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Investment Banking Conflicts: Research Analysts and IPO Allocations

As investors sobered up from the "irrational exuberance" of the tech stock bubble, a critical eye turned to securities industry practices. In hindsight, few people could understand what pushed the markets so high when the tech stocks that lead the charge had nothing to show in the way of profits. The answer seemed to be that research analysts consistently were bullish on many stocks and remained so even as the bubble burst and the market price of many of those same stocks plunged. What explains the analysts' behavior?

Some charge that research analysts of the major investment banking firms created the stock boom by hyping the stock of companies for which their investment banks had provided or were seeking to provide investment banking services. The companies benefited because their stock price rose. In exchange, the banks benefited when they received large investment banking fees for services provided to those companies. The alleged effect was that


4. See id; Randall Smith & Geeta Anand, Piper Jaffray is Fined for Research Threat, WALL St. J., June 26, 2002, at C1. The securities firm Piper Jaffray “was fined for allegedly threatening to drop research coverage of a biotech company if it didn’t get a plum assignment to manage a stock offering for the company.” Id.

5. See Smith & Anand, supra note 4. The charge was that because Piper threatened to drop research coverage during the company, Antigenetics, suffered during its stock offering. Id.

6. See generally Charles Gasparino, Spitzer Staff Gathers Salomon E-mails Criticizing Grubman, WALL St. J., July 16, 2002, at C1 (reporting that Jack Grubman, an analyst for Salomon Smith Barney, never disguised his dual role of stock analyst and investment banking marketer for Salomon) [hereinafter Gasparino, Spitzer Gathers Emails]; see also Gasparino, Merrill Will Pay Fine, supra note 2 (analysts roles changed during the last decade to help record large investment banking fees).
small investors were misled by these optimistic recommendations, which investors assumed were objective, and then lost out when the stocks eventually tumbled.\(^7\) In addition, banks doled out initial public offering (IPO) shares to company executives purportedly in exchange for prior or continued investment banking business, a transaction known as spinning.\(^8\) Overly optimistic stock analysis created artificial demand, allowing executives to reap huge profits during the tech stock boom days of the late 1990s when they sold those IPO stocks almost immediately.\(^9\)

After an investigation by New York’s Attorney General, Eliot Spitzer, Merrill Lynch entered into a $100 million settlement in May of 2002 that restricted interactions between its research analysts and bankers.\(^10\) Following New York’s lead, the Securities and Exchange Commission (SEC) approved proposed rule changes for two self-regulatory organizations (SROs), the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE).\(^11\) Currently, the SEC is considering

\(^7\) See Gasparino, Merrill Will Pay Fine, supra note 2; Charles Gasparino, Susanne Craig & Randall Smith, Salomon Faces Questions on IPO, WALL ST. J., July 10, 2002, at C1.


\(^9\) See id; Randall Smith & Susan Pulliam, How a Star Banker Pressed for IPOs, WALL ST. J., September 5, 2002, at C1 [hereinafter Smith & Pulliam, Star Banker]; Gasparino, Craig & Smith, supra note 7. The IPO allocations resemble bank tying arrangements that are expressly prohibited by federal statute. See Tying Arrangements, 12 U.S.C. § 1972 (2001) (the extension of credit by a bank can not be tied to the condition that the customer obtain additional credit or a service from the bank). Touting stock in return for additional investment banking fees is at least analogous to illegal tying, but illegal tying will not be discussed in this Note, because it lacks the common element of research analysts.


\(^11\) See Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. and Amendment No. 1 to the Proposed Rule Change by the
additional amendments to the new regulations, which took effect over a period between July 9, 2002, and November 6, 2002. The approved rules and new proposals look similar to the terms of the Merrill Lynch settlement, but will affect all members of these SROs. In September 2002, the NASD fined Citigroup's investment banking arm, Salomon Smith Barney, $5 million for improperly hyping the tech stock Winstar. Most recently, on December 20, 2002, leading Wall Street firms entered into a global pact (GP) agreement with the various regulatory agencies and state securities regulators that will require the firms to pay a total of $1.435 billion for penalties, independent research, and investor education.

Though the inquiry into research and banking conflicts was the center of most regulatory attention, the SROs, SEC, and the New York Attorney General's office were also seeking to resolve what they saw as conflicts of interest in the allocation of IPOs. The NASD has proposed rules to eliminate the practice of


13. See SEC Research Conflicts, 67 Fed. Reg. at 34,969. In addition, in Footnote 11 of the document, the SEC notes that the SRO regulations will only apply to research reports on equity securities, and not research reports covering debt securities. Id.

14. See Charles Gasparino, Salomon Agrees to Settle Stock-Hype Case, WALL ST. J., Sept. 24, 2002, at C1 [hereinafter Gasparino, Salomon Settles Case]. Among other things, Salomon was fined for misleading statements and omissions regarding Winstar made by its star analyst Jack Grubman. Id. Grubman and Ms. Gochuico were charged with setting an unreasonable price target and violating just and equitable principles of trade. Id.

15. See Randall Smith, Will Investors Benefit from Wall Street's Split?: Regulators Set Accord With Securities Firms, But Some Issues Persist, WALL ST. J., Dec. 23, 2002, at C1 [hereinafter Smith, Regulators Set Accord]. A final settlement has not been reached, as the finer details are still being negotiated. Id.

spinning, and for those firms that entered into the GP, spinning has been explicitly prohibited.\textsuperscript{17}

The rules seeking to eliminate the conflicts of interest between analysts and investment bankers appear as if they will achieve their purpose: objective analysis on which investors can rely. But at what cost will this be achieved? Serious questions remain as to whether or not research can sustain itself and whether the new regulations are an unnecessary expense.\textsuperscript{18} Beyond disclosure of IPO allocation practices, proposals that restrict the discretion investment banks have when allocating IPOs will be unnecessary. Allocating IPOs to good clients is a business judgment consideration and will remain so unless a new system is created.\textsuperscript{19}

Part I of this Note examines the conflicts of interest that exist between research analysts and their investment banks and then will review and analyze the newly adopted rules for the NASD and NYSE.\textsuperscript{20} Part II of this Note examines investment banks’ IPO allocation practices and similarly reviews and analyzes the proposed NASD rule.\textsuperscript{21}

I. RESEARCH ANALYSTS’ CONFLICTS OF INTEREST

A. Recent Practices

The changed role of the research analyst on Wall Street has precipitated the recent investigation into analysts’ conflicts.\textsuperscript{22} Just a decade ago, Wall Street analysts were out of the limelight.\textsuperscript{23} But,

\begin{enumerate}
  \item See infra notes 22-168 and accompanying text.
  \item See infra notes 169-263 and accompanying text.
  \item Gasparino, \textit{Merrill Will Pay Fine}, supra note 2.
  \item Id.
\end{enumerate}
the increasing competition for underwriting fees during the boom days of the 1990s brought analysts to the forefront. Not only were analysts assessing stocks but also actively promoting them in an attempt to win investment banking business for their firms. The New York Attorney General's investigation of Merrill Lynch and Salomon Smith Barney (and in the case of Merrill Lynch, settlement), provide many of the examples that explicate the practices allegedly engaged in by a number of Wall Street firms and analysts.

1. Merrill Lynch

In an affidavit submitted to the Supreme Court of the State of New York, assistant New York Attorney General Eric R. Dinallo alleged that while Merrill Lynch publicly rated companies “buy” or “accumulate,” their research analysts were internally disparaging those same stocks. In one instance, Merrill Lynch’s head internet stock analyst, Henry Blodget, saw no floor to the falling stock price of Internet Capital Group, an investment banking client of the firm. Although the recommendation of the stock to the public remained high, internally Blodget “was obviously exceptionally and accurately pessimistic . . . for which he anticipated a drop of an additional 60 percent.”

