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Buy, Sell, or Hold?

ANALYST FRAUD FROM ECONOMIC AND NATURAL LAW PERSPECTIVES

Ronald J. Colombo†

INTRODUCTION

What are the fundamental purposes of U.S. securities regulation? To foster efficient capital markets? To protect the individual investor? To promote virtue in the securities industry? The question is an important one, as its answer ought to frame the legislative, regulatory, and judicial responses to the numerous issues and challenges confronting the field of securities law. By ignoring the full set of fundamental purposes of securities regulation, we run the risk of fashioning remedies inconsonant with the regulatory regime and hence more likely to undermine, rather than promote, a consistent, coherent approach to securities regulation. This Article posits that not all the fundamental purposes of U.S. securities regulation have been honored equally. Moreover, this Article suggests that a way of recapturing respect for the full range of aims that gave rise to the U.S. securities laws is to replace (or at the very least augment) the prevailing analytical approach employed in securities law thinking (namely, that of law and economics) with a different approach (namely, that of natural law theory).

If one looks at the inspiration behind the 1933 and 1934 Securities Acts, one quickly finds that, contrary to popular belief and the focus of current scholarly wisdom, the promotion of virtue and the extirpation of vice were central to both the President's and Congress's conceptualization of these acts. Indeed, it was understood and expected by President Roosevelt and the 72nd Congress that the promotion of virtue in the

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securities industry would best serve to protect the individual investor and resuscitate the capital markets.[1]

Today, very few understand the securities laws as did President Roosevelt and Congress in the 1930s. Perhaps the single most influential reason for the divergence of today's understanding of securities regulation and the understanding of its progenitors is the successful advance of "law and economics" thinking, which has come to dominate many fields of study, most especially those concerning economic regulation. For, under law and economics thinking, the seemingly subjective concerns of morality and normative values are displaced by the seemingly objective concerns of economic reasoning.[2]

The successful advance of law and economics should not be surprising given today's diverse, pluralistic society in which it is difficult to achieve consensus on arguments that are moral or normative in nature.[3] For law and economics purports to put aside those things over which individuals disagree and instead to focus on those things upon which individuals can agree: that efficiency should be preferred to inefficiency and that societal wealth should be maximized.[4]

Despite the appeal of law and economics, the movement has had its detractors. One line of criticism levied against it is that law and economics elevates a societal means (namely, efficient laws) over more ambitious (and more important) societal ends. Put differently, law and economics is viewed as deficient in failing to recognize that law does not exist for its own sake, but rather to further greater societal goals, such as the common good. Although individuals might disagree over what these goals should be, the whole enterprise of using law to achieve such goals should not be abandoned.[5]

The second line of criticism takes an opposite tack. To these detractors, law and economics' shortcoming is not that the movement divorces law from normative ends, but rather that law and economics substitutes the traditional normative ends of law with its own norms and values: namely, those of

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1 *See infra* Part III.A.

2 *See* Richard A. Posner, *Law and Economics* Is *Moral*, 24 VAL. U. L. REV. 163, 166-73 (1990).

3 *Cf.* ALASDAIR MACINTYRE, AFTER VIRTUE (1981) (arguing that Western Civilization no longer possesses a means of resolving disputes of an ethical or moral nature).

4 *See, e.g.*, Posner, *supra* note 2, 166-73.

5 *See infra* notes 243–244 and accompanying text.

the free market. That is, the problem is not that law and economics is "value neutral," but rather that law and economics is heavily value laden (with efficiency and wealth maximization serving as its primary values).[6]

Whatever deficiencies law and economics may suffer from, it is not unfair to demand, as its proponents often do, that discourse over law and public policy be on terms that are based on reason and logic (such as the terms of economic reasoning), rather than on feelings and opinion (which are often the bases, actual or perceived, of moral and normative arguments).[7] Therefore, the challenge to those who would confront law and economics from a normative or moral perspective is to provide objective, reason-based justifications for such a perspective. I suggest that natural law theory provides a philosophical framework, if not *the* philosophical framework, most up to this challenge.

A thorough elucidation of the merits of natural law reasoning *per se* is beyond the scope of this Article. (Moreover, others have effectively done this.) Instead, this Article examines what the application of natural law thinking to securities regulation would accomplish. This Article shall demonstrate that the application of natural law thinking to securities regulation generates results that hew more closely to the original intent of the securities laws than do those generated via a law and economics approach. Thus, on at least this ground, natural law reasoning can be proclaimed as the superior analytical approach to securities regulation. Moreover, as stated previously, application of natural law reasoning to securities law issues can also serve as a means of restoring respect for an original, driving objective of the Securities Acts that has largely been forgotten: to help mold a more virtuous securities industry.

This Article shall utilize a specific securities law problem to illustrate the promise and potential of a natural law approach to securities regulation: research analyst conflicts of interest. Part I of this Article sets forth the background to this particular problem, reviewing the role of research analysts and identifying the conflicts in question. Part II discusses why the primary antifraud mechanism of the securities laws (Rule 10b-5) is inadequate to address this problem, hence prompting

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[6] *See infra* note 219.

[7] *See* Posner, *supra* note 2, at 166-73.

calls for (and attempts at) other solutions. After reviewing the goals and values of U.S. securities law in general, Part III proceeds to analyze the solutions (proposed and potential) to the analyst problem, first from a law and economics perspective and then via a natural law approach. A juxtaposition of these two approaches reveals that the insights and solutions offered by natural law reasoning are superior to those offered by an economic approach to the law because, at a minimum, they are more harmonious with the complete set of goals and values that define the U.S. securities regulatory regime.

I. BACKGROUND

The research analyst conflict-of-interest scandal has led to increased litigation concerning, and regulation of, these specialized market participants. Research analysts, who issue widely followed research reports recommending whether a particular security should be bought or sold, were found to have issued reports and recommendations inconsistent with their own true opinions. Additionally, most analysts failed to disclose in their research reports the existence of substantial conflicts of interest that could reasonably be expected to influence their recommendations. Investors, relying on these reports and recommendations, claimed injury by virtue of their purchase of a misrepresented or overpriced security (which subsequently declined in value). This Part of the Article shall explain more fully the role of research analysts within the securities industry, the nature of their conflicts of interest, and the nature of their misconduct as alleged by investors and regulators.

A. The Role of Research Analysts

The U.S. Supreme Court has remarked that research analysts are "necessary to the preservation of a healthy market."[8] The Securities and Exchange Commission ("SEC") has similarly observed that "[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work

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8 Dirks v. SEC, 463 U.S. 646, 658 (1983).

redounds to the benefit of all investors."[9] What exactly do research analysts do that is so important?

Research analysts "perform research and analysis on companies in order to evaluate securities and estimate their value as investments."[10] This research and analysis is then typically presented in a report, along with a recommendation regarding whether the covered company's security should be bought, sold, or held.[11] "Sell-side" analysts, who comprise about a third of all analysts, are typically employed by brokerage firms or investment banks.[12] These analysts produce their research reports for their firm's customers and other investors, ordinarily free of charge and/or contingent upon a certain minimum level of investing with the analyst's firm.[13] As a result, the information produced by sell-side analysts becomes "widely disseminated in the financial markets."[14] The dissemination of this information is valuable to the investing

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[9] *Id.* at 658 n.17 (quoting SEC's brief, 21 S.E.C. Docket 1401, 1406 (1981)) (alterations in original).

[10] Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1040 (2003).

[11] *Id.* at 1040-41. As Professors Fisch and Sale explain in detail:

> In theory, [research analysts] serve as information conduits . . . between the companies they investigate and actual or potential investors in those companies. Their work involves collecting and processing information from a variety of sources, both inside and outside of the company. As a result of their research, analysts typically produce two products: a "report" and a "recommendation." In the report, analysts offer facts and opinions about the subject company and its securities. The recommendation, which is generally a selection from a series of rating categories, advises the investing public to buy, sell, or continue to hold the securities in question . . . . Analysts read and digest company reports and other secondary sources, speak with company officers and employees, and, where appropriate, visit company sites to help them form an independent impression of the business. Analysts review company documents filed with the SEC . . . and secondary sources like Standard & Poor's that compile, summarize, and republish it. Analysts also may review trade publications, including industry-specific magazines.

Id. (citations omitted); *see also* John Jacob, Steve Rock & David P. Weber, Do Analysts at Independent Research Firms Make Better Earnings Forecasts? 7 (July 2003), *available at* http://ssrn.com/abstract=434702.

[12] *See* Fisch & Sale, *supra* note 10, at 1040-41. There are other kinds of analysts, such as "independent analysts" (who are not associated with investment banks and who sell their research to the investing public) and "buy-side analysts" (who provide their research to the investment banks that employ them, and not to investors or the public at large), but these analysts do not share the same conflicts that sell-side analysts do. *See id.* at 1041 & n.18. Thus, independent and buy-side analysts are not the focus of this Article and, unless otherwise indicated, the terms "analysts," "securities analysts," and "research analysts" shall be used interchangeably in reference to sell-side analysts alone.

[13] *See id.* at 1040-41.

[14] *Id.* at 1041.

public not only insofar as individual investors might rely directly upon the analysis or recommendations contained in a particular analyst's reports,[15] but, moreover, insofar as the dissemination of this information contributes to the efficiency of the market, thereby helping to foster the accurate pricing of securities.[16]

B. *The Conflicts of Interest*

As indicated, sell-side analysts are typically employed by brokerage firms or investment banks.[17] Since it is the desire of such firms to attract and retain investment banking clients, institutional pressures toward this end unsurprisingly come to bear upon sell-side analysts.[18] This is problematic because investment banking clients (current and potential) can be expected to favor *positive* research coverage over *accurate* coverage, and thus analysts are pressured to skew their reports

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[15] *See* Robert P. Sieland, Note, Caveat Emptor! *After All the Regulatory Hoopla, Securities Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531, 544 (2003).

[16] *See* Kelly S. Sullivan, Comment, *Serving Two Masters: Securities Analyst Liability and Regulation in the Face of Pervasive Conflicts of Interest*, 70 UMKC L. REV. 415, 424 (2001); *see also* Robert Brooks & Huabing Wang, *The Securities Litigation Reform and Its Impact on Analyst Research* 7-8 (2004), *available at* http://ssrn.com/abstract=606822 (setting forth results of a study that "highlights analysts' role as an information intermediary in the financial market, especially when information in the market tends to be complex" and how such a role is "increasingly important" following the Private Securities Litigation Reform Act of 1995); Fisch & Sale, *supra* note 10, at 1061 (referring to the work of the sell-side research analyst as a "public good"). This understanding is grounded upon the efficient market hypothesis, which, in its widely applied "semi-strong" form, theorizes that "stock price will incorporate all publicly-available information relevant to the valuation of the stock." *See* Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 97 n.59 (2006); *see also* Robert J. Shiller, *From the Efficient Market Theory to Behavioral Finance* 4 (Cowles Found. Discussion Paper No. 1385, 2002), *available at*, http://papers.ssrn.com/abstract_id=349660. Thus, the more information of relevance regarding a security that is made available to the market, the more accurately that security's price will reflect its value. *See* Richard C. Strassner, *How Much Information Is Enough: Securities Market Information and the Quest for a More Efficient Market*, 5 TRANSACTIONS: TENN. J. BUS. L. 5, 9-12 (2003).

[17] *See supra* note 12 and accompanying text.

[18] *See* Barbara Moses, *They Were Shocked, Shocked: The "Discovery" of Analyst Conflicts on Wall Street*, 70 Brook. L. Rev. 89, 97 (2004); *see also* Fisch & Sale, *supra* note 10, at 1045-54. Investment banking clients typically include companies seeking to raise capital via the sale of securities to investors. This business—underwriting—is highly lucrative because the investment bank selected to lead the underwriting sales effort typically earns a fee of approximately 7% of the total amount of equity securities sold in the underwriting. *See* George J. Papaioannou & Adrian Gauci, *Deregulation and Competition in Underwriting: Review of the Evidence and New Findings*, 5 J. INT'L BUS. & L. 47, 59 (2006).

in a positive direction.[19] A textbook conflict-of-interest case arises: on the one hand, the analyst is expected to produce a fair, objective research report for the benefit of investors, but on the other hand the analyst has an interest in producing a report that portrays the covered company in a positive light in order to generate (or maintain) lucrative investment-banking revenue for the benefit of his or her firm.[20]

And the conflict in question is not just theoretical—its existence, and its effects, have been empirically demonstrated.[21] "According to the SEC, downgrades [in analyst recommendations][22] occurred in only 1% of the securities covered for the year 2000."[23] Some firms adopted official policies forbidding analysts from "making negative or controversial comments" about investment banking clients.[24] Further still, many firms linked an analyst's salary, and/or the analyst's bonus, to his or her contribution to the firm's investment banking business.[25] As Laura Unger, then acting Chairwoman of the SEC, testified before Congress on July 31, 2001:

> 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.[26]

Thus, structural conflicts of interest exist for many analysts, and several have clearly allowed their research to be affected by these conflicts.[27] An investigation of Merrill Lynch, for example, revealed an analyst who publicly recommended certain securities for purchase, but privately described these

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19 *See* Fisch & Sale, *supra* note 10, at 1047.

20 *See id.*

21 *See, e.g.*, Moses, *supra* note 18, at 95-99; Fisch & Sale, *supra* note 10, at 1047-54.

22 That is, where an analyst changed a recommendation from more favorable to less favorable.

23 Fisch & Sale, *supra* note 10, at 1047.

24 *Id.* at 1049.

25 *See id.* at 1052-54; *see also* RICHARD ROBERTS, WALL STREET 60 (2002).

26 *Conflicts of Interest Faced by Brokerage Firms and Their Research Analysts: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 107th Cong. (2001) (testimony of Laura S. Unger, Acting Chair, SEC), *available at* http://www.sec.gov/news/testimony/073101ortslu.htm.

27 *See infra* text accompanying notes 28-29.

same securities as "junk";[28] an analyst at Salomon Smith Barney who rated an issuer as a "buy" was discovered to have indicated to two colleagues that the company was a "pig" and should instead be rated "underperform."[29]

C. Claims Against Research Analysts

While the market was performing favorably in the 1990s, relatively scant serious attention was paid to the issue of analyst conflicts of interest.[30] Even less litigation was generated over the issue.[31] But as the market began to falter in 1999, and as stock prices began to drop, analysts became the focus of scrutiny and litigation.[32]

The New York Attorney General, the SEC, the National Association of Securities Dealers ("NASD"), the New York Stock Exchange, and the North American Securities Administrators Association all launched investigations into the conduct of research analysts, which resulted in a "Global Settlement" among the regulators and ten Wall Street firms.[33] Under the terms of the settlement, "the settling firms agreed to pay a total of approximately . . . $875 million in penalties and disgorgement . . . , $433 million to fund independent research, and $80 million to fund and promote investor education."[34]

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28 *See* Fisch & Sale, *supra* note 10, at 1049.

29 *See* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 757 (2005).

30 *See* Moses, *supra* note 18, at 97-98.

31 *See id.*

32 *See* Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?* 2002 COLUM. BUS. L. REV. 631, 631-33 (2002); *see also* Moses, *supra* note 18, at 97-104.

33 *See* Moses, *supra* note 18, at 99-103; *see also SEC Launches Inquiry into Research Analyst Practices*, 7 No. 22 Andrews' Bank & Lender Liab. Litig. Rep. 11 (May 16, 2002).

34 Moses, *supra* note 18, at 102-03. Additionally,

> the Global Settlement requires the brokerage firms to insulate their research analysts from investment banking pressure by: (i) physically separating the departments; (ii) requiring senior management to determine the research budget without input from investment banking; (iii) prohibiting any investment banking role in evaluating analysts or determining their compensation; (iv) requiring the managers of the research group alone to make all decisions to initiate or terminate company-specific coverage; and (v) keeping analysts out of 'beauty contests' and roadshows. In addition, the firms agreed to purchase independent research from at least three outside firms, to furnish that research to its customers for the next five years, and to make its own analysts' historical ratings and price forecasts publicly available in order to enable investors to compare analyst performance throughout the industry.

