They Were Shocked, Shocked: The "Discovery" of Analyst Conflicts on Wall Street

Barbara Moses
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THE "DISCOVERY" OF ANALYST CONFLICTS ON WALL STREET

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Once respected, and even celebrated, the sell-side equity analysts who were such visible players in the bull market of the 1990s have more recently faced criticism, investigation, litigation, and in some cases disgrace. They have been pilloried by pundits and plaintiffs for having routinely offered positive opinions and overly aggressive buy recommendations while not disclosing to the investing public their material conflicts of interest. The mere existence of those conflicts strongly suggests that the analysts' investment advice was less independent, objective, and trustworthy than their employers hoped it would be perceived. This conclusion has been reinforced by academic studies quantifying the bias infecting sell-side recommendations and graphically illustrated by the discovery of internal brokerage firm emails in which some analysts privately disparaged (or sold) the same stocks they were publicly praising. Many argue that tainted advice from conflicted analysts played an important role in the expansion of the so-called Internet bubble.

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1 See, e.g., In re Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 362 (S.D.N.Y. 2003) (quoting plaintiffs' brief, which stated, "[s]ome, and perhaps much, of the 'Internet bubble' was a classic stock market manipulation engineered by Wall Street's investment bankers and research analysts"); cf. Robert P. Sieland, Note, Caveat Emptor! After All the Regulatory Hoopla, Securities Analysts

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This article accepts, in large part, the premises underlying much of the current criticism of sell-side analysts and their conduct during the 1990s: that the analysts were, in fact, operating within a system that subjected them to pervasive pressure to recommend stocks based on the needs of the investment banking divisions of the brokerage firms that employed them instead of the best interests of retail investors. Consequently, many analysts (though by no means all) issued overly-optimistic research reports pushing stocks that they privately doubted or even derided. Nonetheless, the flurry of editorializing, rulemaking, enforcement activity and civil litigation that began in 2001 and went into high gear in 2002— all in response to what by then was called the analyst conflict "scandal"—reminds this cynical observer a bit of the classic scene in Casablanca where Captain Renault, standing in front of the roulette wheels he has played for years, solemnly announces: "I'm shocked, shocked to find that gambling is going on in here."

No securities regulator should have been shocked to discover that sell-side equity analysts were joined at the hip to their investment banking colleagues and that the objectivity of their research suffered as a result. To the contrary: throughout the last decade, the pressures placed on analysts to favor the interests of investment bankers over the interests of investors were discussed frankly in the nation's financial press. Moreover, the fact that these pressures compromised the objectivity of the research product was well understood by sophisticated market participants. Indeed, in the late 1990s—well before Eliot Spitzer made headlines with his investigation of Merrill Lynch—at least two separate academic studies found that the recommendations issued by analysts working for firms with investment banking ties to the companies they covered were more positive, but less accurate, than the recommendations issued by their non-compromised colleagues.

The empirical evidence also shows that the recommendations published by underwriter-affiliated analysts had less of an impact on market prices than recommendations

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Remain Conflicted on Wall Street, 2003 U. ILL. L. REV. 531, 542 (2003) ("Analysts, of course, were not solely responsible for the Internet bubble.").

2 Warner Bros. 1942.

3 See infra text accompanying notes 16–39.

4 See infra text accompanying notes 52–62.

5 See infra text accompanying notes 20–25.
authored by more independent analysts, meaning that the market discounted research likely to be biased. This in turn suggests that such research had less to do with the Internet bubble - and that the discovery of the bias had less to do with the bubble's collapse - than the current crop of class action plaintiffs and their lawyers would like to believe.

It is undoubtedly true that many unsophisticated retail investors were unaware of the structural and institutional pressures on sell-side analysts, and may have relied on unsound recommendations in purchasing securities that they otherwise would have eschewed. However, the fact that "the market" understood the weaknesses inherent in such recommendations has proven to be a significant hurdle for many of the high-dollar class actions based on analyst conflict allegations. Some have been dismissed on statute of limitation grounds,7 and some have failed due to an inability to plead loss causation.8 And while many other cases have survived these challenges at the pleading stage, plaintiffs can expect increasing resistance at the class certification and summary judgment stages, where allegations must be supported by admissable evidence. In fact, as a precondition to applying the fraud-on-the-market doctrine in analyst conflict cases, the Second Circuit recently signaled that it may require a trial court to conduct a rigorous analysis, at the class certification stage, of the evidence supporting the alleged causal link between an analyst’s reports and movements in the price of the company’s stock.9 Such a ruling could make class certification motions far more challenging for the plaintiffs in analyst-conflict cases than in most other securities fraud class actions.10