Mr. Dinallo also described the conflict created by the compensation scheme for analysts at Merrill Lynch. Analysts’ compensation reflected the success of their efforts to bring in investment banking fees and clients. One e-mail uncovered by

24. Id.
25. Id.
28. Id. at 11.
29. Id.
30. Id. at 14.
31. Id.
the Attorney General’s investigation lays bare the direct relationship, as the firm’s insiders understood it, between research analysts’ coverage of a company’s stock and generating investment banking clients.\footnote{Dinallo Affidavit, \textit{supra} note 27, at 15.} While discussing a strategy to attract an investment banking client away from a competitor, a banker stated to an analyst that “[the firm] should aggressively link coverage with banking.”\footnote{\textit{Id.} (citing Merrill Lynch document 05229-30 submitted to the Attorney General's office during their investigation).}

Even Mr. Blodget’s time as the head of internet research was devoted primarily to banking activities and secondarily to research.\footnote{\textit{Id.} (citing Merrill Lynch document 34660-61 which states that Blodgett’s work schedule was devoted to “85% banking, 15% research” in a week).} However, the pressure on the analysts from the investment bankers to curry favor from current and future clients with favorable research began to take its toll.\footnote{\textit{Id.} at 19, 20.} In an e-mail, a seemingly frustrated Blodget wrote that his research team would “just start calling the stocks . . . like we see them, no matter what the ancillary business consequences [would be],” thus admitting that their research coverage was not objective, but colored by investment banking concerns.\footnote{\textit{Id.} at 19, 20.}

2. Salomon Smith Barney

Allegedly much of the same was occurring within the research department of one of Merrill Lynch’s competitors, Salomon Smith Barney, a Citigroup subsidiary.\footnote{\textit{See Gasparino, Spitzer Gathers Emails, \textit{supra} note 6.}} Salomon Smith Barney’s lead analyst under investigation by the New York Attorney General was Jack Grubman.\footnote{\textit{Id.}} “At issue for Mr. Grubman is his dual role helping Salomon Smith Barney win lucrative securities business from the nation’s top telecom outfits while he was recommending investors snap up shares of these companies in his role as the firm’s top-rated telecom analyst.”\footnote{\textit{Id.}}
One key difference between Mr. Blodget and Mr. Grubman is that Mr. Grubman apparently never tried to hide this dual role of providing stock analysis and attracting investment banking clients. Nevertheless, New York Attorney General Spitzer believes he can show, through uncovered e-mails, that Mr. Grubman's intimate ties with investment banking improperly influenced his ratings of companies.

Salomon Smith Barney has paid the NASD $5 million to settle charges that Mr. Grubman and another analyst, Christine Gochuico, "materially misled" investors by officially touting the stock of Winstar Communications Inc., while privately questioning its value and prospects. Notably though, Mr. Grubman personally fought those NASD charges. He argued that his original research reports contained his honest beliefs about Winstar. When Winstar's prospects changed, he attempted to downgrade his rating of Winstar in April 2001, but was prevented from doing so by Salomon's legal department. But, in another research call about AT&T, several memos between CEO Sandy Weill and Grubman have surfaced which indicate that Grubman may have changed his rating to help Weill insure control of Citigroup in exchange for Weill helping Grubman get his kids into a prestigious preschool program. Mr. Grubman's issues appear to be moot, as he has agreed to pay a fine of $15 million and be barred from the securities industry for life.

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40. Id.
41. Id.
42. Gasparino, Salomon Settles Case, supra note 14 (referring to the NASD complaint against Salomon).
43. Id.
44. Id.
45. Id. The NASD charges that the investment banking relationship prevented the issuance of the new report. Mr. Grubman, though, has indicated that he is willing to talk to investigators about the pressures he felt from investment bankers to help win clients and deals. Id.
The extensive facts collected by the New York Attorney General tending to show serious conflicts of interest between bankers and analysts forced Merrill Lynch to enter into a settlement with all fifty states in May. In an early attempt to restore investor confidence and avoid extended litigation, Salomon Smith Barney’s chief executive announced that his firm would voluntarily adopt the reforms mandated in the Merrill Lynch settlement and in October took a further step by splitting its research and brokerage houses from investment banking.

B. Analysis of New Regulations

1. Merrill Lynch Settlement (MLS) and New SRO Regulations

Broadly, the multi-state MLS and the new SRO regulations are intended to provide disclosure of potential investment banking conflicts and to relieve pressure placed on analysts by the demands of investment banking. The MLS was dependent upon the assent of all other states involved in the investigations and was binding only on Merrill Lynch.

i. Original SRO Rules

Under the SRO rules (prior to amendment and after), disclosure of conflicts of interest must be made when a member firm recommends the purchase or sale of a security. The rules require the member firm to disclose if it makes a market in the

48. See Gasparino, Merrill Will Pay Fine, supra note 2; see also text accompanying note 10.
49. Schroeder, supra note 26. Mr. Spitzer’s reaction to this news was to confirm his ongoing investigation into Salomon Smith Barney’s practices. Id. Paul Beckett, Outsider Aims to Restore Citigroup’s Luster: Bank Moves to Reduce Its Regulatory Woes, Separates Operations, WALL ST. J., Oct. 31, 2002, at C1. Citigroup named Sallie Krawcheck, CEO of Sandford C. Bernstein, as head of the new brokerage-research house to be named Smith Barney. Id.
50. See Merrill Lynch Settlement, supra note 10; SEC Research Conflicts, 67 Fed. Reg. at 34,969. The rules primarily affect NYSE Rule 472 and create NASD Rule 2711. See id. at 34,968 n. 3.
52. SEC Research Conflicts, 67 Fed. Reg. at 34,969.
recommended security, if it has managed or co-managed a public offering of the security issuer within the last three years, and if it has a general financial interest in the recommended security.\textsuperscript{53}

ii. New Disclosure Requirements

The MLS and the new SRO rules mandate the disclosure on all equity research reports issued by the researcher's firm of any investment banking compensation received in the past twelve months or any compensation they are entitled to receive from covered companies.\textsuperscript{54} The MLS also requires research reports to state whether or not Merrill Lynch is or will be seeking investment banking compensation from a company it covers in its reports.\textsuperscript{55}

The SRO rules go a little further by requiring disclosure in research reports of any research analyst compensation received from general investment banking revenue, and after any recommendation of a stock in a public appearance whether or not the issuer of the stock recommended is an investment banking client of the firm.\textsuperscript{56} The SRO rules also require that research analysts disclose in public appearances any ownership of stocks by the firm and/or the analyst.\textsuperscript{57} If the proposed amendments are adopted, the definition of public appearance would include "print media interview[s]... or the writing of a newspaper article or other type of public written medium in which [a research analyst] makes a recommendation" concerning an equity security.\textsuperscript{58}

Further, the SRO rules require firms to provide investors with a better understanding of the objectivity and analytical rigor of a firm's research method in their research reports by defining the meaning of ratings used and providing that the definitions be

\textsuperscript{53} Id.

\textsuperscript{54} See Merrill Lynch Settlement, \textit{supra} note 10, at 3; SEC Research Conflicts, 67 Fed. Reg. at 34,969. The SRO rules would require additional disclosure when the research company managed or co-managed a public offering of a covered company or expects to receive investment banking compensation from a covered company in the next three months. \textit{Id}.

\textsuperscript{55} See Merrill Lynch Settlement, \textit{supra} note 10, at 3.

\textsuperscript{56} SEC Research Conflicts, 67 Fed. Reg. at 34,969.

\textsuperscript{57} \textit{Id}. at 34,970.

\textsuperscript{58} SRO Proposals, 68 Fed. Reg. at 830-31. The already approved rules include television appearances in their definitions of public appearance. \textit{Id}.
consistent with the word’s plain meaning. Additionally, firms must provide the percentage of all ratings assigned to their equivalents of Buy/Hold/Sell categories. Finally, they will be required to provide a price chart, which maps historical price movements of securities and “indicates those points at which ratings or price targets were assigned or changed.” Under Merrill Lynch’s settlement terms, it must also provide the percentages for all stock recommendations it gives, including a separate analysis of recommendations for its investment banking clients’ stocks.

Besides the administrative expense of compliance, none of these provisions appear to be very onerous. The primary concern involves disclosures about future investment banking transactions, since such disclosures may harm future negotiations, alter competitive advantages between investment banks, and provide fodder for investor speculation.

iii. Compensation Factors

The MLS and the SRO regulations also affect analyst compensation. The MLS requires that the evaluation and determination of analysts’ compensation be completely separate from investment banking considerations. The new SRO rules also provide that a research analyst’s salary may not be tied to.

