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NOTE

FROM BEHIND THE CORPORATE VEIL: THE OUTING OF WALL STREET'S INVESTMENT BANKING SCANDALS - WHY RECENT REGULATIONS MAY NOT MEAN THE DAWN OF A NEW DAY

*Gina N. Scianni**

> It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way.[1]

INTRODUCTION

It was the dawn of a new millennium, and the infamous Internet tech bubble was about to burst. For years on Wall Street you could practically recommend anything "beginning with 'e-'

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1. CHARLES DICKENS, A TALE OF TWO CITIES 1 (unabridged ed., Dover Thrift 1999) (1859).

and see it trade at astronomical prices."[2] However, behind the scenes, Wall Street was harboring a dirty little secret. Some of its highest paid investment bankers were handing out hot IPO[3] shares in return for kickbacks. Others were offering favorable stock recommendations from their research analysts in order to secure lucrative investment banking contracts. In effect, Wall Street was catering to "two key constituencies: its institutional investors and its corporate clients. If the individual investor wanted to join the party, well, *caveat emptor*."[4]

With the advent of the Internet, along with the proliferation of business news rags, and financial TV programs, Wall Street has seen an increase in investor participation in the stock market.[5] Unfortunately, quantity of information is no guarantee of quality, and the armchair investor is an easy prey. "Recent investigations into conflicts of interest on Wall Street have shown that in too many cases in the past, investors' interests were compromised for greater investment banking revenues."[6] In response, State and Federal regulators have proposed a number of comprehensive

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2. *See Chinese Walls Need a Leak Test*, NAT'L BUS. REV., Oct. 25, 2002, *available at* http://www.sharechat.co.nz/features/nbr/article.php/46aeb302 (last visited Sept. 19, 2003).

3. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 260 (4th ed. 1995) (defining "IPO" as "a corporation's first offering of stock to the public. IPOs are almost invariably an opportunity for the existing investors and participating venture capitalists to make big profits, since for the first time their shares will be given a market value reflecting expectations for the company's future growth.").

4. Landon Thomas, Jr., *Can Settlement Actually Level Playing Field for Investors?*, N.Y. TIMES, Dec. 23, 2002, at C1.

5. *See* NASD Guide to Understanding Securities Analyst Recommendations, *at* http://www.nasdr.com/analyst_brochure.htm (last visited Sept. 19, 2003) [hereinafter NASD Guide] (explaining that as a result of expanded market participation "there is a din of data for investors to sift through today . . . and as a result it has never been harder for small investors to assess which information they should rely upon in making decisions.").

6. NASD News Release, *NASD Charges Frank Quattrone with Spinning, Undermining Research Analyst Objectivity, Failure to Cooperate in Investigation*, Mar. 6, 2003, *at* http://www.nasdr.com/news/pr2003/release_03_010.html (last visited Mar. 9, 2003) [hereinafter NASD News Release, *Quattrone*] (citing Mary L. Shapiro, NASD's Vice Chairman and President of Regulatory Policy and Oversight).

reforms in an effort to restore investor confidence and integrity to the capital markets.[7]

Part I of this note discusses pertinent background information; the role of the research analyst in the capital markets, types of conflicts of interest and early examples of regulation that in the end proved unsuccessful. Part II begins with illustrations of recent high-profile corporate scandals regarding research analysts' conflict of interest, and then moves on to discuss the recent regulatory efforts to curtail such activity. Part III analyzes some of the problems and inconsistencies inherent in some of the new rules and ultimately concludes that a number of them fall short of their intended goals and that the road to restoring investor confidence and market integrity is a long way off.

I. BACKGROUND

A. The Role of the Research Analyst

Research analysts examine companies in light of "economic, industry and business trend information."[8] That research is used by broker-dealers to assist their customers in making informed investment decisions,[9] and as a marketing device to promote buy and sell recommendations on publicly traded securities.[10] In addition, these brokerage firms commonly have investment

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7. *See* NASD Understanding Securities Analyst Recommendations, *A Message from the Chairman and CEO of the NASD, at* http://nasdr.com/analyst_bgmessage.htm (last visited Mar. 11, 2003) (discussing recent "steps to educate investors and improve industry practices in the area of securities analyst recommendations" . . . as a part of a larger trend to maintain the highest standards of investor protection and market integrity).

8. NASD Guide, *supra* note 5.

9. *See id.*

10. *See* Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 COLUM. BUS. L. REV. 631, 635 (2002) (noting that brokerage firms typically use the research to recommend and sell securities to their customers).

banking divisions, which underwrite securities.[11] "An underwriter acts as intermediary between the company publicly offering securities and investors buying new stock."[12]

Typically research analysts fall into three categories: "sell-side," "buy-side," and independent.[13] Sell-side analysts work for large financial firms with brokerage customers.[14] Buy-side analysts, however, typically work for "institutional money managers such as mutual funds, hedge funds or investment advisors."[15] Finally, some analysts are unaffiliated, selling their independent research to financial institutions or private investors on an *ad hoc* or subscription basis.[16]

B. Types of Conflicts

Following the burst of the Internet bubble, the SEC launched extensive on-site examinations of several full service brokerage firms focusing on buy recommendations made by supposedly independent research analysts to the investing public for technology stocks.[17] Investigators wondered how so many analysts could have been wrong.[18] In scrutinizing analysts'

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11. *Id.* (explaining that "the investment banks will use the research to serve an important due diligence function for the underwriters.").

12. *See* NASD Guide, *supra* note 5.

13. *See* Gross, *supra* note 10, at 635.

14. *See id.*

15. NASD Guide, *supra* note 5.

16. *See id.*

17. *See* Laura S. Unger, Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services United States House of Representatives, *at* http://www.sec.gov/news/testimony/073101tslu.html (last visited July 31, 2001) [hereinafter Unger Testimony]; *see also* Gross, *supra* note 10, at 632 (explaining that securities industry participants and observers focused on buy recommendations made by analysts who appeared to have been independent once the tech bubble burst and Internet stocks began to plummet).

18. *See* Gross, *supra* note 10, at 632 (stating that questions were raised as to how so many of the analysts could have been wrong in recommending tech stocks that were soon to crash).

methods and motivations, the SEC discovered a number of remarkably prominent areas of conflict.[19] According to Laura Unger, then Acting Chair of the SEC, it became evident that the line between research and investment banking had become increasingly blurred.[20] The SEC acknowledged that research analysts are subject to myriad influences that affect the reliability and value of their analysis and recommendations.[21]

1 *Investment Banking Relationships*

A sell-side analyst's firm can significantly benefit from "providing investment banking services, such as underwriting an IPO, or advising on a merger or acquisition."[22] All firms examined by the SEC stated that analysts provided substantial assistance to investment banking, such as consulting on corporate finance deals, participating in road shows[23] and advising in possible mergers and acquisitions.[24] "Moreover, it was established by the investigations that analysts often provided advance notice of their changes in recommendations and even issued 'booster-shot' research reports right around the time a lock

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19. *Id.* (delineating major areas of conflict, for example analysts' "recommended the purchase of securities to the investing public and to customers of their own firms without disclosing the fact that they owned those very securities." Additionally, their compensation was "tied to their recommendations," ... and perhaps most importantly, their firms "received compensation —typically in the form of investment banking business— from the issuer.").

20. *See* Unger Testimony, *supra* note 17; *see also* Gross, *supra* note 10 at 632.

21. *See id.* (explaining that there is a "mood of skepticism about analysts' stock recommendations" which is in large part due to the now apparent conflicts of interest analysts face).

22. NASD Guide, *supra* note 5.

23. Downes and Goodman define "road show" as:

> [P]resentation by an issuer of securities to potential buyers about the merits of the issue. Management of the company issuing stocks or bonds doing a road show travel around the country presenting financial information and an outlook for the company and answering the questions of analysts, fund managers, and other potential investors.

DOWNES & GOODMAN, *supra* note 3 at 493.

24. *See* Unger Testimony, *supra* note 17.

up period expired."[25] One could argue that an analyst might be more conscientious in his research precisely because his firm did the underwriting.[26] However, given the fierce competition in the banking industry, analysts often feel pressure to issue a positive recommendation in their reports, as not to endanger current or prospective clients for their investment banking colleagues.[27]

For the buy-side analyst, the conflicts are no different. An institutional money manager with a substantial holding in a security does not wish to see an analyst put out a sell recommendation on that security that may lead to a decline in its price.[28] As a result, there has been "a proliferation of euphemistic ratings—such as 'Hold,' 'Retain' and 'Market Perform'—which small investors take at face value but which professional and institutional investors know are often tantamount to 'sell.'"[29] What's more, the ratings scales from firm to firm may vary making it even more difficult for the average investor to comparison shop and make an informed decision.