Additionally, by November 2002, "over 150 securities fraud class actions were pending against Merrill Lynch alone, based primarily on analyst conflict-of-interest allegations."[35] These actions were typically brought under section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, which "prohibits fraud in connection with the purchase or sale of a security."[36] The crux of these complaints is that an analyst's failure to disclose conflicts of interest constitutes a material omission and/or that an analyst's publishing of a disingenuous opinion constitutes a material misstatement.[37] This, in turn, renders the analyst's research report(s) false or misleading, and thereby constitutes a fraud in connection with plaintiff's purchase of the security (or securities) that are the subject of the research report.[38] What makes these cases particularly interesting is that, in many ways, they test the limits of existing securities law.[39]

II. ANALYST LIABILITY UNDER THE SECURITIES LAWS

A. Rule 10b-5

Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of "any manipulative or deceptive device or contrivance of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" in connection with the purchase or sale of a security.[40] SEC Rule 10b-5, promulgated pursuant to § 10(b) of the Securities Exchange Act, has been the principal mechanism by which investors have challenged the alleged misrepresentations and/or omissions in research reports.[41] Although multiple theories of liability can be formulated pursuant to Rule 10b-5 (such as liability on the part of those who "employ any devise, scheme, or artifice to defraud," or who "engage in any act, practice, or course of

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Id. at 103.

[35] *Id.* at 104. As of November 2007, a large number of these have been settled. *See* Cohen Milstein Hausfeld & Toll, Securities Fraud/Investor Protection, Merrill Lynch Co. and Henry Blodget, http://www.cmht.com/cases_merrilllynch.php.

[36] Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2006); *see also* Moses, *supra* note 18, at 104.

[37] *See* Moses, *supra* note 18, at 104-05.

[38] *See id.* at 105.

[39] *See id.* at 114-15; *see also* Fisch & Sale, *supra* note 10, at 1057-58.

[40] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j) (2000).

[41] *See supra* text accompanying note 36.

business which operates or would operate as a fraud or deceit upon any person"[42]), the primary means by which alleged analyst misconduct has been challenged has been via the assertion of liability based upon "misstatements or omissions" within the context of a private right of action, and thus this shall be the focus of this Article.[43] Additionally, this Article shall assume that all of the factual information contained in an analyst's report concerning the covered issuer and security is accurate and complete. This is because, as commentators have pointed out, the issue of liability for false factual information contained in a research report (such as misstating the revenue of a covered company) is not a particularly difficult one to resolve.[44] Furthermore, this assumption allows one to focus on the more difficult questions of analyst liability arising from (1) misstatements concerning the analyst's opinions and recommendations as set forth in his or her report, and/or (2) omissions concerning the analyst's conflicts of interest.

To state a valid claim for violation of Rule 10b-5 based upon a misstatement or omission, a plaintiff must allege that the defendant "(1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff relied, and (6) that reliance proximately caused the plaintiff's injury."[45] These elements of Rule 10b-5 liability shall be examined in turn.[46] With regard to omission-based liability, this section shall also briefly examine whether an analyst must

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[42] 17 C.F.R. § 240.10b-5 (2006).

[43] *See* Moses, *supra* note 18, at 105. The theory of these lawsuits is as follows:

> When analysts, with the intent to gain business through manipulation of security prices, yield to the pressures of investment banking conflicts, they have perpetrated fraudulent activity in connection with the purchase or sale of securities. . . . Section 10(b) of the Securities Exchange Act and its corresponding Rule 10b-5 make these behaviors unlawful.

Sullivan, *supra* note 16, at 427.

[44] *See, e.g.*, Shirli Fabbri Weiss, *Securities Analysts in Securities Class Actions*, *in* SECURITIES LITIGATION 1999, at 431, 454 (P.L.I. Corp. Law and Practice Course Handbook Series No. 1136, 1999).

[45] Kevin P. Roddy, *Eight Years of Practice and Procedure Under the Private Securities Litigation Reform Act of 1995*, *in* POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, at 141, 177 (A.L.I.-A.B.A. Course No. SK027, 2004). It should also be noted that in an enforcement action undertaken by the SEC, the elements of reliance and loss causation need not be demonstrated. *See* SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985).

[46] The jurisdictional requirement that defendant made "use of any means or instrumentalities of interstate commerce, or of the mails, or of any facility of any national securities exchange" shall be assumed. 17 C.F.R. § 240.10b-5 (2006).

owe a duty to a plaintiff in order for that plaintiff to maintain a Rule 10b-5 cause of action.[47] As shall be seen, there are significant ambiguities concerning the application of Rule 10b-5 to analyst misconduct.

1. Misstatement or Omission

The first element of a Rule 10b-5 claim is that the defendant in question made a misstatement or omission.[48] Despite the oft-repeated characterization of Rule 10b-5 liability as simply pertaining to "misstatements or omissions,"[49] the actual text of Rule 10b-5 does not impose liability upon "misstatements" or "omissions" generally, but rather upon "any untrue statement of material fact" or the omission of "a material fact necessary in order to make the statements made . . . not misleading":[50]

> It shall be unlawful . . . [t]o make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .[51]

The omission in a research report of a statement revealing an analyst's conflicts of interest would certainly constitute the omission of a "fact." With regard to misstated opinions, however, this text provides some difficulty in that it requires us to consider whether an analyst's opinion or recommendation could ever constitute an "untrue statement of . . . *fact*."[52]

As opinions are, by definition, not statements of fact, it could seem to follow, *a fortiori*, that an analyst's opinions (including his or her recommendations) could not, by definition, constitute an untrue statement of fact.[53] However, at issue is

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[47] *See infra* Part II.A.7.

[48] *See* Roddy, *supra* note 45, at 177.

[49] *See id.*

[50] 17 C.F.R. § 240.10b-5 (2006).

[51] *Id.*

[52] *Id.* (emphasis added).

[53] *See, e.g.*, *In re* Boston Tech., Inc. Sec. Litig., 8 F. Supp. 2d 43, 64 (D. Mass. 1998) ("[A] 'recommended' or 'buy' rating is not actionable because opinions generally do not provide sufficient basis for 10b-5 liability. . . . A recommendation or rating by an independent securities firm is the purest of opinions.") (citation omitted); *see also* Wright v. IBM, 796 F. Supp. 1120, 1124-25 (N.D. Ill. 1992) (stating that "actions for violations of the federal securities laws typically may not be predicated on mere opinions or projections," although acknowledging that "the recent trend . . . has moved toward recognition of an expanding range of opinions and projections as potentially actionable"); *see also* Moses, *supra* note 18, at 112.

not the correctness of the analyst's opinion or recommendation *per se*, but rather whether what is set forth as the analyst's opinion or recommendation is truly the analyst's opinion or recommendation. That is, although an opinion is not the same thing as a statement of fact, whether or not an individual possesses a particular opinion is itself a factual question.[54] Thus, to the extent that an analyst declares that "my opinion is *x*" or "my recommendation is *y*," he or she is fairly characterized as making a factual assertion as to what his or her opinion or recommendation is.[55] While some courts have held that "analysts' optimistic statements can be actionable if not genuinely and reasonably believed,"[56] others "have found that recommendations and statements in analysts reports are inactionable statements of opinion."[57]

The U.S. Supreme Court grappled with the actionability of disingenuous opinions, albeit within the context of proxy solicitation, in *Virginia Bankshares, Inc. v. Sandberg.*[58] In *Virginia Bankshares*, plaintiffs alleged that defendant's proxy solicitation materials were materially misleading in violation of § 14(a) of the 1934 Securities Exchange Act.[59] The bases of plaintiffs' allegation in *Virginia Bankshares* were statements contained in the proxy solicitation materials regarding defendant's directors' stated beliefs that (1) minority shareholders would receive a "fair" price and "high" value for their shares under the terms of a merger proposal under consideration, and that (2) the directors recommended adoption of the merger proposal for these reasons.[60] Plaintiffs alleged that these statements did not reflect the directors' true beliefs,

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[54] *See* Edgington v. Fitzmaurice, 29 Ch.D. 459, 483 (Ch. App. 1885) ("[T]he state of a man's mind is as much a fact as the state of his digestion.").

[55] *See In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1113 (9th Cir. 1989) (holding that a "projection or statement of belief contains at least three implicit factual assertions," including the assertion that "the statement is genuinely believed"); *see also* Mut. Life Ins. Co. of N.Y. v. Hillmon, 145 U.S. 285, 295 (1892) (acknowledging that one's state of mind can be "a material fact to be proved") (non-securities law context); Vulcan Metals Co. v. Simmons Mfg., 248 F. 853, 856 (2d Cir. 1918) (Hand, J.) ("An opinion is a fact. . . . When the parties are so situated that the buyer may reasonably rely upon the expression of the seller's opinion, it is no excuse to give a false one.") (non-securities law context).

[56] Weiss, *supra* note 44, at 441; *see also* Fisch & Sale, *supra* note 10, at 1083 (recommending "a rule that treats analyst recommendations as factual statements and holds analysts accountable if they do not actually believe those statements").

[57] Weiss, *supra* note 44, at 454; *see also supra* note 53.

[58] 501 U.S. 1083 (1991).

[59] *Id.* at 1086-87.

[60] *Id.* at 1088.

hence rendering the proxy literature materially misleading.[61] The Court concluded that although both such statements were indeed "factual"[62] (as well as material[63]), they would only be actionable under § 14(a) if they could be deemed to "expressly or impliedly assert[] something false or misleading about" their underlying subject matter.[64] That is, "disbelief or undisclosed motivation, standing alone" was deemed "insufficient to satisfy the element of fact that must be established under § 14(a),"[65] but a falsely presented opinion coupled with "something false or misleading in what the statement expressly or impliedly declared about its subject" would be actionable under § 14(a).[66] The Court resisted the recognition of liability "on mere disbelief or undisclosed motive without any demonstration that the proxy statement was false or misleading about its subject," noting that it would not permit litigation "confined solely to . . . the 'impurities' of a director's 'unclean heart.'"[67]

Virginia Bankshares, then, recognizes the correct characterization of feigned opinions and/or recommendations: such statements are properly deemed untrue statements of fact. However, *Virginia Bankshares* adds to the complexity of the issue by proceeding to hold that, even though factual, such statements are nevertheless not necessarily actionable *per se* (at least within the context of § 14(a) actions). Whether the reasoning of *Virginia Bankshares* will be applied to research analysts statements challenged under Rule 10b-5 (and, if so, how) remains to be seen. If it were applied, actions against analysts who issued otherwise-accurate reports containing misstated opinions might be characterized as grounded upon "mere disbelief," and thus not capable of entitling plaintiffs to relief. On the other hand, a better argument could be made in favor of the proposition that an analyst's opinion "impliedly asserts something false or misleading" about the underlying security itself, and is not, therefore, properly characterized as

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[61] *Id.* at 1088-89

[62] *Id.* at 1092.

[63] *Id.* at 1090-91.

[64] *Id.* at 1096.

[65] *Id.* at 1090-91.

[66] *Id.*

[67] *Id.* The Court acknowledged that "it would be rare to find a case with evidence solely of disbelief or undisclosed motivation without further proof that the statement was defective as to its subject matter." *Id.* Nevertheless, the Court felt it important to circumscribe liability in such cases given that "the temptation to rest an otherwise nonexistent § 14(a) action on psychological enquiry alone would threaten . . . strike suits and attrition by discovery." *Id.*

merely a statement of personal belief divorced from the subject matter at issue (that is, the covered securities). This is because a "buy" rating, for example, impliedly—if not expressly—asserts that the security in question is going to perform well, regardless of the analyst's own personal beliefs. Under such a line of reasoning, the analyst's false opinions would be actionable as per the logic of *Virginia Bankshares*.

2. Materiality

"A fact is material if it is substantially likely that the fact would be viewed by a reasonable investor as significantly altering the 'total mix' of information available, and if there is a substantial likelihood that a reasonable investor would consider it important to the investment decision."[68] As the continuum of potential misstatements and omissions is a long one, the question of materiality is ordinarily considered a question of fact.[69]

In some instances, however, the question of materiality would seem resolvable as a matter of law. For example, it is not difficult to imagine a misstatement or omission that would be immaterial as a matter of law by virtue of its marginality, such as an opinion that is only slightly exaggerated or a conflict that is quite attenuated. A more interesting question is whether even egregious misstatements of a research analyst's opinion, or the omission of very clear and serious conflicts of interest on the part of the analyst, might be properly considered immaterial as a matter of law. Put differently, perhaps, as a matter of law, analyst opinions and analyst conflicts should be deemed *per se* immaterial.[70] For it is not altogether obvious that a reasonable investor could ever view an analyst's opinion as "significantly altering" the "total mix" of information available regarding a given security or company. In the case of an analyst's opinion in line with those of all (or most) other analysts, how would such a redundant opinion "significantly

[68] Roddy, *supra* note 45, at 178; *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (adopting as materiality standard for Rule 10b-5 the standard previously set forth by the Court within the proxy solicitation context in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[69] *See* Roddy, *supra* note 45, at 178.

[70] As one court observed: "a statement of opinion emanating from a research analyst is far more subjective and far less certain [than a statement of fact from an issuer], and often appears in tandem with conflicting opinions from other analysts as well as new statements from the issuer." DeMarco v. Lehman Bros., 222 F.R.D. 243, 246-47 (S.D.N.Y. 2004).

alter" the "total mix" of information available? With regard to an outlier opinion by an analyst, how could an outlier—by definition, almost—ever be viewed as significantly altering the total mix of information available? And, if the opinions of covering analysts are split as to a particular security or company, again, how could the opinion of one additional analyst significantly alter the total mix of information?

Regarding an analyst's failure to disclose his or her conflicts of interest, the general presumption has been that such an omission would be material[71] and, consequently, actionable under Rule 10b-5.[72] The prevailing assumption notwithstanding, the conflation of "materiality" with "actionability" is suspect. A strict textual analysis of Rule 10b-5 reveals that not every omission of a material fact is unlawful, but rather only the omission of "a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" is unlawful.[73] The type of omission contemplated by Rule 10b-5, then, would be one in which a communication states that the company should perform well next year on account of an expected doubling of revenue, without mentioning that a tripling of expenses is also expected.[74] Omission of information concerning an analyst's conflicts of interest, however, does not so clearly make the other statements in a research report misleading. Courts and commentators have not generally focused on this issue, but, as indicated, have rather presumed that so long as the omitted information is material, its

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[71] *See* Sullivan, *supra* note 16, at 428 (2001) ("Based on the assumption that conflicts of interest influence the objectivity of research reports and recommendations made by analysts, conflicts of interest appear to be factors that the reasonable investor would consider when making an investment decision.").

[72] *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) ("[F]ailure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase . . . was an omission of a material fact in violation of Rule 10b-5.").

[73] 17 C.F.R. § 240.10b-5 (2006).

[74] *See, e.g.*, Wallace v. Sys. & Computer Tech. Corp., No. 95-CV-6303, 1997 WL 602808, at *11 n.30 (E.D. Pa. Sept. 23, 1997).

nondisclosure is unlawful under Rule 10b-5.[75] This presumption may be unwarranted.[76]

Additionally, assuming that all the underlying facts concerning the covered company and security are complete and accurate, are not reasonable investors armed with all the information they need to make an investment decision, regardless of the analyst's own opinions, recommendations, and biases? And is this not especially the case if, as in many cases, investors rely upon their brokers' advice (who apply expertise in sifting through research reports and other market information) in deciding upon which securities to buy, sell, or hold? And what if, added to this information, the report also fully discloses whatever conflicts of interest the analyst has? Would this tip the materiality balance regarding misstated opinions in favor of immateriality? A strong argument could be made that it would.[77] And arguments such as these (albeit outside of the specific context of research analyst reports) have led to the development of the judicially crafted "bespeaks caution" doctrine,[78] which Congress codified, in limited form, as a safe harbor under the Private Securities Litigation Reform Act,[79] each of which is addressed below.

a. *Safe Harbor of the Private Securities Litigation Reform Act*

In 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA"), which includes a "safe harbor" provision eliminating liability for certain forward-looking statements.[80] The applicability of the safe harbor provision on analyst reports is uncertain.[81]

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75 *But see In re* Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 277 (3d Cir. 2004) ("A determination that information missing from a registration statement is material does not end our analysis. We must also decide whether the issuer had the duty to disclose that material fact such that its omission made the statement misleading.").

76 Of course, failure to disclose a conflict of interest would be actionable under Rule 10b-5 if the research report affirmatively touts its objectivity. *See* Shah v. Meeker, 435 F.3d 244, 248 (2d Cir. 2006).

77 *But see* DeMarco v. Lehman Bros., 222 F.R.D. 243, 246 (S.D.N.Y. 2004) (noting that empirical evidence suggests that "some research analysts may have the ability to influence market prices on the basis of their recommendations").

78 Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 71 (1999).

79 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

80 *Id.* at § 102 (codified at 15 U.S.C. §§ 77z-2, 78u-5).

81 *See* Weiss, *supra* note 44, at 442-44.

