

**FIRESIDE CHAT – STATE SECURITIES REGULATION
TUESDAY JUNE 22, 2004**

DONALD LANGEVOORT: Good afternoon. I'm Don Langevoort, professor of law at Georgetown University, and host of the Fireside Chats of the Securities and Exchange Commission Historical Society. The Securities and Exchange Commission Historical Society is a non-profit organization separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum at www.sechistorical.org. Today's chat will be preserved in the museum so you can listen to the discussion or read the transcript later.

Today's Fireside Chat looks at State Securities Regulation. Our guest is Christine Bruenn, Securities Administrator for the State of Maine, and immediate past President of the North American Securities Administrators Association. The remarks made today are solely our own and are not representative of the Society. Our speaker cannot give investment or legal advice. I'd like to thank the North American Securities Administration Association for sponsoring today's Fireside Chat.

Chris, we're going to talk today about what is known as Blue Sky Law, or State Securities Regulation. It's a body of law that I suspect not all our listeners are familiar with. The first comprehensive state securities statute was found in Kansas in 1911, twenty years before we had federal securities regulations, so it's the long-standing system of securities regulation in the United States. Once nearly all states had securities regulation, the natural question came, how are states going to coordinate their activities so there's not conflict or overlap, or difficulties. Congress in the 1930's faced up to this issue when it put into place a system of federal securities law, but Congress very carefully chose not to preempt state securities regulation, and instead encouraged its development and encouraged a system of what was then called cooperative federalism. So I guess the first question I want to ask you is now that we're sixty or seventy years after the federal securities laws, and coming up on a hundred years since the first comprehensive state law, what's happened, what kinds of steps have been taken at the state level to reduce the problem of conflict and overlap? There's got to be a long history there.

CHRISTINE BRUENN: There is a long history, and I think it would take more than the hour that we have here to really go into any detail, but I think the thing that sort of sums it up is the evolution of the Uniform Securities Act and this idea that we would try to the extent possible while allowing individual states to exercise sovereign power to have a uniform way of doing business, and the Uniform Securities Act of 1956 and then the revised Securities Act in '75 all tried to evolve that process, right up to a more modern evolution.

DONALD LANGEVOORT: So it was in 1956 finally we got some attempt to coordinate what the laws look like in the various states, and most states have adopted something based on either the original Uniform Securities Act or the more modern revisions we've seen in the last decade or so. Describe for me in general how a Blue Sky Law statute looks. Let's take Maine, which is your state. What power does it give you as a securities administrator?

CHRISTINE BRUENN: Right. Yes. The Uniform Act gives us sort of a few different general pieces of authority. One, it allows us to review all of the securities offerings that are going to be sold in our state. Now we've been preempted and we'll talk about that probably later, but the idea is that before a security can be sold in Maine or in any other state, it needs to be reviewed by the securities regulator or have some sort of an exemption. It allows us to review and make a determination about what firms or professionals are going to be allowed to do business in our state.

DONALD LANGEVOORT: So a brokerage firm or an investment advisor has to deal with you as well as with the SEC and NASD.

CHRISTINE BRUENN: That's right. It's sort of like having a license to practice law or be a doctor. It's a professional license and is controlled at the state level. It allows us to do on-site

exams of broker dealers and investment advisors and use the information that we find in those exams to monitor what's going on in our states. And then it has a broad range of enforcement authority, everything from administrative to civil to criminal, investigative to prosecutorial authority.

DONALD LANGEVOORT: And we're going to talk a lot today about the enforcement and prosecutorial authority that the states have, but let's talk for a minute about registration because I suspect many lawyers and people familiar with securities law would say that's the real heart of Blue Sky Law. If you want to make an offering of securities, deal not only with the SEC, but the various states in which you want to sell your securities. And you mention federal preemption, there's a story there, for a long time, states had very broad authority with respect to all different kinds of offerings.

CHRISTINE BRUENN: Yes, and I'd just like to comment on the term Blue Sky Law. As state regulators, we never use that term.

DONALD LANGEVOORT: Why is that?

CHRISTINE BRUENN: To me, it's a term that the Bar uses a lot to describe the process or the rules that they research and have to follow in order to make a securities offering in a state, and while the term has a lot of good historical meaning, we don't use it at all to describe our current law because it's so much broader than how to register a security. But I think you were asking about registration. Before NSMIA, which is the first big chunk of preemption...

DONALD LANGEVOORT: Which occurred in 1996.

CHRISTINE BRUENN: 1996, that's right. National Securities Market Improvement Act, in case anyone doesn't know the acronym. Before that time, every security that got sold in our states had to be cleared by us or qualify for an exemption that occurred under state law. After NSMIA, Congress basically took away the authority for us to make any determination about a large body of securities; the biggest would be the mutual funds. Before NSMIA, yes, most New York Stock Exchange securities, for instance, did not have to be registered in a state, but that was by virtue of state law. After NSMIA, that's where we've incorporated those exemptions into federal preemption, but that didn't really impact us as much as not being able to review those mutual fund filings and make a determination about whether they could be sold in our state.