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25. Gross, *supra* note 10, at 641. In her Comment Letter to the SEC, Christine Bruenn, President, North American Securities Administration Association, noted:

> [F]irms often issued favorable reports on a company for which it had performed investment-banking services, just prior to or after, the lock-up period for the IPO ended. Insiders of the issuer generally are prohibited from selling shares of stock they own in a company until a certain date has passed (the 'lock-up period'), after which they may sell their shares on the secondary market . . . . The favorable report would cause the issuer's stock to rise and allow the insiders to sell stock at a premium.

Comment Letter from Christine Bruenn to Jonathan Katz, Secretary, the U.S. Securities and Exchange Commission, Relating to Research Analyst Conflicts of Interest (Amendments) Release No. 34-47110; File nos. SR-NASD-2002-154; SR-NYSE-2002-49, Mar. 10, 2003 [hereinafter NASAA Comment Letter].

26. *See* NASD Guide, *supra* note 5 (arguing that an analyst may be "more knowledgeable or diligent in his research because his firm did the underwriting," as opposed to feeling pressure not to "say or write things that could jeopardize existing or potential relationships for their investment banking colleagues.").

27. *See id.* (claiming that analysts are paid "at least partly and indirectly on the basis of their firms' underwriting profits"); *see also* Unger Testimony, *supra* note 17 (corroborating that many firms "pay their analysts largely based upon the profitability of their investment banking unit.").

28. *See id.*

29. *Id.*

2. *Compensation*

Further complicating this dynamic between investment banker and analyst is the fact that "many analysts are paid at least partly and indirectly on the basis of their firms' underwriting profits."[30] In fact at some firms, investment bankers are directly responsible for reviewing the firm's research analysts to determine their compensation.[31] In such instances, analysts will be averse to issuing a report that could jeopardize the firm's profits and in turn their own compensation. In addition, an analyst's report can also indirectly assist the firm in generating commissions by provoking more buying and selling of covered securities.[32] Given that a significant portion of a firm's income is contingent upon the success of its investment banking department, an analyst will undoubtedly feel pressure to issue reports that will keep those revenues coming in.[33]

3. *Ownership Interest*

Finally, the analyst, other employees, and the firm itself, may own substantial interests in the companies or market sectors in which the analyst conducts his research.[34] "An analyst may participate in employee stock purchase pools that invest in companies they cover or they may own stock directly."[35] Additionally, in a practice called "venture investing," firms and analysts may obtain a stake in a start-up company by acquiring discounted, pre-IPO shares.[36] According to the SEC's study, "if

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30. *Id.*

31. *See* Unger Testimony, *supra* note 17 (stating that many firms "pay their analysts largely based upon the profitability of their investment banking unit.").

32. *See* NASD Guide, *supra* note 5 (explaining how an analyst's report can generate money for the firm indirectly, through brokerage commissions).

33. *Id.* (stating that analysts will most likely be reluctant to make recommendations that could threaten future investment banking profits, and hence their own compensation as well).

34. *See id.*

35. Unger Testimony, *supra* note 17.

36. *Id.*

the company went public and the analyst's firm underwrote the IPO, the analyst almost always issued positive research on the company."[37] Issuing a positive research report can set higher trading volumes that would not only increase the value of the shares themselves, but would also result in higher commissions for the firm itself.[38]

C. Early Rules Designed To Regulate Analyst Conflicts of Interest

Previously, there were no broad sweeping regulations that barred analysts from owning stock in companies they covered, although some firms did attempt to put policies in place.[39] Often the analyst was simply prohibited from executing a personal trade for a company he covered that was "contrary to the analyst's outstanding recommendation."[40] However, that policy was usually too difficult to monitor; in fact, nearly all firms examined "did not know whether their research analysts owned stock in companies they underwrote and upon which their analysts then issued research reports."[41] Furthermore, disclosure of analyst and firm ownership in recommended securities often varied in both written reports or during public appearances in the media.[42] Some firms expressly stated that they or their employees held positions in recommended companies.[43] Other firms merely used boilerplate language stating that "the firm or employees *may* have positions in the recommended issuer"[44]—not to mention that many analysts who frequently hyped certain securities on television or on the radio hardly ever revealed any conflict of interest.[45]

For many years regulators have attempted to control and monitor the relationship between analysts and the financial

37. *Id.*
38. *Id.*
39. *See id.*
40. *Id.*
41. *Id.*
42. *See id.*
43. *See id.*
44. *Id.*
45. *See id.*

institutions they provide research for, by implementing rules and mandating disclosures. For example, the Investment Advisers Act of 1940[46] precludes those who provide investment advice to customers including advisers and buy side analysts, from engaging in "any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client."[47] Specifically under section 206, a failure to disclose to a client or prospective client "a financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients" shall constitute a fraudulent act.[48] Section 17(b) of the Securities Act of 1933[49] (the "Securities Act") makes it unlawful for any person to receive money or property as compensation for making an "untrue statement of a material fact" or for omitting a material fact in order to encourage a purchase or a sale of a security.[50] Finally, the National Association of Securities Dealers ("NASD"), a self-regulatory organization ("SRO"),[51] creates rules to regulate the conduct of its members, which include nearly all securities firms in the United States. "Because most sell-side research analysts work for broker-dealers that must register with the NASD, they

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46. The Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 18a (2003) [hereinafter Investment Advisers Act].

47. Investment Advisers Act § 206, 15 U.S.C. § 80b-6. This section, entitled "Prohibited Transactions by Investment Advisers," deals more specifically with fraudulent activity through any means or instrumentality of interstate commerce. However, given the current ways in which securities transactions occur, including the internet, this has a rather broad effect.

48. *Id.* at § 206(4).

49. The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000) [hereinafter Securities Act].

50. *See* Securities Act § 17(b), 15 U.S.C. § 77q(b).

51. Downes and Goodman define "SRO" as:

> [P]rincipal means contemplated by the federal securities laws for the enforcement of fair, ethical, and efficient practices in the securities and commodities futures industries. It is these organizations that are being referred to when "industry rules" are mentioned, as distinguished from the regulatory agencies such as the Securities and Exchange Commission or the Federal Reserve Board.

DOWNES & GOODMAN, *supra* note 3, at 521.

are deemed "associated persons"[52] of their registered broker-dealer firms and are thus covered by NASD rules of conduct." NASD Rule 2210 states "no member shall, directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading."[53] Recent events have made it clear that such laws were insufficient and that new regulations would be necessary to curtail conflict of interest behavior.

II. KEY PLAYERS ON WALL STREET LOSE THEIR CELEBRITY STATUS AS INVESTIGATIONS REVEAL WIDESPREAD CONFLICTS OF INTEREST — IN RESPONSE SROs IMPOSE FINES AND NEW REGULATIONS

A. The Bigger They Are, The Harder They Fall

Beginning in April 2000, it became gradually apparent that manipulating analyst recommendations was not only extremely profitable, but was also rampant on Wall Street and rapidly threatening the integrity of the industry.[54] Henry Blodget of Merrill Lynch ("Merrill"), Jack Grubman of Salomon Smith Barney ("Salomon") and Frank Quattrone of Credit Suisse First Boston ("CSFB"), to name just a few of Wall Street's luminaries, achieved star status by tipping stocks such as Amazon.com and WorldCom.[55] However, when the tech bubble burst and stock

52. Section 3(a)(18) of the Securities Exchange Act of 1934 defines "associated persons" as among other things "any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer." 15 U.S.C. § 78c(a)(18) (2000).

53. NASD Conduct Rule § 2210(d)(2). In general, the NASD rules dealing with communications with the public state, "all member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security." *Id.* at § 2210(d)(1).

54. *See Chinese Walls Need a Leak Test, supra* note 2 (discussing the April 2000 "tech wreck and subsequent corporate scandals" . . . most notably Henry Blodget, former celebrity tech stock analyst at Merrill Lynch).