By its terms, the safe harbor excludes as a basis of liability "any forward-looking statement" that is either immaterial or, more importantly, is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[82] Thus, it appears as though the PSLRA's safe harbor could provide a "Joe Isuzu"[83] defense for research analysts who issue reports containing biased, exaggerated, or otherwise dishonest opinions and recommendations, but who also include in their reports accurate and complete information regarding the covered company and its securities, as well as an accurate and complete disclosure concerning whatever conflict(s) of interest the analyst has (for this information and disclosure, properly presented, would arguably constitute "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those" expressed in the analyst's opinions and recommendations).[84] Indeed, "Congress specifically intended that application of the safe harbor should be determined without any inquiry into the defendant's state of mind."[85] However, the utility of the safe harbor to lying analysts would be limited if one takes the position that the only

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[82] 15 U.S.C. § 78u-5(c)(1) (2000). The safe harbor provision also excludes from liability forward-looking statements regarding which scienter cannot be proven, but because of the disjunctive nature in which the safe harbor was drafted, the question of scienter need not be reached if the conditions regarding "meaningful cautionary statements" are satisfied. *Id.*

[83] "Joe Isuzu" was a fictional salesperson, portrayed by actor David Leisure, in a television ad campaign launched by American Isuzu Motors, Inc. in the mid-1980s. *See* Cullen Thompson, *Isuzu Case Study* (Nov. 26, 2000), *available at* http://www.unc.edu/~cullent/isuzu.html. In the commercials, Joe Isuzu "would say anything to get consumers to buy his car" and "outright lied to his audience." *Id.* However, as he was doing this, "the words 'He's lying' ran across the bottom of the screen followed by the actual facts." *Id.*

[84] 15 U.S.C. § 78u-5(c)(1). I am assuming here that an analyst's opinion regarding the future prospects of a particular security is indeed a "forward-looking statement" as that term is understood under the safe harbor.

[85] John F. Olson et al., *Recent Developments in Disclosure and Dealing with Analysts and the Financial Press*, *in* POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, at 313, 346-47 (A.L.I.-A.B.A. Course No. SE10, 1999). *See also* Brooks & Wang, *supra* note 16, at 4 (noting that Senator Joseph Biden remarked that the PSLRA's safe harbor grants corporations "a license to lie"). *But see* ROBERT J. HAFT & MICHELLE H. HUDSON, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS § 7.5 (2005) ("Many commentators believe that the courts will not protect the dissemination of knowingly false statements accompanied by literally compliant cautionary statements."); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 576 (S.D. Tex. 2002) ("The safe harbor provision does not apply where the defendants knew at the time that they were issuing statements that the statements contained false and misleading information . . . .").

disclosure capable of constituting a "meaningful cautionary statement[]" with regard to an analyst's misstated opinion would be one indicating that the research analyst was, in fact, misstating his or her opinion.[86]

Another question concerning the availability of the PSLRA safe harbor is whether its limited applicability even extends to research analysts. For the safe harbor only applies to forward-looking statements made by (1) an issuer; (2) a person or entity acting on the issuer's behalf; and (3) "an underwriter, with respect to information provided by such issuer or information derived from information provided by such issuer."[87] The only category into which a research analyst might reasonably fall is the third.

Although an analyst's report is based largely on information "provided by [an] issuer" and/or "derived from information provided by [an] issuer," whether the analyst constitutes an "underwriter" is far from clear.[88] The term "underwriter" in the PSLRA has "the same meanings as in the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 et seq.],"[89] which is:

> "Underwriter" means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission.[90]

In those cases where the analyst's own firm is engaged in the underwriting of the security covered by the analyst's reports, such analysts could be deemed (depending on the facts) to have participated in the underwriting. Indeed, a key contention in many of the Rule 10b-5 actions against analysts is that analysts have had indirect (if not direct) participation in their firm's banking activity via their role in touting the

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86 *See supra* note 83; *see also infra* Part II.A.2.b (discussing "meaningful cautionary statements" within the context of the bespeaks caution doctrine).

87 15 U.S.C. § 78u-5(a) (2000).

88 *See* HAFT & HUDSON, *supra* note 85, at 552 n.164 (opining that the safe harbor "would only apply, if at all, to an investment bank that underwrote securities of the issuer. It would not apply directly to analysts.").

89 15 U.S.C. § 78c(a)(20).

90 *Id.* § 80b-2(a)(20).

underwritten securities in their research reports.[91] Moreover, regardless of his or her actual role in the underwriting effort, the mere fact that the analyst is an employee of the underwriting firm could arguably transform him or her into an "underwriter" for purposes of the PSLRA under agency principles.[92]

In the Joint Explanatory Statement of the Committee of Conference which recommended passage of the PSLRA, the "muzzling effect of abusive securities litigation" was discussed prominently.[93] The Committee explained that it "adopted a statutory 'safe harbor' to enhance market efficiency by encouraging companies to disclose forward-looking information."[94] The Committee's comments on the provision's applicability to underwriters does not, however, shed much light on whether an analyst would be covered.[95] Thus, even if Rule 10b-5 liability were found applicable to a research analyst accused of including misleading opinions in his or her report, whether such analyst could avail himself or herself of the PSLRA's safe harbor by revealing his or her conflicts of interest is itself an open question.

b. "Bespeaks Caution" Doctrine

In promulgating the PSLRA's statutory safe harbor, the Conference Committee explicitly noted that it did not intend for the safe harbor "to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts."[96] The bespeaks caution doctrine has been applied to analyst statements in securities litigation brought against

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[91] *See* Fisch & Sale, *supra* note 10, at 1047; *cf.* Olson et al., *supra* note 85, at 371.

[92] *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. C (2006).

[93] *Joint Explanatory Statement of the Committee of Conference*, *in* SAILING IN "SAFE HARBORS": DRAFTING FORWARD-LOOKING DISCLOSURES, at 39, 52-53 (P.L.I. Corporate Law and Practice Course Handbook Series No. 1020, 1997) [hereinafter *Joint Statement*].

[94] *Id.* at 53.

[95] *See id.* at 55 ("The safe harbor covers underwriters, but only insofar as the underwriters provide forward looking information that is based on or 'derived from' information provided by the issuer. Because underwriters have what is effectively an adversarial relationship with issuers in performing due diligence, the use of the term 'derived from' affords underwriters some latitude so that they may disclose adverse information that this issuer did not necessarily 'provide.'").

[96] *Id.* at 56.

research analysts[97] and may approximate the "Joe Isuzu" defense contemplated earlier, regardless of the availability of the statutory safe harbor.[98]

The judicially created bespeaks caution doctrine essentially reduces otherwise-material statements to immaterial under certain circumstances.[99] Under the doctrine, "forecasts, opinions, or projections do not amount to 'material misrepresentations' if 'meaningful cautionary statements' accompany the forward-looking statements."[100] As with the PSLRA's safe harbor, the definition of "meaningful" is not entirely clear, but will depend on the circumstances. Again, *Virginia Bankshares* might be instructive here, as in that case the Supreme Court addressed the closely related issue of materiality within the context of a proxy statement containing both accurate data and misleading statements:

> [P]etitioners are on perfectly firm ground insofar as they argue that publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability.
>
> But not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow.[101]

In the case of those analysts who have fully disclosed their conflict(s) of interest, it becomes difficult to see how such analysts' opinions could ever have a substantial likelihood of being considered important to the investment decision of a reasonable investor. For would not a reasonable investor, informed of an analyst's conflicts, appropriately discount the importance of that analyst's opinion as subject to potential bias? Thus, full disclosure of an analyst's conflict(s) of interest could be deemed to put investors on notice that, at a minimum, the opinions and recommendations contained in the analyst's report are subject to bias and are not to be relied upon as an "important" factor in a reasonable investor's research decisions,

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97 *See In re* Salomon Analyst AT&T Litig., 350 F. Supp. 2d 455, 467 (S.D.N.Y. 2004).

98 *See supra* text accompanying note 83.

99 *See* Roddy, *supra* note 45, at 218.

100 *Id.*

101 Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991).

thereby defeating any argument that such opinions are material.[102]

Taken to its logical conclusion, then, the bespeaks caution doctrine would appear to insulate analysts from liability for false opinions, so long as the reader of the analyst's reports has sufficient disclosure of the analyst's conflicts along with complete and accurate information regarding the company as outlined above—in other words, disclosure that would enable the investor to (1) grasp the incongruity between the analyst's recommendations or opinions and the condition and/or prospects of the covered company, and (2) discount the analyst's opinions on account of clear grounds for bias.[103] As Professor Palmiter has explained:

> Federal courts in securities fraud cases have declared that disclosures must be read in their context and if forecasts, opinions, or projections are accompanied by sufficiently clear warnings so that no reasonable investor would rely on them, they are not actionable.[104]

Since the bespeaks caution doctrine, unlike the PSLRA's safe harbor, is not limited to issuers and underwriters,[105] research analysts should not have much difficulty invoking its potential applicability to their statements. However, some have argued that "all the cautionary language in the world does not remove the taint of fraud from statements of opinion that are actually false."[106] To that end, there does not appear to be any decision in which a court applied the bespeaks caution doctrine to protect a defendant who was accused of making a knowingly false statement. Thus, as with the safe harbor provision of the PSLRA, the bespeaks caution defense is ultimately of questionable utility to a research analyst who includes

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[102] This understanding of the expected effect that knowledge of analyst conflicts can be expected to have on investors presents, in turn, a strong argument in favor of finding the omission in a research report of such conflicts to be itself material. And it certainly is fair to say that regulators apparently find such omissions important (and, as can be safely assumed, material as well), as evidenced by their aggressive prosecution of those research analysts whose firms entered into the aforementioned Global Settlement. *See supra* text accompanying notes 33-34.

[103] *Cf.* Weiss, *supra* note 44, at 454-55 (observing that sufficient warnings and disclaimers "may insulate the analyst from liability"); *Virginia Bankshares*, 501 U.S. at 1097 ("publishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability.").

[104] Palmiter, *supra* note 78, at 71 (addressing the bespeaks caution doctrine).

[105] See *supra* note 87 and accompanying text; *id.* at 71-73.

[106] *In re* Salomon Analyst AT&T Litig., 350 F. Supp. 2d 455, 468 (S.D.N.Y. 2004).

dishonest statements of opinion in a report, even if the report is otherwise complete and accurate, and contains sufficient disclosure of the analyst's conflicts.

3. Scienter

Scienter for Rule 10b-5 purposes encompasses an "intent to deceive, manipulate, or defraud," or recklessness to that same end.[107] Intentionally misportrayed opinions on the part of analysts satisfy the element of scienter by definition. Scienter would most likely be difficult to prove within the context of an omission concerning conflicts of interest, especially in the absence of any accompanying false or misleading statements.[108] For, in the absence of a skewed research report that contained false or misleading statements, the omission of a statement regarding the analyst's conflicts of interest would appear to be unintentional rather than purposeful. However, it could be argued, perhaps, that even a completely honest analyst has an incentive to keep secret any conflicts of interest in order to bolster the credibility of his or her reports, and the factual record could potentially bear that argument out. In any event, difficulty in demonstrating the existence of scienter goes to questions of proof, and not whether, theoretically, this particular element could ever be satisfied. Thus, the element of scienter does not pose a theoretical challenge to the applicability of Rule 10b-5 liability to analysts whose reports include misstatements and/or omissions.

4. In Connection with the Purchase or Sale of Securities

The courts have interpreted the element of "in connection with the purchase or sale of any security" quite broadly, encompassing practically everything that played a role in a reasonable investor's decision to purchase or sell a security.[109] Thus:

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[107] *See* Elizabeth A. Nowicki, *A Response to Professor John Coffee: Analyst Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 U. CIN. L. REV. 1305, 1317 (2004) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976)).

[108] *See* Gross, *supra* note 32, at 664.

[109] *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) (en banc); *see also* Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

> In cases involving the public dissemination of false and misleading information, courts have held that "where the fraud alleged involves the public dissemination of information in a medium upon which an investor would presumably rely, the 'in connection with' element may be established by proof of the materiality of the misrepresentation and the means of its dissemination."[110]

In light of the standard applied, this element of Rule 10b-5 liability would readily be satisfied in the case of a securities analyst whose reports included material omissions or misstatements, and, as with scienter, does not present a theoretical ambiguity with regard to the Rule's applicability.[111]

5. Reliance

A Rule 10b-5 plaintiff must prove that "defendant's *mis*representation or omission caused him to purchase the recommended security."[112] This element is known as reliance, sometimes referred to as "transaction causation."[113] Within the context of an omission, the Supreme Court has essentially dispensed with the reliance requirement, holding that so long as the omission was material, a presumption of reliance will be made.[114] Within the context of an affirmative misstatement, reliance can be demonstrated by evidence showing that the analyst's report played a role in plaintiff's decision to purchase (or sell) the security in question.[115] Absent such evidence, a plaintiff could possibly enjoy a presumption of reliance under the "fraud-on-the-market" doctrine.[116] "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."[117] An efficient market, as explained previously, is one in which the price of a security is affected by all publicly available material information.[118] By relying on the stock price, an investor in an efficient market is (the argument goes) relying, in part, on

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[110] *See* Nowicki, *supra* note 107, at 1345 (citing Semerenko v. Cendant Corp., 223 F.3d 165, 176 (3d Cir. 2000)).

[111] *See id.*

[112] *See* Gross, *supra* note 32, at 671.

[113] *See id.*

[114] *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972).

[115] *See* Gross, *supra* note 32, at 671.

[116] *See id.* at 672.

[117] *See id.*

[118] *See supra* Part I.A.

analyst reports, even if he or she never read them, because the information contained in such reports would have been assimilated into the stock price.[119] And, as one commentator has concluded, "[s]ince virtually all securities covered by a research analyst are traded in an efficient market, a plaintiff could sue an analyst without the need to prove reliance."[120]

Others, however, have questioned the availability of the fraud-on-the-market doctrine to analyst statements.[121] As Judge Rakoff of the Southern District of New York explained:

> [T]here is a qualitative difference between a statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst. A well-developed efficient market can reasonably be presumed to translate the former into an effect on price, whereas no such presumption attaches to the latter. This, in turn, is because statements of facts emanating from an issuer are relatively fixed, certain, and uncontradicted. Thus, if an issuer says its profits increased 10%, an efficient market, relying on that statement, fixes a price accordingly. If later it is revealed that the previous statement was untrue and that the profits only increased 5%, the market reaction is once again reasonably predictable and ascertainable. . . .
>
> As a result, no automatic impact on the price of a security can be presumed and instead must be proven and measured before the statement can be said to have defrauded the market in any material way that is not simply speculative.[122]

Thus, for the largest class of potential plaintiffs (those purchasers of a security who did not rely directly on the defendant-analyst's research report), the question of reliance is

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[119] *See* Basic Inc. v. Levinson, 485 U.S. 224, 241-47 (1988).

[120] *See* Gross, *supra* note 32, at 672-73.

[121] *See, e.g.*, DeMarco v. Lehman Bros., 222 F.R.D. 243 (S.D.N.Y. 2004) (questioning applicability of fraud-on-the-market theory in context of non-issuer statements). In 2005, the Second Circuit indicated that it would review the applicability of the fraud-on-the-market doctrine to non-issuer statements. Pamela A. MacLean, *Investor Suits May Face New Challenge*, NAT'L L.J., July 18, 2005, at 1. But the court ultimately based its subsequent ruling on a finding that the IPO market should not be considered efficient, and not on whether non-issuer statements can serve as the basis of a fraud-on-the-market theory of reliance. *In re* Initial Public Offerings Sec. Litig., 471 F.3d 24, 42-43 (2d Cir. 2006). The court did opine, however, that "[i]t is also doubtful whether the *Basic* [*v. Levinson*] presumption can be extended, beyond its original context, to tie-in trading, underwriter compensation, and analysts' reports." *Id.* at 43 (citing West v. Prudential Sec., Inc., 282 F.3d 935, 938 (7th Cir. 2002)).

[122] *DeMarco*, 222 F.R.D. at 246-47. *But see id.* at 246 (acknowledging that there is evidence to suggest that "some research analysts may have the ability to influence market prices on the basis of their recommendations"); SEC, *Securities Analyst Recommendations*, http://www.sec.gov/answers/analyst.htm (last visited Sept. 10, 2007) (noting that "[a]nalyst recommendations can significantly move a company's stock price").

unsettled. But for investors who could prove that they did in fact rely directly on an analyst's reports, the reliance element would clearly be met.

6. Loss Causation

Loss causation, for purposes of Rule 10b-5, is a "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[123] Ordinarily, loss causation is calculated by examining the reaction of stock price to the announcement or news rectifying the actionable misstatement or omission in question.[124] However, in most analyst-conflict cases, the conflicts of interest and/or the disingenuousness of opinions are discovered well after a security's price drops for other reasons.[125] This makes it exceedingly difficult for Rule 10b-5 plaintiffs to demonstrate loss causation within the context of analyst misconduct.[126] Notwithstanding this difficulty, however, the element of loss causation poses only a factual/pleading problem and does not present a conceptual obstacle as applied to research analyst misconduct.

