CAVEAT EMPTOR! AFTER ALL THE REGULATORY HOOPLA, SECURITIES ANALYSTS REMAIN CONFLICTED ON WALL STREET

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In the late 1990s, many investors entered the stock market seeking fortunes promised by an ever-rising market. Along with this democratization of the stock market, dedicated financial news television stations and publications sought a wider audience, often elevating securities analysts to celebrity status. Many new investors accepted such analysts' research as impartial, unaware of analysts' often divided interests.

The author examines the common conflicts of interest between securities analysts, investment bankers, and the companies analysts evaluate and considers their implications. The author then analyzes several possible solutions. While a complete separation of analyst research from investment banking is overly broad, the author argues the current industry rules, regulations, and standards cannot be strengthened without potentially reducing the amount of analysis available. At the same time, the author argues that analysts affiliated with investment banks will inevitably be subject to some pressure to serve underwriters and companies rather than investors. Consequently, the author recommends addressing the challenge of informing nonprofessional investors of sell-side analysts' divided interests by characterizing their reports as sales literature or marketing material.

I. INTRODUCTION

Wall Street has been aware of the symbiotic relationship between investment bankers and analysts for years.[1] Only since the Internet bubble of the late 1990s burst, however, has the investing public taken notice. The public backlash against analysts began in 2001 with complaints filed against two of Wall Street's most notable stock analysts alleging that they had fraudulently conspired, in violation of Rule 10b-5 under

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1. For examples of articles alerting followers of Wall Street events to analysts' conflicts of interest, see Michael Siconolfi, *Incredible 'Buys': Many Companies Press Analysts to Steer Clear of Negative Ratings*, WALL ST. J., July 19, 1995, at A1; Michael Siconolfi, *Under Pressure: At Morgan Stanley, Analysts Were Urged to Soften Harsh Views*, WALL ST. J., July 14, 1992, at A1.

section 10(b) of the Securities Exchange Act,[2] to inflate the prices of stock that the analysts covered.[3] One case was dismissed while the other was settled out of court.[4] More recently, an investigation conducted pursuant to New York law by its Attorney General, Elliot Spitzer, uncovered e-mails at Merrill Lynch showing that analysts' personal opinions were contrary to those published in their reports.[5] Merrill Lynch settled with the N.Y. Attorney General in May 2002 for $100 million and formed an agreement intended to separate analysts from the oversight of underwriters.[6] On the heels of the Merrill Lynch settlement, the N.Y. Attorney General extended his investigation to other major Wall Street firms, working with other state securities regulators, the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the North American Securities Administrators Association (NASAA), and the Securities and Exchange Commission (SEC).[7] In December 2002, the investigation culminated in a $1.4 billion settlement, the terms of which included an agreement for the Wall Street firms to fund independent research for their clients for five years and an agreement intended to separate analysts from underwriters.[8]

Separately, and in the wake of attention sparked by the Spitzer investigation, Congress mandated in the Sarbanes-Oxley Act that analyst conflicts of interest be minimized and disclosed.[9] With Congress having finally spoken and Wall Street firms having avoided direct prosecution, the regulatory authorities have likely left the public spotlight. Nonetheless, it remains unclear how the SEC and Self-Regulatory Organizations

2. Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000).

3. For judgments dismissing the same complaint against Mary Meeker and Morgan Stanley filed on behalf of various plaintiffs, see Pludo v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,541 (S.D.N.Y. Aug. 21, 2001); Thomson v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,539 (S.D.N.Y. Aug. 21, 2001); Senders v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,536 (S.D.N.Y. Aug. 21, 2001); Soto v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,540 (S.D.N.Y. Aug. 21, 2001); Stein v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,537 (S.D.N.Y. Aug. 21, 2001); Lloyd v. Morgan Stanley Dean Witter & Co., [2001–2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,538 (S.D.N.Y. Aug. 21, 2001). The complaint against Henry Blodget was settled by Merrill Lynch for $400,000 through arbitration. *Merrill Paying in Wake of Analyst Call on Tech Stock*, CFO.COM, July 20, 2001, *at* http://www.cfo.com/article?article=4247.

4. *See supra* note 3.

5. Kip Betz & Rachel McTague, *Broker Dealers: N.Y. Court Stays Order Requiring Merrill Lynch to Disclose Rating System*, 34 Sec. Reg. & L. Rep. (BNA) 610 (Apr. 15, 2002).

6. *In re* Spitzer v. Merrill Lynch Co., No. 02/401522 (N.Y. Sup. Ct. May 21, 2002) (Agreement Between Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner, & Smith, Inc., dated May 21, 2002), *available at* http://www.oag.state.ny.us/investors/investors.html (last visited Jan. 16, 2003).

7. Patrick McGeehan, *U.S. and State Regulators Join Inquiry on Analysts*, N.Y. TIMES, Apr. 24, 2002, at C10.

8. See Phyllis Diamond et al., *Broker Dealers: Wall St. Agrees to $1.4 Billion Payment, Broad Reforms, Resolving Conflict Changes*, 34 Sec. Reg. & L. Rep. (BNA) 2037 (Dec. 23, 2002).

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 791–93.

(SROs) under the SEC's oversight should act now that the dust is settling.

This note examines the conflicts of interest that are common among financial analysts and recommends regulations to minimize their effects on the market. Part II introduces the role of security analysts. It then looks at the three factors that most influence analysts' recommendations, using popular accounts of some of the analysts that sparked this debate. Part II finds that pressure from issuers and from the analysts' institutions creates a conflict of interest, the effects of which on trading markets can be aggravated by external factors such as new investors unfamiliar with market risks and media hype.[10]

Part III considers the three most commonly advocated means of addressing analyst conflicts of interest and considers their advantages and disadvantages. Part III first examines the current regulatory regime and asks whether conflicts of interest can be adequately resolved by better applying current rules, regulations, and industry guidelines. It finds that initiatives to strengthen industry standards will fail for lack of an enforcement mechanism while Rule 10b-5's applicability is too limited.[11] Part III then considers the new rules from the NASD and the NYSE adopted to address analysts' conflicts of interest. It concludes that they are a great improvement but are inadequate because the average investor lacks a frame of reference to evaluate the importance of a potential conflict of interest.[12] Part III finally evaluates the most sweeping reform option: complete separation of analyst and investment banking functions. Recognizing the support and expertise analysts legitimately provide to investment bankers, this note finds such a measure too sweeping.[13]

In light of these options, part IV argues that the new NASD and NYSE rules sufficiently regulate as mandated by the Sarbanes-Oxley Act, but also advocates requiring analysts who work for broker-dealers to characterize their research as sales literature. As a radical departure from the conventional disclosure regime used by the SEC, this note argues that analysts should be certified as "independent analysts" or be required to provide their market insight as "marketing material."[14]

Finally, part V concludes that the average investor will repeat his error and take analysts at their word without a more blunt and pervasive disclosure of analysts' underlying conflicts.[15]

10. *See infra* notes 93–110 and accompanying text.
11. *See infra* notes 131–74 and accompanying text.
12. *See infra* notes 212–14 and accompanying text.
13. *See infra* notes 227–29 and accompanying text.
14. *See infra* Part IV.C.
15. *See infra* Part V.

II. BACKGROUND: SECURITIES ANALYSTS HERETOFORE

A. Sell-Side Analysts and Their Culture

"Analysts" in the financial industry serve many roles and audiences, all sharing a "principal task of performing diligent and thorough investigations of specific securities, companies and industries."[16] Their functions vary according to whether they are on the "sell-side" or on the "buy-side." Sell-side analysts generally work for investment banks and distribute their research reports to the public.[17] Buy-side analysts generally work for large institutional investors such as mutual funds, hedge funds, and investment advisors.[18]

This note focuses on sell-side analysts' conflicting responsibilities and will refer to sell-side analysts simply as analysts. Whereas buy-side analysts tailor their research to their employer's needs, to whom there is a definite fiduciary duty, sell-side analysts distribute their research to the public, to whom the scope of their duty remains unclear. Part III of this note will further analyze the scope of analysts' duty to the public.[19]

In the most basic scheme, investment banks have two functions: underwriting securities and selling securities.[20] Both functions exert pressure on analysts.[21] Brokerage firms pressure analysts to develop reputations for providing insight into the stocks that they sell.[22] In this sense, the interests of the analyst and the investor are aligned. Reputation is predicated on the predictive value of an analyst's analysis.[23] Unfortunately, the insight that generally distinguishes analysts at brokerage firms often comes from the officers of the companies on which they report.[24] As a result, analysts fear retaliation from the companies on which they report if they issue a negative analysis.[25]

Because of analysts' traditionally cozy relationship with management, underwriters exert pressure on analysts to promote the underwrit-

16. Frank Fernandez, *The Role and Responsibilities of Securities Analysts*, RES. REP. (Sec. Indus. Ass'n, Washington D.C.), Aug. 22, 2001, at 3, *available at* http://www.sia.com.

17. *Id.* at 4.

18. *Id.*

19. *See* discussion *infra* Part III.A.2.

20. NASD REGULATION, GLOSSARY, *available at* http://www.nasdr/glossary/i.asp (last visited Sept. 26, 2002) (defining "investment banking" as "[t]he business carried on by a broker or dealer; . . . a business that underwrites or distributes securities issues; a business that buys or sells securities for itself or on the account of others").

21. *See* discussion *infra* Part II.B–C.

22. *See infra* Part II.B.

23. *See infra* Part II.B.

24. Andy Kessler, *We're All Analysts Now*, WALL ST. J., July 30, 2001, at A18.

25. Siconolfi, *Incredible 'Buys'*, *supra* note 1; *Preserving the Integrity of Research*, PROPOSED ISSUES PAPER (Ass'n for Inv. Mgmt. & Research, Charlottesville, Va.), July 10, 2002, at 3 *in* INVITATION TO COMMENT: PROPOSED ISSUES PAPER ON ANALYST INDEPENDENCE (Ass'n for Inv. Mgmt. & Research, Charlottesville, Va.), *available at* http://www.aimr.org/pdf/standards/ai_comment.pdf [hereinafter PROPOSED ISSUES] ("Research analysts may justifiably fear that companies will limit an analyst's ability to conduct thorough research by denying 'negative' analysts direct access to company management and/or barring them from conference calls and other communication venues.").

ing services of the analysts' firms.[26] The allure of positive coverage by a well-recognized analyst is often a major factor in a company's choice of underwriter.[27] As more companies have come to expect positive research reports, analysts have become more conflicted.[28]

Since the stock market has become more accessible to the average investor who picks stocks in his free time by means of retail brokerage firms, Internet trading sites, and dedicated financial news on the Internet and on television, analyst opinions have spread like gospel.[29] The impact analyst opinions have on conventional market wisdom has consequently changed and analysts' inherent conflicts of interest can no longer be dismissed with the adage *caveat emptor*.[30]

B. Fear of Retaliation: The Traditional Conflict

Analysts do not simply become analysts and then crunch numbers for the remainder of their career, only vaguely aware of their opinion's impact on stock prices and on the clients of the investment banks that employ them. Rather, an analyst's worth is determined by his influence—a product of his reputation among money managers.[31] An analyst's salary is based upon surveys of money managers who rank him against his peers.[32] As an analyst's reputation rises, corporate management becomes more willing to talk with him, further boosting his reputation.[33] Investment banks with strong analyst groups are more likely to get underwriting deals.[34] When analysts contribute to the relationship between underwriters and corporate clients, this contribution is also factored into their salaries.[35] The process is circular, but it always starts and

26. ROBERT G. ECCLES & DWIGHT B. CRANE, DOING DEALS: INVESTMENT BANKS AT WORK 173–75 (1988).

27. *See, e.g.*, Stephen Barr, *The Chinese Wall, and Other Urban Legends*, CFO.COM, Nov. 28, 2001, *at* http://www.cfo.com/printarticle/0,5317,5617M,00.html (recounting stories of analysts' relationships with CFOs, including "an analyst who griped that because his firm wasn't chosen for the company's latest underwriting assignment, his bosses thought he wasn't doing a good job").

28. *Id*.

29. *See* Howard Kurtz, *Who Blew the Dot-Com Bubble?; The Cautionary Tale of Henry Blodget*, WASH. POST, Mar. 12, 2001, at C1 ("The media invented Blodget [see *infra* Part II.B]. In a bull market everyone loves to cheer, and Henry Blodget was everyone's first phone call. . . . Where were they when companies were trading for 150 times revenues? They were repeating the words of these guys." (quoting Christopher Byron, a columnist for Bloomberg News and MSNBC)).

