TESTIMONY OF WILLIAM FRANCIS GALVIN

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Financial Services Committee

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I am William Galvin, Secretary of State and chief securities regulator of The Commonwealth of Massachusetts. I want to commend Representatives Frank and Bachus for calling today's hearing to examine the causes of the failure of the market for auction rate securities and potential ways of making our regulation of the securities industry more effective. I submit this testimony based on my experience as the head of the Massachusetts Securities Division.

Today, I would like to briefly discuss the findings of the Massachusetts Securities Division's investigations into UBS's and Merrill Lynch's sales of auction rate securities to retail and other customers, lessons learned from those investigations and our investigation of Bank of America, and proposals for preventing such problems from occurring in the future. Specifically, the five themes I believe arise from the auction rate debacle are (1) that conflicts of interest need to be more aggressively monitored and, when appropriate, disclosed to investors, (2) that financial advisor incentives need to be disclosed and financial advisor training needs to be enhanced, (3) that supposedly objective research reports need to be more tightly regulated, (4) that principle-based regulation is not effective to prevent a scandal such as this one, and (5) that state regulators, in conjunction with their federal counterparts, need to continue to be actively involved in enforcement actions I believe that the need to ask ourselves difficult questions about how we can make our regulatory system more effective is especially important given this week's market events.

A. <u>Brief Description of UBS Complaint</u>

In June of this year, my office filed an administrative complaint against UBS, based on an investigation that exposed a conflict of interest between UBS and its customers and the devastating effect that this conflict had on those customers, who were not apprised of the conflict and how it was affecting UBS' actions and recommendations.

Beginning in mid-February 2008, the Division began receiving scores of telephone calls from shocked and outraged customers of UBS who were sold instruments that they were told were safe and liquid. These instruments were often pitched to clients as money-market instruments or cash alternatives, and the client was told that they would have access to cash at the next auction period, which was typically 7 or 28 days. These instruments were auction rate securities ("ARS"), some of which were listed on UBS's customer statements under the titles "cash alternatives/municipal securities" and others as "cash alternatives/money market instruments."

The common theme of all of the customers that contacted the Division was that the money UBS placed into ARS was intended to be their safe money and that it would be 100 percent principal-protected and completely (subject to the 7-day or 28-day auction delay) liquid. Investors that purchased those securities ranged from retirees, who sought to invest their money in ultra-safe, liquid investments that they could access if they needed the funds, to small business owners who needed to park operational cash in highly-liquid instruments to be accessed upon short notice for continuing operations and upcoming projects.

Those investors were not told that the auctions were not, in fact, true auctions. They were not told that UBS submitted a support bid for every auction for which it was the lead or sole broker-dealer to ensure that the auction did not fail. They were not told that UBS itself set the interest rate in most of the auctions with the bids it submitted. They were not told that UBS actively managed the interest rates so that they would be just high enough to move the ARS it had underwritten but not so high as to make the issuers that were its underwriting clients unhappy. They were not told that the only products offered to them were products that UBS had underwritten and was trying to distribute. They were not told that in August 2007 UBS intentionally let certain auctions fail because there were not sufficient buyers and UBS did not want to own more of the ARS paper that it was trying to auction off.

UBS retail clients were also kept in the dark about the dangerous increase in auction rate security inventory that UBS was carrying on its books beginning in the Fall of 2007 and continuing through to February 2008. They were not informed that UBS' short-term desk had exceeded, multiple times in 2007 and in early 2008, the amount of capital it was authorized to use to support the auctions, and that the auction rate desk was forced to repeatedly request an increase in that cap. They were not told of the extreme efforts that UBS made to decrease its inventory of ARS at the insistence of its risk management department—and they certainly were not told that sales to them were the cornerstone of UBS' inventory-reduction program. UBS failed to inform its clients that beginning in the Fall of 2007, certain ARS, which UBS had structured and brought to market, were approaching their interest rate caps and were in danger of becoming unmarketable. Moreover, clients were not informed that beginning as early as September 2007, UBS was actively considering scenarios which included pulling out of its auction program altogether.