7. Duty

Most courts and commentators have presumed that a duty to disclose must exist before an investor can recover damages under § 10(b) premised upon the omission of a material fact.[127] This presumption is based on the general understanding that one ordinarily does not have a duty to speak, and thus a lawsuit alleging fraudulent silence requires the presence of some pre-existing duty.[128] The basis of such a duty within the context of analyst omissions is unclear.[129]

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[123] Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003).

[124] *See* Moses, *supra* note 18, at 108.

[125] *See id.* at 108-09.

[126] *See id.* at 109-10; Dura Pharm. v. Broudo, 544 U.S. 336, 346 (2005).

[127] *E.g.*, *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 574 (S.D. Tex. 2002).

[128] *See* John J. Clark, Jr. & William F. Alderman, *Potential Liabilities in Initial Public Offerings*, at 319, 347 (P.L.I. Corp. Law & Practice, Course Handbook Series No. 1518, 2005) ("A defendant cannot be held liable for a failure to disclose information allegedly withheld from the market unless the defendant was under a duty to disclose the information at the time."); *see also* Chiarella v. United States, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it

Other commentators, however, have pointed out that the text of §10(b) does not require liability for an omission to be conditioned upon a duty.[130] As Professor Elizabeth Nowicki has explained:

> A close look at Section 10(b) . . . makes clear that Congress never spoke of duty when crafting Section 10(b). There is no "duty" prerequisite to the applicability of Section 10(b), nor is "duty" an element of a successful Section 10(b) claim. . . . When Congress drafted Section 10(b), Congress did not speak to the characteristics of the target of Section 10(b)'s application. . . . All that matters is that the . . . elements of a Section 10(b) claim are satisfied, regardless of *who* is the defendant satisfying the elements.[131]

Regardless of whether such a duty exists, however, it is fairly well established that once a party elects to make a statement, Rule 10b-5 requires that such statement not omit whatever material facts are necessary in order to make the statement not misleading.[132] Therefore, once an analyst decides to communicate to investors (and potential investors) via a research report, that report must not omit anything that would cause its content to be misleading.[133]

B. Analyst-Specific Regulatory Requirements

Prompted, in part, by the limitations of, and difficulties of recourse to, Rule 10b-5 to address the problem of analyst conflicts, the SEC and NASD have enacted regulations to govern the conduct of research analysts: SEC Regulation AC and NASD Rule 2711. As shall be seen, SEC Regulation AC closes whatever loopholes might exist that would permit a

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catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

129 *See* Sullivan, *supra* note 16, at 428 ("The extent of an analyst's duty to disclose conflicts of interest to potential investors is unclear."). It should be noted that when the investor in question is a client of the analyst's firm, the duty would appear to exist. *See id.* As Professor Gross has explained, broker-dealers, including sell-side analysts employed by them, "have a duty to deal fairly with their customers. This duty of fair dealing encompasses the duty to give customers their undivided loyalty." *See* Gross, *supra* note 32, at 636.

130 *See* Nowicki, *supra* note 107, at 1314.

131 *See id.* at 1314, 1324. *But see* Sieland, *supra* note 15, at 550 ("[B]ecause section 10(b) alleges fraud, there must be a duty extending from the defendant to the plaintiff.").

132 *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.19 (5th ed. 2005).

133 *Id.* As explained previously, whether an analyst's failure to disclose a conflict of interest constitutes an actionable omission under Rule 10b-5 is not entirely certain. *See supra* text accompanying notes 71-76.

research analyst to evade potential liability for issuing false opinions and recommendations (by, for example, attempting to rely on either the PSLRA's safe harbor or the bespeaks caution doctrine), and NASD Rule 2711 requires (of NASD members) that companies adopt policies and procedures to address those factors that give rise to an analyst's conflicts of interest.

1. Regulation AC

SEC Regulation AC ("Analyst Certification") requires "all brokers, dealers, and certain other persons associated with brokers and dealers to add certifications to their research reports stating that the research analyst believes that the report accurately reflects his or her personal views and disclosing any compensation or other payments received in connection with the recommendations or views."[134] Regulation AC, therefore, addresses the dishonesty issue squarely, and positively precludes a research analyst (via the certification requirement) from setting forth an opinion or recommendation that runs counter to his or her true beliefs—regardless of the accuracy or completeness of the factual information contained in the report, and regardless of any disclosure of the analyst's conflict(s) of interests. In light of Regulation AC, a research analyst could not issue a fraudulent opinion and successfully hide behind the fig leaf of full disclosure in an attempt to evade sanction.

2. Rule 2711

Implemented in 2002 by the NASD, following SEC approval, Rule 2711 mandates that NASD members implement certain structural safeguards to diminish a research analyst's potential conflicts of interest.[135] These safeguards include prohibitions on promises of favorable research coverage by investment banks to their clients (or potential clients), prohibitions on submission of research reports to covered company's before publication, and prohibitions on investment banking "supervision or control" over research analysts.[136] Also prohibited is basing analyst compensation on "any relationship between the analyst's research reports and investment banking

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[134] *See* Fisch & Sale, *supra* note 10, at 1069.
[135] *See* Hurt, *supra* note 29, at 779-81.
[136] *See id.* at 780-81.

clients."[137] Additionally, Rule 2711 requires an analyst to disclose certain conflicts of interest in his or her research reports, but it does not require the analyst to affirmatively vouch for the authenticity of his or her opinions and/or recommendations, as does SEC Regulation AC.[138] Thus, Rule 2711 attempts to minimize the fundamental conflicts of interest that give rise to research analyst misconduct via structural changes and disclosure, but stops short of demanding that an analyst certify the honesty and truthfulness of his or her published recommendations and opinions.

C. *The Need for a Normative Analysis*

Due to questions regarding, among other things, the actionability of opinions in general, the materiality of analyst opinions in particular, and the applicability of the fraud-on-the-market presumption in place of individualized reliance, Rule 10b-5's ability to serve as a vehicle for imposing liability on analysts for misstated opinions is questionable. This questionability gave rise to the flurry of regulatory activity that brought about Regulation AC and Rule 2711—each designed to fill the perceived gap created by Rule 10b-5's apparent inability to police analyst conflicts of interest. But this begs an interesting question: is Rule 10b-5's apparent inability truly a shortcoming? Perhaps the failure of the traditional elements of Rule 10b-5 to cover the phenomenon of analyst fraud suggests that such fraud ought not be subject to sanction. And, if not, then Regulation AC and Rule 2711 could arguably cause more harm than good. For these and similar questions, a normative lens is needed through which securities law and policy can be analyzed.

III. NORMATIVE ANALYSIS OF SOLUTIONS TO RESEARCH ANALYST CONFLICTS OF INTEREST

The inadequacy of Rule 10b-5 to address the issue of analyst conflicts of interest invites a discussion of other potential solutions to this perceived problem. It also invites a discussion of whether any solution should be adopted at all. The business of dividing wheat from chaff, of judging various solutions for appropriateness and efficacy, is obviously

137 *See id.* at 781.

138 *See id.* at 781-82; 17 C.F.R. § 242.501 (2005).

predicated upon some standard (or set of standards) that enables such judgments to be made. Economic analysis has been heavily relied upon by those considering questions of securities law, and such reliance seems most reasonable given the direct role of U.S. securities law in regulating an important part of the U.S. (and, indeed, the world's) economy. In keeping with this practice, this Part shall provide an economic analysis of the problem of analyst conflicts (and of solutions proposed thereto). But in a break from the common, this Part shall also review the problem of analyst conflicts from another source of standards and norms—those of the natural law tradition. As indicated at the outset of this Article, this demonstration shall reveal that a natural law approach to the problem of analyst misconduct yields results and recommendations that comport better with the philosophy of U.S. securities regulation than does the law and economics approach.

Preliminary to a comparison of economics-based and natural law-based approaches to the problem of analyst conflicts, and an assessment of how these approaches comport with the underlying philosophy of U.S. securities regulation, is, of course, an identification of this underlying philosophy. Thus, this Part commences with a brief review of the history of U.S. federal securities regulation and an identification of the values that undergird the regulatory approach.[139]

A. *Objectives and Values of U.S. Securities Laws*

On the heels of the Stock Market Crash of the 1929 and the Great Depression that followed, Franklin D. Roosevelt ran a 1932 presidential campaign that included an attack on Wall

[139] The federal securities laws (as do virtually all substantive laws) both reflect and effectuate certain values or norms. *See* H.L.A. HART, THE CONCEPT OF LAW 203-04 (2d ed. 1994) ("The law of every modern state shows at a thousand points the influence of both the accepted social morality and wider moral ideals."); *see also* CHARLES E. RICE, 50 QUESTIONS ON THE NATURAL LAW 95 (1999). Thus, when ambiguities in the law must be resolved, or when decisions must be made regarding the appropriate scope or application of the law, it is inevitable, fitting, and proper to consult a broader source of norms to supplement, to the extent necessary, the moral framework of the particular law in question. *Cf. id.* at 95 (observing that "all human law enforces morality of some sort . . . . The question is therefore not whether the human law should enforce morality but rather which morality it will, and should, enforce."); Jack Balkin, *The Proliferation of Legal Truth*, 26 HARV. J.L. & PUB. POL'Y 5, 8 (2003) ("[L]aw does shape what people believe and what they understand. Law has power over people's imaginations and how they think about what is happening in social life. Law in this sense is more than a set of sanctions. It is a form of cultural software that shapes the way we think about and apprehend the world.").

Street's "unscrupulous money changers" who knew "only the rules of a generation of self-seekers."[140] He pledged to "restore [the] temple to the ancient truths," including "honesty," "honor," "the sacredness of obligations," "faithful protection," and "unselfish performance."[141] Only upon such a restoration, Roosevelt argued, could investor confidence, and thus the capital markets, be resuscitated.[142]

Shortly after his inauguration, President Roosevelt went to work on the "moral reform of Wall Street," and early SEC officials sought to restore "traditional standards of right and wrong."[143] In Congress he had a willing partner and, in short time, the 1933 Securities Act and the 1934 Securities Exchange Act were passed.[144] In passing this legislation, Congress, as one commentator has remarked, "was attempting to improve the morality of the marketplace."[145] And as John H. Walsh (former Chief Counsel in the SEC's Office of Compliance Inspections and Examination) explains, the moral vision that inspired the Securities Acts were not lost upon those initially chosen to oversee the newly implemented regulatory regime:

- Baldwin B. Bane, Chief of the Securities Division of the Federal Trade Commission (the agency initially responsible for administering the Securities Act), stated that the recently passed securities legislation was "based on a 'moral ideal.' It was the 'realization that [the economy's] ills [were] due . . . to the weakening of [the nation's] moral fibre, [and] to easy temporizing with traditional and tried standards of right and wrong.'"[146]
- Joseph P. Kennedy, the first Chairman of the SEC, said that the SEC's most important objective was

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140 John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015, 1036 (2001).

141 *Id.*

142 *See id.*

143 *Id.* at 1037-42, 1070.

144 *Id.* at 1042-52.

145 David Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 VAND. L. REV. 621, 622 (1970).

146 *See* Walsh, *supra* note 140, at 1054 (alterations in original) (citations omitted).

"spiritual," and that it sought "to prevent vice" in the securities industry.[147]

- John Burns, the first General Counsel of the SEC, proclaimed that the "failure of morals and religion to put a bridle to the acquisitive motive[s] of . . . business . . . made the intervention of the law inevitable."[148]

A moral prescription for economic ills was not seen as inapposite given the understanding that a more ethical securities industry would improve investor confidence and, in turn, improve the capital markets.[149] As the drafters of the 1934 Securities Exchange Act explained:

> [i]f investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. . . . [I]t becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect . . . ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.[150]

From this statement can be gleaned the interrelated concerns and insights of the architects of the U.S. securities regulatory regime. Investor protection and the health of the capital markets were objectives of paramount concern; necessary to the ascertainment of these objectives was the restoration of certain virtues to the U.S. economic system—namely, moderation, honesty, and trustworthiness.[151] More recently, the Second Circuit has opined that Congress passed

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[147] *Id.* at 1053.

[148] *Id.* at 1052-53.

[149] *See id.* at 1036.

[150] Nowicki, *supra* note 107, at 1312 (quoting Report to Accompany S. 3420, Federal Securities Exchange Act of 1934, 72d Cong., S. Rep. No. 792 (Apr. 17, 1934)) (alterations in original).

[151] *See id.* As recently as 1997 Congress echoed the fundamental purposes of U.S. securities regulation: "to protect investors and to maintain confidence in the securities markets, so that our national savings, capital formation and investment may grow for the benefit of all Americans." *Joint Statement*, *supra* note 93, at 41.

the 1934 Securities Exchange Act "to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges"[152]—thereby summarizing a primary purpose of the securities laws as the achievement of "fairness."[153]

Pursuant to the wisdom that "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman,"[154] Congress opted, primarily, for a regime of mandatory disclosure to achieve its legislative ends.[155] As one commentator has explained:

> When promulgating the federal securities acts, Congress examined different theories of securities regulation, and ultimately chose a licensing scheme that embraced a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus achieve a high standard of business ethics in the securities industry.[156]

Full disclosure, however, for all its fundamentality to the U.S. approach to securities regulation is, of course, not the sole mechanism relied upon by Congress to protect investors. At the forefront of enactments supplementing the disclosure regime are Section 10(b) of the 1934 Securities Exchange Act and SEC Rule 10b-5 promulgated thereunder.[157] These antifraud provisions go beyond disclosure alone and directly ban the issuance of false statements and deceptive omissions in securities trading—regardless of whether these statements and omissions concern mandatorily disclosed information.[158] Thus,

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152 SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968).

153 *Id.*

154 LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT 92 (1914).

155 *See* Leonard J. DePasquale, *Helping to Ameliorate the Doctrine of Caveat Emptor in the Securities Market:* Reves v. Ernst & Young, 26 NEW ENG. L. REV. 893, 896 (1992).

156 *Id.* (internal quotations omitted) (alterations in original).

157 *See supra* Part II.A.

158 It could be asserted that the prevailing modern approach to securities regulation cares less about truthfulness *per se* in light of the advent of the bespeaks caution doctrine and the PSLRA's safe harbor (especially within the context of "soft" information such as opinions and forecasts). However, one must be careful not to read too much into the safe harbor and bespeaks caution doctrine. Although they may technically grant a "license to lie," *see* Brooks & Wang, *supra* note 85, at 4, they more properly are read as efforts at encouraging the dissemination of non-required disclosure by creating a zone of safety to protect against litigation and liability. Akin to "good Samaritan laws," the purpose of which is not to protect those who would literally kick a victim while he or she was down, but rather to free would-be rescuers from the

although eschewing an approach of requiring minimum solvency standards for companies whose securities are purchased and sold (which characterized the approach taken by state securities laws at the time), Congress did require that investors be provided with certain key pieces of information, and that all the information furnished to investors (whether required or not) in connection with the purchase or sale of security be complete and accurate.[159]

Applying the objectives, values, and philosophy of the securities laws to the question of research analyst conflicts certainly confirms that the issue is correctly identified as a problem to be addressed. Investors have been hurt, confidence in the market has been compromised, and whether long-term harm to economic growth shall result from this remains to be seen. As for the most appropriate response to this problem, we shall now turn to the analytic tools of the economics and natural law reasoning.

B. *Law and Economics Analysis*

1. Law and Economics Generally

One of the most powerful approaches in the analysis of law in recent decades is that offered by economics, commonly referred to as "law and economics" or an "economic analysis of the law." Few such approaches have had such impact on legal scholarship and thought, and few subjects are more

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risk of liability, the safe harbor and bespeaks caution doctrine aim at removing the liability-risk disincentive against those who, in good faith, would like to go beyond the bare minimum disclosure requirements of the securities laws but are fearful of doing so. Understanding this context helps disabuse one of any notion that Congress and the courts have moved away from a model of investor protection based on the coupling of disclosure with an antifraud rule; rather, Congress and the courts are merely seeking to promote the release of supplemental, "soft information" by making it more difficult to hold good faith suppliers of such information liable merely for estimating or forecasting incorrectly. Indeed, Congress's expressed purpose in passing the PSLRA's safe harbor was, in part, to "enhance market efficiency." *Joint Statement*, *supra* note 93, at 52. As the promulgation of false or misleading information does not enhance market efficiency (and may, in fact, harm market efficiency, *see* Fisch & Sale, *supra* note 10, at 1086), the arguable protection of authors of such information from liability should be interpreted as a necessary evil at best, and not as a statement of change in philosophy or policy.

