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Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?

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SECURITIES ANALYSTS' UNDISCLOSED CONFLICTS OF INTEREST: UNFAIR DEALING OR SECURITIES FRAUD?

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I. INTRODUCTION

Following the burst of the Internet bubble, securities industry participants and observers have focused on "buy"

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recommendations[1] made by purportedly independent research analysts[2] to the investing public for technology and Internet stocks. Questions have been raised as to how all of those analysts could have been so wrong in their recommendations. Subsequently, their motivations and methods have been scrutinized.[3] Critics have focused on the apparent conflict of interest certain analysts faced: they recommended the purchase of securities to the investing public and to customers of their own firms without disclosing the fact that they owned those very securities, that their compensation was tied to their recommendations, or, even more significantly, that their firms received compensation -- typically in the form of investment banking business -- from the issuer.[4]

In light of the media attention and public criticism lavished on brokerage firms' analysts and their undisclosed conflicts of interest, the industry has implemented many

[1] Analyst recommendations typically fall into three categories: buy, hold/neutral, or sell. *See* Securities and Exchange Commission, *Analyzing Analyst Recommendations*, [hereinafter *Analyzing Analyst Recommendations*], *at* http://www.sec.gov/investor/pubs/analysts.html (last modified June 20, 2002).

[2] Securities research analysts "study publicly traded companies and make buy and sell recommendations on the securities of those companies. Most specialize in a particular industry or sector of the economy." *Id.*

[3] *See, e.g.,* Geraldine Fabrikant & Simon Romero, *When Wall Street Advice Turns Costly*, N.Y. TIMES, Mar. 11, 2002, at C1 (reporting on firm's analyst's recommendation of securities of issuer, with which the firm had lucrative investment banking relationship); Gretchen Morgenson, *Telecom's Pied Piper: Whose Side Was He On?*, N.Y. TIMES, Nov. 18, 2001, § 3, at 1 (criticizing reputable telecommunications analyst who maintained buy recommendations on companies as he reportedly helped his securities firm collect lucrative investment banking fees from the issuers); Scott Thurm, *When Do Analysts Cover Their Own Interests?*, WALL ST. J., Dec. 10, 2001, at C1 (reporting on one analyst who recommended purchases of companies without disclosing his ownership interests).

[4] Reflecting the level of public condemnation directed towards analysts as the scapegoat for the investment excesses of the Internet bubble, even the daily comic strip "Dilbert" featured a series of strips mocking analysts for recommending stocks they owned. Dilbert Daily Comic Strips, Oct. 15, 16, 17, 2001.

changes. Many financial services firms have altered their company policy precluding or limiting the ownership by analysts of stocks they follow[5] and securities self-regulatory organizations ("SROs") have enacted rules requiring heightened disclosure of any potential conflicts of interest.[6]

Most significantly, regulators have begun enforcement investigations and proceedings.[7] As one striking example of sweeping regulatory action, on April 8, 2002, New York State's Attorney General brought an enforcement action in state court under New York's state securities statute, the Martin Act,[8] seeking a preliminary injunction directing Merrill Lynch and some of its research analysts to refrain from misleading disclosures in their research reports and seeking judicial intervention in the continuing investigation.[9] The affidavit that the Attorney General filed in support of that application for relief was replete with egregious examples of conflicts faced by Merrill Lynch analysts --

[5] For example, in August 2001, the Goldman Sachs Group took the first step of insisting that its research analysts disclose any ownership interests in companies they follow. *See Analysts Told to Reveal Stakes*, N.Y. TIMES, Aug. 9, 2001, at C4. Just six months later, the firm took the additional steps of banning all of its analysts from owning stocks in sectors they cover and separating its research department from the investment-banking division. *See* Patrick McGeehan, *Goldman Sachs Moves to Tighten Stock Analysts' Independence*, N.Y. TIMES, Feb. 20, 2002, at C15; *see also* Charles Gasparino & Jeff D. Opdyke, *Merrill Alters a Policy on Analysts*, WALL ST. J., July 11, 2001, at C1 (reporting on new policy adopted by Merrill Lynch & Co. barring its analysts from buying stock in companies they cover).

[6] *See infra* notes 51-68 and accompanying text.

[7] SEC Press Release, SEC Launches Inquiry Into Research Analyst Conflicts, *available at* http://www.sec.gov/news/press/2002-56.html (Apr. 25, 2002); Patrick McGeehan, *U.S. and State Regulators Join Inquiry on Analysts*, N.Y. TIMES, Apr. 24, 2002, at C10 (reporting that the Department of Justice and state securities regulators would begin investigating analysts).

[8] N.Y. GEN. BUS. LAW §§ 352 *et seq.* (2002).

[9] Press Release, Office of New York State Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest, *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (Apr. 8, 2002).

including the allegation that the analysts themselves had different opinions of the issuers than those disseminated publicly in their supposedly independent research reports.[10] The Supreme Court of New York granted the requested relief and, pending completion of the Attorney General's investigation, issued an order temporarily restraining the respondents from violating the Martin Act and specifically from preparing or disseminating any research report on an issuer without disclosing Merrill Lynch's investment banking relationships with that issuer.[11] Not long after, Merrill Lynch settled with the Attorney General before it even filed formal charges -- agreeing to pay a $100 million penalty and to restructure its research department to insulate analysts from many of these conflicts.[12]

Outside of the regulatory landscape, investors increasingly have brought lawsuits and arbitrations against analysts for damages resulting from recommendations tainted by conflicts of interest.[13] For example, in July 2001,

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[10] Affidavit of Eric Dinallo in Support of Application for an Order Pursuant to General Business Law § 354 [hereinafter Dinallo Aff.], *available at* http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf (Apr. 8, 2002). If true, the evidence described in the Dinallo Affidavit provides a strong evidentiary basis to suggest the analysts recklessly or even intentionally defrauded investors.

[11] Order Pursuant to General Business Law Section 354, In the Matter of An Enquiry By Eliot Spitzer, Sup. Ct. N.Y. Co., Index No. 02-401522, *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (Apr. 8, 2002).

[12] *See* Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices, *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html (May 21, 2002).

[13] *See, e.g.*, Jeff D. Opdyke & Susanne Craig, *Hunt Family Members Win Case Against Goldman*, WALL ST. J., Aug. 10, 2001, at B2. In the case reported in the article, a securities arbitration panel awarded about $400,000 to an investor against Goldman Sachs for losses in securities whose issuer was covered by a Goldman analyst who failed to disclose his conflicts of interest in the recommended security. However, because the award did not include an opinion (as arbitration awards typically do not), the reasoning of the arbitrators remains unknown. *See In re* Arbitration

Merrill Lynch settled an arbitration proceeding brought by a former customer before an arbitration panel of the New York Stock Exchange. Merrill Lynch agreed to pay $400,000 to the customer who alleged that he was misled by a favorable research report issued by Merrill Lynch technology-stock analyst, Henry Blodget (the analyst whose e-mails played a significant role in the New York State Attorney General's investigation), on a company whose securities the customer purchased. Both the customer's broker and Merrill Lynch's report failed to disclose that Merrill Lynch had an investment banking relationship with the issuer.[14] Due to the settlement, however, the legal theory underlying the claimant's case against Merrill Lynch and Blodget has not been tested.

Securities research analysts provide securities recommendations for institutional and individual investors, and hold themselves out as providers of independent objective analyses of issuers. Analysts generally divide themselves into three types: "sell-side," "buy-side," or independent. Sell-side analysts are those analysts who work for large brokerage firms with brokerage customers.[15] The brokers use the research to recommend and sell securities to their customers. These firms also typically have investment banking divisions that underwrite securities, and the investment banks use the analyst research to serve an important due diligence function for the underwriters.[16] In contrast, buy-side analysts "typically work for institutional money managers -- such as mutual funds, hedge funds, or

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Between Stuart Hunt, et al. v. Goldman, Sachs and Co., Docket No. 00-00249, 2001 WL 1008474 (N.A.S.D. Aug. 8, 2001).

[14] *See* Charles Gasparino, *Merrill is Paying in Wake of Analyst's Call on Tech Stock*, WALL ST. J., July 20, 2001, at C1.

[15] *Analyzing Analyst Recommendations*, *supra* note 1, at 1.

[16] *Id.* at 2; *see also* Testimony of Robert R. Glauber, Chairman and Chief Executive Officer, National Association of Securities Dealers, Inc., Before the Senate Committee on Governmental Affairs, Hearing on Analyst Independence [hereinafter Glauber Testimony], *available at* http://www.nasd.com/news/sp/pp1_28.html (Feb. 27, 2002).

investment advisers."[17] Buy-side analysts work for firms that manage portfolios of others and make investment decisions directly on their behalf.[18] Finally, independent analysts are not affiliated with either the sell-side or the buy-side and "sell their research reports on a subscription or other basis."[19]

Analysts' conflicts of interest are troubling to investors, who rely on the integrity of these industry professionals. Under the shingle theory,[20] broker-dealers, including their sell-side analyst employees, have a duty to deal fairly with their customers. This duty of fair dealing encompasses the duty to give customers their undivided loyalty.[21] If an analyst serves two competing masters -- his firm's customers to whom he recommends the purchase of a security, on the one hand, and the investment banking department of the firm, which stands to lose lucrative investment banking fees from an issuer if the firm does not maintain a "buy" recommendation on the issuer's stock, on the other hand, then the analyst has violated this duty of loyalty.[22] By failing to disclose these divided loyalties in research reports, analysts have deceived the customers who rely on these reports to reflect an unbiased, objective analysis of the strengths, weaknesses, and market value of the securities.

However, there appears to be scant precedent supporting an investor's right to civil damages for undisclosed conflicts of interest by analysts. The federal securities laws, as currently interpreted by the Supreme Court, do not clearly

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[17] *Analyzing Analyst Recommendations*, *supra* note 1, at 2.

[18] *Id.* at 1.

[19] *Id.*

[20] The shingle theory of liability of broker-dealers to their customers "presume[s] that a broker-dealer that hangs out a shingle and solicits customers makes an implied representation of fair dealing." Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1271 (1995).

[21] NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION § 2.03[A][2] (3d ed. 2002).

[22] For a discussion of the variety of conflicts of interest that currently exist in the securities industry, see *id.* at § 1.02.

provide investors with a right of action against a broker-dealer or its employees merely for a breach of their professional duties.[23] Indeed, numerous scholars have questioned the validity of the shingle theory as a basis for imposing federal securities fraud liability.[24] Furthermore, enhanced industry regulation does not necessarily translate into additional private rights of action for the investing public.