In the months following August 2007, UBS became increasingly concerned about the viability of its auction program and structural flaws in certain ARS, and began to debate pulling out of its auction market program. Numerous emails from insiders at UBS indicated an increasing awareness of the vulnerabilities of the auction market and the increased likelihood that UBS would consider pulling out of the market altogether. For example, in a September 6, 2007 email, the Global Head Municipal Securities Group and

Head of Fixed Income Americas at UBS Securities at UBS stated in an email that he "is under severe inventory pressure from client base in the auction rate markets" and he is having "legal looking into options to EXIT some business lines (to resign from supporting the programs that we have been senior manager on for 5+ years) to accommodate our firms request and what our liability in the marketplace/WM and reputational issues with issuers as well as investors would be." In another email that day, he stated, with respect to the auction rate product: "I don't want to service this product either –quite frankly and am happy to responsibly dispose of it---we are trying for sure."

In an October 31, 2007 email, that same insider referred to the auction rate program as "a huge albatross." In a December 11 email, a senior manager on UBS's Short-Term Desk sent an email acknowledging that "the auction process is flawed" and saying "I think eventually most of the book needs to be converted as the auctions aren't going to come back." Likewise, UBS' Risk Management Division also understood the dire straits that the auction program was mired in. In a December 11 email from risk management stated that: "we need to be totally comfortable from a credit perspective on all of the assets that we auction if we are going to support auctions." Even the investment banking group realized the fundamental foundations of continuing the auction rate program were in jeopardy. On December 12, the person responsible for overseeing underwriting public finance for UBS Securities, sent an email warning of "the continued deterioration of the auction rate market." Similarly, on December 12, the senior manager on UBS's Short-Term Desk referred to above sent an email stating: "the entire book needs to be restructured out of auctions" and an email stating that "[t]he auction product does not work and we need to use our leverage to force the issuers to confront this problem our options are to resign as remarketing agent or fail . . " On December 15, 2007 Global Head of the Municipal Securities Group and Head of Fixed Income Americas sent and email to UBS Securities' Chief Risk Officer indicating that he "will need some guidance from you as well as [Deputy CEO Global Wealth Management and Head of Wealth Management US] in terms of our overall position and philosophy as it relates to continuing to support these auctions. . . . . What is clear is that the fundamental mechanism of the [ARS] structure is not working in a liquidity squeezed environment..."

The same vulnerabilities in its auction rate program that were troubling UBS were causing some corporate cash clients to shun those specific instruments and were putting substantial pressure on all of UBS' auction rate instruments. As its awareness of these problems increased, UBS also had to step in with more and more of its own capital to make sure that auctions cleared, thus allowing it to continue its lucrative business of underwriting ARS through the end of 2007. In order to offset this inventory buildup, UBS began an all-out effort to market ARS generally and, in particular, troubled student loan-backed auction rate certificates (which had interest rate caps built into them that began to render them unmarketable). This marketing effort was considered necessary in order to offset sales by investors (generally corporate cash managers) who began to become uncomfortable with these instruments and thus to keep the auctions functioning without UBS extending more of its capital to support them than its risk management department was comfortable with. UBS's Global Head of its Municipal Securities Group and Head of Fixed Income Americas stated, as the justification for these marketing campaigns, that he was "under a lot of pressure to move paper." He was being told by risk management that "we need to beat the bushes harder than ever to unload this paper." However, in order to keep offloading its inventory of ARS, UBS kept purchasers in the dark about the very vulnerabilities of its auction rate program that UBS had discovered.

In and after August 2007, UBS insiders spearheaded increased marketing efforts with respect to ARS after August 2007. They orchestrated a number of conference calls with UBS Financial Services' Wealth Management franchise's FAs to get them to focus on the value of ARS to retail clients. However, on August 22, 2007—just as he orchestrated the enhanced marketing program for ARS—the Global Head of the Municipal Securities Group and the head of Fixed Income spearheading the marketing campaign sold a large portion of his personal holdings of ARS. When asked in an on-the-record interview why he made those sales, he stated he was worried about the safety of those instruments after UBS and other broker-dealers allowed certain auctions to fail in August of that year. At the same time, this insider sold a large amount of municipal weekly ARS and purchased variable rate debt obligations. When asked why he did this, he stated: "Because I wanted to be in VRDO instruments because they had a liquidity backstop on those securities and I thought there was more protection."

