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ANALYST CONFLICTS, EFFICIENT MARKETS AND "FAILURE TO SUPERVISE" LIABILITY

by

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On April 28, 2003, the Securities and Exchange Commission ("SEC" or "the Commission") brought and settled an enforcement action against Citigroup Global Markets, Inc. ("Citigroup") and its senior telecom analyst, Jack Grubman, for alleged conflicts of interests involving Grubman and other analysts working with Mr. Grubman at Salomon. Now, the Commission is reportedly preparing to bring so-called "failure to supervise" enforcement actions against senior executives of several broker-dealers arising out of the analyst conflicts of interest during the bull market of the late 1990s. The former chief of global stock research at Salomon Smith Barney, and Mr. Grubman's erstwhile supervisor, John B. Hoffman, has reportedly received a "Wells" notice from the Commission informing Hoffman that he will be the subject of a civil enforcement action to be brought shortly by the Commission. The SEC reportedly intends to pursue other executives on such "failure to supervise" charges, as well.

Lawmakers have been pressuring the Commission to bring such charges, supposedly to protect small investors who were harmed by the bursting of the late 1990s stock market bubble.[1] The Commission clearly has the authority to pursue charges against senior Wall Street executives on a "failure to supervise" theory, should it choose to do so. Unlike pursuing charges against Jack Grubman, Henry Blodgett or others who were reportedly directly involved in issuing knowingly misleading research, however, it is unclear that pursuing the senior management of Wall Street on a failure to supervise theory is likely to promote the policies and objectives of the Commission or protect individual investors

Section 15(b)(4) of the Securities Exchange Act of 1934 (the "Exchange Act") permits the Commission to "censure, place limitations on the activities, functions, or operations of, suspend for a period of not more than twelve months, or revoke the registration of any broker or dealer if it finds . . . that such broker or dealer . . . has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such violations, if such other person is subject to his supervision."

[1]*See, e.g.,* Randall Smith, *Next Big Target in Wall Street Probe: Bankers*, WALL ST. J., C1 (May 9, 2003).

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15 U.S.C. § 78j (b)(4)(E).[2] Numerous so-called "failure to supervise" cases have been brought under Section 15(b) in a variety of contexts. *See, e.g., In the Matter of Robertson Stephens, Inc.*, Admin. Pro. File No. 3-11003, 2003 LEXIS 42 (Jan. 9, 2003) (analyst conflicts of interest).

Failure to supervise cases have also been brought against senior Wall Street executives. Indeed, the most prominent "failure to supervise" case is an enforcement action brought against John Gutfreund, John Merriweather and Thomas Strauss in connection with the Salomon Brothers bidding-rigging scandal in the market for newly-issued Treasury bonds. *See In the Matter of John H. Gutfreund, Thomas W. Strauss, and John W. Merriweather*, Admin. Pro. File No. 3-7930, 51 SEC Dkt. 93 (1992).[3] In *Gutfreund*, the Commission brought charges as a result of three different improper and false bids submitted by Salomon Brothers trader Paul Mozer as part of an effort by Mozer to circumvent aggregate bid restrictions in the auction market for "on-the-run" Treasury bonds. *Id*. at 2-3, 6-7. In *Gutfreund*, the Commission found, among other things, that the senior Salomon executives possessed information which suggested,

> that a high level employee of the firm with significant trading discretion had engaged in extremely serious misconduct. . . . [T]his information required, at a minimum, that the supervisors undertake to investigate what had occurred and whether there had been other instances of unreported misconduct. . . . If they were unable to conduct the inquiry themselves or believed it was more appropriate that the inquiry be conducted by others, they were required to take prompt action to insure that others in fact undertook those efforts. . . . The supervisors were also required, pending the outcome of such an investigation, to increase supervision of Mozer and place appropriate limitations on his activities.

Id. at *12. The SEC decision in *Gutfreund* provides several additional guidelines to financial executives attempting to comply with their supervisory responsibilities under Section 15(b). In particular, *Gutfreund* makes clear that:

- Determining whether a particular person is a "supervisor" within the scope of Section 15(b) "depends on whether, under the facts and circumstances of a particular case, that person has the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."[4]

- It is imperative, especially in large organizations, that those in supervisory positions exercise particular vigilance when indications of irregularity reach their attention.

- It is important for those in supervisory positions to take prompt action, in the face of credible claims of wrongdoing by an individual employee, to place limitations on the employee's powers and responsibilities with a view toward preventing future acts of misconduct.

- Even where the knowledge of those in authority is limited to "red flags" or "suggestions" of improprieties, "they cannot discharge their supervisory obligations simply by relying on the unverified representations of

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[2]Section 15(b)(4)(E) provides an affirmative defense, according to which a supervisor will not be penalized if there has been established "procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect . . . violations by such other person, and . . . [the supervisor] has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with."

