# SECURITIES ANALYSTS' CONFLICTS OF INTEREST: ETHICAL AND LEGAL ISSUES AND INTERNATIONAL REGULATORY REACTIONS

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## I. BACKGROUND

Early in 2000, the American stock market, whether measured by the Dow' or the NASDAQ,[2] achieved record highs. Stocks had enjoyed a stunning climb that had observed the NASDAQ gain 86% in 1999. On December 9, 1999, the initial public offering (IPO) of VA Linux Systems soared 698% on its first day of trading, exemplifying the frenzy. The financial whirlwind in the markets is what US Federal Reserve Chairman Alan Greenspan had in 1996, accurately, but too quickly, described as "irrational exuberance."[3]

The role that irrational investor sentiment plays in influencing stock prices is hardly surprising. As Robert Shiller observes, stock prices are likely to be "relatively vulnerable to purely social movements because there is no accepted theory by which to understand the worth of stocks and no clearly predictable consequences of changing one's investments."[4] Financial analysts—particularly "celebrity" analysts—played a pivotal role in fueling this irrational exuberance. The US Securities and Exchange Commission (SEC)observes that "[t]he mere mention of a company by a popular analyst can temporarily cause its stock to rise or fall—even when nothing about the company's prospects or fundamentals has recently changed."[5] Consistent with this view is the practice of analysts justifying a change in their recommendations on the basis of price movements in stocks.[6] Such behavior leads investors and analysts to follow a circular logic, whereby the recommendations of analysts influence stock prices, which in turn leads analysts to revise their recommendations, leading to higher prices, and so on.[7]

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[1] The Dow Jones Industrial Average's record of 11,722.98 was set on Jan. 14, 2000, *available at* http://www.djindexes.com/jsp/industrialAverages.jsp.

[2] The NASDAQ's record high close of 5,048.62 was March 10, 2000, *available at* http://dynamic.nasdaq.com/reference/IndexDescriptions.stm.

[3] Alan Greenspan, *The Challenge of Central Banking in a Democratic Society,* Address at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, Dec. 5,1996, *available at* http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm.

[4] Robert J. Shiller, *Stock Prices and Social Dynamics, 2* BROOKINGS PAPERS ON ECON. ACTIVITY 457, 464 (1984).

[5] Securities and Exchange Commission, *Analyzing Analyst Recommendations.* June 28, 2001, *available at* http://www.sec.gov/investor/pubs/analysts.htm.

[6] Ho and Harris observe that most changes in analyst recommendations cite company fundamentals, but that one in eight recommendations is made only on the basis of price movements. *See* Michael J. Ho & Robert S. Harris, *Brokerage Analysts ' Rationale for Investment Recommendations: Market Responses to Different Types of Information,* 23 J. FIN. RES. 449 (2000).

[7] Richard Bruner, *All About Financial Analysts,* ELECTRONIC NEWS, Nov. 20,2000, at 54.

The rise in investor reliance on analyst recommendations coincided with the tech-stock boom and the concomitant rise in Internet-based discount securities brokers.[8] This led to rapid year-by-year increases in online trading by, in particular, individual investors. For example, in 1999, 35 per cent of stock trades by individuals were made online, up from 20 per cent in the previous year.[9] One consequence of this convergence of information, technology and greed (a notable feature of the Internet bust) was that individual investors traded more frequently—and more recklessly. Internet trading technologies also allowed investors rapid access to analyst reports. Some researchers propose that, in contrast to institutional investors, individual investors were largely unaware of the conflicts of interest that may taint analyst recommendations. For example, Robert Frick observes that:

> prior to the late 1990s, few small investors tried to match wits with the big boys in trading stocks short-term. 'Everybody just knew the game, knew the rules.... All of a sudden you had a new constituency that didn't necessarily know what the rules were.'
>
> There is an inherent conflict of interest in the relationship between the investment banking or underwriting activities of brokerages and their stock research reports. The institutions—such as mutual funds, pension funds and commercial bank trust departments— knew about the conflict and factored it into the advice they received. They learned from experience which brokers let those conflicts influence research and which ones didn't. Unfortunately, individual customers of the brokerage houses had no way of knowing the rules. In some instances, brokers protected their small clients. But even when individual investors lost out due to biased research from their brokerage, their numbers were so small that their voices were muted.[10]

The growth in online trade and the simultaneous increased availability of analysts' research reports created numerous problems, as many small investors were all too willing to listen to the recommendations of analysts. In this regard, considerable empirical research indicates that investors are influenced by analyst recommendations.[11] Unfortunately, analysts tend to be optimistic in their recommendations, particularly for those stocks that they recommend investors "sell" or "hold."[12] Nevertheless, at least on a conceptual level, analysts perform for

[8] *See generally* Robert Frick, *To Tell the Truth*, KIPLINGER'S STOCKS, Winter 2001, at 64, 67 [hereinafter Frick],

[9] Frank G. Zarb, *The Coming Global Digital Stock Market*, INT'L FIN., Nov. 1999, at 441.

[10] *See* Frick, *supra* note 8.

[11] Analyst recommendations are typically displayed at the start of a research report and provide a summary of a company's investment attractiveness. This summary typically classifies securities as one of "strong buy," "buy," "hold," "sell," and "strong sell."

[12] Francis and Philbrick find that analyst earnings forecasts are, on average, optimistic, but are even more optimistic for stocks recommended as "sell" or "hold." *See* Jennifer Francis & Donna Philbrick, *Analysts' Decisions as Products of a Multi-task Environment*, 31 J. ACCT. RES., 216,229 (1993).

investors two useful functions: reducing agency costs and increasing market efficiency.[13] In essence, investors view analyst ratings as a form of risk reduction. As Jane Cote observes, "[b]y providing an unbiased assessment of the firm's future potential and evaluating managerial skill, analysts reduce the risks inherent to outside stockholders who cannot observe the actions of management. This lowers the return demanded by the market."[14] By relaying market information from management to investors, analysts also serve a useful function in enhancing market efficiency and by addressing the agency problem that occurs when stockholders cannot observe management.[15] To wit, the SEC commented, in a November 1998 statement, that "[a]nalysts fulfill an important function by keeping investors informed. They digest information from Exchange Act reports and other sources, actively pursuing new company information, put all of it into context, and act as conduits in the flow of information."[16] Similarly, the US Supreme Court and the Securities and Exchange Commission have observed that "the value to the entire market of analysts' efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by their initiatives to ferret out and analyze information, and thus the analysts' work redounds to the benefit of all investors."[17] Unfortunately, it appears that the reputation of analysts has been undermined, thereby reducing their effectiveness in reducing agency costs and in enhancing market efficiency.

The reputation of analysts has not been helped by the competitive practices of investment banks. One would expect that a major form of competition between investment banks would be the level of their fees; however, as John Coffee observes, underwriters do compete with one another, but not on the basis of their fees.[18] He notes that the Antitrust Division of the Justice Department "has expressed some concern at the curious coincidence that most underwriters charge a 7.5 percent underwriting discount on initial public offerings."[19] Coffee notes that historically many underwriters competed by offering positive outcomes for clients regarding the distribution of company stock: they placed the stock with retail investors and distributed the stock so as to ensure diffuse ownership, thereby reducing the ability of shareholders to exert control over management. In contrast, Coffee observes that today:

> "hot" IPO's tend to go to institutional investors in return for their brokerage business (and allegedly for above-market commissions in some cases). Thus, the one remaining battleground on which underwriters can compete is the quality of their securities analysts.

[13] Jane Cote, *Analyst Credibility: The Investor's Perspective,* 12 J. MANAGERIAL ISSUES 352 (2000).
[14] ***Id.***
[15] *See id.*
[16] *Quoted in* Frank Fernandez, *The Roles and Responsibilities of Securities Analysts,* Research Reports, Aug. 22, 2001, at 5 [hereinafter Fernandez], *available at* http://www.sia.com/reference_materials/ pdf/RsrchRprtVol2-7.pdf.

[17] *Id.*
[18] John Coffee, *Virtue and the Securities Analyst,* N.Y.L.J., July 19,2001, at 5 [hereinafter Coffee].

> This consideration is relevant to the issuer's management and founders because in an IPO they are almost certainly subject to a stock lock-up that denies them the ability to sell their stock in the company until typically six months after the offering. Hence, their focus is rationally on what price the stock will command in six months, and this can depend on how analysts support the stock in the aftermarket.[20]

Bubbles, be they soap or stock market, eventually burst. For the first time in almost six decades, stocks declined for the three-year period 2000 through 2002[21] The dimensions of the losses are illustrated by two examples: 1) Lucent Technologies declined 82% in 2000, 53% in 2001, and a further 80% in 2002, to close at $1.26 at the end of that year; 2) Yahoo reached a price of $237.50 per share in January 2000 and enjoyed a market valuation greater than all of the "old economy" US auto industry. It subsequently reached a low of $8.94 in 2002.

In the aftermath of the bursting of the bubble, some investors sought to lay the blame on others than themselves.[22] Members of the securities industry and their regulators began examining the multi-year roller-coaster ride of market participants. The role played by securities analysts in these events came into focus and their role is a major topic of this article.[23]

The Securities Industry Association[24] observes that most analysts failed to forecast this reversal or to adjust quickly to the dramatic shift in valuation. This is particularly true of those sectors of the market—technology, media and telecommunications—that experienced the most dramatic inflation of valuations in 1998 and 1999. Most analysts failed to explain this "bubble," to forecast its sudden collapse or to advise investors to sell prior to the sharp reversal in stock prices.[25]

Let us now examine how the role of analysts changed, how these changes accompanied the development of a "bubble" in the stock market, and how the potential for undisclosed conflicts of interest arose. We will then proceed to discuss rules developed by Self-Regulating Organizations (SRO's) regarding conflicts of interest, and the remedies that may be available for individual investors.

## II. ANALYSTS' ROLE IN INFLATING A BUBBLE IN THE MARKET

The incentives that analysts have to issue self-serving recommendations led many investors to view analysts in an extremely negative light. As John Coffee observes, "[ajnalysts are increasingly seen in the popular press as financial 'ladies of

[20] *Id.*

[21] Fernandez, *supra* note 16, at 5.

[22] *See* Frick, *supra* note 8. Also, for an excellent discussion of the development of the "bubble," *see* Anthony B. Perkins & Michael C. Perkins, The Internet Bubble (1999).

[23] For further discussion, *see* Fernandez, *supra* note 16, at 6.

[24] For more information about this body, *see* http://www.sia.com/about_sia.

[25] Femandez, *supra* note 16, at 5.

the evening,' with respect to whom the only relevant question is price."[26] It appears that, during the 1990s, analysts' recommendations became increasingly suspect: in the early 1990s, buy recommendations outnumbered sell recommendations by six to one, yet, by 2000, that ratio had increased to 100 to l.[27]

Conflicts of interest are often cited as one major reason for the unwillingness of many analysts to issue more realistic ratings on the securities they cover. There are two main ways that conflicts of interest arise in investment banks.[28] First, agents may choose to pursue their own self-interest at the expense of clients.[29] For example, analysts may choose to give unrealistic recommendations in order to increase their own compensation packages. Second, conflicts of interest may emerge when a group within an organization (such as financial analysts) performs duties for two or more parties with conflicting objectives (e.g., individual investors seeking impartial advice and corporate finance clients seeking to talk up their stock prices). Boatright proposes that conflicts of interest are inherent in the provision of financial services, owing to "the ubiquitous roles of agent and fiduciary, with their attendant duties to serve the interests of others."[30] In a similar vein, Laura S. Unger (who, in 2001, was Acting Chair of the SEC) comments that:

> the issue of analyst conflict of interests is largely structural, not personal. Most stem from the blurring of the lines between research and investment banking.... This blurring can be seen in a number of ways. First, an analyst's salary and bonus may be linked to the profitability of the firm's investment banking business, motivating analysts to attract and retain investment banking clients for the firm. Second, at some firms, analysts are accountable to investment banking for their ratings. Third, analysts sometimes own a piece of the company they analyze, mostly through pre-IPO share acquisitions.[31]

[26] This view is echoed by Andres Rueda, who notes: "Assisted by armies of irrepressibly optimistic analysts, Wall Street investment banks corrupted the EPO process into a form of quasi-legal commercial bribery, with which to attract their institutional clients, venture capitalists, corporate executives, and others. Indeed, Wall Street insiders have profited handsomely from IPO's." Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust,* 7 FORDHAM J. CORP. & FIN. L. 21, 53-54 (2001) [hereinafter Rueda],

[27] Frick, *supra* note 8. *See also* Kelly S. Sullivan, *Comment: Serving Two Masters: Securities Analyst Liability and Regulation in the Face of Pervasive Conflicts of Interest,* 70 UMKC L. Rev. 415 (2001). During 1999 there were about 6,000 recommendations by analysts. Only six among them were "sell." *See* Thor Valdmanis, *Some Widely Touted Analysts Didn 7 Perform So Well,* USA TODAY, Nov. 27, 2002, *available at* http://vAvw.usatoday.com/money/industries/brokerage/2002-l l-27-analysts_x.htm.

[28] *See generally* John R Boatright, *Conflicts of Interest in Financial Services,* 105 Bus. & Soc. Rev. 201, 202 (2000) [hereinafter Boatright].

[29] *See generally* Matthew L.A. Hayward & Warren Boeker, *Power and Conflicts of Interest in Professional Finns: Evidence from Investment Banking,* 43 ADMIN. SCI. Q. I (1998).

