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Volume 3
Third Quarter
2001

INSTITUTIONAL INVESTOR

Advocate

A SECURITIES FRAUD AND CORPORATE GOVERNANCE QUARTERLY

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SELECTING LEAD COUNSEL IN THE MIDST OF JUDICIAL CHAOS

By Keith L. Johnson

What Happens After You Say "I Do"

Many large investors have begun to develop procedures for determining when they should seek to be appointed lead plaintiff in securities class actions. However, once a decision to file for lead plaintiff is made, attention must be turned to selecting lead counsel and deciding how lead counsel should be compensated. Some courts have even intertwined the lead plaintiff and lead counsel decisions by rejecting lead plaintiff candidates that failed to use a lead counsel selection process acceptable to the court.

This article describes some of the conflicting conclusions that have been reached by the federal courts on approving lead counsel and offers observations about lead counsel selection from the perspective of one institutional investor's chief legal counsel.

The Importance of Being Earnest

Over the last five years, the State of Wisconsin Investment Board (SWIB) has received almost $30 million from class action claims in 100 lawsuits *in addition* to the cases where SWIB served as lead plaintiff. This is the natural result of being a large investor (the tenth largest public pension fund in the country) with a broadly diversified stock portfolio. Most other institutional investors also have signifi-

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Keith Johnson is Chief Legal Counsel at the State of Wisconsin Investment Board, the tenth largest public pension fund in the United States. SWIB has been appointed to serve as lead plaintiff in the CellStar, Physicians Computer Network, Just for Feet, and Anicom federal securities class actions. The comments in this article are solely those of the author and should not be attributed to SWIB.

The tragedy of September 11 has tested the faith and mettle of New Yorkers, as well as the rest of the country. We extend our deepest sympathy to those who have suffered loss and our gratitude to those who demonstrated such remarkable courage.

Now the difficult task of healing and rebuilding begins.

Bernstein Litowitz Berger & Grossmann LLP

SELECTING LEAD COUNSEL

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cant financial interests in securities class action litigation where they are passive claimants.

In the aggregate, the amounts involved in class action lawsuit recoveries and legal fees are staggering. National Economic Research Associates (NERA) estimates that class action recoveries between 1991 and mid-1999 totaled almost $11 billion. The subsequent Cendant settlement alone recouped $3.2 billion for investors. NERA data also shows that plaintiffs' attorney fees paid by class members have averaged about 31 percent, despite indications from the experience of SWIB and other lead plaintiffs in using competitive lead counsel fee negotiations that class legal fees could be cut by one-half to one-third from current averages. In fact, if SWIB's competitive fee setting practices had been replicated by all lead plaintiffs, SWIB might have *saved as much as $6 million in legal fees* on its 100 passive claim recoveries over the last five years. Such savings alone would have more than offset SWIB's total direct legal fee expenditures during the same period on all other matters.

Hundreds of millions of dollars of these essentially invisible legal fees are awarded on behalf of investors in class actions each year. This was not lost on Congress when it enacted the Private Securities Litigation Reform Act of 1995 (Reform Act). In addition to the creation of provisions authorizing lead plaintiffs to choose lead counsel (subject to approval of the court), the Reform Act also limited fee awards to a "reasonable percentage" of the recovery. Interpretation of this limit has resulted in a plethora of recent court decisions on appointment of lead counsel. Lead plaintiffs should be familiar with the potential challenges presented by these decisions.

Inside Look

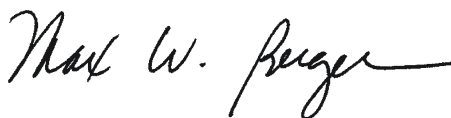
I am tremendously pleased that Keith L. Johnson, Chief Legal Counsel for the State of Wisconsin Investment Board (SWIB), contributed the lead article for this issue of the *Advocate*. Mr. Johnson, as counsel for the tenth largest pension fund in the country, is uniquely qualified to address the *Advocate's* readership. A highly-respected commentator on the important role that institutional investors play in corporate governance issues and in private securities litigation, he recently testified before the Third Circuit's Task Force on selection of counsel in class actions. He is a co-author of *The Elephant in Securities Class Actions: Lessons Learned About Legal Fees (The Corporate Governance Advisor,* March/April 2001) and it is an honor to provide Mr. Johnson's views in this issue of the *Advocate*.

