanizes” the national securities market, those criticisms are actually misguided: the underlying criticism is that a state attorney general appears to have encroached on the SEC’s authority, and in the process, affected the national market.

Because of the large scope of the subject, this paper will limit itself to Eliot Spitzer’s investigation of Merrill Lynch by assessing how Spitzer handled the problem, and then proceeding to address the criticisms that have been levied at Spitzer for his role in the research analyst cases. This paper does not profess to show the degree to which blue sky laws balkanize the national market – it merely attempts to draw upon the experiences of one defendant under the state and federal securities regulatory regime as a starting point for an analysis of what steps must be taken to improve the interplay of the two regulatory bodies.

Part I will provide an overview of the financial analyst conflict of interest case at Merrill Lynch. Part II will assess the relevant provisions of the Martin Act (the Act), as applied to the investigations of Merrill Lynch.


\textsuperscript{11} See infra pp. 7-17.
Part I: Financial Analyst Practices at Merrill Lynch

During the 1990’s, more Americans than ever committed their money to the stock market. Investment banks throughout the country used the promise of independent analyst research to draw the public into the market. Some firms even set up mutual funds exclusively devoted to technology and the Internet, managed by star analysts, as a way of drawing in investors. It would later be discovered that the analysts who were holding themselves out as impartial were inflating stock ratings as a method of drawing more investment banking clients to their firms.

An investor named Debases Kanjilal filed a complaint in March of 2001 with the New York Stock Exchange, alleging that he lost a half million dollars by following the investment advice of Henry Blodget, a star Internet analyst at Merrill Lynch. Kanjilal had bought stock in a company named InfoSpace at a price of $122 per share, and held onto it even as it dropped below $10 per share. He claimed that he attempted to sell the stock on several occasions, but held onto it after being persuaded to do so by a research analyst, who cited bullish reports by Blodget. The complaint by Kanjilal concluded that Blodget had recommended InfoSpace’s stock because it was planning to purchase a separate company called Go2Net, which was another client of Merrill Lynch.

A series of e-mails produced by Merrill to New York state authorities in 2001 revealed that analysts at Merrill were themselves wary of some of the favorable ratings supported by Blodget. For

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13 *See id.*
example, On June 15, 2000, Scott Jones, an Austin based broker e-mailed Blodget to complain about his rating of InfoSpace, whose stock was plummeting. Jones asked Blodget, “Why do we continue to talk so positively about this stock?”\textsuperscript{15} On July 10, 2000, a Merrill broker in Greenwich, Connecticut named Michael Devito e-mailed Blodget, “From your recent reports, it seems that InfoSpace is your favorite stock. Should we worry that the chairman has sold over 1MM shares before their quarterly earnings?”\textsuperscript{16}

Blodget himself appeared to be concerned about InfoSpace as well, admitting that he had “enormous skepticism” about InfoSpace in a message he sent to a colleague. Despite his skepticism, Blodget reiterated his buy rating on InfoSpace’s stock a day after Go2Net hired Merrill to represent it in a possible sale of the company to InfoSpace. Blodget added, “We continue to believe that InfoSpace has the best technology platform for wireless Internet.”\textsuperscript{17} Despite his support of InfoSpace, however, the company’s stock continued to fall, and analysts continued to inquire as to why Merrill was supporting such a weak stock. Apparently tired of getting comments about InfoSpace, Blodget wrote to one of his subalterns, “Can we please reset this stupid price target and rip this piece of junk off whatever list it’s on. If you have to downgrade it, downgrade it.”\textsuperscript{18} InfoSpace was not downgraded until December 11, 2000, after it had purchased Go2Net, and its stock had fallen to below $15.\textsuperscript{19}

The story of GoTo.com was strikingly similar to that of InfoSpace. GoTo.com found itself running out of cash and unable to issue more stock, until Merrill promised to help it raise equity from European investors. GoTo.com did not have a stock rating, however, so Blodget asked one of his colleagues to start researching the company. After running the numbers through the computer, the colleague concluded that the company was still making heavy losses and did not deserve a positive rating. Despite this conclusion, Blodget gave GoTo.com a positive rating of short-term accumulate, long-term accumulate. It was not until GoTo.com informed Merrill that it was going to CSFB for its offering that

\textsuperscript{14} See id.  
\textsuperscript{15} See id.  
\textsuperscript{16} See id.  
\textsuperscript{17} See id.  
\textsuperscript{18} See id.
Blodget approved the downgrading of GoTo.com’s rating. The correspondence between Blodget and his colleagues regarding InfoSpace and GoTo.com provided Eliot Spitzer’s team with enough information to elevate their investigation of Merrill, and to ultimately reach a settlement for fraudulent and deceptive practices.20

**Part II: The Martin Act as Applied to Merrill**

A. Applicable Provisions of the Martin Act

The Martin Act was previously believed to have limited enforcement potential outside the prosecution of high-pressure securities boiler rooms and fraudulent stock scams.21 Eliot Spitzer resurrected the law, however, because it gave him a number of tools and advantages that are unavailable to federal prosecutors, and he felt he needed a strong enforcement tool in response to the growing number of corporate fraud cases.22 The Act proved particularly valuable in the investigation the financial analyst practices at Merrill Lynch.

Section 352 is the first section of the Act, and delegates investigative authority on the Attorney General of the State of New York.23 For purposes of simplifying, section 352[1] of the Martin Act can be broken down into two parts: 1) the attorney general must be made aware of fraud relating to investment advice concerning the sale of stocks; and 2) the attorney general has broad investigative authorities once he has been made aware of that fraud.24

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19 See id.
20 See id.
23 N.Y. GEN. BUS. LAW § 352 (McKinney’s 2003).
24 Id. at § 352[1].
The definition of fraud under the statute is very broad, giving the attorney general enforcement powers that cannot be found under the federal securities laws. Among the litany of behavior that comes within its definition of fraudulent practices are deceptions, misrepresentations and representations beyond reasonable expectation in connection with the issuance, purchase, exchange, investment advice or sale of securities. Virtually any act that is arguably “fraudulent,” therefore, would fall under the definition.

Fraud under the Act can be proven without proof of scienter, intent, reliance or damages for misdemeanor violations. This is another feature that is not typically found in federal antifraud statutes. A sale of stock does not even have to be consummated in order to trigger a violation of the Martin Act.

The Attorney General’s power to conduct inquiries under the Martin Act is exceedingly broad, and his application for leave of court to conduct an inquiry into alleged frauds and practices tending to deceive or mislead the purchasing public is not measured by the same standards as would be required upon trial of the charges he seeks to investigate. The Act does not provide for judicial review of the Attorney General’s discretion in dealing with a Martin Act violation, another feature that is unique to state law.

