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Missing the Mark: NASD Rule 2711 and NYSE Rule 472 Mistakenly Emphasize Disclosure Rather than Amending the Pleading Requirements of PSLRA

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MISSING THE MARK: NASD RULE 2711 AND NYSE RULE 472 MISTAKENLY EMPHASIZE DISCLOSURE RATHER THAN AMENDING THE PLEADING REQUIREMENTS OF PSLRA

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I. INTRODUCTION

On May 10, 2002, under pressure from the investing public and political pressure,[1] the Self-Regulatory Organizations ("SROs") of the securities industry enacted National Association of Securities Dealers ("NASD") Rule 2711, Research Analysts Research Reports ("NASD Rule 2711"), as well as proposed amendments to New York Stock Exchange ("NYSE") Rule 472, Communications with the Public ("NYSE Rule 472").[2] The new SRO rules were largely enacted in

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* J.D. candidate New York Law School, 2004. I would like to dedicate this article to my grandfather. This one is for you "pal." Special thanks are in order for my parents, grandmother and Molly for their unconditional love and support over the years. Additionally, I would like to thank Professor Jeffrey Haas, Maya Grant, Joshua Sanders as well as Professor Cameron Stracher and numerous Law Review members for their helpful contributions and insightful comments during the writing and editing process. Also, I would like to take a moment to remember all those who can no longer share in my personal ups and downs, which include my uncle and cousin, Fredrick and Michele Hoffmann, who perished along with many good friends and former co-workers at Cantor Fitzgerald with the attacks on the World Trade Center on September 11, 2001.

1. Many individual investors sustained huge losses in the U.S. stock markets after the Internet and technology crashes from 2000 to 2002. *See* Greg Ip, *A Year of Living Dangerously: Though Nasdaq was Massacred, Dow, S&P 500 Declines Missed Measuring Stick for Bear Market,* WALL ST. J., Jan. 2, 2001, at R1; E.S. Browning, *Floating on the Winds of Uncertainty: A Tumultuous Year for Stocks Keeps Investors Hoping for a Rebound, But Caution Tempers Optimism,* WALL ST. J., Jan. 2, 2002, at R1; E.S. Browning, *Investors Seek Ray of Hope: After Three Straight Years of Stock Market-Misery, Many Remain Hunkered Down Amid Risk of Another Slump,* WALL ST. J., Jan 2., 2003, at R1.

2. *See also* Press Release, Securities and Exchange Commission, 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 New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest (May 10, 2002), available at http://www.sec.gov/rules/sro/34-45908.htm. It is also noteworthy that Sarbanes Oxley mandated that the Securities Exchange Commission ("SEC") pass laws to: 1) ensure analyst independence; and 2) to disclose analyst conflict of interest to the public. *See* Robert P. Sieland, Note, *Caveat Emptor! After All the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531,

response to criticism from commentators and state and federal regulators who objected both to the quality and objectivity of the recommendations provided by stock analysts.[3] Spearheaded by New York State Attorney General Eliot Spitzer,[4] public officials and regulators alleged that a "conflict of interest" tainted the objectivity of large brokerage firms' securities research departments.[5] The regulators alleged that the existence of investment banking and research functions in the large brokerage firms, each with differing proprieties and responsibilities, present a conflict of interest for the securities analysts.[6] According to the regulators, the securities ana-

561 (2003,) *citing* 15 U.S.C. § 780-6(A)(1) and § 780-6(B). Additionally in 2003, Regulation Analyst Certification ("Reg. A.C.") was adopted, requiring research analysts to certify the truthfulness of their views in research reports . . .and disclose whether they have received any compensation related to the specific recommendation provided. . ." 17 C.F.R. § 242.500-505.

3. While there are several varieties of analysts that include buy-side, sell-side, and independent analysts, when referring to analysts, this paper is referring to sell-side analysts. Sell-side analysts are analysts that work for broker-dealers and offer brokerage services to both institutional and retail customers. Buy-side analysts work for institutional money managers, which include hedge funds. Independent analysts sell their research through subscription fees. *See generally* Securities Exchange Commission Online Publication, *Analyzing Analyst Recommendations,* (June 20, 2002), at http://www.sec.gov/investor/pubs/analysts.htm.

4. Press Release, Office of the New York State Attorney General Eliot Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), available at http://www.oag.state.ny.us/press/2002/may/may21a_02.html. *See also* Press Release, Office of the New York State Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest (Apr. 8, 2002), available at http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html.

5. A "conflict of interest" denotes a situation in which two or more interests are present and competing or conflicting. ABUSE ON WALL STREET 4 (Steering Committee on Conflicts of Interest in the Sec. Markets ed., 1980). Commentators have identified a number of conflicts of interest in the securities industry, among them the existence of both investment banking and research departments. *See also* Press Release, University of Michigan Business School, Chinese Walls Fail to Curb Conflicts of Interest in Securities Firms (Feb. 13, 2002), available at http://www.umich.edu/news/releases/2003/Feb03/r021103a.html. The press release examines a forthcoming study produced by University of Michigan professor, H. Nejat Seyhum, whose findings suggest that the measures taken by the securities firms, i.e. establishment of Chinese walls, have not effectively eliminated the conflict of interest in the securities firms.

6. Prior to the enactment of the current regulations, many commentators encouraged the Self-Regulatory Organizations ("SROs") to adopt measures requiring mandatory disclosure of conflicts of interest for analysts. *See* Kelly S. Sullivan, Comment, *Serving Two Masters: Securities Analyst Liability and Regulation in the Face of Pervasive Conflict of Interest,* 70 UMKC L. REV. 415 (2001). Other commentators noted that imposing analyst liability under a traditional interpretation of the SEC's Rule 10b-5 is nearly

lysts' conflict of interest prevented the individual investor from receiving objective or reliable information.[7] The regulators argued that internal pressures from within the investment banking departments of the analysts' firms, resulted in a tendency to favor maintaining and developing investment banking business[8] over the interest of providing objective research to the investing public.[9] The regulators rely on a 1999 study that found only eight "sell" recommendations out of the overall 6,000 recommendations[10] made by Wall Street analysts in 1999.[11] According to the regulators, this over-optimism in the portion of "buy" recommendations reflects the conflict of interest that exists within the analysts' recommenda-

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impossible. *See* Jaimee L. Campbell, Comment, *Analyst Liability and the Internet Bubble: The Morgan Stanley/Mary Meeker Cases*, 7 FORDHAM J. CORP. & FIN. L. 235 (2001).

7. *See also* Andes Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP & FIN. L. 21 (2001). Rueda suggested that the market mania of the 1990s might have been caused by analysts' "buy recommendations" that had no relationship with the financial realities of the issuers they covered. *See also* Laura S. Unger, How Can Analysts Maintain Their Independence?, Remarks at the Ray Garrett Jr. Corporate and Securities Law Institute, Northwestern University School of Law (April 19, 2001), *in* 1273 PLI/CORP. 57.

8. *See The Watchdogs Didn't Bark: Enron and the Wall Street Analysts: Hearing Before the U.S. Senate Governmental Affairs Comm.*, 107th Cong. (2002) available at 2002 WL 335642. Several commentators at the congressional hearings suggested that the analysts' failure to warn the public was one of the prominent reasons for the crash of Enron's stock. In fact, ten of the largest financial firms have admitted as much by agreeing to settlement of fines with the regulatory bodies. On December 19, 2002, the Securities and Exchange Commission, New York State Attorney General Eliot Spitzer, National Association of Securities Dealers, New York Stock Exchange and a group of state regulators announced that ten of the largest securities firms (Salomon Smith Barney, Credit Suisse First Boston, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bear Sterns, Deutsche Bank, Bear Stearns, J.P. Morgan Chase, Lehman Brothers, UBS Warburg) reached a settlement. The securities firms agreed to pay 1.435 billion dollars, including $900 million in penalties, $450 million for independent research over the next five years and $85 million for investor education. *See* Press Release, Office of New York State Attorney General Eliot Spitzer, New York Attorney General, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practice (Dec. 20, 2002), available at http://www.oag.state.ny.us/press/2002/dec/dec20b_02.html. *See generally* Scot J. Paltrow, *Dark Side of the Street: Why Scandals Continue to Erupt*, WALL ST. J., Dec. 23, 2002, at C1. *See also* Randall Smith, *Will Investors Benefit from Wall Street's Split,* WALL ST. J., Dec. 23, 2002 at C1.

9. Jeff D. Opdyke, *Analysts' Reports: Don't Believe the Hype*, WALL ST. J., July 10, 2001, at C1.

10. This represents less than 1 percent of the overall stock recommendations.

11. *See* John C. Bogle, *Remaking the Market: Reality Bites,* WALL ST. J., Nov. 21, 2002, at A16.

tions[12] and has been often cited as an element that contributed to the price inflations in the stock market of the late 1990's.[13]

In an attempt to resolve the analysts' conflict of interest,[14] the securities' industry SROs enacted NASD Rule 2711[15] and amend-

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12. Some commentators have suggested that the causal connection between the "buy" recommendations and the overheated market is based on circumstantial evidence and ignores the complexities of how stocks are chosen for coverage. *See* Frank Fernandez, *The Roles and Responsibilities of Securities Analysts*, SIA Research Reports, (Aug. 21, 2001) available at http://www.sia.com/research/pdf/RsrchRprtVol2-7.PDF.

13. One of the most notorious cases of the alleged conflict of interest on Wall Street involves the analyst, Jack Grubman of Salomon Smith Barney. The Salomon stock analyst allegedly attempted to prop up the price of MCI Worldcom by recommending the stock as a "buy" even after it became apparent that the company was in serious financial trouble so that the investment bank would not lose issuance "business" from MCI Worldcom. This sort of appearance of impropriety has attracted the attention of the regulators including New York State Attorney General Eliot Spizter and resulted in analysts and their firms becoming the subjects of civil lawsuits.
See Kristen French, The Street.com, *Analyst Jack Grubman Is on a Tightrope at Salomon* (April 30, 2002), available at http://www.thestreet.com/markets/kristenfrench/10019951.html. Grubman's coverage of AT&T was also criticized for keeping a "buy rating" on AT&T. However, the shareholder class action against the analyst and his firm proved to be unsuccessful. *See* Korsinsky v. Salomon Smith Barney, Inc., 2002 WL 27775 (S.D.N.Y. 2002). *See, e.g., Analyzing The Analysts: Are Investors Getting Unbiased Research From Wall Street: Hearing Before the House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the House Comm. on Financial Services*, 107th Cong. (June 14, 2001) (statement of Rep. Paul E. Kanjorski, Member, House Comm. on Financial Services).

14. According to the SEC, these rules seek to accomplish several goals. First, the rules seek to alter the structure of the financial services firms by establishing communication restrictions between the investment banking and research departments. Second, the rules require disclosures of potentially material conflicts of interest in research reports and during public appearances that might bias the research analysts' recommendations and their firms. *See* Press Release, Securities and Exchange Commission, 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 New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest (May 10, 2002), available at http://www.sec.gov/rules/sro/34-45908.htm.

15. NASD Rule 2711(h)(1)-(h)(2) provides for disclosure requirements.

> NASD Rule 2711(h)(1) requires a member to disclose in research reports and a research analyst disclose in public appearances if:
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> (i) the research analyst or a member of the research analyst's household has a financial interest in the securities of the subject company, and the nature of the financial interest (including, without limitation, whether it consists of any option, right, warrant, future, long or short position.);

ments to NYSE Rule 472.[16] The underlying purpose of the enactment was to: 1) improve the objectivity of the research produced by the large Wall Street firms, and 2) provide investors with more use-

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(ii) if, as of five business days before the publication of the research report or the public appearance, the member or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company; and

(B) any other actual, material conflict or interest of the research analyst or member of which the research analyst knows or has reason to know at the time of publication of the research report or at the time of the public appearance.

NASD Rule 2711(h)(2) (A) requires that a member disclose in research reports if:

(a) the research analyst principally responsible for preparation of the report received compensation that is based upon (among other factors) the member's investment banking revenues; and

(b) the member of its affiliates received compensation from the subject company within twelve months before, or reasonably expects to receive compensation from the subject company within three months following, publication of the research report.

(B) A research analyst must disclose in public appearances if the analyst knows or has reason to know that the subject-company is a client of the member or its affiliates.