55. *See* Patrick McGeehan, *S.E.C. Seeks Information on Analysts' Supervision*, N.Y. TIMES, June 3, 2003, at C1 (stating that "regulators singled out a couple of

prices began to plummet, all three found themselves at the center of investigations for violating securities laws.

1. *Merrill Lynch and Tech-Stock Analyst Henry Blodget Fall Under Scrutiny When E-Mails Reveal "Piece of Junk" Stock Received a Favorable Rating*

Henry Blodget, the high profile technology stock analyst, first came under scrutiny in 2001 when a former client "claimed losses of a half-million dollars from alleged misleading calls" made by Blodget.[56] The client contended "he bought about 4,600 shares of the company [Infospace Inc.] and was persuaded by his Merrill broker and Blodget's optimistic recommendation on the stock, to keep the shares, despite their downward spiral."[57] The client filed for arbitration which Merrill later agreed to settle for $400,000. The significance of this landmark case is that it shows when an investor relies to his detriment upon an analyst who fails to disclose a conflict of interest, the firm will be held accountable.[58]

Shortly thereafter, New York State Attorney General Elliot Spitzer filed charges against Merrill Lynch. Spitzer alleged "Merrill's recommendations were 'biased and distorted in an attempt to secure and maintain lucrative contracts for investment banking services' in what he described as 'a shocking betrayal of trust by one of Wall Street's most trusted names.'"[59] In recent

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prominent former analysts in their findings, like Jack B. Grubman of Citigroup and Henry Blodget of Merrill Lynch."); *see also* Gretchen Morgenson, *Analyst Coached WorldCom Chief on His Script*, N.Y. TIMES, Feb. 27, 2003, at A1 (discussing specifically the details surrounding the WorldCom scandal); *see also* Meg Richards, *Former CSFB Banker Faces Regulatory Charges over IPO Spinning*, ASSOCIATED PRESS, Mar. 7, 2003 (describing how Frank Quattrone, former CSFB technology banker was charged with spinning violations along with creating and overseeing an organizational structure that undermined research analyst objectivity).

56. *Merrill Settles Complaint; No.1 Broker Pays Client $400,000 over 'Misleading' Call by Analyst Blodget*, CNN MONEY, July 21, 2001, *at* http://money.cnn.com/2001/07/20/investing/merrill_blodget/ (last visited Sept. 25, 2003).

57. *Id.*

58. *See id.*

59. *See Chinese Walls Need a Leak Test*, *supra* note 2.

months, both Merrill and Blodget have been the target of numerous class action and arbitration suits disputing that Blodget's bullish research reports on Internet stocks, were an inaccurate reflection of his own personal views.[60] Substantiating these claims were more than 30,000 internal emails, from a number of employees, including Blodget, which privately disparaged stocks calling them "a piece of junk" and a "piece of s**t" that publicly got high ratings from the firm.[61] Spitzer stated the evidence illustrated how "analysts were heavily influenced by Merrill's banking relationships with companies the firm covered."[62] Merrill eventually settled for $100 million dollars without admitting any wrongdoing—a standard in an offer of settlement.[63] In April of 2003, Blodget was permanently barred from the securities industry.[64] In addition, Merrill stated it would implement a number of new policies. First, it would separate how analysts are paid from the investment banking business, stating they "will be compensated for only those activities and services intended to benefit Merrill Lynch's investor clients."[65] Second, it would create a "Research Recommendation Committee" to evaluate changes in stock ratings to ensure impartiality. Finally, it would appoint a Spitzer-approved "compliance monitor" to ensure the firm adhered to the settlement.[66] These policy amendments—along with an earlier change by Merrill prohibiting its analysts from owning stock in the companies they cover—were an attempt to allay concerns about analyst objectivity. In addition, they foreshadowed aspects

60. *See* Landon Thomas, Jr., *UBS Analyst Forced Out for Remark*, N.Y. TIMES, July 3, 2003, at C1.

61. *See Chinese Walls Need a Leak Test*, *supra* note 2.

62. Kim Kahn, *Merrill Settles Charges: Brokerage Firm to Pay $100M, Doesn't Admit Wrongdoing; Spitzer Sees It as a Model for Wall Street*, CNN MONEY, May 21, 2002, *available at* http://money.cnn.com/2002/05/21/news/companies/merrill/ (last visited Sept. 25, 2003).

63. *Id.* ("[o]f the $100 million, $48 million will to go New York, while $52 million will go to all other states.").

64. *See* Thomas, *supra* note 60.

65. Kim Kahn, *supra* note 62.

66. *See id.*

of future industry wide regulation, which will be discussed in more detail in the next section.

2. *Inspectors Focus on Analyst Jack Grubman When E-Mails Indicate He Directed WorldCom Chief on What To Say Regarding Fourth Quarter Financial Troubles*

Jack Grubman, a former telecommunications analyst for Salomon Smith Barney, earned more than twenty million dollars in the years before resigning in August 2002, in the midst of stern criticism over inadequately performing stock picks.[67] Months later, he settled with regulators for a $15 million fine and a lifetime ban from the securities industry.[68] In early January 2003, a group of small investors filed for arbitration against Salomon and Grubman, over Grubman's recommendations to invest in WorldCom.[69] Grubman "recommended investors purchase WorldCom stock as it fell to less than $5 a share, from $60, changing his rating to 'neutral' less than three months before the telecommunications company filed for the largest bankruptcy in U.S. history."[70] As shares of WorldCom stock were falling, the company's founder, Bernard J. Ebbers, held a conference call with Wall Street analysts in an attempt to snuff out any rumors of underlying financial crisis.[71] According to e-mail messages uncovered by regulators during their investigations, Ebbers relied heavily on a script from Grubman advising him to put a positive spin on things when discussing liquidity issues, off-balance sheet matters and accounting problems. In reality, WorldCom was rapidly approaching a meltdown.[72]

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67. *See* Chris Burritt, *Citigroup's Krawcheck Says Analysts Free from Banking*, BLOOMBERG NEWS, Mar. 5, 2003; *see also* Morgenson, *supra* note 55.

68. *See* Morgenson, *supra* note 55.

69. *See Salomon Arbitration Cases*, N.Y. TIMES, Jan. 14, 2003, at C18 (describing complaints which claimed fraud and breach of contract as well as violation of the Securities and Exchange Act).

70. *See* Burritt, *supra* note 67.

71. *See* Morgenson, *supra* note 55.

72. *See id.* (emphasizing the unusual level of collaboration between analyst and executive. The emails reveal that Grubman was "anything but impartial about WorldCom.").

> There is nothing illegal about an analyst advising a chief executive how to approach a crucial conference call. But providing such detailed coaching to an executive, as the email message does, is highly unusual for an analyst and seems to indicate that Mr. Grubman considered himself a close advisor to Mr. Ebbers, playing a supporting role to what would normally be the task of a corporate insider or public relations specialist. "It looks as if Jack was calling the shots;" . . . "the tone of it is a complete reversal of what you would see, where the C.E.O. tells the analyst how he conducts the business. The analyst would never be in the position to have the superior knowledge base, ostensibly.[73]

Although Grubman admitted to having an intimate understanding of WorldCom, he claimed he received such information by attending some of WorldCom's board meetings.[74] Yet despite his close affiliation, Grubman claimed he had no knowledge of WorldCom's accounting difficulties and that his positive view of the company was "based solely on public financial statements prepared by the company's management."[75] Immediately following the conference call Grubman put out a bullish research report confirming his strong buy recommendation.[76] Five months later WorldCom filed for Bankruptcy.[77]

As of March 2003, there were "nine suits pending against Salomon alleging that Grubman overvalued technology and telecommunications stocks such as Global Crossing Ltd.[78] and

73. *Id.*

74. *See id.* (testifying before Congress in July 2002 Grubman maintained that his work required him to "engage in a serious, active dialogue with the people who make the decisions in order to put S.E.C. filings and audited financials into context.").

75. *Id.*

76. *See id.* (quoting Grubman as saying "perhaps the most significant outcome of WCOM's earnings release was its very clear denial of the unfounded rumors surrounding its liquidity position, balance sheet and accounting.").

77. *See id.*

78. David E. Rovella, *Ohio to Lead Salomon, Global Crossing Analyst Lawsuit*, BLOOMBERG NEWS, Mar. 12, 2003:

> [L]ead plaintiffs in this case are two Ohio pension funds: Ohio Public Employees Retirement System and State Teachers Retirement System of Ohio.