60. Id. Firms generally have a low percentage of sell ratings no matter what the market is doing. See e.g., Dinallo Affidavit, supra note 27, at 9.
61. SEC Research Conflicts, 67 Fed. Reg. at 34,970. This is in response to the perception that reductions in ratings occur long after the market has declined. See Dinallo Affidavit, supra note 27, at 10; see also SRO Proposals, 68 Fed. Reg. at 828, 832 (proposing amendments that would require a firm to disclose when it discontinues coverage of a company).
63. See SEC Research Conflicts, 67 Fed. Reg. at 34,972-73 (mentioning concerns by industry commentators on the rules that disclosure of investment banking relations may “signal” or “tip” the public investor about non-public transactions).
65. Merrill Lynch Settlement, supra note 10, at 5.
specific investment banking transactions. Thus, there should be no correlation between a research analyst's compensation and the amount of investment banking compensation received from the companies covered by the analyst. Under the MLS, the extent to which a research analyst participates in investment banking transactions, such as solicitations, will not be a factor in determining analyst compensation.

The MLS and the proposed amendments to the SRO rules provide the factors that may be considered in computing analyst compensation. In general, analyst compensation may be tied to those services benefiting their investor clients. This means that compensation may be based on the quality of research and performance of investment recommendations. Additionally, the proposed SRO amendments would require analysts' work performance and compensation to be reviewed by a compensation committee that does not include representatives of the firm's investment banking side.

Changes affecting compensation may be the key element in the MLS and the new SRO regulations. Removing the incentive for analysts to generate investment banking revenues significantly reduces the incentive for analysts to provide overly optimistic research reports. Further, the factors that are to be considered when deciding compensation for analysts are proper. The compensation scheme puts the analysts' interests in line with the interests of the investors that rely on their recommendations. However, given that research does not pay for itself, investment

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68. Merrill Lynch Settlement, supra note 10, at 6. If the SRO amendments are approved, the compensation of a research analyst may not reflect his or her contribution to investment banking revenue. SRO Proposals, 68 Fed. Reg. at 828, 832.
70. Merrill Lynch Settlement, supra note 10, at 5; see also SRO Proposals, 68 Fed. Reg. at 828, 832.
banking revenues must be used in some form to pay for the cost of research, including analyst compensation.\textsuperscript{73} Unless analysts have no idea for whom their bankers are working, the potential conflicts of interest seem inevitable. Yet, if compensation is rewarded based on analyst research performance, then even if the money comes from general investment banking revenue, the analyst should not get paid unless he first does a good job at picking stocks.

iv. Restrictions

A major area affected by the MLS terms and the SRO regulations is communication and interaction between investment banking departments and research departments.\textsuperscript{74} The new regulations stipulate that a firm’s investment banking department may not supervise any research analysts.\textsuperscript{75} There is to be no discussion of pending research between researchers and bankers unless the communication is intermediated by someone from the legal or compliance staff.\textsuperscript{76} Finally, there is to be no review of research reports by a company covered in the report for anything other than the accuracy of facts.\textsuperscript{77}

The MLS imposes new restrictions on research analyst participation in the solicitation of investment banking business.\textsuperscript{78} Research management must approve participation by an analyst.\textsuperscript{79} The SRO’s proposed amendments would go further by prohibiting an analyst from issuing a report on a company that the analyst communicated with in an attempt to generate investment banking business.\textsuperscript{80} Under both the settlement and the approved SRO rules, a research analyst or the firm he or she works for may not offer favorable research as an inducement or as consideration for

\textsuperscript{73} See Malkiel, supra note 18.
\textsuperscript{74} See Merrill Lynch Settlement, supra note 10, at 8-9; SEC Research Conflicts, 67 Fed. Reg. at 34,969.
\textsuperscript{75} SEC Research Conflicts, 67 Fed. Reg. at 34,969.
\textsuperscript{76} Id.
\textsuperscript{77} Id.
\textsuperscript{78} See Merrill Lynch Settlement, supra note 10, at 8-9.
\textsuperscript{79} Id. at 8.
\textsuperscript{80} See SRO Proposals, 68 Fed. Reg. at 827, 832.
the receipt of investment banking business or compensation. And, at least in the MLS, an analyst may not change the recommendation of a company because of the company's decision not to hire Merrill Lynch for investment banking services.

Under the new SRO rules, "quiet periods" will be instituted during which a firm acting as a manager or co-manager of an initial offering cannot issue a report "within 40 days after an initial public offering . . . or within 10 days after a secondary offering of an inactively traded security." Under the proposed amendments, the restrictions during the "quiet period" would extend to public appearances by research analysts.

Significantly, the new rules have placed new restrictions on analysts' personal trading capabilities. A research analyst governed by SRO regulations "may [not] purchase or receive an issuer's securities prior to its IPO, if the company engages in a type of business covered by the analyst." No research analyst may trade stock issued "by companies the analyst follows for the period beginning 30 days prior to issuance of the research report and ending five days after the date of report." Finally, a research analyst "may not engage in trading contrary to the analyst's most recent recommendation."

Some of these new restrictions may be unnecessary. One service an analyst can certainly provide to his banker colleagues is the identification of potential clients. Monitoring all

82. Merrill Lynch Settlement, supra note 10, at 9.
83. SEC Research Conflicts, 67 Fed. Reg. at 34,969.
84. SRO Proposals, 68 Fed. Reg. at 827-28, 832. Also, the SRO amendments would prohibit a public appearance or the release of a research report concerning a company by an investment banking firm for which the firm has acted as a manager or co-manager of a stock offering within fifteen days prior to or after the expiration of a lock-up agreement that the firm has entered into with the company covered in a report or public appearance. Id. at 828, 832.
86. Id.
87. Id.
88. Id.
89. Cf. Charles Gasparino & Randall Smith, Citigroup Offers Separate Research Arm in Settlement Bid, WALL ST. J., Sept. 30, 2002, at C1 (claiming that even with a splitting of Citigroup's research arm from investment banking, the investment banking department will most likely employ its own analysts who will not be able to
communications between bankers and analysts could be quite burdensome and inefficient. The disclosure requirements already put forward would seem to take care of any problems that discussions between analysts and bankers could create. Disclosure that a relationship exists between a company and the firm that is analyzing its stock should be a sufficient caveat to investors.

Rules restricting stock trades and the timing of report issuances also seem excessive. It is likely that the firm(s) who manage or co-manage an offering have access to the best information by which to evaluate a stock, and to deprive the market of that information in the form of a “quiet period” only further harms investors who then trade on imperfect or incomplete information. Restricting analysts’ trades so that they comply with their own recommendations will impose high monitoring costs and will not truly further the goal for which they were written. Market conditions change constantly, and once an analyst issues a report, the report may become instantly dated. Perhaps a less costly and less restrictive solution would be to simply require disclosure of analyst trades that run counter to their most recent recommendations. An investor can weigh this information with all the other market information available when making investment decisions.

v. Compliance

Maybe the most burdensome obligation the settlement imposes on Merrill Lynch, which is absent from the SRO rules, is the duty to create an in-house research recommendation committee (RRC). The RRC will monitor the performance of recommendations and analyze them “for objectivity, integrity, and a rigorous analytical framework.” Also under the MLS, any recommendation changes must be approved or ratified by the
Applications to change a recommendation must be accompanied by disclosures of any participation by the research analyst in an investment banking transaction with the subject company within the last twelve months. Any intention to participate in investment banking solicitations must be disclosed to the RRC, and, as stated previously, participation in investment banking business in the last twelve months must be disclosed. Furthermore, the RRC is responsible for setting up a system to monitor electronic communications between investment bankers and analysts. Finally, Merrill Lynch must designate a compliance monitor whose job will be to ensure it is complying with the settlement.

Requiring the creation of the RRC seems redundant. The RRC only checks to make sure the firm is complying with the settlement. Is there any doubt that Merrill Lynch would have set up monitors on their own without the requirement that a separate committee be created for oversight? Therefore, any added expense would not be attributable to additional monitoring costs, but to the creation and maintenance of a separate compliance vehicle.

vi. SEC Regulation AC

On top of the SRO rules, the SEC has proposed Regulation AC - Analyst Certification. In general, Regulation AC would require a broker or dealer to include in any research report prepared by an analyst a prominent statement by the analyst attesting that the views expressed in the report accurately reflect the analyst’s personal views about the security or issuers, and that

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93. Id. at 8.
94. Id.
95. Id.
96. Merrill Lynch Settlement, supra note 10, at 8.
97. See id. at 10-11.
the analyst’s compensation is not related to the specific recommendation in the report. In the alternative, the analyst may state that part of his compensation is related to a specific recommendation. He or she must then identify the source and amount of compensation and state that the compensation may influence his recommendation. Furthermore, a broker or dealer must make the same verifications within thirty days after the calendar quarter of any public appearances by the analyst in which the analyst expressed his views regarding securities.