DONALD LANGEVOORT: And one of the philosophies that Congress articulated in 1996 was the sense that the state should focus their regulatory resources on smaller offerings, as opposed to the big ones, and that's a line largely respected, but there are some curiosities in NSMIA. For example, some kinds of very small private offerings get preempted as well.

CHRISTINE BRUENN: That's right, and I think that's one of the ones that gets under the skin a little bit of state regulators. I think you have to look at those offerings almost on an individual offering level and we used to spend a lot of time looking at who were the folks that put those offerings together, what experience did they have, what kind of money were they going to collect, how were they going to use that money, what kind of fees were they taking, and I think that's a place where we added a lot of value to making sure that before our citizens were exposed to an offering, it had passed certain minimum levels and I think, in my view, that's one of the ways that NSMIA went too far in making that purely a notice filing in our states and taking away the ability to look at those more closely.

DONALD LANGEVOORT: Which provides us with a natural bridge to what we're going to talk about for most of the rest of the hour, which is enforcement, because what NSMIA's saying really is don't regulate these kinds of offerings up front, rather wait for something bad to happen and then step in, and I guess it's the bad things that happen that you all have to focus on today. Before we go to that, I want to ask one more question because this Fireside Chat is sponsored by NASAA. Explain what NASAA is and when it came about.

CHRISTINE BRUENN: NASAA, the North American Securities Administrators Association, is the oldest international organization of securities regulators. It was organized in 1919, and it's a way for the securities regulators in both the United States and the Canadian

provinces to get together and share information about issues that are coming up in our regulatory areas, to collaborate on enforcement initiatives or exam initiatives, to comment as a group on trends that we see going on in the industry. It gives us a mouthpiece to the SEC and the SRO's in terms of their rulemaking or their initiatives that they might be taking.

DONALD LANGEVOORT: So if NASAA's been around since 1919, a very distinguished existence, does that mean that there has been a very coordinated system of state securities regulation since 1919, in terms of enforcement and inspection and all of those other things? Or is it a more recent story that NASAA has come forward and really made it so that multi-state securities enforcement works?

CHRISTINE BRUENN: I think it's the more recent story. We talked about the Uniform Securities Act. I think a lot of the collaboration among state securities regulators was looser before the '80's and a couple of reasons for that. We didn't have the types of technology we have today. I think we've already started to take for granted things like email and conference calls. To do a collaborative effort pre-'80's, you had to have an in-person meeting or rely on the US Postal Service, the snail mail, and that just made broader coordination not as practical and efficient. During the '80's, we started to see a couple of things happening. One, the Central Registration Depository, fondly known as the CRD, was a collaborative effort between the NASD and NASAA to provide for one-stop shopping for licensing, which, before 1984, if you were a broker in New York and you wanted to be licensed in all the fifty states, you had to send a piece of paper with your picture and a form and a fee to each of those states. After 1984, you could file this one form with the CRD system and it would go electronically to every state, and it started that automating of licensing which in 2004, we take a lot of online licensing and processing for granted. I know I can renew my driver's license now on the Internet, but in 1984, this was just unheard of and from a regulator's perspective, it allowed us for the first time to have an index of every person who was acting as a broker, every broker dealer, and where they were, and we gradually added information there about branches and who the managers were, information about whether they'd had complaints or arbitrations or regulatory actions against them, so it provided this vast amount of information that allowed regulators to really get good information about the regulated industry. The other thing it did was in order to get on the system, we started instituting these minimum competency exams and NASAA developed the Series 63, which is the state law exam which we own, and it provided funding for NASAA, meaningful funding for NASAA for the very first time.

DONALD LANGEVOORT: So in other words, if a broker, registered rep or financial advisor wants to be qualified to work in an office in Maine, he or she has to take the nationwide test?

CHRISTINE BRUENN: Generally what happens is a broker would take that Series 63, part of that funding would come to NASAA. Before this exam, each state oftentimes had its own exam, so this is a good way to bring efficiency. It brings more uniformity to the process, and at the same time it allowed us for the first time, us being NASAA, to have enforcement conferences, or send teams of brokers like we did in the '80's out to Denver, Colorado on something we called the Denver project, to go and examine a couple of dozen penny stock firms. It allowed us to leverage the knowledge that might be in one state that had a large staff in terms of how to do examinations, or how to do enforcement actions. As a young lawyer in Maine in the '80's, I learned how to examine broker dealers by going to penny stock firms in Denver and watching folks from Connecticut and California and Florida who had a lot more experience do that and participate in that. Then I was able to come back to Maine, and I'm sure I'm not an exception, and start an exam program in a small state where we might not have had one. So it was a way to have all the boats float, or whatever that expression is.

DONALD LANGEVOORT: So maybe it's worth tying all of this together because we've thrown out a whole bunch of ideas here. In the '80's, we have the Central Depository that is going to allow you in Maine to see that somebody who is a bad guy in your state seems to have

set up shop in Massachusetts. You could talk to the Massachusetts regulators. Somebody, there was a now a basis for sharing information and ideas.

CHRISTINE BRUENN: And can I add a point to that, Don?

DONALD LANGEVOORT: Absolutely.