[30] Boatright, *supra* note 28.

[31] *Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts: Hearings Before the House Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Comm, on Financial Services, 107th Cong., Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts* (statement of Laura S. Unger Acting Chair, U.S. Securities & Exchange

In response to these developing conditions in the securities markets, the SEC issued an investor alert in 2001, in which it outlined the potential for conflicts of interests among "sell-side" analysts.[32] "Sell-side" analysts, sometimes also referred to as "supply-side" analysts, work in brokerage firms and for investment banks and their job is to sell stock to investors, *i.e.* to convince them to purchase securities in companies that are many times clients or prospective clients of their employer. They are to be distinguished from "buy-side" analysts. The latter are employed by institutional investors and their role is to make recommendations as to what securities their employer should buy, hold or sell in its portfolio. "Independent" analysts are the fewest in number and they make recommendations on the securities of companies with which their employer has no client relationship. Value Line Investment Survey is a well recognized provider of "independent" research. This SEC action was precipitated by a surge in investor complaints following substantial declines in value in their investment holdings.[33]

Furthermore, the SEC recommended that an investor not simply rely upon one analyst's report, but also use a company's own financial reports and other independently available resources.[34] A major factor calling into question the credibility of sell-side analyst recommendations is the almost complete absence of negative recommendations. Fewer than 2% of recommendations fall in the sell category.[35] This propensity for analysts to be positive is illustrated by the fact that, even after the market bubble burst, their recommendations remained upbeat. For example, a December 2000 survey by Thomson Financial found that 71% of all analyst recommendations were "buy," 27% were "hold," and only 2% were "sell."[36] Sell-side analysts have greater incentives to provide optimistic ratings than do, say, independent analysts. For example, research by Hirst, Koonce, and Simko found that

> investors attribute the reason for a research report from an analyst whose firm offers both investment-banking and research-analysis services more to that analyst's incentives to be favorable than they do for an identical report from an analyst whose firm only per

Comm.). (July 31, 2001), available at http://www.sec.gov/news/testimony/073101ortslu.htm. These comments are also echoed by Boatright, *supra* note 28. at 201: "Although personal interest plays some role, the conflicts of interest in financial services arise primarily from attempts to provide many different kinds of services to a number of different parties, often at the same time. Conflicts of interest are built into the structure of odr financial institutions and could be avoided only with great difficulty. . . . The challenge, therefore, is not to prevent conflicts of interest in financial services but to manage them in a workable financial system."

32 Securities & Exchange Comm'n, Press Release, *SEC Cautions Investors About Analyst Recommendations*, June 28,2001, *available at* http://www.sec.gov/news/press/2001-66.txt.

33 *See* Rueda, *supra* note 26.

34 Securities & Exchange Commission, *supra* note 32.

35 Emily Thornton & Amy Borrus, *Grill Wall Street's Kingpins Next*, BUS. WK., Mar. 25,2002, at 82.

36 *See* James Toedtman, *Wall Street Analysts Face Probe, House Investigates Industry Behavior*, NEWSDAY, June 15,2001,atA63.

> forms research analysis. However, our results reveal that investors do not incorporate these differential perceptions into their stock performance judgments when favorable reports are received. In contrast, when investors receive unfavorable reports from analysts, they do distinguish between the two types of reporting analysts in their stock performance judgments. Specifically, investors judge the company's stock as having less potential when an unfavorable report originates from an investment banking analyst than when it originates from a non-investment-banking analyst. Our results also show that investors' judgments about a stock are influenced by the strength of the arguments contained in the analyst's report, but only when unfavorable reports are issued."[37]

Evidence shows that analysts offer more positive ratings for clients of their firm than do independent analysts.[38] If "buy" ratings are consistently issued and the stocks consistently go up, how many investors will question the accuracy of their research? When recommendations are favorable, and the markets are steadily increasing, there is slight risk that an analyst will bear the blame for a bad call,[39] or that a bad call will be issued.[40] With increasing press coverage, analysts became well known and having a "celebrity" analyst on its investment banking team served as a major plus as a firm competed for IPO's.[41]

### III. THE POTENTIAL FOR CONFLICTS IN ANALYSTS' RECOMMENDATIONS

"Institutional" investors, pension funds, insurance companies, and mutual funds are aware of the potential conflicts of interests inherent in recommendations by sell-side analysts. The conflicts pose the greatest danger to the investment decisions of individual investors participating in the market, as they may consider an analyst's report to be that of an expert rendering a completely objective opinion and be unaware of the presence of conflicts of interest of the nature described below.[42]

Conflicts can be posed because: a) the analyst may serve two masters concurrently, working for the research department as well as for the investment banking team attempting to increase its IPO business segment; b) the institution's

[37] D. Eric Hirs, Lisa Koonce, & Paul D. Simko, *Investor Reactions to Financial Analysts' Research Reports*, 33 J. ACCOUNTING RES. 335,336 (1995).

[31] *Id.* at 338, observing that "[prior research] reportfs] that when analysts are employed by firms that have an investment-banking relationship with a company . . . their stock recommendations are more favorable than when they are employed by firms that do not have such a relationship.. .

[39] Amy Tsao, *When 'Hold' Means 'Dump if*, BUS. WK. ONLINE, Aug. 3, 2001, *available at* http://www.businessweek.com/bwdaily/dnflash/aug2001/nf2001083_357.htm.

[40] Mike Palmer, *quoted in* Deirdre McMurdy, *Radical Idea: Sell the Truth*, MACLEAN'S, Jan. 22, 2001, at 32.

[41] *See id.*

[42] For a more complete discussion of analysts' conflicts, *see* Fred Naffziger & Mark A. Fox, *Potential Conflicts of Interest in Stock Analysts ' Recommendations: The U.S. Regulatory Response*, 36 BUS. L. Rev. 131 (2003).

reporting system may place the analysts under the supervision of the investment banking arm; c) the development of practices such as "spinning" and "laddering"; d) the design of analysts' salary and bonus system; e) the possible relationship that has grown between the analyst and the high ranking executives of the covered company, potentially skewing his objectivity or providing him access to material inside information; f) the analyst's own stock holdings, that of his employer, or the portfolios of the firm's influential clients; g) the potential ability of corporate subjects of less than positive report to exert pressure upon the analyst author; and h) a lack of sophistication on the part of investors.[43]

These are the areas where tension can develop for analysts between doing what is ethical and doing what is most lucrative for the analysts and for their employers (securities firms). Arthur Levitt, former chairman of the SEC, has remarked, "I wonder how many investors realize the professional and financial pressures many analysts face to dispense recommendations that are more in a company's interest rather than the public's interest."[44]

### A. *The Combination of Investment and Commercial Banking*

After the 1929 stock market crash and the Great Depression, Congress enacted the Glass-Steagall Act of 1933.[45] It prohibited the same bank from operating both as an investment bank and as a commercial bank. As financial activities became more global in nature,[46] American financial institutions found themselves competing against foreign banks not constrained by such a requirement.

Congress responded to this competitive situation in 1999 by enacting the Gramm-Leach-Bliley Financial Services Modernization Act of 1999.[47] Now that banks could both lend money and underwrite securities, they naturally began pursuing profits in investment banking. With a booming stock market, underwriting IPO's was not only a lucrative business, but also held the promise of both future profits from subsequent securities issues, providing merger and acquisition advice, and extending commercial loans.

If a prominent analyst could assist in gaining investment-banking business, it is only natural to expect the firm to exploit his presence. The value of a "star" analyst's presence in a firm is exemplified by CSFB (Credit Suisse First Boston, a unit of Switzerland's Credit Suisse Group) and Frank Quattrone. He was hired in 1998 and given the then unheard-of joint control of CSFB's stock research and investment banking in the technology area. His hiring produced spectacular results.

[43] Frick, *supra* note 8, suggests that, in contrast to institutional investors, individual investors lack the ability to accurately assess analyst ratings.

[44] *Quoted in id.* at 64.

[45] Banking Act of 1933 (also known as the Glass-Steagall Act), Pub. L. No. 73-66,48 Stat. 162, 12 U.S.C. §227.

[46] *See* Gordon R. Walker & Mark A. Fox, *The Securities Industry and International Financial Integration*, 7 CANTERBURY L. REV. 239 (1996).

[47] Financial Services Modernization Act of 1999 (also known as the Gramm-Leach-Bliley Act), Pub. L. No. 106-102,113 Stat. 1338, codified in various sections of titles 12 and 15 of the U.S.C.

By the following year, CSFB held the number two ranking for initial public offerings by technology firms, up from number fourteen.[48]

Merrill Lynch and its star technology analyst, Henry Blodget, have also encountered regulatory problems. New York Attorney General Eliot Spitzer discovered internal Merrill e-mails, in which Mr. Blodget made negative comments upon stocks that varied from Merrill's public recommendations.[49] Merrill Lynch's research report comments included "We do not see much more downside to the shares [of Excite at Home]"; "InfoSpace continues to be one of the best ways to play the wireless Internet"; and "We think LFMN [LifeMinders] represents an attractive investment." Comments made by Blodget in e-mails at around the same time as these research reports include "ATHM [Excite at Home] is such a piece of crap!," "This stock [InfoSpace] is a powder keg," and "I can't believe what a POS [Piece of Shit] that thing [LifeMinders] is."[50]

With regards to the Merrill Lynch e-mails, Spitzer comments,

> The e-mails are revealing in the extreme. They reveal what was going on and the failure to observe the firewalls that had been created. Analysts were giving out ratings that did not reflect their true views about the stocks.... The degree to which analysts acknowledged in the e-mails that their own research was tainted by the desire to serve the investment banking clients was profound.[51]

The Attorney General also alleged that Mr. Blodget "prioritized" research coverage for stocks according to whether the issuer had an investment-banking relationship with Merrill.[52] Merrill settled the case by agreeing to a series of reforms and by paying a penalty of $100 million.[53]

Salomon Smith Barney is the brokerage and investment banking unit of Citigroup. It and its prominent analyst, Jack Grubman, have also run into regulatory problems with respect to his recommendations. Winstar Communications paid $24 million in various investment banking fees to Salomon Smith Barney. Grubman had

[48] Subsequent investigations have had significant negative repercussions for both CSFB and Mr. Quattrone. In January 2002, CSFB agreed to pay $100 million, without admitting or denying wrongdoing, to settle SEC charges that it forced some investors to pay excessive commissions in return for stock allocations of technology IPO's. In December 2002, it agreed to pay $200 million in settlement of civil allegations that analyst recommendations were flawed due to the presence of conflicts of interest. Mr. Quattrone resigned from CSFB in March 2003. An enforcement action by the NASD against him over allegedly improper allocations of hot IPO's brought him a one-year suspension from the securities industry and a $30,000 fine, which actions both he and the SEC are appealing. In a criminal trial, he was convicted of obstruction of justice in May 2004, for urging his staff to "clean up those files" while the SEC had an investigation underway of his firm and of his activities. Andrew R. Sorkin, *Wall St. Banker Is Found Guilty of Obstruction*, N.Y. TIMES, May 4,2004.

[49] *Quoted in* Ron Insana, *The People* v. *Wall Street*, MONEY, June 2002, at 71-72.

[50] *Id.*

[51] *Id.*.

[52] Charles Gasparino, *Merrill Lynch Analysts Told To Change Ways,* WALL ST. J., Apr. 9, 2002, at Cl.

[53] Charles Gasparino, *Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts*, Wall St. J., May 22,2002, at Al.

issued a price target for $50 on the stock. The Citigroup unit continued to maintain a "buy" rating on the stock while its price on the market declined to pennies per share. Comments with respect to the stock in internal e-mails were more negative. In addition, Winstar was provided copies of proposed recommendations prior to their issuance for purposes of its comments. It filed for bankruptcy in 2001.[54]

B. *IPO Allocation Distortions: Spinning & Laddering*

Problems with analyst conflicts are likely to be most severe during the IPO process.[55] Michaely and Womack propose three reasons for this. First, IPO's are the major source of revenues for most investment banks, hence there are significant incentives to see that this revenue stream is maximized.[56] Second, associated with taking companies public is the explicit or implicit expectation on the part of the issuer that the underwriting firm will have analysts that not only cover the security being issued, but do so favorably.[57] It is commonplace for investment banks to cover the stocks that they help take public. One study of 317 IPO's by the SEC found that 308 involved firms acting as underwriters while also providing research coverage.[58] Michaely and Womack observe that such coverage is invaluable to new firms, "because they are not known in the marketplace and they believe that their value will be enhanced when investors, especially institutional investors, hear about them."[59] Finally, positive recommendations for current IPO clients appear to increase the likelihood that the client will choose the same underwriter for further offerings.

In the late 1990's, every IPO seemed to be a "hot IPO," where the clamor of investors for shares of the stock greatly exceeded the number available.[60] Thus, when the stock begins public trading, the effect is to drive the market price greatly in excess of that paid by investors lucky enough to have been allocated shares in the IPO. At the end of the first trading day, the latter investors would pocket a healthy profit by selling their shares. This raises the question whether the underwriters have fulfilled their fiduciary obligation to the issuing company to obtain true market value for the stock's issuance.

When a star analyst occupies a role in the allocation of IPO shares, conflicts of a different nature are possible. "Spinning" is the term used to describe the practice of an underwriting firm assigning shares in an expected hot IPO to the personal brokerage accounts of corporate executives, directors and venture capitalists. With

[54] The National Association of Securities Dealers brought a regulatory action against Salomon, Mr. Grubman, and one of his assistants, alleging that Salomon's research was materially misleading. Salomon settled, neither admitting nor denying guilt, and paid a $5 million fine. Jack Grubman was permanently barred from the securities industry and paid $15 million to settle all the charges against him. NASD News Release, April 28,2003, *available at* http://www.nasd.com.