Section 352[2] gives the attorney general the power to subpoena witnesses, compel their attendance, examine them under oath and require the production of any relevant books or papers. Failure by a potential defendant to comply with a Martin Act subpoena is guilty of a misdemeanor, and such

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25 People v. Federated Radio Corp., 154 N.E. 655, 657 (1926) (“The words “fraud” and “fraudulent practice” in this connection should, therefore, be given a wide meaning so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law.”).
26 People v. Lexington Sixty-First Associates, 38 N.Y.2d 588, 595 (1976) (“[T]he terms ‘fraud’ and ‘fraudulent practices’ [are] to be given a wide meaning so as to embrace all deceitful practices contrary to the plain rules of common honesty.”).
28 See infra, rule 10b-5.
33 Id. at §352[4].
failure also constitutes prima facie proof that the defendant has engaged in the suspected fraudulent practices, thereby providing a basis for entry of permanent injunction.34

Public investigations can be conducted under section 354, by seeking an order from a State Supreme Court Justice directing that witnesses appear before the court or produce documents.35 The Attorney General may file such a request before commencing an action, and may include with the request an application for a preliminary injunction or stay, which the court may grant if it finds it “proper or expedient.”36 The potential harm to a defendant from a public hearing can be detrimental. Thus, the ability of the attorney general to conduct public investigations provides him with enormous leverage in conducting his investigation, and in reaching a settlement.

*Ex parte* injunctive relief is one of several remedies that are available to the Attorney General, and was nearly used by Spitzer against Merrill Lynch. 37 The standard for usual injunction proceeding requires a showing of likely success on the merits – in Martin Act cases, the merits often are not yet even delineated in the answered complaint.38 When used effectively, “status quo” injunctions can be just as damaging to defendants as pursuing ultimate success on the merits.39 In 1989, Power Securities Corp. was effectively put out of business when a Section 354 injunction prohibited the firm from soliciting any New York business while the case was ongoing.40

There is no private right of action under the Martin Act, leaving to the attorney general the responsibility of invoking the statute’s remedial provisions. Under section 353, the attorney general has the authority to seek an injunction for any fraudulent act in which he believes any person or entity has engaged

38 See McTameny, *supra* note 5.
39 *Id.*
40 *Id.*
or threatens to engage, and can also seek restitution of funds or property obtained either directly or indirectly by any fraudulent practice.41

Finally, Section 352-c sets forth the criminal provisions of the Martin Act, and makes it illegal for any person or entity, engaged in the promotion, issuance, distribution, exchange, sale, negotiation or purchase of a security to employ any fraud, deception, concealment, suppression, false pretense, promise or representation as to the future that is beyond reasonable expectation or unwarranted by existing circumstances.42 Intentional fraud violations are felonies under the Act.43

The ability to assert both civil and criminal authority is unique to the state attorney general, as the federal system divides civil and criminal authority between the SEC and the Department of Justice, respectively. On the federal level, at least, the fear is that an agency will exploit its criminal authority to bring settlements to civil enforcement actions.44 Having assessed the relevant provisions of the Martin Act, this paper will now proceed to examine how Eliot Spitzer used the Act to address the analyst conflicts of interest at Merrill Lynch.

B. How Spitzer Proceeded Under the Martin Act

Under section 352 of the Martin Act, the attorney general may commence an investigation whenever an instance of fraud is brought to their attention.45 Bruce Topman, a former Wall Street lawyer who had been hired by Eliot Spitzer for the investigation, focused on the legal complaint filed by Debases Kanjilal with the New York Stock Exchange as a starting point for his investigation. The allegations brought forward by Kanjilal fell clearly within the definition of fraud under the Martin Act, as Kanjilal was suspicious of Blodget’s continually positive ratings of InfoSpace.

42 Id., § 352-c.
Section 352[2] of the Act gives the attorney general power to subpoena witnesses, compel their attendance, examine them under oath, and require production of any relevant books or papers. Having been made aware of the possible fraud through Kanjilal’s complaint, Topman commenced his confidential section 352 investigation by sending Merrill Lynch a lengthy subpoena in April of 2001. Because the discovery provision allows production of any relevant books or papers, Topman was able to request internal documents relating to Internet IPO’s, stock recommendations, and compensation of Internet stock analysts. A second subpoena later in 2001 enabled Topman to request that Merrill produce documents relating to GoTo.com. The SEC has required all securities firms to save all of their e-mails for at least three years, thus Topman was enabled to gather an extensive paper trail of Blodget’s correspondences regarding InfoSpace and GoTo.com.

One particular e-mail produced by Merrill included an e-mail that was sent by Blodget to a colleague after GoTo.com had announced that it was using CSFB as its underwriter for its upcoming stock issue. After months of refusing to downgrade the stock, Blodget finally conceded to the downgrade when GoTo.com chose CSFB as its underwriter over Merrill. Topman used this e-mail as an affirmative indication that there was a conflict of interest among the analysts at Merrill.

Topman and other investigators used their power under section 352[2] to interview Blodget. During the interviews, Blodget gave away little, stating that he had always described internet stocks as high-risk investments, and that he had advised investors to only keep a small percentage of their wealth in them. Blodget did concede that in deciding which stocks to cover, he considered whether the company had

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49 John Cassidy, The Investigation: How Eliot Spitzer Humbled Wall Street, THE NEW YORKER, April 7, 2003, at 54 (provides a good overview of the investigation into Merrill Lynch’s analysts).
50 John Cassidy, The Investigation: How Eliot Spitzer Humbled Wall Street, THE NEW YORKER, April 7, 2003, at 54 (provides a good overview of the investigation into Merrill Lynch’s analysts).
an investment banking relationship with Merrill, but insisted that this was not the only factor.\(^\text{51}\) Blodget did not seem affected by the attorney general’s investigation, and in fact seemed to be more evasive than cooperative. The attorney general’s staff expected more, given the substance of his e-mails.\(^\text{52}\)

In November of 2001, when the investigation resumed following the September 11 attacks, Eliot Spitzer reviewed the evidence relating to InfoSpace and GoTo.com. Spitzer doubted that had strong enough evidence to support a high-profile case against a defendant as powerful as Merrill Lynch. While some of the e-mails were damning, he needed incontrovertible evidence of systematic wrongdoing. Spitzer also recognized that the actions of Blodget were really symptomatic of the financial analyst conflicts that had arisen throughout the financial industry. Spitzer was more interested in changing the way the entire industry operated, than by punishing one individual and one bank for its wrongdoing.\(^\text{53}\)

Spitzer’s assessment of the situation influenced his investigative strategy. To change the practices on Wall Street, Spitzer needed to show that the practice was pervasive. Using the broad discovery powers under section 352[2]\(^\text{54}\), Spitzer asked his staff to broaden its investigation beyond InfoSpace and GoTo.com, and to include e-mails dating from 1997. The request forced Merrill to produce some tens of thousands of new documents, including more damning e-mails to and from Blodgett. Spitzer’s team needed to show that the financial analysts were working with the investment bankers to generate business for the firm.\(^\text{55}\)

The new e-mails produced under their discovery orders produced documents with hard evidence that the financial analysts had a conflict of interest. Internet Capital Group (ICG) was another financial firm that Merrill had taken public in August of 1999. When its stock fell from $212 to $15, Blodgett


\(^{52}\) John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER, April 7, 2003, at 54 (provides a good overview of the investigation into Merrill Lynch’s analysts).