CHRISTINE BRUENN: I think it was also a necessity because the industry started to use the telephone and the telemarketing concept really took off in the '80's so that you could be sitting in Maine or Utah or California and the broker who was calling you and offering you a stock was sitting in Denver or Salt Lake City or Florida. They weren't respecting state boundaries. So one of my predecessors said securities regulation in Maine is not like regulating barbers. There's no relationship between the need for resources and the number of heads that need their hair cut in the state. We have folks from all over the country trying to sell to Maine investors, and so as state regulators, we needed to get a better handle on what was going on everywhere, not just in our own jurisdiction.

DONALD LANGEVOORT: And you used the phrase penny stocks, and Denver and Salt Lake City. That's not happenstance, either. There's a long history to things, matters states have particularly been interested in with respect to the kinds of scams, boiler room operations that fly often under the national radar screen, set up locally, exploit people. Explain a little bit about how investors get hurt in those kinds of scams that would lead to something like the Salt Lake project or the Denver project. What is it we're going after here?

CHRISTINE BRUENN: What we saw in the '80's was some pretty outrageous conduct. We would go so far as to call these boiler rooms. A lot of young people recruited without any experience in the brokerage industry, given scripts and taught how to do a hard sell of securities that were, the securities often were being manipulated, the markets were being manipulated, and the brokers had scripts where...

DONALD LANGEVOORT: And these were tiny, largely unheard of, stocks?

CHRISTINE BRUENN: Right. They were stocks you'd never heard of before, and one of their selling points were they're a penny stock. You can buy these for one cent a share or five cents a share. Of course you had to buy a hundred thousand shares to make it meaningful, but some of the scripts we saw in those days would have, you know, you have to make a decision now. This is, we've only got so many shares of this. You have to make, the deal's going to close at the end of the day. We have inside information that it's going to go through the roof by next week, and when people resisted, they had all kinds of responses. Playing on male egos, my favorite was who wears the pants in your family? You don't have to check with your wife before you can make a commitment to buy this security. So they really engaged some outrageous practices. I guess the granddaddy of them all was Blinder Robinson, that started business in 1982 in Denver, and so from there we see dozens of these Blinder spin-offs starting and the states in this time period are starting to band together to go to Denver, Salt Lake and do combined exams and see if we couldn't get a handle on who these people were and try to find aspects of state law that we could use to shut them down. Sometimes it was as easy as finding unlicensed broker dealers or brokers and going at them from that perspective, but just as fast as we'd shut them down, five or ten more would spring up.

DONALD LANGEVOORT: So you as a Maine securities regulator went to Denver or Salt Lake City to learn about how a coordinate process of inspection and enforcement works, and obviously that process was very important in helping develop communication. You got to know people in this world of state securities regulation and the lines of communication got opened that hadn't been opened before.

CHRISTINE BRUENN: Yes. I'm glad you put it in those terms because that's exactly right. It allowed us to meet each other in the other states, and you started to see certain leaders evolving in terms of states that were particularly good at this, but it also was the beginning of some pretty good partnerships and relationships with the NASD and the SEC in terms of sharing information about these penny stock brokers, and also forming sort of a collaborative

spear because the actions were so outrageous that it sort of unified all the regulators in their efforts to want to put an end to this.

DONALD LANGEVOORT: Explain how that happened. How did the SEC, I can understand how NASAA sponsored a coordinated effort among the states, were NASD and SEC people simply invited to sit in and discuss and share ideas? Is that how it happened?

CHRISTINE BRUENN: We started having annual enforcement conferences on the NASAA side and we always invited heads of enforcement at the NASD and the SEC, and it gave rise to some relationships, so that people called each other in between times, and also was the ability for regulators to share tips and information about trends that they were seeing and just try to work a little more closely together.

DONALD LANGEVOORT: So, the groundwork was laid by these kinds of projects for more cooperation and what you're really telling is a technology-based story.

CHRISTINE BRUENN: Yes.

DONALD LANGEVOORT: Once there were ways of communicating and relationships got built, then communication and cooperation happened much more easily than it had in the past.

CHRISTINE BRUENN: As state regulators, we always say we're the ones that are closest to the investors, and in a way it gave us the ability to close a loop with the federal regulators using communication, so that we could take what they were seeing on a national market-wide basis with what we were hearing from our local investors and put that information together.

DONALD LANGEVOORT: And that's an important point. We're going to come back to this later on, but there is a way in which you sitting in Maine may have a better feel for what's going on in some of these kinds of cases than somebody sitting in Washington would, simply because people can get through to you a little bit more easily than they might to somebody sitting in a big agency.

CHRISTINE BRUENN: I think that's one of the great selling points for state securities regulation, really, is that any citizen can pick up the phone and call and get me and we often have one investor walking in with a bag full of account statements saying I have a problem here, and we have the ability to try and sort out, one investor at a time, their problems. I think the larger regulators have to go on numbers. They have to wait for certain numbers of complaints about a certain topic, or a certain dollar amount of losses before they can focus on it. We find that by hearing the collective stories of individual investors, we often hear things faster and can respond faster, and I think you can see that even in the early days, in looking at the penny stock issues, we were, I think it was, I'm trying to think, well, one, in 1989, NASAA did a resolution, which is basically a collective pronouncement saying that blank check, blind offering pools were fraudulent practices, and then you see in 1990, Congress actually passing the Penny Stock Reform Act. So, I think these issues are being raised and looked at on sort of parallel tracks at that time, with some information going back and forth. Some other examples of that would be later on when we start looking at limited partnerships and the rollout problems that we saw, you see NASAA coming out and saying there's a problem here, and then shortly after that, Congress passing some legislation or doing some hearings.