Historically, the courts have imposed liability on industry participants for failure to disclose their intent to trade on the short-term market effect of their recommendations -- a practice known as "scalping."[25] However, beyond scalping, what legal duties do analysts have to customers to disclose their conflicts of interest in the securities they recommend?

Part II of this article addresses recent regulatory efforts to proscribe undisclosed conflicts of interest beyond mere scalping, including ownership interests in recommended securities, and the compensation connection between analysts and investment bankers within a firm. Part III of this article traces the history of prior cases imposing liability on industry participants, including investment advisers, analysts and others, for failing to disclose their conflicts of interest when recommending securities. Part IV of this article then examines the question of whether analysts have any civil liability to those relying on their recommendations for failure to disclose actual or potential conflicts of interest. Finally, the author concludes that, in light of the new regulations, analysts should be liable to investors for their undisclosed conflicts of interest.

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[23] Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006-07 (2002).

[24] *See* Karmel, *supra* note 20, at 1272.

[25] *See infra* notes 69-86 and accompanying text.

II. REGULATORY EFFORTS TO LIMIT UNDISCLOSED ANALYST CONFLICTS OF INTEREST

A. Existing Regulation

Even before the recent criticism of analysts, regulations did mandate certain disclosures by industry participants -- including analysts -- involving potential conflicts of interest. First, section 17(b) of the Securities Act of 1933 ("SA")[26] precludes any person, including any analyst, from receiving undisclosed compensation for making a securities recommendation.[27] Second, the Investment Advisers Act ("IAA")[28] regulates those who provide investment advice, including buy-side analysts.[29] However, the IAA does not provide a private right of action to investors,[30] and none of these regulations target sell-side analysts.

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[26] 15 U.S.C. § 77q(b) (2000).

[27] This section explicitly prohibits publishing an investment newsletter or article containing a description of a security without disclosing any compensation received or to be received from the issuer. *Id.* However, most courts addressing this issue do not imply a private right of action under section 17(b). *See, e.g.,* Ostler v. Codman Research Group, Inc., 1999 WL 1059684, at *4 (D.N.H. Apr. 20, 1999); Sowell v. Butcher & Singer, Inc., 1987 WL 10712, at *3 (E.D. Pa. May 13, 1987).

[28] 15 U.S.C. § 80b-1 *et seq.* (2000).

[29] 15 U.S.C. § 80b-6 (2000). This section precludes advisers, including buy-side analysts, from "employ[ing] any device, scheme, or artifice to defraud any client or prospective client"; "engag[ing] in any transaction, practice or course of business which operates as a fraud or deceit upon any client"; "acting as principal for his own account" without disclosure; and "engag[ing] in any act, practice or course of business which is fraudulent, deceptive, or manipulative." While the statute does not expressly require disclosure of buy-side analysts' conflicts of interests, the Supreme Court has construed this section to cover scalping. *See infra* notes 69-86 and accompanying text.

[30] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 19-20 (1979). The IAA does permit investors to sue for the limited relief of rescission of an investment advisory agreement and return of advisory fees paid. *See* 15 U.S.C. § 80b-15 (2000).

The National Association of Securities Dealers ("NASD") closes this regulatory gap.[31] Because most sell-side research analysts work for broker-dealers that must register with the NASD, they are deemed "associated persons"[32] of their registered broker-dealer firms and thus are covered by NASD rules of conduct.[33] Until recently, one NASD Conduct Rule mandated disclosure of only certain limited conflicts of interest by members in any advertisements and sales literature (including research reports).[34] NASD Rule 2210, Communications with the Public, requires that members disclose in research reports that, among other things, the member firm makes a market in the recommended security, the member or its officers or partners own options, rights or warrants to purchase the recommended security, and the member managed or co-managed any public offering of the recommended security within the last three years.[35] This regulation applies to analysts' public recommendations broadly disseminated to the public, where analysts are not in a fiduciary relationship with investors and the precise nature of their obligations to the public is less clear than in the individual context of the broker-customer relationship.[36]

Significantly, this rule does *not* require that the member or analyst disclose any ownership interest in a recommended security. Thus, until very recently, there were no rules

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[31] The National Association of Securities Dealers, Inc. is an SRO established pursuant to 15 U.S.C. § 78o-3(a), that creates rules to regulate the conduct of its members, which include almost all securities firms in the United States. The NASD is the world's largest securities SRO. NASD Regulation, Inc. enforces these rules.

[32] The Securities Exchange Act defines "associated persons" and includes any employee of a broker-dealer. *See* 15 U.S.C. § 78(c)(18) (2000). Associated persons must register with the SEC. 15 U.S.C. § 78o (2000). Article V of the By-Laws of the NASD similarly requires associated persons of NASD member firms to register with the NASD. By-Laws of the NASD, Art. V(1), NASD Manual (CCH) 2002.

[33] *See* Glauber Testimony, *supra* note 16.

[34] NASD Conduct Rules, Rule 2210(d)(2), NASD Manual (CCH) 2002.

[35] *Id.*

[36] *See* THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 14.16[6] (2002).

prohibiting buy-side or sell-side analysts from owning stock in the companies they cover, or rules controlling their relationship with the investment bankers in their own firms that may underwrite the companies they cover. It is precisely this loophole that garnered so much attention.

B. Recent Regulatory Efforts

On July 31, 2001, Laura Unger, the then acting Chairwoman of the Securities and Exchange Commission ("SEC"), testified before Congress regarding the conflicts of interest that research analysts face.[37] She identified for the House Financial Services Subcommittee the sources of these "acute" conflicts:

> First, an analyst's salary and bonus may be linked to the profitability of the firm's investment banking business, motivating analysts to attract and retain investment banking clients for the firm. Second, at some firms, analysts are accountable to investment banking for their ratings. Third, analysts sometimes own a piece of the company they analyze, mostly through pre-IPO share acquisitions.[38]

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[37] Laura S. Unger, Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives [hereinafter Unger Testimony], *available at* http://www.sec.gov/news/testimony/073101ortslu.htm (July 31, 2001). Commissioner Unger also simultaneously submitted similar written testimony to Congress. *See* Laura S. Unger, Written Testimony Concerning Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives [hereinafter Unger Written Testimony], *available at* http://www.sec.gov/news/testimony/073101tslu.html. (July 31, 2001).

[38] *See* Unger Testimony, *supra* note 37. Analysts' equity stakes in the positions they cover may also derive from direct stock purchases or participation in employee stock purchase pools. *See* Unger Written Testimony, *supra* note 37.

In making these observations of industry practices suggesting troubling conflicts of interest, Unger relied on evidence gathered by SEC staff that conducted on-site inspections of firms.[39] These inspections revealed that research analysts routinely: (1) consulted with investment bankers at their firms regarding issuers the analysts covered, (2) covered companies that their firms underwrote, (3) provided investment bankers with advance notice of their changes in recommendations, and (4) issued "booster-shot research reports" right around the time a lock-up period expired (during which time the firm's associated persons may be restricted from selling).[40] Unger also noted the more obvious problems of analysts owning stakes in companies they followed and the fact that positive research reports can "trigger higher trading volumes, resulting in higher commissions for the firms."[41] The inspections also revealed that firm policies with respect to proscribing these practices varied greatly, that existing regulations did not prohibit many of these practices, and that compliance with the few existing regulations which do limit some of these practices was minimal, at least at some firms.[42]

Commissioner Unger then highlighted several steps that the regulators and the industry had taken recently to improve the objectivity and independence of research analysts, including firm-wide review of internal policies and procedures and enhanced SRO regulation.[43] She also emphasized the importance of investor education, and the SEC's role in educating investors to the potential conflicts analysts face.[44] She concluded by urging continued

[39] Unger Written Testimony, *supra* note 37.

[40] Unger Testimony, *supra* note 37.

[41] Unger Written Testimony, *supra* note 37.

[42] *Id.*

[43] Unger Testimony, *supra* note 37.

[44] *Id.* Commissioner Unger noted that the SEC's Office of Investor Education and Assistance published on its website an investor alert issued the previous month to explain to the public investor the role of the research analyst in order to help the investor identify potential conflicts of interest faced by analysts in issuing their recommendations, and to advise

examination of these conflicts and additional regulation to "minimize and manage" these conflicts.[45]

In response to the public's focus on analyst conflicts, the NASD proposed strengthening its rules to regulate analyst disclosures. In July 2001, NASD Regulation ("NASDR") requested that the public comment on proposed amendments to NASD Rule 2210.[46] The amendments were designed to enhance disclosure requirements imposed by the NASD on research that analysts in their securities recommendations made either in written research reports or during public appearances (TV, radio, on-line chats, etc.). NASDR stated that the "proposal represents a first step to address issues related to the quality and independence of research recommendations issued by firms and associated persons."[47]

The proposed amended rule would have required analysts to disclose: (1) any financial interest they have in a recommended security, (2) "if the member firm owns five percent or more of the total outstanding shares of any class of securities of the recommended issuer," and (3) that the "member has received compensation from the recommended issuer for any investment banking services provided to the issuer within the last 12 months." The amended rule also would have required that any written disclosures be made "specifically and prominently."[48]

In February 2002, the NASD superseded the July 2001 proposal with a new, more comprehensive proposed rule change to amend NASD rules to address many of the practices identified by Commissioner Unger. Pursuant to

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investors how to protect themselves. *Analyzing Analyst Recommendations*, *supra* note 1, at 1.

[45] Unger Testimony, *supra* note 37.

[46] *See* Required Disclosures for Securities Recommendations, NASD Notice to Members 01-45 -- Request for Comment (July 2001).

[47] *Id.* at 1.

[48] *Id.* at 3. The NASDR writes that "[t]his language is intended to prohibit the use of boilerplate in footnotes and other inconspicuous locations in advertisements and sales literature, so that investors can more readily ascertain the existence and degree of any potential conflicts of interest." *Id.*

section 19(b)(1) of the Securities Exchange Act of 1934 ("SEA")[49] and SEC Rule 19b-4,[50] the NASD filed with the SEC a proposal to establish NASD Rule 2711, "Research Analysts and Research Reports," to address analyst conflicts of interest.[51] Additionally, on February 27, 2002, the NYSE filed with the SEC a proposal similar to that of the NASD, seeking to amend NYSE Rule 472, "Communications with the Public," to regulate stock exchange members and its associated persons (including analysts), with respect to minimizing and/or disclosing analyst conflicts of interest.[52]

On March 8, 2002, the SEC filed the NASD and NYSE proposals in the Federal Register, seeking public comment on the text of the amended rule.[53] Following a period of public comment, and the filing of additional minor amendments, on May 8, 2002, the SEC approved these proposed rule changes.[54] As approved, NASD Rule 2711 prohibits:

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[49] 15 U.S.C. § 78s(b)(1) (2000).

