Securities Analysts and "Tainted" Research:

What Regulations and Professional Standards Apply?

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ENRON, MARTHA STEWART, DENNIS KOZLOWSKI, WorldCom. These are some of the names that will "live on in infamy" following the stock market tumble at the turn of the Twentieth Century. They will forever be associated with accounting chicanery, insider trading, corporate greed, and massive investor fraud. There are, however, other less familiar names that may also deserve to be included on that list - names like Jack Grubman, Mary Meeker, Henry Blodget, and Frank Quattrone - some of the highest paid securities analysts in Wall Street history. New York's Attorney General Eliot Spitzer's investigation into Wall Street has brought to light a number of pernicious practices, among them IPO spinning and improper mutual fund trading. But probably the most prominent and widespread mischief that came to light as a result of Spitzer's campaign to clean up Wall Street was a number of conflicts of interests associated with securities analyst research.

For some years preceding the recent market downturn, securities analysts employed by brokerage firms to independently research stocks (for the benefit of the firms' retail brokerage as well as for the firms' proprietary trading) had been not-so-secretly partnering with the firms' investment banking divisions. Fees generated by stock sales were only a fraction of what they had been in the 1970s, having been hammered by low-cost online and traditional retail competitors. On the other hand, IPOs were in their heyday, especially in the internet and telecommunications sectors. Competition for investment banking business was fierce. Brokerage houses, taking part in so-called "bake offs", were pitted against one another in bids to obtain lucrative IPO businesses and the brokerage fees associated with selling those same stocks. Ringers in the form of firm analysts, who covered the relevant industry, were pulled in to increase a firm's chances of wooing the business. Analysts' pay was increasingly being tied - in some cases directly and in others somewhat indirectly - to their ability to generate investment banking business. At more than one bank, analysts' self prepared year-end performance evaluations included lists of deals they claimed to have assisted the bank in landing. This practice was so common and considered so routine that one firm even included a breakdown of research analysts' compensation that came from the investment banking division on their pay stubs, calling it a "helper fee."[1]

While we know that some analysts had become more like salespeople than the independent researchers of old, presumably no evidence of written promises by firms to initiate favorable coverage of stocks they underwrote will surface. Regardless, by the late 1990s, analysts - always viewed as somewhat optimistic on the companies they covered - had become full fledged cheerleaders. As a point of reference, in December of 2000, 99.9% of analysts' more than 27,000 recommendations were Hold, Buy, Strong Buy, or similar. That's right. Only one tenth of one percent of all recommendations being made late in the recent bull market were Sell (0.8%) or Strong Sell (0.2%).[2]

The liaisons between analysts and investment banking reached their height during the years 1999-2000, when "star" analysts like Jack Grubman of Salomon Smith Barney were earning as much as $10 to $20 million annually. Even junior analysts in hot sectors were being paid $350,000 to $500,000 a year.[3] At least some of that cash compensation was used to create additional wealth for analysts in the form of ownership interests in the same stocks that were being underwritten by the firm. Analysts' ownership in securities issuances the firm had underwritten was often all but hidden from view - like that of the bank's executives' and managers' - in private equity funds trading for their benefit. While officers and directors of the stock issuer itself were required to disclose their trades in their company stock by filing Form 144 with the SEC, a public document, analysts and bank executives were under no such SEC filing obligation. So while the rosy recommendations buoyed the stocks' prices, some analysts were privately selling shares and making thousands more than their annual base compensation in the process. Their optimistic reports not only benefited the companies involved, but also benefited the analysts themselves by bolstering the stock prices long enough for the analysts, as well as others in the industry, to get out with tidy profits.[4]

The arguably less-than-independent and perhaps more-than-just-optimistic reports and recommendations were intertwined with some analysts' ownership conflicts of interest. Separately and together they resulted in a win-win-win - unless you were Joe Average. These industry-wide conflicts of interest coincided historically with the rise of the day trading phenomenon and the emergence of the Financial News Network and CNBC, entire cable channels devoted to financial news. Blue and white collar workers alike quit their day jobs in favor of stationing

themselves between a computer with internet access and a television set, quickly and inexpensively trading stocks, making a hundred here and hopefully a thousand there.[5] Information was the tool of this trade: hard information from independent research reports, recommendations from analysts with lots of experience both in the relevant industry and with the market, and eventually any information at all. Even absurd predictions and flimsy opinions became the basis upon which speculators small and large were shooting in and out of stocks.[6] With veteran stock brokers and novice day traders seeking to capitalize on any new recommendation, perhaps regardless of its underpinnings or even plausibility, the highest profile and highest paid stock analysts naturally became media darlings. These analysts eventually became so well known and powerful that their ratings and other recommendations could allegedly move market prices for the hundreds of stocks that they and their firms followed.[7]