Mr. Johnson's article, *Selecting Lead Counsel in the Midst of Judicial Chaos*, recounts the experiences of SWIB in the area of selecting counsel and lists various factors for institutional investors to consider when retaining a law firm. The article provides excellent insight, and I highly recommend it.

Also in this issue, Wolfram Worms, an associate in the firm's California office, reports on the growing skepticism surrounding the independence of research analysts, who are supposed to offer impartial investment recommendations on publicly-traded companies in *Does "Buy" Mean "Sold Out"?*

In *Eye On The Issues*, Steve Mellen provides his cogent synopsis of significant events that have made the news since the previous issue of the *Advocate*.

On a personal note, we here at the firm pray for all Americans as we go through this incredibly difficult time.



Playing When the Rules Keep Changing

Unfortunately, federal judges have been unable to agree on what legal principles should apply to court oversight of lead counsel selection. For example, courts have reached the following diverse conclusions:

- Where no institutional investor sought to serve as lead plaintiff, a Northern District of California court found that all lead plaintiff candidates in the *Quintus Securities Litigation* were incapable of adequately negotiating a fee agreement with lead counsel and ordered a competitive bidding process through which the court itself would select lead counsel;
- The *Comdisco Securities Litigation* court in the Northern District of Illinois decided an institutional investor lead plaintiff cannot insist on appointment of its selected law firm as lead counsel and *must accept* the lowest responsible bidder;
- In the *Cendant Securities Litigation* in the District of New Jersey, the district court ordered an auction for lead counsel but allowed the lead plaintiffs' selected

firms to match what the court thought was the most favorable bid—this decision, however, was subsequently reversed by the Third Circuit Court of Appeals, as discussed further on page 4;

- The *Network Associates II* court in the Northern District of California tied the lead plaintiff and lead counsel decisions together, reasoning that a lead plaintiff candidate's ability to negotiate a reasonable fee agreement with lead counsel should be taken into consideration when determining whether that candidate could adequately represent the class and be appointed as lead plaintiff;
- In the District of South Dakota, the *IBP Securities Litigation* court refused to order an auction for appointment of lead counsel and deferred to the lead plaintiff's pick but required submission of an affidavit from the lead plaintiff, explaining how its lawyers were selected and what fee arrangements had been made;
- In the *Razorfish Securities Litigation* in the Southern District of New York, the court rejected an auction system for choosing lead counsel, emphatically concluding that the Reform Act does not allow it to arrange a "shot-gun marriage" between the lead plaintiff and strangers that submit the lowest bid. Instead, after finding the fee proposal of lead plaintiff's selected firm excessive, the court allowed the firm to submit a more competitive proposal that was subsequently found to be reasonable.

Confused? So is the federal judiciary. Earlier this year, the Federal Court of Appeals for the Third Circuit appointed a Task Force on Selection of Class Counsel and charged it with developing recommendations for selection and compensation of lead counsel. The Task Force held three public hearings in Philadelphia this spring and is expected to issue a report at the end of the year. I presented the following observations on selection of lead counsel in testimony to the Task Force.

Problems Faced by Courts in Selection of Lead Counsel

From my involvement as the lead plaintiffs' supervising attorney in four separate class actions, I view selection of lead counsel as one of the most important decisions made in a case. In addition, I believe that most institutional investor lead plaintiffs are in a better position to make that decision than the court. This is a view that was shared by Congress when it passed the Reform Act. The Congressional Conference Committee Report on the Reform Act stated that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions."