[50] 17 C.F.R. § 240.19b-4 (2002).

[51] Form 19b-4, Proposed Rule Change to Establish Rule 2711, National Association of Securities Dealers, Inc., *available at* http://www.nasdr.com/pdf-text/rf02_21_analyst.pdf (Feb. 8, 2002).

[52] Form 19b-4, Proposed Rule Change by New York Stock Exchange, Inc., *available at* http://www.nyse.com/pdfs/2002-09fil.pdf (Feb. 26, 2002).

[53] NASD and NYSE Rulemaking: Notice of Filing of Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 45,526, 67 Fed. Reg. 11,526 (Mar. 14, 2002). The SEC filing also reported that, on March 7, 2002, the NASD submitted an amendment to its proposed rule change which clarified the impact of proposed Rule 2711 on existing Rule 2210, and conformed certain required disclosures to the NYSE proposal. *Id.* at n. 3.

[54] SEC Press Release, Commission Approves Rules to Address Analyst Conflicts; S.E.C. Also Requires EDGAR Filings by Foreign Issuers, *available at* http://www.sec.gov/news/press/2002-63.htm (May 8, 2002); *see also* NASD and NYSE Rulemaking: 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

the investment banking department of a firm from supervising or controlling analysts;[55]

employees of the investment banking department from reviewing or approving a research report in advance of publication;[56]

members from submitting a research report to the issuer for its review before publication;[57]

members from tying analyst compensation to specific investment banking transactions;[58]

members from promising favorable research to an issuer in exchange for business or compensation;[59]

underwriters from issuing research reports on a company during a certain "quiet period" following an initial public or secondary offering;[60]

analysts and their household members from buying or receiving an issuer's securities prior to an offering;

New York Stock Exchange, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45,908 (May 10, 2002).

[55] As approved, NASD Rule 2711 and its commentary is available at http://www.nasdr.com/pdf-text/0239/ntm.txt (Oct. 20, 2002).

[56] NASD Rule 2711(b)(2)-(3). The rule makes an exception for investment banking review -- via the compliance or legal department -- for the purpose of verifying the factual accuracy of information or screening for any potential conflict of interest.

[57] NASD Rule 2711(c)(1)-(2). The rule makes an exception for review, under limited circumstances, by the issuer to verify the factual accuracy of company information.

[58] NASD Rule 2711(d).

[59] NASD Rule 2711(e).

[60] NASD Rule 2711(f)(1)-(2). The "quiet period" is forty days following an initial public offering and ten days following a secondary offering. This provision is intended to "reduce a manager's ability to improperly reward the subject company for its underwriting business by publishing favorable research after completion of the offering." Form 19b-4, *supra* note 51.

if the company is principally engaged in the same type of business covered by the analyst;[61]

analysts and their household members from trading securities in companies they cover either 30 days before or 5 days after the issuance of a research report;[62]

analysts and their household members from trading against their current recommendations;[63]

members from issuing research reports or an analyst from making public appearances without disclosing the analyst's financial interest in the recommended company or the member's beneficial ownership of 1% or more of common stock of the company, or of any other known conflicts of interest of the member or the analyst;[64]

members from issuing research reports or an analyst from making public appearances without disclosing additional information suggesting a conflict of interest, such as compensation received from the covered company, any officer or director position held by the analyst in the company, and whether the firm makes a market in the covered securities;[65] and

members from issuing research reports without disclosing certain information about the analyst's rating, including the meaning of its ratings, the

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[61] NASD Rule 2711(g)(1).

[62] NASD Rule 2711(g)(2)(A)-(B). The rule does not cover such trading when an analyst seeks to sell all of his securities held in a company at the inception of coverage or following a significant news event concerning the subject company.

[63] NASD Rule 2711(g)(3)-(4). The rule does permit such trading in limited circumstances, such as personal financial needs of the beneficial owner of the research analyst account.

[64] NASD Rule 2711(h)(1)-(10). All disclosures required by subsection (h) must be "clear, comprehensive and prominent."

[65] NASD Rule 2711(h)(2), (3)-(8).

distribution of its ratings, and valuation methods used to determine any price target.[66]

Finally, the rule requires each member to adopt and implement supervisory procedures designed to ensure compliance with proposed Rule 2711.[67]

III. CIVIL LIABILITY OF SECURITIES INDUSTRY PARTICIPANTS FOR UNDISCLOSED CONFLICTS OF INTEREST

Now that these new rules are effective, the question arises as to whether any violation of them would give rise to civil liability for securities fraud under the federal securities laws to an investor who purchased a security based on the analyst's recommendation.[68] An examination of the judicial development of liability for a more egregious undisclosed conflict of interest -- scalping -- can help answer this question.

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[66] NASD Rule 2711(h)(4)-(9). The rule also provides a "catch-all" to cover any disclosures already required by any applicable rule or regulation.

[67] NASD Rule 2711(i). Simultaneous with the publication of these proposed rule changes, the NASD launched an investor education initiative designed "to educate investors about research reports, their value and their limitations." Press Release, NASD Launches Analyst Disclosure Investor Education Initiative, *available at* http://www.nasdr.com/news/pr2002/release_02_010.html (Feb. 12, 2002). As part of this initiative, the NASD published a "Guide to Understanding Securities Analyst Recommendations" and a "Glossary of Analyst Research Terms," both *available at* http://www.nasdr.com.

[68] Implicit in this question is the assumption that the new analyst rules do not provide for a private cause of action. While it is well-established that a violation of SRO rules does not give rise to a private right of action (*see, e.g., In re* VeriFone Sec. Litig., 11 F.3d 865, 870 (9th Cir. 1993); Craighead v. E.F. Hutton & Co., 899 F.2d 485, 493 (6th Cir. 1990)), at least one court has refused to vacate an arbitration award based on an SRO rule violation, concluding that the well-settled law precluding private lawsuits in courts for SRO rule violations does not preclude an award to a customer suing in arbitration for damages solely based on SRO rule violations. *See* Freeman v. Arahill, Index No. 111119/01 (N.Y. Sup. Ct. N.Y. County Oct. 18, 2001).

A. Liability Under the Investment Advisers Act

In 1963, the Supreme Court first addressed the practice of scalping -- defined as, at least with respect to a registered investment adviser, the "practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation."[69] In *Capital Gains*, the SEC brought an enforcement action against a registered investment advisor and his investment advisory firm, claiming that defendants' scalping activities violated section 206(2) of the IAA.[70] At a preliminary injunction hearing in the United States District Court for the Southern District of New York, the SEC established that defendants, on six different occasions in an eight-month time period, purchased shares of a security "shortly" before a monthly report published by their investment advisory service recommended it for long-term investment.[71] On each occasion, the market price and trading volume of the recommended security rose within a few days after the service distributed the report.[72] Defendants "immediately thereafter" sold their shares of the securities at a profit,[73] without disclosing "any aspect of these transactions to their clients or prospective clients."[74]

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[69] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963).

[70] 15 U.S.C. § 80b-6(2)(2000). This section prohibits any "transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client."

[71] 375 U.S. at 182-83. In the Second Circuit's opinion affirming the denial of the injunction by the district court, the court of appeals reported that each of defendants' purchases were made three to seven days in advance of the recommendation. SEC v. Capital Gains Research Bureau, Inc., 300 F.2d 745, 747-48 (2d Cir. 1961), *aff'd on reh'g en banc*, 306 F.2d 606 (2d Cir. 1962), *rev'd*, 375 U.S. 180 (1963).

[72] 375 U.S. at 183.

[73] *Id.* Defendants sold their stock within one or two weeks following the recommendation. *SEC v. Capital Gains Research Bureau*, 300 F.2d at 747-48.

[74] 375 U.S. at 183.

In denying the injunction application, the district court narrowly construed the terms "fraud" and "deceit" in section 206(2) and found that, absent proof that defendants intended to defraud their clients or that defendants injured their clients, the SEC could not establish a violation of the IAA.[75] The SEC appealed. On appeal, the Second Circuit, sitting *en banc*, affirmed the denial of injunctive relief.[76] The court of appeals ruled that a violation of the Act necessarily required a showing of intentional fraud, such as, *inter alia*, proof that defendants made the recommendations with the purpose of artificially inflating the value of the stock so that they could sell their shares at a profit.[77]

The Supreme Court reversed the denial of the SEC's application for an injunction.[78] First, after reviewing the legislative history and applying principles of statutory construction, the Court found that the SEC need not prove scienter to establish a violation of section 206(2).[79]

Second, the Court held that the practice of scalping by a registered investment adviser violates the antifraud provision of the IAA.[80] The Court focused on the nondisclosure to the clients by the fiduciary[81] -- the investment adviser -- of his practice of "secretly trad[ing] on the market effect of his own recommendation."[82] Such an adviser, the Court found:

> may be motivated -- consciously or unconsciously -- to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated

[75] *Id.* at 184.

[76] *Id.* at 184-85.

[77] *Id.* at 185.

[78] *Id.* at 201.

[79] *Id.* at 195.

[80] *Id.* at 197.

[81] The Court acknowledged that, through section 206 of the IAA, Congress imposed a statutory fiduciary duty on investment advisers. *Id.* at 191-92.

[82] *Id.* at 196.

> activity from the recommendation (which would profit the adviser). An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving "two masters" or only one . . . "especially . . . if one of the masters happens to be economic self-interest."[83]

Thus, a trial court can reject the argument as irrelevant that the adviser believed in his recommendation and "did not offer it for the purpose of furthering personal pecuniary objectives."[84] Rather, the Court stated, "[i]t is the practice itself . . . with its potential for abuse, which 'operates as a fraud or deceit' within the meaning of the [IAA] when relevant information is suppressed."[85] The Court concluded that the SEC has the power to bring an action for injunctive relief requiring an investment adviser to disclose his personal interest in investments he recommends before trading on the market effect of those recommendations.[86]

Since *Capital Gains*, the SEC has brought several enforcement proceedings under the anti-fraud provisions of the IAA against investment advisers for failing to disclose scalping conduct and other conflicts of interest in their investment advice.[87] For example, in *Patrick Clements*, the

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[83] *Id.* (quoting United States v. Mississippi Valley Generating Co., 364 U.S. 520, 549 (1961)). Thus, the trading is not fraudulent as long as it is disclosed; it is the nondisclosure of the fiduciary that constitutes the deceit.