\(^{54}\) Art. 23-A, § 352[2].

maintained its accumulate-buy rating. When asked why he kept his rating so high, Blodgett replied in an e-mail, “Part of the reason we didn’t highlight it is b/c we wanted to protect icg’s banking business.” A series of e-mails that followed also showed that Blodgett continually refused to downgrade ICG, even when he conceded that it was a terrible investment. After continuous criticisms from brokers, Blodgett admitted in e-mails that he was getting tired of working to satisfy the investment banking clients, and that he was going to start calling the stocks as they were. Such e-mails clearly proved that Blodgett had been shaping stock ratings to reflect Merrill Lynch’s investment-banking interests.

Spitzer and his team were finally convinced they had enough evidence to sue Merrill under the Martin Act in March of 2002. Blodget’s team had helped produce roughly a hundred and fifteen million dollars in investment banking revenues for Merrill, some of which was returned to Blodget. He received $3 million from Merrill in 1999, $5 million in 2000, and $12 million in 2001, plus a $2 million dollar severance pay.

Merrill asked Spitzer in April what it would take to stop the investigation and settle the case. Spitzer informed the bank that they would have to pay fines and reform their financial analyst practice. Merrill requested that the information not be made public, but Spitzer refused on the grounds that public investors had a right to know about that information and to sue based on that information.

As far as what type of suit to pursue, Spitzer had options. He could pursue a criminal indictment under section 352-c of the Martin Act, but was reluctant to go that far. Criminal indictments had put

59 Initially, Spitzer believed that reform throughout the industry would have to come through mandating that underwriting firms spin-off their securities analysts into separate entities, and then distribute the stock from the new entities as dividends to the organizations’ shareholders, thus creating a complete separation of investment bankers from financial analysts. See John C. Coffee, *Competitive Federalism: The Rise of the State Attorney General*, NEW YORK LAW JOURNAL, Sept. 18, 2003, at 5.
companies out of business in the past, most notably Arthur Andersen, and Spitzer did not feel that Merrill
should pay the price for a practice that was widespread on Wall Street. The alternative was to file a civil
suit, so Spitzer prepared for a public investigation under section 354 of the Martin Act, in the event that
settlement talks broke down.61

When the settlement talks did break down on Friday, April 2, 2002, Spitzer sent his team to the
State Supreme Court at 60 Centre Street to request a public hearing under section 354 of the Martin Act.62
The judge granted the request, instructing Merrill to hand over more documents, and to state clearly in its
stock circulars whether Merrill had an investment banking relationship with the company concerned.
Spitzer subsequently issued a press release that set off a media frenzy, and was subsequently made aware
that Merrill might have to shut down parts of its business under the Investment Company Act of 1940. The
potential damage posed by such a shutdown could have been devastating to Merrill. He was reluctant to go
that far, so upon hearing this information, he requested a stay of his section 354 order while the two sides
resumed their settlement talks.63 Spitzer was also clearly cautious of using his injunctive power under
section 354 the Martin Act, for the very same reasons: injunctions can be devastating to a company, and
given his goals of reforming practice on Wall Street, an injunction would not further those goals unless the
firm proved uncooperative.

Nevertheless, Spitzer’s actions caused Merrill’s stock market value to plummet by more than $5
billion. Merrill subsequently gave in to Spitzer’s requests, and issued a public apology. Representatives for
Merrill Lynch were upset, however, that they had publicly been singled out for a practice that is rampant
on Wall Street. Spitzer proposed, and Merrill agreed to pay a fine of $100 million as part of the settlement,

61 John Cassidy, The Investigation: How Eliot Spitzer Humbled Wall Street, THE NEW YORKER, April 7,
2003, at 54 (provides a good overview of the investigation into Merrill Lynch’s analysts).
62 Art. 23-A, § 354; see also Affidavit In Support of Application for An Order Pursuant to General
63 John Cassidy, The Investigation: How Eliot Spitzer Humbled Wall Street, THE NEW YORKER, April 7,
2003, at 54 (provides a good overview of the investigation into Merrill Lynch’s analysts).
a number that in his view would not bankrupt them, but would force them to wake up.64 Other significant parts of the settlement called for Merrill to: 1) sever the link between compensation for analysts and investment banking; 2) prohibit investment banking input into analyst’s compensation; 3) create a new investment review committee responsible for approving all research recommendations; 4) establish a monitor to ensure compliance with the agreement; and 5) disclose in research reports whether Merrill has received or is entitled to receive any compensation from a covered company over the past 12 months.65

**Part III: How the SEC Monitors the National Securities Markets**

A. Brief Overview of the SEC

The Securities Exchange Commission (the SEC) is the federal executive body responsible for the monitoring and protection of the national securities markets. The principle theory behind the Commission’s oversight of the securities markets is that of disclosure: all investors, whether large institutions or private individuals should have access to certain basic facts about an investment prior to buying it.66 Another important practice of the SEC is oversight of Self-Regulatory Organization’s, such as the NYSE and NASDAQ, which promulgate rules for their members.67 In furtherance of its objectives, the SEC’s primary activities include rulemaking, surveillance of the markets, interpretation and review of corporate filings, determination of compliance, and bringing civil enforcement actions.68 The Commission has investigative authority, and the authority to seek civil remedies against those accused of violating federal

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65 Press Release, *Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices* (Spitzer Website)
66 For more information about the SEC’s role in securities regulation, see [http://www.sec.gov/about/whatwedo.shtml](http://www.sec.gov/about/whatwedo.shtml).
67 (see footnote 18 of Shalini’s paper)
securities laws. Criminal enforcement authority rests in the hands of the Department of Justice, which is assisted by the Commission’s investigations.

B. Applicable Laws and Regulations

The applicable antifraud statutes under the federal securities laws are found in Rule 10b-5 of the Securities and Exchange Act,69 and in Section 17(a) of the Securities Act.70 Fraud is construed broadly under Section 17(a), but is not construed as broadly under federal securities laws as it is under the Martin Act.71 Rule 10b-5 prohibits of deceptive or manipulative devices in connection with the purchase or sale of any security72, while Section 17 uses similar language but only applies to the sale of securities.73 Under Rule 10b-5, the prohibition applies to any person who has made false statements in connection with a securities purchase or sale or has engaged in insider trading or other illegal practices.74 For the most part, Rule 10b-5 has been effective at deterring fraud, although isolated instances have arisen which gave rise to enforcement actions.75 Private rights of action are permitted under Rule 10b-5, but not under Section 17(a).