"Price targets" were one way in which analysts' reports seemed to affect the market for some stocks. For example, in December of 1999, Qualcomm's stock rose by more than 30% to a high of $717.24 after Walter P. Piecyk, Jr., a PaineWebber analyst, opined that it would reach $1,000. Other analysts' target prices for tech sector stocks that at first appeared outrageous were also achieved and even surpassed. Analysts' reports were rife with "new" valuation methods, models that to the untrained eye seemed to justify the continued positive recommendations. Instead of analyzing stocks' value or potential based on earnings and cash flow, such valuation was often based on such things as revenues and web site visits.[8] The bubble continued to expand. As long as the market continued to rise, everybody was making money. Joe Average - with his life savings, or at least his 401k money invested in mutual funds or securely supervised by a retail stock broker - was none the wiser. Nobody else cared to question the conflicts of interest that were apparent in stock research. That is until the house of cards collapsed, and Joe Average was left holding stocks worth a fraction of what analysts' target prices had been only months earlier.

And collapse it did. As the market began its downward spiral, and what were once hundred dollar stocks were now trading in single digits, analysts' recommendations stayed consistently and incredibly bullish. But finally the press - and more importantly, New York's Attorney General Eliot Spitzer - cottoned on to the paucity of sell recommendations, to the questionable nature of some of the valuation methods being employed, to a number of analysts' and other bank executives' ownership interests in stocks covered by them or their research departments, to a few of the star analysts' cozy relationships with corporate executives, and to the fact that many analysts' compensation was at least indirectly tied to their ability to attract investment banking business. Eventually allegations surfaced and the argument was pieced together that in many cases analysts' widely published reports and recommendations, as well as their comments and predictions made on financial talk shows, were not truly independent stock research upon which investors could rely.[9] Even Congress got into the act, conducting hearings in the summer of 2001 into the independence of analyst research.[10]

Indeed the bubble had burst. Both the Nasdaq Composite and the S&P 500 indices had begun to dive into the abyss around September 2000, with lows being recorded in the Spring of 2001. Then, in Fall 2001, Enron and other major corporate scandals began to surface, many involving accounting shenanigans. With the pressure to meet "the Street's" short term earnings expectations too much to bear, almost no sector was left untouched. While the analysts had been pumping up New Economy stocks for their own reasons, Old Economy stocks had succumbed as well. Even the accounting at brick and mortar blue chips like General Electric and I.B.M. came under suspicion.[11] With Joe Average now stuck holding the proverbial empty bag, the spotlight quickly turned to Wall Street for someone to shoulder the blame for the massive loss of investor wealth. In pretty short order, Congress passed the Sarbanes-Oxley Act of 2002, billed essentially as legislation to clean up Corporate America, but also including some provisions targeted at the analyst conflict of interest problem. The effect of that legislation, which is discussed in pertinent part below, largely remains to be seen. Spitzer continued his crusade to protect Joe Average, expanding his probes beyond where the Securities and Exchange Commission dared go,[12] with several other state attorneys general following suit. In the process, damaging evidence was unearthed against brokerage firms and their analysts in the form of internal memoranda, messages, and emails that included references to various stocks as, among other derisive names, "dogs" and "piece[s] of junk" by some of the same analysts who had simultaneously given those stocks strong ratings.[13]

Spitzer and the SEC eventually settled with ten of the largest Wall Street firms, who paid fines and penalties totaling $1.4 billion, while also promising to purchase independent research for the next five years and to revamp their firms' structures so as to separate banking from research.[14] In the meantime, a wave of change

had hit the industry, with brokerage firms scrambling to make personnel changes and to reform their stock rating systems in an effort to rehabilitate investor confidence.[15] Within a year, both the regulators and the relevant self-regulatory organizations (NASD and NYSE) had promulgated new rules aimed at eliminating investment banking's influence on research, requiring more transparency with regard to firms' and analysts' financial stakes in subject companies, and mandating certification of all analysts' reports.

Civil Liability under Federal Securities Laws Uncertain

As expected, the inevitable stream of investor lawsuits alleging securities fraud began to flow into the federal court system. A large number of suits with allegations centered primarily on "tainted research" are pending today, many of which are class actions brought under the rubric of the 1933 Securities Act and the 1934 Securities Exchange Act. Based on a disclosure paradigm, the federal securities laws do not squarely address the analyst-investment banking conflict of interest or the conflict posed by analyst ownership in stocks covered. Furthermore, the laws do not seem to account for the type of influence analysts appear to have had on the capital markets and the investing public at large. At least one judicial opinion from the early 1990s stated as a settled fact, that an analyst's primary incentive was to publish accurate research, since "the analyst's reputation and livelihood depend solely on the analyst's ability to be correct."[16] By the year 2000, that had apparently changed, at least in some quarters.