Winstar Communications[79] to win investment banking business."[80]

3. NASD Files Charges Against Star Banker Frank Quattrone for Distributing Shares of Lucrative IPOs to "Friends of Frank" Executives in Return for Banking Business

When Frank Quattrone joined CSFB in 1998 to lead the technology sector investment banking unit, he was already considered a superstar.[81] Quattrone played a leading role in the business of underwriting new issues for technology companies.[82] He "created what amounted to a firm-within-a-firm at CSFB, bringing with him dozens of colleagues and associates and fashioning an organizational structure under which research analysts, investment bankers, and brokers all reported to him."[83]

> The Ohio funds control two of the largest securities fraud suits against Citigroup . . . they were previously appointed to lead the shareholder suit against Global Crossing, which includes Citigroup as a defendant. The same group should lead the suit against Salomon for hyping shares of the bankrupt owner of fiber-optic networks.

Id.

79. *See* NASD News Release, *Salomon Smith Barney Fined $5 Million for Issuing Misleading Research Reports on Winstar: Charges Filed Against Jack Grubman and Christine Gochuico*, Sept. 23, 2002, *available at* http://www.nasdr.com/news/pr2002/release_02_054.html (last visited Feb. 2, 2003):

> Winstar was a broadband telecommunications service provider that filed for bankruptcy last year. Salomon's research reports strongly recommended Winstar as a 'Buy'—Salomon's top rating—with a 12-to-18 month target price of $50 even at the stock plummeted from approximately $20 on Jan. 25, 2001, to 14 cents on April of that year. In the settlement today Salomon agreed to findings that it did not have a reasonable basis for that target price.

Id.

80. *See* Rovella, *supra* note 78.

81. *See* NASD News Release, *Quattrone, supra* note 6; *see also* Daniel Dunaief, *CSFB Sidelines Quattrone: Tech Banker Put on Paid Leave in Cover-up Fallout*, N.Y. DAILY NEWS, Feb. 4, 2003, at 45 (calling Quattrone the "godfather of Amazon and Netscape and the most powerful tech banker in the Internet Frenzy.").

82. *See id.*

83. *Id.*

This structure was not only profitable for the firm,[84] but was also personally rewarding to Quattrone himself, who received compensation of over $200 million between the years of 1998 and the end of 2001.[85] One way Quattrone sought to win and retain investment banking business was by "spinning" IPO shares—that is, giving hot IPOs such as Amazon.com and Netscape Communications, to a select group of Silicon Valley corporate executives (the so called "Friends of Frank") who were able to influence their employers' choice of investment banks.[86] The shares were allocated to these individuals and then "flipped back to CSFB in aftermarket trading," producing substantial profits.[87] Additionally, investment banking business was obtained through holding out to potential clients the idea of CSFB issuing a positive report about them.[88]

> Tech group research analysts actively participated in soliciting investment banking business. "Pitch-books" used in presentations to prospective clients included excerpts from favorable research reports prepared by Tech Group analysts for other CSFB client companies. Quattrone created a powerful incentive for analysts to initiate and maintain positive coverage on investment banking clients by linking their compensation to investment banking revenue and encouraging investment bankers to participate in analysts' performance evaluations. He also allowed issuers to review and comment on draft research reports, including proposed recommendations and price targets.[89]

After standing behind Quattrone for nearly two years—despite a $100 million settlement with the SEC and NASD

84. *See id.* ("[I]n 1999, CSFB managed more U.S. IPOs than any other firm. In 2000, investment banking was the firm's second largest revenue source, generating $3.68 billion dollars, a 60 percent increase over the year before.").

85. *See id.*

86. *See* Richards, *supra* note 55.

87. *See* NASD News Release, *Quattrone*, *supra* note 6 ("[T]he NASD considers this to be tantamount to cash gifts - a violation of the agency's rules.").

88. *See id.*

89. *Id.*

regarding the spinning allegations—CSFB finally backed away.[90] Quattrone was put on administrative leave in February 2003 and resigned in early March when NASD charged him for spinning violations in addition to supervising an "organizational structure that undermined research analyst objectivity."[91] In a separate complaint, Quattrone was later charged with "failing to cooperate in an NASD investigation into whether he encouraged CSFB Tech Group employees to destroy documents after he was notified of NASD and federal investigations."[92] Evidence shows he sent an e-mail to his Tech Group employees encouraging them to "cleanse their files."[93]

Some say the "unraveling of the CSFB investment banker is a big step in the market's healing process . . . because he's bigger than Blodget, and he's bigger than Grubman. Symbolically, he's the big fish, as big to this era's story as Michael Milken was to his."[94]

B. Legislators, Regulators and SROs Band Together To Eliminate Research Analyst Conflict of Interest

These recent events have revealed a significant hole in the SROs' armor and have raised questions about the effectiveness of SRO regulation.[95] It is only in the last few years that regulators have publicly acknowledged the "systematic problems in their rules that created the potential for corporate scandal and

90. *See id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. Adam Lashinsky, *So Long, Frank Quattrone*, FORTUNE, Feb. 5, 2003, *available at* http://www.fortune.com/fortune/bottomline/0,15704,419947,00.html (last visited Sept. 19, 2003).

95. *See* Ari Weinberg, *Rewriting Wall Street's Rulemakers*, FORBES, Oct. 16, 2002 *available at* http://www.forbes.com/2002/10/16/1016sro_print.html (last visited Sept.26, 2003) (recalling how Elliot Spitzer in a late September 2002 speech "blew the cover off rarely discussed but supposedly wide-reaching Wall Street practices. He demonstrated that SROs were disadvantaged by their close ties to the securities industry and public companies, which were supposed to be their rule-making and enforcement strengths.").

conflicting business interests."[96] In response, federal regulation was established with the advent of the Sarbanes-Oxley Act.[97] Additionally, Spitzer, along with the NASD, the Securities and Exchange Commission ("SEC") the New York Stock Exchange ("NYSE") as well as other state regulators, have teamed up to tighten the regulatory gap, restore investor confidence, and breathe new life into the capital markets. The question is, will this new set of laws be enough to accomplish these goals? It is up to the SROs to prove that they are in fact significant market forces and not merely façade organizations.[98]

1. *The Sarbanes-Oxley Act of 2002*

In July 2002, the Sarbanes-Oxley Act ("SOA") was signed into law by President Bush.[99] Among other things, SOA adds another layer of federal regulation regarding research analysts by creating a new section 15D of the Securities Exchange Act of 1934.[100] This new section mandates that the SEC adopt, or direct the SROs to adopt, rules "reasonably designed to address conflicts of interest that are known or should have been known by the securities analyst or broker or dealer."[101] This, in relevant part, includes those issues that can arise when "securities analysts recommend equity securities in research reports and public appearances."[102] Section 15D additionally delineates specific areas which must be addressed by regulators, such as disclosures relating to an analyst's holdings in a subject company,[103] and restrictions on prepublication authorization of research reports by investment

96. *Id.*

97. Sarbanes-Oxley Act of 2002, Pub.L.No. 107-204, 116 Stat. 745 (to be codified as scattered sections of 11,15,18, 28, and 29 U.S.C.) [hereinafter SOA].

98. *See* Weinberg, *supra* note 95.

99. *See* SOA *supra* note 97.

100. *See* Securities and Exchange Act of 1934 (15 U.S.C. 78a et seq.), amended by Sarbanes-Oxley Act of 2002, Pub.L.No. 107-204, 116 Stat.745, *supra* note 97, at § 501(a) [hereinafter Amended 34 Act].

101. *Id.*

102. Brandon Becker et al., *Will Multiple Regulators Spawn an Inconsistent Framework for Research Analyst Regulation?*, WALL ST. LAW. (Sept. 2002), at 24.