The standards of proof under the federal statute are more stringent than those of the Martin Act. Plaintiffs bringing a case under Rule 10b-5 must prove that the defendants acted with scienter,76 although, the Supreme Court has found that violations of clauses (2) or (3) Section 17(a) can be shown without

70 (find citation for section 17(a))
72 17 C.F.R. § 240.10b-5 (2002); see David L. Ratner and Thomas L. Hazen, SECURITIES REGULATION IN A NUTSHELL, ch. IV, (7th ed. 2002).
73 15 U.S.C. §77q; While an offer to sell is sufficient to trigger Section 17(a), under Rule 10b-5, there must be a “contract of sale or disposition of a security or interest in a security, for value.” See 15 U.S.C. § 77b(a)(3).
75 David L. Ratner and Thomas L. Hazen, SECURITIES REGULATION IN A NUTSHELL, § 17, (7th ed. 2002).
proving scienter. Analyst conflicts of interest could fall under either Rule 10b-5 or under Section 17(a), although the SEC would most likely choose to bring a civil enforcement action under Section 17(a)(2) or (3) because of the lack of a scienter requirement. A simple textual reading of Section 17(a) shows that analyst conflicts of interest would most neatly fall under clause (3). 78

The investigative authority for the SEC is set forth in Section 21 of the Securities Exchange Act 79, and in Sections 19(b) and 20(a) of the Securities Act. 80 The authority includes the power to subpoena witnesses, administer oaths, and compel the production of books and records anywhere in the United States. When there is doubt as to whether the SEC has jurisdiction, the SEC is empowered by the federal securities laws to conduct an initial inquiry into whether the subject of the inquiry is in fact subject to the securities laws. 81 SEC investigations are normally conducted privately, in order to avoid unwarranted injury to the reputations of the persons being investigated. 82 Public investigations are permitted under Rule 7, but if the record contains implications of wrongdoing by an individual, that individual is permitted to cross-examine and produce rebuttal testimony or documentary evidence. 83 Where it is alleged that the SEC commenced an investigation because of political pressures, a court may deny enforcement of an SEC subpoena on grounds of abuse of process. 84 Witnesses compelled to testify are entitled to counsel at hearings. 85 If the SEC investigation uncovers evidence of a wrongdoing, the commission may order an

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77 See Aaron v. SEC, 446 U.S. 680 (1980); also, note that clauses (2) and (3) of Section 17(a) are identical to clauses (2) and (3) of Rule 10b-5.
78 Section 17(a)(3) of the Securities Act states that it shall be unlawful “to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.” 15 U.S.C. § 77q(a)(3). Distribution of deliberately misleading analyst research reports would most likely be considered a practice that operates as a fraud upon the purchaser.
81 SEC v. Wall St. Transcript, 422 F.2d 1371 (2d Cir. 1970).
82 Rules Relating to Investigations Rule 5 (p. 246 of the Nutshell)
83 Rules Relating to Investigations Rule 7(d) (p. 247 of the Nutshell)
84 SEC v. Wheeling-Pittsburgh, 648 F.2d 118 (3d Cir.1981)(___).
85 Rules Relating to Investigations (p. 245 of the Nutshell)
administrative hearing to determine responsibility for the violation and to impose sanctions, and all such hearings are public. Administrative hearings are not available under the Martin Act.

There are several methods of enforcement or prosecution under the federal securities laws. Under Section 21(d) of the Exchange Act and Section 20(b) of the Securities Act, the SEC may seek injunctions against defendants. Injunctions are only granted where there is a reasonable likelihood of further violation in the future. In addition to the injunctions, the SEC will often ask the court for ancillary relief appropriate to the type of violation committed. The Department of Justice has the authority to prosecute under Section 32 of the Exchange Act and Section 24 of the Securities Act. Violations are punishable by fine or imprisonment or both. Last, one of the sanctions available to the SEC is the ability to suspend or revoke a respondent’s membership in a Self-Regulatory Organization. SRO’s are required to impose sanctions on their members who violate securities laws.

New York State law effectively affords federal law pre-emptive rights in the sense that a defendant cannot be charged under the Martin Act when he has already been prosecuted under federal securities charges arising out of the same transaction. It is the federal double jeopardy statute, on the other hand, which does not precludes successive federal and state charges arising out of the same transaction or act. The Supreme Court has held that two identical offenses are not the same offense if

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87 (cite section 21 of the Securities Act)
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90 SEC v. Caterinicchia, 613 F.2d 1310 (D.C.Cir.1981)().
91 David L. Ratner and Thomas L. Hazen, SECURITIES REGULATION IN A NUTSHELL, § 33, (7th ed. 2002) (SEC may ask court to mandate that the defendant make rescission offer, or turn over profits to the issuer or court appointed trustee for distribution to persons entitled to them).
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94 David L. Ratner and Thomas L. Hazen, SECURITIES REGULATION IN A NUTSHELL, § 34, (7th ed. 2002).
95 SEA §§6(b)(6), 15A(b)(7), 19(g)(1).
97 People v. Rivera, 60 N.Y.2d 110 (1983)().
prosecuted by different sovereigns.\textsuperscript{98} The reasoning of the Supreme Court’s majority is that federal prosecutors would be hindered in their capacities if state actions served as a bar to subsequent federal actions.\textsuperscript{99} While there is no official rule or regulation that bars the federal government from prosecuting a defendant who has already been prosecuted under state law, the Department of Justice has an internal policy known as the “Petite Policy” which precludes federal action following a state action, unless the federal government determines that their interests have not been vindicated by the state action.\textsuperscript{100}

One other important federal regulation to be aware of is the “Chinese Wall.” Following the stock market crash in 1929, the federal government erected the “Chinese Wall” to protect against insider trading.\textsuperscript{101} The Chinese Wall prevented Investment Bankers from passing on tips to traders, who could use such inside information to their advantage. The wall has generally failed, though, to separate investment bankers from financial analysts.\textsuperscript{102} This failure was due largely to the technology boom of the 1990’s, which created intense pressure on financial analysts to help their firms generate business, not to mention to potentially lucrative payouts that analysts were able to receive.\textsuperscript{103}

C. How the SEC Addressed Analyst Conflict of Interests

The SEC had been aware of the analyst conflicts of interest a year before Eliot Spitzer’s settlement, but the commission backed off its investigation under the orders of Harvey Pitt, then chairman

\textsuperscript{99} United States v. Lanza, 260 U.S. 377 (1922)(____).
\textsuperscript{100} Robert G. Morvillo and Robert J. Anello, White Collar Crime: Securities, Investigations and Prosecutions Under the Martin Act, NEW YORK LAW JOURNAL, April 1, 2003, at p. 3.
\textsuperscript{101} Keith Kalawsky, Analysts: Life After Enron, Cracks in the Chinese Wall, Financial Post, Wednesday, September 25, 2002 (assesses the failure of efforts to separate financial analysts from investment bankers).
\textsuperscript{102} Keith Kalawsky, Analysts: Life After Enron, Cracks in the Chinese Wall, Financial Post, Wednesday, September 25, 2002 (assesses the failure of efforts to separate financial analysts from investment bankers).
\textsuperscript{103} Keith Kalawsky, Analysts: Life After Enron, Cracks in the Chinese Wall, Financial Post, Wednesday, September 25, 2002 (assesses the failure of efforts to separate financial analysts from investment bankers).
of the SEC. The Commission had never requested that the brokerages produce e-mails, however.