It remains to be seen how the traditional securities fraud causes of action will apply to this situation. Perhaps the highest profile investor suit, that against WorldCom, Salomon Smith Barney, Jack Grubman and others, has overcome motions to dismiss and is proceeding to a trial currently scheduled for January of 2005 before U.S. District Judge Denise Cote of the Southern District of New York. Other such suits have met with different fates. Early on, a group of six consolidated investor suits against Morgan Stanley and Mary Meeker were summarily dismissed *sua sponte* by Senior U.S. District Judge Milton Pollack with, among other colorful references, a brusque analogy of the stock market to a "gambling pit."[17] More recently, Judge Pollack has also dismissed other investor suits based on a similar viewpoint.[18]

While plaintiffs' lawyers are naturally optimistic, it must be conceded that there are a number of legal issues that threaten the viability of the class action securities fraud suits based on allegedly "tainted" research. For example, many affected investors did not necessarily buy or sell, but rather held their free falling stocks based on analysts' allegedly biased hype. Given that the securities laws protect buyers and sellers who are defrauded, potential plaintiff "holders" face a major threshold battle over standing.[19] Moreover, the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 will require investor plaintiffs to marshal enough evidence to plead with particularity in their civil complaints facts permitting not just an inference or a reasonable inference of scienter, but instead a "strong inference that the defendant acted with the required state of mind."[20] While the telling emails publicized by Spitzer will help some investors, robust specific evidence of motive might not be attainable by others prior to formal discovery. For those cases that do get to trial, consider for example the hurdle that may be posed by proof of loss causation. Even assuming recklessness, self-interest, or improper pressure from the banking side drove some analysts' ratings, defense lawyers are sure to argue that analysts and their recommendations were not the cause of the recent stock market crash, and therefore, of the losses sustained by investors.[21]

Other Standards Applicable to Securities Analysts

Some aggrieved investors will be excluded from the court system altogether, while others will fail in their attempts to hold analysts liable in formal litigation. Equally relevant, many other investors who lost money allegedly based on tainted analyst research reports were also clients of the brokerage firm upon whose advice they will claim to have relied. To the extent these client plaintiffs seek redress individually, rather than by way of class action, they are generally bound by the terms of their brokerage account agreements to pursue claims against the brokerage firm and its employees by way of NASD-sponsored arbitration proceedings. At these informal arbitration hearings, the legal questions considered will undoubtedly be different than those raised in the lawsuits filed in the formal court system. At arbitration, the relevant inquiry may be based not on the technical elements of federal rights of action, but instead on whether a particular analyst or brokerage firm complied with the cornucopia of regulations, rules, and professional standards of conduct that govern their dissemination of research reports and other recommendations.

The rules, regulations, and standards that apply to most analysts have a number of different sources. Most broker-dealers are member firms of the so-called Self-Regulatory Organizations (SRO), i.e. the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) and are subject to these organizations' rules of conduct. Of particular interest are rules that relate to analysts' industry and company reports and those that govern analysts acting in a supervisory capacity. Many of the more qualified analysts are personally members of the Association for Investment Management and Research (AIMR), which is a national professional organization consisting of more than 60,000 financial analysts and other investment professionals. Nearly 50,000 of its members hold the Chartered Financial Analyst (CFA®) designation. Both AIMR members and candidates who are in the process of obtaining their CFA® designation

are bound by AIMR's Code of Ethics and its Standards of Practice, which are widely recognized both in the U.S. and internationally. Importantly, they are available for adoption by governments and brokerage firms and have already been adopted by a number of firms in the U.S. Candidates meeting varying levels of requirements for CFA® designation are deemed to have met various securities licensing requirements in the U.K., Canada, Hong Kong, and the U.S. For example, the NYSE permits substitution of acceptable performance on the CFA® Level I examination for its qualification requirements for supervisory analysts. Thus, for the past forty years, the AIMR has been a powerful force guiding professional conduct in the area of financial analysis and investment management. These, along with the rules promulgated by the NASD and NYSE, may form the basis in some fora for the argument that analysts and/or their brokerage firm employers failed to meet applicable standards of conduct.