DONALD LANGEVOORT: Right, and I think Internet securities fraud is another place if we move forward in time, where the states, in many ways, got there first.

CHRISTINE BRUENN: That's right. In 1996, which is jumping forward just a little bit, the state regulators were the first ones to issue interpretive guidance on how you could use the Internet to sell your offering without being deemed to sell unregistered securities in our jurisdiction. And shortly thereafter, the SEC issued interpretive guidance at the federal level, which largely followed the model that the states had set a couple of years earlier.

DONALD LANGEVOORT: Okay. Let's wind back in time. I guess if we're looking for big events in the federal/state relationship, or cooperation among the states, we come to a series of

major enforcement actions that happened involving some of the nation's biggest brokerage firms. Tell that story and how the states came to be involved in cases like Salomon and Hutton.

CHRISTINE BRUENN: Yes. I think against that backdrop of having some funding now to do multi-state cases and communication sort of improving, conference calls coming onto the scene, the states started to do collective cases, and at first, I would call these sort of piggyback, or sometimes we call them "me too" cases, where, for instance, in the Hutton instance were they had had the convictions on check kiting, because those were criminal violations under state law, that could be a disqualifier from being able to do business in a state under the Uniform Securities Act, and so what happened was the states approached Hutton and said, you know, you've got a problem with us, too.

DONALD LANGEVOORT: So this is after the SEC had taken the lead on this particular matter? But the states saw that they had a role by itself.

CHRISTINE BRUENN: After they had revolved that matter, and you'll see it again in the Drexel, remember the Drexel cases, where there had been some resolution at the federal level without really any communication between the states and the SEC on how that would get resolved, and the states coming forward and saying well, you've got a problem with us, too. So this is kind of, I'd say it's the beginning of the collective cases by the states, but largely following on something that the SEC had done.

DONALD LANGEVOORT: So the SEC identifies a violation. The states step forward and say it's something more than a federal securities law violation. If you want to do business in our state, of course, you're not going to be a brokerage firm unless you're qualified to do business in the various states. You have to settle with us, too, or face some kind of remedy.

CHRISTINE BRUENN: Correct. And the firms started to see that if they didn't come to the states as a group, what would happen is one or two states might file actions and that would be tougher on them than if they sort of initiated some way to resolve it with all the states. In some of those early case, the firm actually had to go state to state to state and say, you know, I've resolved it with these six states this way, can I get you to go along with this, too? One of the big cases was with Salomon which was with the Treasury bond cases and that was unique in that it was resolved also with Salomon contributing to the Investor Protection Trust, which was a non-profit set up by the state regulators to fund investor education initiatives. And so we started to see the importance of investor education rising because we had some funding to spend on it, and the firms sort of more willing to fund that type of effort than to pay more in a fine.

DONALD LANGEVOORT: Now was there an effort in cases like Salomon and Drexel by the states to improve the process of coordination, or were states by and large happy to be negotiating individually and extracting their bits of remedies?

CHRISTINE BRUENN: I think both. I think there was some recognition on the states' side that we might do a better job if we coordinated and did it in a uniform way. There was also some pushback at this point from the firms and the law firms they hired saying this is ridiculous and expensive to have to go one state at a time and negotiate these unique deals for each state. You all basically have the same cause of action, even if it would be in different jurisdictions. Can you not get together? So you start to see these collective task forces set up, sometimes with some contact with the SEC, sometimes not. I think the first really big one and sort of a watershed case was the Prudential Limited Partnership case, where the state regulators probably had their finger on the pulse of this sooner because individual investors were calling and saying this is what's happened to me. I've been wiped out.

DONALD LANGEVOORT: You might explain what the Prudential case was all about and how the investors felt they were.

CHRISTINE BRUENN: Yes. Prudential was an interesting case in that if you were a state regulator and you got a complaint about someone selling you a limited partnership that said it was just as safe as a CD or it was going to return this really strong return on an investment, something that was out of proportion, even for the early '90's. You might think you

had a rogue broker or a rogue branch office, but as the states looked at this more closely, it led right back up to the top of Prudential, and the way they put together the Prudential limited partnerships, they were fraudulent right from the beginning and right all the way through, and it was just because it was Prudential, nobody really believed that or caught onto that for quite sometime.

DONALD LANGEVOORT: Explain how that investigation evolved. Were various states independently being visited by investors who were making these complaints? Did NASAA put in motion a coordinated effort to do this investigation, or were a lot of people doing the same work at various places around the country?