[84] *Id.* at 200.

[85] *Id.*

[86] *Id.* at 201. While the SEC in *Capital Gains* sought only an injunction, Congress has since empowered the SEC, in the Securities Enforcement and Remedies Act of 1990, to seek monetary penalties against registered investment advisers for violations of the IAA. See 15 U.S.C. § 80b-9(e) (2000).

[87] *See, e.g., In re* Kingsley, Jennison, McNulty & Morse, Inc., 50 S.E.C. Docket 310, 1991 WL 288369, at *11 (S.E.C. Nov. 14, 1991) (censuring investment adviser and its principal for failing to disclose to clients its "soft dollar" commission arrangement with brokerage firm and stating

SEC found that an investment adviser, aided and abetted by its president, violated sections 206(1) and (2) of the IAA by failing to disclose in its investment letters -- which recommended a certain stock -- that the president personally purchased shares of that stock just prior to the recommendation.[88] The president sold the shares for a loss after the recommendation, but the SEC did not find it relevant that the president lost money on the transaction.[89] In some cases, the defendants did not even trade in the securities following the recommendation; rather, the SEC focused merely on the investment adviser's failure to disclose the potential conflict of interest in owning the recommended securities as the violative conduct.[90]

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that "whenever trading by an investment advisor raises the possibility of a potential conflict with the interests of his advisory clients, the investment adviser has an affirmative obligation before engaging in such activities to obtain the informed consent of his clients on the basis of full and fair disclosure of all material facts" (quoting *In re* Kidder, Peabody & Co., et al., 43 S.E.C. 911, 916 (1968))); *In re* Frank S. Arko, 12 S.E.C. Docket 1378, 1977 WL 176094 (S.E.C. Release No. 13801, July 25, 1977) (reporting institution of administrative proceedings against registered investment adviser under, *inter alia*, section 206 of the IAA for failing to disclose scalping scheme with respect to securities in three different companies); *In re* Patrick Clements, 42 S.E.C. 373, 1964 WL 66207 (S.E.C. Oct. 12, 1964).

[88] 1964 WL 66207.

[89] *Id.* at *5. The SEC concluded that "[e]ven though the shares were sold at a loss, the recommendation by [the investment adviser] of a stock in which [the president] was trading without revealing his personal interest in that stock constitutes fraudulent conduct."

[90] *See In re* Chancellor Capital Management, 57 S.E.C. Docket 2204, 1994 WL 570098 (S.E.C. Oct. 18, 1994). In this case, the SEC found that an investment adviser and one of its portfolio managers violated section 206 and other sections of the IAA by failing to disclose to clients that, on at least two occasions, the portfolio manager recommended the purchase of shares in a company in which he personally owned shares. The portfolio manager had established business relationships with these companies and acquired the securities for nominal consideration as much as *eighteen months* earlier, during the formation stages of the companies. *Id.* at *3-4. The SEC noted that the firm had a general policy instructing employees to avoid conflicts of interest in making recommendations. *Id.* at *2. The SEC did not discuss whether the portfolio manager had sold his shares

While there seems to be little doubt that the IAA imposes strict liability for investment adviser scalping, claims under the IAA for scalping activities are limited in scope for several reasons. First, the IAA applies only to registered or unregistered investment advisers, as defined in the statute.[91] Thus, the SEC cannot rely on the IAA to bring disciplinary violations against other industry participants, such as sell-side research analysts. Second, it is well-settled that investors do not have a private right of action for compensatory damages under the strict liability provisions of the IAA.[92] Therefore, the investing public needed to invoke some other legal basis to sue industry participants for making recommendations without disclosing their scalping or other conflicts of interest.[93]

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following the investment recommendation, as it viewed the violating conduct to be the lack of disclosure of the conflict of interest, not any post-recommendation trading. *Id.* at *6-7.

[91] 15 U.S.C. § 80b-2(11) (2000).

[92] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 19-20 (1979).

[93] SROs also have disciplined their registered broker-dealers and their associated persons for scalping conduct under SRO disciplinary rules. For example, in *In re* Smith, Barney, Harris Upham & Co., 31 S.E.C. Docket 212, 1984 WL 53102 (Aug. 15, 1984), the SEC affirmed the American Stock Exchange's finding that a member brokerage firm had violated the Exchange's Constitution by engaging in conduct "inconsistent with just and equitable principles of trade," i.e., scalping. The Exchange found that Smith Barney effected certain transactions in options of a company in the firm's proprietary account before disseminating to the firm's public customers a research recommendation on that company. The SEC agreed with the Exchange that, "[i]n order to avoid any potential conflict of interest, a firm should give its customers sufficient time to receive and digest a research recommendation that represents a material change in the firm's position before the firm trades the subject stock or related options for its own account." *Id.* at *2. The Exchange did not bring this disciplinary proceeding under anti-fraud provisions, and therefore, it focused on the trading rather than the failure to disclose as the unlawful conduct.

B. Liability Under the 1934 Act for Scalping

As a result, after *Capital Gains*, both the SEC and private plaintiffs seeking relief from tainted recommendations looked to the most commonly-used statutory basis of liability for securities fraud: the antifraud provisions of the SEA.[94] Today, a successful private plaintiff[95] in a section 10(b)/Rule 10b-5 lawsuit must prove the following elements: (1) a misrepresentation or omission[96] of material[97] fact, or other

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[94] Section 10(b) of the SEA, 15 U.S.C. § 78j(b) (2000), and Rule 10b-5 promulgated by the SEC, 17 C.F.R. § 240.10b-5 (2002), prohibit fraud in connection with the purchase or sale of securities. Section 10(b) provides:

> It shall be 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 . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement. . .any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

> It shall be 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, (a) To employ any device, scheme, or artifice to defraud . . . or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

The scope of liability under Rule 10b-5 "is coextensive with the coverage of § 10(b)." SEC v. Zandford, 122 S. Ct. 1899, 1901(2002). By contrast, the anti-fraud provision of the SA prohibits fraud in connection with the *offer* or purchase of securities. 15 U.S.C. § 77q(a) (2000).

[95] SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985) (holding that, contrary to a private plaintiff, the SEC need not prove the elements of justifiable reliance or damages).

[96] Chiarella v. United States, 445 U.S. 222, 235 (1980) (holding that for liability premised on omissions, defendant must have a duty to disclose).

deceptive device, (2) in connection with[98] the purchase or sale of a security,[99] (3) scienter by the defendant,[100] (4) justifiable reliance by the plaintiff[101] and (5) causing damage to the plaintiff.[102]

Several courts have allowed a plaintiff to pursue a securities fraud claim for failure to disclose scalping and other conflicts of interest in connection with the recommendation of a security.[103] For example, in *Zweig*, the owners of one of the companies involved in a corporate merger sued a newspaper financial columnist, alleging that he violated section 10(b) and Rule 10b-5 by writing a favorable article about the other merging company without disclosing that he owned stock in that company, and that he

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[97] Information is deemed "material" if there is a substantial likelihood that a reasonable investor would have considered it important in making an investment decision. *See, e.g.,* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1987); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[98] The Supreme Court interprets the "in connection with" requirement broadly and has held that it is met as long as the scheme to defraud and the securities transaction "coincide." Zandford, 122 S. Ct. at 1906.

[99] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (limiting those who have standing to sue under § 10(b) to purchasers or sellers of securities).

[100] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (holding that private cause of action for damages under § 10(b) and Rule 10b-5 will not lie absent scienter, defined in the opinion as "a mental state embracing intent to deceive, manipulate, or defraud").

[101] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1970) (holding that "all that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of the decision").

[102] For a general discussion of all of these elements, *see* POSER, *supra* note 21, at § 3.01[D][2]-[6], § 4.01[A].

[103] *See, e.g.,* Laird v. Integrated Resources, Inc., 897 F.2d 826 (5th Cir. 1990) (reversing grant of summary judgment to defendants on grounds that investors alleged valid § 10(b) claims against their investment advisers for failure to disclose commissions received in recommended investments); Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979); Barthe v. Rizzo, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974) ("It is clear that [plaintiff investor] was entitled to know that [his broker] was in a position to gain financially from the deal" which the broker recommended.).

intended to sell some of the stock following the sharp rise in price that his article would cause.[104] During a bench trial, the district court granted the columnist's motion to dismiss on the grounds that plaintiff's theory of liability for scalping under section 10(b) was not valid.[105]

The Ninth Circuit reversed the district court's dismissal of the action, holding that the columnist's conflict of interest was a material fact that his readers were entitled to know.[106] The court of appeals reasoned that "[r]easonable investors who read the column would have considered the motivations of a financial columnist such as [defendant] important in deciding whether to invest in the companies touted."[107] The court also found that defendant "assumed" a duty to disclose the information withheld once he chose to "encourag[e] purchases of the securities in the market."[108] The court analogized the defendant to a corporate insider who withholds material information about the company's financial condition while trading in the stock, and found that the financial columnist has the same duty to his audience to avoid misleading them as to the reliance they could place on his column.[109]

Finally, the court had little difficulty concluding that plaintiff could prove scienter through the defendant's knowledge of his ownership interests in the stock and his intent to benefit from the column.[110] Thus, the court held that the federal securities laws:

> require a financial columnist, in recommending a security that he or she owns, to provide the public with all material information he or she has on that security, including his or her ownership, and any intent he or she may have (a) to score a quick profit

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[104] Zweig v. Hearst Corp., 594 F.2d at 1262-63.

[105] *Id.* at 1263.

[106] *Id.* at 1264-66.

[107] *Id.* at 1266.

[108] *Id.* at 1268.

[109] *Id.* at 1266-67.

