

21ST CENTURY INVESTMENT FRAUD: CHEERLEADER STOCK ANALYST LIABILITY

by: Harry S. Miller



The burst of the tech stock bubble, the crash of the Nasdaq market in 2000 and 2001, and the harsh bear market of the past three years has resulted in losses of billions of dollars for investors who trusted their brokers and brokerage firms to protect their accounts. Angry investors nationwide who lost substantial amounts of their life savings feel their trust was betrayed - and they are demanding to know who is responsible. From a legal perspective, the answer may well be the brokerage firms and stock analysts who acted as cheerleaders for their stocks.

By the late 1900s, stock analysts of the major brokerage firms had become media superstars. Analysts such as Henry Blodget of Merrill Lynch, Jack Grubman of Salomon Smith Barney, Mary Meeker of Morgan Stanley and Frank Quattrone of Credit Suisse First Boston were the gurus of the technology market boom. The media attention given to these expert prognosticators reinforced the trust of investors with little understanding of the technological and economic forces at work.

Brokerage firms created these media celebrities by feeding on the market frenzy and on prospects of unimaginable wealth for "savvy" investors; the analysts held the keys to unlocking that wealth for ordinary investors. The wisdom of these powerful seers could answer every wish and turn dreams into realities, and investors hung on their every word.

Stock analysts' objective research reports frequently touted the stock of companies they covered. Strong buy recommendations and increasingly high price targets set by analysts were accompanied by rosy forecasts. The analysts had become cheerleaders. The boundless excitement for Nasdaq tech stocks was in no small measure responsible for causing what is now described as "irrational exuberance."

The valuation criteria and access to information of the top brokerage firms gave the statements of these experts an aura of untarnished, independent truth. These analysts were operating in an environment tainted by huge investment banking fees. The traditional "Chinese wall" between the research and investment banking divisions of brokerage firms had crumbled.

Major brokerage firms were providing investment banking services for high-tech companies that were being touted by their analysts. The analysts' activity was critical for firms to secure the lucrative investment banking business. Underwriting fees of hundreds of millions of dollars were generated for the Wall Street firms, and the analysts as cheerleaders of Wall Street, were rewarded accordingly.

Contrary to the public perception promoted by brokerage firms, these analysts were not unbiased experts providing independent research based on an objective, analytical process. Rather, they were actively encouraging investors to purchase and hold those stocks for which their firms were investment bankers, and the analyst's compensation was tied to the banking business.

Holding analysts accountable

Although this is a developing area of the law, it seems clear that analysts will be held to certain legal standards, and brokerage firms will be liable for the actions of their analysts who fail to meet those standards. Federal and state regulators have entered a historic \$1.4 billion settlement with Wall Street firms based on the investigations of biased analyst reports.

The Massachusetts Securities Division filed a complaint against Credit Suisse alleging fraudulent and deceptive conduct in the issuance of biased and misleading research analyst reports. The regulatory investigation determined that Credit Suisse issued analyst reports favorable to companies that were also investment banking clients, when its analysts actually had negative views of the companies.

Massachusetts Secretary of State William Galvin stated, "It appears at least in some cases that (analysts) treated investors like suckers, and apparently the motive was simply more profit for the company (Credit Suisse), with a reckless disregard for the rights of investors."

The National Association of Securities Dealers has also filed a complaint against Credit Suisse's former tech star, Frank Quattrone, for allegedly promising investment banking clients favorable research analyst coverage.

New York Attorney General Eliot Spitzer brought an action against Merrill Lynch and its superstar Internet analyst, Henry Blodget. Merrill agreed to pay a fine of \$100 million and made a commitment to maintain "objectivity" ill stock picks.

In a separate action involving Salomon, Spitzer found that "Grubman issued misleading ratings of stocks in favor of investment banking clients." Grubman is now banned from the securities industry, and Salomon agreed to pay \$400 million as part of its settlement with regulators.

Legal standards for analyst liability

Securities laws hold brokerage firms liable for damages caused by misrepresentations of their agents. Securities rules also require a reasonable basis for recommendations. Investors may have a right of recovery for securities fraud based on the failure to disclose a conflict of interest, such as the firm and analyst's financial interest in the stock being recommended and investment banking fees tied to it.

The SEC has adopted new rules in response to the much publicized securities and corporate accounting scandals. The rules address the analysts' conflict of interest. Full disclosure is now required, along with a separation between research and investment banking and a strict prohibition against analyst compensation based on investment banking business.

For countless investors, these reforms come too late. Their only recourse may be securities arbitration against the brokerage firms responsible for the analysts.

Brokerage firms are vigorously defending these cases. But for investors who have been victims of the fraud and conflicts of interest of analysts, filing claims in arbitration against the firms that employed the analysts may be the best hope for obtaining some restitution of their losses.

This article was previously published in the Boston Business Journal.