CHRISTINE BRUENN: Well, since we do the enforcement conference once a year, we have the opportunity, even if we're on separate tracks, to bring it together at least one time a year, and I think that's what was happening in the late '80's and about 1990. All of a sudden, states individually were seeing this rise of complaints about Prudential limited partnerships. Then there was an enforcement conference where one person raised the issue and all of a sudden, a lot of hands went up and said yes, I'm seeing this, too. I'm seeing this, too. And the NASD and the SEC were at that meeting as well, and there was a determination made to do a sort of loose collaboration, the states carrying forward on their investigation of the individual investor complaints, and the SEC taking off the piece of investigating the firm and what was going on at the top and amongst the managers. And that was, I think, the first time we see a true collaboration in the investigation and settlement. Up until that time, there had been investigation by the SEC we piggybacked on, or investigations by the states but not resolutions sort of individually. The Prudential case is a big fraud. It's more work that any one regulator can do. There's recognition that we need to try and pull this together, and at the same time, these are like foreign worlds meeting each other. Once they get past the nice conversation about tips and information, all of a sudden you have to try and coordinate, well, who's going to talk to this person and who's going to make the judgments about what it all means? Who's going to make the decision about how this case should be resolved? And Prudential, I think, formed an opinion that the SEC was going to be easier, that they would allow them one, that they had a bias in favor of letting them stay in business, where as a couple of those...

DONALD LANGEVOORT: Because they were so big?

CHRISTINE BRUENN: Because they were the SEC and because it was Prudential, such a big, iconic member of the market that they weren't going to let The Rock go out of business. Where as there were a couple of wild-eyed state regulators who had interviewed enough investors and said this is the same kind of stuff we shut down penny stock brokers over. Why shouldn't we shut down Prudential? It's the same high-pressure marketing, same outrageous promises. It's fraud, same fraud.

DONALD LANGEVOORT: And I want to go into this a little bit because we have the potential for 50 or so state regulators having different points of view on what the right thing to do with the Prudential is, and it would seem to me there'd be a lot of room for disagreement and it would be very hard to come to a consensus, even among, forget about the SEC for a minute, even among the states. How did that process get worked out? I mean, it was ultimately a successful effort. I'm curious to know how the wild-eyed group got reined in, so that you could get to an acceptable agreement on this deal.

CHRISTINE BRUENN: Well, we formed a task force, and appointed administrators from a number of states to be on that, and they represented different groups. Some of them had a lot of complaints, like Arizona and Idaho had already had a lot of complaints. Some of them were sort of the old (they would hate it if I called them the old and wise group) but they were the elder statesmen. The people that everybody looked to and thought had good judgment and good knowledge, folks like Lou Brothers and Don Saxon from Florida, Lou Brothers from Virginia. And that had the effect, I think, of helping the group collectively feel like there was a plan and there were good people who were both the energetic enforcement "we're gonna get 'em" types, and

the more measured folks who had the longer perspective and that they would reach a good arrangement. The other thing that that case was interesting, too, unique in that for the first time, the states sent out questionnaires to a very large sampling of Prudential investors to try and sort of quantify in a more scientific way exactly what had been invested and how those investors thought they had been wronged. So that evidence coming together allowed, it all came to one place, so it allowed that sort of coordination and collaboration at a more universal level. And I don't want to lead you astray. There were always states on the sidelines, especially as it got towards settlement that said I want a little bit more or I'm a little unique or there's something, some reason why we shouldn't participate in the collective, global settlement. But in the end, those things got worked out.

DONALD LANGEVOORT: And it was a matter of leadership from this group that pressured the states that might have considered defecting to stay with the program?

CHRISTINE BRUENN: It was. It was clearly leadership. It seems at the right moment, the right people came forward with the right message and were able to unify the group to come up with one common answer. And as you said, it became more complicated because we were working with the SEC and they had their own ways of doing things and their own perspectives and Prudential had this sense that they could settle with the SEC because they were "more reasonable," and they entered settlement negotiations with the SEC and even reached a tentative settlement and sort of presented that to the states as though, okay, this is the settlement. And the states' response, even from the measured, more laid-back state administrators was forget it. You haven't negotiated with us. We haven't been part of this. And the firm tried to say, well, we always had an empty chair for you at the table, which was besides being pretty funny, is insulting and rather arrogant, and if anything, it fed the idea that the states needed to reach their own settlement based on their own judgment, and what ended up happening was more collaboration between the SEC and the states in terms of how that ultimate resolution was going to come along. And some of that was frustrating. There was one report from somebody who was there at the time about one of the SEC attorneys calling the states fifteen nibbling ducks, and that sort of captures that idea of if you're the SEC, you can't just negotiate with one group that calls itself the states, even though we work through NASAA, we're each sovereign states. And sort of this sense of we're the SEC, who are these people and why do we have to deal with them? And then the state side of it being, you know, we're the ones who have been interviewing these investors. We know how bad the harm is and we're not going to go away until we have a restitution fund that we can live with and we're willing to yank the ticket, take away the license of Prudential if we have to, to get there. In that way, the states provided leverage, I think, to the SEC, and we ended up with from a state securities regulators perspective was a great settlement, over a billion dollars being paid in restitution to investors.

DONALD LANGEVOORT: In fact, what was created was an open-ended restitution fund in which investors could make their claims before an impartial team of arbitrators, evaluators, and whatever the amount came to, Prudential was obligated to pay.