103. *See* Amended 34 Act, *supra* note 100 at (b)(1)-(4).

bankers.[104] Additionally there must be limitations on persons who supervise and provide evaluations of analysts,[105] as well as prohibitions on retaliation against analysts by their employers for issuing unfavorable reports.[106] Finally, there must be defined quiet periods during which firms that have or will participate in a subject company's IPOs are banned from releasing a research report.[107]

2. *The Global Settlement: The Dawn of a New Day on Wall Street*[108]

On December 20, 2002, then SEC Chairman Harvey L. Pitt, along with Elliot Spitzer, Christine Bruenn, President of the North American Securities Administrators Association ("NASAA"), Robert Glauber, Chairman and CEO of NASD, Dick Grasso, then NYSE Chairman, and state securities regulators, "announced an historic settlement with the nation's top investment firms to resolve issues of conflict of interest at brokerage firms."[109] The resolution is designed to "bring about balanced reform in the industry and bolster confidence in the integrity of equity research."[110] The terms of the agreement include:

a. The Insulation of Research Analysts from Investment Banking Pressure

Firms will be "required to sever the links between research and investment banking, including analyst compensation for equity research."[111] In addition, analysts will no longer be permitted to accompany investment banking personnel on

104. *See* Amended 34 Act, *supra* note 100 at (a)(1)(A).
105. *See* Amended 34 Act, *supra* note 100 at (a)(1) (B).
106. *See* Amended 34 Act, *supra* note 100 at (a)(1)(c).
107. *See* Amended 34 Act, *supra* note 100 at (a)(2).
108. See *SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices*, SEC Press Release, Dec. 20, 2002, *available at* http://www.sec.gov/news/press/2002-179.htm (last visited Sept. 26, 2003) (citing Christine Bruenn, NASAA President).
109. *Id.*
110. *Id.*
111. *See id.*

pitches and road shows.[112] This rule is designed to maintain analyst objectivity so that recommendations are not swayed by the firm's efforts to obtain investment banking fees.[113]

b. A Complete Ban on the Spinning of IPOs

Brokerage firms are prohibited from doling out lucrative IPO shares to corporate executives who are in the position to greatly manipulate investment banking decisions.[114]

c. An Obligation to Furnish Independent Research

"For a five year period, each of the brokerage firms will be required to contract with 'no less that three' independent research companies that will provide research to the firm's customers."[115] In addition, an independent "monitor" for each firm, with final authority to acquire research from independent providers, will be chosen by regulators.[116] This provision ensures that investors have exposure to unbiased research and investment advice.[117]

d. Disclosure of Analyst Recommendations

Each firm will make openly available its ratings and price target forecasts.[118] This will enable investors to compare the accuracy and quality of the analysts' performance, as well as promote informed investment decision making.[119]

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112. *See id.*
113. *See id.*
114. *See id.*
115. *Id.*
116. *See id.*
117. *See id.*
118. *See id.*
119. *See id.*

e. Settled Enforcement Actions Involving Significant Monetary Sanctions

"Each of the firms will pay a fine, pay monies towards investor restitution, and will be required to escrow funds that will be used to pay for independent research."[120] The agreement reached "totals more than, $1.4 billion in penalties, restitution and monies used for investor education."[121] The settlement payments for each firm are outlined in the chart below. In addition to the $900 million in retrospective relief, the firms will also pay $450 million over five years for independent research and $85 million for nationwide investor education.[122]

Name of Firm	**Retrospective Relief ($ millions)**	**Independent Research ($ millions)**	**Investor Education ($ millions)**
Bear Stearns & Co. LLC	50	25	5
Credit Suisse First Boston Corp.	150	50	0
Deutsche Bank	50	25	5
Goldman Sachs	50	50	10
J.P. Morgan Chase & Co.	50	25	5
Lehman Brothers, Inc.	50	25	5
Merrill Lynch & Co., Inc.	100*	75	25
Morgan Stanley	50	75	0
Salomon Smith Barney, Inc.	300	75	25
UBS Warburg LLC	50	25	5
Total	**900**	**450**	**85**

120. *Id.*
121. *See id.*
122. *See id.* (citing chart entitled "Settlement Payments").

* Payment made in prior settlement of Research Analyst conflicts.[123]

3. Regulation AC: Analyst Certification

In partial response to SOA, the SEC proposed, and recently approved, Regulation Analyst Certification[124] ("Reg AC") which is intended to compliment other rules governing conflicts of interest disclosure by research analysts, principally NASD Rule 2711 and NYSE Rule 472, discussed below.[125] Reg AC "requires research analysts to certify that research reports they issue represent their actual views and to provide disclosures as to whether they have received compensation for the opinions expressed in those reports."[126] If any portion of the analyst's compensation is or will be directly or indirectly related to his recommendations in the report, the analyst must specify "the source, amount, and purpose of such compensation," . . . and further disclose that it may influence the recommendation in the research report.[127] Furthermore, broker-dealers are required to keep records of all public appearances made by their analysts "within 30 days after each calendar quarter" in which the appearance was made.[128]

Reg AC also includes a number of defined terms, which differ in a several respects from some of the SRO definitions. The meaning of "research analyst," for example, covers "any natural person" instead of just any "associated persons of a member."[129]

123. *Id.*

124. Securities Exchange Act Release No. 47384 (Feb. 20, 2003), 68 FR 9482 (Feb. 27, 2003) [hereinafter Reg AC].

125. *See* Barbara M. Johnson et al., *SEC Issues Proposed New Regulation AC-Analyst Certification*, Testa, Hurwitz & Thibeault, LLP, Aug. 19, 2002, *available at* http://www.tht.com/pubs/SearchMatchPub.asp?ArticleID=833 (last visited Sept. 26, 2003).

126. Statement by SEC Chairman Harvey L. Pitt: *Proposal of Regulation AC*, July 24, 2002, *available at* http://www.sec.gov/news/speech/spch578.htm (last visited Feb. 13, 2003) (paraphrasing Reg. AC).

127. Reg AC at § IA(B)2.

128. *Id.* at § IB.

129. *Id.* at § IIA 1.

The broad scope of this definition "is warranted because Reg AC imposes core standards of integrity that should pertain to all research distributed by broker-dealers and covered persons."[130] Similarly, the description of "research report" was expanded to cover debt securities as well as equity securities. The notion is that such extension will promote the overall integrity of research reports and confidence in research analyst recommendation, by also protecting debt investors.[131] In contrast, the definition of "covered person" has been tailored not to include any associated person that does not have officers or employees in common with the broker or dealer.[132] The purpose is to "focus the rule on research that appears to be most susceptible to pressures that might compromise integrity," (i.e., to generate investment banking business), rather than to apply Reg AC to individuals who are significantly independent from the broker- dealer.[133]

4. *NASD/NYSE Regulations*

Over the past several months, NASD and the NYSE have attempted to coordinate comprehensive new rules to regulate research analyst conflict of interest issues. In May 2002, the Board of Directors of NASD Regulation, (now NASD) approved Rule 2711, Research Analysts and Research Reports, and authorized its filing with the SEC.[134] Concurrently, NYSE approved amendments to Rule 472 Communications with the Public, and Rule 351, Reporting Requirements.[135] These amendments were designed to "improve the objectivity of research and provide investors with more useful and reliable information when making

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130. *Id.* at § IIA(1).
131. *See id.*
132. *See id.*
133. *See id.* at § A(2).
134. *See* NASD Proposed Rule Regarding Research Analyst Conflicts of Interest, File No. SR-NASD-2002-21 at 13 (Feb. 8, 2002) (last amended May 1, 2002) [hereinafter NASD Proposed Rule, File No. SR-NASD-2002-21].
135. NYSE Amendment No. 1 to SR-NYSE-2002-09 Relating to Amendments to NYSE Rules 472 and 351, (April 29, 2002) [hereinafter NYSE Amendment No.1 to SR-NYSE-2002-09].

investment decisions."[136] In October 2002, after subsequent "examination and further discussions with the SEC staff, NASD and the NYSE agreed that additional rules [as well as amendments to existing rules] governing members' research activities were necessary to protect investors."[137] Amendments to NASD Rules 2711 and 1120 were proposed, along with the addition of new Rule 1050.[138] Simultaneously, the NYSE proposed further amendments to its Rules 344, 345A, 351 and 472.[139] Final amendments to both the NYSE and the NASD Rules were proposed and adopted in July of 2003. Below is a brief discussion of some of the key provisions.

a. The Parallel Provisions of NASD and NYSE Rules

i) Investment banking and research department relationships

Both NASD Rule 2711 and NYSE Rule 472 propose to minimize the control that an investment banking department has over its research department by monitoring the communication between those two divisions through an authorized legal or compliance official.[140] Correspondence between analysts and investment bankers prior to the publication of a research report is only to ensure factual accuracy and to watch for conflicts of interest.[141] Similarly, to reduce conflicts between the member

136. NASD Proposed Rule, File No. SR-NASD-2002-21, *supra* note 134, at 13–14.

137. NASD Proposed Amendments to Rules Governing Research Analyst Conflicts of Interest, File No. SR-NASD-2002-154 at 10 (Oct. 25, 2002) (last amended July 29, 2003) [hereinafter NASD Proposed Amendments, File No. SR-NASD-2002-154].

