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Reprinted from 'The European Lawyer' July/August 2002 issue 20

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As after-shocks from the collapse of Enron and the dotcom market send tremors of indignation and distrust through the capital markets, auditors, executives and directors of public companies brace for broad reforms. Surprisingly, however, the prize for the earliest victim of post-Enron pique was awarded months ago to securities research analysts.

And even now, more may be in the offing. Law suits, investigations and probable new laws all imperil the continued coexistence of securities research under the same roof with investment banking. That it should have come to this for US analysts may bewilder, if not worry, foreign *confreres*, who have for some time seemingly operated in a similar regulatory environment. But, then too, it may only be in America that, as one star analyst put it, the new economy definition of "conflict of interest" was "synergy."

No-one will benefit if analysts are so burdened with regulatory and reputational baggage that the field becomes unsustainable. Much may be said about the state of corporate disclosure, but this does not diminish the role of analysts in smoothing informational friction and enhancing the efficiency of markets. Sidelining analysts would underscore once again that bad facts make bad law.

We did not get into this mess without warning. Could we seriously have believed that names such as Meeker, Blodget, Cohen and Grubman took on celebrity status based on some bottom-line celibacy? In 2000, the Securities and Exchange Commission (SEC) adopted Regulation Fair Disclosure (FD), a simple rule that forbids sharing of material inside information selectively with, among others, analysts. Should we have raised at least one eyebrow when the research world claimed FD would spell its end? Weren't we curious to know why analysts never met a stock they didn't like?

Perhaps not. What purpose was there in outing this scene? A rising stock market has too many willing witnesses. Both regulators and the public clung to what now seems the quaint notion of the Chinese wall. No-one saw it necessary to probe the personal ownership or pay of the analysts themselves.

But by the late 1990s, as the market cooled, there were misgivings. Former SEC Chairman Arthur Levitt, Jr. complained that analysts were "just a bit eager to report that what looks like a frog is really a prince. Sometimes a frog is just a frog." His agency questioned conflicts between investment banking and analysts, and reports of direct links between analyst compensation and investment banking revenue seeped under Wall Street's doors.

Mr Levitt, a Democrat, stepped down in early 2001 to make way for a new administration. The securities industry sighed in relief, assuming that the Bush agenda would have a light hand for Wall Street. But Mr Levitt's acting successor, Republican Laura Unger, herself a former SEC enforcement attorney, would hear none of it. Although predisposed to industry self-correction, Ms Unger was determined to get to the necessary facts on the table. She also faced an increasingly restive Congress during an appropriation process in which her agency continued to pursue pay and budget increases to deal with mounting concerns about staff turnover and capacity. Through inquiries into analyst trading practices and participation in Congressional hearings, the SEC uncovered a troubling record, one that included cosy relationships between analysts and investment banking clients, threats of unfavourable ratings to obtain business, opportunistic trading by analysts in securities they covered, ambiguity in recommendations including a dearth of anything resembling "sell," and opaque disclosure regarding any of the above.

In June 2001, the Securities Industry Association issued a set of best practices to guide research activities of member firms. At the same time, the National Association of Securities Dealers (NASD) proposed new rules to cover analysts. Neither of these initiatives was particularly strong, and both were palatable to the industry. The table was set for newly confirmed SEC Chairman Harvey Pitt, who had built a strong reputation as a securities attorney on structuring back-office deals. The time seemed right for a graceful closure, acceptable to both politicians and Wall Street.

That was until Enron. Some may have seen the Enron eruption building, but not enough of the analysts. In the days before Enron declared bankruptcy on December 2, 2001, after its stock had fallen 99 per cent and after the SEC had opened its investigation, 14 of 16 analysts who covered the company still recommended that clients buy or hold the stock. This ensured that they would be swept up in the outrage that followed.