[110] *Id.* at 1271. Similarly, the court presumed reliance from the nondisclosure, following the Supreme Court's decision in *Affiliated Ute. Id.*

> on the recommendation, or (b) to allow or encourage the recommendation to be published as an advertisement in his or her own periodical.[111]

Private investors are not the only ones who have looked to the broader antifraud provisions of the SEA. The SEC enforcement staff has parlayed its success in scalping cases against investment advisers to bring enforcement proceedings against an expanded universe of defendants, including stock promoters and analysts, for failure to disclose conflicts of interest under section 10(b) of the SEA.[112]

The district court's decision in *Blavin* -- as one of the first courts to apply section 10(b) to scalping in an SEC enforcement proceeding -- is instructive. In *Blavin*, the trial

[111] *Id.* In dicta, the Ninth Circuit discussed how to measure the damages: the difference between the actual market value of the merging company and the inflated value due to the rise in price following the defendant's misleading column. *Id.* at 1269-70.

[112] *See, e.g.*, SEC v. Park, 99 F. Supp. 2d 889 (N.D.Ill. 2000) (motion to dismiss denied on the grounds that securities information provider on the Internet is subject to IAA); SEC v. Carlisle, et al., Litigation Release No. 15,949, 1998 WL 751084 (Oct. 27, 1998) (reporting filing of federal court complaint against defendants, who provided investor relations and stock promotion services, for scalping activities as violations of section 10(b) and Rule 10b-5 of the SEA and section 17(a) of the SA); SEC Wins Summary Judgment Against Internet Microcap Stock Tout, SEC v. Huttoe, Litigation Release No. 15,906, 68 S.E.C. Docket 174 (S.E.C. Release No. 15,906 Sept. 24, 1998) (reporting district court's grant of summary judgment for the SEC against newsletter writer and publisher employee for scalping); *In re* Ronald v. Speaker, 63 S.E.C. Docket 1640, 1997 WL 987 (S.E.C. Release No. 38161, Jan. 13, 1997) (reporting simultaneous institution and settlement of proceedings against investment adviser for failing to disclose conflict of interest in recommendation); *In re* Penny Stock Newsletter, Inc., 32 S.E.C. Docket 84, 1984 WL 472325, at *4 (S.E.C. Dec. 19, 1984) (following *Zweig* and imposing sanctions on publisher of investment advisory newsletter under antifraud provisions of SEA and IAA, as well as section 17(b) of SA, for failing to disclose four separate pre-recommendation purchases and for falsely representing in newsletter that he would not purchase or sell recommended securities within 30 days of recommendation; the SEC concluded that "[s]ection 10(b) of the [SEA] requires an investment adviser to disclose potential conflicts of interest."); SEC v. Blavin, 557 F. Supp. 1304 (E.D.Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985).

court granted summary judgment to the SEC on its section 10(b) claim under the SEA as well as its section 206(2) claim under the IAA.[113] Blavin was an unregistered investment adviser who authored, published and disseminated to subscribers and potential subscribers a newsletter that discussed and recommended certain securities.[114] Blavin did not dispute that, on numerous occasions, he owned or purchased large amounts of these securities just prior to publishing his "glowing" recommendations.[115] It was also undisputed that Blavin failed to disclose in the newsletter that he personally owned shares in the companies he was recommending.[116] The SEC also established that he sold his shares at a significant profit by trading on the market effect of his recommendations.[117] In fact, Blavin continued this practice after the SEC began investigating his activities and even after the SEC had obtained a preliminary injunction against him in this case.[118]

In holding that this conduct violated section 10(b), the district court found that Blavin's failure to disclose his conflicts of interest to his subscribers was a material omission made with scienter in connection with the purchase or sale of securities.[119] First, because the "sole purpose" of the newsletters was to recommend the purchase of stock, the court had no difficulty finding that Blavin's conduct met the "in connection with" requirement of section 10(b).[120] Second, the court concluded that Blavin's failure to disclose his ownership interests in and intent to sell the recommended securities constituted a material omission.[121]

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[113] 557 F. Supp. at 1310-15.

[114] *Id.* at 1308.

[115] *Id.* at 1311.

[116] *Id.*

[117] *Id.* at 1308-09.

[118] *Id.* at 1309. These additional violations in the face of a preliminary injunction resulted in a criminal contempt conviction against Blavin. *Id.*

[119] *Id.* at 1310.

[120] *Id.* at 1310-11.

[121] *Id.* at 1311 (relying on *Zweig* and stating that "[c]ourts have uniformly held that such schemes violate the securities Law [sic] and that

Finally, the district court found that Blavin acted with scienter because the "pattern of Blavin's activity creates an overwhelming presumption that this activity was intentional."[122] Blavin testified at his deposition that he purposefully concealed from the SEC (once the investigation had begun) his large purchase of one particular stock "because he knew it would look wrong in view of the fact that he had recommended [the stock]."[123] Finally, Blavin filed a form with the SEC contemporaneous with his violative conduct stating that he would not buy or sell a security recommended in his newsletter for 60 days before or after making such a recommendation.[124] This constituted "clear evidence Blavin knew that his scalping activities were wrong."[125]

However, neither the Sixth Circuit nor the district court in *Blavin* mentioned the Supreme Court's decisions in *Chiarella v. United States*[126] and *Dirks v. SEC*,[127] both insider

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a failure to disclose such a 'scalping' scheme is a material omission prohibited by § 10(b)"). On appeal, the Sixth Circuit specifically affirmed this holding, and stated that "[t]he effect of such large holdings on Blavin's objectivity in making investment recommendations would be particularly important to his clients." 760 F.2d at 711. The district court also agreed with the SEC that certain company information in the newsletters contained material misstatements and omissions. 557 F. Supp. at 1311.

[122] 557 F.Supp. at 1312. On appeal, the Sixth Circuit questioned the district court's finding that the defendant acted intentionally, but held that the district court did not need to reach the issue of intent because the defendant's conduct certainly was reckless and thus satisfied the "recklessness" prong of scienter. 760 F.2d at 712 ("At a minimum, Blavin recklessly failed to disclose that he was trading in stocks that his newsletter recommended.").

[123] 557 F. Supp. at 1312.

[124] *Id.*

[125] *Id.* The court also found that the same conduct violated sections 206(1), (2) and (4) of the IAA, where the SEC did not have to prove scienter. *Id.* at 1315.

[126] 445 U.S. 222 (1980) (pre-dating *Blavin*). In *Chiarella*, the Court refused to impose insider trading liability on a printer who learned through his printing clients about their upcoming tender offers and then bought stock in the target companies. The Court found that the defendant's silence could not be the basis of fraud because he had no duty

trading cases, where the Court held that there can be no section 10(b) liability for omissions absent a duty to disclose.[128] Nor did the *Blavin* court address whether the defendant had a duty to disclose. Thus, under current Supreme Court jurisprudence, the scope of section 10(b) and Rule 10b-5 arguably is more limited than that recognized by the Ninth Circuit in *Zweig*, or even the Sixth Circuit in *Blavin*.[129]

Alternatively, one can infer that the district court, while calling the defendant's failure to disclose a "material omission," implicitly treated the omission as one that renders an affirmative statement (the recommendation in the newsletter) materially misleading, and therefore the SEC did not have to establish the existence of a duty to disclose. The Sixth Circuit's treatment of the issue was more direct: it considered the failure to disclose the extent of defendant's ownership in the recommended securities and

to disclose arising out of a relationship of trust and confidence. The defendant's ability to utilize non-public information because of his position in the marketplace did not impose on him such a duty.

[127] 463 U.S. 646 (1983) (post-dating district court's, but pre-dating Sixth Circuit's decision in *Blavin*). Dirks was an analyst and an officer of a brokerage firm who received a tip from a former officer of an insurance company that the company's assets were overvalued as a result of fraud. After investigating the allegations, Dirks informed his clients, institutional investors, about the fraud, and the clients sold their shares in the company. The SEC found him liable under § 10(b) as an aider and abettor of the insider trading of his clients, but the Supreme Court reversed, concluding that Dirks was not liable because he had no duty to the company's shareholders. Moreover, the officer who had tipped him about the fraud had not breached his duty to the shareholders because his motive for disclosing -- to expose the fraud -- was laudable.

[128] *Dirks*, 63 U.S. at 230; *Chiarella*, 445 U.S. at 228.

[129] Since *Zweig* also pre-dates *Chiarella* and *Dirks*, the Ninth Circuit has questioned its holding in *Zweig* with respect to the duty to disclose. *See* Feldman v. Simkins Indus., 679 F.2d 1299, 1304 (9th Cir. 1982). However, other courts still consider *Zweig* to be good law. *See* SEC v. Park, 99 F.Supp.2d 889, 899 (N.D.Ill. 2000). For a more general discussion of how several significant Supreme Court opinions in the 1980s narrowed the scope of civil liability under the SEA, *see* Roberta S. Karmel, *Outsider Trading on Confidential Information -- A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 90-92 (1998).

the post-recommendation trading as material facts that rendered the disclaimer in the newsletters misleading.[130] Under this treatment, the *Dirks* and *Chiarella* decisions -- while narrowing the scope of section 10(b) and Rule 10b-5 in the context of omissions -- have little impact on the result in *Blavin.*

Recent legislation has further limited the scope of section 10(b) and Rule 10b-5. Plaintiffs filing their claims in federal court (as opposed to bringing an arbitration proceeding) must satisfy the strict pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA").[131] Plaintiffs must allege with specificity "each statement alleged to have been misleading" as well as "the reason or reasons why the statement is misleading."[132] In addition, in order to satisfy the element of scienter, the plaintiff must "state with particularity facts giving rise to a strong inference that defendant acted with the required state of mind."[133]

Furthermore, because sell-side analysts are by definition employed by broker-dealers who are members of the NASD, many investor claims against analysts, particularly against those who work for the same firm with which the customer has the relevant trading account, would be brought as securities arbitration claims.[134] However, securities SRO

[130] SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985).

[131] 15 U.S.C. § 78u-4 (2000).

[132] 15 U.S.C. § 78u-4(b)(1) (2000).

[133] 15 U.S.C. § 78u-4(b)(2) (2000).

[134] NASD Code of Arbitration Procedure 10301 requires member firms and their associated persons to arbitrate, upon a customer's demand, "[a]ny dispute, claim or controversy . . . arising in connection with the business of such member or in connection with the activities of such associated persons . . . ." Moreover, most customers' agreements with their brokerage firms contain pre-dispute arbitration agreements ("PDAA"), requiring arbitration of disputes arising out of the account. *See* Black & Gross, *supra* note 23, at 991. Whether or not an investor's claim against an analyst employed by a firm other than the one where the investor was a customer can be arbitrated pursuant to Rule 10301 or the PDAA would be a litigable issue.

arbitration rules do not permit class action arbitrations.[135] Thus, class action plaintiffs must, under the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"),[136] bring almost any securities fraud claim in federal court rather than in state court. Because investor claims against sell-side analysts are likely to be brought as class actions, section 10(b) and Rule 10b-5 will supply the primary basis of analysts' potential liability towards investors.