Accordingly, this article identified and discussed the relevant rules and standards of the NASD, NYSE, and AIMR that were in effect prior to recent changes, amendments, and additions promulgated beginning in May of 2002.[22] Some of the rules and other standards established by these organizations relate to the general conduct of investment professionals, while others address specific issues like the preparation of research reports. Particularly with regard to preparation of research reports and recommendations made to clients and the public, these standards together require independence and objectivity, disclosure of conflicts of interest, competence, and the exercise of due diligence. All are needed to establish a reasonable basis for investment recommendations, as well as forbearance from making exaggerating and misleading statements or omissions. Analyst and brokerage firm conduct vis-à-vis clients generally requires fair dealing and fiduciary duty, as well as ongoing concern for suitability of investments. Finally, the brokerage firms' supervisory duties may also be relevant when determining whether inappropriate conduct has occurred. Each of these areas of conduct and the relevant sources are identified and discussed more fully below.

General Principles

Relevant Standards: NASD Conduct Rule 2110; AIMR Code of Ethics; AIMR Standards I.A and I.B.

A NUMBER OF BASIC PRINCIPLES guiding proper conduct are set forth in rules like NASD Conduct Rule 2110, which requires members to "observe high standards of commercial honor and just and equitable principles of trade." Likewise, the AIMR Code of Ethics includes such fundamental tenets as requiring its members to act, inter alia, with professionalism, integrity, dignity, and generally to act ethically when dealing with the public as well as both with clients and prospects. Importantly, AIMR Standard I.A. mandates members' compliance with "all applicable laws, rules, and regulations of any government, governmental agency, regulatory organization, licensing agency, or professional association..." Section B of AIMR Standard I prohibits knowing participation or assistance "in any violation of such laws, rules, or regulations." These two broad provisions incorporate all other possible applicable laws and regulations, expressly binding members to either the laws, rules and regulations of the member's state or country or the AIMR Standards, whichever standard of conduct is higher.

Objectivity and Independence

Relevant Standards: AIMR Code of Ethics; AIMR Standards IV.A.3.

INDEPENDENCE AND OBJECTIVITY are cornerstones of the AIMR standards. It is at least arguable that an analyst is unable to provide an objective and unbiased recommendation when the success of investment banking impacts his or her compensation, and when the analyst has an ownership stake in the subject company.

The AIMR Code of Ethics expressly requires the exercise of "independent professional judgment" by members. Similarly, subsection A.3 of AIMR Standard IV dictates the use of "reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action."

Disclosure of Conflicts of Interest

Relevant Standards: AIMR Standard IV.B.7; NASD Conduct Rule 2210(d); NYSE Rule 472.

IN CONNECTION WITH DISCLOSURE of conflicts of interest, subsection B.7 of AIMR Standard IV obliges members to disclose to clients and prospects "all matters, including beneficial ownership of securities or other investments, that reasonably could be expected to impair the member's ability to make unbiased and objective recommendations."

Regarding recommendations not made specifically to clients, NASD Rule 2210 governs "Communications with the Public." It provides standards applicable to sales literature, including research reports, as well as public speaking engagements and activities, including seminars, other fora, radio, and television interviews. Rule 2210 has both general and specific standards with respect to communication with the public. For example, at subsection (d)(2)(B)(i) it requires disclosure when the member makes a market in the security, and when it buys or sells from customers on a principal basis. Of particular relevance to analysts' reports and recommendations, disclosure is also required by Rule 2210 when the member firm or its officers or partners either own options or other

rights on the issuer, or was a manager or co-manager of a public offering of the issuer within the last three years.

The NYSE's rules also govern member firms' communication with the public. These include Rule 472, which at Supplemental Material ¶2472.40(2) requires disclosure if the member organization is a market maker in the security, when the securities are to be sold or bought on a principal basis, when the member organization was a manager or co-manager of a public offering of the subject company within three years, when the firm or employees preparing the communication have any securities or options of the subject company, and when the member, allied member or employee is a director of the subject company.

Due Diligence, Competence, and Reasonable Basis for Investment Recommendations and Research Reports

Relevant Standards: AIMR Code of Ethics; AIMR Standard IV.A.1 and A.2; NASD Conduct Rule 2210(d)(1)(A) and (d)(2)(C); NYSE Rule 472

A NUMBER OF STANDARDS REQUIRE that analysts be competent, exercise due diligence, and have a reasonable basis for their recommendations. First, the AIMR Code of Ethics mandates maintenance and improvement of competence by members at all times, as well as the general exercise of reasonable care. More specifically, AIMR Standard IV.A.1 requires members to act diligently and thoroughly when making investment recommendations and when taking investment actions. Not only must there be a "reasonable and adequate" basis for making such recommendations and actions, the recommendation or action must be "supported by appropriate research and investigation," of which appropriate records are maintained. Specifically with regard to research reports, Standard IV.A.2 obliges members to "distinguish between facts and opinions," and to employ "reasonable judgment" as to the inclusion or exclusion of relevant factors. It also calls for members to "indicate the basic characteristics of the investment involved" whenever making general recommendations that are "not directly related to a specific portfolio or client."