See Press Release, National Association of Securities Dealers, Rule Language Approved By SEC, (May 9, 2002), available at http://www.nasdr.com/analyst_guide.htm. *See also* Press Release, Securities Exchange Commission, Commission Approves Rules to Address Analyst Conflicts SEC Also Requires EDGAR Filings by Foreign Issuers (May 8, 2002), available at http://www.sec.gov/news/press/2002-63.htm.

16. In order to control the amount of interaction between the investment banking and research departments, the SEC enacted NYSE Rule 472(b) (1)-(2). *See* Press Release, New York Stock Exchange, Proposed Amendments to NYSE 472, (May 8, 2002), available at http://www.nyse.com/pdfs/2002-09fil.pdf. Rule 472(b) (1) provides that Research Department personnel or any associated person(s) engaged in the preparation of research reports may not be subject to the supervision or control of the Investment Banking Department of the member or member organization. Research report may not be subject to review or approval prior to distribution by the Investment Banking Department. Rule 472(b)(2) provides that Investment Banking personnel may check research reports prior to distribution only to verify the accuracy of information and to identify or to review for any potential conflict that may exist, provided that (i) any such written communication concerning the accuracy of research reports between the Investment Banking and Research Departments must be made either though the Legal or Compliance Departments; and (ii) any such oral communication concerning the accuracy of research between the Investment Banking and Research Department must be documented and made either with Legal or Compliance personnel acting as intermediary or in a conversation conducted in the presence of Legal or Compliance Departments. *See generally,* David B. Harms & Justin Smith, *The Impact of Enron: Regulatory, Ethical and Practice Issues for Counsel to Issuers, Underwriters and Financial Intermediaries*, 1321 PLI/CORP. 39, 101 (2002).

ful and material[17] information in making their investment decisions. Although not explicit, a failure to disclose would be an omission of material fact, and thus a violation of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated there-under.[18] However, the proponents of the new SRO regulations, which emphasize disclosure of conflicts, rather than prosecution of fraud, are likely to be disappointed by the new rules' myriad of unintended consequences. Particularly, problems arise from the rules' broad draftsmanship and spring from a misguided focus on disclosure rather than on anti-fraud protection.[19]

This note will explore NASD 2711 and the amendments to NYSE Rule 472 emphasizing their misplaced focus on disclosure instead of focusing on a modification of the anti-fraud provisions of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Part II examines the regulatory environment in the securities industry that existed prior to the enactment of new rules and the reasons that securities regulation generally avoided regulating the securities analyst. Part III analyzes and examines specific provisions of the new rules pertaining to the new disclosure requirements placed upon securities analysts. Part III also argues that because the new disclosure requirements are drafted so broadly as to avoid insider-

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17. Unfortunately, the term "material" is not defined by the new regulations.

18. 10b-5, promulgated under § 10b of the 1934 Securities Exchange Act, has been used frequently as authority to bring claims in federal court for recovery of losses sustained from the sale of securities. *See* 17 C.F.R. § 240. Rule 10b-5 is comprised of a number of elements, many of which are now under close scrutiny by the courts. To succeed under Rule 10b-5, a plaintiff must allege and prove that the defendant:

(a) either employed a device, scheme or artifice to defraud, or made a material false statement or omission
(b) relied upon by the plaintiff
(c) in connection with the purchase or sale
(d) of a security
(e) with intent to defraud
(f) causing damage

See Michael A. Collora, *The Restricted Application for Rule 10b-5,* MASS LAWYERS WEEKLY, *at* http://dwyercollora.com/articles/mc_restricted.asp#rule. *See generally* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1216-17 (1st Cir. 1996). *See* Jacob H. Zamansky, *Assessing Analysts' Liability for Securities Fraud*, N.Y.L.J., Jan. 3, 2002, at 1.

19. Some commentators have advocated the need for greater anti-fraud measures. *See generally*, Stephen J. Choi, *Company Registration: Towards a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 576 (1997); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 626 (1992).

trading rules,[20] the information mandated to be revealed does not provide meaningful information to the public. Furthermore, the regulations, by solely focusing on disclosure, fail to address or to provide the means by which victimized investors can remedy their injuries. In Part IV, this note argues that Congress should alter the PSLRA.[21] In particular, the scienter requirement of the PSLRA should be altered to include recklessness[22] and the PSLRA itself should broadened to include analysts as aiders and abettors to fraud. The adoption of these two measures will make it less difficult for private individuals to plead Rule 10b-5 fraud when analysts commit actual disclosure violations or when analysts make fraudulent statements.[23] An emphasis on fraud, rather than the approach taken by the new rules with their sole emphasis on disclosure, provides a more cogent approach due to the deterrence value of strong anti-fraud regulations. This note concludes in Part V, highlighting the need to amend the PSLRA to make private class actions against

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20. *See generally* Nicholas L. Georgakopoulus, *Classical and Cross Insider Trading Variation on the Theme of Rule 10b-5*, 28 AM. BUS. L. J. 109 (1990). See also Jeffrey J. Hatch, *Logical Inconsistencies in the SEC's Enforcement of Insider Trading: Guidelines for a Definition*, 44 WASH. & LEE L. REV. 935 (1987).

21. 15 U.S.C. § 78u-4 (2000). Several circuit courts state that PSLRA intended to "combat the filings of abusive and meritless lawsuits that sprang out private Rule 10b-5 litigation. *See* In re Cendant Corp. Sec. Litigation, 182 F.R.D. 144, 145 (D.N.J. 1998).

22. 15 U.S.C. § 78u-4(b)(2) (2000).

Required state of mind:

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

23. 17 C.F.R. § 240.10b-5 (1992). Rule 10b-5 makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

1) to employ any device, scheme, or artifice to defraud,
2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
3) 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.

securities analysts a more effective tool against the most fraudulent abuses by securities analysts.

II. Regulatory Environment Prior to the Enactment of NASD 2711 and NYSE 472

Prior to the enactment of the new regulations, the securities industry already had a regulatory structure to deal with both conflicts of interests as well as fraud and misrepresentation in the financial markets. However, as a general rule, analysts avoided exposure to fraud liability based on their role in the operation of the efficient market.[24] The securities regulatory environment, affecting the security analyst, blends self-regulatory measures that include Chinese Walls[25] with a maze of regulatory rules and regulations.[26] Although the underlying purpose of the Exchange Act is the protection of individual investors from fraudulent schemes,[27] the focus of the regulation of the securities markets wavers from an emphasis on "anti-fraud" measures[28] to regulation focused on "mandatory disclo-

24. Kelly S. Sullivan, Note, *Serving Two Masters: Securities Analyst Liability in the Face of Pervasive Conflicts of Interest*, 70 UMKC L. Rev. 415 *citing* Dirks v. SEC, 463 U.S. 646, 658 (1983). *See also* Herbert S. Wander, *Development in Securities Law Disclosure*, SF05 A.L.I./A.B.A. 441 (2000). Wander discusses the costs and benefits of the analysts' involvement in the initial public offerings.

25. Chinese Walls are self-regulatory means that prohibit information flow from the investment-banking department to research department and vice a verse. Some commentators have suggested that a breach in the Chinese wall contributed to the crisis. *See* Henry Sender, *Deals & Deal-Makers: Banking 'Firewalls' May Have Some Cracks*, Wall St. J., Dec. 26, 2002, at C1. *See also* Christine M. Bae & Carlton R. Asher, Jr., *Chinese Walls-Procedures and Remedies for Dealing with Conflicts of Interest and other Abuses by Broker-Dealers in Connection with Conduct by their Securities Analysts*, 1327 PLI/Corp 123 (2002).

26. To further complicate the situation, investors have retained the ability to bring causes of action based upon common law fraud and misrepresentation based upon state law. Attorney General Eliot Spitzer has taken it upon himself to bring a number of suits against the securities houses for supposed analyst misconduct. *See Committee on Senate Commerce Science and Transportation Subcommittee on Consumer Affairs, Foreign Commerce and Tourism Hearing on Corporate Governance*, 107th Cong. (June 26, 2002) available at 2002 WL 20318470 (statement by Eliot Spitzer).

27. *See* S.E.C. v. Texas Gulf Sulphor Co., 401 F.2d 833, 858 (1968). *See also* Securities Exchange Act of 1934, Release No. 3230 (2d Cir. May 21, 1942).

28. In this paper, the term "anti-fraud measures" refer to prohibitions that impose civil liability or sanctions for false or misleading disclosure. While there are various anti-fraud measures, the focus of this paper will be Rule 10b-5.

sure".[29] The two measures differ significantly. In particular, "anti-fraud measures" are designed to eliminate deception in disclosure by prohibiting materially false and misleading representations. In contrast, the mandatory disclosure measures are designed to increase the overall amount of information that investors possess in making their investment decisions.[30] Generally, analysts avoided the purview of the anti-fraud provisions,[31] and the SEC has tended to focus on mandatory disclosure. Regulation Fair Disclosure ("Reg. FD"),[32] enacted by the SEC in 2000, reflects the SEC's emphasis on disclosure and aims to enable individual investors to make informed investment decisions by providing a level informational playing field.[33]

Analysts play an important role in the securities markets by ferreting out and analyzing information to the benefit of all investors.[34] In the 1950s and 1960s, analysts' salaries originated from the

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29. See, Joseph A. Franco, *Why Antifraud Prohibitions are not Enough: The Significance of Opportunism , Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 232 (2002). Franco suggests that disclosure requirements focus more broadly on an issuer's business operations and financial results within a prescribed period of time. The most important of these requirements is the filing of annual reports, quarterly reports and current reports.

30. Chairman Levitt expressed concerns about conference and other telephone calls between the issuers and analysts as well as private meetings between companies and analysts that excluded the media and members of the public.

See Harold S. Bloomenthal, SECURITIES LAW HANDBOOK 2043 (2002) *citing* Arthur Levitt, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, SEC Speaks (Feb. 27, 1998), available at http:///www.sec.gov/news/speeches/spch202.txt.

31. Coni Rae Good, Comment, *An Examination of Investment Analyst Liability Under Rule 10b-5*, 1984 ARIZ. ST. L. J. 129 (1984). Good examined how analysts have generally avoided liability for insider trading. Good suggested that in order to remedy the problem statutory reform was needed to create a effective regulatory scheme that should include: 1) definitions of the materiality of inside information that preclude its use without disclosure; 2) limitation of the duty to disclose inside information or refrain from trading to those situations where the information was misappropriated or the source breached a trust relationship in providing the information; and 3) guidelines on appropriate means to publicly disclose inside information.

32. 17 C.F.R. § 243.100-03 (2001) (adopted on Aug. 10, 2000 and effective as of Oct. 23, 2000).

33. *See* Press Release, Securities and Exchange Commission, Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881 (Oct. 23, 2000), available at http://www.sec.gov/rules/final/33-7881.htm.

34. Dirks v. SEC, 463 U.S. 646, 658 n. 17 (1983).

transaction fees paid by retail investors[35] as analysts idled away in relative obscurity doing due diligence and writing research reports.[36] This salary structure, which linked research analysts to the retail base, helped to ensure that analysts focused predominately on providing reliable and objective research to build retail loyalty.[37] However, in the 1970s the limitation of fixed transaction fees and the advent of discount brokerages altered both the analysts' salary structure and the analysts in the investment house.[38] The securities analysts of the 1980s and early 1990s, lacking an independent revenue stream, found themselves in the difficult position of justifying their existence within firms' cost structures.[39] The profit stream of the larger Wall Street firms moved away from retail/individual investors towards investment banking, market making of stocks, and the trading of debt instruments.[40] By the later 1990s analysts found their place in the firm dependent upon their investment banking departments.[41]

Commentators argue that the analysts' dependent relationship with the investment banking department contributed to a tendency by research analysts to help the investment banking departments either retain or attract business relationships.[42] According to commentators, analysts engaged in a *quid pro quo* relationship with their own investment banking departments and corporate issuers.[43] According to the logic of the commentators, analysts supplied overwhelmingly favorable recommendations of the issuing companies in order to solidify the relationships with the corporate issuers that constituted the profit stream of the investment-banking depart-

35. Stephen Gandel, *Why Wall Street Fights to Keep Research: Giants Fear Small Firms will Benefit,* CRAIN'S N.Y. BUS., May 20, 2002, available at 2002 WL 9593723.

36. Johnnie D. Johnson, *Evolution and the Securities Analysts,* INSTITUTIONAL INVESTOR: STRATEGIC INVESTOR RELATIONS, Spring 2001, 25-28.

37. *See id.* at 25.

38. *See id.* at 26.