According to Stephen Cutler, the SEC’s enforcement chief, “Whoever thought people would be so stupid to put this stuff in e-mails?” Cutler kept himself abreast of the developments in Spitzer’s investigation of Merrill. Upon learning of Spitzer’s proposal to have the major firms separate the analysts from the investment bankers, Cutler told Spitzer that if he did that, there would be “dire consequences to investors.” Cutler was clearly concerned about Spitzer taking actions that might harm the national markets.

Cutler wanted to find a way to get the SEC involved in the investigations. His real challenge in getting the SEC involved in the analyst investigations was negotiating with Pitt, who felt that Spitzer was encroaching on the SEC’s turf for his own political gain. Cutler explained to Pitt that that might be the case, but that the SEC’s reputation would be harmed if it failed to act. Cutler was eventually able to convince Pitt to allow the SEC to investigate the research analyst matter.

Regulators wanted a quick end the research analyst controversy when the market began sending skittish signals. The quickest end to the controversy would involve the New York State Attorney General, the SEC, and the NYSE cooperating to get the remaining banking firms to settle. Dick Grasso, then chairman of the New York Stock Exchange, had earlier agreed to work with Spitzer on the condition that Spitzer modulate his position. Convincing Harvey Pitt to work with Spitzer, on the other hand, was not as easy: Grasso had to ask Pitt to put aside his contempt for Spitzer’s “politicalization” of the issue, adding that

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104 According to Harvey Goldschmid, SEC Commissioner, the SEC actually knew far more about the analyst conflicts of interest than did Eliot Spitzer. See Symposium, The Newest Federalism: State Attorneys General in Cases of National Significance, [publication forthcoming] (2003).
“[u]ltimately, you have the same interests.”110 It was not until Pitt and the SEC were brought on board that regulators finally agreed to share evidence and jointly interview witnesses, with an eye toward developing a “global settlement” that would transform the Wall Street research practices.111

Following Eliot Spitzer’s settlement with Merrill Lynch, the SEC launched an inquiry into the market practices of research analysts and their potential conflicts of interest with investment bankers.112 Several steps were taken by the SEC in an effort to curb the fraudulent analyst practices.

In May, 2002, rules were adopted by the SEC to address the issues found in their inquiry into analyst practices.113 The following are some of the more notable provisions adopted as part of the rule change: 1) Analysts are now prohibited from offering or threatening to withhold a favorable research rating or specific price target to induct investment banking business from companies; 2) Research analysts are now prohibited from being supervised by the investment banking department; 3) Analyst’s compensation can no longer be tied to specific investment banking transactions; and 4) Securities firms will be required to disclose in a research report if they managed or co-managed a public offering of equity securities for the company or if it received any compensation for investment banking services from the company in the past 12 months.114 The regulations stop short of mandating a physical separation of the analysts from investment bankers115, but the regulations to seek to eliminate incentives for institutions to influence

115 Eliot Spitzer was not the only person who called for a complete separation of research from investment banking – William Gavin, the Massachusetts secretary of state, supported this claim as well. His state has one of the largest securities fraud divisions, thus his statement has been taken seriously in the world of securities regulations. See Joshua Chaffin, Banks Must End Research Lings, Says Financial Regulator, Fin. Times, Oct. 9, 2002, at 15; See Joshua Chaffin, Dealing in Shares – Celebrity Analysts Hit “Bubble
analysts, and attempt to induce the adoption of policies that will prevent this type of influence from occurring. Intense public and regulatory scrutiny, as well as a desire to “head off stiffer measures,” have caused many firms to cooperate in the adoption of rules that eliminate the analyst-banker conflict of interest.

In December of 2002, a “global settlement” deal was announced by state, federal and private regulators, to end the analyst conflict of interest probes at many of the large investment banks and brokerages: Citigroup, owner of Salomon Smith Barney, Credit Suisse Group’s Credit Suisse First Boston; Morgan Stanley; Goldman Sachs Group and Merrill Lynch & Co. As part of the settlement, ten large firms would pay from $50 to $325 million to settle the charges that had been brought against them. The firms were also required to spend $450 million over the next five years purchasing reports from independent analysts and distributing them to investors. Other requirements under the settlement included a ban on brokerage practice of distributing IPO shares to corporate executives, and insulating the research analysts from investment bankers.

The final piece of the regulatory puzzle came when the SEC adopted Regulation Analyst Certification (“Regulation AC”) in February, 2003. That regulation requires research reports distributed by brokers and dealers to include certifications, attesting to the analysts’ personal beliefs in the substance

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Scraphead’ Conflicts of Interest, Fin. Times, Sept. 28, 2002, at 8 (the problem with complete separation is that research requires investment, but generates no direct revenues).


of the reports.\textsuperscript{123} The regulation also requires disclosure as to whether the analyst received compensation or other payments connected to the analysts’ recommendations.\textsuperscript{124} There is uncertainty, however, as to whether this regulation will be sufficient.\textsuperscript{125}

**Part IV: Comparison of State and Federal Laws: Why Spitzer’s Use of the Martin Act against Merrill did not Balkanize the Federal System**

This section will distinguish the Martin Act from the federal securities laws, in order to help us determine how Eliot Spitzer’s actions affected the SEC’s ability to regulate. Beginning with fraud, our assessment of the laws shows that the definition of fraud is construed broadly under both the Martin Act and the federal securities acts, but it is construed even more broadly under the Martin Act.\textsuperscript{126} To prove fraud under the Martin Act, no purchase or sale has to be consummated, whereas a contract of sale is required under Rule 10b-5 of the Exchange Act, and an offer to sell must be made under section 17(a) of the Securities Act.\textsuperscript{127} Finally, proof of fraud under the Martin Act does not require a showing of scienter, intent, reliance, or damages, while scienter is required under Rule 10b-5, and under Section 17(a)(1). Sections 17(a)(2) and (3) do not require a showing of scienter. Thus, a comparison of the two laws shows that the Martin Act is broader in terms of both what constitutes fraud, and in proving fraud. As applied to Merrill, however, the allegations in Debases Kanjilal’s complaint fall under both the state and federal definitions of fraud.