30. "Let the buyer beware." BLACK'S LAW DICTIONARY 215 (7th ed. 1999).

31. Kessler, *supra* note 24.

32. *Id.*

33. *Id.*

34. *Id.*

35. *See, e.g.*, Charles Gasparino, *Heard on the Street: Analysts' Contracts Link Pay to Deal Work*, WALL ST. J., May 6, 2002, at C1 (describing analysts' contracts specifically linking compensation to development of underwriting transactions); *Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enters., Comm. on Fin. Servs.*, 107th Cong. (2001) (Statement of Laura S. Unger, Acting Chair, U.S. Sec. and Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/07310/tslu.htm (last visited July 31, 2002) [hereinafter *Analyzing Analysts*] (reporting that "[m]any firms pay their analysts largely based upon the profitability of their investment banking unit, and in-

ends with the analyst's relationship with the company on which he reports.[36] As a result, there is great pressure on analysts to promote the companies their employers underwrite.[37] One analyst explains:

> In the annual polls, money managers voted for analysts who called them, so analysts were commanded to make 100 phone calls a month. As an analyst back then, I learned quickly that getting ranked in the polls was leverage: you helped your own firm's overall ranking. . . .
>
> In addition, the higher you ranked in the poll, the easier it was for your firm to win initial public offering pitches, what is known as the "bake off" or "beauty contest." And then, in a strange circle, the more quality companies your firm did banking business with, the higher you would get ranked in the poll.[38]

Put more harshly, analysts and issuers are dependent on one another. Analysts go to companies seeking special insight while companies rely on analysts to preach the virtues of their stock. Analysts often do not get access to the company without giving positive reviews of the company's stock.[39] Companies give access to those analysts who have a good reputation and can lend credibility to their stock.[40] Analysts get their reputation through access to companies and by being the first to tell the institutional money managers the insights they have garnered from meeting with a company's management.[41]

Regulation FD (FD),[42] which became effective October 2000,[43] has not changed this fundamental role of analysts. FD is intended to limit the ability of companies to play favorites with analysts by requiring the full disclosure of all material nonpublic information to the public at the same time or before the disclosure of the same information to analysts.[44] While surveys indicate a general perception that FD has limited information flow from issuers to analysts and the general public,[45] FD has not substantially changed the relationship between analysts and the companies they cover. FD was adopted with the SEC recognizing the "mosaic

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vestment bankers at some firms are involved in evaluating the firm's research analysts to determine their compensation. Seven [out of nine] firms reported that investment banking had input into research analysts' bonuses").

36. Kessler, *supra* note 24.

37. *See, e.g.*, Barr, *supra* note 27 (recounting stories of analysts' relationships with CFOs).

38. Kessler, *supra* note 24.

39. *See, e.g.*, Barr, *supra* note 27 ("'I know many CFOs . . . who say that if an analyst writes a negative report, they won't speak at [the brokerage firm's] next conference' for investors") (quoting a CFO (alteration in original)).

40. *Id.*

41. Kessler, *supra* note 24.

42. Regulation FD: Selective Disclosure, 17 C.F.R. § 243 (2002).

43. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts 240, 243, 244).

44. *Id.*

45. *See Special Study: Regulation Fair Disclosure Revisited* (Dec. 2001) (report by Laura S. Unger, Commissioner, U.S. Sec. & Exch. Comm'n), *available at* http://www.sec.gov/news/studies/regfdstudy.htm (last visited Sept. 26, 2002).

theory,"[46] which holds that a company has not disclosed material non-public information if it discloses *non*material information to an analyst who subsequently puts together a "mosaic" of nonmaterial information, which, as a whole, is material nonpublic information.[47] Further, the SEC holds that "since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst."[48] FD thus leaves the analyst's role intact. "Analysts can provide a valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusion."[49]

The story of Henry Blodget's rise as an analyst illustrates the traditional relationship between analyst and issuer. His prediction of Amazon.com's incredible growth in market value gave him his cachet.[50] As a result of his prediction that Amazon.com's stock price would exceed $400 per share and the market's quick realization of that prediction, Blodget became a legend.[51] The month after Amazon.com's stock ex-

46. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,722 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249) ("[A]n issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material.").

47. *Id.*

48. *Id.*

49. *Id.*

50. David Streitfeld, *Analyst with a Knack for Shaking Up Net Stocks; Henry Blodget Is Wall Street's Link Between Online Firms, Investors*, WASH. POST, Apr. 2, 2000, at H1 (describing Blodget's prediction of Amazon.com's stock growth and his access to Amazon.com).

51. The *Washington Post* describes the market prediction that made Blodget a legend:

> It still took his bold move with Amazon to make him a household name in the world of Internet stockholders. The retailer was at its most controversial then, full of swaggering ambition and bleeding red ink. It was also a hot stock, one that had doubled and redoubled. Two months earlier Blodget had put a 12-month price target of $150 on it. The stock quickly breezed by that to close on Dec 15. at $242.
>
> So he set an "outlandish" new target—$400. "I was trying to say, 'stop asking me the price target. There's plenty of upside.'" he says. "But it was like I threw gasoline on a bonfire."
>
> Blodget made his forecast public during Oppenheimer's "morning call," when the firm's analysts update its brokers on what they're recommending. Blodget was the last of the six analysts to speak, and Amazon wasn't even the first stock he mentioned.
>
> "Oppenheimer has a value bias," he says. "I would have to talk about [Internet stocks] after a 10-minute evaluation of Rubbermaid, and its change from LIFO to FIFO inventory accounting practices in China."
>
> A Bloomberg News reporter got a tip on Blodget's aggressive forecast, and wrote a story about it. A couple of minutes later, CNBC picked up the story, noting Amazon stock was already up $10 in early-hours trading. A few minutes after that it hit the chatboards, provoking hundreds of messages during the course of the day.
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> At 9:30 a.m., the market opened with Amazon at $259, up $17. It continued rising all day, the commentary making the stock climb, which in turn provoked more commentary. It was as if Blodget had been understood to say Amazon was going to go to $400 that day.
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> The stock closed at $289, up nearly 20 percent, on quadruple its normal volume.
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> . . . .
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> On Jan. 6, 1999, Amazon closed at $138. Since it had split three-for-one in the meantime, that works out to be $414. The stock had done in three weeks what Blodget said would take a year. The next month, Blodget replaced Cohen at Merrill Lynch, for a salary that he declines to discuss but is reported to be $4 million.

ceeded a split-adjusted $400 per share, Blodget left CIBC Oppenhiemer for a reported $4 million salary at Merrill Lynch.[52] Merrill Lynch paid for Blodget's reputation.

Blodget's growth in influence came quickly. His move to Merrill Lynch not only helped him financially; it also boosted his reputation. With reputation, a pulpit at Merrill Lynch, and an audience ready to hear the virtues of the Internet, Blodget was a self-perpetuating success story.[53]

Of course, Blodget has not been targeted simply because of his professional success. Rather, his access to Amazon.com's management had become a *quid pro quo* arrangement.[54] An April 2, 2000 *Washington Post* article profiling Blodget relates:

> The Amazon[.com] folks know exactly what Blodget is thinking because he's e-mailed them his financial model—an extensive breakdown of Amazon[.com]'s past results and future expectations. "Feedback is valuable," the analyst says. "It's become so important for a company to beat expectations that they want to make sure they don't get out of hand."
>
> Investors also like a company to beat forecasts. As a result, there's a tendency in models to keep expectations modest—to say that Company X will increase profits by 10 percent. Then the earnings come in, as usual, 20 percent higher. The stock jumps, and everyone but the short sellers are happy.
>
> So on stocks such as Amazon[.com], Blodget keeps a private model, too. This one doesn't incorporate feedback from the company. It's more speculative. It's also probably closer to the truth—even if it serves no one's interests to make it public.[55]

Blodget's access may have been extraordinary.[56] Considering that details of Blodget's reporting on Amazon.com came from Blodget himself, however, it is likely that he thought the relationship was standard industry practice, or at least the ideal.[57] Regardless of Blodget's intent, he compromised his analysis to protect the market value of Amazon.com. Because Blodget adjusted his numbers to their liking, Amazon.com ex-

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> The events still bemuse him. He quotes Jay McInerney, who explained how he abruptly became famous for his novel, "Bright Lights, Big City" in 1984: "I plucked the cords of the Zeitgeist."

Id.

52. *Id.*

53. Kessler, *supra* note 24.

54. Streitfeld, *supra* note 50.

55. *Id*.

56. Blodget's access was not atypical, however. *See infra* Part II.C (describing Mary Meeker's connections with Amazon.com and Jack Grubman's connections with the telecom industry); *see also* Peter Elstrom, *The Power Broker*, BUS. WK., May 15, 2000, at 70 (describing telecom analyst Jack Grubman's influence with respect to corporate planning).

57. One former analyst comments, "[A]re Henry Blodget at Merrill Lynch, Mary Meeker at Morgan Stanley and Jack Grubman at Soloman sinister figures, perpetrating ruin on unsuspecting retirement accounts? . . . Hardly. They are smart, savvy people at the top of a game that is changing . . . ." Kessler, *supra* note 24.

ecutives met Blodget's earnings expectations, thus avoiding any detrimental market reaction for failure to meet an analyst's expectation.

C. Blurring the Lines Between Analyst and Underwriter

The consequences of losing the inside track with issuers have become more costly as analysts increasingly have been relied upon to promote the underwriting, as opposed to the brokerage, abilities of their firms.[58] This distinction is critical because, whereas brokerage services are sold to investors, underwriting services are sold to the same issuers who are the subject of analysts' reports.

Traditionally, analysts served the needs of brokers at investment banks, providing analysis regarding the prospects of a security or industry.[59] The promise of better research analysis distinguished brokerage firms, luring customers.[60] The analysis also helped brokers make recommendations to customers, thus encouraging trades.[61] The accuracy and integrity of analysts' reports were an important factor in attracting and retaining brokerage customers. In 1975, however, brokerage commissions were deregulated and their role changed as investment banks were forced to compete with new discount brokerages.[62] Commissions from trades have diminished substantially since the 1970s and brokerage firms consequently have less money to support the services of analysts.[63] As compensation became less tied to brokerage services, analysts' compensation became more tied to investment banking.[64] Year-end performance-based bonuses were offered to analysts for their investment banking business development skills rather than their analysis.[65] A clear conflict of interest has grown out of this relationship.

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58. The root of these conflicts goes back to the mid-1970s, when the securities business was threatened with price-fixing charges. That brought about the end of fixed-rate minimum commissions, and as a result, trading fees plummeted and analyst research reports no longer paid for themselves. The big money would be made generating banking and advisory fees, and analysts increasingly became part of that effort—coming "over the wall" to attract new corporate finance clients, to promote initial public offerings on road shows, and to use their research reports to hype companies' prospects.

Barr, *supra* note 27.

59. ECCLES & CRANE, *supra* note 26, at 173 (commenting that analyst research was regarded as "a cost that contributed to the ability of sales and trading to generate revenues from investing customers").

60. *See id*. at 174.

61. *Id.*

62. *See* Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. §§ 78k-1, 78o-4, 78q-1, 78kk (2002)); Kessler, *supra* note 24.

63. ECCLES & CRANE, *supra* note 26, at 173–76.

64. *See infra* Part II.C.

65. In acting as a distribution channel for information on issuers to investors, analysts build relationships with issuing customers and often develop access to high-level executives. Information resulting from these relationships, plus their general knowledge of the industry, can lead to suggested deals for the analyst's investment bank. A number of firms encouraged this by paying transaction-based bonuses to analysts for bringing in deals.

In 1988, Eccles and Crane noted in their book *Doing Deals*[66] that "the practice of paying analysts deal-based bonuses was more prevalent in the medium-sized firms, which did not have the same strong client relationships, than it was in the larger firms."[67] The practice of paying deal-based bonuses is no longer limited to medium-sized firms; it has become commonplace at all firms.[68] Although the details of particular employment contracts vary, analysts' bonuses, which can be many times greater than their base salary, are often contingent on their involvement in developing underwriting business.[69] For instance, an affidavit filed by N.Y. Attorney General Spitzer alleges that, based on evidence obtained from subpoenas, in the Fall of 2000, Merrill Lynch's cohead of global equity research "surveyed all equity analysts, asking them for details on where their research coverage played a role in securing an investment banking assignment."[70] Blodget and the rest of Merrill Lynch's Internet group responded that they were involved in over fifty-two completed or potential investment banking transactions that had resulted in $115 million in fees for the firm.[71] Blodget's compensation consequently increased from $3 million in 1999 to $12 million in 2001.[72] Underwriters now actively encourage analysts to develop underwriting relationships.[73]

Many articles have vaguely asserted that analysts are pressured by investment bankers to develop deals.[74] Generally, they have asserted that analysts receive bonuses based on their deal-making ability.[75] The case of Mary Meeker, who, like Henry Blodget, was regarded as one of

ECCLES & CRANE, *supra* note 26, at 174. Today, relationships between underwriters and analysts are commonplace. Jack Grubman, a telecom analyst at Solomon Smith Barney, comments, "What used to be a conflict is now a synergy." Elstrom, *supra* note 56.