39. *See id.* at 27.

40. *See id.* at 28.

41. *See id.*

42. *See generally* Jill E. Fisch & Hilary A. Sale, *The Securities Analysts as Agent; Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035.

43. Issuers became the source of the bulk of the large financial services revenue in the late 1990s as hundreds of I.P.O.s and offerings were brought to the market. *See* Burton G. Malkiel, *Remaking the Market: The Great Wall Street?,* WALL. ST. J., Oct. 14, 2002, at A16.

ment. The same commentators argue that the tendency to favor the interests of the investment bankers over the interest of providing objective research tainted the objectivity of the research provided by the research analysts.[44]

A. Rule 10b-5: Anti-Fraud Measures

Section 10b of the Exchange Act and Rule 10b-5 provide the heart of the regulatory matrix covering fraud[45] and misrepresentation in the sale of securities. In particular under Rule 10b-5, a plaintiff is required to demonstrate that the defendant made a misstatement or omission of a material fact, the scienter requirement, and that the reliance was the proximate cause of the plaintiff's harm.[46] However it should be noted that individual investors have generally been unsuccessfully in employing Rule 10b-5 in remedying the fraudulent activities of securities analysts for a number of reasons.

Although pleading causation and reliance in the past was generally a barrier to pleading securities fraud, the Supreme Court in *Basic, Inc. v. Levinson*[47] relaxed these requirements, when it adopted the "fraud on market theory" ("FOMT").[48] The primary

44. *See* Accounting and Investor Protection Issues Raised by Enron and Other Public Companies before the Senate Comm. on Banking, Housing and Urban Affairs, 107th Cong. (2002) (written testimony of Harvey L. Pitt, Chairman, Securities and Exchanges Commission) available at http://www.sec.gov/news/testimony/032102tshlp.htm for a discussion on the securities analysts conflict of interests questions involved in the Enron controversy.

45. Fraud is deliberately making untrue statements regarding objective facts or the failure to disclose a conflict of interest. ALAN R. PALMITER, SECURITIES REGULATION 160 (1998). *See also In re* Credit Suisse First Boston Corp. Securities Litigation, 97 Civ. 4760, 1998 WL 734365 (SDNY Oct. 20, 1998). In *In re* Credit Suisse First Boston, the court found the failure to disclose a short position in a stock that the research department issued a negative report constituted a Rule 10b-5 violation.

46. Jaimee L. Campbell, Note, *Analyst Liability and the Internet Bubble: The Morgan Stanley/Mary Meeker Cases,* 7 FORDHAM J. CORP. & FIN. L. 235, 237 (2001), *citing* Rule 10b-5.

47. *See generally* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) for an examination of the elements necessary to plead Rule 10b-5 fraud.

48. *See* Nicolas L. Georgakopoulos, *Frauds, Markets, and Fraud -on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671, 730 n. 8 (1995). Some commentators have favored a general relaxation of the regulators' enforcement of the securities law in general and the regulators' enforcement of fraud in particular while at the same time focusing on the fraud on the market reliance. *See generally* Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Imper-*

purpose was to ease the pleading requirement in such cases.[49] While, the FOMT's immediate result was to remedy defendant's wrongdoing in the secondary market,[50] other courts extended the doctrine to newly issued securities in the primary market through "the fraud created market theory" ("FCMT").[51] In particular *Shores*

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sonal Markets, 78 VA L. REV. 623 (1992); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory*, 42 STAN L. REV. 1059 (1990); and Richard A. Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159 (1986).

49. FOMT assumes that individuals trading on public trading markets rely on the integrity of the market prices for stocks. LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXAMINATIONS 361 (3d ed. 1999). FOMT is based on the efficient market hypothesis. *See* Zachary Shulman, *Fraud-on-the Market-Theory after Basic v. Levinson*, 74 CORNELL L. REV. 964 n. 48 (1989) *citing* J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY (7th ed. 1986) and J. FRANCIS & S. ARCHER, PORTFOLIO ANALYSIS 193 (1971) for a discussion of the efficient market theory. The FOMT posits that market prices of stocks traded on publicly traded exchanges reflect all available public information about a company's stock. SOLOMON, *supra* note 49, at 361.If a corporation or an individual associated with that corporation issues misleading information, the market price will not accurately reflect the actual state of affairs within the corporation. *See* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 352 (1999). Pinto notes that the FOMT provides these investors, a useful substitute to the reliance element in cases involving publicly traded securities. However, Pinto also notes that FOMT is solely available in the prosecution of "fraud" in large liquid stocks. *See also* Schlanger v. Four Phase Systems Inc., 555 F. Supp. 535 (S.D.N.Y. 1982); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975). The FOMT also posits when a materially misleading statements is disseminated to the market, individuals are defrauded if they rely on market prices. PINTO at 352 (citing *Basic, Inc.*, 485 U.S. at 246-47). (stating that underlying EMT is a notion that that stock market is efficient and stock prices instantaneously reflect all the public information known about the company).

50. *See* Ronald J. Gilson and Reiner H. Kraakman, *The Mechanics of Market Efficiency*, 70 VA. L. REV. 549 (1984). Gilson and Kraakman describe the market having prices that fully reflect all available, relevant information is an efficient market. The efficient capital market hypothesis asserts that all available, relevant information about a company's financial prospects is fully and virtually instantaneously reflected in the market price of the company's securities. *See also* Peter H. Wemple, *Rule 10b-5 Securities Fraud: Regulating the Application of the Fraud on the Market Theory of Liability*, 18 J. MARSHALL L. REV. 733 (1985).

51. *See* HAROLD S. BLOOMENTHAL, 2 SECURITIES LAW HANDBOOK 1402 (2002 ed.) (citing Abell v. Potomac Ins. Co., 858 F. 2d 1104, 1121 (5th Cir. 1988). (Bloomenthal noted that the fraud created the market theory has four elements:

> 1) that the security be purchased in a market of some type rather than directly from an issuer or in a negotiated transaction,
>
> 2) the security is in fact "unmarketable"- a security which is so lacking in basic investment worthiness that, in absence of the scheme, the securities would have never reached the market,

v. Sklar,[52] the Fifth Circuit addressed inefficient markets.[53] In *Shores*, the fraudulent misrepresentation occurred prior to the issuance of municipal bonds and inflated the valuation of what otherwise would be a worthless security.[54]

While FOMT and FCMT partly overcame the reliance and the causation requirements in pleading securities fraud, the scienter requirement proved to be a more daunting hurdle for plaintiffs' attorneys to overcome.[55] The scienter requirement of Rule 10b-5 demands that a "plaintiff allege either (a) that the defendant had both motive and opportunity to commit fraud or (b) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[56] In *Ernst & Ernst v. Hochfelder*, the Supreme Court had the opportunity to examine the scienter requirement of Rule 10b-5.[57] Confronting a lawsuit that alleged an accounting firm's negligence, aided by a company scheme to defraud investors,[58] the Supreme Court held that pleading mere negligence was insufficient and inferred intent to be a necessary component of pleading fraud.[59] Nonetheless, the Court left open the question of whether recklessness actually fulfilled the scienter requirement.[60] In choosing not to specify clearly the degree of recklessness required, the

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3) the security has reached the market as the result of a fraudulent scheme to effect that end, and

4) the plaintiff relied upon the "integrity of the market."

Id. at 1400-01. *See also* Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), cert denied, 103 S. Ct. 722 (1983). However, it should be noted that the fraud created the market theory has not enjoyed universal acceptance. In addition to the Fifth Circuit, the Tenth Circuit in T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth., 717 F.2d 1330 (10th Cir. 1983) accepted the theory, the Sixth Circuit in, Freeman v Laventhol & Horwarth, 915 F.2d 193 (6th Cir. 1990) and the Seventh Circuit in Eckstein v. Balcor Film Investors, 8 F.3d 1121 (7th Cir. 1993) declined to extend the theory.

52. *Shores*, 647 F.2d 462.

53. *Id.* at 467.

54. *Id.*

55. *See In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 984-85 (9th 1999). (holding that although a compliant draws an inference of deliberate recklessness, it lacks sufficient detail and foundation necessary to meet either the particularity or strong inference requirements of the PSLRA."). *See also* Ann Morales Olazabal, *The Search for Middle Ground: Towards A Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard* 6 STAN. J. L. BUS. & FIN. 153 (2001).

56. Press v. Chem. Inv. Servs. Corp., 163 F.3d 529, 538 (2d Cir. 1999).

57. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

58. *Id.* at 186.

59. *Id.*

60. *Id.* at 187.

Supreme Court opened the door and allowed the opportunity for the Circuit Courts to differ on the interpretation.[61]

Furthermore, in an attempt to stop the flow of private litigation, the PSLRA established a heightened pleading standard.[62] The standard required the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the (necessary) state of mind."[63] If the plaintiff is unable to plead with the prerequisite particularity, he or she is denied discovery.[64] Nonetheless, PSLRA's statutory language and legislative history does not specifically attempt to define the required mental state needed to plead fraud.[65] While the circuits are still split[66] as to

61. Although a full examination of the circuit split is well beyond the scope of this paper, in general the circuits have been split between those who found a pleading alleging recklessness as sufficient and those that require a pleading of actual intent. *See In re* Staffmark, Inc Sec. Lit., 123 F. Supp. 2d 1160 (E.D. Ark. 2000) (stating Circuit courts addressing the PSLRA's effect on scienter pleading have divided in three basic ways. First, the Second Circuit in Press v. Chemical Inv. Services, Corp., 166 F.3d 529, 537-538 (2d Cir. 1999) and Third Circuit in *In re* Advanta Corp. Sec. Litig., 180 F. 3d 525, 534 (3d Cir. 1999) continued after PSLRA rule to require "plaintiff's facts to give rise to strong inference of defendant's fraudulent intent. Secondly, the Ninth Circuit in In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 979 (9th Cir. 1999) requires actual intent to be suggested by plaintiff's facts. Third, the First Circuit in Greebel v. FTP Software Inc., 194 F.3d 184, 196 (1st Cir. 1999), the Sixth Circuit in *In re* Comshare Inc.Sec. Litig, 183 F.3d 542 , 549 (6th Cir. 1999), and the Eleventh Circuit in Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1286 (11th Cir. 1999) require plaintiffs to state, with particularity, facts giving rise to the strong inference that the defendant acted with the required state of mind. The Eighth Circuit in Alpern v. Utilicorp United Inc., 84 F.3d 1525, 1534 (8th Cir. 1996) requires, "at minimum, form of recklessness.")

62. *See* 15 U.S.C. § 78u-4(b)(2) (1995). *See generally* Jonathan M. Hoff, Brian J. Fischer, Katherine A. Cleary, & Stacey L. Schreiber, *Developments in Pleading Under the PSLRA and the Application of the PSLRA Safe Harbor*, 1269 PLI/CORP 9 (2001) (discussing the various pleading standards adopted by the circuits).

63. 15 U.S.C. § 78u-(4) (2000). *See generally* Bruce G. Vanyo, *The Pleading Standard of the Private Securities Litigation Reform Act of 1995*, 1199 PLI/CORP 9 (2000), Nancy A. Brown and James B. Weidner, *Pleading Motions Under the Reform Act*, 1070 PLI/CORP 229 (1998). *See also* Joseph A. Grundfest & Michael A. Perino, *Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995*, 1022 PLI/CORP 297 (1997).

64. Miranda S. Schiller & Haron W. Murage, *Circuit Courts Divided on What 'Scienter" Means Under Standards of Private Securities Litigation Reform Act*, SEC. L. WKLY. (Oct. 20, 1999).