[3]The Report released by the Commission settling the claims against Meriweather, Gutfreund and Strauss included a Report of Investigation Pursuant to Section 21(a) of the Exchange Act setting forth the "supervisory responsibilities of brokerage firm employees in certain circumstances." *Id*. at 1.

[4]The Commission has recently made clear that this means, among other things, that in order to found to have occupied a supervisory position within the meaning of Section 15(b), a person need not have the ability to control the actions of the underlying wrongdoer through, for example, "the independent ability to hire, fire, reward, and punish" the wrongdoer." *In the Matter of George J. Kolar*, Admin. Pro. File No. 3-9580, Exchange Act Release No. 46127 (June 26, 2002) (quoting *Gutfreund*).

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employees.[5] Instead, as the Commission has repeatedly emphasized, '[t]here must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity. . .'"

- Once those in supervisory positions become aware of wrongdoing, "it is imperative that they take prompt and unequivocal actions to define the responsibilities of those who are responding to the wrongdoing."

- An executive's supervisory responsibilities under Section 15(b) do not end "with communication of the matter to more senior executives." Rather, the supervisor reporting possible misconduct remains responsible for preventing and detecting future acts of misconduct.

Id. at *12-13. In addition, the Commission's Section 21(a) report provided guidance concerning the responsibilities of those in legal or compliance positions at a broker-dealer. *Gutfruend* advises that, although legal and compliance personnel do not become "supervisors" within the scope of Section 15(b) merely by virtue of their legal/compliance positions, "once a person [in a senior legal or compliance] position becomes involved in formulating management's response to the problem, he or she is obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct." *Id.* at *15-16.

What is striking about the actions brought against Citigroup and Mr. Grubman is that nearly all of the allegations of misconduct concern Mr. Grubman's allegedly improper failure to downgrade battered technology stocks in 2000 and 2001. The SEC's earnest focus in the Citigroup case on analyst upgrades and downgrades, and the basis on which those upgrades and downgrades were made, is peculiar. On the one hand, vigorous efforts by the SEC to root out dishonesty in the markets are unassailable. There are serious allegations in the SEC's complaint that Citigroup employees — some very senior employees — who were entrusted with providing clients disinterested investment advice, engaged in sundry improper and dishonest practices. Mr. Grubman, for example, is alleged to have upgraded AT&T as part of a concerted effort at Citigroup to win an underwriting role for Salomon in a planned AT&T debt offering. Mr. Grubman is further alleged to have been pressured to do so by Citigroup's Chairman, Sandy Weill. Pursuing such wrongdoing is entirely appropriate.

Nevertheless, pursuing enforcement actions against senior Wall Street executives under Section 15(b)(4) — on what is little more than a theory of vicarious liability — for the misconduct of research analysts, is questionable on several grounds. First, although not all of the facts are known, the circumstances that have been alleged publicly to support a case against senior Wall Street executives have been well-known to the investing public, and indeed to the Commission itself, for years. Indeed, the structural biases on the sell-side have been known to investors for decades.[6] And the conflicts of interest plaguing sell-side analysis, in particular, has been well known by market participants and regulators for years.[7]

In addition, since Regulation FD went into effect on October 26, 2000, sell-side analysis should have a greatly diminished effect on the value of publicly-traded securities. Indeed, the combination of an efficient

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[5]The *Gutfreund* decision notes that many of the "failure to supervise" enforcement proceedings the Commission has brought "arise from situations where supervisors were aware only of "red flags" or "suggestions" of irregularity, "rather than situations where, as here, supervisors were explicitly informed of an illegal act." *Id.* at *12.

[6]*See, e.g.,* Benjamin Graham and David L. Dodd, SECURITY ANALYSIS, at 9 *ff.* (NY: McGraw Hill 1934).

[7]For example, the *Wall Street Journal* reports that, handwritten notes that Mr. Hoffman took during a meeting of senior Salomon executives "crystallized" Mr. Spitzer's investigation. Suzanne Craig and Randall Smith, *Now, Jack Grubman's Boss at Salomon Faces Sanctions* WALL ST. J., at C1 (July 9, 2003). Those notes were also cited in the SEC's Citigroup complaint as evidence of the involvement or knowledge of senior Citigroup executives in analyst wrongdoing. The *Journal* described the notes as follows: "Mr. Hoffman's notes were headlined 'Rising issue of research integrity — Basic inherent conflict between investment banking, equities and retail.' The notes said the firm's ratings were the 'worst,' adding: 'ridiculous on face.' Using positive stock research to win investment-banking business, the notes said, was creating a credibility problem at the big Wall Street firm. With no 'sells' and just one 'underperform' rating out of 1,179 stocks assessed as of Jan. 29, 2001, Mr. Hoffmann wrote that concern among the firm's brokers and their clients 'is growing." *Id.* Mr. Hoffman was, however, merely stating what was then known to anyone who read the daily newspaper. *See, generally,* Randall Smith, Deborah Solomon and Suzanne McGee, *Grubman's Missed Call on AT&T Could Affect Influential Analyst's Stature*," WALL ST. J., at C1 (Oct. 4, 2000) (quoting Mr. Grubman as follows: "Let's call a spade a spade. Nobody on the sell side puts negative ratings on stocks. Very few people have anything less than a positive rating.").