66. ECCLES & CRANE, *supra* note 26.

67. *Id.* at 175.

68. An SEC on-site examination of nine broker-dealers that underwrote significant numbers of initial public offerings found:

> [A]ll firms reported that research analysts provided assistance to investment banking, such as consulting on possible mergers, acquisitions and corporate finance deals, participating in road shows and initiating research coverage on prospective investment banking clients. Many firms pay their analysts largely based upon the profitability of their investment banking unit, and investment bankers at some firms are involved in evaluating the firm's research analysts to determine their compensation. Seven firms reported that investment banking had input into research bonuses.

Analyzing Analysts, *supra* note 35 (testimony of Laura S. Unger).

69. *See, e.g.,* Gasparino, *supra* note 35.

70. Betz & McTague, *supra* note 5.

71. *Id.*

72. *Id.*

73. Barr, *supra* note 27.

74. "One analyst called investor relations very, very annoyed, feeling very much at risk within his firm," [one] CFO notes. "In another case, the CEO [of a securities firm] called and said, 'It looks like our analyst was not on top of things. I thought he was doing a better job.' It's tough if analysts have to prove their worth by generating investment-banking business. [The CEO] was almost holding the analyst responsible for his firm not getting the business."

Id. (alteration in the original).

75. Peter Elkind, *Where Mary Meeker Went Wrong: She May Be the Greatest Dealmaker Around. The Problem Is, She's Supposed to Be an Analyst*, FORTUNE, May 14, 2001, at 72 ("These days most analysts' pay is directly linked to the number of banking deals they're involved in.").

the best Internet analysts in the late 1990s,[76] is indicative of the extent to which analyst functions have blurred. She too was a star analyst, and her salary was clearly based on her deal-making ability.[77]

Frank Quattrone, the leader of Morgan Stanley's technology-banking team, which combined research analysts and underwriters in the technology sector, hired Mary Meeker as an analyst in 1991.[78] Meeker replaced Quattrone in 1996 after he left Morgan Stanley.[79] Morgan Stanley's hiring and promotion of Meeker reflects two important aspects about its institutional framework.

First, an analyst—Meeker—was hired by an investment banker—Quattrone.[80] A clear implication is that an investment banker could also have fired an analyst. Whereas analysts presumably could assert that their first duty is to offer objective research and that any deal development is only incidental to their reputation, Morgan Stanley's union of analysts and underwriters under a single group created an inescapable conflict of interest. Meeker's underwriting development was as important as her analysis. Her functions were joined.

Second, Meeker's promotion to head of Morgan Stanley's technology group crystallized the conflict of interest to which she was already subject. Whereas she might have been able to rationalize her conflicting duties as an analyst in the technology group, perhaps arguing that she always gave objective advice, as head of Morgan Stanley's technology group, she had a clear duty to Morgan Stanley to develop deals and to Morgan Stanley's underwriting clients.

Another prominent example of an analyst acting as an investment banker is Soloman Smith Barney's telecommunications analyst Jack Grubman. Grubman was not only a renowned analyst who could sway the price of a telecom stock, he was also a telecom dealmaker. *Business Week*, for instance, credited Grubman with advising executives at SBC Communications, Inc. to acquire Ameritech and other regional telecoms.[81] SBC tendered $72 billion for Ameritech three months later.[82] Grubman describes his role as "sculpting the [telecom] industry."[83] Implicit in his self-described role, however, is his own involvement in the companies on which he reports, in the companies from which he is sup-

76. *See* John Cassidy, *The Woman in the Bubble: How Mary Meeker Helps Internet Entrepreneurs Become Very, Very Rich*, NEW YORKER, Apr. 26, 1999, at 48.

77. Elkind, *supra* note 75, at 82 (reporting that Meeker's salary increased from $6 million to $15 million as a result of Morgan Stanley's increased underwriting business).

78. *Id*. at 71.

79. *Id*. at 74–76.

80. *Id*. at 71.

81. Elstrom, *supra* note 56, at 70.

82. *Id.*

83. *Id.* at 72.

posed to be independent.[84] Grubman dismissed such criticism in the *Business Week* article: "What used to be a conflict is now a synergy."[85]

Semantics, however, cannot eliminate the conflict. The union of the analysis and underwriting functions at Morgan Stanley and Soloman Smith Barney indicates the extent of the erosion of the Chinese walls to which securities firms are supposed to conform. Functional separation of departments is a basic Chinese wall.[86] The Practicing Law Institute (PLI) recommends segregation of supervisory authority and support groups to implement the Chinese wall.[87] Contrary to the PLI recommendation, both Meeker and Grubman supervised both underwriters (by aiding in deal development) and analysts (by issuing reports as a celebrity analyst).

The consequences of Meeker's and Grubman's dual roles significantly undermine the integrity of analyst research. Brokerages have always faced a conflict between serving their clients' best interests and generating revenue by encouraging trades.[88] Analyst reports consequently have been suspect since the advent of brokerages themselves.[89] When analysts only answered to brokerages, however, their compensation was secure whether they recommended clients to buy or sell a stock.[90] Either way, the brokerage made a commission. By contrast, underwriters do not get business if they have a reputation for putting downward pressure on their clients' stocks.[91] Consequently, analysts who are accountable to underwriters are significantly more compromised. Analysts issue negative reports at their peril and are richly compensated if they demonstrate an ability to drive up stock prices.[92]

D. Analysts' Audience and Market Psychology

Analysts, of course, were not solely responsible for the Internet bubble. For every analyst that succumbed to pressure to promote, rather

84. *Id.* at 72, 74.
85. *Id.* at 74.
86. Julia B. Strickland & David Neier, *Regulation of Security Analysts*, *in* ?, at 167, 173 (PLI Corp. L.aw & Practice Course, Handbook Series No. 962, 1996).
87. *Id.*
88. *See* Martin Mayer, *Broker-Dealer Firms*, *in* TWENTIETH CENTURY FUND, ABUSE ON WALL STREET: CONFLICT OF INTEREST IN THE SECURITIES MARKETS 434 (1980) ("The over-the-counter house which conducts a brokerage business and which also takes underwriting positions, or participates in distributory syndicates or sells securities at retail is under temptation to induce its customers to purchase securities which it is anxious to sell." (quoting SECUTITIES EXCHANGE COMMISSION REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER)).
89. *Id.*
90. Barr, *supra* note 27.
91. *Id.*
92. Elkind, *supra* note 75, at 80–82 (reporting that Mary Meeker's salary jumped from $6 million in 1998 to $15 million in 1999 because Morgan Stanley did more Internet underwritings than it had done the previous four years combined); Elstrom, *supra* note 56, at 76 (reporting that Jack Grubman, Internet analyst at Soloman Smith Barney, was paid $20 million in 1999).

than analyze, equity investments, there was an issuer that expected it.[93] And while analysts reacted to the demands of companies, company executives reacted to investors who were new to the stock market. These new investors entered the stock market in record numbers during the late 1990s expecting easy returns from one of the longest bull markets in history.[94] Arthur Levitt, former commissioner of the SEC, summarized the unfounded expectations of analysts, company executives, and investors as a "culture of gamesmanship."[95] Traditional measures of stock value were often abandoned, especially with respect to Internet stocks.[96] Market psychology swept analysts away.[97] An analyst who questioned the wisdom of the market—at least in so far as the market valued a stock that the analyst followed—was on shaky ground.[98] All of Wall Street

> 93. Executives of public companies, as a group, clearly expect and reward biased treatment from sell-side analysts. . . . Execs [sic] appear to believe that analysts control investor behavior regardless of fundamentals. Execs [sic] appear to be unaware that asking analysts to be biased violates the execs' [sic] fiduciary duty to shareholders.

Letter from Randle G. Reece, CFA, to Association for Investment Management and Research 3 (Aug. 2, 2001), *available at* http://www.aimr.org/pdf/standards/comments/RandleGReece.pdf [hereinafter Reece Letter].

94. Theresa A. Gabaldon, *The Role of Law in Managing Market Moods: The Whole Story of Jason, Who Bought High*, 69 GEO. WASH. L. REV. 111, 111–12 (2000) (book review); Kurtz, *supra* note 29 ("Critics and naysayers had their say, but the overall message was clear: This rocket was leaving the platform.").

95. *Opening Statement: Hearing on the Collapse of Enron Before the Senate Comm. on Governmental Affairs*, 107th Cong. (2002) (statement of Arthur Levitt, Former Chairman, Securities and Exchange Commission), *available at* 2002 WL 89761 (F.D.C.H.) (defining his "culture of gamesmanship" as "an obsessive zeal by too many American companies to project greater earnings from year to year").

96. Don Sussis, *Conflict of Interest*, INTERNET.COM, *at* http://ecommerce.internet.com/news/insights/econsultant/article/0,3371,10418_799491,00.html (last visited July 11, 2001) (noting that the price earnings ratio of the Standard & Poors 500 was above thirty in 1998, 1999, and 2000 while its historical average was fourteen and describing analysts' means of justifying stock valuations).

97. *See, e.g.*, Elkind, *supra* note 75, at 82.

> Mary Meeker got so caught up in the allure of the Internet—the celebrity, the money, the thrill of dealmaking—that she forgot that she was supposed to be analyzing the companies. "She was flying at 50,000 feet, talking about trends," says a rival banker. "She had no idea what the fundamentals were." Thus, when a company like Priceline turned out to have serious problems, including its disastrous foray into gasoline and groceries, Meeker didn't have a clue. Instead, here's what she says about Priceline, a company (it almost goes without saying) that Morgan took public in 1999: "It wasn't troubled until it was troubled. It was fine on Wednesday, bad on Thursday. . . . You can say, 'Why didn't the idiot analyst figure it out?' [But] you have to have some degree of trust in the concepts and the management team. With Priceline, that was a mistake." Even so, she maintains her outperform rating on the stock.
>
> Then again, why wouldn't she? "It's one thing if you've got a disciplined valuation criteria," says a banker who worked with Meeker. "But if you don't and you're outperform for no good reason, what's the reason for turning it to an underperform?"

Id.

> 98. On Wall Street, you only have your reputation. Once you have it, you'll do anything not to lose it. Especially if you are what is known as the "axe" in a stock, when a change in your body language can send the stock down five points. *Pavlonianly, you can't stop recommending it, . . . figuring all the heat you'd get if it goes to $200*.

Kessler, *supra* note 24 (emphasis added); *see also* Elkind, *supra* note 75, at 82.

> Forced to support companies that weren't all that good, at valuations that were increasingly difficult to justify, she was boxed in. In May 1999, Morgan Stanley took a company called Scient public at $20. By the time the quiet period had ended—and Morgan, with Meeker as co-analyst, could initiate coverage—the stock had jumped to almost $40 a share. Because of the run-up, the Morgan analysts gave the stock a rare "neutral" rating, citing valuation concerns. Three months

prospered in a bull market, and no mechanism existed to distinguish analysts from the herd.[99]

Some analysts tried to caution the market about the tenuous nature of Internet stocks in general while remaining optimistic about their covered securities.[100] As short-term recommendations, their recommendations were reasonable for speculative investors.[101] Analysts abandoned traditional valuation criteria, however, and touted stocks based on creative valuation techniques to support otherwise untenable market valuations.[102] So long as the bull market lasted, there was continued upside potential in stocks that were already valued beyond their fundamentals. Once the bull market ended, however, Internet stocks—including those picked by star analysts—dropped precipitously.[103]

Analysts did not openly distinguish their audiences.[104] Sophisticated institutional investors knew the perils of Internet stocks and saw it as a short-term, speculative game.[105] To many in the investing public, however, the analyst's word was gospel—and it was spread far and wide by the financial press.[106] To use Mary Meeker again as an example, *Fortune* wrote:

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later they upgraded to "outperform"—even though the stock had climbed to $63. "The market was saying, 'You're an idiot, you're an idiot, you're an idiot,'" Meeker says now. "This is the reality of the world we live in."