65. *See* Aron Hansen, Comment, *The Aftermath of Silcon Graphics: Pleading Scienter in Securities Fraud Litigation,* 34 U.C. DAVIS L. REV. 769, 782 -783 (2001). Mr. Hansen noted that the only clue as to the requisite mental state to plead fraud under PSLRA is contained in the legislative history of the PSLRA stating that the Framers of the PSLRA intended to have a more stringent standard than that of the Second Circuit. *See also* H.R. Conf. Rep. No. 104-369, at 41 (1995), (labeling section "Heightened Pleading

whether recklessness is an actionable state of mind under PSLRA,[67] pleading scienter under PSLRA is an extremely difficult task.[68] John C. Coffee, a Columbia Law School professor, noted that the heightened pleading requirement prevents plaintiffs from obtaining discovery if they are unable to plead with particularity, and plaintiffs can only plead with necessary particularity after discovery has been conducted.[69]

Standard" and stating congressional intent to strengthen pre-existing pleading standard of Second Circuit). In the Second Circuit, "[t]he requisite 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *See* Pilarczyk v. Morrison Knudsen Corp., 965 F. Supp. 311, 320 (N.D.N.Y. 1997) (citing *In re* Time Warner Inc. Sec. Litig. 9 F.3d 259, 268-69 (2d Cir. 1993). *See also generally* Erin Brady, Comment, *Determining the Proper Pleading Standard Under the Private Securities Litigation Reform Act of 1995 After In Re Silicon Graphics*, Comment, 28 PEPP. L. REV. 471 (2001) for a discussion of the difference between the Second Circuit and PSLRA pleading requirements. For a sample of the dozens of notes and comments that have been written about the vagueness of the pleading requirements of the PSLRA. *See also* Justin M. Fabella, Note, *Does Anyone Know the Required State of Mind? The Uncertainity Created by the Vagueness of the Private Securities Litigation Reform Act of 1995,* 7 SUFFOLK J. TRIAL & APP. ADOVOC. 81 (2002); Bruce Cannon Gibney, Comment, *The End of the Unbearable Lightness of Pleading: Scienter After Silcon Graphics,* 48 U.C.L.A. L. REV. 973 (2001); Scott H. Moss, Comment, *The Private Securities Litigation Reform Act: The Scienter Debacle*, 30 SETON HALL L. REV. 1279; Nicole M. Briski, Comment, *Pleading Scienter under the Private Securities Litigation Reform Act of 1995: Did Congress Eliminate Recklessness, Motive, and Opportunity*, 32 LOY. CHI. L. J. 155 (2000); Bradley R. Aronstam, Note, *The Private Securities Litigation Reform Act of 1995's Paradigm of Ambiguity: A Circuit Split Ripe for Certiorari,* 28 HOFSTRA L. REV. 1061 (2000).

66. See Aron Hansen, *The Aftermath of Silicon Graphics: Pleading Scienter in Securities Fraud Litigation*, 34 U.C. DAVIS L. REV. 769, 782-83 (2001), for an excellent discussion of the circuit split. *Compare In re* Silicon Graphics, Inc. Securities Litigation, 183 F. 3d 970 (9th Cir. 1999) (holding that plaintiff must plead that defendant acted with deliberate recklessness) with Press v. Chem. Inv. Serv. Corp., 166 F.3d 529 (2nd Cir. 1999) (holding that a plaintiff only has to plead ordinary recklessness to satisfy scienter and that defendant had motive and opportunity to commit fraud).

67. *See* William H. Kuehnle, *On Scienter, Knowledge, and Recklessness under the Federal Securities Laws,* 34 HOUS. L REV. 121, 122 (1997) (stating that there is uncertainty as to whether recklessness satisfies scienter in securities fraud context).

68. *See generally*, Hilary A. Sale, *Heightened Pleading and Discovery: An Analysis of the Effect of the PSRLA's Internal-Information Standard on '33 and '34 Claims*, 76 WASH. U. L.Q. 537 (1999) (noting the fact that the heightened pleading of the PSLRA prevented plaintiffs from receiving discovery).

69. *See* John C. Coffee, *Understanding Enron," Its About the Gatekeepers, Stupid,"* 57 BUS. L. 1403 (2002).

See also generally, Melvyn I. Weiss, Samuel H. Rudman & Michael A. Swick, *The Adequacy of Notice and Appointment of Lead Plaintiff and The Stay of Discovery During the Pendency of a*

In an attempt to avoid the heightened pleading requirements of PSLRA, plaintiffs began a trend to characterize what otherwise would have been federal securities class action claims as breaches of fiduciary duties in state court under state common law causes of actions where the pleading requirements are a bit more relaxed.[70] In reaction to this trend, Congress enacted Securities Litigation Uniform Standards Act of 1998 ("SLUSA") to close what regulators perceived as a pleading loophole.[71] SLUSA requires the removal of a case from state to federal court if the complaint alleges "an untrue statement or omission of material fact in connection with the purchase of a covered security."[72]

To further complicate matters, analysts have been shielded from liability for aiding and abetting securities fraud. In the past, plaintiffs' attorneys alleged complex, fraudulent schemes, orchestrated by the primary issuer involving willful malfeasance of secondary players like analysts, lawyers, or financial firms.[73] The conduit theory[74] which enables the prosecution of third party individuals like analysts and lawyers who merely pass false or materially misleading information originating from issuers exposes secondary players such as analysts to Rule 10b-5.[75] However, the Supreme Court in *Central Bank of Denver v. First Interstate Bank of Denver*, interpreted

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Motion to Dismiss Under the PSLRA, 1085 PLI/CORP 869 (1998), Elliott J. Weiss and Janet E. Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH U. L.Q. 457 (1998), and Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533 (1997).

70. *See* Seth Aronson and Amy J. Longo, *Recent Developments in Litigation under the Securities Litigation Uniform Standards Act*, 1332 PLI/CORP. 745, 752 (2002). *See also* MDCM Holdings, Inc. v. Credit Suisse First Boston Corp., 216 F. Supp.2d 251 (S.D.N.Y. 2002).

71. By 1998, however, Congress realized that many of the goals of PSLRA were being frustrated because plaintiffs were simply shifting their securities class actions from federal to state court. *See* Dennis J. Block and Jonathan M. Hoff, *SLUSA Preclusion of Claims Against Brokers*, N.Y. L. J., (Apr. 25, 2002), available at http://www.cwt.com/assets/SLUSA%20Preclusion%20Of%20Claims%20Against%20Brokers%20April%202002.pdf.

72. Pub L. No. 105-353, 112 Stat. 3227 (1998), codified as amended at 15 U.S.C. § 77P.

73. *See, e.g.*, Harmsen v Smith, 693 F.2d 932 (9th Cir. 1982), IIT v. Cornfeld, 619 F.2d 909, 922 (2nd Cir. 1980) and SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974).

74. *See, e.g.*, *In re* Azurix Corp. Sec. Litigation, 198 F. Supp. 2d 862, 885 (S.D. Tex). The conduit

75. Robert Norman Sobol, *The Tangled Web of Issuer Liability for Analyst Statements: In re Cirrus Logic Securities Litigation*, 22 DEL. J. CORP. L. 1051, 1057-58 (1997).

Rule 10b-5 to require that defendants be the "primary violator who engages in actual fraudulent behavior, not merely provide collateral assistance."[76] Consequently until recent years, plaintiffs' attorneys generally inferred a prohibition of the sort of "aiding and abetting" claims involving fraudulent conspiracy based on the conduit theory from a reading of *Central Bank of Denver*.[77] As a result of the plaintiffs' bar interpretation, few suits were brought alleging false or misleading statements contained in research reports by analysts under Rule 10b-5 because financial firms were often thought of as mere conduits for the issuer's primary fraudulent activities.[78] Furthermore, the PSLRA did not ease the ability of private individuals to bring lawsuits under the theory of aiding and abetting liability.

Many commentators suggest that the circumstances discussed above acted jointly to minimize the effectiveness of private actions against analysts.[79] However, it should be noted that while the PSLRA and SLUSA pleading requirements prove to be steep, such pleading requirements do not constitute insurmountable barriers for a plaintiff's lawyer to overcome.[80] For example, existing case law suggests that analysts' optimistic statements can be actionable, if not made in good faith or grounded in reasonable basis.[81] For instance, in *Cooper v. Pickett*, the plaintiffs alleged that the underwriters and analysts knew of the issuer's misstatements and were liable

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76. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

77. *Id.*

78. Raymond L. Moss, Michael P. Gilmore, Gerald B. Kline, *The Wall Street Analyst: Rise and Fall of a Rock Star*, 1327 PLI/CORP. 99, 114 (2002).

79. *See generally* Larry D. Soderquist, *Fraud in the Purchase or Sale of Securities: Rule 10b-5*, *in* Nuts & Bolts of Securities Law 251 (Larry D. Soderquist ed., 2000). Several commentators have argued that the anti-fraud prohibitions are insufficient to deal with the analysts and argue that the mandatory disclosures should be required. *See* Joseph A. Franco, *Why Antifraud Prohibitions are not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure,* 2002 COLUM. BUS. L. REV. 223 (2002). Others have noted that the pleading requirements are extremely difficult to surmount. *See also* Elliott J. Weiss, *Pleading Securities Fraud,* 64 LAW & CONTEMP. PROBS. 5 (2001).

80. *See In re* Initial Public Offering Securities Litigation, 241 F. Supp. 2d 281 (S.D.N.Y. 2003) Judge Scheindlin held that the Rule 10b-5 claims for material misrepresentation were properly pled.

81. Cooper v. Pickett, 137 F.3d 616, 629 (9th Cir. 1998).

for dispersing misleading information to the market.[82] Additionally, courts found that plaintiffs can plead Rule 10b-5 fraud if projections were published in bad faith, reasonably calculated to cause the stock price to decline, or to create a profit from an undisclosed short position.[83] While there are exceptions to the general rule, plaintiffs' suits have proven to be generally unsuccessful in sufficiently pleading the requisite scienter which is that the analyst knew or was reckless in not knowing that the reports were false.[84]

B. Focus on Disclosure: Regulation FD

While the analysts have generally avoided liability under the anti-fraud measures such as Rule 10b-5, analysts have been subject to the disclosure requirements. For example in 2000, the SEC focused on the practice of selective disclosure of market information by securities analysts.[85] Corporations engaged in a policy of releasing information, such as earnings and forecasts, to analysts prior to the release of the information to the general public via a policy of conference calls and private meetings with analysts.[86] The analysts would then disperse information about earnings and company "upgrades" to large institutional investors before releasing the information to the general public.[87] Moreover, the practice of selective disclosure was apparently endorsed by the Supreme Court in *Chiarella v. United States*[88] and *Dirks v. SEC.*[89] In 2000, the SEC's

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82. *Pickett*, 137 F.3d at 629.

83. *In re* Credit Suisse First Boston Corp. Securities Litigation, 1998 WL 734365 (SDNY).

84. *See In re* Stratosphere Corp. Sec. Litigation., 1 F. Supp.2d 1096 (D. Nev. 1998); McNamara v. Bre-X Minerals Ltd., 197 F. Supp 2d 622 (E.D. Tex. 2001); and *In re* Lloyd v. Morgan Stanley Dean Witter & Co., 2001 WL 959190 (SDNY 2001).

85. Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, IC-24599,
[1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ *51,716* (Oct. 23, 2000), available at http://www.sec.gov/rules/final/33-7881.htm.

86. Jennifer Caplan, *Wall Street Feels Reg FD's Pain: Some Top Securities Analysts Used This Week's SEC-Sponsored Forum to Explain Why They're Chafing under Reg. FD's Restrictions*, (April 26, 2001), available at http://www.cfo.com/article/1,5309,2863%7C%7CA%7C22%7C2,00.html.

87. *Id.*

88. Chiarella v. United States, 445 U.S. 222 (1980) (holding that possession of non-public information and use of such information for trading purposes without the existence of a relationship of trust between the person trading and the corporation did not violate Rule 10b-5).

Chairman, argued that selective disclosure created an information disparity where market insiders possessed more information than the general investing public.[90] Consequently, the SEC made a conscious effort to increase the full disclosure of material market information to customers in order to "level the playing field" on the amount of information each market player possesses in making investment decisions[91] by enacting Regulation Fair Disclosure ("Reg. FD")[92] in 2000. Reg. FD requires that whenever:

> an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer on its securities to any person described, the issuer shall make public disclosure of that information (1) simultaneously, in the case of an intentional disclosure and (2) promptly, in the case of a non-intentional disclosure."[93]

However, commentators are sharply divided on both Reg. FD's overall effectiveness and effect on the marketplace.[94] In any case it

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89. Dirks v. Sec. & Exch. Comm'n., 463 U.S. 646 (1983) (holding that an analyst who traded on material nonpublic information was not liable for insider trading under Rule 10-b5 unless the information provided by an insider in breach of the insider's fiduciary duty to the corporation's shareholders).

90. Glen Banks, *The SEC Puts the Weight on the Other Side*, N.Y.L.J., Sept. 29, 2000, at 6.

91. Although Reg. FD did not define the term material, it quoted TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438(1976) for the proposition that information is considered material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision, or if it would have significantly altered the "total mix" of information made available. Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72594 *citing* TSC Indus., 426 U.S. at 449.