[159] *See* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 26-27.

appropriately analyzed under the lens of economics than the securities laws.[160]

The economic approach to the law embraces, as given, the fundamental premises of the free market economy: that individuals are rational beings who predictably pursue their self-interest and, in doing so, generally serve to maximize society's creation of wealth.[161] The objective of law, therefore (under a law and economics approach), is to establish rules that assist society to so function (largely by addressing market failures and minimizing transaction costs) in order to maximize societal wealth (often referred to as promoting "efficiency").[162] This line of reasoning has led some scholars to argue that "properly understood, securities regulation is not a consumer protection law," but rather a regime concerned with "facilitate[ing] a competitive market for information traders."[163]

Thus, applied to the research analyst conflicts-of-interest issue, the law and economics approach frankly suggests disregarding the promotion of virtue, the extirpation of vice, even "investor protection" as goals *per se*, and instead aims simply at increasing market efficiency by reducing transaction costs and correcting for market failures.[164]

2. Law and Economics Applied

In order to facilitate a law and economics review of the research analyst conflict-of-interest problem, solutions (both potential and applied) to the problem have been sorted into

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[160] *Cf.* David B. Sentelle, *Law and Economics Should Be Used for Economic Questions*, 21 HARV. J.L. & PUB. POL'Y 121, 121 (1997) (arguing that the judiciary's use of economic analysis should be limited to questions properly pertaining to economics).

[161] *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 10-11 (3d ed. 2003); J.M. ROBERTS, THE PELICAN HISTORY OF THE WORLD 675 (1983).

[162] *See* Francesco Parisi & Jonathan Klick, *Functional Law and Economics: The Search for Value-Neutral Principles of Lawmaking*, 79 CHI.-KENT L. REV. 431, 444-45 (2004); Annalise E. Acorn, *Valuing Virtue: Morality and Productivity in Posner's Theory of Wealth Maximization*, 28 VAL. U. L. REV. 167, 171 (1993); POLINSKY, *supra* note 161, at 7.

[163] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation* 1 (Am. Law & Econ. Ass'n 15th Annual Meeting Working Paper No. 9, 2005), *available at* http://law.bepress.com/alea/15th/art9. Lending anecdotal support to this position (within the context of research reports, at least), is the proclamation of at least one prominent analyst that her audience is not the individual investor, but rather "professional money managers" and institutions. *See* Sieland, *supra* note 15, at 545.

[164] *See* POLINSKY, *supra* note 161, at 7. A dichotomy exists between positive (purely descriptive) and normative (prescriptive) approaches. *See id.* at xvii. As may have already been discerned, the approach taken (and critiqued) in this Article shall be normative (prescriptive).

four general categories: (1) a laissez-faire approach, (2) an antifraud rule, (3) mandatory disclosure, and (4) a structural approach. The merit of each of these categories shall be assessed, in turn, from a law and economics perspective.

a. Laissez-Faire Approach

Under a laissez faire approach to the problem of analyst misconduct, no legal rule would be adopted to address the conflict of interest problem. Instead, the market would be expected to most efficiently address this issue.[165]

As there are costs associated with the disclosure of information, any fixed rule regarding disclosure is bound to require either too little or too great an amount of disclosure.[166] This is because rules are bound to be imperfect, if for no other reason than the fact that rules are fairly static and the demands of the market are dynamic.[167] Sub-optimal levels of disclosure extract an unnecessary cost on disclosing parties and, consequently, on the market as a whole. Assuming a properly functioning, competitive market, the optimal level of disclosure, just as the optimal price of a good or service, should be set by the market through competition.[168]

Much literature has been generated over the issue of the optimal level of corporate disclosure under the securities laws.[169] The focus of this literature, however, has almost invariably been disclosure on the part of issuers of securities for the purpose of attracting investment (either primarily, through disclosure sufficient to support an offering, or secondarily, through disclosure sufficient to maintain a healthy secondary market for the issuer's securities).[170] The need to attract investment (and maintain a healthy secondary market) creates competition among corporate issuers for investors.[171] This competition encourages issuers to disclose the optimal

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[165] *Cf.* Giuseppe Dari Mattiacci, *Tort Law and Economics*, *in* ECONOMIC ANALYSIS OF LAW: A EUROPEAN PERSPECTIVE 6 (forthcoming).

[166] *See* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1034 (2000).

[167] *Cf.* David Van Drunen, *Aquinas and Hayek on the Limits of Law: A Convergence of Ethical Traditions*, J. MARKETS & MORALITY, Fall 2002, at 315, 327 (observing the inability "to legislate a system of law that cleanly resolves all future matters of conflict").

[168] *See id.*

[169] *See, e.g.*, *id.*; *see also* Palmiter, *supra* note 78.

[170] *E.g.*, Palmiter, *supra* note 78.

[171] *See id.*

level of information necessary to investors—that is, just enough information to attract the required amount of investment.[172] The provision of less information would cause investors to eschew the putative issuer in favor of competing issuers' securities; the provision of more information would be unnecessary and therefore wasteful at best.[173] As for the quality of the information provided (in terms of accuracy and honesty), the market would punish an issuer who disclosed false or misleading information by devaluing the price of its future offerings on account of a lack of trust. Thus, there is an economic incentive for issuers to make disclosures that are accurate as well as sufficient.

With regard to research analyst reporting, a threshold question from a law and economics perspective is whether circumstances exist so as to justify departing from the conclusion that market forces should result in an optimal state of affairs. Put differently, one must consider whether research reporting takes place within a properly functioning, competitive market—an assumption that forms the basis for the law and economics conclusion that market forces alone should maximize societal wealth. The existence of serious conflicts of interest challenges these assumptions.[174]

As explained previously, sell-side analyst reports are usually provided free of charge to a bank's customers.[175] Thus, such reports are part of the total mix of goods and services that banks use to attract and maintain investor clients. The greater the value that the market for investors assigns to these reports, the more effective these reports will be in attracting and maintaining investor clients and, consequently, all things being equal, the more competitive their issuing bank will be.

However, as has also been previously discussed, analyst reports serve (or traditionally have served) at least one additional purpose: the promotion of the securities offerings of a bank's investment-banking clients in order to attract and maintain such clients.[176] Again, the investment-banking market will assign a value to these reports relative to their worth to investment banking clients, and the higher the value, all

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[172] *See id.*

[173] *See id.*

[174] *See generally* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

[175] *See supra* text accompanying note 13.

[176] *See supra* Part I.B.

things being equal, the more competitive the investment-banking franchise of the bank issuing the research reports will be.

Conventional wisdom posits that the cross-purposes served by research reports give rise to a classic conflict of interest.[177] However, scrutiny reveals that the dual purposes of the research reports arguably work in tandem to compel optimal levels of disclosure and accuracy. For what distinguishes a research report from mere marketing material is its aura of objectivity and the quality of data contained therein (especially the underlying factual data). The only divergence created by the different purposes of research reporting is that whereas investor clients want objective, honest research reports, investment-banking clients care more about the *perception* of objective, honest research reports (coupled with their more pressing desire for *positive* research coverage). Since, presumably, the best way of developing and maintaining such a perception is to actually publish objective, honest research reports, banks have an incentive to act accordingly for the benefit of each identified category of clients. To the extent that an analyst is caught behaving dishonestly, his or her personal integrity would be tarnished, along with (possibly) the integrity of the bank for which he or she works. The result would be a decline in the market value of the bank's research reports to both investor and investment-banking clients. In short, as "[r]eputation remains the lifeblood for [the financial industry] firm, often overwhelming other incentives,"[178] it appears as though the market should sufficiently check egregious analyst misbehavior.

And to the extent that analysts spin or skew their reports in order to satisfy their banking clients, it could be argued that the cost of this dishonesty is more than offset by the tremendous market benefits provided by the voluminous accurate financial and statistical data that research analysts unearth and include in their reports.[179] Moreover, research suggests that market participants are largely aware of this lack of complete candor on the part of sell-side research analysts, as reports issued by bank-affiliated analysts are valued less by individual investors than reports issued by

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[177] *See* Fisch & Sale, *supra* note 10, at 1047.

[178] *See* Palmiter, *supra* note 78, at 112.

[179] Perhaps such spin or skew could be analogized to the commercials that one must endure in order to enjoy the desired content contained in free radio broadcasts.

independent research firms.[180] This is despite the fact that, as research also suggests, analyst reports issued by banking-affiliated analysts are of higher quality than reports issued by independent research firms.[181] Additionally, through the use of brokers, investors should be able to avoid investing on the basis of unsupportable recommendations and instead invest upon quality factual data. Thus, it could be argued that the conflicts of interest commonly alleged are largely illusory and, in any event, result in negligible harm to the market.

However, notwithstanding the market incentives in favor of honest research reporting, and notwithstanding the ability of investors (and brokers) to discount for the possibility of bias, the fact remains that certain analysts have published persuasively dishonest research reports, and apparently certain individual investors, perhaps unaware of the conflicts of interest on the part of the researcher whose report they are reading, claim to have placed unwarranted (in retrospect) levels of reliance on these reports. Additionally, some scholars have argued that false opinions and recommendations are not properly discounted by the market, but rather do harm to the accuracy of stock pricing (and therefore undermine market efficiency).[182]

But simply with regard to the issue of misled investors: can such investors be sacrificed even if this redounds to the greater good of the securities market as a whole (that is, even if the optimal level of disclosure and honesty can be established by the market)? Perhaps here the potential advice of the economist and the mandates of the securities laws most clearly diverge. For it was Congress's explicit desire to displace the "laissez-faire" model that predated the 1933/1934 Securities Acts with one that mandated fixed disclosure and required certain minimum levels of investor protection.[183] A laissez-faire approach, therefore, fails to honor either concern. Thus, even if such an approach may indeed maximize wealth (itself a goal of the securities laws), it does so at the expense of other, more pressing goals (primarily, investor protection), and is in contravention of the fundamental values (such as honesty and fairness) inherent in the securities laws.

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[180] *See* Moses, *supra* note 18, at 90-91.

[181] *See* Jacob et al., *supra* note 11, at 32.

[182] *See* Fisch & Sale, *supra* note 10, at 1086.

[183] *See supra* text accompanying note 156.

b. Antifraud Rule Approach

One alternative to a laissez-faire approach would be the imposition of an antifraud rule applicable to fraudulently issued analyst opinions.[184] Whether via the imposition of civil, regulatory, or criminal liability, the rule would simply punish (in one way or another) a research analyst who sets forth opinions and/or recommendations that he or she does not actually believe. Because of their functional equivalency, certification requirements, such as Regulation AC, are included in this category,[185] along with Professors Fisch and Sale's suggestion that a "duty of reliability" for research analysts be recognized.[186] The rule could also force research analysts to disclose their conflicts of interest, out of fear that neglecting to do so could constitute a fraudulent omission.[187]

An antifraud rule could reasonably be expected to reduce the issuance of false opinions on the part of analysts, as, in economic terms, it increases the cost of issuing such opinions via the threat of punishment and/or liability for such opinions.[188] But, as indicated earlier, market forces alone should also serve to reduce, to an extent, the issuance of false opinions.[189] Thus, the marginal benefit of an antifraud rule, with regard to its role in reducing the issuance of false opinions, appears likely to be small.

A more substantial benefit, perhaps, flowing from an antifraud rule would be the enhanced credibility (and thus increased value) it would arguably bestow upon analyst opinions. For in the presence of an antifraud rule applicable to analyst opinions, investors would be able to rely more heavily upon such opinions, thereby increasing the value of these opinions.[190]

Weighed against the potential benefits of an antifraud rule applicable to analysts are its significant costs: the

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[184] *See, e.g.*, Goshen & Parchomovsky, *supra* note 163, at 27-29.

[185] *See supra* Part II.B.1.

[186] *See* Fisch & Sale, *supra* note 10, at 1081-88 (recommending liability for research analysts whose reports contain recommendations "that would not have been issued by a reasonable person").

[187] *See supra* Part II.A.1. For a discussion of the costs and benefits of compelling such disclosure, see *infra* Part III.B.2.c.

[188] *See, e.g.*, Goshen & Parchomovsky, *supra* note 163, at 27-29.

[189] *See supra* Part III.B.2.a.

[190] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-80 (1984) (discussing economic effect of antifraud rules).

potential chilling effect on the issuance of research reports that such a rule would likely have.[191] Exposure to potential liability for fraudulent opinions (or material omissions) in research reports can be expected to decrease the issuance of such reports, by both banks responsible for the issuance of reports that contain exaggerated or otherwise dishonest statements of opinion and by banks responsible for the issuance of reports that are completely genuine. With regard to the latter, an inevitable fear will develop on the part of banks that statements of opinion in research reports, even if entirely honest and truthful, may nevertheless subject the bank to litigation if time were to demonstrate that the opinion was ill-founded or mistaken. Regardless of the likely failure of such litigation (as we are assuming here that the opinions in question were genuine and published in good faith), the mere commencement of even an unsuccessful litigation can be expensive and time consuming, and this risk of litigation becomes a cost associated with the promulgation of research reports.[192] Of course, this is a cost that accompanies practically any antifraud rule and not one unique to its application within this context. However, given the precarious economics of the research analyst business model, under which the full value of research reports to the marketplace arguably exceeds the revenues they are able to generate for their sponsoring firms, the additional costs imposed by an antifraud rule could tip the balance against their continued sponsorship to the detriment of the market as a whole.[193]

With regard to research reports that contain disingenuous statements of opinion, an antifraud rule will, of course, deter the publication of these as well. And although that is instinctively viewed as a good thing, additional scrutiny will reveal that even this effect is not without certain potential negative consequences. As has been discussed previously, banks have traditionally issued research reports with two key

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191 *See Joint Statement*, *supra* note 91, at 52-53 (expressing concern over the "muzzling effect of abusive securities litigation").

192 *See* S. Rep. No. 104-98, at 4 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 683 (Senate Report accompanying passage of PSLRA addressing problem of "frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation": "These suits, which unnecessarily increase the cost of raising capital and chill corporate disclosure, are often based on nothing more than a company's announcement of bad news, not evidence of fraud.").

193 *Cf.* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 274-76 (2003).

audiences in mind: their investor clients and their investment banking clients.[194] Since these reports are ordinarily provided free of charge, the costs of their production are indirectly covered by the revenues they assist in generating from each of these client groups.[195] As precluding exaggeration, hyperbole, and other disingenuous statements of opinion diminishes the value of these reports to the bank's investment banking clients, banks may be less inclined to issue these reports,[196] thereby reducing the dissemination of the otherwise valuable accompanying factual information regarding the covered company. In short, it might be better in general for the market to have more reports circulating (including tainted reports that contain an admixture of accurate factual data alongside disingenuous opinions and recommendations) versus a smaller number of completely trustworthy (or more trustworthy) reports.[197]

These concerns suggest that, from an economics perspective, efforts to curb research analyst dishonesty resist resorting to antifraud rules.[198] But the absence of an antifraud rule directed against dishonest analysts seems incongruous with the philosophy of federal securities regulation on at least two grounds. First, given the importance of honesty, fairness, and trustworthiness to the drafters of the U.S. Securities Acts, the absence of any rule prohibiting fraudulent misconduct on the part of analysts, so as to allow a modicum of dishonesty in research reporting, would appear to be a glaring inconsistency. Second, reliance on market mechanisms to minimize fraudulent analyst misconduct, although well-founded, nevertheless appears insufficient; although market mechanisms would most likely serve to protect most investors, knowledge of the fact that an antifraud rule would serve to further reduce fraudulent misconduct, and serve to protect all (or at least more) investors[199] from such misconduct, makes it

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194 *See supra* Part III.B.2.a.

195 *See* Choi & Fisch, *supra* note 193, at 274-76 (2003).

196 Unless, perhaps, their enhanced value to their investor clients, as a result of the antifraud rule, outweighs this diminishment in value to the investment banking clients. *See* Goshen & Parchomovsky, *supra* note 163, at 28-29.

197 *But see* Fisch & Sale, *supra* note 10, at 1086 (arguing that analyst reports that contain misstatements of opinions distort stock prices (rather than enhance market efficiency)).

198 *But see* Palmiter, *supra* note 78, at 135.