The investigative powers of the State Attorney General are similar to those of the SEC. The New York State Attorney General has broad discretion in determining when an inquiry is warranted, without judicial review of his decision. The SEC, on the other hand, can conduct an inquiry to determine whether

they have jurisdiction to conduct an investigation, but there is judicial review of their decision to conduct investigations. Overall, the New York State Attorney General has broader, unfettered discretion in determining when to conduct an investigation. Had Pitt been more aggressive with regards to analyst conflicts of interest, there would not have been a notable difference between the investigative authority of the SEC and the authority of the state attorney general, except that the SEC is subject to judicial review.

In terms of civil remedies, the State Attorney General has the authority to seek ex parte injunctions after a showing of likely success on the merits has been made. There is no private right of action under the Martin Act, however, leaving the attorney general as the sole individual who can seek restitution on behalf of the public under state securities law. The SEC has the authority to seek injunctions when there is a reasonable likelihood of further violations in the future, and also has the power to seek ancillary relief, such as rescission offers, or disgorgement of profits. There is no private right of action allowed under Section 17(a), but there is under Rule 10b-5.

Finally, with regards to criminal remedies, the State Attorney General has the authority to seek criminal prosecutions under the Martin Act. In the federal government, that power is vested with the Department of Justice. One commentator notes that the reason for this division in the federal government is that giving one agency civil and criminal regulatory power creates the potential that the criminal power will be exploited to achieve civil or regulatory settlements. One could make an argument that Spitzer’s leverage was dramatically increased by his authority to bring both a civil enforcement action and a criminal prosecution against a defendant.

Overall, the Martin Act gives broader enforcement powers to the New York State Attorney General than the federal securities acts give to the SEC. With regards to the analyst conflicts of interest, their conduct constitutes fraud under both the Martin Acts and the federal securities acts. As applied to Merrill, the difference was that the state law gave more facility to the State Attorney General in both investigating and prosecuting the analysts’ conduct, whereas the SEC would have been subject to greater

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127 10b-5, Section 17(a).
procedural and political restrictions. The Martin Act effectively allowed Spitzer to investigate Merrill
without facing the procedural and political hurdles that the SEC have would faced, and allowed him to
reach a settlement quickly.\textsuperscript{129} Spitzer’s investigations brought to light fraud across the industry, raising
public awareness of the fraud, and ultimately forcing SEC was to become involved in the process.

While it is apparent that the state laws do not differ substantially from the federal laws, Eliot
Spitzer did substantially affect the market: Merrill Lynch’s market value dropped by $5 billion when it was
announced that they were being investigated by the office of the attorney general. However, the decline in
market value cannot be attributed to the “balkanization” effect of Eliot Spitzer enforcing state laws that
differ from the federal securities laws, as the laws are too similar to infer any balkanizing effect from the
New York laws. The argument Spitzer’s actions balkanized the market is especially weak, when
considering that it is based on Spitzer’s proposal to split research analysts from investment bankers – a
proposal that was ultimately dropped.

Eliot Spitzer acted within the boundary of the law as the State Attorney General of New York. He
claims that he took action because the SEC was not doing enough to prevent securities fraud from
occurring. Had the SEC investigated Merrill Lynch and other investment banks, similar market results
would have occurred. Therefore, it cannot be fairly argued that the laws or even Spitzer’s state action have
a balkanizing effect on the national market, as any SEC action would most likely have rendered similar
results. The criticism of Eliot Spitzer, while couched in terms of balkanizing state law, is really that a state
attorney general encroached on the authority of the SEC, and in the process, affected the national market.
Of course, it is not actually true that Spitzer encroached on the SEC’s authority, but in the world of politics,
perception is reality. A comparison of the state and federal laws is only part of the solution, therefore: to
fully understand the criticisms that have been levied against Eliot Spitzer, the political and financial
elements must be assessed.

\textsuperscript{129} Robert G. Morvillo and Robert J. Anello, \textit{White Collar Crime: Securities, Investigations and
Prosecutions Under the Martin Act}, NEW YORK LAW JOURNAL, April 1, 2003, at p. 3.
Part V: Political Factors: The Real Sources of the “Balkanization” Criticism, and Proposals to Limit the Roles of State Attorneys General

A. Criticisms of Spitzer and the SEC

As mentioned earlier, the practice of research analysts inflating potential client ratings was not uncommon on Wall Street, particularly during the boom years of the 1990’s. The practice was widely known, and the SEC had, in fact, looked at the issue in 2001, but backed off the issue under the orders of its Chairman, Harvey Pitt. Even as Spitzer closed in on a settlement with Merrill, Pitt was reluctant to get the SEC involved in the investigation, but finally conceded to the wishes of Stephen Cutler. Pitt was hesitant to work with Spitzer throughout the process that led up to the global settlement, arguing that Spitzer was “politicizing” the issue for his own personal gain. He was also angry that Spitzer had been attacking the SEC in the media.

Pitt is an obvious candidate for blame when assessing who was responsible for the SEC’s failure to capitalize on the analyst problem, but he was by no means solely responsible. Eliot Spitzer cast blame in several directions. “Self-regulation failed,” according to Spitzer. In addition to Pitt, the SEC, and self-regulatory bodies, Spitzer also blames Congress, stating that it continuously ignored Arthur Levitt’s (the SEC Chairman under President Clinton) pleas for overhauls and more resources, adding that he was outgunned by Wall Street lobbyists.

129 Spitzer also points out that charges could have been brought against Merrill Lynch in New York under an ordinary common law theory of fraud. See Symposium, The Newest Federalism: State Attorneys General in Cases of National Significance, [publication forthcoming] (2003).
Spitzer is also quick to point out that the SEC cannot blame its lack of resources for its failure to address the issue of analyst conflicts of interest. “We have only 15 lawyers in my investment protection bureau, and have managed rather easily to reveal the evidence that verified an underlying theory that had been out there for years. It is not that the SEC lacks resources: it is a matter of will, of desire, of aggressiveness, of leadership.”

On the other side, the SEC has been just as scathing in its criticisms of Eliot Spitzer. As mentioned previously, Pitt was angry that Spitzer was politicizing the issue for his own personal gains and for attacking the SEC in the media. There were also those in the agency who believed that the analyst conflicts could have been better addressed by the agency with new regulations and its own continuing investigation. William Donaldson stated at his confirmation hearing that he wanted the SEC to be to the top cop when it comes to enforcing securities laws, and added that he did not want a regulatory “balkanization.” His comments echoed statements by Congressman Oxley, and others, who are concerned about the effects of state action on the national market.

In addition to these criticisms, there are those individuals who were concerned that state actions can impede federal enforcement actions by exposing defendants to double jeopardy. New York State’s statutory double jeopardy provision protects against the assertion of Martin Act charges against a defendant who has already been prosecuted under federal law on charges arising out of the same transaction.