92. Commodity and Security Exchanges, 17 C.F.R. § 243.100 (2003).

93. 17 C.F.R. 243.100.

94. Some commentators have suggested that the new regulations might have a positive influence on the market place by leveling the playing field between individual investors and Wall Street. *See* D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and Its Impact on Market Participants*, IND. L.J. 551 (2002). However, the bulk of commentators have suggested that the enactment of Reg F.D. would provide less market transparency.

See also, Andrea J. Sessa, Note, *The Negative Consequences of Regulation FD on the Capital Markets*, 45 N.Y.L. SCH. L. REV. 733, (2002), Michael P. Daly and Robert A. Del Giorno, Note, *The SEC's New Regulation FD: A Critical Analysis, 16* ST. JOHN'S J.L. COMM. 457 (2002), Joanna E. Barnes, Comment, *Regulation FD Will Result in Poorer Disclosure and Increased Market Volatility*, 29 PEPP. L. REV. 609 (2002), J. Scott Colesanti, Note, *Bouncing the Tightrope: The S.E.C. Attacks Selective Disclosure, But Provides Little Stability for Analysts*, 25 S. ILL. U. L.J. 457 (Fall 2000). Recent events, particularly, SEC v. Schering-Plough is arguable that, rather than providing increased market transparency as promised,[95] Reg. FD tended to decrease individual investor participation, market efficiency and liquidity.[96] Individual investors, unlike institutional investors, may not have the time or expertise to interpret the rapid release of market information in a meaningful way to make investment decisions.[97] Although empirical studies prove inconclusive,[98] Reg. FD's focus on the massive, rapid and direct disclosure of information, without providing investors with the means or time to interpret the information's value,

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Corp., Litigation Release No. 18330, (Sept. 9, 2003), available at http://www.sec.gov/litigation/litreleases/lr18330.htm, add further uncertainty of the Reg. FD's consequences on the analysts. *See* Todd R. David, JOURNAL OF INVESTMENT COMPLIANCE: *Regulation FD: What the SEC's Recent Enforcement Actions Teach About Avoiding Liability*, Dec. 22, 2003.

95. *Cf.* Partha S. Mohanram and Shyam V. Sunder, *Full Disclosure*, STERNbusiness (Fall/Winter 2002), available at http://www.stern.nyu.edu/Sternbusiness/fall_winter_2002/fulldisclosure.html. Mohanram and Sunder argue that overall Reg. FD has accomplished what it set out to do, level the playing field of information.

96. Some commentators have suggested that the Reg. FD might have changed the market dynamic from one based on efficient market theory to one based on behavioral economics. *See* Scott Russell, Note, *Regulation Fair Disclosure: The Death of Efficient Capital Market Hypothesis and Birth of Herd Behavior*, 82 B.U.L. REV. 527 (2002). The efficient market theory states that the market price of stocks reflects all publicly available information. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 552 (1984). While efficient market theory is based on rational decision makers, the behavioral economic is based on decision makers that are flawed and biased. *See* Jon D. Hanson & Douglas A. Kysar, *Taking Behaviorism Seriously: The Problem of Market Manipulation*, 74 N.Y.U.L. REV. 630 (1999).

97. Marissa P. Viccaro, *Can Regulation Fair Disclosure Survive the Aftermath of Enron?*, 40 DUQ. L. REV. 695, 701 (2002) *citing* Squawk Box, 8:00 am (CNBC television broadcast, Aug. 27, 2001).

See also Thomas G. Donlan, Editorial, Phony Fairness: Regulation FD Will Hurt Markets and Investors, Barron's, Oct. 23, 2000, at 78 available at 2000 WL 22213607(supplying alternative names for Regulation FD, such as Regulation SD for "sudden disclosure," Regulation V for "volatility" and Regulation CSI for "crushing small investors").

98. For an examination of the economic effect of Reg. FD see Eric Zitzcwitz, REGULATION FAIR DISCLOSURE AND THE PRIVATE INFORMATION OF ANALYSTS, 21 (Stanford Graduate School of Bus. Working Paper, Apr. 2002), available at http://faculty-gsb.stanford.edu/zitzewitz/Research/regfd.pdf. Zitzcwitz argues that the Reg. FD has had a positive effect on information dispersion. *See also* Chistopher Gadarowski and Praveen Sinha, ON THE EFFICACY OF REGULATION FAIR DISCLOSURE: THEORY AND EVIDENCE 7 (Cornell Graduate School of Mgmt. Working Paper, July 2002), available at http://www.hotelschool.cornell.edu/chr/research/working/disclosure.pdf. Gadarowski and Sinha suggest that Reg. FD might have unintended consequences that involve increased market volatility and increased costs.

may have a detrimental effect on the individual investor.[99] The speed of information dispersion may result in individual investors reacting to the market actions of other market players rather than independently evaluating the merits of the information.[100] If this phenomenon were found to exist, such a negative effect would defeat the underlying purpose of Reg. FD, which was to make the capital-markets more rational by dispersing more information to the investor to make more informed decisions.

C. *Self-Regulatory Measures: Chinese walls*

In addition to outside regulation, financial institutions implemented a series of self-regulatory mechanisms in reaction to the legal issues presented by the problematic relationship between research analysts and their investment banking departments.[101] The most noteworthy of these is the Chinese wall.[102] The Chinese wall refers to the variety of measures taken by securities firms to separate the investment banking and research departments so that investment banking does not influence the objectivity of the research provided by the analysts.[103] However, situations exist, where analysts operated as both researchers and investment bankers.[104] Ac-

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99. *The Effect of Regulation Fair Disclosure: Hearing Before Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises House Committee on Financial Services*, 107th Cong. 5-7 (2001) (statement of Stuart J. Kaswell, President, Securities Industry Association), available at http://www.sia.com/testimony/html/kaswell5-17.html

100. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. Cin L. Rev. 1023, 1038 (2000).

101. For an overview of the self-regulatory measure enacted by financial firms *see generally*, Theodore A. Levine, Arthur F. Matthews, and Yoon-Young Lee, *An Overview of Compliance Policies and Procedures for Multi-service Financial Institutions*, A.L.I.-A.B.A. Course of Study, May 3, 1990, available at C522 A.L.I.-A.B.A. 891.

102. Following the crash (1929, not 1987) the government sought to provide a separation between investment bankers and brokerage firms in order to avoid the conflict of interest between objective analysis and the desire to have a successful stock offering. These regulations became known as the "Chinese wall" because they were meant to create a barrier as effective as the Great Wall of China between the two operations. Most investment/brokerage firms even re-located departments to different floors. For a discussion of the conflicts of interest present within securities firms *see generally* Norman S. Poser, *Conflicts of Interest Within Securities Firms,* 16 Brook. J. Int'l L. 111 (1990).

103. Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 826-830 (3rd ed. 1995).

104. The most notable of the analysts wearing two hats is Jack Grubman, the former chief analyst of telecommunications at Salomon Smith Barney. *See* Amy Feldman &

cording to a recent study of the analyst ratings, such an interdependence of analysts, investment banking, and research roles may have resulted in analysts overwhelmingly rating stocks that their firm had investment banking relationships with as a "buy."[105] The study concluded that strong incentives existed for analysts to recommend stocks for which the investment-banking department recently completed an initial public offering.[106] The example of Jack Grubman, who acted both as head of securities analysts and lead investment banker, exemplifies the securities industry's failure to effectively self-regulate, the problem posed by the overlapping structure of the investment house. As a result of the various barriers that prevent analysts from being exposed to securities fraud liability under Rule 10b-5, the regulator's emphasis on disclosure, and the breaches of self-regulatory measures such as the Chinese walls, the SROs enacted NASD Rule 2711 and NYSE Rule 472.

III. Curing the Wrong Disease

Although well-intentioned, the new rules, following the precedent established by Reg. FD, misguidedly emphasize the disclosure of potential conflicts of interest posed by the structure of the investment banks rather than the strengthening of the anti-fraud measures of Rule 10b-5. This emphasis on disclosure misinterprets the intent of the Exchange Act, the purpose of which is to: 1) protect investors from fraudulent schemes and devices; and 2) provide the means by which individual investors can deter fraudulent activity by

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Joan Caplin, *Is Jack Grubman the Worst Analyst Ever,* Money Magazine (May 1, 2002), available at http:/money.cnn.com/2002/04/25/pf/investing/grubman/index.htm.

Additionally, analysts would frequently be involved in the road shows of initial public offerings that their investment banking departments were bringing to market. *See generally* Brian C. Eddy, *Internet Road Shows: Its Time To Open The Door For the Retail Investor*, 25 J. Corp. L. 867 *citing* Stephen J. Schulte, Note, *IPO Road Shows Today: A Primer for the Practitioner*, reprinted in 2 26th Annual Institute on Securities Regulations 205, 206 (1999).

105. *See* Roni Michael & Kent Womack, *Conflicts of Interest and the Credibility of Underwriter Analyst Recommendations, The Review of Financial Study Rules*, 12 Rev. Fin. Study 653, 654-6 (1999).

106. *Id.* at 654-56.

bringing private suits.[107] In addition to their misplaced focus, the new rules are drafted too broadly. Encompassing a multitude of situations, as not to violate the inside trading regulations, the disclosure provided by the new rules does not provide the individual investor with meaningful information. Additionally, the new regulations, by not altering the pleading requirements of PSLRA or amending Rule 10b-5 to enable private lawsuits for aiding and abetting Rule 10b-5 violations, do not provide a viable means for individual investors to hold analysts accountable for a variety of malfeasance.[108]

The new NASD regulations possess several fundamental weaknesses and are an example of a cure that addresses the wrong disease.[109] The new rules possess a number of mundane, as well as controversial elements. However, a full examination of all of the provisions of the new regulations is beyond the scope of this paper. Consequently, this note will limit itself to the most glaring flaws of

107. Peter J. Dennin, Note*, Which Came First, The Fraud or the Market: Is Fraud-Created the-Market Theory Valid Under Rule 10b-5?* 69 FORDHAM L. REV. 2611, 2648 (2001) *citing* John Schmidt, Comment, *The Fraud-Created-The -Market Theory: The Presumption of Reliance in the Primary Issue Context*, 60 U. CIN. L. REV. 495, 519-20 (1991) (arguing that the central goal is to protect investors from fraudulent conduct, and to promote honest securities markets).

108. Potential malfeasance by analysts can involve a number of situations such as: (1) failing to disclose the existence of a conflict; (2) making material misrepresentations; or (3) knowingly or recklessly passing inaccurate information to the public.

109. The proposals were subject of a heated debate resulting in over 40 comment letters to the Securities and Exchange Commission. Many large law firms including, Sullivan & Cromwell LLP, whose major clients are the financial services companies vigorously, opposed the new proposals. Sullivan & Cromwell LLP attacked the disclosure of conflicts mandated by the proposals on a number of grounds. First, that the proposed rules include no guidance as to what is material conflict of interest. Second, and perhaps most importantly, these rules could create a serious problem regarding disclosure of material, non-public information about a firm's investment banking clients. The entire comment letter is available at http://www.sec.gov/rules/sro/nd200221ny200209/sullivancromwell1.htm.

Additionally other commentators have criticized the regulations for containing ambiguous terms or being a burden on the compliance departments of the financial services companies. *See* Robert C. Mendelson, Steven W. Stone, and John V. Ayanian, *NASD and NYSE Tackle Research Analyst Practices . . . But Are Their New Rules Workable?* 1336 PLI/CORP. 529 (2002). *See also* Sam Scott Miller, *Chaperoning Analysts: Procedures to Manage, Minimize, Disclose Conflicts*, 34 BNA SEC REG. & LAW REPORT 879 (June 3, 2002), available at http://www. lawcommerce.com/newsletters/art-ohs_marketregulation020530.asp who suggests that the new regulations and the market, not the regulators should address the problem.

the new SRO rules.[110] Namely, it will address: 1) the inherent conflict of interest within the nature of financial services firms that these new rules overlook; 2) the creation of inexperienced and inappropriate new gatekeepers of information; 3) the disclosure requirements that are over-broad; 4) the possible creation of an appearance of impropriety; and 5) the redundancy of the new disclosure measures.