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capital market, Regulation FD and recent enforcement activity on the selective disclosure front,[8] should already have rendered sell-side analysis — and the conflicts of interest that come with it — mostly obsolete. The efficient market hypothesis holds that the price at which a security changes hands in a thickly-traded market includes all of the publicly available information about the particular stock.[9] The price at which a stock trades also incorporates the analysis of the issuer's business and finances by the buyers and sellers of the stock. Informed institutional buyers typically determine the market price of a security.[10] It strains credulity to suggest that sophisticated institutional investors defer to what a sell-side analyst says publicly about the operations, value and prospects of a particular security *unless* such investors believed that such an analyst has access to material, non-public information. And Regulation FD specifically prohibits such tipping of sell-side analysts.[11] Thus, while it may have been the case, prior to the release of Regulation FD, that prominent sell-side analysts could be thought to have access to material non-public information, that is no longer the case. The influence of the sell-side on the markets should diminish accordingly.[12]

The fact that the institutional buy-side principally sets the price of securities traded in efficient public markets, and does so based on independent analysis of the issuer, should mean that sell-side upgrades or downgrades of a security should have no material effect on a small investor *even if* that investor actually relies on the analysis in making a decision to purchase or sell the security. The reason is that, in an efficient market, informed institutional traders have set the price of the security *regardless* of the sell-side's analysis.[13] The independent analysis of the buy-side — and concomitant discounting of the sell-side's biases — will be impounded into the price that small, uninformed investors pay. Lastly, the investment losses experienced during the years 2000-2002 were by all indications attributable to the market risks that were fully disclosed, rather than to misrepresentations by sell-side analysts.[14]

There is no question that corrupt analysts and those who knowingly or willfully participate with them in breaching the trust of investors should be punished. The merits of pursuing enforcement actions against those who supervised corrupt sell-side analysts, however, are more questionable. Such enforcement actions will not serve to protect the interests of small investors and will have little effect, if any, on the factors that contributed to the trillions of dollars of losses experienced by investors in the last several years.

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[8] *See, e.g., In the Matter of Secure Computing Corporation and John McNulty*, Admin. Pro. File No. 3-10948, Exchange Act Release 46895 (Nov. 25, 2002).

[9] *See, e.g.,* Eugene F. Fama, "Market Efficiency, Long-Term Returns and Behavioral Finance" University of Chicago Graduate School of Business, Center for Research of Securities Prices Working Paper (available at http://gsbwww.uchicago.edu/fac/finance/papers/).

[10] It is possible that uninformed — or so-called "noise" — traders can have a non-trivial effect on the price of publicly-traded securities if such "noise" trading makes up a significant percentage of the volume of trading in the security. The issue of the effects that "noise" trading has on securities prices is complicated and inevitably somewhat theoretical. *See* Paul G. Mahoney, "Is there a cure for 'Excessive Trading'?," 81 VA. L. REV. 713 (1995).

[11] The release promulgating Regulation Fair Disclosure very generally explains the rule as follows, "[w]hen an issuer, large or small, discloses material nonpublic information, Regulation FD requires it to file or furnish a Form 8-K, or to otherwise make public disclosure of information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public." Release Nos. 33-7881, 34-43154, IC-24599.

[12] *See, e.g.,* Laura Unger, "Fallout From Regulation FD: Has the SEC Finally Cut the Tightrope?" Speech before the Glasser Legalworks Conference on SEC Regulation FD (Oct. 27, 2000) ("In effect, investors will now [under Reg FD] be forced to perform the role previously played by analysts.")

[13] *See, e.g.,* Mahoney, 81 VA. L. REV. at 719 ("Although any individual trader may make an incorrect forecast, the errors should be random, not systematic, and over time traders should learn from their mistakes. Thus, in a rational expectations equilibrium, the price that investors are willing to pay for a particular asset will accurately reflect the objective return-generating process, or the 'fundamental' economic facts about the asset.").

[14] *See*, *e.g.*, *In re Merrill Lynch & Co, Inc.*, Nos. 02 MDL 1484 MO., 02CV 3210MP, 02CV 3321 MP. (S.D. NY June 30, 2003) (holding in civil suit alleging fraud by sell-side analyst that "plaintiffs' allegations utterly fail to take into account the intervening cause of the market collapse")

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