The Issue of Analysts

By June the beginning of 2001, the NASDAQ market index had fallen by 50% on the year, and was down 86% from its high in March 2000 – see chart. The markets were filled with unhappy and nervous investors in the great American technology boom of the late 1990s. Some investors believed they had been misled or had been the victims of fraud, and filed law suits or initiated NASD arbitration proceedings with the broker-dealers that had sold them the securities in which they had experienced big losses.

During the summer of 2001 the issue of what constituted improper conduct -- by investment bankers underwriting IPOs, by securities analysts recommending stocks, and by brokers selling them to their clients -- exploded. The media were reporting many cases that purported to represent misconduct, and regulators were issuing policy statements on the issues in question. Securities firms were responding by announcing changes in longstanding policies regarding "Chinese Walls," and disclosure of investments held by analysts and other employees.

The following pages are a representative sampling of newspaper reporting on the issue of analyst conduct during this period.

Analysts are employed by their firms to report on the investment prospects of companies, usually in a specific business sector, to discover new companies to recommend to clients, and in addition to assist investment bankers in soliciting new business and handling relationships. They are valued for their industry expertise and their reputation among institutional investors, by whom the leading analysts are evaluated in annual "All-star" rankings. Analysts are governed by the relevant policies of their firms, but otherwise constrained only by general anti-fraud laws and the anti-fraud provisions of the securities laws.
Questions

1. Specifically, what are the allegations levied against securities analysts, which gained widespread public attention during 2000 and 2001?

2. To what extent are these allegations justified?


4. What if anything should be done to deal with this issue:

$ By securities firms?
$ By clients?
$ By regulators?
$ By legislators?
$ By individual analysts?
Holdings of Analysts Just a Sideshow


New York, July 27 (Bloomberg) -- Some months ago I had a weird encounter with the then head of enforcement at the Securities and Exchange Commission, Richard Walker.

I was visiting his boss, then SEC Chairman Arthur Levitt, to learn what I could about the agency's prosecution of a 15-year-old New Jersey boy named Jonathan Lebed.

The kid had bought shares in small-cap companies and then posted messages on the Internet telling other people they should buy them too. Every time he did this, he drove the stock price up and got out with a profit. The SEC had found this investment technique offensive, and so set about putting him out of business.

I wanted Levitt to explain to me how what the kid did was ethically different from what Wall Street analysts did every day. He couldn't -- at least not to my satisfaction -- so he called Walker into his office.

No sooner had I repeated my unpleasant question than Walker became upset with me. He said my point was ridiculous, because Wall Street analysts didn't own stock in the companies they recommend.

Plausible, Just Wrong

I didn't call him on this as a) I assumed he knew what he was talking about, b) it sounded like a reasonable enough claim, since most journalists are prevented from owning stuff they write about and c) there was a more insidious conflict of interest on Wall Street, one that much more successfully corrupts analysts' willingness to tell the truth: Every analyst knows that if he offends a big company with a negative recommendation, he puts in jeopardy his employer's ability to rake in huge investment banking fees from that company.

Now it turns out that, in addition to the primary source of corruption, the analysts indeed owned the stocks they plugged. A few days ago, Credit Suisse First Boston followed the lead of Merrill Lynch & Co. and announced that from here on out its analysts would no longer be allowed to own stock in the companies they cover.
This was a weird case where the news of the reform came bundled with the news of the original offense. A CSFB spokeswoman named Victoria Harmon told Bloomberg News, apropos of its old code of ethics for analysts, that "we didn't do anything that everyone else wasn't doing." Allowing analysts to invest in companies that the firm was taking public, and that they would later cover, "was a bigger deal than dress-down Fridays, but it was really just another incentive to stem the tide of employees leaving for dot-coms," she said.

So They Were Clueless?

It's fiercely tempting to make Richard Walker's -- and the SEC's -- idiocy the point of this column. It's amazing to me that the SEC's director of enforcement would be as clueless as everyone else about what appears to have been standard practice on Wall Street. (At what point do investigators investigate themselves, and explain how on earth they remained blind to all of the financial activity that occurred right under their noses during the Internet Boom that they now claim to find so sinister?)

But the truth is, I didn't know myself that Wall Street analysts owned the stocks they told investors to buy. (Did you?) So perhaps Walker was just ordinarily stupid rather than extraordinarily so.

No, the real point of this story is that analysts eating their own cooking is beside the point, which is why CSFB and Merrill are so ready to make rules against it.

Making Matters Worse

CSFB and Merrill Lynch would like you to believe they've cleaned up that little apparent conflict of interest. They've probably just made matters worse.

Preventing analysts from owning what they recommend to others will only further untether Wall Street analysis from reality. As one investor intelligently pointed out, if you wanted to clean up the system, and compel analysts to say what they actually think, you would require them to invest a big chunk of their bonus money into the stocks they plugged, and insist that they hold that stock for at least a year.

But that sane idea has no chance in the currently insane world, where every Wall Street boss is scrambling to find ways to appear to reform his business without actually doing so.

Brain Drain
Henceforth any analyst at CSFB and Merrill Lynch who actually possesses real insight into the future value of a company or an industry will be much more inclined to quit his job and go work someplace where he is permitted to eat his own cooking. The colleagues they leave behind will be the only people on the planet who are allowed to invest in anything except what they actually know about.

The end result will be to lower the quality of Wall Street analysis, and so to raise the relative importance of their natural competitors for public attention, mainly journalists and financial pundits.