In early December 2007, in order to offset the increased inventory that UBS was taking on, the Global Head of the Municipal Securities Group and Head of Fixed Income Americas, again, orchestrated another all-out sales effort in order to get retail customers to see the "value" in ARS at the prices at which UBS was willing to offer them. Yet, at the same time, on December 12, he quietly sold the remainder of his personal holdings of ARS. He subsequently explained that he made these sales because "my risk tolerance from a credit perspective was – was something that drove me to want to sell" ARS. UBS' customers (and certain UBS Financial Services FAs), who were not apprised of the information that this insider and the other UBS higher-ups knew about the escalating problems with UBS' auction rate program, were not so lucky. UBS Financial Services' FAs were encouraged to, and did, make sales of ARS to Massachusetts clients up until the last auction cleared on February 12.

On February 13, 2008, without advance notice to its customers, UBS stopped supporting its auction rate program, leaving hundreds of customers stuck with instruments that were now illiquid. This Division's investigation uncovered a profound disconnect between UBS' understanding to the ARS it was selling and its FAs' explanations of these securities to their customers. In addition, by setting up a situation where it was actively controlling whether auctions would clear and what rate they would clear at, UBS had (unbeknownst to its customers) set up a situation which put it in a fundamentally conflicted role between its desire to keep its underwriting clients happy with the promise of low financing costs and its obligation to retail customers to keep the auctions it had set up afloat. When corporate cash buyers started leaving the market and UBS' inventory started ballooning, UBS was confronted with a conflict between its customers who thought they had purchased safe, liquid, money-market instruments which without UBS' continued support would no longer be liquid, and its risk management arm which did not want to be stuck holding the very paper UBS underwrote and pushed to its clients.

None of these conflicts were visible to UBS' retail clients. As the Deputy CEO Global Wealth Management and Head of Wealth Management US subsequently admitted in April 2008, "if at any moment UBS announced that we weren't as committed in auctions, it would have been the same as giving up on auctions." Those customers trusted the advice of their UBS financial advisers who sold them these instruments that were liquid, safe and risk free and they were blindsided by the very people who were supposed to have their best interests at heart.

B. Brief Description of Merrill Lynch Complaint

In July of this year, the Massachusetts Securities Division filed an administrative complaint against Merrill Lynch, based on a comprehensive investigation it had undertaken. The investigation focused on the manner in which Merrill Lynch conducted its auction rate securities business, as well as how it interacted with its research department. The complaint charged the firm with creating and implementing a sales and marketing scheme which significantly misstated not only the nature of ARS, but also the overall stability of the auction market. Ultimately Merrill Lynch abandoned thousands of investors holding ARS that became illiquid when it stopped supporting its auction rate program.

Particularly egregious, was the manner in which Merrill Lynch co-opted its supposedly independent Research Department to assist in sales efforts geared towards reducing its inventory of ARS. Specifically, Merrill Lynch permitted its Sales and Trading, including Auction Desk, managers to unduly influence and pressure the Research Department in a number of ways. First, it allowed Sales and Trading to directly request and advocate for written research endorsing the safety and high quality of nearly all types of ARS and recommending investors buy ARS. In one instance, a Managing Director in charge of the Merrill Lynch's auction desk, directly emailed a Fixed Income Analyst in the Research Department, stating that "[a]ny renewed research focusing on the high quality of closed end fund preferreds of ALL tax status, auction municipal bonds and student loan backed bonds, wrapped around the value added proposition with today's rates would be extremely helpful."

Further, when Sales and Trading, including Auction Desk personnel, did not agree with the tone or context of a published research piece, Merrill Lynch managers, permitted Sales and Trading to insist the published report to be retracted and replaced with a more sales friendly piece. In one instance in August 2007, a research piece was published in Merrill Lynch's Fixed Income Digest primarily for the purpose of highlighting the differences in liquidity features for auction rate preferreds ("APS") and Variable Rate Demand Obligations ("VRDOs") in light of certain recent failed auctions. The primary distinction noted by the author, a Fixed Income Analyst in the, was that VRDOs have a hard put, while APS do not. Upon reading this research report, the Managing Director of Merrill Lynch's auction desk referred to above immediately called the analyst and demanded a retraction and clarification on the grounds that the report was misleading. The analyst initially refused to retract the report because he thought it was accurate. The Managing Director of the auction desk elevated the complaint to her boss and another, more senior Research Analyst. She also emailed persons in the Financial Products Group with the following all caps message:

> I HAD NOT SEEN THIS PIECE UNTIL JUST NOW **AND IT MAY SINGLE HANDEDLY UNDERMINE THE AUCTION MARKET.** IF YOU ARE GETTING ANY CALLS, PLEASE LET ME KNOW. I HAVE ASKED FOR AN IMMEDIATE CLARIFICATION TO BE PUBLISHED AND A RETRACTION OF THIS.