Some of these class actions have not survived the pleading stage. For example, a series of class action lawsuits were brought against Morgan Stanley Dean Witter & Co. ("MSDW") and its employee, the well-known research analyst Mary Meeker. Plaintiffs -- open market purchasers of stocks covered by Meeker -- filed the complaints under the PSLRA in the United States District Court for the Southern District of New York. The complaints alleged that MSDW and Meeker violated, *inter alia*, section 10(b) and Rule 10b-5 of the SEA by recommending the purchase of several Internet stocks (AOL Time Warner, amazon.com, and Ebay) without disclosing Meeker's conflicts of interest based on financial arrangements with the issuer.[137] The complaints alleged that Meeker used the positive recommendations to drum up investment banking business for her employer, MSDW, and that Meeker was compensated, in part, on the basis of the investment banking business she generated.[138] The complaints did not survive the pleading stage, however, as the court dismissed them without prejudice, *sua sponte*,[139]

[135] *See, e.g.,* NASD Code of Arbitration Procedure 10301(d).

[136] 15 U.S.C. § 78bb(f) (2000).

[137] Tamara Loomis, *Analyst Accountability: Suits Over Stock Recommendations Pose New Wrinkle*, N.Y.L.J., Aug. 16, 2001, at 5.

[138] *Id.*

[139] *See* Senders v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,536, 2001 WL 958927 (S.D.N.Y. Aug. 21, 2001); Stein v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,537, 2001 WL 958936 (S.D.N.Y. Aug. 21, 2001); Lloyd v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,538, 2001 WL 959190 (S.D.N.Y. Aug. 21, 2001); Thomson v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,539, 2001 WL 958925 (S.D.N.Y. Aug. 21, 2001); Soto v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,540, 2001 WL 958929 (S.D.N.Y.

on the grounds that they violated Federal Rule of Civil Procedure 8(a)(2) requiring "a short and plain statement of the claim showing that the pleader is entitled to relief."[140]

IV. UNDISCLOSED CONFLICTS OF INTEREST AS A PRIVATE VIOLATION OF RULE 10B-5

The author is unaware of any case awarding damages to an investor who brought a claim for securities fraud under the SEA against an analyst or other industry participant lacking a fiduciary duty to the investor for recommending a security in a research report without disclosing conflicts of interest.[141] However, when publicly disseminating a research report, an analyst's failure to disclose his ownership of the recommended stock or any compensation arrangements related to his firm's investment banking activities for the issuer should lead to section 10(b)/Rule 10b-5 liability to an investor who invests in reliance on that research report (the "misrepresentation"), as the conduct appears to satisfy each of the elements a private plaintiff must prove to prevail. Moreover, imposing such liability squares with the "fundamental purpose" of the SEA to implement a "philosophy of full disclosure" to protect the integrity of the

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Aug. 21, 2001); Pludo v. Morgan Stanley Dean Witter & Co., Fed. Sec. L. Rep. ¶ 91,541, 2001 WL 958922 (S.D.N.Y. Aug. 21, 2001).

[140] FED. R. CIV. P. 8(a)(2). The court did not describe or even mention the substance of the securities fraud allegations, as it dismissed the complaints -- which were replete with quotes from and references to media coverage of Meeker -- due to "pleading improprieties" it considered "gross and unrestrained." *See, e.g., Pludo*, 2001 WL 958922, at *1.

[141] Two recent cases with unusual facts have survived a motion to dismiss. Cyber Media Group, Inc. v. Island Mortgage Network, Inc., 183 F. Supp. 2d 559 (E.D.N.Y. 2002) (discussed *infra* notes 152-56 and accompanying text); *In re* Credit Suisse First Boston Corp. Secs. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,306, 1998 U.S. Dist. LEXIS (S.D.N.Y. Oct. 20, 1998) (denying motion to dismiss class action complaint against broker-dealer and an employee of its proprietary trading group who issued "Trading Notes" in the form of an analyst research report containing negative information about the issuers without disclosing that the firm had a short position in the covered securities).

securities markets.[142] As the Supreme Court first announced in *Capital Gains Research* and has announced repeatedly since then, in enacting the SEA, Congress sought to "achieve a high standard of business ethics in the securities industry."[143]

A. Materiality

First, courts routinely deem "material"[144] the fact that an individual or entity recommending a security has a personal financial interest in the security and/or the issuer -- no matter how small the stake.[145] An analyst might argue that an undisclosed small stake in the recommended security, in the context of a well-researched and analyzed report, is not

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[142] Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477 (1977) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972), quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)); *see also* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (stating that the "animating purpose of the Exchange Act" is "to insure honest securities markets and thereby promote investor confidence").

[143] SEC v. Zandford, 122 S. Ct. 1899, 1900 (2002) (quoting *Affiliated Ute Citizens of Utah*, 406 U.S. at 151).

[144] See *supra* note 97 for the definition of materiality.

[145] *See, e.g.*, SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985) (stating that "[t]he effect of such large holdings on Blavin's objectivity in making investment recommendations would be particularly important to his clients"); Chasins v. Smith Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (finding nondisclosure of market-making activity of broker in recommended security material); Addeo v. Braver, 956 F. Supp. 443, 452 (S.D.N.Y. 1997) (holding that "though defendant's [undisclosed] commission was small, the court cannot say, as a matter of law, that the potential conflict of interest arising out of the commission would not have been material in the eyes of a reasonable investor"); Capital District Physician's Health Plan v. O'Higgins, 951 F. Supp. 352, 356 (N.D.N.Y. 1997) (holding that a failure of investment adviser to disclose conflict of interest was material omission); SEC v. Hasho, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); Shivangi v. Dean Witter Reynolds, Inc., 107 F.R.D. 313, 318 (S.D. Miss. 1985) (holding that "a person recommending a stock must disclose if he will gain financially from the sale above and beyond normal compensation"); Barthe v. Rizzo, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974) (holding that customer was entitled to know that his broker "was in a position to gain financially" from the recommendation).

material. Instead, some investors might be comforted to know that the analyst owned the stock, as a sign that the analyst had faith in the long-term performance of the issuer. However, every analyst report carries the implied representation that the analyst is disinterested, unbiased and objective, and this representation may be rendered materially misleading by the analyst's ownership of the stock. As courts have stated repeatedly, the investor is entitled to know that the recommendation might have been motivated -- even subconsciously -- by the recommender's own financial interest rather than the investment value of the recommended security.[146]

B. "In Connection With"

Second, the Supreme Court construes the "in connection with" element quite broadly.[147] Therefore, the mere fact that the analyst's misstatement or nondisclosure appeared in a securities research report or recommendation should suffice to meet the "in connection with" requirement.[148]

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[146] *See, e.g., Addeo*, 956 F. Supp. at 452; *Credit Suisse*, 1998 U.S. Dist. LEXIS 16560, at *19-20 (concluding that "a reasonable investor would have discounted the projections in the report if the investor had been aware of the [firm's] self-interest"); *see also Capital Gains*, 375 U.S. at 196 (holding that an investor must "be permitted to evaluate [even unconscious] overlapping motivations").

[147] *See, e.g., Zandford*, 122 S. Ct. at 1900 (reversing Fourth Circuit's narrow interpretation of "in connection with" requirement and holding that element is met even if there is no "misrepresentation about the value of a particular security"); *O'Hagan*, 521 U.S. at 655-56 (concluding that "in connection with" element met as long as securities transaction and nondisclosure in breach of duty coincide); Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (holding that "section 10(b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b), whatever might be available as a remedy under a state law").

[148] *See* SEC v. Texas Gulf Sulphur, 401 F.2d 833, 860 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (finding that "in connection with" requirement permits section 10(b) to reach any device on which a reasonable investor would rely); *see also* SEC v. Gorsek, 2001 WL

C. Scienter

Unlike under the IAA, the antifraud provisions of the SEA require proof of scienter -- an intent to deceive or recklessness.[149] In all of the scalping cases, the defendants traded against their recommendations without disclosure of the trading. While the author has found no case expressly ruling that a sell-side analyst acted with scienter based merely on an undisclosed conflict of interest, rather than undisclosed trading, the cases suggest that the lack of any post-recommendation trading by an analyst who recommends the purchase of a stock without disclosing his personal financial interest in the stock does not preclude a finding of scienter -- even though the analyst does not profit off of the short-term effect of his market recommendation.[150]

34001242, at *9 (C.D.Ill. Apr. 20, 2001) (ruling that defendants' actions in attempting to influence investment decisions were done "in connection with" the sale of securities); SEC v. Park, 99 F. Supp.2d 889, 900-01 (N.D.Ill. 2000) (finding that the omissions were made "in connection with" the purchase or sale of securities, as the allegations demonstrated that defendants expected their subscribers to act on their advice by purchasing securities); Castillo v. Dean Witter Discover & Co., 1998 WL 342050, at *7 (S.D.N.Y. June 25, 1998) (holding the omission that, *inter alia*, brokers recommending funds had economic interest in the recommendation was "in connection with" the purchase of securities); *Blavin*, 557 F. Supp. at 1310-11.

[149] While the Supreme Court expressly left open the issue of whether reckless conduct can constitute scienter (Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1976)), every circuit court that has addressed this issue has found that it does. *See* POSER, *supra* note 21, at § 3.01[D][4]. Recklessness for purposes of establishing scienter is defined as "those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *Id.* (quoting McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989)).