A. *Conflict of Interest Inherent in the Nature of Financial Services Firms*

First, the new rules improperly address the conflict of interest, due to the existence of both research and investment departments, that is inherent in an intermediary role. Financial services firms serve an important role as the middleman in the capital markets.[111] Conflict of interest is an unavoidable aspect of an intermediary role.[112] To distribute the product from the sellers of capital (i.e. the issuers of equity and debt securities) to the buyers of such capital (both individual and institutional investors), Wall Street firms advertise their product (initial public offerings, equity, and debt offerings) to their customers-retail and institutional investors. Sell-side analysts[113] perform the advertising function by issuing research reports and by appearing in print and television mediums.[114] While deliberately making factually untrue statements constitutes fraud even in advertising, puffery is part of both the advertising and securities business.[115] However, actions that cross the line, by either intentionally or recklessly dispersing false information, should

110. The new regulations also include NASD Rule 2711(h) 4,5,6 which requires analysts to explain their rating systems in plain English which an investor can easily understand together with explanatory graphs and charts that track the firm's recommendations.

111. Don Luskin, *Eliot Spitzer's Attack on Securities Industry*, Capitalism Magazine, (November 10, 2002), available at http://www.capmag.com/article.asp?Id=2146.

112. Andy Kessler, *The Rise and Fall of Full Service,* WALL ST. J., Aug. 20, 2002, at A18.

113. An analyst employed by a brokerage firm or another firm that manages client accounts. Unlike that of the buy-side analysts employed by mutual funds, research produced by sell-side analysts is usually available to the public. *See generally* Randall S. Thomas, *Measuring Securities Market Efficiency in the Regulatory Setting*, 63 LAW & CONTEMP. PROBS. 105, 114 (2000).

114. *See* Luskin, *supra* note 116.

115. *See generally* Jennifer O'Hare, Note, *The Resurrection of the Dodo: The Unfortunate Re-Emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L. J. 1697

be prosecuted for fraud. For example, Henry Blodgett and other analysts at Merrill Lynch often privately referred to some of the same Internet stocks that were officially recommended as "buys" on his company's recommended list, as "junk" and "dogs" in private emails.[116] Such conduct probably crossed the line between fraud and puffery.[117] Unfortunately, the new rules solely focus on the disclosure of such purported conflicts of interest without attempting to remedy or provide relief for the victims of fraud and misrepresentation.

B. *Creation of Inexperienced and Inappropriate New Gatekeepers of Information*

Under the new regulations, investment bankers will not be permitted to supervise research analysts.[118] Instead, legal and compliance personnel are to act as intermediaries between research and investment banking with regard to the contents of research reports.[119] This rule, therefore, turns legal and compliance personnel of the investment firms into gatekeepers of information.[120] Such a structure transforms legal and compliance personnel into supervisors of both investment banking and research departments rather than maintaining the traditional role of regulatory or legal advisors to the analyst and banker.[121] Commentators suggested that legal and compliance personnel might lack the expertise or subjective understanding of the materiality of the information con-

(1993). *See also* R. Gregory Roussel, Note, *Securities Fraud or Mere Puffery: Refinement of the Corporate Puffery Defense*, 51 VAND. L. REV. 1049 (1998).

116. Burton G. Malkiel, *Remaking the Market: The Great Wall Street?* WALL ST. J., Oct. 14, 2002, at A16.

117. *See generally* Christine M. Bae and Carlton R. Asher, Jr., *Chinese Walls-Procedures and Remedies for Dealing with Conflicts of Interest and Other Abuses by Broker Dealers in Connection with Conduct by their Securities Analysts*, 1327 PLI/CORP. 123 (2002).

118. NYSE Rule 472 (b)(1).

119. NYSE Rule 472 (b)(2).

120. Comment Letter from Stanely Keller, Chair, Committee on Federal Regulation of Securities, American Bar Association, to Harvey L. Pitt, Chairman, Securities and Exchange Commission 8 (April 30, 2002), available at www.sec.gov.rules/sro/nd200221ny200209/keller1.htm.

121. *Id.* at 8.

tained within the reports to make decisions regarding compliance with the new rules.[122]

C. *Disclosure Requirements Drafted Broadly*

The new regulations require disclosure if the member firms or its affiliate(s): 1) managed or co-managed a public offering of securities for the subject company in the past twelve months; 2) received compensation for investment banking services from the subject company in the past twelve months; or 3) expected to receive, or intended to seek compensation for investment banking services from the subject company in the next three months.[123] Additionally, in research reports, the analyst must disclose the amount of compensation the analyst received from the firm's investment banking department.[124] Analysts who appear on television or radio are required to disclose: 1) if they have a position in the stocks they are discussing, and whether the companies are investment-banking clients of the firm;[125] 2) if their firm makes a market in the securities which are the subject of his or her recommendation;[126] and 3) if the analyst has a personal and/or financial interest in the security in question.[127] Arguably, a failure to disclose one of the above situations constitutes a Section 10(b) or Rule 10b-5 violation.

While the new regulations are essentially identical in substance and principles already implicitly embodied in the NASD's concept of fair and equitable principles of trade,[128] such new disclosure requirements pose several new problems. First, the requirement that

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122. *See* Sam Scott Miller, *Chaperoning Analysts: Procedures to Manage, Minimize, Disclose Conflicts*, 34 SEC. REG. & L. REP., 879 (2002).

123. NASD Rule 2711(h)(2)(A).

124. NASD Rule 2711(h)(2)(A)(i).

125. NASD Rule 2711(h)(2)(B).

126. NASD Rule 2711(h)(8).

127. NASD Rule 2711(h)(1)(A).

128. NASD Rules of Conduct 2210 requires that in making a recommendation in advertisements and sales literature, whether or not labeled as such, a member must have a reasonable basis for the recommendation and must disclose any of the following situations which are applicable: a) that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, or that the member or associated persons will sell to or buy from customers on a principal basis; b) that the member and/or its officers or partner owns options, rights or warrants to purchase any of those securities that are recommended, unless the extent of such ownership is nominal; c) that the member was manager or co-

the firm has or will receive compensation might create the prospect of tipping analysts and/or the recipients of research to the existence of investment banking deals. Such information is supposed to be beyond the knowledge both of the analyst due to the existence of Chinese walls[129] and of the public due to the confidentiality of the investment banking relationship.[130] Therefore, in an attempt to avoid tipping/tippee problems, the NASD provisions broadly encompass the multiple scenarios listed above[131] to avoid potential breaches of the Chinese walls and insider trading. However, with the exception of the analyst's interest in the security, analysts theoretically lack personal knowledge as to which of the above situations applies to a given security.[132] Such a broad disclosure, therefore, raises the question as to how an analyst's opinion on a particular stock can be tainted by a conflicting relationship of which he or she did not know existed prior to such disclosure.[133]

According to Credit Suisse First Boston's comment letter to the SEC, the largest investment banks possess thousands of relationships with issuing companies, ranging from underwriting billion-dollar new issues to maintaining relatively small brokerage accounts for executives and employees of companies.[134] The regulations require the disclosure, not only of compensation received in the past, but also a disclosure of expected compensation from future business. Credit Suisse and others argue that the investment houses might be tempted to employ blanket disclaimers to comply with the new disclosure requirements.[135] However such blanket disclaimers

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manager of a public offering of any securities of the recommended issuer within the last three years.

129. Comment Letter from Stuart J. Kaswell, Senior Vice President, Securities Industry Association, to Harvey L. Pitt, Chairman, Securities and Exchange Commission 9 (April 11, 2002) [hereinafter Kaswell Comment Letter], available at http://www.sec.gov/rules/sro/nd200221ny200209/kaswell1.htm.
Id. at 8.

130. *Id.*

131. *Id.* at 9.

132. Kaswell Comment Letter, at 9.

133. *Id.*

134. Comment Letter from Credit Suisse First Boston, to Jonathan G. Katz, Secretary, United States Securities and Exchange Commission, 3 (April 19, 2002) [hereinafter Credit Suisse Comment Letter], available at http://www.sec.gov/rules/sro/nd200221ny200209/creditsuisse1.htm.

135. *Id.*

will tell the public little, if anything substantive, about the nature, degree, or the extent of the supposed conflict that is the subject of the disclosure[136] because individual investors lack the time and expertise of the institutional market participant to evaluate the relevance of the potential conflict disclosed.[137]

D. *Possible Creation of an Appearance of Impropriety and Shifting of Burden of Persuasion in Securities Litigation*

The new regulations blur the line between fraud and the concept of conflict of interest. By emphasizing disclosure with a possible negative connotation implied, the general public is left with the impression that a conflict of interest implies a fraudulent activity. While disclosures might substantively reveal little because the firms might employ blanket disclosures, the disclosure of one of the above situations even without any fraudulent activity might create the appearance of impropriety in the eyes of the public. The new regulations set a potentially dangerous precedent in altering the relationship between the individual investor and the securities analyst by creating an implied fiduciary duty.[138] For example, in the following hypothetical, prior to the enactment of the amendments to NYSE Rule 472 and the adoption of NASD 2711, a securities analyst at ABC Securities who is on XYZ television station recommending ZZZ security did not owe Citizen J- a member of the general public- a fiduciary duty. At the same time, the NASD rules dealing with communicating with the public require analysts' statements to be free from material misrepresentations.[139] Assuming that Citizen J is also a client of ABC securities, Citizen J's financial

136. *Id.*

137. Credit Suisse Comment Letter, at 3.

138. Matthew Goldstein, *Toward a New Legal Definition of Analyst*, THESTREET.COM (Aug. 15, 2002), available at http: www.thestreet.com/_tsclsii/markets/matthewgolstein/10037733.html. Goldstein cites what at the time was a forthcoming law review entitled "The Securities Analyst Rethinking the Regulation of Analysts." See, *supra* note 45. *See generally* Jill E. Fisch & Hilary A. Sale, *The Securities Analysts as Agent; Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035. Professors Jill Fisch of Fordham Law School and Hillary Sale of University of Iowa Law School argue that the new regulations in their emphasis of mere disclosure do not go far enough. Fisch and Sale argue that analysts owe some fiduciary obligation to investors and argue for a new conception of the analyst as a quasi-agent of the investors. *Id.* at 1098.

139. NASD Rule 2210(d) Standards Applicable to Communications with the Public:
1) General Standards

advisor would also owe Citizen J a fiduciary duty based on the suitability requirements of the NASD Practice Rules.[140] The trend towards the creation of an implied fiduciary duty is illustrated by several recent cases filed in the Southern District of New York.[141]

A) All member communications with the public shall be based on principles of fair dealing and good faith, and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communications to be misleading.

B) Exaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members. In preparing such communications, members must bear in mind that inherent in investment are the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield and no member may publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

NASD Rule 2220(d) Standards Applicable to Communications with the Public:

1) General Standards

No Member or member organization or person associated with a member shall utilize any advertisement, educational material, sales literature or other communications to any customer or member of the public concerning options which:

A) contains any untrue statement or omission of a material fact or is otherwise false or misleading;

B) contains promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts;

C) contains hedge clauses or disclaimers which are not legible, which attempt to disclaim responsibility for the content of such literature or for opinions expressed therein, or which are otherwise inconsistent with such communication;

D) would constitute a prospectus as that term is defined in the Securities Act of 1933, unless it meets the requirements of Section 10 of said Act.

140. NASD 2310 Recommendations to Customers (Suitability): In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

141. *See* Hardy v Merrill Lynch, Pierce, Fenner & Smith, Inc., 189 F. Supp.2d 14 (S.D.N.Y. 2001); Korsinsky v. Salomon Smith Barney Inc., 2002 WL 27775 (S.D.N.Y.); McCullagh v. Merrill Lynch & Co., 2002 WL 363774 (S.D.N.Y). In *Hardy,* the customer alleged that Merrill Lynch breached its fiduciary duty to its customers by maintaining a favorable rating on Internet Capital Group, Inc, a company that Merrill Lynch under-

In these three cases, the customers of securities firms sued for breach of fiduciary trust arising from the failure to disclose an analyst conflict of interest to the firms' customers.[142] Although all three were dismissed on pleading technicalities,[143] courts in the future might interpret the existence of a conflict of interest, even when disclosed, to create an implied presumption of impropriety if the SEC adopts a regulatory scheme based on implied fiduciary duties that appear to be embodied in NASD Rule 2711 and NYSE Rule 472. Such a scheme would possibly taint the securities analyst without requiring the showing of any other wrongdoing.[144] A shift of the burden of proof in securities litigation from the plaintiff to the defendant would result in a transformation of securities litigation from one based on enforcing violations for willful or reckless misrepresentations to one based on state law breaches of fiduciary trust. Commentators have suggested that such an appearance of impropriety might result in the situation where analysts might become reluctant to cover[145] stocks that could present a potential con-

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wrote, while the market price of the stock plummeted from $200 to $2 per share. In *Korsinsky*, the plaintiff alleged that Salomon Smith Barney alleged that the financial firm breached its fiduciary duty to its brokerage customers by issuing artificially positive recommendations for several telecommunications stocks, including AT&T in order to attract more investment banking business. In *McCullagh*, plaintiffs alleged that Merrill Lynch breached its fiduciary duty by its general practice of issuing buy rating on stocks that they had investment banking relationships with.