[55] Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations.* 12 REV. FIN. STUDIES 653 (1999) [hereinafter Michaely & Womack],

[56] *Id.* at 654.

[57] *Id*

[58] *See* Unger, *supra* note 31.

[59] Michaely & Womack, *supra* note 55, at 654.

[60] *See* Rueda, *supra* note 26.

its almost guaranteed profit potential, it is a method to curry favor with them and possibly snag future investment banking work from the companies with which they are associated.[61] To "spin" the stock is to sell one's IPO shares on the initial day of trading.

"Laddering" is the custom of increasing the number of allocated shares to a client, with the understanding that it will then also buy additional shares in open market purchases. This market activity assists with increasing the price above the initial price, allowing those "spinning" to profit. A "sweetener" may also lie in this, if client agrees to pay a higher commission rate for the "laddered" shares. This may indirectly permit the client to share its profits on the spun shares with the underwriter.

Such an IPO allocation system is obviously unfair to non participants, as well as secret. In the words of NASD Vice-chairman Mary Shapiro, "Spinning contributes to the public's perception that the IPO market is rigged in favor of company insiders who receive highly profitable shares as a payoff for lucrative investment banking business."[62]

The lucrative nature of this process, both to the investment bank and to the individuals to whom shares are made available, is exemplified by the Piper Jaffray & Co. matter. That company, which neither admitted nor denied the charges, was censured and fined $2.4 million by NASD for spinning.[63] Piper Jaffrey's investment bankers identified and ranked 22 corporate executives for IPO allocations. Their total profits on the spun shares were about $2.4 million and Piper Jaffiay earned in excess of $16 million from these issuers. For example, it granted shares on numerous occasions to the CFO of Liquid Audio prior to both its initial public offering and a subsequent secondary offering. The spun shares gained $92,000 in profits for the CFO and Piper earned $764,000 as co-manager of the IPO and $703,000 as comanager of the secondary offering.

As part of the SEC's 2003 $1.7 billion "Global Settlement" of certain analyst conflicts, discussed later in this article, both Salomon Smith Barney and Credit Suisse First Boston agreed they would no longer engage in spinning of hot IPO's. In its regulatory action against CSFB's Frank Quattrone, the NASD has charged him, among other alleged violations, with engaging in spinning.[64] In 2004, as part of a different settlement, both Deutsche Bank Securities and Thomas Wiesel Partners agreed to eliminate the practice of "spinning."[65]

The NASD has also censured three major investment banking firms for receiving unusually high commissions from certain customers without inquiry and within one day of allocating shares in hot IPO's to those same customers. Technically, they were not charged with "laddering." The process operated as exemplified by the following incident with Bear, Steams. It allocated 125,000 hot

[61] *See generally* Roberta S. Karmel, *Securities Regulation Analyst Conflicts of Interest and New Regulations, Prosecutions,* 228 N.Y.L.J. 3 (2002).

[62] NASD News Release, July 12,2004, http://www.nasdr.com/news/pr2004/release.

[63] http://www.nasdr.com/news/pr2004/release.

[64] http://www.nasdr.com/news/pr2003/release_03_010.html.

[65] *See* http://www.sec.gov/news/press/2004-120.html.

IPO shares (their share price increased 84% on the first day of trading) to a customer who then made over $1 million in profits. On that same day, the customer sold 50,000 shares of a highly liquid security through Bear, Steams and paid a commission of $2 per share, when a typical commission would have been only six cents per share. The Bear, Steams monetary sanction was $4.95 million, that of Deutsche Bank Securities $5.29 million, and that of Morgan Stanley $5.39 million.[66]

Spinning and laddering raise serious legal ethical questions about fiduciary duties, market manipulation of prices, and full and fair disclosure in the marketplace. They should have no place in our securities markets.

### C. *Conflicts Inherent in Analyst Compensation Packages*

The objectivity of analysts' research reports are called into question by certain compensation practices. The income derived by an investment banking firm from stock commissions is dwarfed by its revenue from investment banking fees. And, many firms tie their analysts' compensation to a determination of what part they played in obtaining investment banking business.[67] Frank Quattrone's pay at CSFB is reported to have exceeded $100 million dollars per year and Jack Grubman drew a salary of as much as $20 million per year at Salomon Smith Barney.[68]

When analysts' income is directly tied to the success of investment banking deals, as it may be,[69] what incentive exists to include negative comments in a report about a client's company or of a prospective client? Elementary fairness requires members of the general investing public to be alerted to such conflicts, when they exist.

### D. *Analyst Access to the Client's Material Inside Information, Their Hidden Role as Advisors to the Client, and Conflicts Created by Their Personal and Employer's Investment Holdings*

If an analyst develops too close a relationship to a particular company or industry he is covering, that also raises questions of objectivity. If the analyst has achieved star status, the star company will find it in its interest to court him favorably. His coverage can draw media attention, and, if positive, may boost the stock price. If his comments downplay negative developments in the company's most recent financial release, the market may place a reduced importance upon them

A company may flatter the analyst by allowing him a glimpse of material inside information. It may request advice from him in writing a financial release or query him about the type of questions he expects to be raised at an analysts' meeting

[66] http://www.nasd.com/news/pr2004/release 04.

[67] David John, *Don't Punish Analysts,* USA TODAY, May 23,2002, at 10A.

[68] E.S. Browning, *Ah, the 1990s,* WALL St. J., Feb. 23,2004, at Cl.

[65] Peter Elkind, *Where Maty Meeker Went Wrong,* FORTUNE, May 14,2001, at 76.

and seek his suggestions as to the best answers. The then-CEO of WorldCom,[70] (now MCI), Bernard Ebbers, solicited advice of that nature from Jack Grubman.[71]

While it is easy to perceive the benefits of such situations to an analyst and the corporation, it is dangerous to any investor who regards the research reports as independent and objective. It is also legally perilous if the analyst, his firm, or the firm's clients trade on material non-public information disclosed to him.

Federal securities law bans trading in stocks on the basis of material inside information.[72] Such information can encompass any fact that, in reasonable and objective contemplation, might affect the value of a corporation's stock.[73] One in possession of such information must either publicly disclose it prior to trading or refrain from trading. The possessor is also legally barred from sharing the information with a "tippee" *{i.e.,* the recipient of the information) who uses it to trade.[74] Thus, an analyst in possession of material inside information cannot use it in trading for his own account or that of his family or friends. Obviously, neither may his investment banking employer trade on the information, nor may it pass the information on to its clients for use in trading..

In response to concerns that stock "price sensitive" information may be selectively disclosed by corporate executives to favored individuals, the SEC now mandates that, when such information is disclosed to one, it must be publicly disclosed to all.[75] It is beneficial to remember that one of the twin goals of the federal securities law is full and fair disclosure of information to investors.[76]

In Regulation Fair Disclosure (commonly referred to as Regulation FD),[77] the SEC formally required that "material nonpublic information" be publicly disclosed at the same time it is disclosed by a corporation to any securities professional.[78] The phrase "securities professional" includes securities analysts,

[70] WorldCom filed for bankruptcy in 2002 and was the largest corporate bankruptcy in the US, measured by assets, at that time. It emerged from bankruptcy in April of 2004 and renamed itself MCI.

[71] Gretchen Morgenson, *Analyst Coached WorldCom Chief on His Script,* N.Y. TIMES, Feb. 27, 2003, at Al.

[72] Section 10(b) of the Securities Exchange Act of 1934 declares it unlawful for any person "to use or employ, in connection with the purchase of sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. 78(jXb) Rule 10b-5, adopted by the SEC in 1942, casts the proscription in similar terms. *See* 17 C.F.R. 240.10b-5. Trading on the basis of material inside information is encompassed within the meaning of a "manipulative or deceptive device," see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[73] List v. Fashion Park, Inc. 340 F.2d 457,462 (2d Cir. 1965).

[74] *See, e.g.,* Dirks v. SEC, 463 U.S. 646 (1983), for a discussion of the scope of conduct prohibited by 10-b.

[75] Frick, *supra* note 8, at 66, mentions how many analysts held meetings to disclose information to big institutional clients, and "only later, after the stock has already jumped, to the brokerage's individual investors."

[76] The second objective is the prevention of fraud in connection with the sale of securities. These two objectives are cited in the preamble to the Securities Act of 1933,15 U.S.C.§ 77 (a)(2001).

[77]17C.F.R. §243.

[7]* 17 C.F.R. § 243.100(2Xiii). Some commentators use the phrase "market moving information" or "price sensitive" when discussing Regulation FD, rather than the statutory language "material nonpublic information." It was adopted October 23,2000.

money managers, and institutional investors.[79] Importantly in this day of the Internet, disclosure of news on a corporate web site does not constitute the required public disclosure.[80] Exempt from the rules are communications with journalists and securities rating firms,[81] as they are gathering the information for public disclosure.[82]

E. *Pressure on Analysts*

Pressure on analysts by current or prospective clients is typically intended to produce positive recommendations or to temper negative opinions.[83] Investment analysts are well aware of the detrimental impacts that the pressures they face can have on investors. The Association of Investment Managers and Research[84] states, "The right of the investment public to receive objective advice is dependent on the analyst being able to communicate judgments without coercion or fear of reprisal."[85]

As we have seen, sell-side analysts do not prepare their research reports in a vacuum. There are internal pressures when their compensation is tied to investment banking deals or they report to an individual in the investment banking department. The presence of such conflicts can call into question the objectivity of their research recommendations.

The pressure placed on analysts can take many forms, as shown by both research findings and public disclosure of pressures that individual analysts have faced. *Institutional Investor* magazine conducted a survey of analysts who were members of the 1989 All-America Research Team and found that 61 percent of these analysts had been "pressured to temper a negative opinion at least once in their careers."[86] The threats faced by these analysts included: losing access to a disgruntled company (61%);[87] a cutoff in investment banking business with the analyst's firm (39%); a prospective lawsuit (13%); and being fired (13%).[88] As well as the professional toll that analysts can face if they make negative recommendations

[79] *See* 17 C.F.R.§ 243.100(b)(i)-(iv).

[80] *See* 17 C.F.R.§ 243.101(e).

[81] *See* 17 C.F.R.§ 243.100(2)(iii). Naturally, the journalist or employee of the rating firm is barred from using the information to trade, prior to its disclosure, by law (Section 10 of the Securities Act of 1934 and its Rule 10(b)(5)) and, most likely, by a provision in an internal corporate ethics code.

[82] In November 2002, the SEC took action against four companies for alleged violations by communicating market moving information to analysts or institutional investors without simultaneous public disclosure. With one firm, the price changed 20% in one day's trading. The largest penalty was a fine of $250,000. The firms settled by denying any violation and promising no future violations. *See* Randall Smith & Jesse Drucker, *Unfair Disclosure: SEC Brings Series of Cases.* WALL ST. J., Nov. 26, 2002, at Cl.

[83] Cote, *supra* note 13.

[84] For more information about the AIMR, *see* http://www.aimr.com/support/about.

[85] Debbie Galant, *The Hazards of Negative Research Reports,* INSTITUTIONAL INVESTOR, July 1990, at 73 [hereinafter Galant].

[86] *Id. at* 73.

[87] *Id.* at 352, observing that "[rjecent academic research models the analyst-management relationship as one where management avidly shares information with analysts when the analyst is optimistically predisposed to the company, but withholds information when the analyst exhibits pessimistic views of the firm's prospects."

[88] Galant, *supra* note 85, at 76-77.

on client firms, part of the toll is emotional. Also, analysts may have to wait a considerable period of time before their negative ratings are confirmed.[89]

Another survey by *Institutional Investor* magazine surveyed Chief Financial Officers (CFOs). When asked how they would react to an analyst writing reports that CFOs perceived to be unfair, 25% of respondents indicated that they would limit analyst access to company officials and information; 40% said they would consider doing this; and 35% would not. Asked if they would put pressure on an analyst's firm to bring the analyst "into line," 10% responded that they would, 56% said they would not and 35% said they would consider this action.[90] Similarly, a survey by Reuters found that 31 per cent of large US companies acknowledged retaliatory action against analysts who had issued negative ratings.[91] In the event that an analyst downgrades a company's stock, company executives have been known to refuse to hire the investment bank the analyst works for.[92] Also, investment banks have been known to place pressure on analysts who have given negative ratings to client companies.[93]

One of the more noteworthy illustrations of the pressure an analyst can face involves Jack Grubman, the telecommunications analyst of Salomon Smith Barney of whom we have previously spoken. Salomon is owned by Citigroup. The latter's CEO is Sanford Weill. Mr. Weill is a member of the board of directors of AT&T Corp. The AT&T Chairman is C. Michael Armstrong, who also was on the Citigroup board of directors. Mr. Grubman did not have a particularly favorable rating on AT&T's stock. In 1996, AT&T did a $3 billion spin-off of Lucent Technologies. Salomon did not play a major role in the deal. Mr. Armstrong reportedly urged Mr. Weill to have Mr. Grubman reevaluate his rating on AT&T. Mr. Weil requested that Mr. Grubman do so and ultimately he upgraded the stock to a "buy." This was done prior to AT&T's April 2000 issuance of a tracking stock for its wireless business. Salomon was one of the major underwriters of the $10 billion deal and reportedly earned almost $45 million in fees. In October 2000, Mr. Grubman again downgraded his rating on the stock.[94] The pressure on Mr. Grubman continued when he was requested by the C.E.O. of his parent company to reconsider his rating on AT&T's stock.