The people who run CSFB and Merrill must know this, so we may assume that they don't much care, and that they are resigned to the slow but sure whittling away of their influence on everyday financial public opinion. Meanwhile the serious conflicts of interest -- the ones that actually cause analysts to fudge their opinions -- go largely unaddressed. That's because the serious conflicts of interest generate the serious profits.

Source: Bloomberg, 12 September 2001
^INDU  DOW JONES INDUS. AVG
Last Trade: 9/10 16:04 EDT

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All prices are 20 minutes delayed
S.E.C. Warns Investors On Analysts

Regulatory Body Cites Potential for Conflict

By GRETCHEL MORGENSON

Responding to an outpouring of complaints, the Securities and Exchange Commission has issued an alert to investors not to rely solely on stock analysts' reports when they make decisions about buying and selling stocks.

Laura Unger, acting chairwoman of the S.E.C., said that the alert was needed because investors might not fully understand the many roles that analysts can play at their firms and the inherent conflicts in those activities. "This alert gives investors a framework for what to look for and identifies key issues that could compromise the objectivity of the research," Ms. Unger said in an interview on Thursday.

The commission's office of compliance, inspections and investigations will expand its scrutiny of analysts to encompass not only whether research is an independent function at brokerage firms, but also whether conflicts result when analysts own stocks they write about or when they are paid by a firm's investment banking arm for their work. If the exams turn up problems, Ms. Unger said, the S.E.C. could take enforcement action or make new rules.

The S.E.C. reported a surge in letters from investors who said they had lost large sums of money, after following analysts' recommendations.

Representative Richard Baker, Republican of Louisiana and chairman of the recent Congressional hearings on analysts' conflicts, applauded the S.E.C. alert. The brokerage industry recently introduced best-practices guidelines in response to its critics, and Mr. Baker has appointed a review board to examine them.

The 13-person board includes representatives from the S.E.C., the National Association of Securities Dealers and the New York Stock Exchange, and academics such as Amy Hutton and Samuel Hayes, both from Harvard Business School, and Andrew Metrick and Robert F. Stambaugh, both of Wharton Business School.

The review board also includes two former Wall Street analysts who now work on their own. Thomas Brown, chief executive officer of Second Curve Capital and formerly with Donaldson Lufkin & Jenrette, has criticized brokerage firms for such practices as linking an analyst's pay to investment banking business generated.

Jonathan Cohen, managing partner of JHC Capital Management, was an Internet and software analyst at Merrill Lynch until February 1999. Mr. Cohen was cautious on Internet stocks, in contrast to his replacement, Henry Blodget, who heartily endorsed Internet shares at lofty prices. Earlier this week, Mr. Blodget dropped coverage of several Internet stocks that he had recently rated a buy.

"Maintaining the legitimacy and the quality of equity research is vital to preserving investor confidence and the efficiency of the public markets," Mr. Cohen said.

Mr. Baker said each member of the review board would put recommendations in writing by mid-August. Then Mr. Baker and his staff will open another round of hearings in early September. A third hearing is planned for later in the fall. "Then we'll determine if further legislative action is needed next spring," Mr. Baker said.
Analyst Reports Pressures of Employer’s Trading

By TOM LAURICELLA

In late December 1999, Sean Ryan then a bank-stock analyst for Bear Stearns Cos., says he received a call from Craig Overlander, head of the firm’s bond sales desk. Mr. Overlander wanted to know when Mr. Ryan was going to start covering Northfork Bank, a small Northeast bank.

Not soon, Mr. Ryan replied.

Mr. Overlander wasn’t pleased. After all, Northfork was a potential customer for buying and selling bonds through the Bear Stearns trading desk. “Look, we’ve created expectations with the customer that you will cover them and it doesn’t look good for us if we can’t meet that expectation,” he said, according to Mr. Ryan. “And it’s not good for you if we can’t meet that expectation.”

For Mr. Ryan, this had been just another in a string of what he perceived to be heavy-handed attempts to influence his recommendations. A month after the call from Mr. Overlander, he quit. “The whole thing was very depressing,” says Mr. Ryan, now an analyst for Fulcrum Global Partners, which provides research and trading to hedge funds and institutional investors.

A Bear Stearns spokesman says the firm’s “analysts are encouraged and expected to maintain their independence,” and Mr. Ryan’s comments “are totally inaccurate.” Mr. Overlander didn’t return phone calls.

There has been a lot of attention paid of late to conflicts created by analysts’ involvement with Wall Street firms’ lucrative investment-banking business. But trading relationships are often overlooked as potential conflicts. Banking analysts, in particular, say they can come under pressure to issue favorable ratings on bank stocks because banks are heavy traders of bonds and stocks through brokerage firms like Bear Stearns.

While banks are steady brokerage customers, the bank stocks themselves are highly cyclical, vulnerable to long periods of being out of favor. And that is what makes life tough for bank analysts.

“There’s a lot of fire that is brought on bank analysts,” says Fred Fraenkel, who started off as a bank analyst at Goldman Sachs in the 1970s, eventually heading up the research departments at the old Shearson Lehman Brothers Inc. and Prudential Securities. “And there are all these hands from around the brokerage firms tugging on analysts all at once,” says Mr. Fraenkel, who heads a private equity firm and now advises Fulcrum.

Mr. Ryan says that while he was at Bear Stearns, for example, bonuses were based on analysts’ ability to market their stock picks to institutional investors, their
Analyst Reports Pressures From Trading

Continued From Page C1

ability to generate trading and how well the analysts worked with the investment-banking group. Stock-picking counted as well, but analysts were only rated on how their recommended and neutral-rated stocks performed—not how their sell recommendations performed. This way of determining bonuses is common on Wall Street.