138. *Id.*

139. *See* NYSE Amendments to Exchange Rules 344, 345A, 351, and 472, File No. SR-NYSE-2002-49. (Oct.8, 2002) (last amended July,29, 2003) [hereinafter NYSE Amendments File No.SR-NYSE-2002-49].

140. *See* NASD Rule 2711(b)(3)(A); *see also* NYSE Rule 472(b)(3)(i)-stating that any communication concerning the content of a research report between investment banking personnel and research personnel must be made through an authorized legal and compliance official).

141. *See* NASD Rule 2711(b)(3); *see also* NYSE Rule 472(b)(3).

firm and the subject company[142] (an issuer may attempt to influence the conclusions stated in a report), an analyst is only permitted to submit certain sections of a report to the subject company and only for the purpose of verifying that they are factually accurate.[143] Any subsequent changes to that report must be accompanied by written justification by the analyst and reviewed by the compliance department.[144]

ii) Restrictions on trading securities by associated persons

There are also provisions to restrict analysts' personal trading of securities. These rules are designed to "ensure that research reports and recommendations are not influenced by the prospect of personal enrichment and to ensure that analysts do not profit from the issuance of a research report or change in a rating or price target."[145] An analyst is banned from receiving any pre-IPO securities,[146] and may not "purchase or sell any security . . . in a manner inconsistent with the research analysts' most recent recommendation."[147] Additionally, there are "black-out" periods, during which no associated person may purchase or sell any security by a subject company, for a period beginning 30 calendar days before and ending 5 days after a research report is published.[148]

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142. *See* NASD Rule 2711(a)(9) (defining subject company as "the company whose equity securities are the subject of a research report or recommendation in a public appearance.").

143. *See id.* 2711(c)(2); *see also* NYSE Rule 472(b)(4) (clarifying that "members and member organizations may not, under any circumstances, provide the subject company sections of research reports that include the research summary, the research rating or the target price.").

144. *See* NASD Rule 2711(c)(2)(C); *see also* NYSE Rule 472(b)(4)(ii) (stating additionally that any change must receive written authorization from the compliance department. Also, all drafts and changes of reports provided to the subject company must be retained for three years following its publication).

145. NASD Proposed Rule, File No. SR-NASD-2002-21, *supra* note 134, at 22.

146. *See* NASD Rule 2711(g)(1); *see also* NYSE Rule 472(e)(1) (clarifying that this is if the issuer is primarily engaged in similar types of businesses as companies which the research analyst typically covers).

147. NASD Rule 2711(g)(3); *see also* NYSE Rule 472(e)(3).

148. *See* NASD Rule 2711(g)(2); *see also* NYSE Rule 472(e)(2).

iii) The imposition of quiet periods

Quiet periods are intended to prevent a manager from rewarding the subject company for its underwriting business by "publishing favorable research after completion of the offering."[149] A member firm is, therefore, prohibited from publishing a research report, and an analyst is prohibited from making a public appearance, regarding a subject company for which the member acted as manager or co-manager for 40 calendar days following the date of the offering of an IPO or for 10 calendar days following a secondary offering.[150] There are exceptions to this rule for certain secondary offerings and for major news and events.[151]

iv) Disclosure required in research reports and public appearances

A member is required to "disclose in research reports and a research analyst must disclose in public appearances: if the analyst (or a member of his household) has a financial interest in the securities of the subject company."[152] Under NASD Rule 2711(h) the analyst must disclose the nature and amount of those financial interests,[153] or other material conflicts of interest held by the member, the analyst, or a member of the analyst's family.[154] In addition, *any* compensation received within the past twelve months based on the member's investment banking revenues, or any expected compensation within the next three months, must

149. NASD Proposed Rule, File No. SR-NASD-2002-21, *supra* note 134, at 21.

150. *See* NASD Rule 2711(f)(1), (2); *see also* NYSE Rules 472(f)(1), (2), (5).

151. *See* NASD Amendment No. 3, to SR-NASD 2002-154 Proposed Amendments to Rules Governing Research Analyst Conflicts of Interest at 7 (last amended July 29, 2003) *available at* http://www.nasdr.com/pdf-text/rf02_154_a03.pdf (last visited Aug. 14, 2003) [hereinafter NASD Amendment No.3]; *see also* NYSE Rule 472 (f)(5).

152. NASD Rule 2711(h)(1)(A); *see also* NYSE Rule 472(k)(1)(iii)(b).

153. *See* NASD Rule 2711(h)(1)(A) (clarifying that a "financial interest can include any option, right, warrant, future, long or short position in the subject company's securities.").

154. *See id.*

be prominently disclosed in the written report.[155] Although a number of comment letters expressed serious reservations with regards to requiring disclosure of *any* compensation, both the NYSE and NASD have the latitude under SOA to impose such disclosure requirements as long as they are consistent with the legislative language and intent of SOA.[156] Consequently, in an attempt to minimize some of the potential conflicts of interest which might occur, especially where a member is unaware of any receipt of compensation, both the NYSE and NASD have incorporated the "reason to know" standard[157] and appropriate information barriers.[158]

There is also a provision regarding the firm's rating system designed to better enable investors to compare and assess research. The rule will require firms to "define in its reports the meaning of each rating used by the member in its rating system" as well as provide historical price and ratings distribution data.[159] "Firms must disclose the percentage of all the ratings they have assigned to 'buy/hold/sell' categories and the percentage of investment banking clients in each category."[160]

v) Supervisory procedures

NASD Rule 2711(i) and NYSE Rule 351(f) each deal with managerial requirements. Each member firm must adopt and implement "written supervisory procedures reasonably designed to ensure that the member and its employees comply with [its]

155. *See* NASD Rule 2711(h)(2)(A)(ii)(b), (c); *see also* NYSE Rules 472(k)(1)(i)(a)(2), (3).

156. *See* NASD Amendment No.3, *supra* note 151 at 10.

157. *See* Amended 34 Act, *supra* note 100 at (a) (mandating "rules reasonably designed to require [disclosure of] . . . conflicts of interest that are known or should have been known by the securities analyst or broker or dealer.").

158. *See* Amended 34 Act, *supra* note 100 at (b)(2) (discussing compensation "received by the registered broker or dealer, or any affiliate thereof, including the securities analyst . . . as is appropriate in the public interest and consistent with the protection of investors.").

159. *See* NASD Rule 2711(h)(4), (5), (6).

160. Brandon Becker et al., *Will Multiple Regulators Spawn an Inconsistent Framework for Research Analyst Regulation?*, WALL ST. LAW., Sept. 2002, Vol.6, at 24 (paraphrasing Rule 2711 (h)(4), (5)(B)).

rules."[161] The member's senior officer must demonstrate annually to the Association and the Exchange respectively, that it has put those procedures into practice.

vi) Ban on IPO pitches

NASD Rule 2711(c)(4) and NYSE Rule 472(b)(5) attempt to prevent analysts from participating in "bake offs" - that is, communications with the subject company intended to pitch the member's investment banking services. With the exception of performing "due diligence"[162] on a subject company, an analyst is prohibited from communicating with an issuer "prior to the time the subject company enters into a letter of intent or other written agreement with the member designating the member as an underwriter" of an IPO.[163] In addition both the NYSE and NASD Rules extend this prohibition beyond IPOs to include "any activity comprehended within the term investment banking business."[164] It is intended that this extension will not only address and clarify issues brought forth in a number of comment letters, but will also better align these rules with the comparable prohibitions set forth in the Global Settlement.[165]

161. NASD Rule 2711(i); *see also* NYSE Rule 351(f).

162. BLACKS LAW DICTIONARY 468 (Bryant Garner, ed. 7th ed. 1999) (defining due diligence as "a prospective buyer's or broker's investigation and analysis of a target company, a piece of property, or a newly issued security.").