Analysts can also face outside pressure from the companies reviewed in their research reports. In late 2002, pharmaceutical industry analyst Christopher McFadden, of Goldman Sachs, downgraded a number of stocks. In conference calls to discuss subsequent quarterly results, the executives from three of those companies refused to take questions from him.[95] Merrill Lynch has done substantial business

[89] "For the most part, however, outside influence usually takes a toll that is both professional and emotional. Analysts often see their reputation sullied before peers and clients in the press. Sometimes they must wait an excruciatingly long time before their negative perceptions are confirmed. *Id.* at 77.

[90] *See* Galant, *supra* note 85, at 78.

[91] *See* Coffee, *supra* note 18, at 5 n .3.

[92] *See* Rueda, *supra* note 26, at 56 n. 237.

[93] *See id.* at 238; Galant, *supra* note 85.

[94] Much of this information is derived from Charles Gasparino, *Inquiry into Salomon Widens to Include Possible Weill Role.* WALL ST. J,, Aug. 23,2002, at A1.

[95] Kate Kelly, *One Analyst Learns Candor Doesn't Pay,* WALL ST. J., Feb. 5,2003 at Cl.

with Tyco International since 1996. The former C.E.O. of Tyco, Dennis Kozlowski, was displeased with Merrill's analyst's coverage of Tyco. He had a personal meeting with Merrill C.E.O. David Komansky, apparently about the matter. Merrill replaced the analyst in 1999 and the new analyst promptly upgraded Tyco's shares from "accumulate" to "buy."[96]

## IV. THE NEW NYSE AND NASD REGULATION OF ANALYSTS' CONFLICTS

The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) formerly mandated the disclosure of certain conflicts of interest when a member firm (or one of its analysts) recommended the purchase or sale of a particular security. Rule 472 of the NYSE and Rule 2210 of the NASD both required disclosure relating to: a) whether the firm made a market in the security, b) whether it managed or co-managed a public offering of the issuer in the prior three years, and c) whether it had a financial interest in the recommended security.

The rules were not comprehensive and differences existed between the two rules. The NYSE disclosure could be in general terms, such as the comment that "the firm or its employees may own stock, options, rights, etc. of the recommended issuer." NASD's rule excluded analysts and only mandated disclosure by the firm or its officers or partners of ownership of options, rights or warrants (unless the ownership was nominal) in any of the issuer's securities, except common stock.

However, the issue of analysts' conflicts had reached such dimensions that both the NYSE and NASD proposed new rules in February 2002 and filed them with the Securities & Exchange Commission.[97] The SEC approved them in May 2002.[98] The new rules address six areas where analysts face conflicts of interest when preparing and publishing research reports on equity securities.[99]

Although many debate whether a Chinese wall is impenetrable or porous,[100] one must now be created between a firm's investment banking entity and its research division. The latter, not the former, must exercise supervision over analysts. If there is to be any discussion of upcoming research reports, investment bankers cannot directly contact an analyst. Rather, the investment banking staff must send any

[96] Charles Gasparino, *Merrill Replaced Its Tyco Analyst After Meeting*, WALL ST. J., Sept. 17, 2000 at Cl.

[97] The proposed rules may be found at http://www.nyse.com/regulation/regulation.html and http://www.nasdr.com/filmgs/rfD2web/idcplg?IdcService=SSJ3ET_PAGE&ssDocNaine'=NASDW-00n44. 21.asp, respectively. Since the rules, and their amendments, are substantially identical and are intended to operate identically, our references are to the NASD's version.

[98] Securities & Exchange Comm'n, *News Digest*, May 8, 2002, *available at* http://www.sec. gov/news/digest/05-08.txt.

[99] The SRO rules on analyst conflicts do not include within their scope research reports on debt securities. *See* S.E.C. Release No. 34-45908, n. 11, available at http://www.sec.gov?news/digest/05-08.txt, which refers to, but does not provide a transcript of, a telephone conservation between NYSE, NASD and Division Staff, May 3,2002.

[100] Chinese Wall is a metaphor describing the separation of units within the same business, so that information cannot flow between them, thereby preventing conflicts of interest. The theory is that it should be as impenetrable as the Great Wall of China. Skeptics believe that, while they exist in theory, they do not exist in reality and that information can flow through them.

communications to an analyst via the legal/compliance section of the firm, so that it can evaluate the appropriateness of the communication.

As to compensation, particular investment banking transactions may not be used to determine the analyst's pay. When a firm's compensation system utilizes general investment banking revenue in calculating analysts' pay, that compensation nexus must be specifically disclosed in the research report. The report must specify also whether it or an affiliate has co-managed a public offering of equity securities for or received investment banking compensation from the subject company in the previous twelve months, and whether it expects to receive or intends to seek compensation for investment banking activities in the next three months. If, in a public appearance, an analyst makes any securities recommendation, he must, if the issuer is a client of the firm or analyst, disclose the relationship.

Promises of favorable research ratings or the promise to name a certain price target on an issuer's stock are prohibited as inducements in solicitations for investment banking business. Whenever a firm manages or co-manages a securities offering, it must observe a "quiet period," during which it may not issue a research report on that client.

Rules are now in effect governing an analyst's securities trading. Any analyst covering an industry can no longer acquire pre-IPO stock of any company in the industry. For a period of thirty days prior to the issuance of a securities recommendation and five days after its release, the author-analyst is prohibited from trading the security. And, while this would seem to be such a fundamental unspoken common sense understanding that would not need mention, it is now in writing that any analyst who trades the security that is the subject of his report must do so in accordance with his recommendation.

Disclosure is mandated, in both research recommendations and public comments, of any financial interest in the issuer held by the analyst making the report. The interest of the investment firm employing the analyst does not require disclosure, if it is below one per cent ownership of all equity classes of the recommended company.

With industry hesitancy to issue negative reports, a practice developed of using euphemisms, *i.e.,* a "hold" came to be understood as really meaning "sell," a "buy" is really a "hold," etc. The problem is that these meanings, while well understood within the industry, may not be understood by typical investors reading the report who, as a result, would give the term its literal meaning. Thus, the new rules provide that the issued report must define its rating language and the definition must conform to its everyday, common-sense meaning, *e.g.,* a rating of "hold" must be defined as meaning "hold." The report must contain a historical price chart that notes the points at which ratings or price targets were assigned or changed for the recommended stock. To provide a reader with additional important perspective, the recommendation must include data on the percentage of all the firm's ratings assigned to the various categories in its rating system.

The requirements described above establish the minimum standards for investment firms and their stock analysts. An investment banking firm remains free to adopt internal guidelines imposing higher standards for its employees.

### V. Sarbanes-Oxley and Analysts' Conflicts

The wave of corporate scandals that accompanied the bursting of the stock market bubble, *e.g.,* Enron, WorldCom, Global Crossing, Arthur Andersen, etc., spurred federal legislative action. It took the form of the Sarbanes-Oxley Act of 2002 which President George W. Bush subsequently signed.[101] While many of its mandates focus upon accounting and corporate governance matters, it does contain a provision relevant to securities analysts. This provision specifies that the Securities and Exchange Commission, or the securities exchanges upon the authorization of the SEC, adopt regulations reasonably designed to address the conflicts of interest that can arise when analysts recommend equity securities.[102]

The approval by the Securities and Exchange Commission of both the New York Stock Exchange and National Association of Securities Dealers' new rules on analysts' conflicts fulfills this legislative mandate. The door, however, is open to future regulatory action in this area because the legislation permits the SEC to "address such other [analysts'] issues as the Commission ... determines appropriate."[103]

### VI. Investors' Legal Recourse for Analysts' Conflicts

Examination of the legal remedies available to investors who believe that they have suffered economic harm by the various conflicts inherent in the relationship amongst analysts, their firm, and the firm's clients shows that such investors must follow one of two distinct paths. Those market participants who did not have a customer relationship with the firm and its analysts can seek recourse through litigation. In contrast, investors who are claiming damage to their portfolios in accounts with the firm employing the analyst will be restricted to pursuit of a remedy via arbitration. Next, we will discuss the significant differences that exist between these two courses of action.

#### A. *Litigation*

Investors who have made poor investment decisions may believe that conflicts of interest have led analysts to give advice or recommendations that have resulted in these decisions. Some of these investors will have been actual customers of the analysts. These individuals—for reasons explained below—cannot pursue litigation; instead, their complaints will be channeled through the private arbitration system In contrast, investors who were not customers of a defendant brokerage firm can allege violations of federal securities law, using the fraud-on-the-market

[101] Pub. L. No. 107-204, July 30,2002,116 Stat. 745.

[102] Securities Exchange Act of 1934,15 U.S.C. 78a *et seq.,* new section 15D.

[103] Sarbanes-Oxley Act of 2002, section 15(D)(a)(4), 15 U.S.C. 78a et seq.

theory.[104] Here, the assumption is that, in an efficient securities market, publicly available information is reflected in the market price of a security and the investor's reliance on any material misrepresentation may be presumed. Thus, it is not fatal to an investor's legal position that he was not directly aware of a material omission or misrepresentation. Let us now look at litigation using this theory.

Investors in two Internet stocks, 24/7 Real Media and Interliant, filed a class action lawsuit against Merrill Lynch and its Internet analyst, Henry Blodget, attempting to recover for their investment losses in those stocks.[105] It was the contention of these investors that the analyst's opinions, expressed in Merrill Lynch- issued research reports, were materially misleading and in violation of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. It was not their contention that the company-prepared information, which the analyst relied upon, was misleading or that the analyst misrepresented any of those facts. Rather, the claims were based upon a misrepresentation in the reports of the analyst's true opinions and the failure to disclose alleged conflicts of interest within Merrill Lynch. The latter had issued in excess of forty research reports with respect to 24/7 Real Media and over thirty reports concerning Interliant in a period from 1999 through early 2001.

1. The decision of the trial court

Case law has established that the plaintiff in a private action seeking damages under section 10 and Rule 10b-5 must show "that the economic harm that it suffered occurred as a result of the alleged misrepresentation."[106] In the Private Securities Litigation Reform Act of 1995,[107] Congress codified this standard and broadened it to include additional forms of securities fraud cases. The plaintiff must allege *scienter* (an intent to deceive, manipulate or defraud), and the complaint must "state with particularity" the facts giving rise to a strong inference that the defendant acted with the required state of mind.[108]

In the instant case, the trial judge granted the defendants' motions to dismiss, stating that the plaintiffs had failed to demonstrate any causation of loss.[109] He said that any failure to disclose alleged conflicts of interest by the defendants did

[104] Basic v. Levinson, 485 U.S. 224 (1988).

[105] In Re Merrill Lynch & Co., Inc. 24/7 Real Media, Inc. Research Reports Securities Litigation, 272 F. Supp. 2d 243 (S.D.N.Y. 2003), 02 MDL 1484, 02 CV 3210 (MP), and Interliant, Inc. 02 CV 3321 (MP), (S.D.N.Y. 2003), 2003 U.S. Dist. LEXIS 13940 (hereinafter cited as *In re Merrill Lynch)-*, *aff d* in part *sub nom* Len tell v. Merrill Lynch, 396 F.3d 161, 2005 U.S. App. LEXIS 1016, (2d Cir. 2005). Eventually, a total of 140 different securities fraud complaints were consolidated into this litigation before this one trial judge.

[106] Citibank v. K-H Corp., 968 F.2d 1489,1495 (2d Cir. 1992).

[107] 15 U.S.C. § 78u 4. The so called "loss-causation" provision is in 15 U.S.C.§ 78u 4(b)(4). Loss- causation must be shown in two respects, transaction causation and loss-causation, *i.e.*, that the fraudulent statement caused the loss and that the resulting loss was a foreseeable outcome of the fraudulent statement. *See* Suez Equity Investors v. Toronto-Dominion Bank, 250 F 3d 87,95 (2d Cir. 2001),

[108] 15 U.S.C. § 78u-4(b)(2).

[109] *In re Merrill Lynch* at 367-68.

not cause any loss in market value in the plaintiffs' portfolios; instead it was the bursting of the Internet's market value that caused their losses. When an investor's losses coincide with a market-wide phenomenon causing comparable losses to other investors, it is less likely that fraud caused any given investor's loss.[110] The judge also found that the plaintiffs had failed to allege specifically which analysts had given conflicts of interest involving which investment banking deals leading to which research reports being misleading, to what degree, and when.

Opinions are subjective by their very nature and are therefore inevitably difficult to challenge legally. The Supreme Court has held that the only basis for successful challenge of a stated opinion is proof that the speaker did not actually hold the opinion he expressed.[111] In an attempt to meet this burden, the plaintiffs referred to a document of the New York Attorney General, used in an ex *parte* regulatory injunctive proceeding, citing internal Merrill Lynch e-mails in which analysts expressed views that ran counter to published research reports. The district court observed that none of the internal e-mails referred to Interliant, while as to the two that did refer to 24/7 Real Media, the plaintiffs failed to explain how they made any contemporaneous report false.