Mr. Ryan’s analyst career began in June 1994 at Lehman Brothers, where he worked for bank analyst Michael Mayo. “He always had a real passion for representing the investor,” says Mr. Mayo, who now works for Prudential Securities. He recalls Mr. Ryan once wanted to change the title on one of their reports to “Shareholders of the World, Unite!”

It wasn’t long after joining Bear Stearns in the summer of 1997 that Mr. Ryan got his taste of the perceived pressures analysts face. He was in the process of deciding which companies he would cover when he received a call from a top research official at Bear Stearns, who said she had just talked to Alan “Ace” Greenberg, then the firm’s chairman. Mr. Greenberg had some friends who owned Colonial Bancgroup Inc., a small Montgomery, Ala., bank, and he wanted to know if Mr. Ryan was going to cover it, according to Mr. Ryan.

Mr. Greenberg stepped aside as head of Bear Stearns this summer but continues to trade there. Bear Stearns said that Mr. Greenberg, who was on vacation, was unavailable to comment for this article.

Mr. Ryan said he hadn’t planned on covering Colonial, a relatively minor industry participant. But the call changed his mind. “There was no explicit pressure, but I had only been at the firm two months, and it was a request from the chairman of the firm,” he said. When Mr. Ryan launched coverage of 10 banks in November 1997, Colonial was among them. A year later, he ended up downgrading the stock, which had been given Bear Stearns’s second-highest rating, when the bank unveiled a restructuring plan and took a $26 million charge, resulting in a loss for the quarter. In the months after his downgrade, Colonial shares languished and then rose briefly, but a year after his call were roughly 20% lower.

A Bear Stearns spokesman denied that Mr. Ryan was pressured to cover Colonial.

But this paled in comparison to what Mr. Ryan says happened in the spring of 1999, as First Union’s shares plunged after the company pre-announced an earnings shortfall, in part due to problems related to a merger with CoreStates Financial Corp. the previous year. Mr. Ryan, who had been bullish on the stock, slammed the bank in a research note, saying, among other things, “the implausibility of management’s assumptions in the CoreStates acquisition was obvious to any sentient being who read the initial merger press release.”

Bear Stearns’s bond salesmen, including Mr. Overlander, were not pleased and complained, according to Mr. Ryan. He was reminded that First Union generated $18 million a year in trading commissions for Bear Stearns. Bear Stearns denies the incident.

At the time, Mr. Ryan was in the middle of writing a short report about Wells Fargo & Co. Near the bottom of the note he wrote, “Wells is (in our opinion) also among the most likely acquirers of First Union.” It was something he had written in previous reports, and it was his only mention of First Union Corp. But when he submitted the report, the Bear Stearns officer in charge of editing the report removed the reference to First Union. Mr. Ryan said he protested but was told that he couldn’t say anything about First Union at that time.

For the next six months, Mr. Ryan didn’t write another word on First Union. When The Wall Street Journal reported on his silence, Mr. Ryan says he was chewed out in an elevator by one of the firm’s public-relations officials. At bonus time, Mr. Ryan says that his check was about one-third less than he had been expecting and that his supervisor told him that was in response to the First Union flap. At a firm like Bear Stearns, an analyst with Mr. Ryan’s experience collects a base salary of around $100,000 to $150,000, with bonuses that can easily amount to another $100,000.

A Bear Stearns spokesman, however, says Mr. Ryan “was never told to stop speaking or stop writing about First Union.”

After quitting Bear Stearns, Mr. Ryan joined up with a start-up firm that intended to provide independent research, but the venture did not go far. Earlier this year, he joined Pulcra, where he is one of a dozen analysts whose job it is to cover stocks with only two ratings: buy or sell. The firm does no investment banking and no proprietary trading. At Pulcra, Mr. Ryan covers seven banks—of which three are sell recommendations, including one on First Union.

“Every time I read an article about conflicts in research, it makes me thankful I’m not working at a company with those kinds of business models,” he says. “I don’t have to worry about having to look over my shoulder.”
Morgan Stanley Tech Star Sued On Bullish Calls

By Colleen DeBaise
And Nick Wingfield
Staff Reporters of The Wall Street Journal

First it was the King. Now it is the Queen.

Investors who say they were burned by bullish Internet-stock calls made by Mary Meeker—once dubbed by Barron’s magazine the Queen of the Net—yesterday sued the high-profile Internet analyst and her employer, Morgan Stanley.

The suits, filed in a New York federal court by investors in Amazon.com Inc. and eBay Inc., follow an arbitration case by a former client who claimed he was misled by a bullish stock call by Merrill Lynch & Co. Internet analyst Henry Blodget, once dubbed King Henry. Last month, Merrill settled that case for $600,000.

The suits have been widely watched on Wall Street. Ms. Meeker and Mr. Blodget were perhaps Wall Street’s two most famous Internet analysts, based largely on a series of “buy” recommendations during the tech-stock bull market. But since the Internet bubble burst last year, many tech stocks have been pummeled, and investors have reviled research analysts and the brokerage business for their rosy stock calls and myriad conflicts.

Stock regulators, Congress and others are examining the issue, asking Wall Street to justify the way it comes up with research recommendations. Critics say the biggest obstacle to independent research is Wall Street firms that seek investment-banking business from companies their analysts follow and that pay analysts partly based on how much banking business the firms get.