99. *See supra* notes 89–91.

100. *See* Elkind, *supra* note 75, at 80–82.

101. *See* Lauren R. Rublin, *Good Times Roll On: And, Chances Are, the Stock Market Will Enjoy Another Rewarding Year, Despite What the Skeptics Say*, BARRON'S, Jan. 3, 2000, at 29 (noting that, from 1995 to 2000, the Dow Jones Industrial Average had gained 197%, the Standard & Poor's 500 had gained 219%, and the NASDAQ 100 had gained 907%).

102. *See, e.g.*, Elkind, *supra* note 75, at 78 (describing Mary Meeker's use of "nonfinancial metrics such as 'eyeballs' and 'page views'" to justify valuation); Gretchen Morgenson, *How Did So Many Get It So Wrong?*, N.Y. TIMES, Dec. 31, 2000, at C1 (quoting a mutual fund manager: "Instead of providing investors with the kind of analysis that would have kept them from marching over the cliff, analysts prodded them forward by inventing new criteria for stocks that had no basis in reality and no standards of good practice").

103. On March 10, 2000, the NASDAQ Composite Index peaked at 5048, and on April 14, 2000, the NASDAQ Composite Index closed at 3321, 34% below its March 10 peak. Andrew Bary, *Ugly Friday Caps Nasdaq's Ugliest Week Ever*, BARRON'S, Apr. 17, 2000, at 5. On March 20, 2002, the NASDAQ Composite Index closed at 1832. Yahoo! Finance, Nasdaq Composite Historical Prices, *at* http://quote.yahoo.com.

104. *Fortune* magazine describes, for instance, Mary Meeker's evaluation of Amazon.com in her research report, which was available to Morgan Stanley's customers, both individual and institutional: "Meeker wrote that the company's valuation 'gives us heartburn of a gargantuan proportion.' But she quickly dismissed the concern: *'We have one general response to the word "valuation" these days: "Bull market" . . . . We believe we have entered a new valuation zone.'*" Elkind, *supra* note 75, at 78.

105. *Written Testimony Concerning Financial Market Analysis Accuracy Before the Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enters., Comm. on Fin. Servs.*, 107th Cong. (2001) (Written Testimony of David W. Tice, David W. Tice & Associates, Inc.) [hereinafter Tice] (quoting the Chairman of the Association for Investment Management and Research: "Most institutional investors realize that Wall Street's recommendations are based on investment banking ties and other considerations. They just wink at the conclusions on these reports and read whatever useful information might be in the report.").

106. Prior to the mid-1990s, individual investors had little exposure to Wall Street analyst research, including buy recommendations. Now that information is only three mouse clicks away. The majority of those who use this information are at best unsophisticated, actually believing that

> As for disgruntled individual investors who feel misled by her recommendations, she offers little sympathy. As she told the Wall Street Journal, "Every individual has got to be accountable for how they're allocating their investments." Her "real" constituency, she added, is professional money managers and other institutional investors.
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> . . . .
>
> She's right, of course, that individuals who have lost money in this market need to look at themselves in the mirror before they begin blaming Wall Street analysts. But the plain implication of her statement is that institutions are sophisticated enough to see through her ratings. And, indeed, some of them are. Former hedge-fund manager Jim Cramer says that it's clear since last summer that "no one [on Morgan's sales staff] was pushing her stuff, because she wasn't enthusiastic. She has a buy because she's gotta have a buy. I thought she distinguished herself by not pushing the stuff. You might call that duplicitous. I was happy because it made me money. [107]

The Internet boom of the late 1990s obviously generated wealth for many.[108] Unfortunately, when investors finally awoke to the fact that the end was near, those who were slow out the door lost.[109] "It's like some of those parties you went to in college—man, until the police showed up, it was wonderful," CSFB tech analyst Mark Wolfenberger told *Fortune* magazine.[110]

The college party analogy above is flawed. Most college kids know when a party is getting out of control and that police might come. Securities laws, by contrast, were enacted to protect those who *do not know when the police might come*.[111] The Securities Act of 1933 ('33 Act) was enacted to address a market where "[a]lluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High pressure salesmanship rather than careful counsel was the rule in this most dangerous enterprise."[112]

> a "buy" means the stock offers compelling value at current prices. In truth, these investors have no way of knowing that in many cases the recommendation is based on little more than expectations of future investment banking business. Twenty-four hours a day, seven days a week, individual investors are bombarded with what we view as little more than bullish propaganda.

Id.

107. *See* Elkind, *supra* note 75, at 82.
108. *See* Rublin, *supra* note 101, at 29.
109. *See supra* note 103.
110. Elkind, *supra* note 75, at 78.
111. H.R. REP. NO. 73-85, at 2 (1933).
112. *Id.*

III. Possible Remedies

In broad terms, the debate over maintaining analyst independence has focused on three possible solutions.[113] The first option is to tweak the system and apply the current regulatory regime more thoroughly. As the argument goes, investors are already sufficiently weary of analyst coverage and they do not need any more regulation.[114] Analysts' recommendations are taken with a grain of salt.[115] Actions rising to the level of fraud can be remedied through the antifraud provisions of the Securities Exchange Act of 1934 ('34 Act).[116] The second option is to restore analyst independence through legal separation of functions while stopping short of separating analysts from investment banks.[117] The SEC recently followed this course of action by approving new NASD and NYSE rules which require greater disclosure of analysts' conflicts of interest and act to separate underwriting and analyst activity.[118] Whether this course of action will ensure analyst independence, however, is uncertain.[119] The third and most draconian measure proposed is a complete separation of financial analyst departments from banks.[120] This view considers the conflicts of interest so extensive that there is little or no hope of analyst impartiality when their function is tied to investment banking.[121] The remainder of this section will discuss each of these proposals.

113. *See, e.g.*, Tice, *supra* note 105 (proposing a range of solutions from most draconian—separation of research from investment banking and trading, to least aggressive—investor education).

114. *See* Letter from David DePietto, Menness, Crespi, Hardt & Co., Inc., to Association for Investment Management and Research 3 (Oct. 22, 2001), *at* http://www.aimr.org/pdf/standards/comments/DavidDePietto.pdf [hereinafter DePietto Letter] (responding to PROPOSED ISSUES, *supra* note 25) ("The current disclosure requirements seem adequate, and need only be applied universally and enforced regularly to deal with the issues mentioned in [the PROPOSED ISSUES].").

115. *Id*.

116. David M. Becker, Speech by SEC Staff: Analyzing Analysts, Remarks Before the Committee on Federal Regulation of Securities of the American Bar Association (Aug. 7, 2001), *at* http://www.sec.gov/news/speech/spch510.htm [hereinafter Becker Speech] ("To some extent, existing law may cover [analyst conflicts of interest]. Some conduct may involve out-and-out fraud. Where there is fraud, the Commission will enforce the law.").

117. *See generally* Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, 67 Fed. Reg. 11,526 (notice of filing Mar. 8, 2002), *at* http://www.sec.gov/rules/sro/34-45526.htm [hereinafter Rule Changes].

118. NASD and NYSE Rule Making, Exchange Act Release No. 34-45908, 67 Fed. Reg. 34,968 (May 16, 2002) (notice approving NASD Rules 2711 and 2110 and NYSE Rule 472).

119. *See infra* Part III.B–C.

120. *See, e.g.*, Tice, *supra* note 105.

121. *See* Letter from Roland Caldwell, Chairman of Caldwell Trust Company, to Association for Investment Management and Research 1 (Aug. 10, 2001), *at* http://www.aimr.org/pdf/standards/comments/RolandCaldwell.pdf [hereinafter Caldwell Letter] (responding to PROPOSED ISSUES, *supra* note 25) ("My conclusion is that until such time as [a] separation is mandated by the industry, backed by the regulators, clear and unambiguous objectivity can never be achieved.").

A. *Option 1: Voluntary Commitments Through Industry Organizations and Heightened Section 10(b) Enforcement*

1. *Reliance on Voluntary Commitments to Industry Standards.*

Despite the accounts of Mary Meeker, Henry Blodget, and Jack Grubman above, many argue that the system is not broken and does not need to be fixed.[122] Investors have long been aware of the bias of sell-side analysts.[123] For years, there have been articles on the dearth of "sell" recommendations and a debate as to the meaning of "hold" recommendations.[124] Articles about analysts' relationships with underwriters are also common.[125] The efficient capital markets hypothesis fills in any information gaps.[126] If the common investor has not read such articles, the average person on Wall Street has. Regardless of whether the average investor actually knows about analyst conflicts of interest, such knowledge is common among the institutional investors on Wall Street that buy and sell a stock most frequently and establish the stock's price. As a result, generally a stock price reflects the true value of the stock in spite of any puffing by interested analysts.[127] In essence, proponents of the efficient capital markets hypothesis believe that the best manager of the market is the market itself. Any changes to the system should thus be intended to restore the reputation of analysts.

Not surprisingly, securities industry groups like the Securities Industry Association (SIA), a voluntary group of over 600 investment banking firms, broker-dealers, and mutual funds,[128] and the Association for Investment Management and Research (AIMR), which administers the Chartered Financial Analyst (CFA) examination,[129] have tried to preempt any calls for new regulation by trying to establish new industry standards.[130]

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122. *See, e.g.*, DePietto Letter, *supra* note 114; Letter from Anonymous to Association for Investment Management and Research 1 (July 26, 2001), *at* http://www.aimr.org/standards/issues/ai_comments.html (responding to PROPOSED ISSUES, *supra* note 25) ("I think there is far more risk in trying to regulate street analysts, and to force them into the research process, than simply to let their activities remain largely unregulated.").

123. Those that argue this generally do not consider the average individual investor. *See supra* note 1.

124. *See id*.

125. *Id*.

126. *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 851 (1992) ("[The Efficient Capital Market Hypothesis's] central insight is that a variety of forces impound available information into stock prices fast enough that arbitrage opportunities cannot be exploited systematically.").

127. *Id*. at 851–53.

128. SEC. INDUS. ASS'N, ABOUT SIA, *at* http://www.sia.com/about_sia/index.html (last visited Nov. 15, 2002).

129. ASS'N FOR INV. MGMT & RESEARCH, ABOUT AIMR, *at* http://www.aimr.org/support/about (last visited Nov. 15, 2002).

130. *See* Richard Hill, *Broker-Dealers: SIA Releases Best Practices Guidelines on Analyst Independence as Hearing Nears*, 33 Sec. Reg. & L. Rep. (BNA) 900 (June 18, 2001) [hereinafter *SIA Releases*] ("Mark Sutton, SIA chairman, said . . . that market pressure would be the chief tool to encour-

The SIA has issued *Best Practices for Research*, a handbook intended to set the professional ideals of analysts.[131] While *Best Practices* addresses many of the issues enumerated above, its solutions are "aspirations."[132] Ultimately, *Best Practices*, while a welcome addition to the current forum regarding analyst independence, has no teeth.[133] It encourages analysts and their employers to adopt its practices but it does not require them.[134]

Unless analysts and firms collectively adopt the SIA's professional standards, any firm or analyst that acts alone would be severely disadvantaged. Relying solely on the SIA's professional standards would result in a situation similar to the classic "prisoner's dilemma." As the dilemma goes, two criminal suspects are held in separate rooms where they cannot talk to one another.[135] The district attorney tells each suspect, "We know that you robbed the bank. If you testify against your friend, we will let you go free and your friend will get fifteen years; if you don't we have enough to get you on a weapons charge and you will get one year in jail." The prisoner asks, "What's the catch?" The district attorney replies, "the catch is that we are offering the same deal to your friend and if both of you turn in the other, both of you will get ten years for armed robbery."[136] In quantitative terms, as with the prisoner's dilemma, if each bank defects, each bank suffers the equivalent of ten "years"; if one bank defects and the others cooperate, the defecting bank only suffers one "year" while each other bank suffers fifteen "years." While abiding by voluntary industry standards would reestablish the integrity of analysts generally, each bank has an incentive to defect from the voluntary regime and gain a competitive advantage. Accordingly, each will defect to avoid being at a competitive disadvantage and market integrity will not be reestablished.