(Emphasis added). The Research Department agreed to retract and re-write the piece. The re-written piece was markedly different in both focus and scope from the original report and its conclusion contained a glowing endorsement of the ARS, "as a buying opportunity for investors who are looking for short-term instruments."
Pressure and objections from the Auction Desk had lasting effects on the Research Department's published opinions. For example in January 2008, after completing changes to a draft research piece involving ARS, the author requested someone review his work before it was published to ensure that it did not upset the Auction Desk, "I want to make sure that research cannot be accused of causing a run on the auction desk, like was the case in August."

Undue influence over the Research Department did not end there. Other times, Auction Desk personnel attempted to directly influence how Research responded to FA questions during sales calls with Merrill Lynch sales staff. In one instance in August 2007, a senior Research Analyst was a featured speaker and was answering FA questions in a "Q&A" style sales conference call. The head of the auction desk had also dialed in to the call and was listening in. After one question was asked, which apparently was not to her liking, she emailed or instant messaged the Research Analyst and stated: "Shut this guy down. Suggest he call outside this call. He is focusing attention away from your positive message." In addition, Merrill Lynch also permitted Sales and Trading managers, including Auction Desk personnel, to communicate to members of the Research Department (in violation of company policies and procedures) sensitive confidential information concerning inventory levels, marketing initiatives and enhanced sales incentives offered to Financial Advisors ("FAs") to sell ARS. Year end employment reviews of certain Research Analysts also took into account the level of support that analyst provided to his "business partners" at the Auction Desk. Further, certain managers in Sales and Trading had direct input in the year-end employment evaluations of at least one Research Analyst. This input directly had the potential to influence the level of bonus awarded to the Research Analyst.

Management regularly incorporated the supposedly independent Research Analysts into sales efforts and relied on them to actively engage and motivate sales staff to sell ARS, even in times when market conditions existed that called into question the suitability of ARS for those customers that needed ready liquidity. In participating in these sales calls, Research Analysts routinely soft-pedaled significant negative events affecting liquidity in the auction markets, and omitted material information which a reasonable investor would need to form an objective opinion as to the suitability of the investment. These actions took place up to and including the time when Merrill Lynch intentionally withdrew from the auction market. For instance, on February 7, 2008, some five days before Merrill Lynch decided to voluntarily withdraw from the auction market, one Research Analyst participated in a conference call with FAs to discuss recent market events. In discussing whether all closed-end funds auctions were suspect or likely to fail, this Research Analyst disagreed and told FAs, that "Merrill Lynch, certainly by all indications, is committed to this product. I would have to let the desk people speak for themselves, but given the fact that through all this turmoil they continue to plod away, I think that shows that the firm is committed to it."

On the evening of February 12, 2008, Merrill Lynch decided to cease supporting its auction rate securities program and intentionally allowed the vast majority of their auctions to fail the following day. However, the market events that led to the failures in the auction market in mid-February, which left investors with illiquid auction rate securities, were no surprise to Merrill Lynch's senior management. Indeed, Merrill Lynch had known for a period of several months that the auction markets were not functioning properly and were, in fact, in significant danger of collapsing. Beginning in August 2007, tightening in the credit markets began causing disruptions in certain ARS auctions, which caused Merrill Lynch to make the decision to cease submitting support bids for some of the riskier ARS it had underwritten and was trying to remarket, resulting in a number of auction failures. The following weeks saw many institutional and corporate cash participants withdraw from the auction markets. Buyers had been exiting the market in droves and inventory was accumulating to critical tipping points. As one executive confided to a personal acquaintance in an email on November 19, 2007,

> Market is collapsing. No more $2k dinners at CRU!! The Financials are being invicerated! (sic) More firings over at Citi…Inventory flooding the street. Going to be a great '08 trading environment.