That is one of the issues in the most recent $7 million suit. Please turn to Page C1, Column 3.

Tech Star Sued Over Bullish Calls

Continued From Page C1

case, Amazon and eBay investors accuse Ms. Meeker in their suits of issuing positive recommendations on the companies’ stocks to generate investment-banking business for Morgan Stanley. The suits, which seek class-action status, also contend that Ms. Meeker’s reported 1999 pay package of $15 million was directly linked to her ability to secure investment-banking fees for the firm.

A spokesman for Morgan Stanley said the company hadn’t seen either lawsuit, but that it believes the complaints are without merit and will be dismissed. “Morgan Stanley research is thorough and objective,” the company said in a statement. “Mary Meeker is one of the most respected analysts on Wall Street. The allegations are unfair, inaccurate and cannot be supported in court.” Ms. Meeker couldn’t be reached for comment.

New York attorney Fred Iseult, who represents the investors, asserts that the suits are the first to spotlight the notion that an individual analyst may have had a personal financial motive to hype a stock. In the past, securities litigation often named analysts as defendants along with the officers of publicly traded companies. But the latest suits have a new twist, in that they focus solely on the analysts and their employers.

Yesterday’s actions emphasize the connection between Ms. Meeker’s compensation and her banking activity to get over the “motivation hurdle,” says Sara Brody, a securities lawyer at Brobeck, Phleger & Harrison LLP in San Francisco. Ms. Brody, who isn’t involved in the Amazon or eBay suits, says that approach could persuade some judges, but she “wouldn’t consider it a slam-dunk argument.”

The suits come one day after the Securities and Exchange Commission disclosed to Congress that it had found widespread conflicts of interest among analysts at the nation’s largest brokerage firms.

Among other things, SEC acting Chairwoman Laura Unger noted the breakdown of the supposed line separating analysts from investment bankers, particularly as analysts routinely got involved in corporate-finance deals and participated in preoffering “roadshows” for institutional investors. She also noted that analysts’ pay at some firms was linked to the performance of the investment-banking unit.

The suits were filed on behalf of all purchasers of Amazon and eBay stock between Aug. 1, 1998, and Jan. 22, 2001.

Ms. Meeker “knew that the financial condition and future business prospects of Amazon did not support her positive comments and recommendations, but she nevertheless issued positive reports encouraging investors ... to purchase shares of Amazon,” according to one of the suits, filed by Amazon shareholder Mark S. Thomson.

Amazon and eBay shareholders further claim in the suits that Ms. Meeker’s overly optimistic ratings artificially inflated the companies’ stock prices. The suits didn’t specify the amount of damages sought, but contend that investors had losses of millions of dollars as a result of Ms. Meeker’s stock calls.
Judge Dismisses Lawsuits Against Analyst Meeker

By Colleen DeBaise
Dow Jones Newswires

In an unusually speedy action, a federal judge dismissed several recent lawsuits against Morgan Stanley's Mary Meeker, calling the allegations "gross and unrestrained."

U.S. District Judge Milton Pollack in Manhattan said the suits, which accuse Meeker of issuing overly optimistic stock calls during the tech stock bull market, are an example of "abusive litigation."

The judge gave the plaintiffs 30 days "to refine the pleadings" and file an amended complaint.

Shareholders of Amazon.com Inc. and eBay Inc. sued Morgan Stanley and Ms. Meeker on Aug. 1 in Manhattan federal court. The investors accused Ms. Meeker, an analyst, of issuing overly positive calls on the companies' stocks to generate investment-banking fees for her firm and pump up her own salary in the process.

Fred Isquith, an attorney for the plaintiffs, hadn't yet reviewed the judge's order.

"We are gratified but not surprised by this decision," said a Morgan Stanley spokesman. "We have said consistently that these complaints are nothing more than publicity stunts masquerading as lawsuits."

The conflict-of-interest allegations are the focus of recent investor lawsuits against not just Morgan Stanley but all the major securities firms. It wasn't immediately clear how the judge's order would affect the other suits.

In a three-page order, Judge Pollack stated that Ms. Meeker is "derogatorily dubbed" as the Internet Queen in the suits, and that the suits contain "a collection of market gossip" excerpted from the news media. "The 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," the judge wrote.

Judge Pollack also wrote in the order that the litigation against Ms. Meeker "is hopelessly redundant, argumentative, and has much irrelevancy and inflammatory material."

He noted that the district court has the power to dismiss a lawsuit when certain requirements aren't met. In this instance, "the complaint filed herein is an abuse of the tenets of federal pleading and to say the least is in grossly bad taste," he wrote.
Why Investors May Find Arbitrators on Their Side