Another organization that has entered the forum regarding analyst independence is the AIMR. Since the early 1960s, the AIMR has had a *Code of Ethics* for its professionals.[137] With the advent of its *Standards of Professional Conduct*, the AIMR began enforcing its professional stan-

age firms to adopt the practices."). For the industry group reactions, see SEC. INDUS. ASS'N, BEST PRACTICES FOR RESEARCH (2001) [hereinafter BEST PRACTICES], *at* http://www.sia.com/publications/html/bp_research.html (on file with the University of Illinois Law Review); PROPOSED ISSUES, *supra* note 25, at 1.

131. BEST PRACTICES, *supra* note 130.

132. *Id*. (Prefatory letter by Mark Sutton, SIA Chairman, and Mark E. Lackritz, SIA President) ("These recommendations embody our industry's *aspirations* to strengthen ethical and professional standards for securities analysts, underscore broker-dealers' commitment to the best interests of our clients, and buttress the overall integrity of the securities markets." (emphasis added)).

133. *See SIA Releases*, *supra* note 130 (reporting that Rep. Richard Baker faulted *Best Practices* for lacking sanctions for noncompliance).

134. *Id*.

135. *See* Richard W. Painter, *Game Theoretic and Contractarian Paradigms in the Uneasy Relationship Between Regulators and Regulatory Lawyers*, 65 FORDHAM L. REV. 149, 153 n.24 (1996).

136. *Id.*

137. ASS'N FOR INV. MGMT. & RESEARCH, STANDARDS OF PRACTICE HANDBOOK (6th ed. 1992).

dards,[138] with removal of the CFA charter as its strongest sanction.[139] Its *Standards of Professional Conduct* are less specific than the SIA's *Best Practices for Research* as to when a security analyst's impartiality is compromised, but they are accompanied by explanatory material, the content of which is part of the CFA examination.[140] The AIMR has sought to establish clearer standards for analyst independence in its *Standards of Professional Conduct*.[141]

While the AIMR's input in the current debate is valuable, its impact is destined to be even more limited than the SIA's *Best Practices*. In addition to sharing the same collective action problem as the SIA's *Best Practices*, the AIMR's standards are addressed to its limited constituency—namely, those who have joined the AIMR and analysts who have taken the CFA exam and become Chartered Financial Analysts.[142] Whereas Certified Public Accountants are state-certified and cannot perform public accounting without the certification, CFAs are chartered by an industry organization and the CFA's value is as a professional credential; it is not as a prerequisite to being an analyst. As a result, the threat of removing the CFA will have little impact on individual analysts. Because the CFA is optional, the AIMR's *Standards of Professional Conduct*, regardless of their ultimate form, will be of limited impact on analyst independence.

2. Strengthening of Current SEC Rules

A final argument in favor of maintaining the status quo is that severe analyst fraud can be addressed through SEC action and private class actions under Rule 10b-5 of the '34 Act.[143] Where the market fails not simply because investors have failed to discount the analysis of interested analysts but also because of a severe fraud on the market committed by

138. *Id.*

139. *Id.*

140. *See id*. at 7–8 (broadly addressing "Priority of Transactions," Standard IV, "Disclosure of Conflicts," Standard V, and "Compensation," Standard VI.).

141. In response to the controversy surrounding analyst integrity, the AIMR has begun a "three-part initiative . . . to support independence and objectivity in research reports and investment recommendations." Part one of its initiative was its *Invitation to Comment*, to which all concerned could comment on the AIMR's characterization of the common conflicts of interest. In part two, the AIMR intends to develop "Research Objectivity Standards" with a view toward "provid[ing] specific, measurable ways that firms can better manage internal conflicts, [explaining] how other contributors to the problem can reduce the pressures they place on analysts, and [effectuating] appropriate and adequate disclosure to the investing public." In part three of its initiative, the AIMR intends to incorporate its refined standards into its *Standards of Professional Conduct*. The AIMR closed part three of its initiative October 10, 2001. PROPOSED ISSUES, *supra* note 25, at 1.

142. According to AIMR, there are 36,328 members in the United States, out of a total membership of over 50,000. Eighteen percent of its members are equity analysts. Assuming the percentage of analysts is proportionally the same as the percentage of AIMR's total membership, approximately 8,000 analysts in the United States are members. The AIMR does not specify how many are "sell side" analysts. ASS'N FOR INV. MGMT & RESEARCH, FACTS ON THE ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH, *at* http://www.aimr.org/pdf/factsheet.pdf (last visited Oct. 1, 2002).

143. *See* Becker Speech, *supra* note 116.

an analyst, section 10(b) of the '34 Act can remedy the problem.[144] A complete review of section 10(b) law is beyond the purview of this note. The following is a quick survey of elements of section 10(b) that will limit its use with respect to analysts.

An analyst could be liable under section 10(b) if they: (1) employed a "device, scheme, or artifice to defraud;"[145] (2) made an " untrue statement of a material fact or . . . omitt[ed] to state a material fact necessary in order to make the statements made . . . not misleading;"[146] or (3) engaged in an act . . . which operates . . . as a fraud or deceit upon any person."[147]

From the outset, because section 10(b) alleges fraud, there must be a duty extending from the defendant to the plaintiff.[148] With the exception of N.Y. Attorney General Spitzer's findings, it is unlikely that a plaintiff would be able to find proof that an analyst misstated their opinion.[149] A more likely and nuanced claim would be that the analyst failed to disclose that his opinion was influenced by external factors.[150] David M. Becker, General Counsel of the SEC, summarizes the problems, "There is a question whether silence about a conflict of interest is fraudulent where there has been no representation about the [facts], unless there is some duty to disclose . . . . I'm not sure that such a duty would run to readers of broadly distributed reports."[151] Analysts' opinions had more impact on investors in the late 1990s because they were disseminated far and wide.[152] But, the Supreme Court has clearly been averse to extending a duty to everyone.[153]

144. 15 U.S.C. § 78j(b) (2000); Becker Speech, *supra* note 116.

145. 17 C.F.R. § 240.10b-5(a) (2002).

146. *Id.* § 240.10b-5(b).

147. *Id.*

148. Chiarella v. United States, 445 U.S. 222, 228 (1980) (noting that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so").

149. Admissions like Henry Blodget's are rare and federal securities laws are not intended to rely on either motions for discovery or investigations under state securities law. *See supra* note 50 and accompanying text.

150. *See generally* Shirli Fabbri Weiss, *Securities Analysts in Securities Class Actions*, in ?, at 431, 436–39 PLI Corp. Law & Practice Course, Handbook Series No. 1136, 1999) (outlining theories against research analysts).

151. *See* Becker Speech, *supra* note 116.

152. *See* LESLIE BONI & KENT L. WOMACK, WALL STREET'S CREDIBILITY PROBLEM: MISALIGNED INCENTIVES AND DUBIOUS FIXES? 9–10 (Feb. 2, 2002), *available at* http://mba.tuck.dartmouth.edu/pages/faculty/kent.womack.

153. Since *Blue Chip Stamps v. Manor Drug Stores*, however, the Supreme Court has been reluctant to expand the scope of section 10(b) liability. Under Chief Justice Rehnquist, the Court has limited the scope of section 10(b), reasoning that "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn." 421 U.S. 723, 737 (1975). For subsequent limitations of the "judicial oak," see *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (holding that section 10(b) does not reach aiding and abetting); *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (holding that a recipient of inside information only incurs section 10(b) liability when an insider has breached his fiduciary duty to shareholders by disclosing information to tippee and the tippee knows or should know that there has been a breach); *Chiarella v. United States*, 445 U.S. 222, 229 (1980) (holding that purchasers buying on the basis of in-

In *Chiarella v. United States*,[154] the Court said:

> We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent.[155]

Of course, courts may find a duty to certain investors under novel theories[156] but, based on *Chiarella*, it seems certain that it would be a duty to a more narrow and specific class of plaintiffs.[157]

Even if a duty exists between the aggrieved and the analyst, the Court has so substantially limited section 10(b) that it might not apply.[158] Two requirements of section 10(b) especially limit its use for redressing wrongs by analysts.

First, both private and governmental section 10(b) claimants must prove scienter under *Ernst & Ernst v. Hochfelder*.[159] It will be very difficult to prove that analysts *knowingly* (1) employed a "device, scheme, or artifice to defraud;" (2) made an "untrue statement of a material fact or . . . omitt[ed] to state a material fact necessary in order to make the statements made . . . not misleading;" or (3) engage[d] in an act . . . which operates . . . as a fraud or deceit upon any person."[160]

For the private claims, as opposed to actions instituted by the SEC, this scienter requirement is drastically complicated by new pleading requirements enacted under the Private Securities Litigation Reform Act of 1995 (PSLRA).[161] The PSLRA requires that allegations regarding a

side information incur no section 10(b) liability if they are not an insider or a fiduciary); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 473–74 (1977) (limiting section 10(b) actions to "deceptive" or "manipulative" conduct); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring scienter as an element of any section 10(b) action); *Blue Chip Stamps*, 421 U.S. at 730–31 (affirming standing requirement that section 10(b) claimants had purchased or sold securities of defendant issuer).

154. 445 U.S. 222 (1980). *Chiarella* dealt generally with an inside trader's duty to the general public. *Dirks*, 463 U.S. 646, dealt with an analyst's duty to the general public and held with *Chiarella* that analysts do not have a general duty to the public.

155. *Chiarella*, 445 U.S. at 233.

156. For example, in *Chiarella* the Supreme Court ruled that a financial printer who bought stock on the basis of inside information but "who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts." *Id.* at 229. Twenty years later, the Court recognized a duty on the basis of a misappropriation theory in *United States v. O'Hagan*, 521 U.S. 642, 665 (1997). "The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652.

157. *See* Becker Speech, *supra* note 116.

158. *See infra* notes 159–74 and accompanying text..

159. *Ernst & Ernst*, 425 U.S. at 193. *Aaron v. SEC*, 446 U.S. 680, 691 (1980), held that the *Ernst & Ernst*'s scienter requirement also applies to the SEC for section 10(b) actions.

160. *See generally* Weiss, *supra* note 150, at 438–39, 442–55.

161. The PSLRA adds section 21D to the Securities Exchange Act of 1934. Private Securities Litigation Reform Act of 1995, tit. 1, § 101(b), tit. 2, § 201(a), 15 U.S.C. § 78u-4 (2000).

defendant's state of mind be plead with particularity.[162] It applies to issuers and the issuers' underwriters—the most likely deep pockets in a class action against an analyst.[163] Further, because most of the allegedly conflicted opinions were with respect to an issuer's future potential (e.g., recommending "buy" because the stock price should climb), analyst opinions might also fall within the PSLRA's safe harbor for forward-looking statements.[164]

The safe harbor protects forward-looking statements made without actual knowledge "that the statement was false or misleading," if (1) the statement is accompanied by "cautionary statements that could cause actual results to differ materially from those in forward-looking statements," or (2) the statement is immaterial.[165] Thus, if analysts couch their predictions of a stock's future success with cautionary language averting investors to the stock's risks, investors have no cause of action unless they can prove that the analyst intentionally mislead investors. The PSLRA stays discovery while a motion to dismiss is pending.[166] Absent an opportunity for discovery, it will be difficult to plead scienter with particularity.[167]

Additionally, for both private and public actions, misstatements or omissions of fact must be material to be actionable under section 10(b).[168] It is unclear whether a court would find that a reasonable investor would

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162. In any private action arising under this Act in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, *the complainant shall, with respect to each act or omission alleged to violate this Act, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*.

15 U.S.C. § 78u-4(b)(2) (emphasis added).

163. 15 U.S.C. § 78u-5(a). In the case of the lawsuit against Mary Meeker, for instance, plaintiffs included Morgan Stanley as codefendant for section 10(b) liability and had a separate count against Morgan Stanley under section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C §78t(a), as a control person. Class Action Complaint for Violations of Federal Securities Laws, at 46, 47; Thomson v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,539 (S.D.N.Y. Aug. 21, 2001).

164. This portion of the PSLRA would only apply, if at all, to an investment bank that underwrote securities of the issuer. It would not apply directly to analysts. 15 U.S.C. § 78u-5(c)(1) (2002).

165. *Id*.

166. 15 U.S.C. § 78u-4(b)(3)(B).