The purpose of this new regulation, like the new SRO rules, is to promote the integrity of research reports and restore investor confidence. Regulation AC provides an additional disclosure requirement beyond those required by the SROs and the MLS. The effect of this regulation will be to make identification of fraudulent reports with specific analysts easier. This will help lower the investigative burden when pursuing fraud claims against broker-dealers or analysts. However, given the SRO rules already proposed and approved, the effect of this extra certification is to increase firms’ compliance costs. One can argue that the disclosure requirements and prohibitions imposed by the SRO rules have the same effect of lowering the investigative burden by simply requiring analysts to sign their research reports. In essence, instead of making a separate certification and filing with the SEC, the analyst would sign his or her report, and the signature would serve as certification that the

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100. Id. at 51,511.
101. Id.
102. Id.
104. SEC Regulation AC, supra note 98. In fact, the SEC’s Regulation AC not only adds a further disclosure requirement for research reports on equity securities, but also requires certification of research reports covering debt securities. Id. at 51,512.
105. See Solomon, supra note 98.
106. Id.
107. But see SEC Regulation AC, supra note 98, at 51,513-515 (stating that the “costs should not be significant,” and estimating those costs to “result in a total annual time burden of approximately 11,296 hours . . . and a total annual cost in dollars of approximately $1,372,464 . . . [so as to comply with Regulation AC]”).
report was an honest reflection of his or her personal views. If any allegations of fraud arose in connection with a report, the SEC could simply turn to the research report itself to find the analyst, and use the signature as proof that the analyst was attesting to the veracity of his or her views expressed in the report.

2. Wall Street Global Pact

The Global Pact (GP) is a preliminary agreement between regulators and at least ten Wall Street firms requiring the firms to pay a total of $900 million in retrospective relief to investors, $450 million to fund independent securities research, and $85 million for investor education. The regulators and firms have not entered into a final settlement, but agreement has been reached on several major provisions that will alter the structure of the investment banking industry.

The first major provision will sever research analysts from investment banking pressures. This will likely look very similar to the already adopted SRO rules, as well as the MLS terms. A few provisions seem to be new or stricter than terms in the MLS and SRO regulations. For example, the GP will include an outright ban on analysts attending sales pitches for investment banking deals and Wall Street road shows where potential clients make pitches to big investors. Moreover, the agreement will


109. See Smith, Regulators Set Accord, supra note 15. Details of the settlement will be released in January 2003 at the earliest, and may eventually serve as an industry wide model. Id.

110. SEC Global Pact, supra note 108.


112. Smith, Regulators Set Accord, supra note 15. Research analysts’ attendance at these pitches would also be prohibited by the proposed SRO amendments. SRO Proposals, 68 Fed. Reg. at 827, 832-33, 835. However, due diligence communications would not be prohibited whereby the analysts are merely communicating to “analyze the financial condition and business operations of the subject company.” Id.
require firms’ research groups to be physically separated from their investment banking departments, with their own legal and compliance departments that do not report to investment banking. However, upon request, analysts will be allowed to give their opinions to investment bankers about potential transactions, in a process called vetting.

Significantly, the research houses will have to buy independent research from independent researchers, which will be made available to the firms’ investor clients. Regulators will appoint a monitor for each brokerage house who will be responsible for buying the independent research. The monitor will have to choose at least three independent research firms to contract with. The $450 million paid by the parties to the GP will pay for this system, at least for the next five years. What will happen after five years is uncertain.

Also, the GP requires the brokerage houses to disclose analyst recommendations in order to allow the public to evaluate and compare the performance of analysts. This disclosure will include analysts’ ratings and price target forecasts. And, as noted above, the GP completely bans the practice of spinning.

Analysis of the GP before it is finalized is guesswork. However, it is fair to say that the major provisions agreed to and made public so far will impose significant structural change to the way investment banking is done on Wall Street. Though the overall goal of ensuring objective analysis is laudable, it is far from clear that the goal will be achieved. As predicted, private claims have been filed against these Wall Street firms, and any relief their

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113. *Id.*
114. *Id.*
116. *Id.*
117. *Id.*
118. *Id.*
119. *Id.*
120. SEC Global Pact *supra* note 108.
121. *Id*; see also *supra* text accompanying note 17.
embattled stocks felt upon the announcement of the GP may be short-lived.\textsuperscript{122}

\section*{C. Prior Regulation}

The creation of new laws and rules raises the inference that the old laws were inadequate. However, recent legal action taken by New York’s Attorney General Eliot Spitzer and the NASD against Wall Street firms indicates the contrary; the old laws are adequate tools to punish the alleged wrongdoings of the securities industry.\textsuperscript{123}

1. New York’s Martin Act

In taking action against Merrill Lynch, Eliot Spitzer employed New York’s Martin Act.\textsuperscript{124} New York’s Martin Act is considered the most stringent securities law in the nation, tougher even than the federal regulation.\textsuperscript{125} Under the statute, prosecutors “do not even have to show scienter, or that perpetrators willfully or knowingly did something illegal, as required under federal law. . . . [a]ll they need to show is that the defendant committed an intentional act constituting fraud.”\textsuperscript{126}

New York case law states that the Martin Act is a remedial statute rather than just a criminal statute and should, therefore, be liberally applied.\textsuperscript{127} To that end, words like fraud have been given a broad meaning that include all acts, even those that do not originate from an evil design to perpetuate a fraud or injury on


\textsuperscript{125} See \textit{State v. Rachmani Corp.}, 525 N.E.2d 704, 708 (N.Y. 1988).

another, which by their nature deceive or mislead the purchasing public and which come within the purpose of the Martin Act.\textsuperscript{128} So far, this has been enough for Eliot Spitzer's purposes to attack what he considers fraudulent practices occurring in the New York securities industry.\textsuperscript{129} The quick Merrill Lynch settlement and the yet-to-be defined Global Pact shows the effectiveness of this law.\textsuperscript{130}

2. NASD Conduct Rules 2110 and 2120

Moreover, the necessity of new rules, at least for NASD members, seems hard to understand in light of the recent settlement the NASD reached with Salomon Smith Barney regarding Winstar's stock.\textsuperscript{131} Salomon paid a fine based on charges that its analyst, Jack Grubman, made misleading statements and omissions regarding Winstar stock, which had the effect of violating just and equitable principles of trade.\textsuperscript{132} The NASD apparently did not proceed against Salomon for violations of NASD Conduct Rule 2210 governing communications with the public, but instead charged Salomon with violations of Rule 2110, which sets forth the standards of commercial honor and principles of trade.\textsuperscript{133}

Rule 2110 is a general proscription against inequitable practices.\textsuperscript{134} It states that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and

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\begin{footnotesize}
\begin{enumerate}
\item[128.] People v. Federated Radio Corp., 154 N.E. 655, 657 (N.Y. 1926). The purpose of the Martin Act is to prevent all kinds of fraud in connection with the sale or purchase of securities and to defeat schemes that fraudulently exploit the public. \textit{Id.}
\item[129.] Gasparino, \textit{Merrill Will Pay Fine}, supra note 2.
\item[130.] \textit{Id.} Merrill Lynch did not admit wrongdoing as part of the settlement, but still felt compelled to acquiesce to the New York Attorney General's demands. \textit{Id. See also} Gasparino, \textit{Stock-Research Pact}, supra note 47 (noting that the SEC's Harvey Pitt may have initially backed off investigations, only to reopen them in an attempt to protect the SEC's turf from encroachment by New York's Martin Act, thereby underscoring the laws pervasive reach).
\item[134.] Conduct Rule 2110, NASD Manual, supra note 133, at 4111.
\end{enumerate}
\end{footnotesize}
just and equitable principles of trade."\(^{135}\) Moreover, NASD Rule 2120 states that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."\(^{136}\) Reading these two rules together, a strong case could be made that research reports and recommendations that were overly optimistic without any basis in objectivity or even in flat contradiction to objective realities were fraudulent and deceptive. The NASD would likely argue that the reports and recommendations were in fact sales pitches intended to induce clients and the investing public to purchase the securities of member firms' investment banking clients. Therefore, member firms' actions violated Rule 2120 expressly, and did not comport to the "high standards of commercial honor and just and equitable principles of trade."\(^{137}\) Salomon did not admit to wrongdoing when it agreed to settle for $5 million, but a settlement was worth that much to Salomon to keep the NASD from finding any potential rule violation.\(^{138}\)