Similarly, NASD Conduct Rule 2210(d)(1)(A) provides that members must "provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed or services offered," and Rule 2210(d)(2)(C) prohibits communications that include "opinions for which there is no reasonable basis."

For its part, NYSE Rule 472 prohibits dissemination of "any communication which contain[ ] ... (iii) opinions for which there is no reasonable basis." Rule 472 further requires supporting information; and all bases or assumptions used in projections and predictions must be made available upon request. Likewise, any communications that include records of past performance must be "balanced" and records relating to these reports must be maintained for three years. Finally, all research reports must be dated and any material that is not current must be identified.

Misleading Statements and Omission of Facts

Relevant Standards: AIMR Standard II; AIMR Standard IV.A.1.c, IV.A.2, IV.B.2.c, IV.B.6; NASD Conduct Rule 2210(d)(1)(B) and (D); NYSE Rule 472.

A NUMBER OF THE RULES AND REGULATIONS have strong prohibitive language that tracks or appears to be modeled after SEC Rule 10b-5, which creates civil liability for untrue statements and/or omissions of material fact, or other statements that are otherwise false or misleading.[23] These types of statements are expressly prohibited by the following rules: NASD Conduct Rule 2210(d)(1); NYSE Rule 472; AIMR Standards IV.A.1.c., IV.B.6.

More specifically, AIMR Standard IV.A.1.c dictates avoidance of material misrepresentations in research reports and investment recommendations. AIMR Standard IV.A.2 requires the exercise of judgment in including or excluding relevant factors from a report, and also mandates distinctions be made between facts and opinions in research reports. Standard IV.B.2.c requires such distinctions between facts and opinions in other investment recommendations. In a related vein, AIMR Standard IV.B.6 prohibits members from making or implying any "assurances or guarantees" with regard to investments, and counsels communication of "accurate information" only.

Likewise, NASD Conduct Rule 2210(d)(1)(B) directly prohibits dissemination of communications the member "knows or has reason to know contains any untrue statement of material fact or is otherwise false or misleading." Subsection (D) of that same rule elaborates on factors that members should consider when "judging whether a communication or a particular element of a communication may be misleading." These include such things as the "overall context" and "the audience," with a warning to tailor the level of explanation appropriately and to bear in mind that readers, viewers, and/or listeners may not be restricted to only the more sophisticated investors. Also echoing Rule 10b-5 is NYSE Rule 472, which at Supplemental Material ¶2472.30(i) prohibits members from utilizing communications containing "any untrue statement or omission of a material fact or is otherwise false or misleading."

On a more general basis AIMR Standard II, which sets forth members' obligations to the profession, proscribes engaging "in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation or commit any act that reflects adversely on their honesty, trustworthiness, or professional competence."

Exaggerated, Sensational, or Unwarranted Claims

Relevant Standards: NYSE Rules 435(5) and 472; NASD Conduct Rule 2210(d)(1)(B).

OF POSSIBLE RELEVANCE TO SOME ANALYSTS' reports and recommendations, the rules prohibit exaggerations and unwarranted statements or promises, as well as the use of superlatives and sensationalism.

NYSE Rule 472 at Supplemental Material ¶2472.30, as well as NASD Conduct Rule 221(d)(1)(B) proscribes "exaggerated," or "unwarranted" claims or statements in any public communications made by members. Further, NYSE Rule 435(5) prohibits rumors of a "sensational character" related to listed securities.

Fiduciary Duty

Relevant Standards: AIMR Standards IV.B.1 and IV.B.4

AIMR STANDARD IV.B.1 "FIDUCIARY DUTIES," clearly provides that "[m]embers must act for the benefit of their clients and place their client's interests before their own." More generally, that Standard also requires members to "use particular care in determining applicable fiduciary duty and [to] comply with such duty as to those persons and interests to whom that duty is owed."

Standard IV.B.4 contemplates beneficial ownership by the member of securities or other investments in which the members' clients or employers may also trade. In that regard, the Standard requires that clients and employers transactions "shall have priority" over members' own transactions, "so that such personal transactions do not operate adversely to their client's or employer's interests."