[150] *See* Zweig v. Hearst Corp., 594 F.2d 1261, 1271 (9th Cir. 1979) (finding scienter based on defendant's knowledge of his ownership interests in the stock and his intent to benefit from the recommendation); SEC v. Gorsek, 2001 WL 34001242, at *8-9 (finding that the SEC proved

Other conduct or circumstances may suffice, such as evidence indicating the analysts did not believe their own recommendations or acknowledging the recommendations as necessary to support their investment banking colleagues.[151]

Very recently, a district court refused to dismiss a complaint alleging section 10(b) violations against an analyst for failing to disclose his conflict of interest, despite the lack of post-recommendation trading.[152] In that case, plaintiff, an Internet advertising firm, alleged that defendants made material misrepresentations and omissions during negotiations to enter into a stock purchase agreement between defendant Apponline.com ("AOP") and Cyber Media Group ("CMG"), pursuant to which AOP would buy the outstanding shares of CMG in exchange for shares of AOP.[153] Plaintiffs sued, among others, a financial analyst and CNN commentator who once touted AOP as a "double-your-money" investment.[154] Plaintiffs alleged that his statement promoting the stock could be an actionable material misstatement and that his failure to disclose that he stood to gain financially by an increase in the value of the stock he was touting could be an actionable material omission.[155] The

scienter for defendants who failed to disclose their own potential for gain when issuing purportedly independent opinions on securities). *But see* Stanley S. Arkin, *Analysts' Conflicts of Interest: Where's the Crime?*, N.Y.L.J., Feb. 14, 2002, at 3 (arguing that, absent conduct such as post-recommendation trading, it would be difficult to establish scienter).

[151] For example, the New York State Attorney General gathered a series of e-mails from Merrill Lynch analysts indicating that the analysts believed the companies they were recommending were not as financially sound as their recommendations indicated but did not disclose such lack of confidence, because the recommendations supported Merrill Lynch's underwriting efforts on behalf of those same companies. *See* Dinallo Aff., *supra* note 10.

[152] Cyber Media Group, Inc. v. Island Mortgage Network, Inc., 183 F. Supp.2d 559 (E.D.N.Y. 2002).

[153] *Id.* at 566.

[154] *Id.* at 567. The analyst, Courtney Smith, was CEO of a venture capital fund that owned AOP stock, and his compensation as CEO included stock in the fund, whose value rose as the value of AOP stock rose. *Id.*

[155] *Id.* at 574.

district court held that the omission could be material and that plaintiffs adequately pled scienter, just by virtue of the analyst's access to information about AOP and his undisclosed conflict of interest.[156]

Furthermore, relying on prior decisions that infer scienter by a securities industry professional merely from the breach of a regulatory rule,[157] a plaintiff can also claim that any breach of the new NASD and NYSE rules of conduct constitutes, at a minimum, reckless conduct. Thus, based merely on the breach of NASD Rule 2711 or NYSE Amended Rule 472, a court could find that an analyst acted with the requisite scienter.[158] While the Supreme Court has held that mere breach of a professional duty does not support a claim for securities fraud due to the lack of deception,[159] that element is met here where the analyst disseminates a research report with the knowledge that disclosure is mandated by regulations and with the implied

[156] *Id.* The court ignored the element of "duty to disclose" entirely, presumably because it regarded the omission as one, like the one in *Blavin*, that rendered an affirmative statement misleading.

[157] *See, e.g.,* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 273 (3d Cir. 1998) (concluding that broker's knowing violation of duty of best execution would allow a fact-finder to find that broker acted recklessly); Brown v. The E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) (stating that "[s]cienter may be inferred by finding that the defendant knew or reasonably believed that" his recommendation violated the suitability rule); Vucinich v. Paine, Webber, Jackson, & Curtis, Inc., 803 F.2d 454, 460 (9th Cir. 1986) (holding that breach of broker's duty to make suitable recommendations is a "reckless violation of Section 10(b)"). *But see* Laird v. Integrated Resources, Inc., 897 F.2d 826, 836 (5th Cir. 1990) (holding that failure to comply with disclosure regulations of the IAA "does not create per se liability under rule 10b-5").

[158] *Cf.* Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885, 889 (5th Cir. 1987) (declining to find scienter because the alleged omission was not conclusively determined to be material by regulators or the courts at the time of the purchase).

[159] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 470, 474-76 (1977) (insisting on a finding of "deception," defined as the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose).

representation of objectivity and neutrality where that neutrality is seriously and knowingly compromised by his own economic interests.

D. Duty to Disclose

Because section 206 of the IAA establishes a statutory federal fiduciary duty for investment advisers,[160] the SEC and the courts, even after *Dirks*, have not hesitated to find the requisite duty to disclose in cases against investment advisers -- registered or unregistered.[161] However, where does the duty to disclose originate, absent the fiduciary relationship of the investment adviser?

The SEC faced just such a dilemma recently in *SEC v. Park*.[162] In that case, the SEC sued a website operator who recommended the purchase of securities to website subscribers without disclosing that he intended to trade on the market effects of his recommendations. The SEC charged that the defendants, including the individual defendant who called himself "Tokyo Joe" and operated the website tokyojoe.com, violated the antifraud provisions of the IAA and the SEA through his scalping.[163] Defendants moved to dismiss the complaint on the grounds that Tokyo Joe was not an investment adviser within the meaning of the IAA, and that, with respect to the section 10(b)/Rule 10b-5 claim concerning omissions, the SEC failed to allege that defendants had a duty to disclose their scalping scheme and that the misstatements were not made "in connection with" the purchase or sale of securities.[164]

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[160] *See* Transamerica Mortgage Advisers, Inc. v. Lewis, 444 U.S. 11, 17 (1979).

[161] *See In re* Penny Stock Newsletter, Inc., 32 S.E.C. Docket 84, 1984 WL 472325, at *4 (S.E.C. Dec. 19, 1984) (stating that "[s]ection 10(b) of the [SEA] requires an investment adviser to disclose potential conflicts of interest"); SEC v. Blavin, 557 F. Supp. 1304, 1311 (E.D. Mich. 1983) (while not identifying a "duty to disclose" as an independent element of a 10(b) violation, recognizing the fiduciary duty imposed by the IAA).

[162] 99 F. Supp.2d 889 (N.D. Ill. 2000).

[163] *Id.* at 892.

[164] *Id.*

The District Court for the Northern District of Illinois denied the motion. First, the court held that the SEC alleged facts sufficient to support the conclusion that defendants were investment advisers within the meaning of the IAA.[165] Second, the district court found that the defendants had a "duty to disclose" and that the material omissions were made "in connection with" the sale of securities.

With respect to a duty to disclose, the court noted the *Chiarella* rule that "[f]raud liability does not attach for failure to disclose material information unless a party is under the duty to disclose."[166] However, the court rejected the SEC's argument that the duty to disclose under the SEA arose from the defendants' legal status as investment advisers.[167] Rather, with little explanation, the court reasoned that the duty "must arise from a relationship outside securities law."[168]

The court then reasoned that defendants' alleged ongoing relationship with their subscribers -- which included daily electronic communications and the payment of a substantial fee for defendants' stock picks and advice -- provided the necessary relationship of trust and confidence. Analogizing the defendants to the newspaper columnist in *Zweig*,[169] the

[165] *Id.* at 893-896. The district court also rejected defendants' First Amendment claim. *Id.* at 896-98.

[166] *Id.* at 899 (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980)).

[167] *Id.* Comparing the Supreme Court's holdings in *Capital Gains* and *Dirks*, the court found the *Capital Gains*' imposition of a duty on investment advisers applies to claims only brought under the IAA and that the *Dirks*' requirement of a duty outside the general duty to comply with the law is more applicable to claims under the SEA. *Id.* Thus, the district court implicitly dismissed prior authority which finds the requisite duty based merely on defendants' status as investment advisers.

[168] *Id.*

[169] *Id.* The district court expressly rejected the view that the holding in *Chiarella* overruled *Zweig*. *Id.* (stating that the Supreme Court in *Chiarella* "nowhere held that someone who encourages people to buy certain stocks and who also charges a fee to these people for this advice has no duty to disclose his interest in the stock").

court concluded that, like the columnist in *Zweig* who "assumed the duty to disclose" by encouraging purchases in securities with an intent to gain personally, the defendants in *Park* who "intend[ed] to engage in scalping" similarly "assume[d] a duty to disclose [their] interest in the targeted stock."[170]

Research analysts who place "buy" recommendations on companies also assume a duty to disclose their personal or institutional financial self-interests. Just as market-makers must disclose the fact that they make a market -- and thus have a financial interest in trades -- sell-side analysts must disclose when they are not as disinterested as the industry holds them out to be.

Another way around the duty to disclose is to frame the allegations in terms of an affirmative misrepresentation made misleading by the failure to disclose the conflict, rather than in terms of a material omission, in which case the plaintiff need not allege nor prove a duty to disclose. This is precisely what the *Blavin* court did: it circumvented the need to prove a duty to disclose by characterizing the "omission" of the disclosure of the conflict of interest as one that rendered an existing statement materially misleading.

In one criminal case, prosecutors followed precisely this strategy in a RICO and conspiracy prosecution involving a myriad of predicate acts, including securities fraud, allegedly committed by defendants and all designed to defraud the

[170] *Id.* at 900. Subsequent to the decision, Park settled the SEC's enforcement action by consenting to entry of an order permanently enjoining him from violating the securities laws and ordering that he disgorge $324,934 and pay $429,696 in civil penalties. SEC News Release, SEC Settles Securities Fraud Action Against "Tokyo Joe" Internet Stock Picker Required to Give Up All Illegal Profits, Pay a Penalty of More than $400,000 and Consent to the Entry of an Anti-fraud Injunction, 2001 WL 226174 (S.E.C. Mar. 8, 2001). In the press release issued in conjunction with the settlement, then SEC Enforcement Director Richard Walker claimed that the case established "ground-breaking precedent," in that it imposed on those in the business of offering stock advice over the Internet the same duties as an investment adviser to disclose conflicts of interest. *Id.*

investing public.[171] The indictment alleged, *inter alia*, that defendants, principals of a brokerage firm,[172] disseminated materially false and misleading research reports recommending certain securities without disclosing (1) their financial interest in those securities, (2) the fact that they had bribed portfolio managers of mutual funds to purchase the recommended securities to create trading volume, (3) their expectation that the reports and the artificial volume would cause a rise in price of the recommended securities, and (4) their intent to trade and profit on the market effect of their bribery and fraudulent recommendations.[173]

Two of the defendants moved to dismiss the conspiracy and RICO counts on the grounds that they had not committed the underlying offense and predicate act of securities fraud because, as in *Chiarella* and *Dirks*, defendants had no duty to disclose the alleged omissions.[174] The government argued that *Chiarella* and *Dirks* applied only to insider trading cases -- where a defendant trades on the basis of inside information, but remains silent to the

[171] *See* United States v. Eisenberg, 773 F. Supp. 662, 662 (D.N.J. 1991). For a similar decision in a companion case against the analyst, see U.S. v. Cannistraro, 800 F. Supp. 30 (D.N.J. 1992). In *Eisenberg*, the government charged the defendants with RICO violations, conspiracy to commit racketeering, and conspiracy to commit securities fraud. 773 F. Supp. at 672. The indictment alleged that the securities fraud served as predicate acts to the RICO violations. While Congress later amended the federal RICO statute to expressly preclude securities fraud as a predicate act (*see* Pub. L. No. 104-67, §§ 107, 109 Stat. 737, 758 (1995), amending 18 U.S.C. § 1964(c) (1994)), this amendment should not affect the analysis in this section. The indictment also charged one of the defendants with obstruction of justice, but those charges are not relevant to this discussion. 773 F. Supp. at 672.