3. SEC Rule 10(b)-5

At the federal level, sections 9 and 10 of the Securities and Exchange Act of 1934 (SEA) attempt to prohibit manipulation of securities.\(^{139}\) SEA section 10(b) provides that it is illegal for one to use, in connection with the purchase and/or sale of securities, any manipulative or deceptive device in contravention of rules or regulations that the SEC may issue for the public interest or investor protection.\(^{140}\) This is a broad rule, but it applies only to those manipulations that are in violation of a rule already promulgated.\(^{141}\) Yet, Rule 10(b)-5 appears to apply to the present

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135. Id.
141. Id.
activities under consideration by the NASD and SEC. Significantly, it states that

[i]t shall be unlawful for any person... (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made... not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

There are several distinct elements that must be present to find a violation of 10(b)-5. For the situations discussed in this Note, the device employed would be the research reports distributed by the firms of the research analysts and/or any other communications made by them via e-mail, radio, or television. One would first have to show that the act in question met the materiality threshold. Were there misstatements or omissions of material facts such that “the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder... [or would have] significantly altered the ‘total mix’ of information made available[?]” One could certainly argue that a failure to disclose the nature of the research analyst’s relationship to a covered company could be an omission of a material fact. For instance, if a research analyst himself or his

144. HAZEN, supra note 139 at § 12.4.
146. TSC Industries, Inc., 426 U.S. at 449.
147. See Gasparino, Salomon Settles Case, supra note 14. The action against
firm has a substantial financial interest in a company, an investor who was not given notice of this relationship would have every reason to believe that the stock recommendation was objective. Also, for an analyst to omit the fact that he or she thinks a stock is worthless, and then maintain a buy rating for retail investors to employ when considering their own purchases and sales, would appear to significantly factor into the "total mix" of information available. The purpose of speaking out of both sides of your mouth is to produce positive stock demand, pushing up the price. As a reward for providing positive research, the analyst's firm is awarded further investment banking fees from the positively covered company. The deception or fraud lies in the non-disclosure of these relationships.

In *Blue Chip Stamps v. Manor Drug Stores*, the Supreme Court held that the plaintiff class for private actions under Rule 10b-5 was limited to actual purchasers and sellers of securities. Furthermore, for actions by the SEC under 10b-5, the "in connection with" requirement is met even when the underlying act is not the manipulation of securities but the stealing of assets. Under these standards, there is no question that the actions of the research analysts would be in connection with the purchase or sale of securities. The research reports were intended for investors to use in making decisions to purchase or sell securities.

Proving scienter would be the most highly contested element of potential 10b-5 violations. In *Ernst & Ernst v.*

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148. *TSC Industries, Inc.*, 426 U.S. at 449. See also supra text accompanying notes 28-29.
149. *Accord Craig, Wall Street Braces*, supra note 122 (indicating that plaintiff's attorneys will not argue investors were hurt by poor stock recommendations, but instead were harmed because the firms did not disclose to investors that their analysts were attempting to win investment banking fees with their research reports).
150. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) Plaintiff alleged that he did not purchase securities because materially misleading statements in the company's offering material were designed to discourage purchases. *Id.*
151. *Id.* at 730-31.
152. SEC v. Zanford, 535 U.S. 813 (2002). Defendant broker misappropriated to himself a client's assets, using an account over which the broker had investment control. *Id.*
Hochfelder, the Supreme Court found that in a private cause of action there must be a "knowing and intentional misconduct" to find a violation of 10b-5. In Aaron v. SEC, the Supreme Court further found that the same scienter requirement imposed on private actions is also necessary to find a violation of 10(b)-5 in actions for injunctive relief brought by the SEC.

Any move against the Wall Street firms would require proof of intentional misconduct that would tend to deceive investors. With pressure from the investment bankers, the analysts intended to provide positive research on firms. They meant for positive research to fall on investors' ears, who would then buy the stock and push stock prices up. If that happened, then the accuracy of their reports did not matter because they had satisfied their investment banking clients, and consequently their own firm, with positive stock movement. The admissions in e-mails sent by Henry Blodget and Jack Grubman evince an understanding of what they were doing. They knew they were being pressured into recommendations that had no basis in reality, and they knew the potential effects their recommendations could have on the stock market. They may have expressed some misgivings about providing optimistic reports, but they did it anyway. One could certainly argue that this adds up to knowing and intentional misconduct, satisfying the scienter requirement of

153. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The Court found that the accounting firm of Ernst & Ernst, though possibly negligent, did not act with an intent to deceive shareholders as auditors for First Securities (a firm running a fraudulent scam), and therefore could not be held liable for a violation of rule 10b-5. Id.
154. Id., at 197-99.
155. Aaron v. SEC, 446 U.S. 680 (1980). Defendant had been informed of fraudulent activities engaged in by some of his employees, but he failed to take any action against them. Id. The SEC filed actions to enjoin him from the sale of securities in the future. Id.
156. Aaron, 446 U.S. at 690-91.
157. See Ernst & Ernst, 425 U.S. at 197-99; Aaron, 446 U.S. at 690-91.
158. See Dinallo Affidavit supra note 27, at 19, 20; Gasparino, Spitzer Gathers Emails, supra note 6. However, Jack Grubman still maintains that he truly believed in the telecom industry and has not backed down from that view. Id. Therefore, proving scienter in his case may be more difficult. Id.
159. See also supra text accompanying notes 28, 29, and 39.
160. See Dinallo Affidavit supra note 27, at 19, 20; Gasparino, Spitzer Gathers Emails, supra note 6.
10b-5. With their stock recommendations, analysts intended to deceive investors into buying questionable securities.

Next, a successful action against these analysts would require proof of the deception. In *Santa Fe Industries v. Green*, the Supreme Court said that an allegation of fraud under Rule 10b-5 required an element of deception or concealment of material information. This element was found lacking in that case because the plaintiffs were given all the relevant information to make a decision regarding their shares in Santa Fe. Nondisclosure and deception are present, however, in the research reports issued by many Wall Street firms. As revealed in the current investigations, analysts sometimes intentionally withhold their true feelings about a stock, particularly when their personal opinion is at odds with their firm's investment banking interests.

4. Securities Act of 1933 Section 17

In the 1933 Securities Act, section 17(a) provides a general proscription against fraud during the offer or sale of a new security that looks almost identical to the language in section 10 of the 1934 Securities and Exchange Act. Specifically, section 17(b) prohibits a person from describing a stock, for instance, through a recommendation, "for consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof." Analysts would argue they receive no consideration for covering stocks, but empirical evidence may suggest otherwise, even if the consideration is indirect. If section 17(b) were read to cover the relationship between investment banking and research, another

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162. *Santa Fe Indus.*, 430 U.S. at 474-76.
163. *Santa Fe Indus.*, 430 U.S. at 474-76.
164. Cf. SEC Research Conflicts, 67 Fed. Reg. at 34,969 (a main purpose of the new regulations is to increase disclosure).
166. Id. at 77q(b).
federal law, effective since the genesis of federal securities regulation, would prohibit much that is dealt with in the MLS and the SRO rules.

Why then has the SEC failed to proceed against these firms under rule 10b-5 or section 17 of the Securities Act of 1933? The answer remains unclear. The facts available to them seem to be sufficient to prove violations of Rule 10b-5. Instead, the SEC has promulgated new regulations and will impose substantial structural changes to the securities industry through the new rules. Providing stricter rules may indeed have the effect of restoring investor confidence, but enforcement of the present rules could do the same.