Two days later, the head of the auction desk in an email relayed the difficulty of merely clearing all Merrill Lynch's Auctions in light of the negative news and dismal auction market conditions. As inventory continued to grow, even the perceptions of Merrill Lynch's investment banking issuer clients had to take a back seat to the acuteness of the inventory problem. As the head of the auction desk stated in an email dated November 26, 2007 pertaining to the continued investor selling and difficulty of pricing inventory to sell, "The gloves are off and we are not concerned about issuer perception of [Merrill Lynch's] abilities and the competition. Gotta Move these microwave ovens!!"

Merrill Lynch managers obsessed over any event or information that might spread fear and contagion throughout the auction market. For instance, as noted above, Managing Director of the Auction Desk, the head of Merrill's auction desk expressed the opinion that one single neutral research report released by Merrill Lynch in August 2007, was enough to "single handedly undermine the auction market." On another occasion, in late September 2007, the same person expressed the opinion that a proposed firm wide ban on offering enhanced production credits as incentives to FAs for selling ARS would be the auction desk's "death-knell" if implemented. Late in January, after having been forwarded a negative story regarding a recent auction failure, he simply forwarded the piece to her boss with the note, "[i]ts like the Sorcerer's Apprentice…cant someone make these people stop bucketing us with water…" Finally, she felt that failure of one or two broker dealers in the auction market would make it a "fait accompli" that the entire auction market would fail. These privately held opinions of Merrill Lynch's management were in stark contrast to the aggressive public sales and marketing campaign touting the safety and quality of the auction market securities that the company promoted to its sales staff and investors.

Deficiencies in the auction market were present even at its inception and set the course for ultimate failure in a liquidity challenged market. First, the auction process itself was fundamentally flawed in that true auctions were not being conducted. Instead, Merrill Lynch, who made a market in auction rate securities, regularly submitted support bids for the entire notional value of the amount of auction rate securities being offered at auction. The result was that Merrill Lynch's support bids were commonly filled in order to prevent a failed auction, thereby concealing the true level of investor demand, or lack thereof, for the products. Broker-dealer support created a false impression that there were deep pools of liquidity in the auction market and rendered potentially misleading claims that auctions never fail.

Another structural problem was that terms were structured in a manner that precluded secondary market value in the event of an auction failure. Maximum rates, those interest rates that would be applied in the event of an auction failure, were set at low levels which were favorable to issuers, but in the case of broad auction failures, provided issuers with little incentive to seek alternative financing in order to redeem the ARS shares. The establishment of low maximum rates directly contributed to issuers' efforts in successfully obtaining AAA ratings for their securities from credit rating agencies. Merrill Lynch (and, independently, UBS) stressed the AAA rating of its ARS in its marketing effort, billing them as ultra conservative investments. But when Merrill Lynch and UBS stopped supporting their respective auction programs, investors came to realize the low maximum rate which had allowed the securities to receive a AAA rating rendered their holdings unmarketable and illiquid.

On the investor side, interest rates were not high enough to compensate investors for their increased liquidity risk. Merrill Lynch had little or no incentive to negotiate for higher maximum rates to balance the market interests, as it was collecting significant underwriting fees from issuers at the outset on the investment banking side. In fact, Merrill Lynch reaped a total of approximately $90 million dollars in total profits from its auction rate program for the years 2006 and 2007. Thus, Merrill Lynch, by working the investment banking side, had a significant interest in keeping its issuer clients happy in hopes of securing future business with those clients.

Merrill Lynch's dual role in representing issuers and investors purchasing ARS created significant and inherent conflicts of interest which could not be reconciled. Time after time, when confronted with conflicts of interest, Merrill Lynch consistently placed its own interests ahead of its investor clients. For instance, Merrill Lynch marketed ARS as safe, cash like, and liquid investments. It categorized ARS as "Other Cash" on customer statements, even after the market imploded. Moreover, it trained its FAs to market ARS as a "Cash Management Tool" to their clients. Despite its promotion of ARS as "cash like," Merrill Lynch had express knowledge that without its support bids being filled, many auctions would have failed and thus, the securities were likely anything, but "cash like."