199 Either prospectively, via the reduction of fraud, or retrospectively, via the provision of clear and certain remedies to victims of fraud.

difficult to square the absence of such a rule with the strong (if not overriding) concerns over investor protection that characterize the U.S. regime of securities regulation.

c. *Mandatory Disclosure*

Another approach to the problem of analyst conflicts is to mandate the disclosure of conflicts of interest.[200] In the absence of an antifraud rule extending to analysts' opinions, mandatory disclosure could approximate a regime in which the bespeaks caution doctrine and/or the safe harbor of the PSLRA foreclosed liability for those analysts who issued false or misleading opinions, but who also fully (and truthfully) disclosed their conflicts of interest.[201] Coupled with an antifraud rule, mandatory disclosure is likely to have little marginal effect if, as expected, the antifraud rule would serve to compel disclosure of conflicts of interest out of a fear that nondisclosure of such conflicts would be actionable.[202] However, if, as suggested, the nondisclosure of an analyst's conflicts of interest might not actually be properly considered an omission which makes the other statements contained in the research report misleading,[203] then a disclosure rule would close this loophole and clearly expose to liability those analysts who did not disclose their conflicts (similar to the effects of Regulation AC and NASD Rule 2711).[204]

Although mandatory disclosure has been widely criticized from an economics perspective as generating inefficiencies,[205] some have justified mandatory disclosure from an economics perspective as a means of reducing wasteful "agency costs"[206] and duplicative research efforts on the part of

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200 *See* Gross, *supra* note 32, at 661-62.

201 *See supra* Part IIA.2.

202 *See supra* Part III.B.2.b.

203 *See supra* text accompanying notes 73-76.

204 *See supra* Part II.B.

205 *See supra* Part III.A.1

206 *See* Fisch & Sale, *supra* note 10, at 1039. Agency costs are those costs associated with, among other things, monitoring and verifying the behavior of those individuals who are purportedly acting on one's behalf. These costs are not otherwise productive, and the benefit of their reduction via a rule of mandatory disclosure would rebound to the market as a whole. *See id.*; *see generally* Eric A. Posner, *Agency Models in Law and Economics* (U Chi. Law Sch. John M. Olin Law & Econ. Working Paper No. 92, 2000), *available at* http://papers.ssrn.com/paper.ta?abstrat_id=204872.

investors.[207] And unlike mandatory disclosure in the context of a stock issuer's financial reporting (which is the focus of most economic-based criticism concerning mandatory disclosure rules), the cost of disclosing the existence of possible conflicts of interest on the part of a research analyst would be relatively small. A rule requiring mandatory disclosure of analyst conflicts would reduce the need for investors to do their own investigation regarding such conflicts before relying upon research reports.[208] The greater and more specific the mandatory disclosure, the less work an individual investor would have to do (and the less agency costs he or she would have to bear) to uncover the same information. And because the disclosure contained in one report could, arguably, reduce agency costs for thousands of individual investors, the argument in favor of such mandatory disclosure is compelling: the costs of its inclusion in the report would appear to be outweighed by the benefits bestowed upon the investing public.[209]

As previously discussed,[210] a regime of mandatory disclosure is precisely the means selected by Congress to regulate the securities industry. Therefore, requiring analysts to disclose their conflicts of interest would be a solution that apparently passes muster under the philosophy of U.S. securities regulation and, as has been seen, can be justified from an economics perspective.

d. Structural Approach

A fourth approach suggested by some is structural: to attack the analyst's conflict of interest directly by forcing structural changes to the securities industry that minimize the factors giving rise to the conflict.[211] This is the approach embodied in NASD's Rule 2711.[212]

Obviously, the structural approach proceeds under the assumption that by eliminating conflicts of interest, research analysts will be made more independent and the quality of

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[207] *See* Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85, 89 (2006).

[208] *See* Posner, *supra* note 206, at 1.

[209] *See* Goshen & Parchomovsky, *supra* note 163, at 24-27.

[210] *See supra* Part III.B.1.

[211] *See, e.g.*, Sullivan, *supra* note 16, at 433.

[212] *See supra* Part II.B.2.

opinions and recommendations contained in their research reports will improve. Although this assumption may be intuitive, at least one study suggests that analysts at independent research firms make earnings forecasts that are inferior to those of analysts associated with investment banks.[213] This may be because bank-affiliated researchers have more resources at their disposal[214]—resources generated, in part, by the bank's calibration of their research reports to optimize value among both their investor clients and investment banking clients.[215] And by inefficiently decreasing the value that a bank can obtain for its banking clients by removing (or reducing) investment banking considerations from the production of research reports, a structural approach may share the same basic deficiency of the antifraud rule approach: it decreases the value of analyst reporting to banks, which in turn will diminish the sponsorship of reporting on the part of banks, ultimately decreasing the flow of valuable information to the market.[216] Thus, as with an antifraud rule, a structural remedy would most likely be disfavored under a law and economics approach. This is because other solutions (namely, either a market solution or a rule mandating disclosure of conflicts) appear to offer similar benefits, while imposing lower potential costs on the securities markets.

Reliance on a structural remedy to the problem of analyst conflicts is neither compelled, nor precluded, by the philosophy of U.S. securities regulation. As Congress opted largely for disclosure and antifraud rules in promulgating a scheme of securities regulation, it cannot be said that failure to promote a structural solution is at odds with the U.S. regulatory approach. On the other hand, the Glass-Steagal Act (the Banking Act of 1933), which precluded commercial banks from engaging in investment banking and brokerage activities, provides clear precedent for a structural remedy were such a remedy deemed advisable.[217]

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213 *See* Jacob et al., *supra* note 11, at 32; *see also* Choi & Fisch, *supra* note 193, at 274-76, 285.

214 *See* Jacob et al., *supra* note 11, at 32.

215 *See supra* Part III.B.2.a.

216 *See* Choi & Fisch, *supra* note 193, at 274 ("Eliminating intermediary conflicts is a flawed solution . . . . Someone has to pay for intermediary services, and eliminating conflicts may block an important source of financing.").

217 Banking Act of 1933, ch. 89, 48 Stat. 162 (1933).

3. Summary of the Law and Economics Approach

A law and economics approach could be expected to embrace a laissez-faire approach to analyst fraud, which would equate to a regime under which Rule 10b-5 liability would not be applicable to research analyst misstatements of opinion, and under which Regulation AC and Rule 2711 would not be present. That said, a rule of mandatory disclosure, under which analysts would be obliged to disclose their conflicts of interest, could be justified under law and economics grounds, given the benefits of such disclosure in comparison to its costs. A general antifraud rule applicable to analyst opinions and recommendations would be disfavored due to its chilling effect on analyst speech (both generally and, arguably, even with regard to the skewed opinions that help make the preparation and promulgation of research reports beneficial to the banks that issue them), and a structural remedy would most likely be rejected as violating the presumptively most efficient way (that is, the market-derived way) of generating research reports.

C. *Natural Law Analysis*

As previously acknowledged, the securities laws invite an economically oriented review by virtue of the important role they play in regulating the U.S. economy.[218] There are, however, numerous other sources of reasoning or norms[219] to which one may turn for assistance in the interpretation and formulation of securities law.[220] Of these, "natural law" is particularly appropriate and helpful. Although a comprehensive articulation and defense of natural law theory[221]

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[218] *See supra* Part III.B.

[219] *See* Posner, *supra* note 2, at 166-67. *See generally* Robert H. Nelson, *Economic Religion Versus Christian Values*, 1 J. MARKETS & MORALITY 142, 154 (1998) ("Economics offers a worldview of its own . . . . Economics is thus part of an overall value system, really a theology of a secular sort.").

[220] *See, e.g.*, Basant K. Kapur, *Harmonization Between Communitarian Ethics and Market Economics*, 2 J. MARKETS & MORALITY, (1999) 35, 38-39, 50 nn.18-22 (identifying Biblical, Islamic, Hindu, Buddhist, and Confucian sources of ethics).

[221] At this point, a distinction should be noted between "natural law" on the one hand and natural law theories, perspectives, reasoning, and thinking on the other. It is one thing to assert (or assume) that natural law exists, it is quite another to assert (or assume) that certain principles, values, or norms are part of, or derived from, the natural law. This Article assumes that natural law exists, and shall draw upon the thinking of those who have articulated the traditional understanding of what the content and implications of the natural law are believed to be. Thus, properly speaking, this final part of this Article discusses and applies natural law *theory* and natural law

is beyond the scope of this Article, a brief overview of natural law theory, along with a more thorough presentation of those components of natural law thinking most applicable is in order and shall be provided.[222] As shall be seen, a natural law approach to the problem of analyst conflicts differs significantly from a law and economics approach, in terms of both the ends pursued and the means employed. With regard to ends, although a natural law approach does not dismiss the important objectives of wealth maximization and efficiency,[223] natural law does not view wealth maximization as the ultimate (or only) societal goal. With regard to means employed, although a natural law approach does not dispute the force of self-interest, it recognizes other motivating factors upon human behavior and, as such, considers a wider range of possible mechanisms for influencing behavior. Taken together, the natural law approach provides a broader set of factors to consider in analyzing problems and proffering solutions. Moreover, as the values and objectives of a natural law approach are more congruent with the full set of values and objectives that originally animated the securities laws, so too are the solutions and approaches derived and endorsed via a natural law perspective.

1. Why Natural Law?

Before delving into a substantive overview of natural law theory, first consider the appropriateness of applying natural law thinking to a securities law analysis. There are at least five reasons for reviewing the problem of analyst conflicts in particular, and issues of securities law in general, via a natural law approach:

First, it is not unfair for proponents of law and economics to demand a sparring partner whose arguments are predicated upon reason and objectivity rather than feelings, opinion, and subjectivity.[224] Given the intellectual rigor and

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thinking, and does not purport to discuss or apply natural law *per se*. *See* JOHN FINNIS, NATURAL LAW AND NATURAL RIGHTS 25 (1980).

222 For an overview of natural law methods of analysis, see generally Randy E. Barnett, *A Law Professor's Guide to Natural Law and Natural Rights*, 20 HARV. J.L. & PUB. POL'Y 655 (1997). For a lengthier (but not too lengthy) defense of a natural law approach to 21st century legal problems (albeit in the context of Contract law), see HENRY MATHER, CONTRACT LAW AND MORALITY 173-78 (1999).

223 Indeed, the efficient allocation and utilization of resources, *ceteris paribus*, is promoted by natural law proponents. *See, e.g.*, FINNIS, *supra* note 221, at 111-12.

224 *See, e.g.*, Posner, *supra* note 2, at 166-73.

rationality of natural law theory, and given the fact that for centuries it has been subject to scrutiny, evaluation, and re-evaluation by some of the greatest minds the world has ever produced, no person of good will who professes a loyalty to reason can deny that natural law philosophy meets this standard.[225]

Second, natural law reasoning has been a force in American political philosophy and jurisprudence since the inception of the United States to the present,[226] and this alone suggests its appropriateness as a reference to assist in the understanding and resolution of American legal controversies. As Professor Kmiec has explained, "the American democracy is . . . rooted in the natural law."[227]

Third, although admittedly controversial in its application to certain other fields of law,[228] natural law thinking is not often applied to economic-related fields of law such as securities regulation, nor, moreover, can natural law readily be categorized as "conservative" or "liberal," "progressive," or "reactionary" with regard to its application in such an area. Thus, application of natural law to the problem of analyst conflicts offers a perspective that is challengingly unfamiliar to many (if not most) in the field of securities law and, perhaps, less likely to be viewed askance or otherwise discounted as a vehicle for a particular political agenda.

Fourth, as one proponent of natural law reasoning has explained, the use of natural law philosophy in legal analysis is a refreshingly ambitious alternative to those more "realistic" approaches to legal analysis employed in our "age of prosaic undertakings."[229] Put differently, a natural law approach, as opposed to a law and economics approach and some other modern theories of jurisprudence, allows us to once again focus the law explicitly on normative ends.

Fifth, and perhaps most compelling, natural law thinking meshes extraordinarily well with the seminal values that produced the securities laws.[230] For the virtues identified

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[225] *See infra* note 234 and accompanying text.

[226] *See* RUSSELL KIRK, THE ROOTS OF AMERICAN ORDER 402-12 (3d ed. 1991). *See generally* Douglas W. Kmiec, *Natural-Law Originalism—Or Why Justice Scalia (Almost) Gets It Right*, 20 HARV. J.L. & PUB. POL'Y 627 (1997) (discussing the natural law underpinnings of the U.S. Constitution).

[227] *See* Kmiec, *supra* note 226, at 636.

[228] *See, e.g.*, RICE, *supra* note 139, at 25.

[229] *See* A.P. D'ENTRÈVES, NATURAL LAW 93-94 (2d ed. 1970).

[230] *See supra* Part III.A.

by Congress as necessary to the ends of the securities laws (namely, moderation, honesty, and trustworthiness[231]), and the Second Circuit's summary of the securities laws as ordered to "fairness,"[232] echo principles of natural law (even if not consciously based upon such principles). And, whereas there are multiple methods of achieving the ends of the securities laws, the means chosen should be consonant with the values inherent in these laws. Since natural law philosophy shares the values previously identified as central to the securities laws, under a natural law approach, one shall be spared the predicament of a solution that furthers one of the ends of the securities laws while simultaneously undermining the laws' other ends, values, or philosophical underpinnings.

2. Natural Law Generally

a. Natural Law Defined

There are multiple competing theories of natural law.[233] Fortunately, much of what follows is shared by most (if not all) of these theories. Where divergences do occur, I have adopted what is commonly characterized as the "virtue ethics" school of natural law, which was originally developed by Aristotle and the ancient Greeks, and most thoroughly expounded upon and augmented by St. Thomas Aquinas.[234]

At the core of natural law philosophy is the notion that reason can lead us to grasp certain fundamental truths about ourselves as human beings and, consequently, about society as well.[235] Armed with the knowledge of these truths, further reasoning should enable us to derive rules and principles of conduct best suited to our human nature—that is, rules and principles of conduct that will promote individual virtue (or

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[231] *See supra* note 151 and accompanying text.

[232] SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968).

[233] *See generally* Brian Bix, *Natural Law Theory: The Modern Tradition*, *in* JURISPRUDENCE AND PHILOSOPHY OF LAW 61-103 (Jules Coleman & Scott Shapiro eds., 2002) (providing an overview of the various theories of natural law).

[234] For a short summary of virtue ethics, see *Virtue Ethics*, *in* STANFORD ENCYCLOPEDIA OF PHILOSOPHY (2007), *available at* http://plato.stanford.edu/entries/ethics-virtue/. For a more thorough treatment of the subject, see generally ALASDAIR MACINTYRE, A SHORT HISTORY OF ETHICS (2d ed. 1998); RAYMOND J. DEVETTERE, INTRODUCTION TO VIRTUE ETHICS (2002).

[235] *See* FINNIS, *supra* note 221, at 23-24.

morality) and societal justice.[236] And by complying with these rules and principles (and only by complying with these rules and principles), human beings are capable of achieving "eudaimonia"—true human flourishing.[237]

Natural law's pedigree is long and illustrious; its various permutations can trace their roots back to ancient Greece, and its influence continues to be felt over the most important issues of our present day:

> [Natural law is] a philosophical theory stretching back to Socrates, Plato and Aristotle, propounded by the Stoics, developed anew by medieval churchmen like Aquinas, elaborated in secular terms by Protestant jurists like Grotius and Pufendorf, reshaped[238] to justify "natural rights" by Locke, Montesquieu, Jefferson and Adams, and invoked in the cause of racial equality by Abraham Lincoln, the Rev. Martin Luther King Jr. and . . . Thurgood Marshall.[239]

Finally, it should be noted that, although perhaps most often associated with Aquinas (who set forth the most complete, systematic exposition of natural law in the *Summa Theologica*[240]), natural law philosophy need not be predicated upon, and is not dependent upon, any particular religion or theology,[241] as even natural law's critics have come to observe.[242]

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[236] *See* D'ENTRÈVES, *supra* note 229, at 92-93, 110-11; *see also* FINNIS, *supra* note 221, at 23-24.

[237] *See* Stephen M. Feldman, *Republican Revival/Interpretive Turn*, 1992 WIS. L. REV. 679, 689.

[238] Arguably, "reshaped" is a euphemism here; perhaps a better term would be "radically transformed." *See, e.g.*, JACQUES MARITAIN, NATURAL LAW AND NATURAL RIGHTS 59 (Doris C. Anson trans., 1943) (commenting that eighteenth-century natural law theory "more or less deformed" classical natural law theory). Nevertheless, the key point remains: the concept of a natural law, in its various permutations, has served as a wellspring of Western thought and inspiration.

[239] Peter Steinfels, *Beliefs*, N.Y. TIMES, Aug. 17, 1991, at 9; *see also* Bix, *supra* note 233, at 61-63.

[240] *See* Bix, *supra* note 233, at 61-62; *see also* Michael P. Zuckert, *Do Natural Rights Derive From Natural Law?*, 20 HARV. J.L. & PUB. POL'Y 695, 704 (1997) ("There were, to be sure, natural-law doctrines prior to Thomas Aquinas, but none so elaborate, so detailed, or so philosophically successful.").