It is possible that analysts and others similarly situated in brokerage firms who sold their own holdings in stocks on which they were simultaneously giving recommendations to clients and the public to Hold, Accumulate, Buy, or similar ratings were operating in violation of this Standard. Any fiduciary duty to clients should extend to all firm clients, including retail clients. Where the focus in making investment recommendations and providing widely disseminated research reports was on bolstering the stock price or the generation of investment banking fees, the conduct of some firms may have ignored this duty to retail clients in particular.

Good Faith and Fair Dealing

Relevant Standards: AIMR Code of Ethics; AIMR Standard IV.B.3; NASD Conduct Rules 2210(d)(1)(A) and 2310.

IT GOES WITHOUT SAYING that investment advisers and analysts, like other professionals, should act in good faith and deal fairly with their clients at all times. This includes using ethical behavior and judgment as well as consideration of the suitability of investments. For example, AIMR Standard IV governs "Relationships with and Responsibilities to Clients and Prospects" and is directed at financial analysts and their research reports. Subsection B.3 thereof calls for fair dealing with clients and prospects in the context of disseminating investment recommendations, making material changes to prior recommendations, and when taking any investment action. The AIMR Code of Ethics' basic call for integrity and professionalism and its general directive to act in an "ethical manner" perhaps promote fair dealing with the public as well.

General standards found in NASD Conduct Rule 2210(d)(1)(A) also provide that all communications with the public, including research reports and recommendations, must be made in good faith and based on fair dealing. Rule 2210's more specific standards cover such topics as disclosure of conflicts of interest and establishing a reasonable basis for recommendations were addressed separately above.

Suitability

Relevant Standards: NASD Conduct Rule 2310; AIMR Standard IV.B.2

REGARDING SUITABILITY, NASD'S RULE 2310 requires that any recommendation be suitable for the customer, and in the case of non-institutional customers, requires the member to make an effort to obtain information about the client's financial status, tax status, and investment objectives. Interpretation IM-2310-2 also emphasizes the requirement that members deal fairly with the public in all sales efforts. Also as regards suitability, AIMR Standard IV.B.2 prohibits members from making recommendations unless they have "reasonably determine[d] that the recommendation is suitable to the client's financial situation, investment experience, and investment objectives." It requires members to make a "reasonable inquiry" into these matters, and to update this information, at least annually, to permit adjustment of investment recommendations to portfolios or clients. The relevant factors that should be considered in connection with suitability and appropriateness determinations are listed in this Standard.

Supervision

Relevant Standards: NASD Rule 3010(a); NYSE Rules 344 and 405

A SAFEGUARD AGAINST VIOLATIONS of the foregoing rules and standards is provided by having supervisory personnel looking over the shoulder of their charges and critically reviewing their reports and recommendations. It may be that some analysts' biased reports and recommendations were made in settings where appropriate oversight was lacking.

Generally, NASD Rule 3010(a) mandates that each member firm establish and maintain a system of supervision that is designed to achieve compliance with securities laws and regulations and with NASD rules. The required proper supervision is of "the activities of each registered representative and associated person."

As regards communications with the public, NYSE Rule 472(b) requires that research reports be approved in advance by a supervisory analyst. NASD Conduct Rule 2210(b)(1) provides that a registered principal of the member firm must approve all literature, including research reports. In the case of research reports regarding debt and equity securities, the NASD permits approval by a supervisory analyst recognized by the NYSE under NYSE rules 344 and 472. Where unapproved reports or recommendations were disseminated by analysts, these supervision rules were likely violated.

Additional supervisory obligations applicable to partners or principals in member firms are set forth in NYSE Rule 405, which mandates diligence with respect to learning "the essential facts relative to every customer, every order, every cash or margin account accepted or carried... and every person holding power of attorney over any account accepted or carried by such organization."

Subsequent Remedial Measures

NO DOUBT SPURRED BY THE RAMPANT CONFLICTS of interest that came to light following the stock market devaluation of 2001-2002, new laws, regulations, and rules have been promulgated. Notably, provisions of the Sarbanes-Oxley Act require securities exchanges and associations to address conflicts of interest in connection with analyst recommendations in research reports and public appearances. Among the new rules to be promulgated under Section 15D of the Securities Exchange Act[24] are the forced separation of investment banking and research functions within firms, disclosure in any public appearance by analysts of their potential conflicts of interest including ownership interest in the subject company, and various restrictions on approval of research reports, supervision and evaluation of analysts.