But early on, regulators and Congressional investigators devoted most of their resources to the immediate victims, culprits and solutions. Few specific plans for analysts seemed imminent, until the New York State Attorney General, Eliot Spitzer, announced that he had commenced an investigation into the practices of Merrill Lynch and other firms. His source of authority was an 81-year old New York securities anti-fraud statute. In a very real sense, he made analysts his bigger fish to fry.

At first, Wall Street and Washington were alternatively bemused and contemptuous. But this turned to disbelief, when Mr Spitzer released a series of internal Merrill Lynch e-mails, documenting how the firm's analysts had privately bashed stocks they were publicly supporting. Suddenly, there was a smoking gun, one which federal authorities had either failed to find or reveal.

Spurred by concern about state regulation of Wall Street, the SEC quickly set up a task force involving the New York Stock Exchange (NYSE), the NASD, Mr Spitzer's office and that of the attorneys general of various other states as part of a formal inquiry into analyst trading practices. The federal watchdog said it was pursuing 10 cases involving possible trading by analysts in conflict with their public recommendations.

Also feeling the heat from Mr Spitzer's investigation, the NASD and the NYSE launched an effort to reclaim the regulatory high ground. Historically, research activities of US broker/dealers, which have an inherent conflict when opining on firm clients, have been covered by a patchwork of general rules against market manipulation and deceptive practices, along with some requirements for supervision and professional qualification. Risk of suit or enforcement was managed through the separation of research and banking by internal barriers or "Chinese walls" and generic disclosure. In times past, this principle-based rules framework may have been sufficient. Not, however, in light of the multiple embarrassing issues surrounding the research activities of investment banking firms. Those issues revolved mainly around ownership and trading of securities by analysts and the interests of financial service firms, particularly investment banks, in the businesses and securities covered by their analysts. The NASD and NYSE wrote rules approved by the SEC in May of this year that targeted these issues directly (see box).

Even as the industry took a dim view of the new rules, the SEC said they were just a start and that it was continuing to investigate the area.

Only a few weeks after approval of the rules, Mr Spitzer, who had made the progress of his investigation daily media fare, announced a settlement with Merrill Lynch. The terms of this agreement called for the firm to pay a $100 million fine, sever the link between analysts and investment bankers, create a new investment review committee responsible for approving all analyst recommendations, and disclose any termination of research coverage on, and compensation from a covered company.

Mr Spitzer's settlement has received much attention and some criticism. Republicans have accused him of grandstanding and warned that state interference could lead to balkanisation of securities regulation. *The Economist* slammed the deal, noting that it failed to address the relationship between analysts' conflicts and investment banking business, while aggravating state interference in an essentially national regulatory problem. To those who saw the settlement as soft, Mr Spitzer described it as "a fair one, tailored

NASD/NYSE rules:

- Bars on investment bankers supervising analysts and mandatory monitoring of discussions between the two about research reports;
- Breaking the link between an analyst's compensation and any specific investment banking transaction;
- Restrictions on when and whether analysts and their families can invest in covered companies, including bars on:
  –investing in companies in sectors covered by the analyst before they go public,
  –trading in covered securities from 30 days before until five days after a research report, and trading against the analyst's most recent recommendations;
- Bars on commissioning favorable research on investment banking business, including a rule against rating securities of a client within 40 days after taking it public or within 10 days after a follow-on offering for less actively traded companies; and
- Disclosures in reports and during public appearances, including links between an analyst's compensation and general investment banking revenues, payments to the firm for investment banking services in the last 12 or next three months:
  –if the analyst has a personal financial interest or the firm has a one per cent or more beneficial interest in a covered company, or either has any other material conflict of interest, including as a director or officer,
  –the meanings and distributions of various ratings, and
  –a graphic plot of at least a year of historical stock prices measured at the time when the firm initiated and changed ratings and price targets for the company.

to the abuses we found." To those who were alarmed that a state prosecutor conducted the investigation and obtained the settlement, Mr Spitzer took more umbrage. "As Attorney General of New York, I have a legal duty to enforce the Martin Act – a law that predates the federal securities acts – and that has been integral to protecting investors for over eighty years, " he said before a Congressional committee. Following the Merrill Lynch settlement, Mr Spitzer announced that he was expanding his investigation to other large Wall Street firms.