Retention of the plaintiffs' attorney in a class action requires careful consideration of a number of things, such as fees, reputation, responsiveness to the client, expertise on issues involved in the matter, knowledge of the judge and other counsel in the litigation, trial experience, command of the facts, analysis of the case, litigation plan, ability to cover expenses, understanding of corporate governance principles, and potentially a host of other factors. Judges are not in a position where they can balance these different considerations without sacrificing their objectivity and taking on an advocacy role for the plaintiffs. Moreover, judges do not have the same inherent interests on many of these issues as the plaintiffs. For example, a judge with a crowded calendar might prefer lead counsel with a reputation for settling cases rather than a firm known for its ability to win at trial. More importantly, a judge is not going to know whether lead plaintiff and counsel will be able to get along and work well together.

Some courts have tried to deal with this disconnect by focusing primarily on the

From my involvement as the lead plaintiff's supervising attorney in four separate class actions, I view selection of lead counsel as one of the most important decisions in the case.

level of fees that would be sought by lead counsel candidates. Introduction of competitive forces on class action fees is important. Indeed, it can substantially increase payments ultimately received by class members. But fees are only part of the picture. The plaintiffs' primary interest is in obtaining the best "net" recovery. Class members would be better served by a law firm that did not submit the lowest bid, if that firm can obtain a higher recovery net of the fee.

In addition, it is not always clear which fee proposal will be the most favorable. This was aptly illustrated by the Cendant case, where the district court approved its own fee arrangement that resulted in a fee that was at least $76 million larger than would have been awarded under the schedule that had been negotiated by lead plaintiffs, though the size of the Cendant recovery also exceeded lead plaintiffs' initial expectations by over $2 billion.

However, the biggest problem created by court selection of lead counsel is that it undermines the ability of the lead plaintiff to supervise lead counsel. When lead counsel is selected by the judge and knows that fees will be set by the judge, there can be less incentive for them to be responsive to the client. Given the potentially divergent economic interests and risk tolerance levels of class members and lead counsel (maximizing payments to the class versus

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obtaining the largest fee), this lack of accountability to the lead plaintiff can seriously affect how a case is handled and the ultimate result.

Courts could avoid these issues and implement intent of the Reform Act by extending some level of deference to lead counsel selection decisions made by lead plaintiffs, much like the courts defer to boards of directors under what is called the "Business Judgment Rule." While the courts have a role to play under the Reform Act in evaluating and approving the lead counsel selection, it is not to become a surrogate lead plaintiff.

In the Cendant appeal, decided just last month, the Third Circuit Court of Appeals agreed. After finding that the district court correctly appointed three institutional investors to serve jointly as lead plaintiff, the Third Circuit reversed the lower court's decision to auction the lead counsel position to the lowest bidder, explaining that the Reform Act gives lead plaintiff the power to select and retain lead counsel.

The Third Circuit is the first appellate court to consider judicial intervention in lead plaintiffs' selection of counsel under the Reform Act. According to the Third Circuit, courts have a limited role in the counsel selection process and should defer to lead plaintiff's selection, even when lead plaintiff selects counsel or negotiates a retainer agreement that is different than what the court would have done. Judicial intervention, therefore, should be limited to instances when lead plaintiff's selection of counsel poses a threat to the interests of the class or evidences a disregard for lead plaintiff's duties. Where lead counsel is selected without conflict of interest and in good faith, with reasonable efforts made to select competent counsel under a competitive compensation arrangement, the courts should uphold that selection.

Indeed, the Third Circuit observed that Congress intended to encourage institutional investors to serve as lead plaintiff, believing that they would do a better job at counsel selection, retention and monitoring than judges have traditionally done. This goal of encouraging participation by institutional investors would be undermined, according to the Third Circuit, if courts can easily take away decisions concerning lead counsel selection from institutional investors.

Remember that the goal is to obtain the best "net" outcome for the class and balance qualitative facts (e.g., experience, reputation, case analysis) with quantitative fee considerations.