163. NASD Rule 2711(c)(4); *see also* NYSE Amendment No.3 Relating to Amendments to Exchange Rules 344, 345A, 351, and 472 with Respect to Research Analysts' Conflicts of Interest, File No. SR-NYSR-2002-49, at 6-7 (discussing Rule 472(b)(5), but notably excludes language referring to the letter of intent or "investment banking mandate" in the final rule) (last amended July 29, 2003) *available at* http://www.nyse.com/pdfs/2002-49am3.pdf. (last visited Aug. 14, 2003) [hereinafter NYSE Amendment No.3].

164. *See* NYSE Amendment No.3, *supra* note 163 at 61 (delineating NYSE Rule 472 (b)(5)); *see also* NASD Amendment No. 3, *supra* note 151 at 6 (discussing NASD Rule 2711 (c) (4)).

165. *See* NYSE Amendment No. 3, *supra* note 163 at 7 (discussing the rationale behind the changes in the rule relating to research analysts communications with the subject company).

vii) Compensation

To further decrease the influence the investment banking division has over the research department, "no member or member organization may compensate for specific investment banking services[166] transactions."[167]

Analyst compensation will be further separated from influence of the investment banking department by employing a compensation committee that reports to the member's board of directors (or senior executive member).[168] An analyst's compensation will be based, among other things, on his performance, productivity and research quality, as well as the correlation between his recommendations and stock's performance.[169] No consideration will be given to the analyst's contribution to the investment banking business.[170]

viii) Definition of research analyst: trading restrictions

Furthermore, both NASD and the NYSE have refined their definitions of research analyst to include those individuals "primarily responsible for the preparation of the substance of a research report."[171] These additions have a direct bearing on the

166. *See* NASD Rule 2711(a)(2) (defining investment banking services as including " without limitation, acting as an underwriter in an offering for the issuer; acting as financial advisor in a merger or acquisition; providing venture capital, equity lines of credit, PIPEs or similar investments; or serving as placement agent for the issuer.").

167. *See* NYSE Rule 472(h)(1); *see also* NASD Rule 2711(d)(2) (clarifying that this rule applies to those "research analysts who are primarily responsible for the preparation and substance of a research report.").

168. *See* NYSE Rule 472(h)(2); *see also* NASD Rule 2711(d)(2) (stating that the committee will not have members of the investment banking division).

169. *See* NASD Rule 2711 (d)(2)(A), (B), (C)); *see also* NYSE Rule 472(h)(2)(i), (ii), (iii).

170. *See* NASD Rule 2711(d)(2); *see also* NYSE Rule 472(h)(2).

171. *See* NYSE Rule 344.10 (clarifying that the rule includes any member, allied member, or employee), *see also* NASD Rule 2711(a)(5) (noting that the definition also extends to "any person who reports directly or indirectly to such a research analyst in connection with, preparation of the substance of a research report.").

provision concerning the restrictions on personal trading by research analysts.[172] Rather than applying the same trading restrictions to supervisory personnel, NASD and NYSE Rules will be amended to compel member or member organizations to require prior approval (from the legal or compliance department) before such persons can "effect trades in securities of companies that are the subject of research reports, ratings or price target changes, which by virtue of their relationships, they can potentially influence or control."[173]

ix) Lock ups

Additionally, in order to further limit the symbiotic relationship between analysts and subject companies, NYSE Rule 472 (f)(4) and NASD Rule 2711(f)(4) prohibit "booster shot" research reports or public appearances "15 days prior to or after the expiration, waiver or the termination of a lock up."[174] This would preclude brokerage firms from publishing favorable research for the benefit of shareholders "whose lock up agreement is no longer in effect by driving up the price of the issuer's shares."[175] This provision shall not apply to the publication of research reports pursuant to SEC Rule 139[176] regarding a subject company with "actively traded securities"[177] or to a public appearance concerning such subject company.

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172. *See* NASD Rule 2711(g); *see also* NYSE Rule 472(e).
173. NYSE Amendment No. 3, *supra* note 163, at 15 (discussing NYSE Rule 472(e)(5)); *see also* NASD Amendment No. 3, *supra* note 151, at 3 (discussing NASD Rule 2711(g)).
174. *See* NYSE Rule 472 (f)(4); *see also* NASD Rule 2711(f)(4).
175. NASD Proposed Amendments, File No.SR-NASD-2002-154 *supra* note 137, at 12.
176. 17 CFR §230.139 (2003).
177. *See* NASD Amendment No 3, *supra* note 151, at 8 (referring to the definition of "actively traded securities" in Regulation M, 17 CFR 242.101 (c)(1)).

x) Qualification of analysts: NASD rules 1050, 1120 and NYSE rules 344, 345A

The general purpose of NASD Rule 1050, and NYSE Rule 344, is to raise the standard of those individuals engaged in research[178] by requiring them to pass an appropriate qualification examination.[179] NASD Rule 1120, like NYSE Rule 345A, relates to continuing education and includes a provision requiring analysts to undergo "training in ethics, and professional responsibility."[180]

III. RESOLUTION

Despite all intents and purposes to restore investor confidence and re-establish market integrity, it is likely that the real impact of these recent laws will fall short of that goal- and may even have some unintended negative consequences. Some critics argue that the rules are so "vague and confusing that it renders them largely ineffectual."[181] Several "consumer groups and members of congress say the new rules are better than nothing . . . but they are years overdue and fall short of what is needed." [182] It is evident that the regulations themselves have caused nearly as much controversy as the corporate scandals that gave rise to them.

The global settlement has a number of positive aspects to it, particularly the provisions set forth for retrospective relief and investor education. Problems may arise, however, in a number of

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178. *See* NASD Rule 2711(a)(5); *see also* NYSE Rule 344.10 (stating respectively that for the purposes of both NASD Rule 1050 and NYSE Rule 344, a research analyst shall mean an associated person "who is primarily responsible for the preparation of the substance of a research report.").

179. *See* NASD Rule 1050.

180. *See* NASD Rule 1120(b)(2)(iv); *see also* NYSE Rule 345A.50.

181. Comment letter from Securities Industry Association Regarding Proposed Rule Changes of NYSE and NASD Relating to Research Analyst Conflicts of Interest, File Nos. SR-NYSE-2002-49, SR-NASD-2002-154, March 10, 2003 at 3, *available at* http://www.sia.com/2003_comment_letters/pdf/SEC3-10-03_AnalystConflict.pdf (last visited Mar. 21, 2003) [hereinafter SIA Comment Letter].

182. Kathleen Day, *SEC Imposes New Rules on Analysts*, WASH. POST, May 9, 2002, at E01.

areas. First, the settlement requires the firms to purchase and distribute independent research from at least three sources over the next five years. The question is: how will those costs get reallocated? As a result of a reduction in their revenue, "firms will probably scale back and not cover as many companies."[183] Or these expenses may just be passed onto the investor, increasing the transaction costs. Second, although some members of the SEC support a permanent regulation that would provide for independent research even after the five-year plan is up,[184] the value of this independent research is questionable.

> The reports Wall Street will distribute to investors will most likely already have been read and acted upon by institutional investors. Professional money managers who run pension, mutual and hedge funds pay large fees to buy these reports directly from the boutique firms that Wall Street is likely to use as their sources for independent research. By the time average investors get this really high quality research, the content of the research will already be reflected in the market price of the stocks covered.[185]

Third, there are potential issues regarding the content and amount of information that will be passed onto the investor. It is likely that the rating systems could be more confusing than the old ones—making it even harder to compare firms.[186] Even the volume of the information itself, complete with disclosures, disclaimers, and explanatory material could simply overwhelm and even discourage the average investor. An industry-wide, uniform rating system could simplify matters, and make the data somewhat more approachable.

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183. Ben White, *Analyst Reform: An Issue of Dividends, Industry Veterans Doubt Investors Will Benefit*, WASH. POST, Jan. 2, 2003, at E01.

184. *See, SEC's Campos Pushes Permanent Independent Research*, in IN THE NEWS, *available at* http://www.compliancereporter.com (last visited Feb. 27, 2003).

185. White, *supra* note 183 (citing Henry T.C. Hu Law, Professor at the University of Texas at Austin).

186. *See id.* (stating "that before the latest round of reforms, most firms issued simple "buy" and "sell" ratings relative to the overall universe of publicly traded stocks. Now, most firms rate companies in relation to a particular sector or industry.").