II. IPO ALLOCATION CONFLICTS OF INTEREST

A. Recent Practices

The IPO allocation investigation is an extension of the investigation into research conflicts. The allegation by the regulatory and enforcement agencies is that investment banks allocated hot IPOs, which in the bubble years were almost guaranteed to reap instant profits, to officers and directors of their client companies in exchange for their continued investment banking relationships. The banks profited through the continued fees they received, and in return the officers and directors of their clients reaped huge personal gains.


168. See also Letter from Joseph S. Borg, President, North American Securities Administration Association, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (September 23, 2002), at http://www.sec.gov/rules/proposed/s73002/jborg1.htm (last visited Feb. 15, 2003). President Borg criticizes the new Regulation AC as implying that under pre-Regulation AC standards analysts were subject to a lesser standard of truthfulness. He fears the creation of new standard instead of the clarification of the old standard. Id.

169. See also supra text accompanying notes 8-9.

170. See also supra text accompanying notes 8-9.

171. See Smith & Pulliam, Buddy System, supra note 8; Smith & Pulliam, Star
executives received the shares at low prices and then sold at high prices to investors who, because they were sometimes misled by the overly optimistic research reports, created high demand, which caused stock prices to soar. By the time the small investor realized the company had little prospect for future profitability, he or she had paid dearly for a stock that, in most instances, had nowhere to go but down.

1. Salomon Smith Barney

The initial query into IPO allocation practices came from two members of the House Financial Services Committee, Pennsylvania Democrat Paul Kanjorski and Connecticut Republican Christopher Shays, after hearing testimony from Jack Grubman on July 8, 2002 regarding the tremendous earnings overstatements made by WorldCom. Specifically, they wanted to know who at WorldCom was allocated IPO shares by Salomon Smith Barney’s brokerage house over recent years. The concern grew out of both Salomon’s role as WorldCom’s lead investment banker and Mr. Grubman’s continued support of the stock during its rapid decline. WorldCom’s CEO Bernard Ebbers and others profited substantially from allocations of IPOs to their accounts. Mr. Ebbers made $11 million over a four-year period trading IPOs. A cursory look at the situation seems to indicate that there was a quid pro quo involved. WorldCom would use Salomon Smith Barney for investment banking services in exchange for allocations

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172. See Smith & Pulliam, Buddy System, supra note 8; Smith & Pulliam, Star Banker, supra note 9.
173. Gasparino, Craig & Smith supra note 7. For instance, Rhythms NetConnections’ stock rose 229% on its first day of trading in 1999, peaking at 431% above its initial price a week later, but quickly ran into financial trouble when the tech-stock bubble burst and has since filed for bankruptcy. Id.
174. Id.
175. Id.
176. Id.
178. Id.
of hot IPOs, benefiting WorldCom directors and officers, as well as Salomon.\textsuperscript{179} To date, the New York Attorney General has only instituted an action against the executives that benefited from the Salomon allocations.\textsuperscript{180} No action has yet been instituted against Salomon for its role in this potentially illegal activity.\textsuperscript{181}

2. Credit Suisse First Boston

Credit Suisse First Boston (CSFB), an arm of the Credit Suisse Group, had already settled a lawsuit regarding some of its IPO practices when a further investigation was launched.\textsuperscript{182} In January 2002, CSFB paid $100 million to settle SEC and NASD charges for “improperly shar[ing] IPO profits with [hedge-fund] trading customers.”\textsuperscript{183} The hedge funds were profiting by quickly selling (“flipping”) newly offered stock and sharing the profits with CSFB in the form of high brokerage commissions for the allocation of the IPO shares.\textsuperscript{184}

The investigations focused on the activities of one of CSFB’s top technology investment bankers, Frank Quattrone.\textsuperscript{185} Allegedly, brokers who worked with Mr. Quattrone oversaw accounts for his investment banking clients.\textsuperscript{186} Generally, a client could open what were known as “Friends of Frank” accounts after they had selected CSFB to underwrite their company’s stock offerings or conduct banking transactions.\textsuperscript{187} Several released e-mails indicate that Mr. Quattrone sought higher percentages of

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\textsuperscript{179} Gasparino, Craig, & Smith \textit{supra} note 7.
\textsuperscript{181} \textit{See id.}
\textsuperscript{182} Smith & Pulliam, \textit{Star Banker, supra} note 9.
\textsuperscript{183} \textit{Id.}
\textsuperscript{184} Randall Smith & Susan Pulliam, \textit{IPO ‘Rogue’ Battles to Clear His Name}, \textit{WALL ST. J.}, September 17, 2002, at C1 [hereinafter Smith & Pulliam, \textit{IPO ‘Rogue’ Battles}]. Flipping is the selling of securities almost immediately after being allocated the shares at the initial public offering. The NASD and SEC noted that the brokers, in some instances, charged commissions of 65% as pay back for IPO profits. \textit{Id.}
\textsuperscript{185} Smith & Pulliam, \textit{Star Banker, supra} note 9.
\textsuperscript{186} \textit{Id.}
\textsuperscript{187} \textit{Id.}
IPOs for the brokers working with his investment banking clients.\(^\text{188}\)

Currently, no smoking gun has been found that indicates the CSFB IPO allocations were done in exchange for further investment banking business.\(^\text{189}\) In 1997, Mr. Quattrone publicly derided the practice of spinning IPOs to client executives in return for investment banking business.\(^\text{190}\) Thus far, CSFB’s response to this allegation is that the “Friends of Frank” accounts were offered to officers and directors of companies who were already investment banking clients, not as an inducement to start an investment banking relationship.\(^\text{191}\) Also, at least some of the individual clients state that they did not feel the accounts and IPO allocations were a kickback for banking business.\(^\text{192}\) Furthermore, allocations among the accounts were apparently distributed uniformly, not in proportion to investment banking business.\(^\text{193}\)

3. Goldman Sachs

Finally, congressional investigators contend that Goldman Sachs participated in the practice of spinning hot IPO stocks to corporate executives in exchange for investment banking business.\(^\text{194}\) IPOs were distributed to the personal accounts of executives from Goldman investment banking clients such as Yahoo, eBay, WorldCom, Enron, eToys, and Global Crossing.\(^\text{195}\) In all, executives from twenty-one companies with investment

\(^{188}\) Id.

\(^{189}\) Id. But see Charles Gasparino, Key Player in the Tech-Stock Boom, Frank Quattrone, Faces NASD Action, WALL ST. J., Jan. 31, 2003, at C1 (Mr. Quattrone has been served by the NASD with a Wells notice, charging him with improper ‘spinning’ and failing to supervise CSFB’s technology-stock analysts. The Wells notice gives Mr. Quattrone a chance to rebut the allegations before the NASD decides to take action).

\(^{190}\) Smith & Pulliam, Star Banker, supra note 9. Mr. Quattrone spoke out against spinning IPOs in a Wall Street Journal article covering the topic in 1997. Id.

\(^{191}\) Id.

\(^{192}\) Smith & Pulliam, Buddy System, supra note 8.

\(^{193}\) See Smith & Pulliam, Star Banker, supra note 9.


\(^{195}\) Id.
banking relationships with Goldman received IPO shares in their personal accounts.\(^{196}\) Goldman responded to the investigation by asserting that there was no preferential treatment given to the corporate executives over other clients, and noting that unlike practices at other firms where IPOs were automatically allocated to certain accounts, their clients had to place orders to get IPOs.\(^{197}\)

**B. Recent Regulation Proposals**

1. NASD Rule 2710 Proposed Amendment and Proposed Rule 2712

In its Notice to Members 02-55, the NASD has enumerated certain activities that it thinks should subject a firm to disciplinary actions by the NASD.\(^{198}\) New Rule 2712 would first prohibit members from allocating IPOs as consideration for excessive compensation for other services provided by the member.\(^{199}\) This seems intended to prohibit investment banks from sharing in IPO profits by charging excessive commissions to the brokerage houses who receive part of the IPO allocation, such as the profit sharing activities that occurred between CSFB and hedge funds.\(^{200}\) In this case, the service that CSFB provided to the hedge funds was access to the IPOs themselves.\(^{201}\) Interestingly, the NASD was able to settle with CSFB for $100 million even without this rule.\(^{202}\)

Second, the proposed rule would prohibit the person allocating IPOs from demanding or requesting that the receiver of the IPOs purchase more shares in the aftermarket (after the initial offering) as a condition of being allocated IPO shares in the first place.\(^{203}\) The intent of an arrangement like this would be to keep

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196. *Id.*
197. *Id.*
198. NASD NM 02-55, *supra* note 17.
199. *Id.*
203. NASD NM 02-55, *supra* note 17.
the demand high by forcing the customer to buy in the aftermarket in exchange for the chance to make substantial profits from the allocation of IPOs. This type of arrangement would benefit the “buzz” surrounding the stock and thus appease the issuer.

