FINANCIAL ANALYSTS

A new deal for Wall Street

Merrill Lynch, Goldman Sachs, Morgan Stanley and J.P. Morgan were once part of Wall Street's burnished elite. Now they are among its chastened. Along with six other firms and two individuals, they have settled claims brought against them by the US Securities and Exchange Commission (SEC), the National Associates of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the Attorney General of the State of New York (NYAG) and numerous state regulators associated with the North American Securities Administrators Association (NASAA). **David Martin**, former head of the SEC's Corporation Finance division, says the two-year investigation has resulted in a paradigm restructuring of the way business must be done from Wall Street and will significantly impact on the international legal profession.

As the unprecedented investment of the 1990s fell victim to the sharp decline of US stock markets in 2000, investment losses staggered investors. That injury was sharpened when allegations were made that Wall Street, in its seemingly insatiable appetite for the fruits of the new economy, had misled investors by publicly championing securities of dubious value. The SEC, NYSE, NASD, NYAG and NASAA each initiated separate investigations into the securities industry. To mount a more efficient probe and to help quell Wall Street concerns that firms would be inundated with subpoenas from multiple investigators, the regulatory authorities agreed to form a joint task force.

Some of what the joint task force found was painfully obvious all along – investment research doesn't generate much income on its own and is better understood as a loss leader. And, as investment banking revenues increased, the lines between investment research and investment banking became blurred. Research analysts were expected to assist investment bankers, often with direct linkage between their research reports, investment banking revenues and their compensation. As research analysts became more entwined with compensation from investment banking business, numerous conflicts of interest emerged that compromised their independence. The joint task force's findings illustrate these conflicts graphically.

One research analyst upgraded his rating on a company after gaining assistance from a member of its board of directors and his own boss to get his child into an exclusive private school. Another emailed colleagues with concerns about a recommendation, saying there was "no reason to own now," and retail investors might lose their retirement "because we don't want [the company's chief financial officer] to be mad at us." Yet another touted stocks to the public but privately scored the picks as "junk" and the companies as "pigs."

All of this illustrates how investment banking eventually came to wield undue influence over investment research and, as a result, the independence and objectivity of research analysts became secondary to pleasing investment bankers and corporate clients with favourable recommendations.

The joint task force settled claims on April 28, 2003 against 10 US investment banking firms and two individuals, Jack B. Grubman of Salomon Smith Barney and Henry M. Blodget of Merrill Lynch. The settlement calls for monetary penalties, institutional reforms, enhanced disclosures, independent research and investor education (see box).

There will be a separate distribution fund for each firm's customers based on the amount paid by each firm in the settlement. The distribution funds will be administered by an SEC-recommended, court-appointed fund administrator who must have a plan to distribute the funds in an equitable and cost-effective manner. The SEC has provided some guidance on who is eligible to receive payments, limiting recovery to firm customers who purchased securities covered by the claims against the firm after publication of a biased research report. Notably, however, while investors must have lost money, they will not be required to show that they relied on recommendations in making their purchases. Recipients of funds can still pursue other remedies against the firms.

There was no equivalent fund established with the money allocated to the states because it was thought to be too difficult to determine which investors had been harmed by relying upon the biased stock research. Therefore, each state is using its share of the funds as it sees fit.

The settlement requires each firm to build higher and better walls between their investment banking and research divisions. Investment banking and research must be physically separated and have completely

Monetary penalties

The firms must pay a total of $875 million in disgorgement and civil penalties, of which $100 million will be credited against the amounts paid by Merrill Lynch in its separate settlement with the NYAG in May 2002. $387.5 million will be set aside for the benefit of customers of the firms, and the remainder will be paid to the states that participated in the settlement.

Firm	Penalty	Disgorge-ment	Independent Research	Investors Education	Total
Bear, Stearns & Co.	$25m	$25m	$25m	$5m	$80m
Credit Suisse First Boston	$75m	$75m	$50m	—	$200m
Goldman, Sachs & Co.	$25m	$25m	$50m	$10m	$110m
J.P. Morgan Securities	$25m	$25m	$25m	$25m	$25m
Lehman Brothers	$25m	$25m	$25m	$25m	$25m
Merrill Lynch	$100m[1]	—	$75m	$25m	$200m
Morgan Stanley & Co.	$25m	$25m	$75m	—	$125m
U.S. Bancorp Piper Jaffray	$12.5m	$12.5m	$7.5m	—	$32.5m
Citigroup Global Markets Inc., f/k/a Salomon Smith Barney Inc.	$150m	$150m	$75m	$25m	$400m
UBS Warburg	$25m	$25m	$25m	$25m	$25m
TOTAL	$487.5m	$387.5m	$432.5m	$80m	$1.3875b

[1] Payment made in prior settlement of research analyst conflicts of interest with the states securities regulators.

separate reporting lines, legal and compliance staffs and budgeting processes. Decisions concerning compensation of research analysts must be documented and based in significant part on the quality and accuracy of the stock research. Compensation cannot be linked to investment banking revenues or input from investment bankers. Investment bankers cannot evaluate analysts and must have no role in determining which companies are covered by research.