This evidentiary burden of showing that the analyst's opinion was not actually the honestly rendered opinion of the analyst, rather than that the opinion turned out—in hindsight—to be incorrect, is a heavy one to bear. This also explains why the severance agreement between Citigroup Global Markets (the new name for Citigroup's former Salomon Smith Barney unit) and its analyst Jack Grubman requires his "confirmation that, at the time it was published, his research fairly reflected, in all material respects, his good faith views."[112]

The judge also pointed to cautionary statements included by Merrill in its research reports. Ratings for both stocks indicated a "high potential for price volatility" and the reports contained comments, including: "the stock's valuation is aggressive in light of the company's relatively early stage of development and risk associated with the consolidation strategy" and "we continue to have concerns about low revenue visibility and volatile margins."[113] He noted the inherently speculative nature of predicting future stock prices and said that the plaintiffs failed to present any particularized allegations of fact that Merrill knew the stock price would not go up in the predicted range, that the market for Internet stocks would collapse and that it would not recover as it had done previously. He said the plaintiffs failed to overcome the "bespeaks caution" doctrine, which says that an investor cannot claim misrepresentation when the document in issue contains language warning of the risk.[114]

[110] Bastian v. Petren Res. Corp., 892 F 2d 680,684 (7th Cir. 1990).

[111] Virginia Bankshares Inc. v. Sandberg, 501 U.S. 1083, 1095 (1991).

[112] For a discussion of the terms of his severance agreement, which were unknown until a year after his resignation and actually still had him on the payroll, *see* Susan Craig, *Grubman Still Gets Pay From Unit of Citigroup,* WALL St. J., Aug. 18,2003, at Cl.

[113] *In Re Merrill Lynch,* 273 F. Supp. 2d at 367-68.

'"*Id.* at 368-78.

The judge also concluded that any failure to disclose analysts' conflicts of interest did not constitute a fraud on the market because—owing to wide-spread discussion—the market was aware of the potential conflicts. He noted that the existence of conflicts of interest was discussed in articles referenced by the plaintiffs to prove the existence of such conflicts. Some of those articles were published more than one year prior to the filing of the lawsuit. This led to his final ruling that the plaintiffs claims were barred by the one-year statute of limitations.[115] They were on inquiry notice of their alleged claims more than one year prior to bringing the action but undertook no inquiry, despite publicly available news articles. Knowledge of these alleged facts constituting such claims are imputed to them on the date the duty to inquire arose.[116]

Is an investor who read and relied upon a report affected by an analyst's conflicts a victim of fraud? To demonstrate common law fraud, one must establish a material representation of facts (past or existing), which representation is false, made with knowledge or recklessness with respect to its false nature, and causes detrimental reliance to the person relying upon the representation.[117] Fraud is not demonstrated by the use of hindsight to illustrate that an analyst's stock prediction failed to come about. By definition, such a recommendation is an opinion and—while it seems probable in the mind of the analyst—it remains open to dispute. Thus, the mere presence of analysts' conflicts, in and of themselves, is unlikely to be a legal foundation for building a legal case of fraud perpetrated upon an investor.

With alleged federal securities fraud claims, Federal Rule of Civil Procedure 9(b) requires that "the circumstances constituting fraud ... be stated with particularity" and the statutory requirement for alleging material misrepresentations or omissions mandates that one "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading."[118] In the trial court's grant of summary judgment in the Merrill Lynch/Henry Blodget case discussed above,[119] he ruled that general claims of manipulated research coverage and misleading ratings to attract and retain unspecified investment banking clients failed to meet these federal specificity standards. However, there would be a case for both common law and securities law fraud in those instances where the brokerage firm makes a securities recommendation to clients while internal communications, such as e-mails, demonstrate that the analyst's actual opinion differs from that being publicly circulated over his name. Such a circumstance did not exist in this case.

[115] For claims arising under Section 10(b) of the Securities Exchange Act of 1934 brought after the enactment of Sarbanes-Oxley, the applicable statute of limitations is two years. *See* Sarbanes-Oxley Act of 2002, *supra* note 101, §804,28 U.S.C. § 1658.

[116] LC Capital Partners, LP v. Frontier Ins. Group Inc., 318 F.3d 148 (2d Cir. 2003).

[117] Medtech Corp. v. Indiana Ins. Co., 555 N.E. 2d 844, 847 (Ind. Ct. App. 1990).

[118] 15 U.S.C. § 78u 4(b) (1), Private Securities Litigation Reform Act of 1995, *supra* note 107.

[119] *Supra* note 105 and accompanying text.

2. The Appellate Court's Affirmance

The United States Court of Appeals for the Second Circuit affirmed the dismissal on grounds that the plaintiffs failed to properly plead loss-causation.[120] The degree of confusion is such, with regard to loss-causation, that the appellate court found it necessary, early in its discussion, to disavow one possible interpretation of one of its prior decisions in reaching this decision, which reflects a different interpretation.[121] It held that loss-causation requires the allegation of a misstatement or an omission of fact which, when disclosed, caused the value of the security to decline. The loss must be both foreseeable and "caused by the materialization of the concealed risk."[122] An attenuated connection, or a failure to demonstrate a casual connection between the misstatement or omission and the actual harm suffered, is legally insufficient. Likewise, the mere allegation that the misstatement or omission induced the investor's purchase, while it explains why the investment was made, fails to disclose the relationship between the fraudulent activity and the decline in the value of that investment. An intervening event, such as a market-wide drop in internet stock prices, causing comparable losses to similar investors, may be the causal spark, rather than the defendant's fraudulent activity. Thus, plaintiffs must plead facts which, if shown, connect the stock loss to the misstatement or omission, rather than the intervening event.[123]

While alleging that Merrill Lynch's recommendations were false and misleading and this inflated the value of those stocks, the plaintiffs failed to allege that any corrective disclosure caused the price decline. They also failed to plead any concealment or misstatement as to the risks in investing in those stocks. The court noted that the risks appear on the face of every report. It said that "systematically overly optimistic" ratings are not "categorically beyond the reach of the securities laws," but here the plaintiffs failed to allege a) facts supporting their argument that the defendant's fraud, rather than other salient factors, was the proximate cause of their losses, or b) facts that could apportion the losses between the disclosed and concealed portions of the risk that ultimately led to the decline in the stocks.[124] This failure was fatal to their case. Lastly, the court said the complaint also failed to meet the pleading standards for a market manipulation case.[125]

[120] Lentell v. Merrill Lynch, 396 F.3d 161, 2005 U.S. App. LEXIS 1016, (2d Cir. 2005). While it is not relevant for our purposes, the district court aiso had held that the plaintiffs' suit was time barred by the statute of limitations. The court of appeals disagreed with the computation of the limitation period and said the suit was timely filed, but nonetheless affirmed the dismissal for the failure of the pleadings to meet the statutory requirements.

[121] The court acknowledged that an earlier decision could be "(mis-)read" as rejecting a particular approach, but such an interpretation is not an "authoritative position," because the wording is dicta confined to a footnote, is framed in terms that are tentative and speculative, and finally is expressly limited to precedents up to 2001. *Id.*, 2005 U.S. App. LEXIS 1016, at 12.

[122] Lentell v. Merrill Lynch, 2005 U.S. App. LEXIS 1016, at 12 (2d Cir. 2005).

[123] *Id.* at 13, quoting First Nationwide Bank v. Gelt Funding Corp, 27 F.3d 763,772 (2d Cir. 1994).

[124] *Id.* at 16.

[125] *Id.* at 17. Because the court disposed of the case on the issue of loss-causation, it found it unnecessary to address the district court's decision with respect to the issues of the pleading's failure to meet the

3. The Last Word on Loss-causation: The 2005 US Supreme Court Decision

There are actually two types of required causation under the statute: 1) "transaction" causation, *i.e.,* that the defendant's statutory violations caused the plaintiff to engage in the transaction, and 2) "loss" causation, *i.e.,* that the defendant's material misstatements or omissions are the cause of the harm suffered by the plaintiff.[126] Transaction causation is analogous to reliance and a plaintiffs pleading must allege that "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction."[127] In a case like Merrill Lynch's, where the plaintiffs do not claim to have read the research reports, nor to have purchased the securities through the defendant brokerage firm, but which rather is framed as a "fraud-on-the-market" case, this form of causation is not a relevant issue.

Loss-causation is our concern in the instant discussion. What is its requirement to demonstrate a causal link between the misstatement or omission and the financial harm suffered by the litigant?[128] The courts have struggled with its meaning over the years. One court of appeals commented that this "loss causation requirement in this circuit and others has been less than clear."[129] For some courts, in fraud-on-the-market cases, the statutory pleading requirement is met simply by the allegation that the price on the date of purchase was inflated because of the misrepresentation.[130] Others have held such an allegation to be inadequate, mandating the additional requirement in the pleading that, after a corrective disclosure was made, a drop in the stock price followed.[131]

A unanimous Supreme Court brought clarity to the issue in its 2005 *Dura Pharmaceuticals* decision, holding that the allegation merely of an inflated purchase price due to a misrepresentation fails to satisfy the statutory requirement.[132] Such a standard ignores, the Court says, two important traditional elements necessary in both fraud and this statutory action, a showing that the misrepresentation was the proximate cause of an economic loss.[133] The misrepresentation must cause the loss, rather than a stock price decline that is attributable to a change in the economy,

particularity requirements under the Federal Rules of Civil Procedure and the Private Securities Litigation reform Act of 1995 and its failure to overcome the "bespeaks caution" doctrine.

[126] McGonigle v. Combs, 968 F.2d 810, 820 (9th Cir. 1992).

[127] Emergent-Capital Inv. Mgmt., LLC v. Stonepath Group, Inc. 343 F.3d 189,197 (2d Cir. 2003).

[128] One court characterized loss-causation as akin to the proximate cause requirement in common law fraud. *Id* at 198.

[129] Binder v. Gillespie, 184 F.3d 1059,1066 (9th Cir. 1999).

[130] Knapp v. Ernst & Whinney, 90 F.3d 1431 (9th Cir. 1991); Gray v. Winthrop Corp., 82 F.3d 877 (9th Cir. 1996); Equity Investors, LP.& SEI v. Toronto-Dominion Bank, 250 F.3d 87 (2d Cir. 2001); Dura Pharmaceuticals v. Broudo, 339 F.3d 933 (9th Cir. 2003).

[131] Semerenko v. Cendant Corp., 223 F.3d 165 (3d Cir. 2000); Robbins v. Koger Properties, Inc. 116 F.3d 1441 (11th Cir. 1997).

[132] Dura Pharmaceuticals v. Broudo, 2005 U.S. LEXIS 3478 (2005).

[133] -7

investor expectations, new industry or firm specific facts, etc. The Court noted that an important objective of the securities statutes is the maintenance of public confidence in the securities marketplace. Allowing victims of securities fraud to recover from those perpetuating such frauds advances such a goal. However, the purpose of the statutes is "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."[134]

The *Dura* case was brought by certain investors in the stock, alleging that the company issued several press releases indicating satisfactory development and testing of a delivery device for asthma medication, as well as rising sales of a particular drug over about a ten-month period. During this time span, the stock peaked at $53 per share. After the company subsequently announced the expectation of lower than forecast revenue and earnings per share, due to slower than expected sales of the particular drug, the stock suffered a one-day loss of 47%, plunging to $20% from $39'/«. Subsequent disclosures revealed that the sale of that medication had actually been declining and that the FDA had not approved the delivery device due to questions about its reliability, as well as manufacturing and control concerns.

The district court dismissed the suit, with prejudice, for a failure to properly plead the loss-causation element of a section 10(b) violation in the amended complaint. As to the delivery device, the court said an allegation was lacking that the disclosure of the device's troubles with the FDA approval process related to the stock price drop, as that was triggered by the announcement of the expected revenue shortfall and the press release made no mention of the device. With regard to the announcements concerning the sales of the drug, the court ruled that the complaint's allegations were not sufficient to indicate that the statements were false and made with knowledge of their falsity.

The appellate court reversed, saying the statutory requirements are met by merely pleading "that the price at the time of purchase was overstated and sufficient identification of the cause."[135] As to the *scienter* requirement, while noting its high standard, the court was of the view that it can be met by collectively considering such allegations, *i.e.*, "Beyond each individual allegation we also consider 'whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness.'"[1 6] Thus, the court said the trial judge had abused his discretion by denying the plaintiffs the right to amend their complaint a third time.

The now rejected "inflated purchase price" theory of the Ninth Circuit effectively removed the "loss" requirement from the statute. In addition, by making it easier for securities fraud complaints to avoid a successful motion to dismiss by a defendant, it increased the incentive for a defendant to settle the litigation out of court. The reversal by the Supreme Court means that class-action suits merely

[134] *id.*

[135] Dura Pharmaceuticals v. Broudo, 339 F.3d 933,2003 U.S. App. LEXIS 15621, at 5 (9th Cir. 2003).

[136] Dura Pharmaceuticals v. Broudo, 2003 U.S. App. LEXIS 15621, at 8 (9th Cir. 2003), quoting Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1038 (9th Cir. 2002).

pointing to a misrepresentation or omission, subsequently followed by a decline in a stock's price, will disappear. In those suits meeting the pleading requirement of material omissions or misstatements, a corrective disclosure and a subsequent drop in price,[137] and which go to trial, the defendant's arsenal has been increased with an argument that the price drop is attributable to other intervening causes. This should increase the plaintiffs burden of proof, by making general claims of a relationship between the misstatement and decrease in price insufficient; direct causal connections demonstrating specific losses will now be necessary.

Finally, it should foreshadow the ultimate conclusion of the *In re Merrill Lynch* litigation in favor of the defendants. The rationale used by the Second Circuit, in affirming the decision of the trial court against the plaintiffs on the motion to dismiss, comports with the Supreme Court's resolution of the loss-causation issue.