As investors watch their portfolios wizen, complaints of broker misdeeds rise at the National Association of Securities Dealers. The group, which runs the nation's largest arbitration system handling investor grievances, reports that through July, 3,850 cases had been filed, 25 percent more than at the same point in 2000. But how many disgruntled investors will succeed in their cases? Will arbitrators, as many in the securities industry do, as greedy opportunists trying to recover losses of their own making by picking the deepest pocket around? One authority on securities arbitration says that for several reasons, many investors will fare well. Lewis D. Lowenfels, at the New York law firm Tolins & Lowenfels, said stock investors' immense losses since last year and the troubling conflicts of interest coming to light among research analysts and other brokerage firm employees will encourage arbitrators to give plaintiffs at least some of what they are seeking. "The tech stock bubble and conflicts at brokerage firms will be central to their decisions," Mr. Lowenfels said. "And given the unpredictability of panels, brokerage firms are going to be more inclined to settle." Not every case will be a winner for the plaintiff, of course. But Mr. Lowenfels' argument is borne out by Merrill Lynch's recent payment of $400,000 to settle a case brought against it and its high-profile Internet analyst, Henry Blodget. A Supreme Court case in 1987 confirmed that investors cannot file claims against brokers in court if they had agreed to bring them to arbitration, as most are required to do in order to open brokerage accounts. So investors have little choice about where they air their grievances. Surprisingly, Mr. Lowenfels said, arbitration may be kinder to beleaguered investors today than courts would be. To win a federal fraud case, for example, an investor must prove intent on the broker's part. Not so in arbitration, where many panels have ruled against firms for recommending unsuitable investments to clients or for failing to supervise brokers. Intent to defraud was never at issue. Arbitration may be more fruitful for investors, especially those suing over losses in stocks recommended by biased analysts, because in federal court, investors can bring a fraud case only if they bought or sold based on the recommendation. Arbitration, on the other hand, allows for cases in which an investor already owned the stock and simply held on because of the analyst's call. Finally, Mr. Lowenfels argued that in some arbitration opinions, panelists have said they were concerned about treating plaintiffs equitably even if it meant appearing to go beyond the law to do it. "In these cases, plaintiffs receive at least some portion of their demands," he said. "But in a court of law, the same claimants would probably have received nothing." Investors are in the midst of the worst bear market since arbitration was mandated. If thongs of them prevail, it will come as an unpleasant surprise to brokers who cheered when they won the right to compel investors to arbitration rather than the courts. They felt that arbitration panels — made up of industry executives, lawyers and business people — would be more conservative than judges of people unfamiliar with investing. But now, Mr. Lowenfels said, "in a number of important areas, arbitration panels seem to have reached beyond existing legal authorities to expand the rights and protections accorded to the investing public." Wonder which brokerage will be first to stop forcing its clients into arbitration?
Note to Suers of Analysts: Rough Road Ahead

By RANDALL SMITH
And JERRY MARKON
Staff Reporters of THE WALL STREET JOURNAL

Wall Street’s research analysts are being hit with a record level of securities-fraud litigation this year, as investors stung by market losses look for deep-pocketed culprits.

But some legal specialists doubt such litigation constitutes anywhere near the same kind of threat to securities firms’ financial health that was posed by the past decade’s litigation against the tobacco and asbestos industries.

“You have to show fraud—which is harder to show than this product injured people,” says John Coffee, a securities and corporate-litigation specialist at Columbia University’s law school in New York. This will be particularly difficult in cases where investors allege Wall Street analysts defrauded them by issuing overly bullish stock calls, he says.

The latest breaker hit Wall Street yesterday. A suit filed in a New York federal court by an investment trust contends that six major securities firms—Credit Suisse Group’s Credit Suisse First Boston unit, Goldman Sachs Group, Merrill Lynch, Morgan Stanley, the Robertson Stephens unit of FleetBoston Financial and the Salomon Smith Barney unit of Citigroup—committed fraud by failing to disclose that the firms required analysts to issue favorable recommendations on stocks of corporate clients as a way of sharing investment-banking fees and other financing business from the same clients.

The suit, seeking class-action status, also alleges the firms’ analysts “frequently acquired shares” in the same companies before they went public “at a fraction of the price that public investors later paid.”

Officials at Credit Suisse First Boston and Salomon Smith Barney said they hadn’t seen the lawsuit and thus couldn’t comment. Officials at Goldman Sachs, Merrill Lynch, Morgan Stanley and Robertson Stephens had no immediate comment.

It is part of the outcry against Wall Street analysts, many of whom remained bullish long after the Internet bubble burst last year. Regulators, Congress and others are examining the issue, asking Wall Street to justify the way it comes up with research recommendations. Wall Street long has maintained it keeps a “Chinese Wall” separating investment banking and research operations. But Wall Street firms, which seek investment-banking business from companies their analysts follow, pay analysts partly based on how much banking business the firms get.

Yesterday’s court action comes a day after investors filed two separate suits accusing Morgan Stanley and analyst Mary Meeker of misleading them by her bullish stock calls. Morgan Stanley says the suits are without merit and that the firm stands behind Ms. Meeker’s calls. Last month, Merrill paid $400,000 to settle an arbitration case filed by an investor who claimed he was misled by a bullish stock recommendation by Merrill analyst Henry Blodget. Merrill denied wrongdoing.

The breadth of the recent class-action suits is unusual. Class-action cases alleging securities fraud often are filed against publicly traded companies whose shares have plunged, on behalf of investors who contend that the company didn’t promptly or fully disclose problems.

These suits account for some of the 238 securities-fraud class-action cases filed so far this year, which already exceeds the previous record of 236 in 1998, according to Joseph Grundfest, a former commissioner at the Securities and Exchange Commission and currently professor of law and business at Stanford Law School.

However, investors expecting to reap windfalls from class-action suits against analysts and their firms should be cautious, specialists say. Unlike mass litigation that helped bring the asbestos industry to its knees, the new plaintiffs are attempting to use novel legal theories that are difficult to prove; potential damages are limited and any settlements are likely to be small. For instance, investors would
Investors Expecting Windfalls From Lawsuits Against Analysts Are Warned to Be Cautious

Continued From Page C1

have to clear several hurdles, including showing the analysts' recommendations had a big impact on the stocks' price. Traditionally, most analysts' recommendations have had only a modest impact on stock values.