Guidelines for Lead Counsel Selection Procedures

In light of the above, lead plaintiffs would be well-served to focus on principles like the following, if they want to minimize chances of judicial intervention in lead counsel selection and compensation:

- Include a process for selecting lead counsel in your lead plaintiff procedures;
- Establish a record to justify the basis for your lead counsel recommendation to the court, including compensation arrangements;
- Provide some mechanism for evaluating competitive market fees in each case, whether by soliciting proposals from law firms or comparing the lawsuit to similar cases where competitive fee levels were established;
- Remember that the goal is to obtain the best "net" outcome for the class and balance qualitative factors (e.g., experience, reputation, case analysis) with quantitative fee considerations;
- Insulate lead counsel selection decisions from political manipulation by including independent participants in the process where such concerns are present; and
- Consider the different methods for setting fees (e.g., negotiated at the beginning or end of the case, set on an increasing or decreasing schedule as the amount of recovery rises, set at a single percentage regardless of recovery amount) and be ready to explain why you think your method is appropriate.

SWIB generally uses a process that involves solicitation of competitive proposals from several law firms and review by a panel with representatives of portfolio management staff, the Chief Legal Counsel, outside case review counsel, and the Attorney General. While we have not placed limits on the types of fee proposals SWIB will consider, we have generally concluded that a pre-negotiated fee schedule that goes up as the amount of recovery increases best aligns the interests of counsel with members of the class. If you would like to view SWIB's procedures, they are posted at: http://www.swib.state.wi.us/class.asp.

While even the best process cannot guarantee that a lead plaintiff's choice for lead counsel will be approved in the current judicial environment, use of a principled process should both increase the chances of approval and ultimately enhance the litigation recovery for the entire class.

DOES "BUY" REALLY MEAN "SOLD OUT"?

By Wolfram T. Worms

Wall Street brokerage firms recently have come under heavy criticism due to apparent conflicts-of-interest that may affect the independence of the firms' securities analysts, who are supposed to research publicly-traded companies and make impartial investment recommendations. Generally speaking, the criticism is probably warranted as the investment industry has appeared more intent lately on promoting particular stocks, rather than impartially reporting on them. Analysts routinely issue "buy" and "strong buy" recommendations and rarely recommend that investors sell, even while the NASDAQ collapses. According to one recent study, less than 1% of research analysts issued "sell" or "strong sell" recommendations in 2000. You may have heard that Congress convened recently to address the issue, the Securities and Exchange Commission has issued a report on the subject, and even the popular press — like *Newsweek* and *Vanity Fair* — has published articles detailing the "dark-side" of business involving Wall Street analysts.

Empirical and anecdotal evidence certainly suggests that brokerage firms use the promise of positive recommendations by their analysts to get underwriting business from the companies that the analysts cover. Underwriting securities offerings makes far more money for brokerage firms than traditional brokerage services. In the past, brokerage firms generated most their money by selling and distributing their analysts' research reports and by collecting brokerage fees. With the increased use of the internet, however, investment information is far more available to the public, and traditional brokerage firms have lost clients to low-cost internet trading firms. Underwriting public offerings, meanwhile, remains as lucrative as ever, leading to an unhealthy relationship between the analysis side and the investment-banking side of the brokerage firm.

Take, for instance, the role of analyst reports during a company's initial public offering ("IPO"). Immediately after a company sells its stock to the public for the first time, the company and its underwriters enter a mandated "quiet period," during which time, it is not uncommon for the stock price to fall steadily. When the quiet period ends, a research analyst from the underwriting firm will "initiate coverage" and issue an extremely favorable report on the company to support the stock price. Wall Street refers to such reports as "booster shots."

