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INVESTMENT BANKING FIRMS SETTLE ENFORCEMENT ACTIONS REGARDING ANALYST CONFLICTS OF INTEREST

By Richard P. Wolfe and R. Joseph Parkey, Jr.

On April 28, 2003, the Securities and Exchange Commission, the National Association of Securities Dealers, the New York Stock Exchange, the New York Attorney General's office and several state regulators announced the settlement of enforcement actions against ten Wall Street investment banking firms.

The settlement followed joint investigations by the regulators of allegations that research analysts at the named firms, unduly influenced by their investment banking departments, routinely issued overly optimistic research reports in an effort to secure investment banking business from the companies about which the reports were written. *(Click here to link to the joint press release issued by the SEC, the NASD, the NYSE, the New York Attorney General's office and the North American Securities Administrators Association summarizing the settlement and the specific allegations with respect to the individual firms.)*

The Allegations Against the Investment Banking Firms

Specifically, the enforcement actions alleged, among other claims, that from approximately mid-1999 until mid-2001 or later, all of the named firms engaged in practices that resulted in inappropriate influence by their investment banking departments over their research analysts, thereby imposing conflicts of interest on the research analysts, and that the firms failed to appropriately manage those conflicts, each in violation of existing rules of the NASD, the NYSE and state statutes. In addition, the enforcement actions alleged that:

- five of the ten firms, without public disclosure, made payments to, or received payments from, other investment banking firms for favorable research in an effort to build more positive ratings on specific stocks, in violation of NASD and NYSE rules and state statutes;
- three of the ten firms issued fraudulent research reports in violation of the Securities Exchange Act of 1934 and state statutes;

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- eight of the ten firms issued research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies or contained opinions for which there was no reasonable basis, all in violation of NASD and NYSE rules and state ethics statutes; and

- two of the ten firms engaged in inappropriate "spinning," or allocating securities in initial public offerings that begin trading in the aftermarket at a premium, to executives and directors of other companies in an effort to procure investment banking business from those companies, in violation of the Exchange Act and NASD and NYSE rules.

The ten investment banking firms against which the enforcement actions were brought are Bear, Stearns; Credit Suisse First Boston; Goldman, Sachs; Lehman Brothers; J.P. Morgan Securities; Merrill Lynch; Morgan Stanley; Citigroup Global Markets (formerly Salomon Smith Barney); UBS Warburg; and U.S. Bancorp Piper Jaffray. The firms have consented, without admitting or denying the allegations made in the enforcement actions, to the entry of a final judgment that would permanently enjoin them from future violations of the specific rules that they have been accused of violating.

The General Terms of the Settlement

Under the terms of the settlement, the firms have agreed to pay disgorgement and civil penalties totaling $875 million, including Merrill Lynch's previous payment of $100 million in connection with its prior settlement with state securities regulators also relating to analyst conflicts of interest. Half of the payments (other than the $100 million previously paid by Merrill Lynch) will be placed into a fund to benefit the firms' customers. The remainder of the payments will be paid to the states. In addition, the firms have agreed to pay a total of $432.5 million to fund independent research, and seven of the firms have agreed to pay a total of $80 million to fund investor education, bringing the total amount of the settlement to approximately $1.4 billion. A recipient of funds from the settlement is not precluded from pursuing any other remedy that may be available against one or more of the firms.

One former Salomon Smith Barney analyst and one former Merrill Lynch analyst were also named as defendants in the enforcement actions. In connection with the settlement, those individuals have agreed to pay disgorgement and civil penalties totaling $19 million and have been permanently barred from participating in the securities business. The firms and the individual defendants have agreed not to seek reimbursement or indemnification for, or any tax deductions with respect to, any penalties that they are required to pay under the settlement.

In connection with the settlement, the firms have also collectively entered into an agreement prohibiting the practice of "spinning" described above. Separately, *The Wall Street Journal* reported on May 14, 2003 that the former chairman of Qwest Communications, Philip Anschutz, has agreed to the settlement of a lawsuit filed by the New York Attorney General that requires Mr. Anschutz to disgorge $4.4 million of profits earned from "spins" of IPO shares he received from investment banking firms. Elliott Spitzer, the New York Attorney General, was quoted in that article as stating that "the proceeds of spinning should be disgorged by the beneficiaries of a practice that is now banned."

Structural Changes Imposed by the Settlement

The settlement also requires changes in the relationship between the investment banking and research departments of the investment banking firms, including the following:

- the firms must separate their research and investment banking departments, including physically separating their operations and implementing separate reporting lines, legal and compliance staffs and budgeting processes;

- analysts may not receive compensation for investment banking activities, and their compensation must be based in significant part on the quality and accuracy of their research;

- analysts' compensation may not be based on investment banking revenues or input from investment banking personnel, decisions regarding analyst compensation must be documented, and analysts may not be evaluated by investment banking personnel;

- analysts may not participate in investment banking road shows or other sales activities;

- the research department's budget must be determined by senior management of the investment banking firm without regard to investment banking revenues;

- investment banking personnel may not have a role in determining which companies are covered by analysts;

- the firms must implement policies and procedures designed to ensure that their personnel do not influence the contents of research reports for the purpose of securing investment banking business;

- the firms must create and enforce firewalls between their research and investment banking departments designed to prohibit improper communications between them; and

- each firm must retain an independent monitor at its own expense to conduct a review and provide assurance that the firm is complying with the structural reforms.

In addition to the structural reforms imposed by the settlement, the investment banking firms are required to contract with at least three independent research firms to make independent research materials available to the investment banking firms' customers for five years. Furthermore, the firms' analysts will be subject to heightened disclosure requirements, including the following:

- each firm must include a legend on the first page of every research report stating that the firm "does and seeks to do business with companies covered by its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report;"

- when a firm elects to terminate coverage of a particular company, the firm must issue a final research report addressing the reasons for the termination; and

- each firm must publish a chart on its website quarterly depicting its analysts' performance and including each analyst's name, ratings, price targets and earnings forecasts for each covered company and an explanation of the firm's rating system.

Requirements similar to those imposed by the April 28th settlement are currently mandated by recently adopted NASD Rule 2711 and NYSE Rule 472. These rules were not yet in effect, however, during the time period addressed by the enforcement actions. Furthermore, proposals to amend each of these rules to provide further restrictions on analysts' compensation and impose additional disclosure requirements for research reports are currently pending.

Recent Controversy Concerning Interpretation of the Settlement

Although the settlement prohibits analyst participation in investment banking road shows, there is apparently some controversy among regulators and several investment banking firms as to whether investment bankers may communicate analysts' revenue and income projections during road shows. On May 13, 2003, *The Wall Street Journal* reported that while officials at several Wall Street firms have expressed the view that the settlement would allow such communications, Stephen Cutler, head of the SEC's Division of Enforcement, stated that investment bankers should be careful not to pressure analysts into providing optimistic projections to help facilitate the success of road shows. In addition, an official with the New York Attorney General's office stated that the view of the investment banking firms is "an aggressive interpretation" of the settlement, and that the Attorney General's office is considering providing additional guidance on the extent to which analysts' views may be expressed during marketing efforts.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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