[172] Defendant Eisenberg was an owner and president of the firm, defendant Cannistraro was a securities research analyst at the firm, and defendant Bertoli had a controlling and beneficial interest in several accounts at the firm. *Id.* at 673.

[173] *Id.* at 674-76. The indictment alleged that defendants purchased the recommended securities just before issuing materially false and misleading research reports, solely with the intent to sell those securities immediately following the dissemination of the reports. *Id.*

[174] *Id.* at 717-18.

investing public with respect to the inside information, and not to cases involving securities fraud based on scalping and bribery.[175]

Agreeing with the government, Judge Lechner denied defendants' motion. The court stated that "[s]ection 10(b) makes illegal any 'manipulative or deceptive device,' which term has come to be defined as 'intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.'"[176] In light of this principle, Judge Lechner followed *Blavin's* holding that scalping allegations need not be analyzed in terms of a duty to disclose, as is the case for insider trading allegations, but in terms of a public statement rendered misleading by the omission of the material information.[177] Thus, the court held that, notwithstanding the presence or absence of defendants' duty to disclose, the government stated a viable securities fraud claim by alleging that defendants intentionally disseminated research reports because their nondisclosures rendered the reports false and misleading.[178]

E. Reliance

A securities fraud plaintiff must also prove that defendant's *mis*representation or omission caused him to purchase the recommended security, also known as the element of "transaction causation." An investor can satisfy this element by demonstrating that he relied on the analyst's report containing the misstatement when deciding to purchase the recommended security. Under this theory,

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[175] *Id.* at 718.

[176] *Id.* at 721 (citations omitted).

[177] *Id.* at 721-23. The court also cited to the Supreme Court's statement in Lowe v. SEC, 472 U.S. 181, 209 n.56 (1985), holding that "public dissemination of publications timed to specific market activity, or to events affecting or having the ability to affect the securities industry, i.e., scalping," is "dangerous activity and covered by section 10(b)." 773 F. Supp. at 723.

[178] *Id.* at 723; *accord In re* Credit Suisse, First Boston Corp. Secs. Litig., Fed. Sec. L. Rep. (CCH) ¶ 90,306, 1998 U.S. Dist. LEXIS 16560, at *16-18 (S.D.N.Y. Oct. 20, 1998).

plaintiffs who reviewed the analyst's report can prove actual reliance on the misstatement or nondisclosure through evidence demonstrating that they would not have purchased the recommended securities if they had known of the conflict of interest faced by the analyst.[179] Additionally, a plaintiff may be entitled to a presumption of reliance in certain situations.[180] First, in cases of material omissions rather than affirmative misstatements, an investor is entitled to a presumption of reliance.[181]

Second, in cases of affirmative misstatements, investor plaintiffs need not prove reliance if they invoke the fraud-on-the-market doctrine.[182] Under this doctrine, plaintiffs are entitled to a rebuttable presumption of direct reliance if they relied on the integrity of an efficient market where face-to-face transactions do not occur.[183] Notably, one factor that courts look to in determining whether the security traded in an efficient market is the existence of a significant number of analyst reports covering the security.[184] Therefore, unless the analyst in question is the only one who covered the pertinent security, the mere fact that there was analyst coverage of the security should help to establish the fraud-on-the-market presumption.

Moreover, courts have held that an investor's reliance on an investment advisor who, in turn, relied on the integrity of the market does not bar the investor from invoking the reliance-on-the-market doctrine.[185] Since virtually all

[179] Of course, at any trial, the investor would have to prove he or she received and reviewed the analyst's report, or that the broker who recommended the security relied on the report.

[180] *See* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001).

[181] *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 154 (1972).

[182] *See Basic,* 485 U.S. at 247.

[183] *Id.*; *see also Credit Suisse*, 1998 U.S. Dist. LEXIS 16560, at *23-24.

[184] *See* Freeman v. Laventhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990); Cammer v. Bloom, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989).

[185] *See* Margolis v. Caterpillar, Inc., 815 F. Supp. 1150, 1156-57 (C.D. Ill. 1991); Grossman v. Waste Management, Inc., 589 F. Supp. 395, 403-06 (N.D. Ill. 1984).

securities covered by a research analyst are traded in an efficient market, a plaintiff could sue an analyst without the need to prove reliance or transaction causation.

F. Causation

The PSLRA provides that, in any private securities fraud claim under Rule 10b-5, "the plaintiff shall have the burden of proving that the [alleged fraudulent] act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages."[186] This is known as the element of "loss causation" -- proving that the reason for the investment's decline in value stems from the defendant's misstatements.[187] If the investor can show that the price of the security had risen in response to the analyst's positive report containing a material misrepresentation, then the investor should be able to satisfy the element of loss causation.[188] Moreover, analyst reports clearly contribute to the market's valuation of the security, as most times an analyst issues a "buy" or otherwise positive recommendation on a security the market price for the security rises immediately thereafter.[189] The investor could argue that, had the investing public known that the analyst had an economic incentive to tout the stock, the stock price would not have been influenced by the analyst's report to the extent that it was. The investor could

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[186] 15 U.S.C. § 78u-4(b)(4) (2000).

[187] *See* Citibank, N.A. v. K-H Corp., 968 F.2d 1489, 1495 (2d Cir. 1992) (Misstatements must be "the cause of the transaction's turning out to be a losing one."); Castillo v. Dean Witter Discover & Co, 1998 WL 342050, at 5-7 (S.D.N.Y. June 25, 1998) (dismissing complaint by customers against their brokers for failure to disclose compensation for failure to plead, *inter alia*, loss causation).

[188] *See* Rothman v. Gregor, 220 F.3d 81, 95 (2d Cir. 2000) (finding complaint adequately pled loss causation where plaintiffs alleged that the market price dropped once the market became aware of the undisclosed material information, even if the initial nondisclosure did not inflate the stock's value).

[189] *See, e.g., In re* PeopleSoft, Inc., 2000 WL 1737936, at *4 (N.D.Cal. May 25, 2000) (acknowledging that "[a]nalysts have . . . clear and immediate influence on the stock market").

prove this element through evidence showing that the price of the security dropped once the market became aware of the analyst's conflicts.[190]

G. Damages

Finally, plaintiffs relying on an analyst's recommendation must prove they suffered damages as a result of the nondisclosure of the conflict of interest.[191] If the plaintiff can prove reliance and causation, and the plaintiff lost money as a result of engaging in the recommended transaction, presumably that plaintiff could satisfy the damages requirement.[192]

V. CONCLUSION

Investors who have lost money in securities transactions undertaken in reliance on recommendations by analysts who had undisclosed conflicts of interest inherent in their recommendations should be able to sue their analysts for the resulting losses under the federal securities laws. There is no credible distinction between buy-side and sell-side analysts that justifies differing disclosure obligations. Both buy-side and sell-side analysts hold themselves out as providers of independent and disinterested research reports on issuers, and both types of analysts know that investors rely, in part, on these research reports when making their investment decisions.

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[190] *Id.*

[191] The PSLRA now limits damages in SEA lawsuits to "the difference between the purchase or sale price paid or received . . . and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market." 15 U.S.C. § 78u-4(e) (2000). This codifies the "out-of-pocket" measure as the applicable measure of damages in Rule 10b-5 actions.

[192] *Cf.* Capital District Physician's Health Plan v. O'Higgins, 951 F. Supp. 352, 356-57 (N.D.N.Y. 1997) (granting award to investor under Rule 10b-5 for damages flowing from undisclosed conflict of interest by investment adviser).

As the Supreme Court noted long ago in *Capital Gains Research*, "affiliations by investment advisers with investment bankers or corporations might be 'an impediment to a disinterested, objective, or critical attitude toward an investment by clients.'"[193] Nearly forty years later, sell-side analyst research reports serve essentially the same function as buy-side analyst reports and similarly should be free of conflicts to live up to their firms' representation that the reports are disinterested. Any violation of that representation should give rise to civil liability under section 10(b) of the SEA, regardless of whether the analyst trades on the market effect of the report because the violation stems not from post-recommendation trading, but from the lack of complete disclosure of the conflict of interest. Such liability is consistent with the primary legislative intent of the SEA to protect the investor.

Moreover, newly enacted NASD Rule 2711 and amended NYSE Rule 472, which impose heightened disclosure obligations on analysts, strengthen an investor's securities fraud claim in several material respects by providing a clear industry standard by which violations are measured. First, the rules firmly establish the materiality of the conflict of interest. Second, the rules impose a duty to disclose on all analysts. Third, the rules ease the burden for a plaintiff to prove scienter because analysts would be hard-pressed to argue that they did not know or appreciate the importance of complete disclosure of any economic self-interest in their research. Thus, courts or arbitrators would see the failure to disclose any conflicts of interest as, at a minimum, reckless, if not intentionally deceptive.

This deceptive aspect to the research report is what pushes the nondisclosure from the merely unfair into the realm of securities fraud. The Supreme Court plainly holds that section 10(b) of the SEA "provides a cause of action for

[193] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187-88 (1963) (quoting Report of the Securities and Exchange Commission, Pursuant to Section 30 of the Public Utility Holding Company Act of 1935, on Investment Counsel, Investment Management, Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 2d Sess. 1).

any plaintiff who 'suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities.'"[194] And the Court itself classified as "deceptive" the failure to disclose conflicts of interest in *Capital Gains Research*.[195] While the securities industry has come a long way in eliminating deceptive conduct, and the Supreme Court and Congress have limited the scope of the antifraud provisions of the SEA, investors are still entitled to honest research reports free from undisclosed and unfair conflicts of interest.

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[194] Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) (quoting Superintendent of Insurance v. Bankers Life & Cas. Co, 404 U.S. 6, 12-13 (1971)).

[195] *Id.* at 475 n.15.