In response to increased scrutiny and regulation, top Wall Street firms have announced voluntary reforms of their internal rules governing research analysts. Salomon Smith Barney has adopted changes that mirror the Merrill Lynch settlement. Goldman Sachs, Credit Suisse First Boston and Merrill Lynch have barred analysts from owning stocks that they rate. Bank of America has gone further to prohibit analysts from owning stocks in industries they cover. Beyond this, Salomon Smith Barney has urged that regulators prohibit analysts from attending roadshows and from helping bankers pitch their services to public companies.

Regulators now appear fully engaged. The SEC continues its investigation and may have more rules in store. The NASD has announced the formation of several rapid response teams to investigate emerging areas, including conflicts of interest. It recently levied a $300,000 fine against US Bancorp Piper Jaffray in a settled claim involving threats to drop stock coverage if the firm wasn't awarded an assignment to manage a stock offering. Mr Spitzer's foray has been joined by at least 40 more states, and the North American Securities Administrators Association has announced that a task force of state securities regulators is targeting conflicts of interest at approximately12 financial services firms.

Even President Bush has weighed in. Speaking out about recent turmoil in corporate America and the capital markets, the president had choice words for analysts: "Stock analysts should be trusted advisors, not salesmen with a hidden agenda." Going on, he promised aggressive enforcement of new rules to deal with the "flat out conflict of interest" between banking and research. "We must prevent analysts from touting weak companies because they happen to be clients of their own firm..." he said. Congress is likely to agree and present the president with legislation that entrenches new regulatory measures in statute.

The legal implications of this new world order for analysts are still in flux. Legal and compliance departments of investment banking firms now have a new mandate to police conflicts rules for analysts, including contacts with bankers and ownership and trading of securities. Whether these departments are up to their new roles as gatekeepers and whether enforcement of new rules will congeal the research process are two very open questions. As for the analysts themselves, personal investing will be more restricted, and, without direct links to the revenue-producing side of the business, salaries and incentives for analysts should fall. It is also likely that analysts can expect more institutional second guessing which may discourage, if not stifle, independent thinking.

And what about companies, investors and the public? Many questions remain up for grabs. Companies will presumably have less, or at least more closely monitored, access to analysts and their work product, particularly draft reports. This will likely not be a bad thing. Companies haven't always been blameless in this area, there having been reports that analysts have been pressured with threats of withholding deals from firms if research is other than glowing. Investors should receive clearer information about analysts' conflicts and clearer ratings. Perhaps not so many of these ratings will be favourable.

The market, a proxy for the public, continues to exert control and may find the most sensible solution of all. Already, public awareness is sorting out the fundamental differences between the "buy" and the "sell" sides of the research house. The stars of pure research firms like Sanford Bernstein should rise higher. Public pension plan investors are threatening to jerk investment banking business from firms that cannot demonstrate a more independent approach to research. Part of this re-education may also involve a dose of reality. Coincidence in the qualitative judgments of bankers and analysts should not be a cause for moralising. There is no incentive for bankers to pick losers. A different series of concerns would surely attend a firm the research and banking decisions of which were more than occasionally at variance.

Will a raised legal bar and new public expectation be enough to restore the image of a tarnished industry? This should be our hope. We cannot afford to vilify or deify analysts. Too much of the efficient market predicate depends on more than retail investors reading and digesting the disclosures of ever-expanding and increasingly complex capital markets. ■

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David Martin is the head of the securities practice group at international law firm Covington & Burling and the immediate past director, corporation finance division, of the SEC. With thanks to Fuad Rana for his assistance in preparing this article.