B. *Arbitration*

When opening an account with a brokerage firm, investors complete a new account form. They furnish data on annual income, net worth, experience and knowledge with investing (in equities, bonds, option/futures, mutual funds, annuities, and trading on margin), the time horizon for their investments (short, intermediate, long), their investment objectives (tax free income, income, growth), and their risk tolerance (low, medium, high). Normally incorporated by reference are the terms of a "client agreement," which specifies that "all controversies which may arise will be determined by arbitration." The new account form will specify that the investors acknowledge receipt and understanding of that agreement and that the agreement contains a binding arbitration clause substantially affecting their rights. This latter warning is normally located just above the space where the client and broker both sign the paperwork. As a consequence, disputes between brokerage customers and their broker are not litigated, but rather handled through arbitration.[138] Investment firms prefer arbitration, because it is secret, quicker, and cheaper, occurs in front of arbitrators, not juries subject to emotional arguments, has less precedential value then does a judicial decision, and is final and binding.

From the perspective of individual investors, arbitration may prove to be a more hospitable environment than litigation for investors claiming that their losses are due to analysts' recommendations that were distorted by analysts conflicts.

[137] The Court noted that it was not deciding an issue that is, so to speak, on the reverse side of this coin, whether the omission or misrepresentation caused the share's higher price to be lower than it otherwise would have been. *Id.* at 6. . .

[138] There are numerous venues for arbitration proceedings. The National Association of Securities Dealers (NASD), National Futures Association (NFA), New York Stock Exchange (NYSE), etc. all maintain arbitration mechanisms to handle disputes with their members and investors. This is the normal method of handling securities arbitration matters. If the parties all desired to use another entity, organizations such as the American Arbitration Association (AAA) are available, or the parties could employ an arbitrator of their mutual choice.

[139] A comprehensive treatment of the many issues involved in the arbitration process can be found in Frank Elkouri & Edna Asper Elkourj, How arbitration Works (Alan Miles Rubin, ed., 6th ed. 2003).

Since they were customers of the brokerage firm employing the analyst, if— unbeknownst to the client—the interests of the investment banking arm of the brokerage firm unfavorably distorted the analysts' recommendation, then the client's legal position may be strong. As is the case with litigation, the client may have legal claims based upon theories of common law fraud, material omissions and misrepresentations under the federal securities statutes (and a state "blue sky" statute, if one exists), breach of fiduciary duties, and breach of their duties to make suitable investment recommendations.

An investor in the public securities market, who has no customer relationship with the analyst's employer, faces a major hurdle in showing reliance upon an analyst's recommendations. That is why, in the Merrill Lynch litigation, the investors sought protection under the fraud-on-the-market theory. It proved to be an interesting use of that legal theory, but it failed.

However, proof of reliance is more likely to be possible by a customer in an arbitration proceeding arguing that his investment portfolio was adversely affected by the analyst conflicts. If the broker possessed and exercised investment discretion over the customer's account, if the firm's analyst recommended purchases of stock with which the investment banking firm had a relationship, and the broker, after issuance of the recommendations, followed them by purchasing the securities for the client's investment account, a *prima facie* case of reliance would seem to exist. Rebuttal evidence will be hard to find. Even in a self-directed customer account situation, substantial evidence of reliance may exist. Brokerage firm business records may demonstrate the issuance of an analyst's recommendation and then show telephone calls, or e-mails, to a client by a broker, and the subsequent purchase of the relevant security. When coupled with oral testimony by the client that he relied upon the broker's and analyst's strong buy[140] recommendations in forming his decision to purchase the stock, that may prove to be persuasive evidence of reliance. If such a factual pattern is repeated in a number of instances, the client's contention of reliance will be further buttressed.

The New York Attorney General's investigation revealed some instances where analysts' internal e-mails seemed to be in direct contradiction to their stock recommendations issued publicly by their firms. If, in such an instance, a party in arbitration acted upon that public recommendation in connection with the purchase of the security, a strong factual case exists for overcoming a respondent's claim that a statement of opinion is not actionable. Now there exists evidence that the speaker of the opinion does not genuinely or reasonably believe it.[141] This evidence could support a common law fraud argument, as well as a material misrepresentation or omission cause under securities law.

[140] We use a recommendation of "strong buy" in our illustration, because "buy" in the old environment usually was interpreted as "hold" and so few "sell" recommendations were issued.

[141] Under Virginia Bankshares v. Sandberg, 501 U.S. 1083 (1991), statements of opinion are actionable when the speaker did not actually hold the opinion. One circuit court has interpreted this to mean that statements may be actionable if there are specific statements of fact that are false or that the speaker does not genuinely or reasonably believe. In re IMB Corp. Sec. Litig., 163 F.3d 102,107 (2d Cir. 1998).

1. Breach of Fiduciary Duties and Arbitration

The strength of breach of fiduciary duties claims will depend on the nature of the relationship between the investor and the brokerage firm and its analyst. When one is simply an investor in the public markets, there is no relationship in existence upon which one can frame a breach of fiduciary claim against a brokerage firm, its broker, and its analyst. The law does not impose a general duty of loyalty and good faith towards members of the public in general or to investors in particular. While tort law imposes upon members of society a duty to exercise a degree of care that a reasonable person would exercise in similar circumstances, state and federal securities statutes impose obligations in specified instances. Investment firms owe no all-encompassing duty of care towards participants in the public markets. However, when a customer relationship exists between an investor and an investment firm, fiduciary duties can exist. As discussed below, member firms of both the New York Stock Exchange and the National Association of Securities Dealers have an obligation to recommend to clients only securities that are appropriate under the circumstances. An alleged breach of this duty is arbitrable. The degree of fiduciary duties to clients will vary according to the nature of the customer relationship. It will be at its highest when the customer has created a discretionary account, for which the broker makes all of the purchase and sale decisions. It will be somewhat less when the broker merely recommends securities transactions to the client, who retains sole decision-making authority over the account.

When a broker recommends a security to a client, and its purchase will generate a commission for both the investment firm and broker, a duty of care exists towards the client. If the purpose of the recommendation is unrelated to the appropriateness of the investment for the client's portfolio and is made only to generate commission income, the broker has breached his duty of loyalty owed the customer. If the purpose is multifaceted, *i.e.*, to generate commission income, earn investment banking fees from the securities issuer in an IPO, and gain future investment banking fees from this investment banking client and attract such business from other prospective investment banking clients, regardless of the soundness of the investment to the client, the requisite duty of care is breached. If an analyst's report that was not issued in good faith is used to buttress the broker s recommendation and to convince the client to make the purchase, the degree of the breach is magnified.

Agency law allows the agent to act, when a potential conflict of interest exists to clients, only when full disclosure of all relevant facts has been made to the principal and the principal authorizes action by the agent despite the conflict s presence. The new disclosure rules issued by the NYSE and the NASD will have eliminated this particular fiduciary issue in the future, because the investment firm will disclose the existing and potential investing banking relationships in analysts reports. However, until all claims prior to the adoption of these rules are arbitrated, a potent argument exists that the investment firm breached its fiduciary duty by failing to disclose the presence of such conflicts with respect to particular stock recommendations.

2. Proof of Loss-Causation in Arbitration

Causation will be the client's most difficult burden of proof in arbitration of securities disputes that revolve around the issue of analysts' conflicts. The brokerage firm's liability will be non-existent unless it can be shown to have caused the loss. The brokerage firm will typically adopt a three pronged defense: a) investing carries risks and you acknowledge acceptance of those risks in the account agreement; b) our recommendations contained cautionary statements, such as: "the valuation is aggressive and risk is associated with the company's strategy," there exists a "high potential for price volatility," etc.; and c) the losses are attributable to a broad and sustained decline in the overall stock market.[142]

Federal securities laws impose liability upon those who *with intent to defraud* make a *material* misrepresentation or omission of*fact* in connection with the purchase or sale of securities that *causes* a plaintiffs loss. Note particularly the word *fact,* there is no statutory liability for misrepresentations and omissions with respect to *opinions.* In the Merrill Lynch litigation[143] the judge pointed to investment risks as the real cause of the plaintiffs losses. He characterized them as "high risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance." He continued by saying that they would have the court "conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost fair and square and they will never return those monies to the plaintiffs."[144]

When, in the customer agreement, the client acknowledges the risks inherent in investing and signs his name to assume those risks, and the investment recommendation relates to a suitable security (discussed below), a plaintiff will find it quite difficult to avoid personal liability for any resulting losses and thereby shift it to the investment firm and broker. Likewise, when the investment recommendation contains accurate cautionary notes about the issuing company, the industry, or the general economy they are given for a reason. While a disappointed investor may attempt to question their effectiveness by labeling cautionary statements as mere "boilerplate," they do "bespeak" a warning. There is a degree of inherent speculation in predicting the future trading price of any stock in the market. Past results do not provide a guaranty of future results. An unsuccessful investor faces credibility problems in arguing that a judge or arbitrator easily should disregard the presence of

[142] These legal arguments met with success in *In Re Merrill Lynch, supra* note 105, and should be expected as defense theories as well in securities arbitration cases.

[143] *Id.* at 5.

[144] *Id.* at 7.

a stock report's warning language when making a determination as to liability for trading losses.

An investor seeking to recover financial damages caused by a decline in price of stocks in an overall up market has a less arduous task than one seeking to recover for the decline in price of one's investment portfolio when the overall market has swooned. The dramatic decline in the US securities markets, referenced at the beginning of this article, form a relevant backdrop against which much of today's securities litigation and arbitration is taking place. The bursting of the bubble in Internet stocks may be the intervening cause of losses suffered by many market participants. When "factors other than the defendant's fraud are an intervening direct cause of a plaintiffs injury, that same injury cannot be said to have occurred by reason of the defendant's actions."[145] When the overall market and the client's stock have both collapsed, the client will need to prove a factual link between the stock's price decline and the conduct of the investment firm. Otherwise, the logical conclusion is that the market decline, not actions by the investment firm, is the intervening cause of the client's losses.

3. Arbitration and the "Know Your Customer" (NYSE) and Suitability (NASD) Rules

The defenses possibly most susceptible to rebuttal by the investor are the first two, *i.e.*, that the investor assumed the risks and was warned of them. Brokerage firms, as members of various stock exchanges, are governed by membership rules. Among these are a "know your customer" rule and a "suitability" rule.[146] It is because of these rules that the brokerage's new account form solicits information from a prospective customer about income, assets, age, investment experience, and investment goals. Under the rules, it is not sufficient for a firm to recommend an investment, and then, by slapping a "risky" label on it, avoid liability to the client for the recommendation. The firm bears the responsibility for determining whether a particular kind of recommended transaction (for instance, purchase or sale of a specific security, purchases on margin, puts and calls transactions, short sales, etc.) is appropriate for a client investor. An investor cannot assume the risk of a speculative investment if he lacks the knowledge to apprehend the risk. A brokerage firm must exercise its expertise in determining the appropriateness of a recommended transaction for its client, prior to making that recommendation. The recommendation of a securities transaction to clients in two very different stations in life, *i.e.*, a well-

[145] Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 189 (2d Cir. 2001) (citing First Nationwide Bank v. Gelt Funding Corp., 27 F 3d 763,769 (2d Cir. 1994)).

[146] New York Stock Exchange Rule 405, "Diligence as to Accounts" (popularly known as the "know your customer" rule), obligates its members to "[u]se due diligence to learn the essential facts relative to every customer. . . . " The equivalent obligation for members of the National Association of Securities Dealers is Rule 2310 "Recommendations to Customers (Suitability)." Others are relevant also: Rule 2310-2 addresses "Fair Dealing with Customers" and treats subjects such as excessive trading or "churning," fraudulent activity, recommending purchases beyond a customer's capability, and with regard to derivates and new financial products;-Rule 2310-3 discusses the suitability obligation in the context of institutional customers, thereby illustrating the broad scope of the obligation.

to-do sophisticated investor and a retiree on a relatively small fixed income, is not rendered appropriate by the mere inclusion of boilerplate language that the trade entails risks and that past performance is no guaranty of future results.

The National Association of Securities Dealers requires that, when a member firm recommends that a customer purchase, sell, or exchange any security, it possess reasonable grounds for believing that the recommendation is "suitable" for the customer, based upon facts disclosed by the customer with respect to his other securities holdings, financial situation and needs.[147] The member firm has the obligation to make reasonable efforts to obtain information concerning the customer's financial and tax status, investment objectives, and other information considered to be reasonable by the member for making recommendations to the customer.[148]

While the NYSE and NASD rules do not explicitly create a private cause of action for civil damages against a member firm for rules violations, an argument can always be made that one implicitly exists. However, if a private cause is to be implied, the plaintiff bears the burden of establishing its existence.[149] Case law is against such an implication.[150] These rulings, however, are not dispositive of the issue within the arbitration context. Remember that arbitration, rather than dealing strictly with the applicability of statutes, is a contractual agreement of the parties to privately enforce the terms of their arbitration agreement. Actions by a party need not be shown to have violated a statute for it to constitute a violation of one's obligations under the parties' agreement. And, while the arbitration hearing will strongly resemble litigation, it follows its own specific mechanisms. For instance, the rules of evidence are not obligatory in an arbitration hearing.[151]

Arbitration of securities disputes frequently will revolve around issues of whether or not the stock broker and the brokerage firm met their obligation to make appropriate recommendations to the client. Demonstrating a violation of the "know your customer" or the "suitability" rule constitutes strong evidence that the brokerage firm and broker are responsible for the investor's loss.