The third proposed provision would expressly prohibit spinning. A member could not allocate IPO shares to executives of a company on the condition that the executive use his power to direct future investment banking business to the member, nor could a member allocate IPO shares to an executive in return for prior investment banking business.

Fourth, 2712 would forbid members from penalizing registered representatives whose customers sell their IPO shares within thirty days of the initial offering date (known as “flipping”). A member could not do this unless the underwriter could “reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.” This proposal apparently says that a member can not prohibit another from engaging in a certain activity and then turn around and engage in that activity itself; a member cannot prohibit flipping if it is engaged in flipping itself. Also, 2712 requires NASD member firms to take steps necessary to implement these prohibitions and ensure they are being followed.

Finally, the NASD has proposed an amendment to rule 2710 that would require members to disclose whether any officer or director of a company with a business relationship to the allocating firm acquired IPO shares from their company’s investment banking firm. If so, the member must disclose,

204. See id.
206. Id.
207. Id.
208. Id; see also supra text accompanying note 184.
209. NASD NM 02-55, supra note 17.
210. See id.
211. Id.
212. Id.
among other things, who acquired the shares, how many shares were purchased, when the director received the shares, and the price paid for them.\textsuperscript{213}

C. Present Regulation

Again, working from the premise that the creation of new laws or regulations suggests that the old regime is inadequate, one must ask what gap the new NASD rules and the Global Settlement on spinning would fill.

1. New York's Martin Act

Recently, Eliot Spitzer sued several company executives for profiting from the allocation of IPO shares, which he says were in exchange for directing investment business back to the underwriting bank.\textsuperscript{214} In this action, Mr. Spitzer has employed the same weapon he used to force Merrill Lynch into the research analyst settlement, the New York Martin Act.\textsuperscript{215} The Attorney General alleges that executives were unjustly enriched because they were allocated hot IPOs without disclosing their relationship to the underwriting firms distributing the stocks.\textsuperscript{216} To disgorge the executives' profits under the Martin Act, Mr. Spitzer must show fraud on their part.\textsuperscript{217} Many believe that fraud will be difficult to prove, even in the absence of the scienter requirement.\textsuperscript{218}

Assuming that Mr. Spitzer could succeed in this course of action, how could he explain his decision not to sue the investment banking houses also?\textsuperscript{219} If fraud was present in these transactions,

\begin{itemize}
\item \textsuperscript{213} Id.
\item \textsuperscript{214} Gasparino, \textit{New York Sues Execs, supra} note 180.
\item \textsuperscript{217} See Schmitt \& Markon, \textit{supra} note 216.
\item \textsuperscript{218} Id.
\item \textsuperscript{219} See Gasparino, \textit{New York Sues Execs, supra} note 180. In fact, Mr. Spitzer alleges that the activity was beneficial for Salomon as well in the form of investment
\end{itemize}
the investment banking firms, because they were the underwriters handing out the securities, would necessarily have to be complicit in the fraud and thus the unjust enrichment of the company executives.\textsuperscript{220}

2. NASD Conduct Rules 2110, 2120, and 2170

Presently, the SRO rules that govern the allocation of IPOs are NASD Conduct Rules 2110, 2120, and 2710. As stated previously, Rule 2110 requires the observance of high standards of commercial honor and just and equitable principles of trade.\textsuperscript{221} As interpreted by the NASD in Interpretive Memorandum-2110-1, this rule

is based upon the premise that members have an obligation to make a \textit{bona fide} public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins (a "hot issue"). . . [t]he failure to make a \textit{bona fide} public distribution when there is a demand for an issue can be a factor in artificially raising the price. Thus, the failure to do so, especially when the member may have information relating to the demand for the securities or other factors not generally known to the public, is inconsistent with the high standards of commercial honor and just and equitable principles of trade and leads to an impairment of public confidence in the fairness of the investment banking and securities business. Such conduct is, therefore, in violation of Rule 2110.\textsuperscript{222}

\begin{flushleft}
\textsuperscript{220} Id.
\textsuperscript{221} Conduct Rule 2110, NASD Manual, \textit{supra} note 133, at 4111.
\end{flushleft}
Section (b) sets out a list of actions that are in violation of Rule 2110. That list does not include the specific activities under review in this Note, but the language of section (b) does not indicate that the enumerated activities are exhaustive.223

Conduct Rule 2120, again, is a prohibition against the use of any manipulative, deceptive or fraudulent device, which would induce the sale or purchase of a security.224 And Conduct Rule 2710 is the Corporate Financing Rule, which sets out allowable underwriting terms and arrangements. Applicable to the present discussion are the terms set out in 2710(c)(1), stating:

No member [of NASD] or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable.225

Together, these three provisions contain broad language that proscribes unfair or inequitable activities that could apply to initial stock offerings.226 A member will be in violation of Rule 2110 when it fails to make a bona fide public distribution and retains information relating to the demand for the security or other factors the public would not be expected to know.227 Are IPOs bona fide when the underwriter allocates substantial shares to the directors and officers of its investment banking clients? The answer will depend on intent.

223. IM-2110-1(b), NASD Manual, supra note 133, at 4112-15. After substantially restating IM-2110-1(a)(1), it states “[t]herefore, it shall be a violation of Rule 2110 for a member, or person associated with a member, to [engage in activities listed].” Id.


The member-underwriter's argument will be that IPO allocations to corporate executives are not directly related to any investment banking business they may bring to the member firm.\(^{228}\) Members say, and perhaps rightly so, that the executives also happen to be good individual clients.\(^{229}\) Giving them the first shot at IPOs is merely a way of rewarding them for being lucrative individual clients for the member's brokerage house.\(^{230}\) Standing alone, this would not violate any of the applicable NASD rules.\(^{231}\) A bystander may not think it is fair because they have access to limited IPO stock, but it would not violate commercial honor or principles of equity in trade.\(^{232}\)

However, when one combines IPO allocation practices with overly optimistic (or blatantly misleading) research reports, the plausibility that violations of NASD Conduct Rules occurred increases.\(^{233}\) Under a cynical view, IPO allocations can be seen as a bonus generated by the underlying analyst scheme, which in turn is fueled by the investment bankers.\(^{234}\) The misleading research reports are manipulative devices under Rule 2120, which induced the purchasing and selling of certain securities.\(^{235}\) In fact, the reports created artificial demand at the IPO stage, raising the stock price in the aftermarket exorbitantly.\(^{236}\) Handing these "hot issue" IPOs to favored corporate executives (i.e. those who also participated in investment banking transactions with the member underwriting the security) in a manipulated and contrived market created, in part, for the executives' personal benefit cannot

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\(^{228}\) See also supra text accompanying notes 191-193, 197 (providing an example in which at least one bank, CSFB, claimed they considered the IPO allocations separately from investment banking interests).

\(^{229}\) See also supra text accompanying notes 191-193, 197; Pulliam, Smith & Schroeder, supra note 177 (firms argue IPO allocations were given to independently important brokerage clients).

\(^{230}\) See also supra text accompanying notes 191-193, 197; Pulliam, Smith & Schroeder, supra note 177.

\(^{231}\) See, e.g., Conduct Rules 2110, 2120, 2710(c)(1), NASD Manual, supra note 133, at 4111, 4127, 4506-07.

\(^{232}\) See Conduct Rule 2110, NASD Manual, supra note 133, at 4111.

\(^{233}\) See, e.g., Conduct Rules 2110, 2120, 2710(c)(1), NASD Manual, supra note 133, at 4111, 4127, 4506-07.

\(^{234}\) See, e.g., supra text accompanying notes 8-9.

\(^{235}\) See Conduct Rule 2120, NASD Manual, supra note 133, at 4127.