Consequently, the SROs have already firmed up and clarified rules on research analysts and their reports. In the case of the NASD, a new rule was created: Rule 2711 "Research Analysts and Research Reports." In the case of the NYSE, Rule 472 was amended. These rules are intended to operate identically according to the SEC. Essentially, they seek to eliminate the research-related conflicts of interest that were pervasive in the late 1990s. They prohibit supervision or control of research analysts by investment banking, including review or approval of research reports. They also restrict communications with the subject company, in most cases prohibiting review of a research report by the subject company prior to its publication. Moreover, favorable ratings or changes in ratings can not be used as an inducement or threat to obtain business or compensation. The new rules also restrict trading in subject company securities or derivatives by analysts, and the compensation of analysts based on specific investment banking transactions is now verboten. Finally, they require numerous disclosures be made to readers, viewers, or listeners. Analysts must disclose such things as ownership and other material conflicts of interest and receipt of any compensation by the analyst from investment banking revenues and by member firms from investment banking services for the subject company. Moreover, the SRO rules now require disclosure by analysts and firms of the meaning of their rating systems and the distribution of the various ratings given.[25]

Finally, if these new rules aren't enough to highlight analysts' independence and integrity obligations, a new SEC regulation now also requires analysts to expressly "certify" in their research reports that the views expressed in the report accurately reflect the analyst's personal views. That same regulation also requires analysts to certify whether any part of the analyst's compensation was or will be related to the views expressed in the report. If so, the analyst must identify the source, the amount, and the purpose of the compensation. Similar disclosures must also be made in connection with public appearances by analysts. [26]

These new laws and rule amendments meet analyst conflicts of interest head on, unquestionably sewing up any perceived loophole. And as this article has demonstrated, it is arguable that the pre-amendment, then-existing professional rules and/or standards prohibited tainted research practices as well. BLB

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ENDNOTES: *Ann Morales Olazábal and Thomas R. Robinson*

[1] Gretchen Morgenson, *Requiem for an Honorable Profession*, N. Y. Times (May 5, 2002) at Section 3, page 1; Eric Schonfeld, *The High Price of Research*, Fortune (March 20, 2000) at 118.

[2] Gretchen Morgenson, *How Did So Many Get it So Wrong?*, N. Y. Times (December 31, 2000) at Section 3, page 1.

[3] *Id.*

[4] Gretchen Morgenson, *Buy, They Say. But What Do They Do? I.P.O. Conflicts Bedevil Analysts*, N. Y. Times (May 27, 2001) at Section 3, page 1.

[5] Patrick McGeehan, *Day Trading is Here to Stay; Now How to Get a Piece of It?,* N. Y. Times (March 29, 2000), Section H, page 16; David Barboza, *Why Big Firms are Courting Day Traders*, N. Y. Times (August 13, 1999) Section C, page 1.

[6] Robert J. Shiller, Irrational Exuberance, Afterword (2001).

[7] *See, e.g.*, Timothy L. O'Brien, *Egg on Face, But Analyst May Profit*, N.Y. Times (November 20, 1997), Section D, page 1.

[8] William Jahnke, *Valuing New Economy Stocks,* J. OF Fin. Planning (June 2000) at 46-48. *See also* Morgenson, *supra* note 2; Jeremy Kahn, *Presto Chango! Sales are Huge!,* Fortune (March 20, 2000) at 90 (discussing questionable accounting practices and attendant "new" valuation methods in use in the internet and tech sectors).

[9] *See, e.g.*, Jacob H. Zamansky, *Stock Analysts' Conflicts of Interest: The Road to "Independence" in Stock Research,* J. Investment Compliance (Winter 2002/2003) at 6-12.

[10] Gretchen Morgenson, *Wall Street's Analysis Put on the Defensive at a Hearing,* N. Y. Times (June 15, 2001), Section C, page 4. *See also Analyzing The Analysts: Are Investors Getting Unbiased Research From Wall Street?*: Hearing Before the House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, 107th Cong. (June 14, 2001).

[11] Alex Berenson, The Number: How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America (2003).

[12] John Cassidy, *The Investigation; How Eliot Spitzer Humbled Wall Street,* The New Yorker (April 7, 2003), at 54; *See also* Shawn Tully, *Breaking the Banks; Think Spitzer is Tough? Wait Till the Angry Throngs get Through with Wall Street,* Fortune (May 27, 2002), at 26.

