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Statement of the Shadow Financial Regulatory Committee

On

State and Federal Securities Market Regulation

February 24, 2003

Recent proceedings against major brokerage houses and investment banks in New York ("securities firms") over the integrity of their investment advice and recommendations to customers have raised again some of the oldest and most fundamental questions about the operation of our form of government—the division of responsibility between state and federal authorities.

First, New York State Attorney General Eliot Spitzer, and later the Securities and Exchange Commission (SEC), launched investigations into the behavior of the firms' security analysts and its relationship to their quest for underwriting business from the companies being rated. The investigations have produced settlement negotiations over monetary penalties and changes in the operating practices of the defendant securities firms, led by the New York Attorney General on behalf of a group of participating states. Although the details of the settlement are not yet final or public, they potentially could create significant alterations in the structure and conduct of the securities industry in the United States.

Should authority over a decision of large magnitude of this nature rest with national or state authority? Our system of government has, for over two centuries, attempted to define appropriate divisions between federal and state decision-making — between national and local issues. The effort has been complicated and the line constantly shifting, but at the ends of the spectrum the answers are clearer.

In the Committee's view, this is one of the clear cases. Security analysts and the large security firms form part of a nationwide distribution and trading market, which should be regulated in its essential aspects by federal and not state authority. In Attorney General Spitzer's view, the SEC had initially abdicated its role, justifying his stepping into the breach. Even if that were true in this instance, however, in general it is undesirable for one or several states to undertake to impose operating regulations on national securities firms. The current settlement arrangements should not be viewed as a precedent to the contrary; if necessary, legislation should be enacted to prevent a repetition.