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By many accounts, this sort of promotion continues after the IPO and helps the brokerage firm get additional investment banking business. Indeed, it appears that positive recommendations become increasingly important to companies as their industry falls out of favor with investors. "This is what you see well into a bear market for a sector," says Thomas K. Brown, who says he was fired by a major investment banking firm in 1998 for making negative calls on banks. "Often there will be something you want to downgrade, and your firm will say it is not a good time," says another financial stock analyst for one East Coast investment bank.

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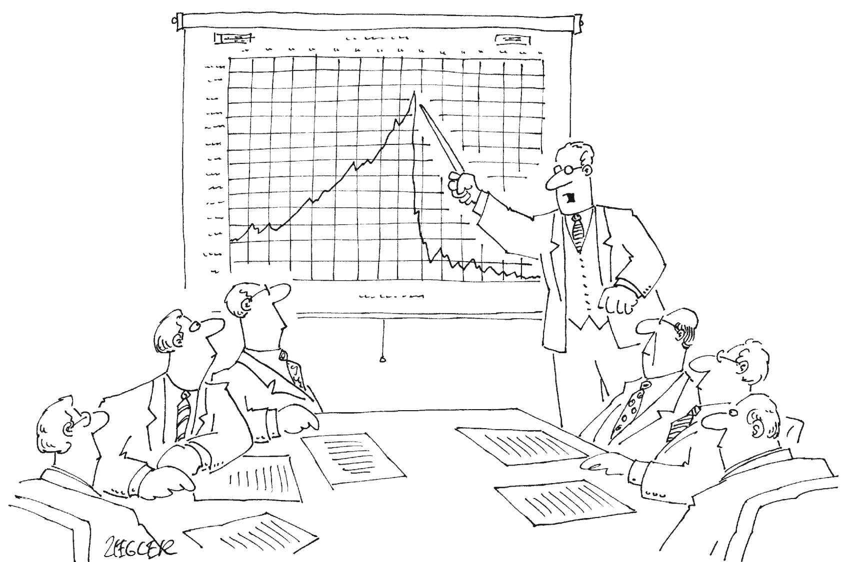

"It was at this point, gentlemen, that reality intruded."

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Eye On The Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Steven E. Mellen

A new era begins at the SEC. Following a smooth and uneventful confirmation process, Harvey Pitt was sworn in as the new Chairman of the Securities and Exchange Commission in August, accompanied by accolades from both sides of the aisle in Washington. Although Pitt will undoubtedly have different priorities than his popular predecessor, Arthur Levitt, early indications are that he will continue to focus on issues important to investors. Pitt has already labeled as "troublesome" a problem highlighted in this issue of the *Advocate* — analysts' conflicts of interest. While noting that the securities industry has taken some "important and constructive" first steps to address this issue, Pitt observed that "there needs to be careful analysis of the conflicts of interest in this area." Pitt's focus on this important problem is a positive sign for advocates of investor protection. *Dow Jones Newswires, August 16, 2001.*

Pitt's challenge: How to do a lot with a little. The SEC is anything but a circus, but that doesn't mean Pitt won't have to perform a juggling act. The SEC is currently struggling to find ways to deal with an unprecedented 260 accounting fraud investigations, far more than in recent years. Making the job that much more complex is the fact that a growing percentage of these inquiries—15% at last count—involve Fortune 500 companies. SEC Enforcement Director Richard Walker, who recently announced his resignation from the agency, told the *Wall Street Journal*: "If we had nothing else to do, the accounting investigations alone could keep us busy for the next five or ten years. The size and magnitude are crushing." Why all these investigations? One basic reason is a dramatic increase in restated financials: 233 companies announced restatements in 2000, compared to only half that number in 1997. With no sign of a reversal in these trends, it could be that the SEC's problems will get worse before they get better. *CNNfn, July 6, 2001.*