The true nature of and risks common to ARS were not adequately disclosed to Merrill Lynch customers, particularly retail customers. Merrill Lynch did not provide any notice or documentation to customers outlining risks or the nature of ARS at the time of, or prior to, sale. Rather, Merrill Lynch instead placed a vague reference on its Trade Confirmation slips which referred to a website at which customers who already purchased ARS could go to read about Merrill Lynch's "Auction Rate Practices and Procedures." Only if the investor visited the website after purchasing the ARS, would he or she be able to review Merrill Lynch's Auction Rate Practices and Procedures, which included an explanation of risks surrounding the ARS market. Merrill Lynch FAs routinely represented these instruments to clients as fully-liquid, principal protected and cash-like. Merrill Lynch failed to disclose to customers that ARS were only liquid at the time of sale because the auction market was artificially supported and manipulated by Merrill Lynch to maintain the appearance of liquidity and stability.

C. Lessons Learned and Ideas to Prevent Abuses From Recurring in the Future

Our goal is that all investors stuck in auction rate securities will be made whole and that in the not-too-distant future, the auction rate security scandal will be behind us. My office, as well as other regulators, have entered into settlements with UBS, Merrill Lynch, Bank of America and other underwriters and sellers of auction rate securities in which the firms have agreed to repurchase tens of billions of dollars worth of these securities from retail and other customers. Much work remains to be done. For example, my office is in discussions with certain downstream broker-dealers, and it is our expectation that those firms will ultimately make good on the point-of-sale promises of liquidity they made to their clients with respect to auction rate securities. We are pleased that Fidelity Investments just last week agreed to repurchase its customers' auction rate securities. However, it is not too early to step back and attempt draw lessons from this experience that might help us prevent such manifest abuse of unsuspecting retail clients from occurring in the future.

1. *Conflicts of Interest Need to be More Aggressively Monitored and, When Appropriate, Disclosed to Investors*

The UBS and Merrill Lynch cases present case studies of the conflicts of interest that can arise between a broker-dealer and its customers. Early in our investigations, it became clear that the broker was controlling the interest rates at which most of the auctions cleared through its provision of a support bid for the entire amount of the securities auctions in a given auction. In its interest-setting deliberations, the broker was beholden to its investment banking clients to whom it had promised low-cost financing, yet needed to raise interest rates just enough to be able to unload its own inventory onto unsuspecting clients. Prior to the market collapsing in February 2008, when each firm made a big push to reduce its own holdings of auction rate securities, it did so by foisting those securities (and their attendant risks) off on unsuspecting clients. In each instance of a conflict, the firm put its own interests ahead of the interests of its clients, many of whom were retail investors with limited sophistication and bargaining power. These conflicts need to be aggressively monitored to determine whether they fundamentally impair a firm’s ability to responsibly attend to its clients needs. At a bare minimum, these conflicts need to be properly disclosed to investors.

2. *Financial Advisor Incentives Need to be Disclosed and Financial Advisor Training Needs to be Enhanced*

Two points which arose starkly in our investigations were (a) the significant incentives to financial advisors to move auction rate product and (b) the profound lack of training those advisors received with respect to those products and their attendant risks.

Most investors that my staff speaks to on a daily basis simply assume that the financial advisor that is selecting financial products for them or otherwise guiding them is applying his or her professional expertise with the sole or primary goal of choosing financial products that are the most appropriate for that customer’s particular financial circumstances and goals. The financial advisor does nothing to dissuade them from that assumption. The client surely knows, on some level, that the advisor is being compensated for his or her efforts, but assumes that client service, not compensation, is the driving factor in product selection. In light of the fact, which was completely unbeknownst to UBS and Merrill clients, that financial advisors were both incentivized to sell ARS and completely lacking a meaningful understanding of how they work or the risks associated with them, it does not strike me as unreasonable to suggest that regulators should require more comprehensive disclosure of the financial incentives that financial advisors receive for selling different products. This would allow the consumer to better assess whether the advisor is selecting products on an informed basis that are most suitable for the needs and goals of the customer or whether the advisor is acting in a manner that simply maximizes commission revenue. The need for such disclosure is dramatically highlighted by the Merrill Lynch case discussed above, where we saw, in addition to its baseline commissions steering financial advisors towards auction rate securities, enhanced production credits at times when Merrill was especially concerned about moving auction rate inventory off of its books.