\(^{236}\) See Craig, Wall Street Braces, supra note 122.
constitute making a bona fide offering under Rule 2110, and thus would not meet the high standards of commercial honor and just and equitable principles required by 2110.237

3. SEC Regulations

If Wall Street firms violated NASD Conduct Rules, the same conduct may have also violated Rule 10b-5 or section 17 of the 1933 Securities Act.238 Again, all the elements that constitute a violation of 10b-5 must be present for a violation to be found.239

Proving that allocations of IPOs to corporate executives alone are violations of 10b-5 or section 17 would be hard, if not impossible.240 If there is no connection between the IPOs an individual client gets and his role as an executive, the arrangement appears sound.241 Yet, even if the individual client has a relationship in his or her role as executive, this is not prima facie evidence of a 10b-5 or section 17 violation.242 To be successful in arguing that certain IPO practices (namely spinning) are fraudulent, it would also be necessary to show fraudulent practices regarding overly optimistic recommendations of stocks.243 The fraud would be based on the relationship between investment banking clients and research analysts; the additional element is that the IPOs are just one part of a quid pro quo scheme in which company officers direct investment banking business to a bank in return for personal profits via rosy research reports (section 17(b)) and the IPO stock allocations.244 If one could show that the research reports and IPO allocations were all part of one transaction or exchange, a powerful case for finding fraud exists. For example, an analyst would violate section 17(b) when he or

237. See Conduct Rules, 2110, 2120, supra note 133, at 4111, 4127.
239. See supra text accompanying note 144.
241. See supra text accompanying notes 228-230.
244. 17 C.F.R. § 240.10b-5; 15 U.S.C. § 77q; see also See Craig, Wall Street Braces, supra note 122.
she fraudulently recommends a new offering, in exchange for investment banking business from another issuer. The company executive who receives an IPO allocation of the new offering, even though it is an offering by another issuer, personally profits from the high demand created by the fraudulent research report, and then directs his or her company's investment banking business to the analyst's firm.

If the SEC attempted to pursue this angle, a major hurdle would be proving the IPO allocations were part of the research scheme and were not offered based on executives' personal relationships with the Wall Street firms. This evidentiary burden may be a factor deterring the SEC from instituting a 10b-5 action. The evidentiary burden may also be a reason why the NASD went ahead with its proposals. In effect, the NASD is turning a blind eye to the past, and setting a course for the future. The rules, however, may provide more confusion than clarity. They appear to prohibit what is already against the law, and at the same time do not provide help for the harder cases, namely the CEO who truly gets IPOs due to his personal account with an investment bank.

4. Possible Common Law Actions

Several alternatives to new regulations and fraud actions have been proposed. One alternative common law action springs from the corporate opportunity doctrine. The idea is that the executives deprived their corporations of an opportunity when they did not disclose to their corporations the IPO shares offered to them. Any successful action under this theory would

245. See 15 U.S.C. § 77q(b); see also supra text accompanying note 166.
247. See, e.g., supra text accompanying notes 191-193.
248. See, e.g., Pulliam, Smith & Schroeder, supra note 177 (introducing the idea that executives may have breached the corporate opportunity doctrine); Murray, supra note 19 (advocating an auction style IPO distribution process); Casey, supra note 205 (hypothesizing that corporate executives underpriced IPO values, to create 'buzz,' in return for personal profits when the 'buzz' demand sent the stock skyrocketing).
249. See Pulliam, Smith & Schroeder, supra note 177.
250. See Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939) President Guth of Loft, Inc., through his role as president was offered the opportunity, which he took, to buy
be based on the fact that the executives gained access to these IPOs through their roles as corporate officers and not merely as private high net-worth individuals. Demonstrating this fact would be difficult. Brokerage firms like to reward their good clients with things such as IPOs. Perhaps, it just so happens that many times their high net-worth clients are also officers or directors of client companies. Plausibly, many times the executive is sold on opening a personal brokerage account because of his contact with the bank through his company. On its face, the genesis of this relationship may appear mischievous. At the same time, however, from the bank's perspective any contact with an executive provides a dual opportunity, the chance to provide financial services to his or her company and the chance to provide personal financial services to a wealthy individual. Should we punish a bank for taking that opportunity or an executive for accepting those services?

During the boom years of the 1990s, did officers and directors seek to have their company’s IPO shares underpriced by the underwriting firm? And if so, might this constitute a breach of the fiduciary duty of loyalty owed by officers and directors to their company? Economists have been unable to fully understand why so many stocks were underpriced at their IPOs in the 1990s. One argument is that executives thought that the “buzz” created by rapid positive price movement on opening day would help ensure prolonged interest and success. Although this idea may be contrary to traditional economic theory, which assumes parties to transactions are rational, an alternative

\[\text{rights to Pepsi-Cola's name and formula. Id. at 506-07. The court found that buying rights in Pepsi was an opportunity that inured to the corporation rather than him. Id. at 511.}\]
\[251. \text{See id.}\]
\[252. \text{See, e.g., supra text accompanying notes 191-193.}\]
\[253. \text{See supra text accompanying notes 228-230.}\]
\[254. \text{See Casey, supra note 205. Underpricing is defined as the difference between the offering and closing prices on the first day of trading. Id.}\]
\[255. \text{See generally Lincoln Stores, Inc. v. Grant, 34 N.E.2d 704 (Mass. 1941) (finding that defendants breached their fiduciary duty of loyalty when they acquired a competing store and began operating it).}\]
\[256. \text{See Casey, supra note 205.}\]
\[257. \text{Id.}\]
“rational” theory may explain it. Perhaps executives underpriced IPO stock in their own company for personal access to other underpriced, hot IPOs. Here the interests of the executive, as executive, and the corporation may indeed have diverged, opening up the possibility for actions based on breaches of fiduciary duties. An argument could be made that executives were being disloyal if they chose particular investment banks with their own personal profit in mind, rather than choosing the investment bank that could get the most profit for the corporation and its shareholders. It seems implausible that an IPO’s price was properly set when first day trading pushes the price up 229 percent, as was the case for Rhythms NetConnections, Inc. On the other hand, the 1990s saw unprecedented activity from the small investor. This had the effect of making it nearly impossible to set a fair price, because the industries normal methods for doing so, polling institutional investors and fund managers, were undercut by the herd mentality that individual investors exhibited in buying stock.

D. Analysis of New Proposals

The proposed regulations of IPOs have the advantage of making certain specific activities illegal. Terms such as fraud, equity and commercial honor do not always lend themselves to precise meanings, but this is also their advantage. The terms are flexible and adaptable to unanticipated situations. In the end, the proposed rules may restore a bit of investor confidence in the way IPOs are handled without resorting to a total overhaul of the system. Yet, the necessity of the proposed rules are extremely questionable in light of the fact that the current regulations and

258. Id.
259. Id.
260. Id.
261. Gasparino, Craig, & Smith, supra note 7.
263. See generally id. (noting the inherent conflict between running an investment banking business and servicing the small investor).
laws of the SEC, NASD, the State of New York, and common law seem adequate to curb any truly improper activity. In fact, introducing these new laws may only muddy our understanding of the laws that govern IPO activities now. Furthermore, the ban on spinning included in the Global Pact may only serve to remove an opportunity for banks to develop new individual client relationships.

III. CONCLUSION

The recent regulatory flurry is a reactionary move. The stock market crashed, therefore insiders are to blame.264 The new regulations are attempts to restore investor confidence by giving the impression that the problem is being addressed.

The current regulatory structure for banking services in the United States is not the result of any grand design or reasoned blueprint. Instead, it represents a set of accumulated responses to a long history of financial crises, scandals, happenstance, personalities and compromises among a broad and competing array of industry and governmental units.265

The old laws were adequate to deal with abusive conflicts of interest that marred the integrity of the market. The new regulations intended to eliminate conflicts of interest among analysts and IPO allocations are only the latest haphazard response to our most recent financial crisis.

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264. But cf. id. (arguing that investors do not want to analyze their own “role in the losses” at the busting of the bubble).
265. Jerry W. Markham, Banking Regulation: Its History and Future, 4 N.C. BANKING INST. 221, 221 (2000); see generally JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (Vol. III 2002) (chronicling the financial industry over the past thirty years and depicting most regulatory actions as reactions to market crises).