Auditors pay landmark civil penalty. Attendees at the most recent BLB&G Institutional Investor Forum may recall an informative discussion of the settlement of the SEC's civil enforcement proceeding against Arthur Andersen LLP arising out of Andersen's audits of Waste Management Inc. Andersen had issued "clean" audit opinions on Waste Management's financial statements for the years 1992 through 1996, notwithstanding that those statements overstated Waste Management's income by a staggering $1 billion. Andersen consented to the entry of a permanent antifraud injunction—the first such injunction in over 20 years—and its $7 million fine was the largest-ever civil penalty in an SEC enforcement action against a Big Five accounting firm. The comments of outgoing Enforcement Director Walker should prove both reassuring to investors and ominous to auditors who fail to exercise the requisite degree of professional care in issuing audit opinions: "Accountants play a critical role in providing access to our capital markets. We will not shy away from pursuing accountants and accounting firms when they fail to live up to their responsibilities to ensure the integrity of the financial reporting process." *SEC News Release 2001-62, June 19, 2001.*

Get paid just for tuning in. In light of the billions of dollars shareholders have recovered in recent years through securities class actions, often as the result of public pension funds taking a leadership role in the litigation, no one can question that institutional investor participation makes a huge difference in terms of the ultimate recovery in these cases. However, while many such investors have become actively involved in prosecuting shareholder litigation, efforts are still in progress to educate many institutional investors about the simplest way to participate in securities class actions: filing a claim form. One-third of the respondents to an informal survey by the National Association of State Auditors, Comptrollers and Treasurers reported that they had not recovered any asset losses in a class action suit in the prior five years. These results are shocking, according to Alan Cleveland, legal counsel to the New Hampshire Retirement System, who observes that it is "highly unlikely that ANY significant public fund invested in the market could possibly have been ineligible to participate in class action recoveries," considering the hundreds of settlements reached during that period. As institutional investors become more aware of their rights, their participation can be expected to increase, and hopefully the day will come when no investor will have to say, as one significant-sized fund told Mr. Cleveland, "Whoops, we're supposed to file claims?" *Dow Jones Newswires, August 31, 2001.*

Auditor conflicts-of-interest back in the news. More information has emerged concerning a key topic which the *Eye* has focused on in recent issues—conflicts of interest that impair the public's ability to rely upon statements by auditors. According to a recent SEC study, over 70% of the fees paid by

Fortune 1000 companies to auditing firms were for non-audit related services. One company featured in this study actually paid non-audit fees to its auditors in excess of 32 times the amount it paid for audit services. As former SEC Chairman Arthur Levitt observed in implementing the push for stronger auditor independence rules last year, there is a very real concern that an auditor will pull its punches or refrain from asking tough questions for fear of losing a client's non-audit business. Although a lack of auditor independence was not directly alleged in the Waste Management action discussed above, the facts are undeniable that Waste Managment paid Arthur Andersen nearly $18 million for non-audit services during the years in question, as compared to $7.5 million in audit fees. Might Arthur Andersen have looked more closely at Waste Management's financials were it not for the prospect of losing that $18 million in business? We may never know the answer in this particular case, but it is difficult to dispute that eliminating such apparent conflicts across the board would result in more accurate and reliable audit opinions. *Bloomberg, June 28, 2001.*

Hard times increase the pressure to commit fraud. The need for vigilance rather than complicity by public auditors is particularly heightened by current market conditions, which all too often induce companies to engage in earnings manipulation in order to meet projections made in rosier times. U.S. Representative John LaFalce (D-NY), the senior Democrat on the House Financial Services Committee, recently called for an investigation "into the increasing incidences of financial fraud in the markets." Rep. LaFalce noted: "At the same time that average Americans are increasingly investing . . . the pressures on firms to manipulate their financial results have grown tremendously." As noted above, these trends have already resulted in an alarming number of financial restatements, and the worst may be yet to come. As SEC Chief Accountant Lynn Turner described the agency's increased investigative load: "Is this an ice cube or an iceberg? There's definitely something there below the water line." *Associated Press, July 6, 2001.*