142. *See* Dennis J. Block and Jonathan M. Hoff, *SLUSA Preclusion of Claims Against Brokers*, N.Y.L.J. (Apr. 25, 2002), available at http://www.cwt.com/assets/SLUSA%20Preclusion%20Of%20Claims%20Against%20Brokers%20April%202002.pdf.

143. The above three cases were dismissed for their failure to comply with the pleading requirements of SLUSA.

144. In 1995, Orange County filed a complaint against Merrill Lynch claiming that the brokerage had breached its fiduciary duty to the County and had committed securities fraud by recommending securities that were not authorized for purchase by state law, not suitable for the investment of public monies, and inconsistent with the County's principal investment objective of preservation of capital. Complaint of County of Orange, *In re* County of Orange, 191 B.R. 1005 (Bankr. C.D. Cal. 1996). In 1998, Merrill Lynch settled the lawsuit for $400 million. *See also* Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, B.Y.U. L. REV. 1493 (2001). Poser suggests that breaches of fiduciary duty, although not recognized by all jurisdictions, might be a viable way to hold brokers liable for misrepresentations of stocks they recommended to their clients. One could make the logical extension of his argument and apply it to securities analysts as well.

145. The term cover means for an analyst to follow a company and issue research reports suggesting an investment position on the stock.

flict of interest.[146] The fear of exposing the firm, and themselves, to potential liability from a supposed conflict may result in less coverage of stocks and fewer research reports being written.[147] This phenomenon possibly could defeat the underlying public policy purpose of the new disclosure requirements resulting in a potential decrease in the amount of information available to the public.[148]

E. *The New Disclosure Measures Possess Elements of Redundancy*

The new regulations possess elements of redundancy. The Securities Exchange Act of 1934 and court interpretations of that act already prohibit undisclosed conflicts of interest that the new rules are intended to address.[149] Additionally, many of the actions that the new regulations prohibit, such as front-running in stocks that the analysts intend to issue favorable reports[150] on or writing research reports containing misleading or fraudulent information, are already criminal actions.[151] In fact, regulatory bodies including the SEC, NYSE, and NASD, possess the tools needed to enforce analysts' violations. It should be noted that only days prior to the enactment of the new regulations the NASD suspended an investment firm called Hornblower & Weeks from all research activities for six-months, after finding that the firm had issued a misleading, baseless research report under existing NASD rules and Rule 10b-5.[152]

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146. Comment Letter from Securities Industry Association, to the Securities and Exchange Commission 1 (April 11, 2002), available at http://www.sec.gov/rules/sro/nd200221ny200209/kaswell1.htm.

147. *Id*; *see also e.g.,* Howard Stock, INVESTOR RELATIONS BUSINESS: *AIMR Slams Corporate Reporting: Analyst Trade Group Says Companies' Disclosure Is Average at Best,* Nov. 10, 2003 (viewing information disclosed as inadequate);

148. *Id.*

149. *See In re* Credit Suisse, 1998 WL 734365. In *Credit Suisse,* the analyst covering companies that were working on trying to solve the Y2K problem issued a negative report on the industry when he had knowledge that CSFB's market makers had short positions in the stocks in question.

150. *See* Carpenter v. United States, 484 U.S. 19 (1987). In *Carpenter*, a *Wall Street Journal* writer was found to have violated Rule 10b-5 for trading in stocks that he had written about in an upcoming article.

151. *See In re* Credit Suisse First Boston Corp. Securities Litigation, 1998 WL 734365 (S.D.N.Y.).

152. Press Release, National Association of Securities Dealers, NASD Regulators Fines Hornblower & Weeks, Inc. $100,000 and Suspends Firm from all Research Activities for 6 months; Firm President Also Fined and Suspended (May 8, 2002), available at http://www.nasdr.com/news/pr2002/release_02_019.html. *See* Barry R. Goldsmith, *The*

Hornblower & Weeks issued a research report recommending common stock of MyTurn.com as a "strong-buy" with a target price of $55 at a time the stock traded at $9. In fact, the report contained baseless projections, misleading and exaggerated statements, and omitted important facts.[153] At the time of the issuance of the "strong buy" report, several members of Hornblower possessed positions of MyTurn.com and maintained an investment banking relationship with MyTurn.com.[154] The Hornblower & Weeks example serves as an illustration of the regulators' ability under the regulations existing prior to the enactment of the current rules.

While the regulatory agencies possess the ability, under Rule 10b-5, to bring sanctions and penalties against perpetrators of fraud, individual investors lack effective tools to sue for failure to disclose or for making intentional or reckless misrepresentations.[155] Under the PSLRA regime, pleading a private action of fraud under the current anti-fraud rules presents an extremely difficult task for a plaintiff's attorney. The regulators did not address this in either NASD Rule 2711 or NYSE Rule 472. In the next section, this note will advocate amendments to SEC Rule 10b-5 reflecting a need to focus on strengthening anti-fraud provisions.

IV. Proposing an Alternative to Mandatory Disclosure

Rather than focusing on measures based on mandatory disclosure, as embodied in both Reg. FD and NASD Rule 2711 and amendments to NYSE Rule 472, legislators and regulators should strengthen Rule 10b-5 anti-fraud prohibitions by easing the ability of private individuals to bring securities fraud causes of action. A

Changing Role of Research Within the Brokerage Industry Workbook Materials, 1336 PLI/CORP 227 for the entire decision of the NASD decision.

153. *See* Press Release, *supra* note 157.

154. *Id.*

155. *See* Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud*, 2002 COLUM. BUS. L. REV. 631 (2002) (discussing the effects of regulatory efforts to limit analyst conflict of interest prior to the enactment of the new rules). Gross argues that the NASD Rule 2711 and NYSE Rule 472 entered into a regulatory environment that featured section 17(b) of the Securities Act of 1933 that precludes any person, including the analyst, from receiving undisclosed compensation for making a securities recommendation. Gross argues that the Investment Advisers Act regulating those who provide investment advice, including buy-side analysts. However, according to Gross, neither of these regulations addressed the sell- side analyst.

fortification of 10b-5 would involve the enactment of two specific modifications by the SEC to existing securities fraud law. First, Congress should resolve the ambiguity involved in pleading fraud under PSLRA by recognizing recklessness as a valid mens rea. Second, the SEC should amend Rule 10b-5 to include analysts under aiding and abetting liability. The combination of these two measures, in expanding the net of liability, would provide effective deterrence for potential analyst malfeasance.

Modifying Rule 10b-5's anti-fraud provisions is a controversial proposition that has sparked debate. Commentators continue to propose a number of alternatives to address the new regulations' numerous shortcomings other than strengthening the anti-fraud principles.[156] Proposals range from a total separation of the investment banking and research departments[157] to a laissez-faire approach that favors the maintenance of the system that existed prior to the enactment of the new regulations, citing that an irrational, not fraudulent, market contributed to the U.S. equity market crash.[158] However, a middle position between a total alteration of the securities markets and the preservation of the status quo preceding the passage of NASD Rule 2711 and NYSE Rule 472 is advisable. Proposals reinforcing Rule 10b-5 provide such a middle way between the extremes of totally altering the investment landscape and doing nothing.

A. *Finding a Middle Ground: A Focus on Fraud*

Rather than altering the whole system, letting the market solve the problem of conflict of interest, or requiring mandatory disclosure of conflicts of interest, legislators and regulatory agencies should either prosecute fraud or pass legislation to enable individuals to obtain relief though class- action lawsuits. The example of the

156. *See NewsHour with Jim Lehrer* (PBS television broadcast, Feb. 21, 2002).

157. *See* Press Release, New York State Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (March 21, 2002), available at http://www.oag.state.ny.us/press/2002/may/may21a_02.html. *See also* Interview by Hedrick Smith of PBS with Arthur Levitt, Former Chairman of the SEC (March 12, 2002), available at http://www.pbs.org/wgbh/pages/frontline/shows/regulation/interviews/levitt.html.

158. *See* John C. Coffee, *Understanding Enron, Its About the Gatekeepers, Stupid*, 57 BUS. L. 1437. (2002). Professor Coffee identified the irrational exuberance of the market as one of the elements that lead to the stock market decline.

prosecution of Hornblowers & Weeks demonstrates that the regulators possess the tools, when willing to use them, to prosecute fraud; however, the individual investor lacks a corresponding effective ability to plead Rule 10b-5.

Prior to the enactment of the new regulations, the private individual possessed a tool in SEC's Rule 10b-5's FOMT embodied in *Basic, Inc. v. Levinson*[159] and FCMT embodied in *Shores v. Sklar.*[160] Unfortunately, the confusion over the prerequisite scienter requirements of PSLRA and the limitations of *Central Bank of Denver*[161] on aiding and abetting liability limited the effectiveness of Rule 10b-5.[162] In 2002, several Democratic legislators proposed legislation to confront several of the problems inherent in pleading and proving private actions of fraud.[163] The legislative proposals include amending PSLRA to include aiding and abetting liability for private lawsuits[164] and allowing plaintiffs to obtain discovery during the pendency of a motion to dismiss.[165] Although, in a Republican dominated Congress, neither of these proposals realistically can muster the necessary votes for passage, addressing fraud rather than mere disclosure provides a more cogent response to the analyst problem.

Measures to strengthen Rule 10b-5 can serve an important deterrence role.[166] While some of the analysts' behavior can be explained by the influence of the investment banking departments,

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159. *See Basic*, 485 U.S. at 224 (1988).

160. *See Shores,* 647 F.2d at 462.

161. *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

162. *See generally* David S. Ruder, *The Demise of Aiding and Abetting? The Future of Aiding and Abetting and Rule 10b-5 After Central Bank of Denver*, 49 Bus. L. 1479 (1994).

163. *See* S. 1933, 107th Cong. § 3 (2002), H.R. 3617, 107th Cong. § 3 (2002) and H.R. 3829, 107th § 3(e) (2002).

164. *See* S. 1933, 107th Cong. § 3 (2002), H.R. 3617, 107th Cong. § 3 (2002) and H.R. 3829, 107th § 3(e) (2002).

165. *See* H.R. 3829, 107th Cong. § 2 (2002).

166. *See generally* William Lerach, *Counterpoint: Class Action Suits Help Keep Predators Away*, San Jose Bus. J., May 25, 1992, at 7. William Lerach is a leading expert on securities law as well as prominent plaintiffs' attorney with the law firm of Milberg Weiss Bershad William Hynes and Lerach. *Cf.* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va L. Rev. 669, 677-79 (1984) (observing that 'a rule against fraud is not an essential ingredient of securities markets', but nevertheless concluding that it may perform an important role in reducing the costs to issuers of certifying their disclosure).

evidence exists that analysts made fraudulent statements of an intentional, reckless, or negligent variety.[167] Nonetheless, the strict scienter requirements of PSLRA and the prohibition against aiding and abetting liability acted in concert to shield analysts from 10b-5 liability. Without fear of exposure to liability, analysts, along with other secondary actors such as accountants and other financial professionals, operated in the market without fear of legal reprisals for actions that bordered on if not equaled, fraud.[168] Of course, innocent misstatements can occur in the advertising function. Therefore, in altering the pleading requirements of PSLRA to ease private actions, legislators should recognize that a fine line separates fraudulent speech, not protected by the 1st Amendment, and puffery. Unfortunately at the current time, plaintiffs cannot obtain the necessary discovery to distinguish between the two.[169] Conse-

167. *Special Report-The Best & Worst Managers: Under Fire- These Execs, Too, are Embroiled in a Range of Investigations*, BUSINESS WEEK ONLINE (Jan. 13, 2003), available at http://www.businessweek.com/magazine/content/03_02/b3815661.htm.