167. For instance, in dismissing sua sponte six identical plaintiffs' complaints against Mary Meeker and Morgan Stanley alleging 10b-5 violations for failure to plead with particularity, Judge Pollack of the District Court of the Southern District of New York commented that "[t]he jury speeches taken from the media and chronicled in the Complaint are hardly what is known as elements of proper pleading of a right to relief." Pludo v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,541 (S.D.N.Y. Aug. 21, 2001); Thomson v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,539 (S.D.N.Y. Aug. 21, 2001); Senders v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,536 (S.D.N.Y. Aug. 21, 2001); Soto v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,540 (S.D.N.Y. Aug. 21, 2001); Stein v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,537 (S.D.N.Y. Aug. 21, 2001); Lloyd v. Morgan Stanley Dean Witter & Co., [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,538 (S.D.N.Y. Aug. 21, 2001).

168. 15 U.S.C. § 78u-5(c)(1)(A)(ii).

find disclosure of an analyst's conflicts important in making an investment decision.[169]

Finally, for private litigants seeking monetary compensation, two further limitations on their right of action exist. First, under *Central Bank of Denver v. First Interstate Bank of Denver*, the analyst must be primarily liable under section 10(b).[170] This limitation could potentially preclude a theory based on an analyst's aiding and abetting a fraud committed by their employer.[171] Second, under *Blue Chip Stamps*, only those who purchased or sold a security can file a claim.[172] Although the standing requirement does not obviate the possibility of a lawsuit against an analyst, it does limit the remedy to a certain class of aggrieved persons. Analyst misrepresentations about a company might also induce investors to hold onto a security when they should have sold it.[173] Those investors have no right of action against analysts.

As a result of the judicial and legislative restraints on what was formerly a very broad provision, section 10(b)—while perhaps appropriate in limited circumstances—fails to address every facet of analyst integrity. Application of section 10(b) would be inconsistent and, consequently, ineffective to ensure analyst independence and integrity.

Over the years, section 10(b) has been limited by Supreme Court decisions and the PSLRA because it was feared that its application was too broad and that "strike suits," wherein private litigants threaten litigation in search of a settlement, were a consequence of section 10(b)'s breadth.[174] Given the Supreme Court's reluctance to expand the scope of section 10(b), any changes to strengthen 10(b) must come from Congress. Any changes, however, would result in liberalizing 10(b) and opening the door wider to "strike suits." Especially with respect to the duty analysts owe to their firms' clients and to the general investing public, any rules clarifying this duty (i.e., whether one exists and, if so, its reach) might swing the doors to strike suits wide open.

Nonetheless, without such clarification, many 10(b) suits could be nonstarters, regardless of their merits. Further, changes to 10(b) would give investors the protection of federal securities laws that they would not otherwise have by mere claims of a breach of SRO rules resolved through arbitration.

169. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (adopting materiality standard for section 10(b) claims that "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"); s*ee also* Becker Speech, *supra* note 116 (commenting "I'm also not sure that courts would find [areas of conflict of interest] material in all instances. Generally, the courts have held that information about motive is not material to investors. I'm not sure that undisclosed bias would be regarded as material fact.").

170. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (1994).

171. Weiss, *supra* note 150, at 439–41.

172. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730–31 (1975).

173. *Id*.

174. *Id.* at 737–49.

Congress should consider liberalizing securities laws. Given the importance and the possible unanticipated effects of such changes, however, Congress should proceed cautiously. In the meantime, new SRO rules can more immediately resolve the fundamental problems of analyst independence.

B. *Option 2: Complete and Specific Disclosure of Conflicts of Interest Plus Some Structural Remedies*

The NASD had been working with the NYSE and the SEC to create new disclosure obligations.[175] However, in light of the controversy in the press surrounding analysts, the NASD promulgated early a proposed amendment to its Rule 2210 for comment,[176] requiring disclosure of conflicts of interest on analyst reports, perhaps in an attempt to preempt criticism.[177] The amendment requires NASD-member firms to disclose conflicts of interest in sales literature and when making television or radio appearances.[178] In written reports and sales literature, the Rule requires NASD-member firms to specifically and prominently outline their conflicts of interest, avoiding boilerplate language.[179] Firms are to indicate whether they own or have the right to acquire more than five percent of the reported stock, whether the analyst responsible for the recommendation has any personal interest in the security, and particular details of the firm's relationship with the issuer.[180] Thus, whereas previously firms would include standard boilerplate language regarding poten-

175. NAT'L ASS'N OF SEC. DEALERS, 01-45 NASD REGULATION REQUESTS COMMENT ON PROPOSED AMENDMENTS TO RULE 2210 (2001), *available at* http://www.nasdr.com/pdf-text/0145ntm.txt [hereinafter NASD REQUESTS COMMENT].

176. *Id.*

177. *See id.* ("The Board felt strongly that . . . such standards should apply to all financial institutions on an equal basis. Given the need to address these problems, however, NASD Regulation has determined to take this step and propose disclosure standards . . . .").

178. *Id.*

179. NASD Rule 2210(d)(2)(B)(i) requires "[a]dvertisements and sales literature, . . . whether or not labeled as such, . . . [to] *specifically and prominently*" disclose conflicts of interest. *Id.* att. A (emphasis added).

180. Rule 2210(d)(2)(B)(i) requires that analysts disclose in their reports:

> a. that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, or that the member or associated persons will sell to or buy from customers on a principal basis;
>
> b. that any officer or partner of the member owns options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;
>
> c. that the member has received compensation from the recommended issuer for investment banking services provided to the issuer within the last twelve months;
>
> d. that the person or persons principally responsible for the recommendation, or any discretionary account managed by such person or persons, has a financial interest in any security of the recommended issuer, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position); and
>
> e. that the member owns (or through the exercise of options or warrants would own) 5 percent or more of the total outstanding shares of any class of equity securities of the recommended issuer.

Id. (emphasis omitted).

tial or actual conflicts of interest, the new Rule requires an actual description of the relationship between the analyst's firm and the issuer.[181] It is thought that this information would allow the investor to better appreciate the extent of the analyst's conflict.[182] Also, the Rule requires that analysts appearing on television or speaking about a security on the radio must also mention their conflicts of interest.[183] The Rule has no requirement to disclose conflicts when analysts or firm officials appear on television or speak on the radio.[184]

Congress reacted coolly to the NASD's proposed solution.[185] In response, the NASD, joined by the NYSE, went back to the drawing board and released new measures in late February 2002, in the wake of the Enron scandal,[186] to remedy analysts' conflicts of interest.[187] The rules, NASD Rule 2711 and NYSE Rule 472,[188] are intended to address areas of analysts' conflicts of interest highlighted by the House Committee for Financial Services' hearings[189] (House Hearings) and the AIMR in its *Invitation to Comment*.[190]

NASD Rule 2711 and NYSE Rule 472 address the three areas of conflict of interest discussed above. First, the Rules try to limit issuers' influence over analysts' research reports by limiting the ability of issuers to review analyst research before it is released to the public.[191] Second, both Rules limit the relationship between analysts and underwriters

181. *Id.*
182. *Id.*
183. NASD Rule 2210(d)(2)(B)(ii):

> Public appearances. In any public appearance, an associated person making a recommendation (whether or not labeled as such) must disclose any of the following situations which are applicable:
>
> a. that the recommended issuer is a client of the member with which the person is associated;
>
> b. that the associated person, or any discretionary account managed by such person, has a financial interest in any security of the recommended issuer, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position); and
>
> c. that the member owns (or through the exercise of options or warrants would own) 5 percent or more of the total outstanding shares of any class of equity securities of the recommended issuer.

"Public appearance" consists of participation in a seminar, forum (including an interactive electronic forum), radio or television interview, or other public appearance or public speaking activity. *Id.*

184. *Id.*
185. *See Broker-Dealers: LaFalce Urges SEC, NASD to Weigh More Stringent Rules for Analyst Conflicts*, 33 Sec. Reg. & L. Rep. (BNA) 998 (July 9, 2001) (quoting Congressman John J. LaFalce, D-N.Y., as characterizing the NASD's proposed rule as "'woefully inadequate' to address the systematic conflicts of analysts").
186. *Id*.
187. For the NYSE's version of its collaboration with the NASD, see Rule Changes, *supra* note 117, at 11,537–38.
188. *Id*. at 11,526.
189. *Analyzing Analysts*, *supra* note 35.
190. PROPOSED ISSUES, *supra* note 25, at 1.
191. NASD Rule 2711(c) and NYSE Rule (b)(3), *in* Rule Changes, *supra* note 117, at 11,527, 11,529.

through a legally prescribed separation of certain functions.[192] Third, the Rules address problems of a naïve investing audience by requiring specific disclosure of each analyst's success or failure in making stock recommendations and disclosure of conflicts of interest.[193] A review of the impact the new Rules will have on these three areas follows. Overall, these new regulations address the appropriate areas. Whether this new regulation will change the subtext of Wall Street relationships, however, is unclear.

To address analysts' relationships with the management of companies on which they report, the Rules prohibit analysts from submitting their complete research reports to a subject company's management for review.[194] Analysts can submit factual data contained in their research reports for verification but they cannot allow review of research summaries, research ratings, or price targets.[195] This addresses popular accounts such as Henry Blodget's lowering his price target on Amazon.com after conferring with Amazon's management.[196] The Rules do not completely eliminate analysts' fear of retaliation, however, because there remains the threat of being shut out by their subject company if they release a negative research report.[197]

Rules limiting underwriters' influence over analysts work in conjunction with those limiting the influence of analysts' subject companies. The NASD and NYSE Rules prevent analysts from using their reports to curry favor with the companies they cover.[198] The Rules thus prohibit actions such as Mary Meeker offering to cover eBay.com in order to underwrite eBay.com's secondary offering.[199] Without the leverage of

192. NASD Rule 2711(b) and NYSE Rule (b)(1) and (2), *in* Rule Changes, *supra* note 117, at 11,527, 11,529.

193. NASD Rule 2711(h) and NYSE Rule 472(k), *in* Rule Changes, *supra* note 117, at 11,528, 11,530.

194. NASD Rule 2711(c) and NYSE Rule 472(b)(3), *in* Rule Changes, *supra* note 117, 11,527, 11,529.

195. *Id*.

196. *See supra* notes 54–57 and accompanying text.

197. *Analyzing Analysts*, *supra* note 35 (testimony of Laura S. Unger) (recognizing "that some conflicts may always exist," including "pressure from issuers").

198. *See* NASD Rule 2711(e) ("No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.") and NYSE Rule 472 (g) ("No member or member organization may directly or indirectly offer a favorable research rating or specific price target, or offer to change a rating or price target, to a subject company as consideration or inducement for the receipt of business or for compensation."), *in* Rule Changes, *supra* note 117, at 11,527.

199. In May 1998, Morgan Stanley was eagerly seeking to underwrite the initial public offering of eBay.com, but Mary Meeker and her technology team lost the underwriting agreement to Goldman Sachs. *Fortune* describes Meeker's reaction:

> She offered her personal apology to eBay's CEO Meg Whitman for failing to convey her full appreciation of eBay's business. Then she held out a carrot no other firm could proffer: a Mary Meeker research report. In July she met Whitman at Boston's Logan Airport for dinner and presented her with a draft of a glowing report on the company. Whitman told Meeker that she felt honor bound to stick with Goldman [Sachs]. Then, when eBay went public a few months later—and with the Goldman [Sachs] analyst forbidden from issuing any eBay research during the post-

promising companies favorable reporting, underwriters should expect less of analysts with respect to deal development.

The Rules further separate analysts from underwriters by prohibiting underwriters from supervising analysts, reviewing analysts' research reports, or basing analysts' compensation on development of "a specific investment banking services transaction."[200] Accordingly, looking back on Mary Meeker's role at Morgan Stanley, under the Rules, Frank Quattrone—an investment banker—could never have hired her because she would have been under the supervision of an investment banker.[201] Moreover, Meeker could not have lead a group that mixed underwriting and analyst functions because wearing both hats would violate the prohibition against underwriters reviewing analyst reports.[202]

Whether Mary Meeker or Henry Blodget's compensation would violate the Rules is less clear, however, and highlights the inescapable conflict of interest to which analysts will remain subject under the Rules. Clearly, their salaries spiked following a record year for underwriting at their firms.[203] But whether their salaries were "based upon *specific* investment banking services transaction[s]" is uncertain. Nonetheless, the incentive behind such compensation is clear.[204] Analysts will still feel pressure from underwriters because their compensation can still be linked to deal development *generally*. An analyst like Meeker—while no longer capable of using her research reports as consideration for new underwriting business—will still be under implicit pressure, at the very least, not to dissuade potential underwriting clients because her compensation is based on the success of underwriting.

So long as analyst compensation is linked to business development, a serious conflict of interest remains to which investors should be adverted. Investor awareness of factors affecting analysts' independence remains a priority. Without it, some investors will continue to take analyst opinions at face value.