Investors are disadvantaged by bundled governance changes. A growing practice which troubles many institutional investors is the "bundling" of corporate governance proposals together with corporate restructuring proposals. Bundling is inappropriate because it forces stockholders who wish to vote to approve a spinoff or other restructuring transaction to also approve tangentially related corporate governance changes. Such changes should be the subject of a separate vote under SEC regulations requiring that a proxy "provide for a separate vote on each matter presented." One recent well-publicized example is AT&T's spinoff of its wireless and broadband operations. According to AT&T's preliminary proxy materials, a vote for the spinoff is also a vote for certain fundamental corporate governance changes, including reincorporating from New York to Delaware and eliminating the rights of shareholders to call special meetings and act by written consent. The Council of Institutional Investors has written to the SEC's Division of Corporate Finance regarding the AT&T transaction, urging the SEC to require the company to separate the various proposals and to apply a similar degree of scrutiny with respect to proxies of other companies. Breaking out proposals into separate votes, of course, will only serve to enhance the ability of shareholders to have their voices heard. *Council Research Service Alerts, July 26, 2001.*

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Bernstein Litowitz Berger & Grossmann LLP prosecutes class and private actions, nationwide, on behalf of institutions and individuals. Founded in 1983, the firm's practice concentrates in the litigation of securities fraud; corporate governance; antitrust; employment discrimination; and consumer fraud actions. The firm also handles, on behalf of major institutional clients and lenders, more general complex commercial litigation. The firm's client base in securities fraud and corporate governance litigation includes large public pension funds and other institutional investors.

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DOES "BUY" MEAN "SOLD OUT?"

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The growing skepticism over analysts' independence comes at a time when the discrepancy between poor stock performances and positive ratings has grown increasingly obvious. In addition to the conflict-of-interest arising from investment banking fees, regulators and investment professionals have identified additional conflicts, including: The link between a positive research report and increased buy orders (corresponding to increased brokerage fees); the practice of compensating analysts based on the profitability of the investment banking business; and analysts owning stock in the companies which they are covering.

> *"[T]he heart of the problem is that analysts are nothing more than claques for their investment banking departments."*

Given the spotlight on analyst-independence issues, changes are afoot. For example, one large brokerage firm recently barred its analysts from buying stock in the companies that they cover. This may be a good start, but some critics observe that such policies fail to address the most significant conflict, which is the role that research reports play in supporting a firm's lucrative investment banking business and in attracting potential new deals. According to Stephen D. Abrams, chief investment officer for asset allocation at Trust Company of the West, "the heart of the problem is that analysts are nothing more than claques for their investment banking departments." Referring to new prohibitions on analysts owning stock in the companies that they cover, Mr. Abrams feels that such policies, "while some sort of noble gesture, don't get to that issue."

Potential liability can deter brokerage firms from using their analysts to improperly promote stocks. In a recent and well-publicized settlement, for example, Merrill Lynch agreed to pay $400,000 to settle an arbitration proceeding brought by a former client who claimed that he was misled by a recommendation that "lacked a reasonable basis in fact." Such individual actions, while important to the people involved, are not as effective a deterrent as litigation on behalf of a class. Class action lawsuits directly against brokerage firms for their analysts' misleading statements are uncommon but not unprecedented, especially when the facts are compelling.

Although the majority of analysts undoubtedly perform their jobs properly, a growing body of evidence shows that portfolio managers and individual investors cannot assume that each analyst is fully independent and impartial. Fortunately, however, the issue now has everyone's attention, which is an important step in solving the problem.

Wolfram T. Worms, an associate at Bernstein Litowitz Berger & Grossmann LLP, can be reached at wolfw@blbglaw.com.

Quarterly Quote

For a company's officer "to cash in his own stock can in appropriate circumstances be like a ship's captain exiting into the safety of a lifeboat while assuring the passengers that all is well."

The Honorable Richard J. Cardamone in
In re Scholastic Corporation Securities Litigation
252 F.3d 63, 67 (2d Cir. 2001)

Contact Us

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