In addition, it would also be advisable to independently investigate how these complex products were allowed to be sold by financial advisors who had not received even minimal training regarding their risks, disclosure obligations, or how the auction market functioned. Another proposal that merits serious consideration is explicitly holding broker-dealer agents to a fiduciary standard of care with respect to their customers. Such a step is especially important given the fact that, as financial engineering creates ever more complicated products (such as auction rate securities), unsophisticated customers become increasingly reliant on the knowledge, expertise and training of financial advisors and increasingly vulnerable to industry misconduct. It has become all too common, when these sophisticated instruments go awry, for the brokers to blame their firms and insist that they too did not understand the true nature of the instruments. Imposing heightened fiduciary duties on them would require them to understand the products that they are selling.

3. *Supposedly Objective Research Reports Need to be More Tightly Regulated*

This part of the story is, unfortunately, familiar to us all. Five years ago a number of securities firms, including Merrill Lynch, reached a $1.4 billion settlement with regulators that was supposed to eradicate the conflicts of interest that pervaded Wall Street research. However, the global research-analyst settlement technically applied only to stock research and not to fixed-income research. Merrill was quick to make this distinction in its statement following the Division's filing of its complaint. However, the <u>principles</u> underlying the settlement—that research reports presented to the public as being supposedly independent should not be tainted by conflicts of interest and that any conflicts, at a bare minimum, need to be properly disclosed—obviously have not been adhered to in this instance. As a result, more rigorous rules pertaining to research reports are necessary.

4. *Principle-Based Regulation is Not Effective to Prevent a Scandal Such as this one*

I believe that the overnight disappearance of the $330 billion market for auction rate securities, and the conflicts of interest and disclosure issues highlighted above, should give pause to those who think that markets can effectively police themselves. The thought that market participants, guided by principles such as FINRA Rule 2110 (which states that "a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade"), will simply act in conformity with such principles in the absence of more detailed regulation is strongly belied by the facts described above. It is, indeed, difficult to imagine that offloading a known and worrisome risk of auction failure off of a firm's own balance sheet and onto its customers' holdings is consistent with "high standards of commercial honor". Similarly, as described above, in the absence of a specific prohibition directly on-point, Merrill clearly strayed far from the principles underling the global research settlement. I believe that a move in the direction of principle-based regulation, at the expense of detailed, enforceable rules—as some have suggested--would simply open the door for more of the same type of innovation without adequate regulation that we have seen with the auction rate market and which has caused so many investors so much harm. This point is especially important given this week's dramatic and unprecedented market events, which, again, show, that large financial firms left to their own devices, or guided only by general principles, cannot be counted on to effectively control the risks they are taking on their own behalf and on behalf of their customers and counterparties.

5. *State Regulators, in Conjunction with their Federal Counterparts, Need to Continue to be Actively Involved in Enforcement Actions*

The Massachusetts Securities Division is proud to have brought the first action alleging fraud in connection with the sale of auction rate securities, which was against UBS, and the only complaint in this matter against Merrill Lynch. We are equally as proud to have, in conjunction with our sister states and the United States Securities and Exchange Commission, negotiated settlements with these brokers that result in multi-billion dollar repurchases of auction rate securities by the large broker-dealers. Just last week Massachusetts entered into a settlement with Bank of America in which the firm agreed to repurchase auction rate securities sold to retail investors nationwide, and it is my understanding that a SEC settlement with Bank of America is pending.

The resolution that the states were able to obtain for investors, in conjunction with our federal counterparts, underscores the important role of state securities regulators, who are often the day-to-day first responders to customer complaints and who can work with agility and aggressiveness to resolve large issues such as this one. I urge that this experience serve as a reminder of the importance of the role of the states in securities regulation and as a cautionary note that state enforcement power should not be diluted in any contemplated regulatory reform package. It is my hope that the resolution of the auction rate securities issue which is, at this point, an ongoing work-in-progress will set the groundwork for even greater federal/state enforcement cooperation in the future.

Thank you for the opportunity to provide this testimony today.

William F. Galvin
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Commonwealth of Massachusetts