"It strikes me as very premature and rash to project that this litigation will cast any kind of financial cloud over the [brokerage] industry," Mr. Coffee says. "You have to take all the standard doctrines of securities law and expand each one of them to have liability against Morgan Stanley or other companies."

But the brokerage firms are likely to be vulnerable on another front: the production of internal documents as the cases proceed that could shine an unpleasant light on various conflicts of interest, much as internal documents damaged tobacco companies that were the subject of mass litigation.

Opening up more of the firms' inner workings to public scrutiny could include laying bare the investment-banking conflicts that may influence Wall Street analysts, and how analysts' pay is affected by their participation in the securities underwriting process.

"There's going to be hot documents coming out of the woodwork. It will happen. Every transaction is a document, and it's a felony to destroy them," said John Coale, a tobacco plaintiffs lawyer in Washington. "That's one area where the companies and analysts should be afraid."

Certainly, some class-action cases have produced big awards against Wall Street firms. Among them: cases filed amid charges by the Justice Department that Wall Street dealers colluded to boost their profit margins in stocks traded on the Nasdaq Stock Market. The result: Securities firms paid out $1 billion in damages to investors in 1997.

The best recent example of mass litigation causing huge problems for an industry is the about 500,000 asbestos-related lawsuits filed nationwide since the mid-1970s.
Market Place

N.A.S.D. Rule Would Oversee Analysts on TV

By GRETCHEN MORGENSEN

The National Association of Securities Dealers said yesterday that it had proposed a rule requiring that equity analysts at the nation's brokerage firms clearly and prominently disclose to investors the potential conflicts of interest that may influence their stock recommendations.

The proposal requires, for the first time, detailed disclosure of personal holdings and investment banking relationships by analysts promoting stocks on television or radio broadcasts, in speeches or other public appearances. The same disclosure requirement would also apply to any sales materials produced by a brokerage firm, including advertisements and research reports.

Under the proposed rule, an analyst making a recommendation would have to divulge any financial interest he or she holds in the security or whether an account managed by the analyst includes any such holding. The analyst would also have to state whether his or her firm owned 5 percent or more of the outstanding shares of the security being recommended and whether the firm had received compensation from the issuer of the security for investment banking services provided during the previous 12 months.

"The rule is significant in that it is very concise, very targeted disclosure about the relationship between analysts and the companies they cover," said Mary L. Schapiro, president of N.A.S.D. Regulation. "It's very broad in that it applies to all sales literature, advertisements and public appearances."

The new rule would require that disclosures be made prominently in written materials, essentially doing away with the vague and almost meaningless disclosures of possible ownership stakes and investment banking relationships that now appear in microscopic print on the back page of most Wall Street research reports.

Looking at public appearances, ads and sales material.

The N.A.S.D., the nation's largest regulator of securities firms, has been considering such a rule since last winter, Ms. Schapiro said. The proposal was made public yesterday and the organization has given the industry and investors until August 13 to comment on it. Any rule change proposed by the N.A.S.D. must be approved by the Securities and Exchange Commission.

During the comment period, the N.A.S.D. said, it hopes the industry will address whether the proposed rule should be expanded to require disclosure of the precise nature of investment banking services provided to the issuer of a recommended security and whether firms should have to disclose ownership interests of less than 5 percent of an issuer's stock.

The N.A.S.D.'s proposal comes about three weeks after the Securities Industry Association issued a new standard of ethics for analysts and their firms. But those guidelines carried no penalty for firms or analysts who flouted them. N.A.S.D. rules carry sometimes severe penalties for firms or individuals who violate them, including censures, fines, suspensions and expulsion from the industry.

Responding to the proposed rule, a spokeswoman for the S.I.A. said: "The industry did address disclosure in the best practices for research and we'd like to see that given time before there is any new rule-making."

Ms. Schapiro said that her organization had hoped to extend the proposal to include analysts who work for investment advisory firms. But these professionals are regulated by the S.E.C., so the N.A.S.D. urged the nation's top securities regulator to develop similar rules to ensure that investors have identical disclosure whether an analyst works for a brokerage firm or an investment adviser.

A spokesman for the S.E.C. said: "We are encouraged by the N.A.S.D.'s attention to this important issue. Because this proposal may ultimately come before the Commission, we are unable to comment further."

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Merrill Alterns a Policy on Analysts

Rule Prohibits Buying Shares in Companies Researched by Firm

By CHARLES GARFARNO
Staff Reporter of The WALL STREET JOURNAL

It is a glaring conflict on Wall Street: Research analysts routinely issue glowing reports on companies whose stocks they own in their personal investment portfolios.

Now, a major Wall Street player has taken a big step to banish the practice. Merrill Lynch & Co., the nation's largest brokerage firm, says it will bar research analysts from buying stock in the companies they cover. The policy, the first among major securities firms, will affect Merrill's 600 stock analysts worldwide, about 150 of whom own shares in companies they research.

The Merrill move is a bid by the securities industry to stamp out controversy over conflicts embedded in Wall Street's influential research departments.

For years, some analysts at Wall Street's most prominent firms have compromised their work, caving into pressure from investment bankers at the firms—who believe negative research will harm the chances of winning corporate-finance deals—or from angry corporate clients or portfolio managers. At the same time, analysts themselves often owned shares in the companies they covered.

These conflicts have gained prominence in the wake of last year's stock-market meltdown. Many prominent analysts remained widely optimistic on stocks, particularly technology shares, even long after those stocks crashed, leaving some investors with large losses. Stock regulators, Congress and even state prosecutors are examining the issue, asking Wall Street to justify the way it comes up with research recommendations.