CHRISTINE BRUENN: That's right, so no matter how tough it might have been to get all those regulators to resolve and come out on one page, ultimately they did. The states all settled, and investors really came out on top in that one.

DONALD LANGEVOORT: So Prudential must have been a big step forward in getting everybody's attention that when there is a big securities fraud, there is a state component to this, as well as a federal component, and also, I assume, in solidifying some relationships between the SEC and the NASAA people and state regulators. Did the states come away with this more comfortable that they could go to the SEC with future cases and there would be a cooperative relationship?

CHRISTINE BRUENN: I think so. The state folks who were on that task force came away from it feeling like they had demonstrated that they were professional, not amateurish securities regulators, and that they could be effective in these types of situations. I think that the

relationships, it established a certain level of trust between the individuals who had been involved, and I think from thereafter, we see large cases, it's hard for the firms to settle unless they have both the SEC and the state regulators willing to sign, to sign on.

DONALD LANGEVOORT: So we owe from Prudential, which is in the early to mid 1990's through the stock market boom of the late '90's, which I think everyone regards as a time in which securities enforcement was not a big issue...

CHRISTINE BRUENN: Funny, there aren't any really big cases in that time period.

DONALD LANGEVOORT: Right, because everybody's making money.

CHRISTINE BRUENN: Covers all the mistakes.

DONALD LANGEVOORT: And yet, at least in retrospect, we start seeing things that are of interest, that what were called penny stocks in the 1980's become micro caps in the 1990's and the gold mining and uranium of the '70's and '80's become dotcoms in the '90's, but, surprise of surprise, we hit the crash of 2000/2001 with the popping of the tech stock bubble, and we come to a new round of enforcement actions where the states come back into the picture.

CHRISTINE BRUENN: Turns out everything wasn't so grand during that time period after all.

DONALD LANGEVOORT: Not surprising at all. Well, I guess our next round and what really has focused a lot of people on the presence of state securities regulators began when Eliot Spitzer, the Attorney General of the State of New York, stepped forward in, with evidence, emails and various things, that he said showed that there was a bias in the big investment banking houses as they were doing their investment research work, and Eliot Spitzer said, among other things, the SEC must have been sleeping here because look what I found, but stepped forward insisting on a very aggressive enforcement action against those firms. Before we go any further, I guess it's worth noting for people that New York is one of those states that is not the typical Uniform Securities Act state, but rather, the Attorney General of New York works with the Martin Act. How's that different from what you have?

CHRISTINE BRUENN: I won't claim to be an expert on that Martin Act, and I'm sure Attorney General Spitzer's probably going to disagree with what I say about it, but I think it's not as strong as the Uniform Securities Act because it's an anti-fraud statute, which the Uniform Securities Act has anti-fraud and this wide range of administrative possibilities, everything from examination authority to cease and desist authority. There's a lot of different ways to resolve something other than, you know, hitting them over the head. I think what, why Attorney General Spitzer's been so successful is he has the securities operation in his office and he's both the person who interprets the laws and prosecutes them, and so he's been able to take an issue, and he was right on target with the research analysts, and he's done a terrific job of highlighting something that needed to change, but his...

DONALD LANGEVOORT: Explain a little bit just so that everyone is aware, the exact nature of the concerns, the complaint against the investment banking firms that the states moved forward on.

CHRISTINE BRUENN: The cases ended up focusing on the fact that research analysts, the people who are putting out the buy/sell ratings were being influenced by investment banking. Most of the money in these big brokerage firms was being brought in by investment banking, again it's the booming '90's, the dotcoms, we have an IPO a week, you can't even keep up with who's doing the gavel at the New York Stock Exchange, and the firms were making a lot of money bringing issues forward, and the relationships between the two parts of the business became so intertwined that the research analysts really became part of the marketing effort of the firm to get the next big investment banking piece of business. And it affected whether they said buy or sell or hold, depending on what kind of business they had gotten from the firms. We saw cases where there was actually outright fraud, where someone issued a rating that they didn't believe in because of investment banking, all the way to the other

end of the range where these large firms were allowing their two, their departments to be so overlapped that it allowed the potential for very serious conflicts of interest.

DONALD LANGEVOORT: And what became famous in terms of the evidence that was uncovered to support those claims was a series of emails.

CHRISTINE BRUENN: Yes, technology comes around again.

DONALD LANGEVOORT: Yes, it becomes one of the themes in this whole story. So Eliot Spitzer, and certainly jurisdictionally being the Attorney General of the State of New York where the big investment banking firms are located, insists that something be done, and in fact is prepared to take this case. He sort of threw down the gauntlet to the SEC. From the standpoint of another state securities regulator, what was your reaction to how this case got built, in terms of, you know, we've just finished talking about Prudential and a series of actions in the late '80's, early '90's, where there seemed to be a very cooperative working relationship that had been built and good personal relationships that had been developed. This seemed to be confrontational, so I guess what I'd like you to do is get into that story a little bit.