Fourth, investment banking deals may still be able to indirectly influence analyst compensation, because analysts can still "improve the bottom line of the firm."[187] It will be difficult for analysts not to release bullish reports to generate investment banking deals... unless firms are prohibited from publishing research altogether.[188]

Similarly, the NYSE and NASD rules regarding analyst compensation, while appearing straightforward, upon implementation will become quite challenging. Although analysts may not be compensated for specific investment banking work, they may still receive compensation based on their overall contribution to the investment banking department. Analysts in their primary function are, therefore, still expected to work hand-in-hand with investment bankers.[189] Even though their relationship will be monitored by special committee, and punctuated by intermittent disclosures, it will still be difficult to parse out those acts not directly related to investment banking. In sum, it is likely that the line between "specific" and "general" contribution to the investment bankers will become necessarily blurred.[190]

Perhaps one of the more highly criticized rules is Reg AC. According to SEC Commissioner Goldschmid, "it represents only one more patch, and a patch of marginal value, on an analyst system that many have come to recognize is badly broken."[191] Reg AC is considered by some to be just a political exercise, established by regulators to pacify the masses, while its primary function is to do what basic securities laws have done for many years- prevent analysts from being dishonest.[192] "There is little or

187. *Id.*

188. *See id.*

189. Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1075 (2003) [hereinafter Fisch & Sale].

190. *See Id.*

191. Robert Schmidt et al., *SEC Approves Rule Ordering Stock Analysts to Certify Reports*, BLOOMBERG NEWS, Feb. 6, 2003 (citing Harvey Goldschmid).

192. *See* Dan Jameson, SEC Comment to File No. S7-03-02; Mike Lilles, Jr. & Karr Tuttle Campbell, SEC Comment to File No. S7-03-02, Sept. 26, 2002 (questioning why Rule 10b of the Securities Exchange Act of 1934 does not

no, prophylactic effect to be expected by requiring an otherwise untruthful analyst to 'certify' that he or she is telling the truth."[193] Certainly since the adoption of Rule 10(b) and perhaps for a longer period under a number of blue-sky laws,[194] "it has been unlawful, as a federal matter, to make such untrue statements."[195] It is, therefore, dubious that Reg AC will increase the likelihood of truthfulness.

Also, on a practical level, it may be unreasonable, if not impossible, to require analysts to disclose their compensation. Research analysts, like many other employees, are often not privy to how their compensation is derived. The language concerning this disclosure is so broad that an analyst who receives compensation, based to some extent on his work regarding a particular company that is an investment banking client, would be "justifiably concerned at having to certify that his or her compensation is not 'related', either 'directly' or 'indirectly' to a specific recommendation or view expressed by the analyst."[196] Perhaps the intent of this provision is clear- regulators are attempting to bar analysts from receiving direct payment as compensation for a favorable review. However, that matter is sufficiently dealt with in the new NYSE and NASD rules. For example NASD Rule 2711(h)(2)(i) provides that a member must disclose if "the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues."[197]

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simply apply to all those who "intentionally mislead investors" with statements for which they harbor secret reservations . . . ."), Joseph Borg NASAA President, SEC Comment to File No. S7-03-02, Sept. 23, 2002.

193. Borg, *supra* note 192.

194. *See* DOWNES & GOODMAN, *supra* note 3, at 52 (defining "Blue Sky Laws" as a "law of a kind passed by various states to protect investors against securities fraud.").

195. Borg, *supra* note 192; *see also* Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588, 595 (2000) (holding that an oral statement in connection with a sale or purchase of a security made with a secret reservation, can support an action under 10(b) of the Securities Exchange Act of 1934).

196. Sullivan & Cromwell SEC Comment to File No. S7-03-02, Sept. 27, 2002.

197. NASD Rule 2711(h)(2)(i).

Although there was a significant effort on the part of NASD and the NYSE to coordinate their efforts in establishing a joint set of regulations, there are still a number of issues which remain unsettled. In addition to the compensation problems already discussed, the rules restricting analysts from investing in the companies they cover do not effectively serve their purpose and may even give rise to other problems. Such restrictions may act as a deterrent for analysts from covering certain companies.[198] Analysts will want to avoid covering those securities they wish to invest in for their own portfolios.[199] In addition, analysts are still able to trade in securities covered by their fellow employees, and thereby benefit from each other's recommendation.[200]

Furthermore, although analysts are prevented from purchasing pre-IPO securities in the sectors for which they provide coverage, there is no provision in place to prevent them from acquiring venture securities endorsed by their employer or by other analysts.[201] Consequently, analysts can symbiotically benefit from each other's positive ratings. In effect, the rule does not curtail the basic conflict which exists when investment bankers own shares in companies they take public.[202]

In the days prior to the completion of this Note, regulators attempted to resolve the issue of analysts' public disclosures in the media. Originally, the NYSE proposed that an analyst should avoid further communication with a media outlet that had failed to include in their reports conflicts of interest disclosures that the analyst had made to them.[203] Those who criticized the NYSE proposal argued that investors' need to have access to all the pertinent information concerning their investment decisions should not trump the media's First Amendment right "to determine, without governmental interference, what information

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198. Discussion with Professor Jill E. Fisch, Fordham University School of Law (Sept. 2, 2003).

199. *Id.*

200. *See* Fisch & Sale *supra* note 189 at 1075.

201. *See id.*

202. *Id.*

203. *See* SIA Comment Letter, *supra* note 181, at 18.

to publish."[204] Critics further argued that the NYSE proposal should be clarified to ensure that print journalists may "in their editorial discretion and without penalty to their publications or imposing restrictions upon access to a research analyst, decline to publish the conflict disclosures required by an analyst."[205]

In response, the NYSE adopted a rule that analysts must still disclose any financial connections between their firm and an issuer, but "it will be left to the discretion of the press to report such disclosures."[206] Analysts will still be required to file a report to their firms, including details of what was discussed with the press.[207]

There is, however, little assurance that the required disclosures will be published by the media. Regulators are unable to dictate to journalists what they should write. Also, many journalists may simply choose not to publish disclosures for lack of interest. As a result, the effectiveness of the required disclosures may be undercut.[208]

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204. Matthew Winkler, Editor-in-Chief of Bloomberg, Comment Letter to SEC, Feb. 19, 2003 (citing Lowe v. SEC, 472 U.S. 181, 230 (1985) ("At some point, a measure is no longer a regulation of a profession but a regulation of speech or of the press; beyond that point, the statute must survive the level of scrutiny demanded by the First Amendment.") and (citing Reliance Ins. Co. v. Barrons, 442 F. Supp. 1341, 1353 (S.D.N.Y. 1977)). ("The Securities laws . . . were not developed with the intention of . . . inhibit[ing] the exercise of freedom of the press.") [hereinafter Bloomberg Comment Letter].

205. *Id.; see also* Miami Herald v. Tornillo, 418 U.S. 241 (1974).

> [T]he choice of material to go into a newspaper, and the decisions made as to limitations on the size and content of the paper . . . constitute the exercise of editorial control and judgment. It has yet to be demonstrated how governmental regulation of this crucial process can be exercised consistent with First Amendment guarantees of a free press as they have evolved to this time.

Id. at 258.

206. John Labate, *Exchange Bows to SEC Request to Examine Governance*, FIN. TIMES, Apr. 4, 2003.

207. Similarly, under the NASD rule, an analyst is not instructed to "boycott further communications with a media outlet" if that outlet fails to broadcast the specified disclosure information outlined in the rule. *See* SIA Comment Letter, *supra* note 181, at 18.

208. Discussion with Jill E. Fisch, *supra* note 198.

Finally, there is little doubt that comprehensive reform will help the industry going forward, "but without stiff individual punishments there will be limited incentives for the brokerages to change their behavior."[209] The recent charges filed by NASD against Quattrone hopefully represents a new trend among SROs to hold more and more individuals personally accountable—instead of having matters settled by their firms.

CONCLUSION

In the wake of all the corporate scandals that have monopolized the headlines over the past two years, investors have become extremely jaded. The recent regulations regarding analyst conflicts of interest, while they show a tremendous first effort on the part of the SROs and state and federal regulators, they fall short on a number of practical levels. Inconsistencies, overly broad language, and unrealistic requirements deduct from their overall effectiveness. Many of these rules will need to be amended before their intended objectives are realized. The goal of restoring market integrity and investor confidence will not be met without clearly resolving the conflicts of interest faced by research analysts.

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209. Paul Lapides, ASSOCIATED PRESS, Dec. 20, 2002.

Notes & Observations