Steps to Closer Scrutiny

Wall Street analysts are increasingly coming under scrutiny for various potential conflicts of interest. Here's a look at some recent actions.

**December 2000** Prudential Securities Chairman and Chief Executive John Strangfeld says the firm's analysts should use terms like "sell" when they mean sell and not hide behind euphemisms like "market perform" or "neutral."

**June 12** The Securities Industry Association adopts a set of "Best Practices" guidelines aimed at increasing the independence of analysts and eliminating undue influence from investment banking.

**July 10** Merrill Lynch, the nation's largest brokerage firm, announces a new policy prohibiting its analysts from buying shares in the companies they cover.

**July 2** The National Association of Securities Dealers proposes rules mandating, among other things, that analysts and brokerage houses definitively disclose ownership in or investment banking business with NASD.

All this is significant for investors because analysts traditionally act as a filter between the stock market and the public. For its part, Merrill's move could prompt major rivals to follow suit; yesterday, several large securities firms said they are reviewing their research policies.

Merrill executives say they didn't buckle to external pressure, but instead modified the policy to better serve clients, which include about five million individual investors. "We're trying to provide some leadership in this area," said Andrew Melnick, Merrill's research chief. "We think we've taken the right steps in that direction."

Critics say this isn't nearly enough. They say the biggest obstacle to independent research is Wall Street firms that seek lucrative investment-banking business from companies whose analysts follow and that may pay analysts partly based on how much investment-banking business the firm gets. (Merrill says analysts are compensated from a pool that includes investment-banking profit.)

In many instances, analysts are pulled into investment-banking discussions to give the deal their seal of approval. Many companies seek out particular brokerage houses in hopes of getting a certain analyst to write positively about them.

Moreover, many Wall Street firms have venture-capital and other private-equity relationships with companies they cover.
units that invest in and own shares of stocks their analysts cover. Some of those units invest on behalf of employees, and in some cases the units have been selling shares even as the firms' analysts tout them, raising concerns about analysts' credibility. All these potential conflicts have yet to be addressed by Wall Street.

Merrill's move "was the easiest thing a brokerage firm can do to erase the perceptions about analysts owning stocks" they cover, said John Markese, president of the American Association of Individual Investors, Chicago. But, Mr. Markese said, too many conflicts still exist that potentially hurt smaller investors: "How many analysts will issue negative research reports on the companies their firms do investment-banking business with?"

Not many. Only about 1.5% of all stock recommendations are labeled "sells," according to Thomson Financial/First Call, and regulators are taking notice.

Congress recently held hearings on conflicts of interest involving Wall Street research and plans to follow up. The Securities Industry Association, Wall Street's main trade group, recently proposed guidelines for firms to follow in a bid to improve analyst independence and eliminate influence coming from investment-banking business.

Meanwhile, the National Association of Securities Dealers, the market's self-regulator, recently issued a proposal mandating that analysts and brokerage firms disclose ownership in or investment banking with companies they cover. The Securities and Exchange Commission, the securities industry's top cop, has launched an examination of conflicts of interests involving research.

Some say it is no coincidence that Merrill has come out with its rule, given that part of the focus of the SEC exam involves conflicts that might arise when analysts own stock in firms they cover.

Officials at Merrill declined to comment about the SEC's probe. They say they long have thought about the stock-ownership policy, which takes effect immediately. The move comes on the heels of a decision last month by Merrill to clarify the way it rates companies in its research reports, as well as to require analysts to disclose when they own shares in companies they cover.

The issue of whether analysts should own stocks they cover has bedeviled Wall Street. Some firms have contended that analysts simply put their money where their mouths are, and that internal policies prevent conflicts of interest. Critics have argued that owning stocks can compromise analysts' integrity.

What everyone seems to have agreed upon is that analysts shouldn't buy shares before making research calls that could affect the stock, or sell their own shares while simultaneously recommending that investors buy the same stock.

Under Merrill's new policy, the firm will give analysts who own stock in companies they cover a "brief window" to choose one of three options. They can sell all holdings of stocks they cover. They can transfer shares to a "managed account" that they have no control over. Or the analysts can keep all the stocks subject to new disclosure rules and stricter policies, under which they can sell the shares only if they have both long and short-term ratings of "neutral" or lower. In the language of Wall Street research, where firms are loath to issue "sell" recommendations, a neutral rating is tantamount to a sell.

In recent months, Merrill's research has been a source of some controversy for the firm. Some Merrill brokers had received complaints from investors and groused to the firm's senior officials about what they viewed as overly optimistic research by Merrill analysts. And Merrill's research practices have been under the microscope after an investor filed an arbitration case with the New York Stock Exchange against the firm and its high-profile technology analyst Henry Blodget.

The pending case contends that a 46-year-old pediatrician lost more than $500,000 because he bought shares of Infospace Inc. based on Mr. Blodget's buy recommendation. The arbitration says Mr. Blodget maintained a "buy" recommendation on the Internet stock to support a financing deal for his firm. Merrill denied the charges and said it will vigorously fight the claim. Mr. Blodget declined to comment.

Some Wall Street executives say the Merrill move is long overdue. "I can't believe we're not much farther down the road," said Douglas W. Atkin, president and chief executive of Instinet Group Inc., which has set up partnerships with nontraditional Wall Street firms that provide independent research to investors.