Federal law, on the other hand, does not prohibit the federal government from bringing charges against a

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defendant who has already been prosecuted under state law. Consequently, there is a fear is that a defendant who has already been prosecuted under state law, or who faces the possibility of prosecution under state law, will be reluctant to cooperate with federal investigators. Such a conflict nearly occurred when Oklahoma Attorney General Drew Edmonson brought charges against former WorldCom CEO Bernard Ebbers, while he was still under investigation by the US Attorneys Office.

B. Problems with the SEC

Despite its criticisms of Eliot Spitzer, it is evident that the SEC was ineffective when it came to the issue of addressing analyst conflicts of interest, and it was this ineffectiveness that gave Spitzer a window in which to operate. The SEC is charged with the task of ensuring fairness in the market, and such an objective requires substantial resources. The nature of the SEC’s duties precludes it from focusing on a single defendant for an extended period of time, such as was the case with Eliot Spitzer’s investigation of Merrill Lynch. The nationwide enforcement staff of the SEC was comprised of only 950 attorneys in 2002, and was responsible for overseeing stock markets, brokers, mutual funds, and the internet. The SEC also lends enforcement attorneys to other offices.

In May of 2002, the General Accounting Office issued a report showing how ill-equipped the SEC was for its task. The SEC’s corporate finance division, which scours reports for signs of malfeasance to turn over to lawyers in the enforcement bureau, was able to review only 16 percent of its annual

140 Adrian Michaels and Peter Spiegel, Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission, Financial Times, July 1, 2002.
corporate filings, well short of its target of 30 to 35 percent.\textsuperscript{143} The report also showed an alarmingly high rate of turnover of the staff at the SEC, which is particularly harmful at the SEC where it takes an average of two years to train new employees.\textsuperscript{144} The turnover rate is attributed to the staff being underpaid.\textsuperscript{145}

One of the central claims as to why the SEC cannot act more pre-emptively is its location in the regulatory framework.\textsuperscript{146} However, even in cases where fraud has been uncovered, critics argue that the SEC has been slow to react.\textsuperscript{147} The reason the SEC gives for their slow reactive time is that it tends to conduct more exhaustive, time consuming probes of a company’s entire operations, rather than focusing on two or three key areas.\textsuperscript{148}

While not the only reason for the SEC’s failure to catch the analyst conflicts, insufficient funding is one of the primary reasons why the SEC has been restricted in its enforcement ability. In 2002, funding for the SEC was limited to $460 million, as opposed to the $766 that had been promised.\textsuperscript{149} Harvey Pitt requested more money from the White House, but they refused, insisting that no agency get an increase until Congress passes its regular spending bills.\textsuperscript{150} For 2003, the House of Representatives approved a budget of $776 million, which constituted a 75% increase over the previous year.\textsuperscript{151} For 2004, Congress

\textsuperscript{143} Adrian Michaels and Peter Spiegel, *Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission*, Financial Times, July 1, 2002.
\textsuperscript{144} Adrian Michaels and Peter Spiegel, *Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission*, Financial Times, July 1, 2002.
\textsuperscript{146} Adrian Michaels and Peter Spiegel, *Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission*, Financial Times, July 1, 2002.
\textsuperscript{147} Adrian Michaels and Peter Spiegel, *Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission*, Financial Times, July 1, 2002.
\textsuperscript{149} Mike McNamee, *The SEC’s Cash Crunch*, Business Week, October 28, 2002.
\textsuperscript{150} Adrian Michaels and Peter Spiegel, *Crisis in Corporate America – Agency underfunded and under pressure – Securities and Exchange Commission*, Financial Times, July 1, 2002.
was expected to approve a budget of $842 million. SEC Chairman Donaldson also proposed increasing the SEC staff by nearly 25%, hiring roughly 700 new lawyers, accountants, and examiners.

Another reason offered by the SEC was the lack of criminal prosecutions for white-collar crimes. The civil enforcement authority of the SEC is not as effective in deterring fraud as are criminal prosecutions. U.S. Attorneys offices and state prosecutors generally lack the expertise and manpower to conduct complicated, labor intensive white-collar cases. Therefore, they are generally reluctant to engage in such proceedings, despite their value in deterring white-collar crime.

Another criticism of the SEC is that it is slow to create new law, particularly the method employed of making new law through enforcement actions. Roberta Karmel, former Commissioner of the SEC (1977-1980), writes that the Commission’s public reputation rests largely on its work as a prosecutorial agency. The Commission’s theory of enforcement is to prosecute institutions, whom they hold responsible for developing structures that will cause individuals to operate within the legal framework of the securities laws. She adds that rather than creating new law through rulemaking, “the enforcement staff generally shapes the Commission’s policies and develops new law through the cases it selects to pursue and the theories it utilizes in prosecuting them.” The net effect is that the SEC is usually slow to create new law.

proscribing law rather than prescribing. One reason for this method of lawmaking is because it is difficult
for the Commission to articulate new standards, particularly in the fast-paced world of securities
regulation, where the government is always in reactive mode, lagging behind developments in the
marketplace.159

Karmel is particularly wary, however, of the case-by-case method of creating new law, and
particularly wary of using novel theories in prosecutions and in SEC civil enforcement cases where there
are serious consequences for the defendants.160 Political and time constraints sometimes make this method
necessary, however.161 She believes that an agency that operates this way needs good judgment and
restraint to maintain its credibility.162 To be effective, she asserts that the government prosecutor must be
attentive to the agency’s and the public’s long term interests, and particularly to current political and
judicial trends.163 While overall, she finds that the Commission takes its obligations seriously, she is wary
of the fact that political and time constraints sometimes necessitate that prosecutors create law on a case-
by-case method.164

Thus, the SEC’s failure to pre-empt the analyst conflict of interest problem did not arise from one
source. Alan R. Bromberg, a professor of law at Southern Methodist University who has followed the
commission for more than 45 years, says there are several reasons why the SEC has lost its leadership. In
Bromberg’s view, “It’s partly because of Harvey Pitt, who came in promising to be friendlier to

159 Roberta S. Karmel, Government Lawyering: Creating Law at the Securities and Exchange Commission:
160 Roberta S. Karmel, Government Lawyering: Creating Law at the Securities and Exchange Commission:
161 Karmel blames several factors for creating an environment where enforcement attorneys must push
forward novel cases. She believes that it is a problem endemic to the administrative agency that combines
prosecutorial, lawmaking, and adjudicatory functions. She also argues that the inherent problems created
by this combination of functions have also been exacerbated by constraints put on the regulatory process in
recent years by Congress and the courts. See, Karmel, 61 Law & Contemp. Prob. 33, 42.
162 Roberta S. Karmel, Government Lawyering: Creating Law at the Securities and Exchange Commission:
163 Roberta S. Karmel, Government Lawyering: Creating Law at the Securities and Exchange Commission:
164 Roberta S. Karmel, Government Lawyering: Creating Law at the Securities and Exchange Commission:
accountants. It’s partly because of this administration, which has been friendlier to big business. And it’s partly because the agency has been starved for money and resources.”