[241] *See* A.P. D'ENTRÈVES, *supra* note 229, at 53 (noting Grotius's "famous dictum that natural law would retain its validity even if God did not exist").

[242] *See* H.L.A. HART, THE CONCEPT OF LAW 187 (2d ed. 1994) ("Natural Law has, however, not always been associated with belief in a Divine Governor or Lawgiver of the universe, and even where it has been, its characteristic tenets have not been logically dependent on that belief.").

b. Virtue and Eudaimonia

As stated, from a natural law perspective, the ultimate goal (or end) of human existence is "eudaimonia"—a term used by Aristotle to denote true human flourishing (sometimes translated more simply as "happiness").[243] This immediately presents a contrast with the focus of law and economics, which does not recognize a unique end of human existence, but rather strives toward whatever ends an individual (or collection of individuals) chooses to pursue.[244] Although both economics and natural law assume that individuals pursue "the good," each defines "the good" quite differently. Under natural law philosophy, the good is an objective truth knowable by reason that is independent of an individual's personal preferences; under economic theory, only preferences are knowable, and the good is defined as that which satisfies an individual's preferences. Thus, the good has no meaning in economics without reference to preferences, whereas to natural law theorists what an individual prefers is not the same as what is truly good for him or her. So, although under natural law thinking, one can state that a particular individual prefers a particular thing that is not truly good for him or her, under economic thinking such a statement would be paradoxical.[245]

Regarding the concept of efficiency, although a natural law approach would generally eschew wastefulness and share in the economist's desire to promote efficiency and maximize wealth,[246] natural law theory does not elevate efficiency and wealth maximization to the status that law and economics elevates them; rather, natural law theory subordinates the concerns of efficiency and wealth maximization to the

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243 Mark A. Sargent, *Utility, The Good, And Civic Happiness: A Catholic Critique of Law and Economics* 19 (Villanova University School of Law, Public Law and Legal Theory, Working Paper No. 2005-6, 2005), *available at* http://ssrn.com/abstract=700684.

244 *See supra* text accompanying notes 162-164. Or, as some have suggested, law and economics generally views wealth (or utility) maximization as the end to which all human undertakings are (or should be understood to be) directed. *E.g.*, Herbert Hovenkamp, *Positivism in Law and Economics*, 78 CAL. L. REV. 815, 825-30 (1990).

245 *See* MacIntyre, *supra* note 3, at 140-41 ("An Aristotelian theory of the virtues does therefore presuppose a crucial distinction between what any particular individual at any particular time takes to be good for him and what is really good for him as a man." Professor Joseph Burke suggests that in economic parlance the natural law approach essentially separates an individual's preferences from that individual's welfare.

246 *See supra* note 223.

furtherance of objective happiness (eudaimonia).[247] Similarly, under natural law thinking, happiness and true human flourishing "does not consist in amusement" (or material goods),[248] but rather in living a life in accord with virtue.[249]

To better understand why a virtuous life leads to true human flourishing (versus the satisfaction of subjective preferences or the maximization of wealth or utility), it helps if one is aware of the definition of virtue in the natural law tradition: the habit of doing "good."[250] "Good," in turn, refers to that which is "to be done and aspired after" because of its consistency with human nature (and, consequently, its tendency to further humans toward their natural ends):[251]

> [G]ood is the first thing that falls under the apprehension of the practical reason, which is directed to action: since every agent acts for an end under the aspect of good. Consequently the first principle in the practical reason is one founded on the notions of good, viz., that good is that which all things seek after. Hence this is the first precept of law, that good is to be done and pursued, and evil is to be avoided. All other precepts of the natural law are based upon this: so that whatever the practical reason naturally apprehends as man's good (or evil) belongs to the precepts of the natural law as something to be done or avoided.[252]

As alluded to previously, the ends of human existence under natural law thinking (and unlike law and economics) "are not arbitrary but rather determined by the dispositional

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247 *See* Sargent, *supra* note 243, at 19; *see also* Luigino Bruni, *The "Technology of Happiness" and the Tradition of Economic Science*, 26 J. HIST. ECON. THOUGHT 19, 27 n.13 (2004).

248 ARISTOTLE, NICOMACHEAN ETHICS 194 (Roger Crisp trans. & ed., Cambridge Univ. Press 2000) [hereinafter NICOMACHEAN ETHICS].

249 *See id.*; *see also* Bruni, *supra* note 247, at 26-29, 40; Sargent, *supra* note 243, at 19. It should be noted, however, that there is nothing necessarily inconsistent between the goal of natural law (eudaimonia) and the goals of wealth creation (or, moreover, the economic goals of securities regulation); a society in which investors are protected, confidence in the markets is maintained, and national savings, capital formation, and investment grow, is arguably establishing, at a minimum, the preconditions of true human flourishing. *See* John E. Coons & Patrick E. Brennan, *Nature and Human Equality*, 40 AM. J. JURIS. 287, 304 (1995) (noting the role of material goods in the achievement of human happiness); ALEJANDRO A. CHAFUEN, FAITH AND LIBERTY 7 (2003) ("One of the commonplaces in Aristotle is that most men need a certain amount of material goods in order to practice virtue."); ARISTOTLE, POLITICS [1253b] 31 (reprint of 1905 Benjamin Jowett tr., Dover 2000) ("for no man can live well, or indeed live at all, unless he be provided with necessaries").

250 THOMAS AQUINAS, SUMMA THEOLOGIAE, I-II, Q. 55, Art. 1.

251 *Id.* Q. 94, Art. 2.

252 *Id.*

properties which make up a human nature."[253] Via the application of "right reason," individuals can distinguish between those acts that are good (i.e., in conformity with human nature and therefore lead toward true happiness) versus those acts that are evil (i.e., not in conformity with human nature and therefore lead away from true happiness).[254]

In sum, therefore, natural law reasoning posits that:

> (1) human beings are naturally oriented toward an end (eudaimonia),
>
> (2) action taken in furtherance of this end is objectively good (and action taken in contradiction to this end is objectively evil);
>
> (3) via the use of reason, individuals can come to recognize that which is good from that which is evil;
>
> (4) the habit of choosing good (and avoiding evil) is called virtue (and its opposite called vice); and
>
> (5) living a virtuous life is living a life in accord with human nature; thus, the more virtuous an individual is, the more fully human that individual is, and the more he or she maximizes his or her human potential (and, consequently, his or her true happiness).[255]

c. *Social Virtues and Truth*

Particularly relevant to this Article is the natural law observation that "man by his nature is a social animal."[256] From this flows the understanding that many virtues are "social virtues" (since "it is by reason of them that man behaves himself well in human affairs").[257] As such, it is virtuous for human beings to act "in the service of the common weal," and "to do well not only towards the community, but also towards the parts of the community, viz., towards the household, or even towards one individual."[258] It is not surprising, therefore,

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[253] ANTHONY J. LISSKA, AQUINAS'S THEORY OF NATURAL LAW 108 (Clarendon Press 1996).

[254] *Id.* at 108-09. Although the application of right reason to particular situations is not always readily apparent, natural law theorists posit that certain broad generalizations can nevertheless be made. *See* D.Q. MCINERNY, A COURSE IN THOMISTIC ETHICS 242, 256 (1997). Thus, at a very high level, Aquinas identifies eternal happiness, self-preservation, procreation, community, and education as human "goods," the pursuit of which "man has a natural inclination" and are "naturally apprehended by reason as being good, and consequently as objects of pursuit." AQUINAS, *supra* note 250, Q. 94, Art. 2; s*ee also* RICE, *supra* note 139, at 52.

[255] *See* NICOMACHEAN ETHICS, *supra* note 248, at 16.

[256] AQUINAS, *supra* note 250, Q. 61, Art. 5.

[257] *Id.*

[258] *Id.*

to count among the virtues articulated within the natural law tradition exactly those same features that Congress highlighted as essential to properly ordered securities markets: moderation, honesty, trustworthiness, and/or fairness.[259] Additionally, the sina qua non of a securities market that is characterized by moderation, honesty, trustworthiness, and/or fairness is *truth*. With regard to truth, the Aristotelian natural law tradition condemns, as a perversion of communication that undermines the fabric of society, all forms of prevarication.[260] This condemnation results from a consideration of the purpose of communication and its role in society, along with an estimation of the consequences to a society that suffers from a lack of truthfulness.[261] Thus, it can safely be concluded that

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[259] *See* C.S. LEWIS, ABOLITION OF MAN 51-61 (MacMillan 1947) (setting forth "illustrations of the Natural Law" that include admonitions concerning general beneficence, honesty, good faith and veracity, and justice). Because, as explained, right reason enables human beings to comprehend conduct proper to their end, it comes not as a surprise to the natural law theorist that so many peoples, across continents and centuries, have come to recognize these (and other) virtues as such. *See id*; Linda M. Sama & Victoria Shoaf, *Reconciling Rules and Principles: An Ethics-Based Approach to Corporate Governance*, 58 J. BUS. ETHICS 177, 183 (2005) (identifying truth, honesty, and fairness as "global hypernorms"); George Bragues, The Ancients Against the Moderns: Focusing on the Character of Corporate Leaders 27 tbl.1 (2006) (Paper Presented at the IESE Bus. School, Univ. of Navarra, 14th Int'l Symposium on Ethics, Business and Society, May 18-19, 2006) (setting forth Benjamin Franklin's recognition of moderation, sincerity, resolution, and justice, among others, as virtues).

[260] *See Lying*, *in* IX THE CATHOLIC ENCYCLOPEDIA 469-70 (1910), *available at* http://www.newadvent.org/cathen/09469a.htm ("Aristotle, in his *Ethics*, seems to hold that it is never allowable to tell a lie, while Plato, in his *Republic*, is more accommodating; he allows doctors and statesmen to lie occasionally for the good of their patients and for the common weal. Modern philosophers are divided in the same way. Kant allowed a lie under no circumstance.").

[261] Natural law theory is not alone in condemning deceit, which can also be condemned from perspectives of consequentialist and Kantian moral reasoning as well:

> Truth consists in a correspondence between the thing signified and the signification of it. Man has the power as a reasonable and social being of manifesting his thoughts to his fellow-men. Right order demands that in doing this he should be truthful. If the external manifestation is at variance with the inward thought, the result is a want of right order, a monstrosity in nature, a machine which is out of gear, whose parts do not work together harmoniously.
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> . . . .
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> The absolute malice of lying is also shown from the evil consequences which it has for society. These are evident enough in lies which injuriously affect the rights and reputations of others. But mutual confidence, intercourse, and friendship, which are of such great importance for society, suffer much even from officious and jocose lying. In this, as in other moral questions, in order to see clearly the moral quality of an action we must consider what the effect would be if the action in question were regarded as perfectly right and were commonly practiced. Applying this test, we can see what mistrust, suspicion,

natural law theorists would find research analysts who prevaricate or otherwise mislead the investing public in breach of the natural law.

d. Positive Law and the Common Good

It should not be concluded that the natural law's imprecation of deceit demands an absolute prohibition on all false statements or opinions contained in research reports, regardless of the quantity and quality of accompanying disclosures. This leap—from natural law's condemnation of prevarication to legal prohibition of prevarication—fails to recognize the important distinction between the natural law *per se* and positive (human) law within natural law theory.[262] Indeed, the proper role and scope of positive law under natural law theory is limited.[263]

As expounded by Aquinas, human law exists not to prohibit every vice or wrongful act, but rather for the more modest purpose of promoting the "common good."[264] As with an individual, the "common good" does not consist merely of wealth or utility maximization, but rather, as Antonio Genovesi put it, a society that exhibits "pubblica felicita" (genuine public happiness).[265] Given the interplay between virtue and happiness, the common good could also be thought of as "the creation of an economy and society that is more virtuous rather than less."[266] Again, the critical role that virtue plays here stems from the communitarian understanding of the individual in the natural law tradition: "No [person] is an island, sufficient unto himself . . . . All of the key social units

> and utter want of confidence in others would be the result of promiscuous lying, even in those cases where positive injury is not inflicted.

Id.

262 *See* Barnett, *supra* note 222, at 667 ("While a natural-law analysis could be applied to a variety of questions, including the question of *how human beings ought to act* (for example, vice and virtue), the question of *how society ought to be structured* is a separate and quite distinct inquiry." (emphasis in original)).

263 *See* AQUINAS, *supra* note 250, Q. 96, Art. 1-2.

264 *See id.* Q. 96, Art. 1; *see also* D'ENTRÈVES, *supra* note 229, at 84 ("[H]uman laws cover only those aspects of human behavior which imply a co-ordination with other men.").

265 Bruni, *supra* note 247, at 26.

266 Mark A. Sargent, *Utility, the Good and Civic Happiness: A Catholic Critique of Law and Economics*, 44 J. CATH. LEGAL STUD. 35, 55 (2005).

are very closely interrelated, and the moral health of any one of them depends upon the moral health of the others."[267]

Since it is the common good that is the proper focus of the positive law, and since not every vice or wrongful act disturbs the common good to the same degree,[268] enacted law ought to focus on forbidding only the "more grievous" vices, only those wrongful acts that threaten the common good.[269] As Aquinas explained:

> Now human law is framed for a number of human beings, the majority of whom are not perfect in virtue. Therefore human laws do not forbid all vices, from which the virtuous abstain, but only the more grievous vices, from which it is possible for the majority to abstain, and chiefly those that are to the hurt of others, without the prohibition of which human society could not be maintained; thus human law prohibits murder, theft and the like.[270]

With regard to the inculcation and development of virtues, here too the role of positive law from a natural law perspective is limited. For it is understood that "[l]aws cannot make men moral."[271] However, as discussed, it is also understood that individual virtue furthers the common good, and thus "the laws have a legitimate subsidiary role to play in helping people to make themselves moral."[272] To this end, proponents of natural law have argued that

> laws forbidding certain powerfully seductive and corrupting vices . . . can help people to establish and preserve a virtuous character by (1) preventing the (further) self-corruption which follows from acting out a choice to indulge in immoral conduct; (2) preventing the bad example by which others are induced to emulate such behavior; (3) helping to preserve the moral ecology in which people make their morally self-constituting choices; and (4) educating people about moral right and wrong.[273]

It is also worth mentioning at this point the comments of the SEC's first Chairman, Joseph P. Kennedy, whose

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[267] *See* MCINERNY, *supra* note 254, at 241; *see also* FINNIS, *supra* note 221, at 165 ("Few will flourish, and no one will flourish securely, unless there is an effective collaboration of persons, and co-ordination of resources and of enterprises . . . . Such an ensemble of conditions of collaboration which enhance the well-being (or at least the opportunity of flourishing) of all members of a community is, indeed, often called the common good.").

[268] *See* ROBERT P. GEORGE, MAKING MEN MORAL 47 (1993).

[269] *See* AQUINAS, *supra* note 250, Q. 96, Art. 2.

[270] *Id.*

[271] GEORGE, *supra* note 268, at 1.

[272] *Id.*

[273] *Id.*

assessment probably still holds true today: "character exists strongly in the financial world," and that the SEC need not "compel virtue," but rather must "prevent vice."[274] The point being, the raw material of virtue is already present in the security industry's participants; law is needed primarily to protect, preserve, and foster this virtue, largely by preventing its corruption—and not to create it out of whole cloth.

Such efforts to use the law to help "people to make themselves moral" would appear particularly justified within the context of the social virtues. As touched upon previously, "[m]an is by nature a social animal, and this fact has immediate implications for the moral life":[275]

> Every man is a member of a community, and he is perfected in and through that community. And it is just here where the influence of law comes in. . . . Any community is a good community by reason of the fact that it has good laws. And a good community, St. Thomas argues, plays a vital role, especially through the medium of laws, in fostering, supporting, and sustaining the moral goodness of its individual members.[276]

A final relevant implication flowing from an acknowledgment of the force of virtue is an appreciation of the fact that economic self-interest is not the only influence upon human activity.[277] That is, a natural law theorist views virtue, and the tendency toward the good (including a tendency toward the common good), as fundamentally innate and therefore capable of motivating human conduct.[278] Thus, in seeking solutions to problems, a natural law perspective would go beyond the paradigm of motivations based solely upon self-interest and cost-benefit analysis—beyond "the economist's standard reliance on a variety of taxes, subsidies, regulatory, and other pecuniarily oriented measures."[279] The natural law theorist would explore, for example, "[t]he government's role in moral suasion, and [seek its] influence [to] mold the ethical

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[274] *See* Walsh, *supra* note 140, at 1058.

[275] MCINERNY, *supra* note 254, at 246 (quoting AQUINAS, *supra* note 250, Q. 92, Art. 1).