### C. *The April 2003 Global Settlement*

New York Attorney General Eliot Spitzer, under the authority of a New York state fraud statute, conducted a major investigation of analysts' and their investment bank employers' conflict-of-interest problems. The Securities and Exchange Commission later joined the probe, along with the National Association of

[147] NASD Rule 2310.

[148] NASD Rule 2310 (b)(l-4).

[149] Sanders v. John Nuveen & Co., 554 F.2d 790, 797 (7th Cir. 1977).

[150] *See, e.g.*, Pyle v. White, 796 F. Supp. 380 (S.D. Ind. 1992), which so holds and cites a number of cases in accord.

[151] *See* 1998 National Futures Code of Arbitration §6053.4(dX3): "The Panel need not apply the technical rules of evidence." Or 1996 NASD Code of Arbitration Procedure # 10323: "The arbitrators shall determine the materiality and relevance of any evidence proffered and shall not be bound by rules governing the admissibility of evidence."

Securities Dealers, the New York Stock Exchange, and other state regulators. The result was a settlement in April 2003 between ten of the largest securities firms and two analysts, which has come to be called the "April 2003 Global Settlement."[152] The settlement agreement provides for a total payment by the respondents of $ 1.4 billion, with $387.5 million of it to create a restitution fund for investors harmed by stock research abuses.[153] This settlement fund will provide an additional remedy for qualifying investors.[154]

With respect to the issue of analyst conflicts, the settlement provides for: 1) clear separation between a firm's investment banking and stock research operations; 2) provision of "independent" research to investors, at no charge; 3) more extensive disclosure of how an investment firm rates stocks; 4) a halt to the practice of "spinning"; and finally 5) agreement not to claim a tax deduction for the financial penalty portions of the settlement, nor to seek reimbursement under the firms' insurance policies.

Both the firms and the analysts neither admitted nor denied the charges asserted against them. They agreed to the entry of an injunction against future violations of the statutes and rules that it is alleged they violated.[155]

Citigroup's Salomon Smith Barney unit will pay $400 million, Credit Suisse First Boston $200 million, Merrill Lynch $200 million, Morgan Stanley $125 million, Goldman Sachs $110 million, Bear Steams $80 million, J.P. Morgan Chase $80 million, Lehman Brothers $80 million, UBS Warburg $80 million and Piper Jaffray $32.5 million.[156] In addition, analyst Henry Blodget, formerly of Merrill Lynch, will pay $4 million and be permanently barred from the securities industry and analyst Jack Grubman, formerly of Salomon Smith Barney, will pay $15 million and likewise be permanently barred from the securities industry. At a subsequent United States Senate hearing, some senators voiced skepticism that the settlement would result in fundamental change within the industry.[157]

In August 2004, the same regulatory authorities reached settlements with Deutsche Bank Securities and Thomas Weisel Partners concerning allegations that they too had allowed investment banking interests to unduly influence securities research performed at their brokerage firms. The terms of this settlement are consistent with those imposed against the ten firms in the Global Settlement. In

[152] "Global" is a misnomer, because all of the regulatory parties to the settlement are American, but the label has become attached to the settlement.

[153] *See* Wall St. J., April 9,2003, for multiple stories that discuss the terms of the settlement..

[154] As to the distribution of these funds, *see* http://www.sec.gov/news/press/2003-62.htm.

[155] SEC Fact Sheet on Global Analyst Research Settlements, http://www.sec.gov/news/ speech/factsheet.htm. ,

[6] The allegations involved four issues: 1) the issuance of fraudulent research reports—CSFB, Merrill, & Salomon; 2) the issuance of research that was unfair or not in good faith—CSFB, Merrill, Salomon, Bear Steams, Goldman, Lehman, Piper, and UBS; 3) receipt of or payment for researchthat was undisclosed— ■J P. Morgan, Morgan Stanley, UBS, Bear Steams and Piper; and 4) spinning—CSFB and Salomon.

See *Senators Skeptical of $1.4 Billion Wall Street Settlement.* May 17, 2003, http://www.Nytimes.com/aponline/business.

*See* http:www.sec.gov/news/press/2004-120.htm.

addition, Deutsche Bank will pay $87.5 million and Thomas Weisel Partners $12.5 million as the financial portion of the agreement.

Has the settlement provided investors with a higher quality of stock research? In the year following the settlement, evidence has been developed showing the advice provided by brokerage firms has become more reliable.[1 9] Under the settlement terms, brokerage firms agreed that whenever they issued a rating on a stock, it would be accompanied by at least one independent analyst's rating on that same security. In the period 2000-2003, the independent researchers performed at a higher level than the recommendations of the brokerage firms, but recently the performance of the latter group is getting closer to that of the independent firms.[160] Also, their tendency to rate the stocks of client firms more favorably is declining[161] This would seem to indicate that the competitive pressure of supplying comparative data is making higher quality information available to investors.

### V. INTERNATIONAL DEVELOPMENTS

Securities markets no longer stop at a nation's borders. Capital goes wherever investment opportunities lie, with the result that investment firms have offices in a multiplicity of nations and corporations raise funds across the globe. There are 459 non-US companies from 47 different countries that have listed their stock for trading on the New York Stock Exchange.[162] All told, the number of foreign companies with US listings is 1,230.[163] The result is an increasing role for the SEC in the affairs of foreign companies, such as the Italian dairy firm Parmalat Finanziaria, the Dutch concern Ahold, and France's Vivendi Universal SA.[164]

While capital is oblivious to national borders, regulators are not. The globalization of markets can create conflicts among regulators over the nature of their respective regulatory domains. But it can also lead to increased cooperation, as they find it in their self interest to do so and necessary for effective regulation to exist.

#### A. *The International Organization of Securities Commissions*

Eleven securities regulatory agencies from North and South America formed an international cooperative forum for securities regulatory agencies in 1983—the International Organization of Securities Commissions (IOSCO). Through the years, it has grown to encompass 181 members, which regulate in excess of 90% of the world's securities markets. It acts both as an international standard setting

[159] Jane Kim, *Stock research Gets More Reliable*, WALL ST. J., June 7,2005, at D1.
[160] *Id.*
[161] *See* Ohad Kadan, Leonardo Madureira, Rong Wang & Tzachi Zach, *Conflicts of Interest and Stock Recommendations—The Effects of the Global Settlement and Recent Regulations, available at* http://students.olin.wustl.edu/~wangr/papers/kmwz.pdf.

[162] http://www.nyse.com.
[163] Michael Schroeder & Silvia Ascarelli, *New Role for S.E. C.*, WALL St. J., July 30,2004, at A1.
[164] *Id.*

body and as an instrument of cooperation and transfer of expertise agent between the developed and emerging markets.

The integrity and objectivity of research are crucial to the protection of investors and ensuring that markets are fair, efficient and transparent, in the view of IOSCO. Thus, it requested that one of its committees study analysts' conflicts and report to the membership. In the *Report on Analyst Conflicts of Interest,*[165] the committee states that the avoidance of analysts' conflicts of interest, or if not avoidable, their appropriate management and disclosure, are crucial to the maintenance of confidence in the markets. Its study focused upon sell-side analysts, buy-side or independent analysts, as having the greatest impact upon retail and small institutional investors and facing the most numerous conflicts of interest.[166]

The report notes that most jurisdictions have no minimum qualifications or registration requirements for securities analysts, although there may be some licensing-type requirement, if they perform other duties in the securities field. Until the recent past, any regulation of analyst conflicts was internal to the firm or by a professional association, rather than by a national regulatory authority. The report acknowledges that the types of conflicts we discuss above do exist in the world's securities markets. Many jurisdictions regulate these conflicts only through the application of anti-fraud, market manipulation, and insider trading laws that govern all market participants. The report concludes that four "key areas" need consideration when a jurisdiction addresses analyst conflicts: 1) How do regulators ensure that firms and their analysts act with integrity? 2) What conflicts of interest need to be avoided, what conflicts managed, and when and in what form is disclosure required? 3) Should specific entry criteria or proficiency requirements be created for an analyst position? 4) What role should investor education play in addressing the issue?[167] In answering these questions, it noted that jurisdictions may also want to include consideration of both cross-border dissemination of research and cross-border regulation of conflicts. Finally, it said that future work might consider issues such as: a) retaliation by issuers against analysts for unfavorable reports; b) whether reports are fairly disseminated to investors or selectively to favored investors; c) whether professional qualifications should be developed for analysts; and d) whether "plain language" requirements and standardized language (buy means buy) meanings should be adopted.[168]

B. *The Response of the United Kingdom to Analyst Conflicts*

The UK equivalent to the American SEC is the Financial Services Authority (FSA). Whereas the SEC has two objectives, full and fair disclosure and the prevention of fraud in connection with the sale of securities, the FSA has four: 1)

[165] *A Report of the Technical Committee of the International Organization of Securities Commissions*, Sept. 2003, Document IOSCOPD 152, *available at* http://www.iosco.org/library/pubdocs/pdf/ JOSCOPD152.pdf.

[166] *Id.* at 3 n.5.
[167] *Id.* at 14-15.
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maintenance of market confidence, 2) promotion of public understanding of the financial system, 3) protection of consumers, and 4) fighting financial crime.[169]

Not surprisingly, there exist both similarities and differences between the US and UK markets. Many of the large American investment banks also are prominent in the financial markets of the UK. Stocks making up the FTSE 100 on the London Stock Exchange hit their peak in December 1999, followed by a drop of 27%[170] (the Dow 30 stocks declined 29% from their all-time high in January 2000). UK analysts share the US bias towards positive recommendations and they are more positive than average when the subject of the report is a client of the investment firm. The proportion of "buy" recommendations on FTSE 100 companies issued by a firm that has a broker/advisor relationship with the company is, at 80%, almost twice as high as the proportion of "buy" recommendations when the analyst does not work for the broker/advisor.[171] Analysts employed by a broker/advisor issue recommendations of "hold" on 18% of their clients and only 2% "sell" or "under perform." Conversely, analysts whose employer is unaffiliated with the company being reviewed issue 45% "buy," 38% "hold" and 18% "sell" recommendations.[172] Individual investors are not the active market participants that they are in the US Consequently, institutional investors play a greater role proportionally in the UK.

The regulatory thrust of the FSA is to issue rules in the nature of general principles, rather than the lists of specific dos and don'ts the SEC, NYSE or NASD promulgate. It has adopted a *Handbook*, which sets out these general principles covering areas under its regulatory authority.[173] As described by the FSA, "The UK regime, unlike the US, is founded on a set of principles which require firms to have arrangements for policing conflicts of interest and to treat their customers fairly. As with many other aspects of our regime, this approach differs from the United States, where 'black letter' rules are more common."[174] The FSA must also accommodate the mandates of the broader European Union when exercising its regulatory authority.

Although not regarding its principle-based regime as being less effective than the US approach, the FSA thought it prudent to make inquiry as to whether the analysts' conflicts exposed in the US were also present in the UK market.[175] Thus, it issued a discussion paper entitled *Investment Research: Conflicts and Other Issues*, outlining the various options available to it in handling such conflicts. It perceived that analyst conflicts may exist due to: their involvement with investment banking activities; a firm's compensation and reporting structure; a client's ability to exert

[169] *See* http://www.fsa.gov.uk.

[170] Financial Services Authority, *Investment Research: Conflicts & Other Issues*, Discussion Paper 15, July 2002, at 11 [hereinafter DP 15], *available* at http://www.fsa.gov.uk/pubs/discussion/dpl5.pdf.

[171] DP 15 at 3.

[172] *Id.* at 18.

[173] The areas include: High Level Standards, Business Standards, Regulatory Processes, Redress, Specialist Sourcebooks, and Special Guides. Occasionally, the *Handbook* will be updated by the issuance of a numbered Handbook Notice. These are available at http://fsahandbook.info/FSA/index.jsp.

[174] DP at 4.

[175] For another perspective on this issue, *see* Fred Naffziger & Mark A. Fox, *Conflicts of Interest in Investment Research: The US and UK Responses*, 14 INT'L COMPANY & COM. L. Rev. 273 (2003).

pressure upon its investment bank; the public impact of research reports and the parallel inexperience of unsophisticated investors to properly evaluate them; access to material nonpublic information, coupled with the securities holdings of an analyst, the firm, or the client; and other miscellaneous potential matters.[176] A reader will note that the nature of these potential conflicts is similar to that in the American securities markets.

The preliminary conclusion of the FSA was that there was no systemic problem of analyst's conflicts in the UK marketplace.[1'7] Nonetheless, it determined that, in light of the similarities between the US and UK markets and the widespread conflicts found in the US, it would be prudent to review FSA procedures to protect investors, to request comments from market participants with respect to the issues, and to evaluate the advantages and disadvantages inherent in any proposed changes to current rules.

It therefore asked interested parties to comment upon the roles actually played by UK analysts, whether the FSA and investment firms are appropriately regulating the conflicts, whether a more specific, rule-based system like that of the US should be adopted, the likelihood that a global system of regulation will replace that of individual nations, and what future action, if any, the FSA should undertake.

The FSA subsequently issued *Consultation Paper 171*.[178] It concluded that, although it is not of the same dimension, the UK shares the analyst conflicts problem with the US. It identified three "key" themes from responses to the earlier discussion paper: a) a regulatory system using broad principles, rather than one of specific rules, remains the appropriate approach to the problems; b) acceptable standards, within these broad principles, need to be made clearer; and c) to the greatest extent possible, the principles must be consistent with those in the EU and the US.