C. The “Baker Bill”: A Proposal to Clip Spitzer’s Wings

In the summer of 2003, Congress proposed an amendment to Section 15[h][1] of the Securities and Exchange Act, titled the “Baker Bill”, proposing to protect broker-dealers from higher, specialized standards imposed on them by any state. The amendment seems to have been drafted with a view to curbing efforts by Eliot Spitzer and other state attorneys general to require additional disclosures by investment banking firms about their research analysts. The proposed amendment was a response to the warnings by Oxley, Donaldson, and others, that aggressive state actions would “balkanize” the national market.

In the end of the analyst conflict of interest case, the SEC worked closely with Spitzer to reach a settlement, and both Spitzer and SEC enforcement officer Stephen Cutler profess mutual respect and talk frequently. However, Spitzer was extremely critical when Donaldson endorsed the amendment to Section 15[h][1], stating that the SEC was again kowtowing to Capitol Hill, adding that they lack the guts to be independent. Donaldson responded by stating that there is nothing in the bill that would prevent the same kind of Merrill settlement from being reached again – the new legislation just says that if the State Attorney General is going to affect market practice, the SEC must be in the room. Spitzer is fine with

allowing the SEC into the room, but fears that the bill will restrict states' ability to reach settlements, even with local brokerage firms, if it involves changing their practices.\textsuperscript{170}

If Eliot Spitzer was primarily responsible for bringing the research analyst conflicts into the open, and for effecting institutional changes on Wall Street, why does he bear the brunt of the criticism from individuals in Washington? It is clear that there deep political and personal animosities behind the reaction to Eliot Spitzer. In the words of Alan Murray, “The investment houses hate Mr. Spitzer because he exposed their corruption. The Republicans in Congress hate him because he is a Democrat with his eyes on the New York statehouse. Many of the enforcement lawyers at the SEC hate him because he upstaged and humiliated them. None of these are very good reasons for making new law.”\textsuperscript{171} While there certainly are valid criticisms of state actions, the response to Eliot Spitzer’s handling of the research analyst conflicts has an overtly political tone that threatens to impede any efforts to improve collaboration between the state and federal government in this area of the law.

D. Can the State Attorneys General be “Reigned In”?

Lost in the political attacks and counter attacks is a more valid concern on the part of the SEC: what happens if a state attorney general does go too far in attempting to regulate the securities market? The most obvious solution, and one that individuals in Washington appear to favor, is that of pre-emption.\textsuperscript{172} State attorneys general are critical of this proposal, arguing that it would restrict long-established practices.\textsuperscript{173}

\textsuperscript{170} Alan Murray, \textit{For the SEC Chief, Fued With Spitzer is a No-Win Situation}, Wall Street Journal, July 22, 2003, at A4.

\textsuperscript{171} Alan Murray, \textit{For the SEC Chief, Fued With Spitzer is a No-Win Situation}, Wall Street Journal, July 22, 2003, at A4.


One other possibility, that has been proposed by Professor John Coffee, is giving the SEC standing to enjoin and/or invalidate any “law, rule, regulation, agreement, or other action by any state or political judgment thereof,” if such law, rule, regulation, agreement or other action “threatened in the commission’s reasonable judgment to unduly burden, hamper or impede the national market system.”\footnote{174} Coffee sees the benefits of competition between state and federal regulators, but is concerned about those possible cases where a state action is so out of line with the federal regulatory regime as to pose a threat to the continuity of the national market. His response is to give the SEC a mechanism, other than pre-emption, by which they can restrict state actions, but still allow those state actions which advance the cause of national securities regulation. There are valid concerns of Coffee’s proposal, however, such as whether the SEC, whose enforcement capacity is already limited, has the resources to monitor state actions. Professor Coffee retorts that the SEC would not have to sue to enjoin every state action, but rather would only act on the one’s that have been brought to the SEC’s attention by defendants.\footnote{175} Such measures, he argues, would also make the SEC directly politically accountable for its actions.\footnote{176} But as Eliot Spitzer has made clear, such actions would do nothing to improve the relationship between state and federal securities regulators.\footnote{177} Coffee’s proposal may be the most feasible option, however.

**Conclusion**

There are those individuals who criticize Eliot Spitzer for acting aggressively in enforcing state securities laws against fraudulent analyst practices, arguing that such actions balkanize the national market.

While there are valid criticisms of overly aggressive state attorneys general in enforcing state securities

regulation, the criticisms of Eliot Spitzer’s action against Merrill Lynch have generally not fallen under the ambit of valid concerns. While Spitzer’s use of the Martin Act allowed him to be more flexible and expedient in his action against Merrill Lynch, the Martin Act standards were not out of line with the federal securities laws: Merrill could have been charged under the federal securities laws just as easily as it could have been under the Martin Act. Indeed, the global settlement that was reached in December of 2002 took into account much of the work done by Eliot Spitzer’s office.

Additionally, it is useless for federal regulators to point out that Spitzer nearly demanded a complete separation of analysts from investment bankers: Spitzer dropped the proposal when urged by the several members of the securities regulatory industry. The SEC even considered adopting its own rule that mandated a separation of analysts from investment bankers, so the proposal was not as outlandish some would have the public believe.

The criticisms generally derive from political differences of opinion between state regulators and the federal government. Spitzer acted because he felt the SEC was not doing enough. The SEC wanted to assert its authority over governing the securities market, but could not afford to be too critical of Spitzer, as it was obvious that the SEC missed the analyst conflicts.

To be certain, there are valid criticisms of Spitzer’s action against Merrill – was it fair that he singled Merrill out for a practice that was rampant in the industry? Certainly not, but Spitzer’s office lacked the resources to investigate all of investment banks and brokerages at once, and as Spitzer would argue, the SEC did not seem like it was willing to take action. There are also valid criticisms for the argument that states and their attorneys general could “balkanize” the market if they continue to enforce state securities regulations. The reality is, however, that in the case of analyst conflicts of interest, Spitzer’s actions did not balkanize the market – they merely exposed a fraud and forced the banks to pay restitution for their actions. Spitzer would not have needed to act as aggressively as he did, had the SEC properly investigated the fraud and assisted the department of justice in prosecuting the guilty parties.

Four conclusions can be drawn from this case study: 1) the SEC needs management that will not be afraid to actually investigate and commence enforcement actions, for fear of alienating Wall Street; 2)
the SEC needs the money and resources to effectively regulate; 3) the SEC must make more of an effort to work with the states, and use them as a resource to fight against securities fraud; and 4) the SEC should be given the authority to review state actions. These reforms can only be accomplished, however, if the federal government, state government, and private regulatory bodies work together to make the necessary amendments. A cohesive and effective securities regulatory system is a real possibility, but it will take a multi-lateral effort to make this vision a reality.