[276] *Id.* at 246 (quoting AQUINAS, *supra* note 250, Q. 92, Art. 1).

[277] *See* Kapur, *supra* note 220, at 9 ("[T]here is a strong normative prescription of non-purely self-interest behavior in the great religious and cultural heritage of the world."); *see also* Stephen M. Bainbridge, *Catholic Social Thought and the Corporation* 5, UCLA Sch. of Law Research Paper No. 03-20, 2003), *available at* http://ssrn.com/abstract=461100.

[278] *See* AQUINAS, *supra* note 250, Q. 63, Art. 1.

[279] *See* Kapur, *supra* note 220, at 37.

climate of the society generally."[280] He or she would consider the capabilities of business leaders to set "the moral tone" of their respective industries.[281] In short, a broader array of means would be considered under a natural law approach, not merely those means which appeal to an individual's self-interest.

Thus, in scrutinizing the problem of analyst conflicts of interest, a natural law approach will first consider whether the problem requires legislative circumscription, and, if so, whether the misconduct at issue would best be curbed by (1) simple prohibitions, and/or (2) efforts to increase the virtues and/or decrease the vices that are at the root of the misconduct.

3. Application of Natural Law

Not surprisingly, applying natural law principles to the problem of analyst conflicts yields results different from the application of law and economics. Whereas the economist views the problem as fundamentally one of inefficiency and/or market failure arising from competing interests, the natural law theorist views the problem as fundamentally a moral one: that of research analysts succumbing to temptations to prevaricate for profit.[282] (Note the confluence of this diagnosis with that of the progenitors of the Securities Acts to the securities industry problems of their day.[283]) The natural law theorist will suggest solutions that protect the common good directly, by seeking to prevent the harm threatened by analyst misconduct, and indirectly, by seeking to inculcate or strengthen the virtues necessary to prevent such misconduct from reoccurring.[284]

However, it should be noted at the outset that this difference does not necessarily indicate a trade-off of "wealth" in favor of "virtue," for the economic benefits promised by a successful natural law approach would be significant. A regime

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[280] *Id.* at 38.

[281] *Id.* at 47; *see also* Bragues, *supra* note 259, at 8.

[282] *Cf.* Michael Prowse, *Why Plastering over Capitalism's Cracks Won't Work*, FIN. TIMES (London), July 13, 2002, at 2 ("The root problem is a loss of belief in objective ethical standards."); William J. Bennett, Editorial, *Capitalism and a Moral Education*, CHI. TRIB., July 28, 2002, at C9 (identifying problems of corporate America as stemming from a mentality of "putting profits ahead of principle").

[283] *See supra* Part III.A.

[284] According to the former President and CEO of the Federal Reserve Bank of New York, corporate America's problems and scandals stem primarily from a failure to abide the fundamental commandment to "love thy neighbor." William J. McDonough, Remarks at the September 11 Commemorative Service at Trinity Church (Sept. 11, 2002), *available at* http://www.ny.frb.org/newsevents/speeches/2002/mcd020911.html.

characterized by increased virtue would "conduce considerably to the more efficient functioning of the economic system, especially when informational asymmetries are pervasive, as they invariably tend to be in modern, complex economies."[285] And, as referred to previously, President Roosevelt and Congress, in addressing the economic crisis of the Great Depression, explicitly identified moral rehabilitation of the securities industry as a necessary prerequisite to the economic restoration of the securities markets.[286] Indeed, studies have identified "the apparent decline in the ability to rely on the honesty of other people (including employees) as a factor in reduced U.S. productivity growth in the late 1970s."[287] Therefore, there are even purely economic reasons for policymakers to seriously consider the insights of natural law.

The ultimate natural law solution to the problem of research analyst conflicts of interest, therefore, even if merely aspirational, would be a regime in which regulation were unnecessary on account of the virtue of research analysts. Research analysts would continue to do their best to please their firm's investment clients, but would resist the temptation of issuing reports that contain feigned opinions and fraudulent recommendations. But of course, if men were angels, we would need neither law nor government.[288] Virtue, therefore, becomes a two-fold objective, pursued both because of its corrective function within the context of securities law and as a desideratum of natural law generally. Thus, a natural law approach would seek means to inculcate such virtue. As virtue is internal and choice-driven, it rarely (if ever) can be developed through coercion, and so an array of incentives conducive to its development would be preferable to injunctive measures.[289] To that end, broader means of encouragement and exhortation, as discussed previously, would be mobilized.[290] The hope would be that, via a sustained and coordinated appeal to the law already inscribed in the hearts of the market's

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[285] *See* Kapur, *supra* note 220, at 45-46.

[286] *See supra* note 145 and accompanying text.

[287] *See* Kapur, *supra* note 220, at 36-37.

[288] *Cf.* THE FEDERALIST NO. 51 (James Madison). *But see* ROBERT P. GEORGE, IN DEFENSE OF NATURAL LAW 107 (1999) ("[L]aw would be necessary to coordinate the behavior of members of the community for the sake of the common good even in a society of angels.").

[289] *See* GERMAIN GRISEZ, CHRISTIAN MORAL PRINCIPLES 58-59 (1997).

[290] *See* text accompanying notes 277-281.

participants,[291] more punitive, coercive action to resolve the problem of analyst misconduct would be unnecessary.

The failure of a system of such "virtue ethics," based upon the natural law, would cause society instead (as it has) to resort to a system of ethics in which "the moral life . . . consists mainly of complying with society's mandated code of conduct."[292] This is the legislative equivalent of stationing a police officer on every corner—a situation that is impracticable logistically, burdensome in cost, and awkward to free societies.[293] Moreover, such rule-based ethical regimes have increasingly exhibited shortcomings, calling into question their efficacy to regulate conduct.[294] Nevertheless, it has long been recognized that, as Professor Koniak has explained, "[n]orms maintained by private means (morality, ethics, religious principles) do not exist in a vacuum. They coexist, affect, and are affected by the norms of law."[295] The solution to societal problems, therefore, lies in fashioning the optimal mix of incentives and disincentives, coercive and non-coercive, in pursuit of the ends sought.[296]

In the absence of an effective voluntary ethics regime, or some other non-coercive solution to the problem of analyst conflicts, the next question becomes whether the false portrayal of a researcher's opinions is a wrongdoing of such magnitude that it justifies the imposition of legal intervention—including all the costs associated with such an

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291 *See supra* note 274 and accompanying text.

292 *See* Bainbridge, *supra* note 277, at 5. For an explanation of the distinction between a rules-based versus a principles-based system of ethics (which this statement implicates), see Sama & Shoaf, *supra* note 259, at 179-82.

293 *Cf.* HART, *supra* note 139, at 162 ("There is a limit to the amount of law enforcement that any society can afford, even when moral wrong has been done."); 1 ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 288-330 (Phillips Bradley ed., Knopf 1993) (1835) (addressing "[p]rinciple causes which tend to maintain the democratic republic in the United States").

294 *See* Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 212-14 (2003). *See generally* Maurice E. Stucke, *Morality and Antitrust*, 2006 COLUM. BUS. L. REV. 443 (2006) (addressing the repercussions of neglecting the role of morality in antitrust enforcement).

295 Koniak, *supra* note 294, at 225.

296 An example of creative, non-coercive means that could be employed to assuage the problem of analyst conflicts is provided by the aforementioned Global Settlement, which directed a portion of settlement proceeds to the funding of investor education and independent research. *See supra* text accompanying note 34. A better educated investing public, coupled with the provision of more independent research, could serve to temper bias in research reporting by reducing the effectiveness of disingenuous opinions; by virtue of their increased understanding coupled with more widely-available "second opinions" from independent research analysts, the public would, arguably, be less susceptible to fraudulent opinions.

imposition. Intentional deceit known to have such serious, harmful consequences for as many victims as analyst fraud ostensibly has had would, I suggest, readily cross the threshold of grievousness to justify legal intervention under natural law principles.[297] And, assuming the failure of other means to curb the problem, it would seem that legal intervention over the issue would not only be justified, but essential.

The last issue to consider, therefore, is the nature of the legal intervention most fitting to address the problem of analyst conflicts under a natural law approach.

a. Laissez-Faire Approach

A laissez-faire approach, relying upon market forces to check dishonesty, would not be favored because such an approach contemplates (and permits) the persistence of a certain amount of deception and dishonesty. The long-term impact of such a regime on society cannot be expected to be good, for it (1) acknowledges a role for dishonesty in the professional work of an entire class of individuals (research analysts) and (2) broadcasts the message that dishonesty is an expected part of certain commercial activity.

b. Mandatory Disclosure

It is unlikely that a natural law theorist would be comfortable with a rule protecting analysts from liability for dishonest opinions so long as full and accurate disclosure of their conflicts and all the underlying factual data accompanies such opinions. An argument justifying such a rule in terms palatable to a natural law proponent would stress that in the context of a full disclosure rule any harm to society resulting from feigned analyst opinions and recommendations would be minimal, and therefore not grievous enough to warrant legislative intervention.[298] But the justification behind this approach focuses solely on the economic consequences of such deception, without regard to the severity of the moral implications to society. For the very fact of circumscribing the limits of the deception arguably institutionalizes it, implying

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[297] *Cf.* Bainbridge, *supra* note 277, at 4 (noting that "there is a limit at which forbearance ceases to be a virtue" and at which point "the state properly steps in. The prudential question is when forbearance becomes a vice.") (internal quotations omitted).

[298] *See supra* Part III.C.2.d.

state approval thereof if contained within the established bounds. The coarsening effect of such a situation, both upon the individuals concerned and on society at large, would appear to warrant state intervention given the importance of truthfulness to the proper functioning of society.[299]

Additionally, a disclosure-alone regime[300] would also conflict with natural law principles by placing the common good (that is, the good of *all* investors and that of society as a whole) second to the particular good (that is, the benefit of those investors sophisticated enough to avail themselves of full disclosure and avoid being deceived by dishonest analyst opinions—even if these investors happen to be in the majority).[301] From a natural law perspective, a regime designed merely to blunt the effects of deception (such as a disclosure rule by itself) would be inferior to a regime that prohibited deception *per se*.

c. *Antifraud Rule*

In light of the preceding, it unsurprisingly follows that a natural law approach would favor an antifraud rule applicable to analyst statements (including opinions and recommendations) over a rule simply mandating the disclosure of conflicts. And although this was not the conclusion reached as optimal under the general law and economics approach set forth previously (largely because of its costs, including the perceived threat to the vitality of the research-analyst industry),[302] it should be noted that such an approach is nevertheless a recommendation made by some who subscribe to an economic approach to the law.[303] For application of a strict antifraud rule to analyst statements could reap the benefits of a market-derived quantity of disclosure and provide a

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[299] *See supra* Part III.C.2.c. Admittedly, the argument in favor of state intervention becomes much weaker if the purported economic harms to society of analyst misconduct are significantly diminished.

[300] Or, put differently, a regime in which analysts are shielded from liability for their feigned opinions if their research reports also contained sufficient cautionary disclosure as per the bespeaks caution doctrine and/or the PSLRA's safe harbor rule.

[301] Although it is laudable for an individual or group of individuals to voluntarily make personal sacrifices for the common good, it is not laudable to wrong a minority for the sake of the majority under natural law principles. Indeed, this would seem to violate the natural law prohibition on using the ends intended to justify the means employed. *See* McInerny, *supra* note 254, at 80.

[302] *See supra* Part III.B.2.c.

[303] *See, e.g.*, Bainbridge, *supra n*ote 166, at 1024.

safeguard against disclosure that was fraudulent or otherwise misleading.[304]

d. Structural Approach

Finally, a natural law theorist could be expected to heartily endorse structural correctives to the problem of analyst conflicts, such as those set forth by NASD's Rule 2711,[305] in addition to other market-influencing efforts, such as the funding of investor education and independent research (as per the Global Settlement[306]). As explained, a natural law approach seeks to fashion an environment that encourages, rather than undermines, virtue.[307] Investor education, and the increased availability of independent research, both serve to reduce the effectiveness (and harm) of biased research reporting and, consequently, should diminish the allure of dishonest reporting.[308] And absent a structural solution, the analyst's conflicted situation presents a constant and forceful temptation to falsify his or her opinions and recommendations in order to advance his or her own pecuniary self-interest. Although the ability of the law to coerce virtue is questionable to say the least,[309] the law can certainly remove certain impediments to the development of virtue. Freed from such impediments, individuals are more likely to develop the habits of virtue, or at the very least are less likely to succumb to the temptations of vice.[310] For this reason, a structural solution to the problem of analyst conflicts would coincide nicely with the ends of both the securities laws and natural law philosophy.

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304 *See* Fisch & Sale, *supra* note 10, at 1086.

305 *See supra* Part II.B.2.d.

306 *See supra* text accompanying notes 34, 296.

307 *See supra* Part III.C.2.d; *see also* GEORGE, *supra* note 268, at 44-45; *cf.* Pope John Paul II, Sollicitudio Reis Socialis ¶ 36 (Dec. 30, 1987), *available at* http://www.vatican.va/holy_father/john_paul_ii/encyclicals/documents/hf_jp-ii_enc_30121987_sollicitudo-rei-socialis_en.html ("'Sin' and 'structures of sin' are categories which are seldom applied to the situation of the contemporary world. However, one cannot easily gain a profound understanding of the reality that confronts us unless we give a name to the root of the evils which afflict us.").

308 *See supra* note 296.

309 *See supra* note 289 and accompanying text. The concept of "coerced" virtue is arguably a contradiction in terms. *Cf.* Barnett, *supra* note 222, at 669 ("Although principles of natural-law ethics can be used to guide one's conduct, they should not be enforced coercively by human law if doing so would violate the moral space or liberty defined by natural rights.").

310 *See* GEORGE, *supra* note 268, at 27, 44.

4. Summary of the Natural Law Approach

Thus, from a natural law perspective, a laissez-faire solution to the problem of analyst conflicts would be rejected, and a rule merely requiring disclosure of such conflicts would likewise be deemed insufficient. Instead, the natural law theorist would endorse an antifraud rule barring the misstatement of analyst opinions and, perhaps even more enthusiastically, endorse a structural remedy that would reduce, if not eliminate, the problematic conflicts of interest themselves.

Lastly, one cannot ignore those who have questioned the utility of natural law reasoning on the ground that it fails to provide a certain, clear method of generating solutions to real-world problems.[311] It is admittedly the case that "the natural law does not determine once and for all the perfect scheme of . . . regulation. A number of different schemes . . . are consistent with the natural law."[312] However, natural law philosophy does provide the policy maker with principles that guide his or her decision-making, and application of these guiding principles can lead a policy maker to favor one potential remedy to a problem over another. In light of this, the flexibility left open to the policy maker by natural law reasoning is an advantage rather than a disadvantage to its use. Finally, it should be noted that, at least based upon an examination of the research analyst conflicts of interest problem, the mainstream law and economics approach does not appear any more determinate than the natural law approach.

CONCLUSION

The U.S. securities laws were predicated upon an appreciation of virtue and vice. Their interrelated objectives and concerns included (1) the promotion of a fairer, more virtuous securities industry, (2) the protection of the individual investor, and (3) the good health of capital markets. Over time, in no small part due to the advance of law and economics thinking, the first of these objectives has been all but forgotten, and some scholars today even question the second. What is needed in order to recover respect for the entirety of concerns

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[311] *See, e.g.*, Walter J. Walsh, *The Fearful Symmetry of Gay Rights, Religious Freedom, and Racial Equality*, 40 HOW. L.J. 513, 548 (1997).

[312] GEORGE, *supra* note 288, at 108 (using "traffic regulation" as an example).

that spawned the U.S. securities regulatory regime is an approach to securities regulation that shares these concerns. In natural law philosophy we have such an approach.

Via the examination of a particular securities law problem—that of research analyst conflicts of interest—this Article has attempted to demonstrate the benefits of a natural law approach to securities regulation. Unlike the economic approach, which favored solutions not entirely consonant with the values or full range of objectives of U.S. securities law, the natural law approach favored solutions consistent with all these values and objectives. The high value placed on veracity within the natural law tradition, in addition to the tradition's recognition that efforts should be undertaken to remove or reduce those root influences that tempt wrongdoing, coincide well with U.S. securities regulation in both theory and practice. Also coinciding is the perceived importance of moral character and virtue.

But the differences between a natural law approach and a law and economics approach should not be unduly inflated. As each approach is grounded in an understanding of human nature and behavior (albeit, an understanding that at times diverges), there is room for significant agreement between them. Additionally, the analytical power of the law and economics approach cannot be gainsaid. Perhaps the optimal, eventual result of this inquiry would be the proper integration of the economic approach to law within the broader framework of natural law thinking.