[13] *See, e.g.*, Susanne Craig, *Betting on Overhaul, Analyst Weighs Getting Back into Game*, Wall St. J. (November 8, 2002) (describing CSFB e-mails discovered by Massachusetts Attorney General's investigation); Gretchen Morgenson, *Regulators Find More Red Flags in Another Analyst's Optimism*, N. Y. Times (September 12, 2002), Section C, page 1 (describing Donaldson, Lufkin & Jenrette e-mail messages uncovered in SEC's investigation into stock analysts' conflict of interest); Patrick McGeehan, *Merrill Lynch Under Attack as Giving Out Tainted Advice*, N. Y. Times (April 9, 2002), Section C, page 1 (describing e-mails revealed by New York Attorney General's investigation into Merrill Lynch).

[14] Securities Exchange Commission, *SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices.* Press release dated December 20, 2002, available at http://www.sec.gov/news/press/2002-179.htm

[15] Ken Brown, *Why Cuts in Analyst Coverage May be Good for Investors,* Wall St. J. (November 28, 2003)(detailing cost cutting measures at firms that resulted in coverage cutbacks because fewer research analysts were employed); David Rynecki, *Can Sallie Save Citi, Restore Sandy's Reputation, and Earn; Her $ 30 Million Paycheck?,* Fortune (June 9, 2003) at 68(discussing Citibank's employment of former Sanford Bernstein standout analyst Sallie Krawcheck to head new independent research division to be known as Smith Barney); Susanne Craig, *Securities Firms Find New Ways to Issue "Sells,"* Wall St. J. (September 13, 2002) at C1 (reporting on brokerage firms' revision of their rating systems and expressing cynical view on increase in "sell" recommendations).

[16] In re Verifone Sec. Lit., 784 F. Supp. 1471, 1481 (N.D. Cal. 1992).

[17] *See, e.g.*, Thomson v. Morgan Stanley Dean Witter & Co., No. 01-CIV-7071, 2001 U.S. Dist. LEXIS 12667 (S.D.N.Y. 2001).

[18] *See* In re Merrill Lynch Research Reports Sec. Litig., 02 MDL 1484, 2003 U.S. Dist. LEXIS 11005 (S.D. N.Y. 2003) (Pollack, J. referring to stock market as "freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches.")

[19] The Second Circuit has held that the requirement, in the Rule 10b-5 context, that alleged misrepresentation or omissions be made "in connection with" the purchase or sale of a security does not cover the *holding* of a security as a consequence of such a misrepresentation or omission. *See, e.g.*, *Gurary v. Winehouse*, 190 F.3d 37, 46 n.9 (2d Cir. 1999). Such a case may, however, be permitted to proceed in state court based on laws other than the federal securities laws without running afoul of the Securities Litigation Uniform Standards Act of 1998 (SLUSA), *15 U.S.C § 78bb*(f)(1) and (2), which requires covered securities fraud actions to proceed in federal court under federal law. *See, e.g.*, *Hardy v. Merrill, Lynch, Pierce, Fenner & Smith,* 189 F. Supp. 2d 14, 18 (S.D.N.Y. 2001).

[20] 15 U.S.C. §78u-4(b)(2) (2003).

[21] *See, e.g.*, John C. Coffee, Jr., *Security Analyst Litigation*, N.Y.L.J. at 5 (September 21, 2001) (opining that plaintiffs face an "uphill battle" against analysts and setting out various defense-oriented arguments); *Cf.* Jacob H. Zamansky, *Assessing Analysts' Liability for Securities Fraud,* N.Y.L.J. (January 3, 2002), Outside Counsel Section, at 1.

[22] New York Stock Exchange, Inc., N.Y.S.E. Constitution and Rules (CCH, May 2002); National Association of Securities Dealers, NASD Manual Online, available at http://www.nasdr.org; Association for Investment Management Research, Standards of Practice Handbook (1999).

[23] SEC Rule 10b-5 makes it unlawful: "...(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, ..." 17 C.F.R. §240.10b-5(b) (West 2003).

[24] Section 15(D) was added to the Securities Exchange Act of 1934, ch. 505, Title I, by the Sarbanes-Oxley Act, Public Law 107-204, Title V, §501(a), 116 Stat. 791 (enacted July 20, 2002).

[25] NASD Conduct Rule 2711(h)(4) & (5) (2003); N.Y.S.E. Rule 472 (2003). *See also* Brandon Becker, *et al., Will Multiple Regulators Spawn an Inconsistent Framework for Research Analyst Regulation?,* 6 Wall St. Lawyer 24 (September 2002) (discussing compliance with Sarbanes Oxley and new SRO rules relative to analyst conflicts of interest).

[26] SEC Regulation AC, Analyst Certification, 17 C.F.R. §242.501 and 502 (February 27, 2003).