Within 18 months after the date of the settlement, each firm must retain an independent monitor to review compliance with these reforms. Each monitor must submit a written report to the SEC, NASD and NYSE within six months after its review begins. Additionally, each firm must disclose prominently on the first page of any research report or recommendation the following: "[Name of firm] does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report." Other conditions have also been imposed. For instance, when a firm decides to terminate coverage of an issuer, it must write a final research report discussing the reasons for the termination. Finally, each firm must publish quarterly on its website a chart showing its research analysts' performance, including each research analyst's name, ratings, price targets and earnings per share forecasts for each covered company, as well as an explanation of the firm's rating system.

Also, for independent research, the firms must pay a total of $432.5 million to fund independent research over a five-year period. Each firm must contract with no fewer than three independent research firms and make available the independent research to the firm's customers. The firms must also notify customers of the availability of independent research, and seven of the firms must pay a total of $80 million to fund investor education. The SEC, NASD and NYSE have authorised that $52.5 million of these funds be put into a fund to support programmes designed to equip investors with the knowledge and skills necessary to make informed investment decisions. The Court will appoint an SEC-recommended fund administrator to establish a non-profit grant administration programme to fund investor education programmes. The remaining $27.5 million of the investor education funds will be paid to state securities regulators for investor education purposes to be determined by each state.

In announcing the settlement, SEC Chairman William H. Donaldson described the cases as a "sad chapter in the history of American business – a chapter in which those who reaped enormous benefits from the trust of investors profoundly betrayed that trust." This statement begs the fundamental question – will the settlement restore investor confidence and trust?

The monetary penalties imposed in the settlement are among the highest ever imposed in a civil securities enforcement action. Unfortunately, this amount is a fraction of the losses suffered by investors. In addition, the penalties allocated to the states will likely not be used to compensate investors – Virginia has already publicly stated that a portion of its settlement allocation will be used to improve motor vehicle services.

As for the firms themselves, the monetary penalties are insignificant compared to the revenues generated from investment banking business during the period under investigation. According to Chairman Richard Selby of the US Senate Committee on Banking, Housing and Urban Affairs: "Citigroup agreed to make the biggest payment of $400 million, but it received $10.5 billion from investment banking revenues between 1999 and 2001 – a monetary sanction of less than four per cent of its investment banking revenues. It is questionable whether such a relatively small payment will serve as a deterrent to future improper conduct." In addition, many of the firms being investigated had an ironic but telling reprieve when their stock prices increased following the announcement of the settlement.

Although the firms are required to use third-party independent research, funding for this obligation terminates after five years. It is possible that many independent research firms may become dependent on Wall Street funding during the five-year period. To maintain funding beyond the five-year period, independent research firms may have an incentive to provide favourable recommendations. In addition, during the five-year period, it is not clear why investors will be any more interested in consulting multiple reports than they were before.

The institutional reforms and enhanced disclosure appear to be more form than substance. Key components have already been adopted by the SEC, NASD and NYSE. During the period when the joint task force was investigating the securities industry, the SEC, NYSE and NASD were engaged in the process of reforming their rules and regulations regarding the investment research industry. In 2002 the NYSE and NASD each adopted new rules to reinforce the separation between investment banking and research divisions and promote research analyst independence. In addition, in February 2003, the SEC adopted Regulation Analyst Certification which, like the new and proposed rules of the NYSE and NASD, seek to address the lack of research analyst independence.

Further, the question remains as to how effective the reforms will be in practice. The business model for standalone investment research is still a challenging one. To some extent, research analysts on the sell side will always be dependent on investment banking business.

Nevertheless, there is a fair argument that all reforms in this area have been propelled by the dynamics of the joint task force's investigation. Regulators have been eager to adopt new rules that appear to fix weaknesses uncovered, while firms have been eager to end negative publicity and reach closure on impending liabilities.

And beyond this, perhaps the biggest significance of the settlement is not in its details, but rather in its record. The evidence accumulated by the joint task force during the two-year process of investigation and negotiation may facilitate civil recovery by investors who can show reliance on tainted research. Rather than being a crucible of restored investor confidence, the settlement may prove to be a trove for private claims. ■

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