> IPO quiet period—Meeker took the unprecedented step of publishing her completed eBay report on the very first day of trading. She instantly became the most visible analyst on the stock. "eBay's market opportunity is huge," she proclaimed—and gave the stock an outperform rating. Seven months later, when the company did a $1.1 billion secondary offering, eBay forced Goldman [Sachs] to split the business with Morgan.

Elkind, *supra* note 75, at 68.

200. *See* NASD Rule 2711(b)(1) and (2) (prohibiting, respectively, underwriters' supervision of analysts and review of analysts' research reports), (d) (prohibiting analyst compensation based upon specific investment banking services); NYSE Rule 472(b)(1) and (2) (limiting similarly underwriters' oversight of analysts), (h) (prohibiting similarly analyst compensation specifically linked to investment banking), *in* Rule Changes, *supra* note 117, at 11,527, 11,529.

201. *See supra* note 80 and accompanying text. Frank Quattrone would be in violation of NASD Rule 2711(b)(1) and NYSE Rule 472(b)(1).

202. *See* NASD Rule 2711(b)(2) and NYSE Rule 472(b)(2), *in* Rule Changes, *supra* note 117, at 11,527–29.

203. *See supra* notes 70, 77 and accompanying text.

204. NASD Rule 2711(d), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(h), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

The Rules seek to resolve this issue by requiring analysts to disclose prominently their conflicts of interest in their research report and in public appearances.[205] With respect to compensation, the Rules require analysts whose compensation is based on investment banking fees to disclose that fact and also require the employers of the analysts to disclose whether they have "managed or co-managed a public offering of securities for the subject company" or "received compensation for investment banking services" within the last twelve months or "expect [] to receive or intend [] to seek compensation for investment banking services from the subject company" within the next three months.[206]

The Rules also require research reports to contain a line graph plotting the historical value of the stock versus the dates of the analyst's recommendations and whether the recommendation was to buy, sell, or hold on those dates.[207] In addition, while analysts' firms may keep their proprietary stock rating systems, all recommendations must be translated into a universal "buy, sell or hold" rating.[208] The Rules require firms to disclose the percentage of all stocks rated a buy, hold, or sell and also the percentage of companies within each rating for which the firm has provided investment banking services within the last twelve months.[209]

The new disclosure regimes go a long way towards alerting investors to the nature of analyst opinions. An investor reading a research report prepared pursuant to the Rules should be well informed about an analyst's biases, his track record, and risks involved in purchasing stock of the subject company. The Rules presume, however, that a common investor relying on the recommendation of the research report actually saw the research report, which may not be the case at all. Many investors rely on analysts because they are featured prominently on television financial news. In such cases, the NASD and NYSE Rules only require disclosing that the analyst or the analyst's firm owns the subject stock and other material conflicts of interest.[210] Further, the disclosures made can be edited from the broadcasted appearance.[211] Alternatively, the Rules' disclosure requirements presume (as does the "truth on the market" theory) that sophisticated investors' awareness of conflicts will be

205. NASD Rule 2711(h), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(k), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

206. NASD Rule 2711(h)(2), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(k)(1)(ii), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

207. NASD Rule 2711(h)(6), *at* http://www.nasdr.com/pdf-test/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(k)(iv), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

208. NASD Rule 2711(h)(5)(A), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472.70, *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

209. NASD Rule 2711(h)(5)(B), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(k)(iv), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

210. *See* NASD Rule 2711(h) at http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(k)(1), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002).

211. *See* Rule Changes, *supra* note 117, at 11,533.

impacted into stock prices, thereby benefiting the unsophisticated as well.

Unless courts begin defining when analysts' conflicts of interest are *material* for 10b-5 purposes,[212] average investors will not learn of the risks and analyst biases outlined in the research report. They will have to rely on the "efficient" market to digest information about analysts' conflicts. Further, second hand accounts of analyst research will not likely disclose all information required by NASD Rule 2711 and NYSE Rule 472. The NASD, in its proposal of Rule 2711, comments that "the proposed rule change would require only that a research analyst make these disclosures. An independent decision by the sponsor of the public appearance, such as a television program sponsor, to edit out the required disclosures, would not constitute a violation of the NASD's proposed rule."[213] Thus, disclosures such as those in the analyst research reports, will continue to protect those who need the least protection, the institutional investors who use analysts' research reports, while the average investor who needs protection most will have gained little.[214]

C. Option 3: Separation of Analyst Functions from Investment Banking

Viewing analysts as inescapably conflicted by pressures to develop, or at least maintain, underwriting business, some commentators advocate a complete separation of analysts from investment banks.[215] Those in favor of this option reject any notion that an analyst report can be impartial while serving a sales function.[216] Rather, they believe that the conflicts of interest of sell-side analysts run so deep that reform is impossible.[217] Instead, they suggest that the only way to ensure an impartial analyst opinion is to separate the brokerage and investment banking operations of a firm from analysts.[218] "Chinese walls" are easily disregarded and do not serve this function.[219] The separation must be a physi-

212. *See supra* notes 168–69 and accompanying text.

213. *See* Rule Changes, *supra* note 117, at 11,533.

214. *See supra* notes 104–12 and accompanying text.

215. *See* Tice, *supra* note 105 ("The best solution to the problem would be to completely separate research from both investment banking and trading.").

216. *See, e.g.*, Caldwell Letter, *supra* note 121.

> All the talk and all the manuals and rules in the world will never be able to bring these two diametrically opposed positions together into one that is fair and objective to clients. They are separate and to ask analysts to be good boys and don't violate the fairness to any client is impossible. One cannot "advise" what is in the best interests of a client if at the same time there is a monetary interest . . . over and above a normal percentage fee for advice, to the analyst or his/her employer if the client accepts the advice.
>
> . . . .
>
> My conclusion is that until such time as [a] separation is mandated by the industry, backed by the regulators, clear and unambiguous objectivity can never be achieved.

Id.

217. *Id.*

218. *Id.*

219. Eric Rau, *Making the Street Safe*, FIN. TIMES, June 27, 2001, *available at* 2001 WL 24309409 (commenting that "[i]t is an open secret on Wall Street that, despite the internal "Chinese walls" be-

cal separation such that brokerage firms and underwriters cannot offer their own analysis to prospective purchasers of a security.[220]

In spite of the sharply delineated role analysts would have if they were separated from investment banks, many find this solution too severe.[221] Analysis from analysts at investment banks, while ultimately sales literature, continues to be valued by institutional investors.[222] Because analysts are so richly compensated when they are affiliated with investment banks, investment banks attract highly talented analysts whose opinions are valued. While a conflict will always exist as long as analysts' salaries are vaguely contingent on the success of underwriters, they are also less constrained to charge high fees for access to their analysis.[223] Most institutional investors receive analyst research in return for using a brokerage firm's services.[224] An effective separation of analysts from investment banks would require that analysts receive their compensation only on the basis of their analysis; investors would have to pay for independent analysis. Whether investors will be willing to pay for independent analyst research is unclear.[225] David W. Tice, speaking before the House Capital Markets, Insurance and Government Sponsored Enterprises Subcommittee, interestingly frames the choice:

> A portfolio manager has two choices for lunch. He can either receive for free an artery-clogging triple cheeseburger (Wall Street research), or walk up 10 flights of stairs and buy a $20 garden salad (independent research). The manager knows the salad will be much better for him, but the cheeseburger will be prepared by the finest French chef, have the best sauces and garnishes, and in fact be served directly to him by the finest wait staff (institutional salesmen). It will be hard to resist. Competing with this free lunch is difficult for the salad vendor who cannot afford to deliver and must spread his fixed costs over the few customers who make the effort to visit him. As a result, his salad seems expensive.[226]

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tween underwriting and analysis departments, the analyst's report often serves the underwriter's purpose"); Emily Thornton, *Wall Street's Chinese Walls Aren't Strong Enough*, BUS. WK., Aug. 27, 2001, at 56 (noting that "the walls are lousy at keeping those in the business of landing investment banking deals separate from those who are supposed to issue objective research"); *see also* Anita Raghavan, *Jack of All Trades: How One Top Analyst Vaults 'Chinese Wall' to Do Deals for Firm*, WALL ST. J., Mar. 25. 1997, at A1; *supra* note 36.

220.
> As long as firms are permitted to engage in <u>BOTH</u> securities underwriting <u>AND</u> the provision of "research," the temptation and motivation to cheat will exist <u>AND</u> <u>WILL</u> continue. You can write position papers and talk about 'Chinese walls' until the cows come home and it will not stop unethical, . . . dishonest, hypocritical people from behaving badly.

Letter from B.T. Rulon-Miller, C.F.A., to Association for Investment Management and Research 3 (July 10, 2001), *at* http://www.aimr.org/pdf/standards/comments/BuckyRulon-Miller.pdf.

221. *See, e.g.*, Reece Letter, *supra* note 93, at 1.

222. *Id*. at 1 ("Only God could make a fish breathe air and a sell-side analyst subsist on the accuracy of his recommendations. That said, sell-side research is far from useless.").

223. *See* Tice, *supra* note 105.

224. *Id.*

225. *See* BONI & WOMACK, *supra* note 152, at 27.

226. *See id*. at 26.

Translated, the metaphor essentially argues that analyst research, while inferior to independent analysis, has enough advantages that many investors would settle for it. Another analyst comments: "In 'fixing' the problem, that is to say forbidding the dissemination of banking research to individual clients, you are making a choice between providing what might be the best information versus what will be perceived as the most objective. This is an expensive price to pay for perceived objectivity."[227]

Mainly because of the costs involved, complete separation of analysts from investment banks is impracticable. Analyst research from investment banks is still valued by institutional investors regardless of analysts' conflicts because they can distinguish salesmanship from analysis.[228] "The disenfranchised are largely the individual investors, who lack the awareness or education necessary to adequately filter brokerage research recommendations."[229]

IV. RECOMMENDATION

A. *The Sarbanes-Oxley Act in Light of the New NASD and NYSE Rules*

On July 30, 2002, George W. Bush signed into law the Sarbanes-Oxley Act.[230] Title V specifically responded to the debate regarding analyst conflicts of interest. In broad terms, the Act mandated the SEC to pass laws to (1) ensure analyst independence[231] and (2) disclose analyst conflicts of interest to the public.[232] While the Act on the whole was touted by politicians as a comprehensive answer to the waning ethical standards in corporate America,[233] Title V does not necessarily mandate any new reforms.

Regarding its mandate to reestablish analyst independence, Title V requires the SEC to establish rules for: (1) "restricting prepublication clearance or approval of research reports [by underwriters];"[234] (2) "limiting the "supervision and compensatory evaluation of securities analysts [by underwriters];"[235] and (3) prohibiting underwriters from "retaliat[ing] against or threaten[ing] to retaliate against any securities analyst . . . as a result of an adverse, negative, or otherwise unfavorable research re-

227. DePietto Letter, *supra* note 114.
228. *See* BONI & WOMACK, *supra* note 152, at 2.
229. *Id.*
230. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 771–75 (codified as amended in scattered sections of 15 U.S.C.).
231. 15 U.S.C. § 78o-6(a)(1) (2002).
232. *Id.* § 78o-6(b).
233. Adam Wasch, *Accounting Reform: President Bush Signs into Law Broad Accounting Reform Legislation*, 34 Sec. Reg. & L. Rep. (BNA) 1303 (Aug. 5, 2002) (quoting President Bush as saying "[t]his new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: You'll be exposed and punished. The era of low standards and fake profits is over. No boardroom in America is above or beyond the law.").
234. 15 U.S.C. § 78o-6(a)(1)(A).
235. *Id.* § 78o-6(a)(1)(B).

port."[236] The section also requires the SEC to establish a cooling off period during which an investment bank's analysts cannot report on securities which have been recently underwritten by the bank or which the bank hopes to underwrite in the near future.[237] Less specifically, the section mandates that SEC "establish structural and institutional safeguards . . . to assure that securities analysts are separated [from underwriters]"[238] and to "address such other issues as the Commission . . . determines appropriate."[239]

Title V also requires improved disclosure of analysts' conflicts of interest. In each research report, analysts must disclose: (1) any ownership the analyst has of the reported security;[240] (2) whether the analyst or the analyst's employer has received or expects to receive any financial compensation for the issuer of the security reported;[241] (3) whether an issuer is, or within the past year has been, a client of the analyst's employer;[242] and (4) whether the analyst has been personally enriched "based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the [underwriter]."[243]

Almost everything mandated by Title V could be satisfied by the new NASD and NYSE Rules. The following chart compares the provisions of the Act with the new NASD and NYSE Rules regarding analysts.