168. *See Prevent Financial Fraud: Repeal the Accountant Immunity Act—the 1995 Private Securities Litigation Reform Act (PSLRA)* ENRON WATCHDOGS: CONSUMERS AND INVESTORS FOR CORPORATE RESPONSIBILITY (June 27, 2002), available at http://www.enronwatchdog.org/topreforms/topreforms5.html. Many experts have argued that the PSLRA and SLRA acted in combination to diminish the legal threat against corporate wrongdoers and their coconspirators, particularly their accountants. The bills made it harder for victims to go to court, build a case once in court, and recover damages, even if they won. As the distinguished securities law Professor John Coffee of Columbia Law School noted in testimony before the Senate in December 2001:

> ". . . the Enron episode and the general increase in accounting restatements suggests that the SEC may not be winning its war against accounting irregularities. What could explain this apparent decline in the quality of financial reporting? A good case can be made that both (1) the legal threat confronting the auditor has been sharply reduced over recent years by a series of recent judicial and legislative developments, and (2) the incentives for the auditor in acquiesce in questionable accounting practices have grown, as the nature of the industry has changed."
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> *Hearing Before the Senate Committee on Commerce, Science, and Transportation*, 106th Cong. (2001) (statement of Prof. Coffee, Professor, Columbia University), available at http://www.senate.gov/%7Ecommerce/hearings/1218 01Coffee.pdf.
>
> *See also Accounting and Investor Protection Issues Raised by Enron and other Public Company Before U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 107th Con. (2002) (statement of Prof. John Coffee, Professor of Law at Columbia University) for a futher discussion of the issues involved in the Enron controversy. *Id.* at 534.

169. *See* 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (1997) (staying discovery during the pendency of a FRCP 12 motion).

quently, the pleading requirements of Rule 10b-5 should be eased to enable private citizens to obtain discovery as a means to distinguish between actionable fraudulent statements and mere hyberbole. If private individuals are able to obtain discovery, plaintiffs might find some of the same evidence that the regulators who investigated Henry Blodget found.[170]

Furthermore, proposals that ease the ability of individuals to bring private fraud lawsuits, by altering the scienter requirements of PSLRA and/or measures amending Rule 10b-5 to include analysts under aiding and abetting liability, should be enacted. The enactment of such legislation would more fully comport with the intent of the Exchange Act, whose purpose is to protect individual investors from fraudulent schemes and devices.[171] The above two measures combined with the resulting civil and possible criminal penalties would act as deterrence to analyst malfeasance.[172]

B. *Throwing-Out the Baby with the Bath Water: Total Separation*

Other commentators suggest a total separation of the research and investment banking business as one possible way to deal with the conflict of interest posed by the financial services companies being in both businesses.[173] The underlying rationale of total sepa-

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170. *See In the Matter of Arbitration of* Debasis Kanjilal and Debjani Kanjilal v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., Henry Blodget and Michael Healy, 1281 PLI/CORP. 245 (2001). In this particular arbitration, the complaint alleged that analysts at Merrill Lynch did not actually believe in the merits of the stocks they recommended. *See also* Matthew Goldstein, *Latest Dragnet May Not Go Much Beyond Blodget*, THE STREET.COM, (Jan 6, 2003), available at http://www.thestreet.com/markets/matthewgoldstein/10061303.html. *See also In re* Merrill Lynch & Co., Inc. Research Reports, 2003 WL 1571998 (S.D.N.Y. 2003).

171. *See* Abner J. Mikva, *When Congress Eased Restraints, Investors Lost Protection from Enron, Others*, FULTON COUNTY DAILY REPORT (Apr. 9, 2002), available at http://www.lawuchicago.edu/news/milva-reformact.html.

172. See, H.R. CONF. REP. NO. 104-369, at 32 (1995) *reprinted in,* 1995 U.S.C.C.A.N. 730, 731. "This Conference Report seeks to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation. This legislation implements needed procedural protections to discourage frivolous litigation." *See also* Daniel S. Boyce, Note, *Pleading Scienter Under the Private Securities Reform Act of 1995: A Legislative Attempt at Putting Teeth Into the Required State of Mind*, 35 NEW ENG. L. REV. 761 (2001).

173. *See* Robin Sidel and Susanne Craig, *Does Independent Research Mean Better Stock Picks?* WALL ST. J., Oct. 31, 2002, at C1. *See also* Silvia Ascarelli, *Independence Isn't Everything in Stock Research,* WALL ST. J., Sept. 5, 2002, at C11.

ration is that as long as financial services companies are involved in both research and investment banking an incurable conflict of interest problem exists that can only be solved by totally separating the two areas.[174] The proponents of separation hold up as a concrete example of the total separation theory in practice, Prudential Securities, a securities firm who voluntarily exited the investment banking business to focus on its retail operation in 2000.[175] However, the illustration of Prudential Securities teaches the observer little, if anything, about either the appearance of the financial services industry after an industry-wide implementation of total separation or the possible impact on the individual investor of such a dramatic restructuring of the securities market. Consequently, serious questions remain concerning the separation of functions that need to be addressed before a market-wide adoption of a total separation of investment banking and research functions. Will clients, who have long grown accustomed to getting research for free, be willing to pay?[176] And is independently produced research necessa-

174. Secretary of the Commonwealth William Francis Galvin charged the investment banking firm Credit Suisse First Boston Corporation with violating the Massachusetts Securities Act by misleading investors on the undue influence its investment banking exerted on its supposedly independent research analysts. As relief, Galvin seeks the total separation of the investment banking and research functions. *See* Press Release, Secretary of the Commonwealth of Massachusetts, Secretary Galvin Files CSFB Complaint (October 21, 2002).

175. *See* Stephen Gandel, *Clipping at the Rock: Prudential Securities Refocuses on Retail Brokerage; Shift from Institutional Work will Eliminate 425 jobs*, CRAIN'S N.Y. BUS., Nov. 6, 2000, available at 2000 WL 9441806. *See also* Lauren Young, *Independence Day*, SMARTMONEY, May 1, 2001, 28 available at 2002 WL 2191410. The above articles examine Prudential's exit from the investment banking business. Through an expensive policy of expansion from 1996 to 1998, Prudential Securities attempted to compete in the lucrative investment banking business and successfully increased their ranking from 20th to 6th in American Banker's ranking of investment banking firms in the number of deals done. However, in 1999 and 2000, high technology issues and IPOs, a weak area for Prudential, dominated the investment banking market. As other investment houses found profits in the IPO markets of 1999 and 2000, Prudential Securities ranking slipped to 19th in 2000 as its losses in their investment-banking department increased. In 2000 after a failed attempt to sell the firm, Prudential Securities jettisoned its investment-banking department to focus on its traditional retail base. Although Prudential Securities has produced the highest proportion of "sell" ratings on the stocks it covers on Wall Street, the firm's analysts' performance in providing quality research has not correspondingly improved.

176. *See* Hugo Dixon, *Remaking the Market: Does Research Still Fly?* WALL ST. J., Nov. 1, 2002, at A14 available at 2002 WL-WSJ 3410520.

rily better research?[177] And how is it possible to produce independent research if the largest investment banks are paying for it?[178] Without clear answers to these questions, an alteration of the entire securities industry is not warranted.

Furthermore, a total separation of research from investment banking might destroy the handful of firms that continue to provide objective research.[179] A total separation of research from investment banking would also leave the process of raising new capital to firms that possess less knowledge of the companies they are asked to underwrite than the large financial firms that currently have personal knowledge and relationships with the issuing companies.[180] From the simple standpoint of sound capital-raising perspective, total separation of research from investment banking makes little sense.[181]

C. Sitting on Our Hands and Doing Nothing: The Market Based Approach

Other commentators suggest that the free market should be allowed to operate on its own to wash out the excesses of the late 1990s.[182] Commentators argue that analysts, who consistently provide the public with "bad information," will soon lose their credibility and eventually their jobs.[183] However, as *Levinson v. Basic*[184] and *Shores v. Sklar*[185] illustrate, fraud can undermine the workings of the

177. *See* Robin Sidel and Susanne Craig, *Does Independent Research Mean Better Stock Picks?* WALL ST. J. Oct. 31, 2002, at C1 available at 2002 WL-WSJ 3410386.

178. *See* Randall Smith, *Will Investors Benefit From Wall Street's Split?*, WALL ST. J. Dec. 23 2002, at C1, available at 2002 WL-WSJ 103129450.

179. *See* Matthew R. Simmons, *It Is Not Hard To Fix Corrupt Investment Research* (Oct. 27, 2002), available at http://www.simmonscointl.com/domino/html/research.nsf/DocID/2E526888AA220BB386256C700004E4B4/$File/Corruptresearchwhitepaper.pdf.

180. *Id.* at 2.

181. *Id.*

182. See James Sheehan, *Market Solutions to Conflicts of Interest*, LUDWIG VON MISES INSTITUTE (Feb. 5, 2002), available at http://www.mises.org/fullstory.asp?control=884 for a further discussion. *See also* Stephen Bartholomeusz, *Conflict of Interest Needs Ethics and Disclosure, Not More Rules*, THEAGE.COM (April 16, 2002) available at http://www.theage.com.au/articles/2002/04/15/1018333480866.html.

183. *See* Ken Brown and Jeff D. Opdyke, *Analysts Were Once the Rock Stars Of the Street, but Tunes Changed,* WALL ST. J. Nov. 16, 2001 at C1 available at 2001 WL-WSJ 29678161.

184. Basic, 871 F.2d at 562

185. Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981),*cert denied,* 103 S. Ct. 722 (1983).

efficient market. The market can only represent the value of companies effectively if it is free from fraud.[186] While the market might lead analysts to lose their jobs, the current regulatory regime does not provide individual investors who have lost money with a viable means to hold analysts accountable for what in some cases was intentional fraud and in others cases constituted reckless behavior that lead to investors receiving misinformation about stocks.[187] Moreover, the various instances of analysts going over the proverbial Chinese wall, in some cases, and the total lack of walls, in others, demonstrates the ineffectiveness of the financial services industry's self-regulation.

V. Conclusion

NASD Rule 2711 and the amendments to NYSE Rule 472 are weak on many levels. Many of the problems of the new rules stem from their faulty focus and emphasis on disclosure rather than fraud. While the underlying goal of Rule NASD 2711 and NYSE Rule 472 is commendable, the rules, in their current state fail to address the true underlying problem of actual analyst malfeasance. The regulators inappropriately emphasized disclosure in the new rules rather than seizing the opportunity to amend the PSLRA.

Other problems of the new rules derive from poor draftsmanship and negative impression implied to the public from the disclosure of a conflict. However, new rules are drafted so broadly so as not to violate insider trading rules. Still other problems originate from the new rules' tendency to blur the line between conflict of interest and fraud.

Perhaps most alarming is the potential negative unintended consequences that the new regulations will have on information flow. The new rules may result in a stifling of information due to the implied impropriety presented by the disclosure of such a conflict.

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186. *In re* Verifone Securities Litigation, 784 F. Supp. 1471, 1478 (N.D. Cal 1992).

187. Although to date no criminal prosecutions have been brought against any stock analysts, regulators have settled cases against Merrill Lynch's Henry Bloget and Salomon Smith Barney's Jack Grubman resulting in fines and bans from the market. Additionally, the industry settlement totaled over 1 billion dollars in December of 2002. *See* Matthew Goldstein, *Brokerages Will Pay $1.4 Billion*, TheStreet.com (Dec. 20, 2002), available at http://www.thestreet.com/pf/markets/matthewgoldstein/10059768.html.

However, rather than altering the entire securities market by separating the research and analyst's functions or doing nothing by allowing the market and the investment firms to self-regulate, regulators should focus on strengthening measures against fraud. Regulators should either prosecute cases of analyst malfeasance using the tools possessed by Rule 10b-5 or empower individual investors to bring private lawsuits against the analysts and their investment houses. However, under the current state of affairs, plaintiffs' attorneys have difficulty meeting the pleading requirements of the PSLRA. Consequently, legislators should amend PSRLA's scienter requirement to include recklessness as a valid mental state and should amend aiding and abetting liability to encompass analysts who recklessly pass inaccurate or misleading information to the individual investor in research reports or on television appearances. Amending the PSLRA to make pleading fraud easier would provide an important function of deterring fraud and misrepresentation. Amendments of the PSLRA would allow the SEC to bolster investor confidence in the securities market and fulfill the intent of the Exchange Act by protecting individual investors from fraudulent schemes and practices. For those reasons, the SEC should take the opportunity to focus on strengthening anti-fraud measures by amending the PSLRA to encompass the full breath of SEC's Rule 10b-5.