CHRISTINE BRUENN: I think this case broke the rules as we had come to see them, which was that you have one regulator very publicly saying that another regulator had dropped the ball, asleep at the switch, whatever phrase you want to use. Our differences with the SEC in the past had been in rooms by ourselves, from one regulator to another. It was unheard of for somebody to go to the media and say another regulator had failed in some way. So we got off on a bad start here. That's not the way to start a collaborative effort by going into the *Wall Street Journal* and the *New York Times* and *Washington Post* and saying the SEC failed. So that was a rough beginning. As a state regulator, which Eliot Spitzer is, his agency is a member of NASAA and whether we liked the way he was going about it or not, was not as important as the fact that he had found something very important, serious, and that there were indications it wasn't just one firm. It wasn't just Merrill Lynch, and it needed to be investigated, and to do that kind of investigation was going to need a collaboration of many states, and so, very shortly after the Merrill Lynch case came together, the rest of the states through NASAA came on board in terms of forming a task force of state regulators to try and tackle the subject marketwide, and we ended up with twelve different investigations with participation by forty-five states. And so you had a lot of, Eliot's group took on Salomon Smith Barney and Morgan Stanley, and of course they did Merrill Lynch to begin with, but all those other firms, the rest of them were investigated in the efforts were of teams of other state regulators who went out looking for, you know, subpoenaing those emails and going through them to see if there was evidence of these conflicts of interest or fraud.

DONALD LANGEVOORT: So you had many, many states actually physically doing the investigations, taking the testimony, looking at the documentary evidence and things like this. What about the SEC? Where was it in this process of investigation?

CHRISTINE BRUENN: Well, I don't think you can say SEC, you were asleep at the switch, and expect them not to have some big reaction, and so their reaction was to put a lot of their resources into doing the same kind of investigations we were doing at that time, going into the top ten, the largest firms, and looking at their email, and we had a very competitive atmosphere there at the beginning, in terms of them not wanting to be shown up again, and trying to recapture their preeminent regulator position. And so, for a period of months, we had a lot of these parallel investigations going on, with the SEC leading investigations by the New York Stock Exchange, the NASD, and of course the SEC staff on the one hand, and NASAA now getting together and taking on the responsibility for these other investigations with participation by New York.

DONALD LANGEVOORT: And yet it was a competitive process as opposed to a coordinated one. Was that because of the tone that was set at the beginning? Do you think had a different tone been set you would not have had that level of competition?

CHRISTINE BRUENN: It was such a unique circumstance, so many firms, such outrageous behavior, I don't know that you wouldn't have had some competition anyway, but certainly the way this got started, the environment was a pretty big hurdle to overcome in the beginning. There was communication. There were regular phone calls and I think securities regulators, even when they're competing, can't help sharing some information about we've looked at these kinds of frauds, or we've figured out how to look at these analysts or this sector or look for these dirty words in emails because they're almost always connected with some conversation about their ratings. There was some collaboration going on, but not nearly at the level it should have been, or maybe would have been if we hadn't started out on the wrong foot together.

DONALD LANGEVOORT: I'm curious whether what we say obviously is the states taking a much more activist role in the '90's and certainly in this round with respect to securities regulation and that can certainly connect to the standard investor protection purposes that have been behind state securities regulation for a long time. Is there also an element here in which states have come to realize that they have a lot of money at stake in the stock market? State pension funds, state treasurer's office, where if you have research bias affecting stock prices, it's not only citizens who've been hurt, it's the state itself. Has that affected how state securities regulators see their role?

CHRISTINE BRUENN: I don't think so. I think what it's lead to is some more activism by other state officials, the treasurers taking a stand on the standards they want applied. The attorney generals looking at Eliot Spitzer and saying, is there a role for me, too. As a state regulator, our focus has been, is, and will continue to be what's best for the investor. Most of our group are career lawyers. Investigators who have been regulators care passionately about protecting investors and will continue to do that as this era fades away and we find other ways of working with the SEC, trying to come up with a framework for the next big case that comes along.

DONALD LANGEVOORT: So, now to get back to our story with respect to what becomes the global settlement in the research analyst cases, rather than waiting for a global settlement, Attorney General Spitzer moved quickly against Merrill Lynch, was able to negotiate a settlement with them that I think is seen largely around the street as a benchmark to which others would have to face, which I suspect created a large amount of anxiety on Wall Street about what it means now to be fighting battles with the states, with the SEC, who seemed now to be competing with each other. How did we finally get to a global settlement? How did we move from the competition you were describing before to a place where in the end for \$1.4 billion, I believe, the case was settled comprehensively.

CHRISTINE BRUENN: I think we all, and by we I mean all the regulators including Attorney General Spitzer, realize that this wasn't good for the market, that the competition maybe had been a good way to get started. We had divided up the work, but really, to fairly resolve this, we needed to bring all of that work together and come up with a unified response to this. As state regulators, we have been concerned for some time about further preemption. We'd seen an initiative by the Morgan Stanley to get a bill introduced to preempt us in early 2002. We were worried about vulnerability, if we didn't come together with the SEC on a resolution. Attorney General Spitzer came to the conclusion that this needed to be unified. We ended up with settlement discussions with the states being represented by NASAA primarily and that's where my personal role came in as NASAA's President, I was our point person, but New York had its own seat at the table because of the role they had played in bringing these cases about, with the SEC, the New York Stock Exchange and the NASD coming together and deciding that we needed to have one way of resolving this, and we had to overcome some obstacles, like do we do restitution, do we do fines? How fast can we do this? How do we compare the apples and oranges of these investigations to come up with a way to figure what fine a particular firm will pay? Exactly what are the details of separating the structural issues,

research banking, research in investment banking? We came up with this innovative idea of providing independent research, which will only go into affect next month, in July of '04, so that's yet to even play out and see how effective that's going to be.