COMPARISON OF NASD AND NYSE RULES WITH SARBANES-OXLEY MANDATED RULES

Sarbanes-Oxley Mandated Rules (Actual Text)	NASD Rule (Actual Text) (with NYSE equivalent rule cited)
15 U.S.C. § 78o-6 (a) Analyst Protections	
(1) [Rules] to protect the objectivity and independence of securities analysts, by—	

236. *Id.* § 78o-6(a)(1)(C).
237. *Id.* § 78o-6(a)(2).
238. *Id.* § 78o-6(a)(3).
239. *Id.* § 78o-6(a)(4).
240. *Id.* § 78o-6(b)(1).
241. *Id.* § 78o-6(b)(2).
242. *Id.* § 78o-6(b)(3).
243. *Id.* § 78o-6(b)(4).

(A) restricting prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;	NASD 2711(b)(2)—Except as provided in paragraph (b)(3), no employee of the investment banking department may review or approve a research report of the member before its publication. *See also* NYSE 472(b).
(B) limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and	NASD 2711(b)(1)—No research analyst may be subject to the supervision or control of any employee of the member's investment banking department. NASD 2711(b)(2)—Except as provided in paragraph (b)(3), no employee of the investment banking department may review or approve a research report of the member before its publication. NASD 2711(b)(3)—Investment banking personnel may review a research report before its publication as necessary only to verify the factual accuracy of information, . . . provided that: (A) any written communication between investment banking and research department personnel concerning such a research report must be made either through an authorized legal or compliance official of the member or in a transmission copied to such an official; and (B) any oral communication between investment banking and research department personnel concerning such a research report must be documented and made either through an authorized legal or compliance official acting as an intermediary or in a conversation conducted in the presence of such an official. *See also* NYSE 472(b).

(C) [brokers, investment bankers, and employees of them] may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst . . . as a result of an adverse, negative, or otherwise unfavorable research report . . . except that such rules may not limit the authority . . . to discipline a securities analyst for causes other than such research report; . . .	NASD 2711(b)—quoted above in reference to 15 U.S.C. § 78o-6(a)(1)(B); *see also* NYSE 472(b). NASD 2711(d)—No member may pay any bonus, salary or other form of compensation to a research analyst that is based upon a specific investment banking services transaction. *See also* NYSE 472(h).
(2) [Waiting Periods] during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities;	NASD 2711(f)—No member may publish a research report regarding a subject company for which the member acted as manager or co-manager of: (1) an [IPO], for 40 calendar days [after offering]; or (2) a secondary offering, for 10 calendar days [after offering.] *See also* NYSE 472(f).
(3) [Chinese Wall within Investment Banks] to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and (4) to address other issues [identified].	NASD 2711(b)—quoted above in reference to 15 U.S.C. § 78o-6(a)(1)(B); *see also* NYSE 472(b). NASD 2711(d)—quoted above in reference to 15 U.S.C. § 78o-6(a)(1)(C); *see also* NYSE 472(h).

(b) [Mandatory] Disclosure [of Conflicts]	
(1) the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;	NASD 2711(h)(1)(A)—A member must disclose in research reports and a research analyst must disclose in public appearances: (A) if the research analyst . . . has a financial interest in the securities of the subject company, and the nature of the financial interest . . . . *See also* NYSE 472(k).
(2) whether any compensation has been received by the registered broker or dealer, . . . including the securities analyst, from the issuer that is the subject of the appearance or research report, [except if would require disclosure of material nonpublic info];	NASD 2711(h)(2)(A)—A member must disclose in research reports if (i) 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; and (ii) the member or its affiliates: (a) managed or comanaged a public offering of securities for the subject company in the past 12 months; (b) received compensation for investment banking services from the subject company in the past 12 months; or (c) expects to receive or intends to seek compensation for investment banking services from the subject company in the next 3 months. NASD 2711(h)(2)(B)—A research analyst must disclose in public appearances if the analyst knows or has reason to know that the subject company is a client of [his employer]. *See also* NYSE 472(k).

(3) whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the registered broker or dealer, and if so, stating the types of services provided to the issuer;	NASD 2711(h)(2)—quoted above in reference to 15 U.S.C. § 78o-6(b)(2); *see also* NYSE 472(k).
(4) whether the securities analyst received compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the registered broker or dealer; and	NASD 2711(h)(2)(A)(i)—quoted above in reference to 15 U.S.C. § 78o-6(b)(2); *see also* NYSE 472(k).
(5) such other disclosures of conflicts of interest that are material . . . as [determined] appropriate.	

In passing the Act, moreover, legislative history contemplates that the SEC can rely on the NASD and NYSE Rules to implement the mandate of Title V. The committee report describing Title V specifically states:

> Existing rules that satisfy the requirements of the bill do not have to be reproposed or readopted. Existing rules that do not contradict the bill or that impose requirements that are not imposed by the bill do not have to be withdrawn or reproposed. *For example, self regulatory organization rules that require disclosure of statistics regarding analyst ratings or of the securities holdings of an analyst's family members in a subject company are not adversely affected by this bill.*[244]

B. Gaps in the New NASD and NYSE Rules

While the NASD and NYSE Rules address the call of the Sarbanes-Oxley Act, the SEC should not stop with them. The new NASD and NYSE Rules, overall, strike an appropriate balance between protecting investors and protecting the viability of the analyst profession—but they are not the ideal. The Rules achieve their balance by a legally imposed

244. *See generally* S. REP. NO. 107-205, at 32–39 (2002) (emphasis added).

separation of functions[245] and by requiring in-house lawyers to monitor communications between analysts and underwriters and between analysts and issuers.[246] The separation, in theory, should protect analysts' integrity. Many areas, averred to above, however, undercut this promise.

First and foremost, analysts' salaries can continue to be *indirectly* linked to their help with deal development.[247] Eliminating funding from investment banking profits would sharply limit the resources available to pay for analysts. Analyst research might no longer be free of charge for many customers of brokerage firms. Nonetheless, the new NASD and NYSE Rules create the perception of real analyst independence when, in reality, they will continue to be beholden at a very basic level to underwriters.[248]

While an analyst's pay might no longer be directly linked to deal development, an analyst that acts unhindered by considerations of his employer's true source of income will still act at his own peril. It is hard to imagine that an analyst issuing negative reports on the stocks of his firm's underwriting clients will have much security.[249] Although an underwriter might not exert much influence over the analyst's future, at some level the two operations are overseen by the firm's management, who will notice the negative impact that its skeptical analyst has on underwriting business.

Second, analysts are not required to disclose the full extent of their conflicts of interest when they make public appearances and the media can edit out the disclosures they do make.[250] Thus, the NASD and NYSE Rules only address a portion of an analyst's audience. Whether an "efficient" market will truly impact this information into stock prices is debatable.

In spite of the NASD and NYSE Rules' improvements, complete analyst independence is a chimera. Analysts are what they are—*sell-side*

245. NASD Rule 2711(b)(1) and (b)(2), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(b)(1), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002) (prohibiting analysts from being under the supervision or control of underwriters).

246. NASD Rule 2711(b)(3)(a) and (b), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003); NYSE Rule 472(b)(2), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002) (permitting underwriters to verify the factual accuracy of research reports but requiring in-house legal personnel to document and maintain records of all written and oral communication between analysts and underwriters).

247. *See* NASD Rule 2711(d), *at* http://www.nasdr.com/pdf-text/rf02_21_final.pdf (last visited Feb. 11, 2003) ("No member may pay any . . . form of compensation to a[n analyst] that is based upon a *specific* investment banking services transaction."); NYSE Rule 472(h), *at* http://www.nyse.com/regulation/regulation.html (Nov. 29, 2002) ("An [analyst] may not receive an incentive or bonus that is based on a *specific* investment banking services transaction. However, a[n analyst] is not prohibited from compensating an [analyst] based upon such person's overall performance, *including services provided to the Investment Banking Department*.") (emphasis added).

248. *See supra* notes 198–206 and accompanying text.

249. *See* BONI & WOMACK, *supra* note 152, at 31 (finding that, while ninety-one percent of institutional investors believe that analysts should not report to underwriters, only forty-eight percent believe that the "guideline can be credibly enforced").

250. *See supra* text accompanying note 211.

analysts. Their function is to promote stock. Unfortunately, while the Rules separate analysts from the immediate influence of underwriters they do not, and cannot, change the nature of a sell-side analyst's job. For the savvy investor who reads analyst reports, the Rules should objectively inform him of the author's biases.[251] For the average investor, the Rules offer little protection.

C. The Need for Certified "Independent Analysts"

Accordingly, while I generally approve of the NASD and NYSE Rules, I have one simple, additional recommendation: regulations should require sell-side "analysis" to be called "sales literature."[252] Any measure adopted to establish analyst independence should be made with the common investor's perspective as a primary concern. The NASD and NYSE Rules fail in this respect, alerting savvy investors of conflicts of which they are already aware while lulling the average investor into a false belief that analysts' opinions are completely independent. Rather than adding more regulation on top on the new NASD and NYSE Rules, the SEC should stop with the Rules and lay out the bottom line. Analysts should simply call their research what it is: "sales literature" or "marketing material." Thus, knowing investors who already understand the benefits and biases of such sales literature can continue using it for whatever benefit they find while the average investor will be alerted of the research's underlying purpose.

The new rule would work along the same lines of the criteria proposed to certify that auditors are truly "independent."[253] Just as auditors cannot certify public company financial statements without qualifying as an "independent" auditor, analysts should not be able to give "analysis" or "independent analysis" unless they are certified by the SEC as being truly independent of the issuer and any pressure from investment banks. The SEC can put forth rules separating the operations of analysts from investment banks similar to those between the consulting operations and auditing operations of accounting firms.[254] Analysis that is certified as "independent" must come from analysts that are completely unsupervised by underwriters and have no contact with underwriters. All research from noncertified firms would be required to distribute their research as "sales literature" or "marketing material."

Obviously, such "independent research" would probably cost the private investor because it would no longer be partially funded by the

251. *See supra* notes 205–09 and accompanying text.

252. *Cf.* Letter from Randall D. Greer, CFA and CFO of Westchester Capital Management, Inc., to Association for Investment Management and Research (Aug. 27, 2001), *at* http://www.aimr.org/standards/issues/ai_comments.html (suggesting that all research reports on investment-banking clients be printed in a distinct fashion).

253. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 STAT. 745, 771–75 (2002).

254. *Id.* at 771–72.

revenues of investment banking activities.[255] Analysts would have to prove to investors that their research is worth its cost. Nonetheless, investors should be more open to paying for such research for two reasons. First, the SEC will have, in effect, given such research the rubber stamp of approval by certifying it as "independent." Second, the research would no longer compete on unequal terms with the research offered by underwriters because the research of underwriters could only be distributed as "marketing material" or "sales literature." Investors would instantly see the trade-off between research from "independent analysts" and from underwriters. As a result, whereas under the current situation truly independent analysts compete on *unequal* terms with research from underwriters, under the new structure, analysis from "independent analysts" would be offered under *completely different terms* from those offering "marketing material."

This regulated distinction between "independent analysis" and "marketing material" ensures that investors know what they are getting without destroying the market for research reports. Rather than eliminating the option of free but partial analysis from underwriters, this certification option creates a market for "independent research" while preserving the economic incentive for underwriters to procure research. Accordingly, this rule should expand the availability of research for investors. Investors who still desire biased research for its other merits, i.e., institutional investors, will still have ample research while the average investor will have the option and assurance of research from analysts who are "certified" as "independent analysts."

V. CONCLUSION

Although investor awareness has piqued as to analysts' conflicts of interest in recent years, such awareness is bound to ebb as investors forget lessons of the past. The new NASD and NYSE Rules will help people forget. Although the Rules resolve many of the past issues of conflicts of interest, underlying conflicts remain and will always remain so long as analysts serve broker-dealers. In addition to the NASD and NYSE's new requirements, the SEC should require, pursuant to its authority under the Sarbanes-Oxley Act, sell-side analysts to characterize their reports as "sales literature" in order that Main Street investors can be reminded in a basic way of the report's nature and purpose. The SEC should also foster a market for independent research by certifying analysts who meet certain independence criteria as "independent analysts."

255. *See supra* notes 223–25 and accompanying text.