In the *Consultation Paper* were additional "policy proposals" to which it invited responses.[179] The first policy proposal is that the prime responsibility for the management of conflicts rests with the senior management of firms. The second is that conflicts are best handled by a combination of tight internal management control and effective market disclosure. It said that the controls must focus upon the supervision of analysts, their involvement in marketing activities, their reward structure, and their susceptibility to pressure from outside companies. It noted that this will "require the exercise of judgment" and that such standards cannot be fixed through "black letter rules." Third, it indicated a belief that investors' understanding of research and its conflicts will particularly benefit from a disclosure of the firm's recommendations for a client, compared to its recommendations across a relevant

[176] *Id.* The paper is for discussion purposes only and does not constitute "guidance" under section 157 of the Financial Services and Markets Act of 2000; *see* DP at 10.

[177] The FSA conducted a series of visits to explore how analysts are supervised and paid the nature of their relationships with other units of their employer, and the internal rules governing their personal

"*1 Services Authority, *Conflicts of Merest: Investment Research and IssueofSecunties* Consultation Paper 171, Feb. 2003 [hereinafter CP 171], *available at* http.//www.fsa.gov. uk/pubs/cp/cp 171 .pdf.

[179] *Id.* at 5-6.

sector coupled with the analyst's own track record. Lastly, and notably, it also declared the practices of spinning and laddering to be "inconsistent" with the current principles of FSA.[180]

In what is an evolutionary process, the FSA evaluated the responses it received and responded with a third document, *Consultation Paper 205.* It said that the standards mentioned in CP 171 are appropriate and a principles-based regime provides the right broad framework for addressing conflicts.[182] According to the agency, such a "Principles-based approach to regulation means that we can minimize the extent to which we add further detailed requirements to those already in place, eg in the US."[183] It yields the flexibility necessary to withstand changes over time in industry structure[184] and addresses the underlying conflicts, rather than particular business structures.[185]

The most significant modification to CP 171 is the requirement that a firm make available to the public its policy on managing conflicts.[186] Responsibility for meeting these conflicts standards is placed firmly on senior managers of a firm. Research presented as objective and unbiased must be objective, in the sense of impartial. It does not consider it necessary to specify what kinds of material must be objective research, rather leaving such a determination to the discretion of a firm's senior management.[187] Unlike US regulators' confinement of conflict rules to the equity markets, it does not regard conflicts of interest as residing solely in the equities market. It perceives the potential for conflict problems to exist also with corporate debt instruments, emerging market debt, commodities trading, and derivatives. Thus, it makes no distinctions amongst the type of instruments governed by its policy.[188] Buy-side concerns that identify no conflicts need not adopt a conflicts-management policy.

In CP 171, the FSA stated that a goal of consistent regulation across national borders does not necessarily mean uniformity, and in CP 205 it reiterated its continued adherence to a "Principles-based approach," even if it means that firms operating in multiple countries need to comply with more than one set of rules.[189] Unlike the US, it is not mandating the funding of independent research, nor the self- certification of analysts.[190] Again contrary to the US, it is not imposing a quiet period on investment research around the date of an IPO.[191] It had proposed such a rule in

[180]/¿.at 6.

[181] Financial Services Authority, *Conflicts of Interest: Investment Research and Issue of Securities,* Consultation Paper 205, Oct. 2003 [hereinafter CP 205], available at http://www.fsa.gov.uk/ pubs/cp/cp205.pdf.

[,t2]*Id.* at 12.

[183] *Id.* at 10.

[184] *Id.* at 21.

[185] *Id.* at 22.

[m] *Id.* at 19.

[w] *Id.* at 17.

[m]*Id.* at 19-20.

[185] *Id.* at 10.

[m] *Id.* at 14.

[1,1] *Id.* at 26.

CP 171, but, in light of comments received, decided against doing so. It had also proposed a ban on linking an analyst's remuneration to a particular transaction or specific recommendation in that document. In CP 205, it not only adopted such a rule, but broadened it to require that the compensation plan should neither create, nor suggest the creation of, compensation for research that is less than objective.[192]

Finally, it decided, in line with its stated intention to be consistent in its approach internationally, not to adopt disclosure rules about a firm's rating system and analysts' track records, since it has become clear that the European Union will be addressing that issue.[193] It said the policy decisions of CP 205 would be effective July 1, 2004. In a continuation of its process of examining this broad area, it solicited comments on: a) the appropriateness of focusing upon objective research of a firm, rather than material used in marketing a firm, and b) whether senior management's responsibility for such policies would be more effective with the development of common industry practices.

C. *Is the UK or the US Approach Preferable?*

It will be interesting to reconsider the matter of analyst conflicts after the passage of a period of sufficient time to measure their effectiveness and then compare the effectiveness of the UK rules *vis-à-vis* the US rules. The UK "principles- based" approach focuses upon the substance of one's actions. The US emphasis on specific "rules" focuses upon the legal form of one's actions.

Criticism of the US approach points to the system allowing a transaction to be structured so that it is technically legal, but in substance misleading. A good example is Enron's use of "special purpose entities" to keep debt off its balance sheet. Under the rules then in place, if an independent investor owned 3% of an entity's equity, Enron did not have to include debt to that entity on its balance sheet.[194] In reality, Enron had substantial monetary obligations to a variety of these entities, yet none of this debt appeared on its balance sheet, creating the appearance that its debt-equity ratio was much better than it actually was. Supporters of the UK philosophy would say that substance-wise, what is the fundamental difference between an independent investor owning 2.9% of the equity, forcing Enron to consolidate the debt on its balance sheet, and a 3% holding, which permits Enron to avoid consolidation? They would argue that the fundamental economic substance of

[1,2] *Id.* at 24.

[193] *Id.* at 5. The FSA based this comment upon Parliament and Council Directive No. 2003/6/EC of 28 Jan. 2003 on insider dealing and market manipulation (market abuse), 2003 O.J. (L96) 16(12 April 2003).

[154] Prior to 1996, there were no Financial Accounting Standards Board (FASB) rules on special purpose entities. The rules came from a body somewhat related to FASB, the Emerging Issues Task Force (EITF). In 1990, EITF published Issue No. 90-15, providing guidance for not consolidating the debt of such an entity. The SEC's staff response was to indicate that 3% equity was the minimum investment required. FASB Statement No. 125 on special equities didn't adopt or reject EITF s position. *See* A1 Hartgraves & George Benston, *The Evolving Accounting Standards for Special Purpose Entities and Consolidations*, 16 Accounting HORIZONS, no. 3, at 245-258 (2003), for a good discussion of the issue. In 2003, the FASB issued FAS Interpretation No. 46, increasing the requirement from 3 o to 1[1]) *o-

the transaction, not its legal form, should control the matter of consolidation and disclosure to investors.

Criticism of the UK approach, that an "investment firm extend fair treatment to customers and maintain internal controls to control conflicts of interest," focuses upon the very general nature of the prohibition and so argues that it provides no real guidance at all. American lawyers are comfortable with a due-process mentality: the nature of the charges require specification for one to fairly defend against them. It makes them suspicious of a process where a regulatory body can allege violations of some undefined "spirit" of a principle, rather than a concrete rules violation.

Both regulatory approaches contain plusses and minuses. It may be that neither is ideal, yet it is too soon to draw any conclusions, and each may prove to be effective in its own way.

D. *A Disturbing Development in France*

A French company, LVMH Moet Hennessy Louis Vuitton SA, took judicial retribution against the negative reviews of an analyst and her American investment bank employer, with results that are disturbing to those who desire the availability of a wide range of analysts' opinions.[195] LVMH and the Gucci Group compete in the luxury goods market and, in 1999, LVMH mounted an unsuccessful takeover attempt of Gucci. Gucci is an investment banking client of Morgan Stanley.

In its suit, LVMH argued that it had been harmed by the negative comments of the Morgan Stanley analyst. It contended that the negative reports were done to favor its investment banking client Gucci, that this relationship was not properly disclosed, that the negative comments were coupled with positive ones about Gucci, and that their purposes were to boost Gucci's stock and to depress LVMH's share price, particularly during the takeover attempt.

The French court ruled in early 2004 in favor of LVMH, saying that Morgan Stanley had engaged in "gross misconduct." The court assessed €30 million for the "moral" damages Morgan Stanley caused and said another proceeding would determine economic damages.[196] Morgan Stanley's position was harmed by some factual misstatements, which LVMH had called to its attention but which were uncorrected, and by some additional information that was subsequently not updated. Not surprisingly, Morgan Stanley has halted analyst coverage of LVMH.[197]

One day after the announcement of this decision, a different French business, Sodexho, announced its right to "seek appropriate redress" against an analyst employed by Citigroup. The research note in question queried the favorable nature of some developments in the company's report and the company's stock price

[195] While the authors realize that this discussion of French legal developments is quite truncated, we regard the developments to be of sufficient interest to merit this brief mention.

[196] Paris Commercial Court (First Chamber), Jan. 12, 2004. The decision may be found at: http://lexinter.net/JPTXT4/responsabilite_des_analystes_financiers.htm.

[197] As a result of the decision, Morgan Stanley amended its financial statements. *See* http://www.morganstanley.com/cgibin/morganstanley.com/pressroom.cgi?action=load&uid=317.

dropped by almost 8% on the Paris Bourse. The analyst then issued a statement saying his opinion was now different, based upon discussion with Sodexho.

Most of the discussion of analysts' conflicts focuses upon protection of the investing public. The French court decision does not advance that purpose; rather it awards damages to the company that is the subject of an analyst's report. We are not saying that the corporate victim of a libelous report should lack legal recourse. Rather, we posit that the French position will stifle vigorous coverage, particularly negative, of public companies. Modem capital markets depend upon information. The flow of timely and accurate information among market participants promotes investor confidence, which in turn, allows businesses to attract capital. Investors have the right to objective research, neither tilted in a positive manner to favor an investment banking client's interests, nor omitting honest negative comments due to the fear of litigation. Investment markets are not circumscribed by one nation's geographical borders. Consequently, if this one French court decision comes to reflect French public policy, it will have negative repercussions within both the European Union and the American stock markets.

## VI. CONCLUSION

When investors venture into the marketplace, they assume a degree of risk and there is some element of *caveat emptor.* There is substantial empirical support for the proposition that analysts provide optimistic forecasts for the securities that are promoted by their own brokerage firms.[198]

The degree of risk that one desires to assume is up to the individual and what is a conservative investment to one individual may constitute an aggressive one to another. Brokerage firms have a duty to know their clients and to recommend only suitable investments to them. When brokerage accounts are opened, the potential client submits a variety of financial information. Data as to the prospective investor's income, net worth, occupation, education, past investment experience, current holdings, investment goals, etc., are requested. As an investor moves along the spectrum from basic investments in stocks and bonds to more risky products, such as options, puts, and calls, to even more speculative ones, such as options on futures, the brokerage firm should be making certain that such investments are appropriate for one in such a position, educating the customer as to the increasing risks and obtaining signed acknowledgments that the risk is understood and assumed.

An inherent risk everyone assumes is that a general decline in the market may affect his individual portfolio; a brokerage firm, a broker, or a stock analyst bears no responsibility for such losses.[199] Retail investors need to exercise a degree

[198] Lynn Hodgkinson, *Analysts' Forecasts and the Broker Relationship.* 28 J. BUS. FIN. & ACCT. 943

'^2 Rowe v. Marietta Corp., 1999 U.S. App. LEXIS 189 at 11 (6th Cir. Jan. 6, 1999) (recovery not allowed for losses related to market risks, only for loss proximately caused by a defendant s wrongdo.ng); Low v. Medco Research Inc., 113 F.3d 79 (7th Cir. 1997) (there is a lack of causation when the stock moves in tandem with the entire market); Fryling v. Merrill Lynch, 5 ,
(one cannot recover damages caused by market decline).

of healthy skepticism when hearing a stock recommendation from an analyst. The recommendation may be fundamentally sound, or it may be have been skewed by conflicts inherent in the analyst's relationship with the company or his employer.

The investor is managing his own money and should do so prudently. One has the wrong attitude about investing if, when considering an investment decision, he consoles himself with the thought that, "if I lose money, I will simply recoup it in legal action by blaming it on my broker and his firm's stock analysts."

In a perfect world, securities analysts would issue objective recommendations based upon thorough financial analysis. All relevant factors, not merely financial, would be thoroughly weighed, including the competence of the company's management, the competitive environment within the industry, and the forecast for the over all economy. The recommendation would be clearly stated. Such a report would contribute to an efficient market in two ways: a) it would provide information to market participants, and b) it would give those participants confidence in the fairness of those markets.

Investment banks' practices, allowing the development-analyst conflicts of interest, resulted in recommendations that sometimes failed to meet such a standard and contributed to the development of the stock market bubble in the United States and England. The regulatory action of United States has eliminated the blatant conflicts of interests and the ethical lapses that have undermined the confidence of some investors in our financial markets. Yet, the SEC, NYSE, and NASD will, in the future, be required to enforce them vigorously, evaluate their effectiveness in eliminating conflicts, be on guard against the birth of new conflicts, and make changes in the regulations, when needed.

In the United Kingdom, the FSA is moving forward positively on the issue, as exemplified by its declaration that "spinning" and "laddering" is against its market principles. When it makes a determination as to exactly what other analyst conflicts exist in its market place, it has indicated a willingness to do so. The French court's decision is a step back, but one hopes eventually it may be overcome by future action of its government or the European Union.