DONALD LANGEVOORT: And one of the tough issues that you had to face was what's \$1.4 billion was created with a combination of disgorgement, restitution and fines, what was going to be done with the money, and that's something, I take it, the states didn't quite see eye to eye on.

CHRISTINE BRUENN: Our tradition has been that once we make the resolution and come up with a settlement amount, it's up to each individual sovereign state to determine what they do with their penalty. Some will do restitution if they can. Some will fund various good efforts. Some will put it into the state treasury. We followed that model really in this global settlement by saying okay, half of this is going to be the federal amount. You, the SEC and the federal government, you can do whatever you want with it, and they made a determination to set up a restitution fund. The states looked at the restitution issue and said we don't think this can be done in any meaningful. We think it's going to be too hard to identify the investors. We won't be able to determine how much, what their damages are and we're not going to be able to get, even with this over a billion dollars, it's not enough money to make meaningful restitution. So we went with our traditional model, which was each state got a check and did what they want to do with it. In Maine, it went into our state treasury. In Missouri, I think they contributed to the federal restitution, and in another state, I believe it was Nebraska, they chaired a law school professor position, and it was just left up to each jurisdiction to make that determination.

DONALD LANGEVOORT: To what extent, do you think that gives us a model for the future? Do you think as whenever, and I guess the mutual funds scandal has provided us with the next round of cases and certainly there has been a lot of state activism with respect to reaching settlements, seeking criminal prosecutions against various participants in the market timing and late trading debates, would you say from now on the drill is going to be if there is a substantial nationwide fraud, NASAA and the states are going to step forward and say we have a place at the table, such that global settlements are going to become the norm and that nobody's going to walk away from a big fraud without satisfying the state constituencies as well as the federal government? Is that now fixed? Is that our template for the future of securities law?

CHRISTINE BRUENN: Yes and no. I think that has been the template for, you know, the last decade or so. I think the global settlement made us all realize, all regulators realize that we needed to have, we needed to have some understanding about this and it lead to us forming what we call the Initiative, the State/SEC Initiative, where we meet regularly with the enforcement folks at the SEC and talk about what kind of cases are you doing? What kind of cases are we doing? Are we duplicating each other's effort? Is there a good public policy reason for duplicating each other's effort? Can we divide up the labor? Can we leverage each other's resources? I think if you're looking at a big fraud, a big market-wide case that involves fraud that can be traced to having some effect on individual retail investors, yes, you can bet the states will be right there saying we regulate the securities markets in our states and we have a right to have a say about how this matter gets resolved. At the same time, I think there's a willingness on the SEC's part to sort of, to work with us and to recognize that role and to try to come back with some common response so that we're not working against each other. We're not eliminating competition here. It's not a perfect system. We barely had time to catch our breath between research analysts and the mutual fund. We haven't worked, we haven't worked through all the issues, but I think there's a willingness on both sides to keep whittling away at it and to try and find the right answers.

DONALD LANGEVOORT: You mentioned before efforts to preempt the states and obviously that was one of the big stories this past year in the aftermath of the global settlement, concern that states really shouldn't have this role in setting policy as to what good and bad

behavior is and what the consequences should be of misbehavior, and certainly the cooperative effort of the task force is an effort to show everyone that this is not a dangerous out-of-hand system, but rather a coordinated exercise in cooperative federalism, to use the phrase. Are you confident that this is going to answer the critics who have said the states may have a role in protecting retail investors, but when it comes to things like policies and procedures at nationwide or worldwide securities firms, they ought to step back?

CHRISTINE BRUENN: I think we demonstrated in these cases, the value of that complementary state and federal system. The fact that the states are the early warning system, we are closest to the investors, we were able to spot a problem early on and bring attention to it, we do act as a counterbalance to the SEC's perspectives on how different regulatory matters ought to be settled. I think if anything we made the case for state securities regulation. I think it's a robust system. I think we ought to put the money and resources into making sure all the regulators have what they need to do their jobs well and I hope that we've demonstrated it's a healthy system that ought to be continued for another hundred years.

DONALD LANGEVOORT: And with that, we're going to have to stop. Thanks, Chris, for our discussion.

CHRISTINE BRUENN: Thank you, Don.

DONALD LANGEVOORT: Just a reminder, today's chat is now archived in the Society's virtual museum so you can listen again to this discussion. Transcript of today's chat will soon be placed in the museum. Next time, our Fireside Chat will focus on forensic accounting. Our guests will be James Barrett and Ernest Ten Eyck of FTI Consulting, Inc. The chat will be sponsored by FTI. Join us Tuesday, September 21st at 2 PM Eastern Daylight Time. Thanks for being with us today.