BLB&G

Bernstein Litowitz Berger & Grossmann LLP

Volume 5
Second Quarter
2003

INSTITUTIONAL INVESTOR

Advocate

A Securities Fraud and Corporate Governance Quarterly

# AS THE INK DRIES, WALL STREET FOLLIES CONTINUE

By Andrew Gschwind

*NOTE TO ADVOCATE READERS: in the next issue of the Advocate we will examine and critique the IPO settlement in greater detail. This article encapsulates the settlement and briefly explores several interesting developments after its announcement.*

Under the terms of the global investment banking settlement announced on April 28th, ten investment banks (Salomon Smith Barney, Merrill Lynch, Morgan Stanley, Goldman Sachs, Bear Stearns, J.P. Morgan, Credit Suisse First Boston, Lehman Brothers, UBS Warburg and Piper Jaffray) will pay regulators $1.4 billion and physically and economically separate their research departments from their investment banking, or underwriting, departments. (*The fines and penalties for each bank are shown in the chart on page 3.)*

The deal ends an embarrassing stretch for an industry accused of deceiving investors with tainted stock market research designed to win lucrative investment banking deals. Or does it?

No sooner had the ink dried on the global IPO settlement, than several Wall Street firms began to either minimize it, ignore it, or violate it. The early indications are that Wall Street is an incorrigible offender.

## Settlement Highlights

The $1.4 billion settlement resolves allegations concerning conflicts of interest between banks' underwriting departments and research departments, in which bankers essentially forced analysts to issue favorable research reports on companies they wanted to do business with. The settlement also resolves allegations concerning the improper allocation of IPO shares to corporate executives with whom bankers wanted to do future business ("spinning"). Under the settlement, not only must banks physically separate their research departments from their banking departments, but compensation paid to research analysts cannot, in any way, be tied to the firm's investment banking business. Research reports must also explicitly disclose any potential conflicts of interest.

Under the settlement, former star stock analysts Henry Blodgett (Internet sector) and Jack Grubman (telecom sector) will pay $4 million and $15 million, respectively, to settle allegations concerning fraudulent research reports they authored. Both are permanently banned from working in the securities field again.

Finally, under the settlement, regulators are publicly disclosing a large number of damaging documents, including e-mails, and plaintiffs' attorneys may attempt to use the documents in private lawsuits against the banks.

Perhaps the most interesting fact to emerge from the settlement is that five investment banks, including Morgan Stanley and Bear Stearns, paid their competitors to issue favorable research reports on stock or bond offerings they underwrote. These payments—euphemistically titled "special research check" or "guaranteed economics for research"—created the appearance that the company was widely followed by independent Wall Street analysts and that all or most analysts were bullish on the company. In short, the payments were bribes, and this practice appears to have been widespread.

## What Settlement?

It didn't take long for Wall Streeters to ignore the "historic" settlement they signed. Indeed, several prime offenders appear quite unrepentant.

The first sign of trouble came from Merrill Lynch's CEO Stan O'Neal. Commenting on the settlement in a *Wall Street Journal* column shortly after its announcement, he said that the settlement allowed Merrill Lynch to move forward with its business and avoid protracted litigation over minor matters. His comments drew an immediate, stern rebuke from Eliot Spitzer, who said, "So, Mr. CEO, and I read your article carefully, if I were you I would reflect. What your company did, and what we have alleged about your company, is that you committed fraud."

The attitude of Morgan Stanley's CEO, Phillip Purcell, was no better. In speaking about the settlement, he told reporters that he didn't see anything in it that should worry retail investors about Morgan Stanley. His comments prompted an unusually harsh and prompt public rebuke by new SEC Chairman William Donaldson, who wrote a letter to Mr. Purcell (immediately provided to the press), saying, "your statements reflect a disturbing and misguided perspective on Morgan Stanley's alleged misconduct. The allegations in the Commission's complaint against Morgan Stanley are extremely serious...[Y]our reported comments evidence a troubling lack of contrition and lead me to wonder about Morgan Stanley's commitment to compliance with the letter and spirit of the law."

The angry, public responses from Spitzer and Donaldson achieved their desired effect. Mr. O'Neal publicly apologized and later sent a company memo to employees, saying that he takes the settlement seriously: "I get it, and I believe all of us at Merrill Lynch get it." Mr. Purcell wrote a letter of apology to Chairman Donaldson, assuring him that Morgan Stanley took the settlement seriously.

**MONETARY TERMS OF GLOBAL SETTLEMENT**

| Firm | Penalty | Disgorgement | Independent Research | Investor Education | Total |
|---|---|---|---|---|---|
| | | | $ in millions | | |
| SSB | $ 150 | $ 150 | $ 75 | $ 25 | $ 400 |
| CSFB | 75 | 75 | 50 | 0 | 200 |
| Merrill Lynch | 100* | 0 | 75 | 25 | 200 |
| Morgan Stanley | 25 | 25 | 75 | 0 | 125 |
| Goldman Sachs | 25 | 25 | 50 | 10 | 110 |
| Bear Stearns | 25 | 25 | 25 | 5 | 80 |
| J.P. Morgan | 25 | 25 | 25 | 5 | 80 |
| Lehman Bros. | 25 | 25 | 25 | 5 | 80 |
| UBS | 25 | 25 | 25 | 5 | 80 |
| Piper Jaffray | 12.5 | 12.5 | 7.5 | 0 | 32.5 |
| **Total** | **$ 487.5** | **$ 387.5** | **$ 432.5** | **$ 80** | **$1,387.5** |

** payment made in prior settlement*

The next shoe to drop involves Bear Stearns. The settlement expressly prohibits research analysts from attending or participating in IPO roadshows in any way. Yet less than one week after the settlement was announced, Bear Stearns Managing Director and research analyst James Kissane appeared in a "net roadshow" promoting the IPO of online credit card processing company iPayment, Inc. In the video, Kissane praised iPayment and touted its stock as a smart investment. Bear Stearns apologized for the incident and barred Mr. Kissane from covering the company.

Only one day later, news leaked out that Lehman Brothers put a last minute stop to a golf boondoggle in Scotland in which three key research analysts were to be flown out to play golf with company bankers and their clients at the elite Gleneagles golf course in an effort to win business. Although Lehman's clients had been told the week before that the three analysts would be attending the trip, Lehman's compliance department nixed the trip at the last minute—perhaps due to the public outrage directed at post-settlement missteps committed by the other banks. The trip would have violated the recent settlement.

The culture of cozy back-scratching and conflicts of interest runs so deep on Wall Street that even regulatory bodies are not immune. In discussing the settlement, New York Stock Exchange Chairman Richard Grasso commented, "The quality and integrity of Wall Street research will be beyond reproach. An analyst is an analyst. A banker is a banker. The two shall never cross." Fine remarks, but perhaps Mr. Grasso should focus his attention closer to home. First, Mr. Grasso was rightly criticized for recently nominating disgraced Citigroup Chairman Sandy Weill to become a director on the NYSE. Second, more importantly, Mr. Grasso currently sits on the board of Home Depot, a company traded on the NYSE, and a co-founder of Home Depot currently sits on the NYSE's board (which determines Mr. Grasso's salary). Mr. Grasso, who regards himself as a reformer, earns $10 million per year serving as Chairman of the NYSE, and there is no good reason why he should also be sitting on the board of a company he regulates.

You see, conflicts run deep on Wall Street—one of America's oldest and most cherished clubs. Only time will tell how much change the recent settlement will bring.

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