Meanwhile, other big Wall Street firms could follow in Merrill's footsteps. A spokeswoman for Credit Suisse Group's Credit Suisse First Boston unit said the firm's policy regarding analysts owning shares is "under review." A spokeswoman for Citigroup Inc.'s Salomon Smith Barney unit said that firm also is reviewing its policies, which allow analysts to own stocks they cover only after going through a multistep approval process.

A spokesman for Goldman Sachs Group said the firm is reviewing its research policies. Currently, analysts can own shares of a company they cover, and the firm has a general disclosure statement in its research stating that the analyst, the firm and Goldman "affiliates" may own shares of the company featured in the research report.

A spokesman for Morgan Stanley said the firm soon will clearly state if an analyst owns shares in a company he or she covers in research reports. Now, the company states in a standard disclosure only that the analyst may or may not own shares.

Last month, Prudential Securities Institute, a policy that requires senior fundamental analysts — those who report on companies — to disclose in their research reports if they own $10,000 or more of the securities they are writing about.

The Prudential Insurance Co. of America unit also has clarified ratings, returning to the simple buy, sell and hold, and is encouraging analysts to call stocks a "sell" instead of holding behind euphemisms such as "neutral" or "market perform."

Institutional investors long have known that middling ratings often mean "avoid the stock," but individual investors unaware of Wall Street semantics often take ratings at their face value. Currently, about 7% of Prudential's ratings are sell recommendations.
HSBC Moves to Ease Concerns on Equity Ratings

LONDON, Sept. 9 (Bloomberg News) — HSBC Holdings, one of Europe's biggest investment banking companies, has told its equity analysts to publish as many negative recommendations on stocks as positive ones. In addition, the bank's 400 analysts will no longer issue hold recommendations.

The moves, announced today, follow accusations by some investors that analysts seldom issue sell recommendations on stocks, partly from their firms' fear of losing underwriting business from companies mentioned in the research. HSBC follows other financial firms, including Morgan Stanley Dean Witter and Merrill Lynch, in taking steps to address such investor concerns.

Mark Brown, HSBC's global head of research, said analysts would advise customers to buy shares of companies that are expected to perform better than industry averages, while recommending that clients sell companies that will probably perform worse. "These guys are highly paid professionals, and they should have a view," Mr. Brown said. "They'll have to have as many negative views as positive views."

Last year, HSBC had positive recommendations — buy or add ratings — on about 45 percent of European companies, Mr. Brown said. About 40 percent were rated hold, and 15 percent were negative recommendations — sell or reduce.

In a report today outlining the new policy, HSBC said, "We have always believed that we can put a 'negative' recommendation on a stock without jeopardizing the relationship with the company, provided that the message is put over in the right way."

Among competitors, Morgan Stanley has told its 129 equity analysts in North America to disclose whether they own shares in the companies they analyze, a practice that an industry group recommended for Wall Street firms two months ago. Merrill Lynch and Credit Suisse First Boston, the securities arm of the Credit Suisse Group, have placed limits on analysts' ownership of stocks.

HSBC's policy changes were initially reported in The Financial Times today.
Levitt Expects Wall Street To Fall Short

BY KAREN TALLEY
Dow Jones Newswires

Don't expect too much from Wall Street's current efforts to police itself, the former chairman of the Securities and Exchange Commission said.

The relationship between analysts and investment banking is a "franchise" that will be hard to unlink, Arthur Levitt said in an interview, in one of his first comments on the subject since leaving the SEC. "It's built into the investment banking culture. To take it out would be very difficult."

Mr. Levitt said that securities-industry proposals to strengthen the so-called Chinese Wall between analysts who follow stocks and the investment bankers who court the companies behind those stocks could remain more promising on paper than in practice. At best, Wall Street may undertake more disclosures about analysts' holdings, which, while helpful, don't prevent them from owning the stocks they talk up, Mr. Levitt said. "This is probably as good as it's going to get."

While sounding a bit resigned to seeing minor, not sweeping, changes on Wall Street, Mr. Levitt makes very clear his preference. He wants to see analysts lose all financial incentives for talking up companies their firm is doing business with and he wants to see the firms themselves stop applying pressure for positive reports. "There should be total separation of analysts and investment banking," he said. "Unless that happens, you're stuck with the same old circumstances."

The circumstances can include implied or even outright promises for positive coverage. "Research has long been used as a way for getting new business," Mr. Levitt said.

Mr. Levitt left the SEC in February after almost eight years. The former chairman, 70 years old, is now a consultant and a board member, keeping his hand in the securities industry.

His comments come at a time of tremendous scrutiny of Wall Street, with congressional and New York State investigators looking into whether investors are truly receiving unbiased information. The summer has also seen the Securities Industry Association, the industry's trade group, adopt "best practices" to step up analyst objectivity.

Mr. Levitt sounds a bit weary of reasons for the measures, suggesting the moves may not be the result of a recent dose of conscience. The spotlight is on Wall Street's practices, Mr. Levitt said. "People tend to react when under pressure."

Mr. Levitt spearheaded the agency's Regulation Fair Disclosure, which requires companies to release information broadly, not to just a select audience on Wall Street. The measure is under fire from the securities industry and under review by the SEC—and Mr. Levitt isn't keen on the prospect of alterations. "I would hope the commission doesn't diminish the impact of FD by making changes that would be dangerous," he said.

Mr. Levitt's likely successor at the SEC, securities attorney Harvey Pitt, 56, a Republican nominated by President Bush, has said during Senate hearings that he will continue the SEC's review of FD. Mr. Levitt speaks well of the nominee, calling Mr. Pitt a "superb" choice as the new SEC chairman.