The first half of this article traces the history of what is now called the analyst conflict scandal, demonstrating that the basic facts "discovered" by Eliot Spitzer, by other regulators, and ultimately by the plaintiffs' bar after the collapse of the Internet bubble were actually well known to sophisticated market participants throughout the 1990s. As a consequence, the research issued by potentially-biased analysts was routinely discounted by the market, blunting the impact of that research on prices. The second half of this article shows that

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8 See infra text accompanying notes 35–39.
7 See infra text accompanying notes 86–92.
8 See infra text accompanying notes 93–116.
10 See infra text accompanying notes 118–25.
the three legal issues that have thus far proved the most challenging for plaintiffs in analyst-conflict class actions— the statute of limitations, loss causation, and the applicability of the fraud-on-the market doctrine—all have their roots in these same historical facts. Many Wall Street observers, including the author of this article, believe that even if most of the current class actions survive these challenges at the pleading stage, they are likely to founder on the same issues at class certification, summary judgment, or trial.

THE ROLE OF RESEARCH ANALYSTS

Research analysts study companies that issue securities and “draw on a wealth of industry, economic, and business trend information to help their clients make better investment decisions.” Based on their review of financial and other information, they make recommendations regarding the purchase, retention and/or sale of securities issued by particular companies or industry groups. Some analysts are employed directly by the institutional investors whose decisions they help guide (such as mutual funds, hedge funds and pension plans) and make their recommendations available only to their employers. Others are employed by independent firms whose primary business is selling research to their paying clients. “Sell-side” analysts, by way of contrast, are typically employed by full-service brokerage firms. These brokerage firms historically provided research as a free or nominal-cost service to their retail clients while making money from other activities, such as commissions charged to those retail clients, proprietary trading, and—most relevant here—investment banking.

Over twenty years ago, the Supreme Court noted that the work analysts do is “necessary to the preservation of a healthy market,” as they “ferret out and analyze information” that, upon reaching the market, “redounds to the benefit of all investors.” This paradigm, however, assumes that the

14 Id. at 659 n.17. (quoting In re Dirks, 21 S.E.C. Docket 1401, 1406, 1981 WL 36329, at *6 (S.E.C. Release No. 34-17480)).
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analysts' work is honest (if not perfect), or at least that any idiosyncratic individual biases are balanced by the countervailing biases held by others. In the case of sell-side analysts working in the 1990s, these assumptions are now widely believed to be faulty.

THE CONFLICTS FACED BY ANALYSTS

Simply put, full-service brokerage firms have a financial interest in the recommendations made by their analysts. In testimony on Capital Hill in mid-2001 – when the drum-beat for regulatory reform was gathering momentum – the Acting Chairman of the Securities and Exchange Commission (Commission or SEC), Laura Unger, explained that positive recommendations in general tend to be good for the firm's bottom line, as they can "trigger higher trading volumes, resulting in greater commissions for the firms."

Positive coverage of companies for which the firm acts (or hopes to act) as underwriter can be even more important to its overall profitability. This was especially true during the bull market of the 1990s, when companies were eager to issue securities to the public, their investment banking divisions were eager to secure that lucrative business, and both sides considered positive research coverage by the firm's analysts to be part of its investment banking services. Indeed, a survey conducted by the SEC in 2001 found that most full-service firms, rather than acting to protect their research analysts from investment banking pressure, exacerbated the problem by, among other things: using analysts to woo issuers as part of the investment banking team; sending analysts on "road shows" to pre-sell the new issue; paying analysts based on the

15 NASD GUIDE, supra note 11.
17 Id.; see also Professor John C. Coffee, Jr., Prepared Statement Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies, Before the Comm. on Banking, Hous. and Urban Affairs, 107th Cong. (March 5, 2002) [hereinafter Coffee Statement], available at http://banking.senate.gov/02_03hrg/030502/coffee.htm.
18 See, e.g., Randall Smith & Suzanne Craig, Heard on the Street: Will Grubman Case Tone Down the Exaggeration by Analysts?, WALL ST. J., Sept. 24, 2002, at C1 ("During the 1980s and 1990s, analysts often served as quasiadvocates for the companies that hired their firms for investment-banking work.")]
profitability of the firm’s investment banking division or giving investment bankers input into their bonuses; and offering analysts opportunities to invest, either directly or through pools, in the stock of the same companies they were then assigned to cover.¹⁹

Not surprisingly, given these inherent structural pressures, analysts issued overwhelmingly positive recommendations during the late 1990s.²⁰ This phenomenon may have been partly due to the herd mentality resulting from a long bull market and the glittering promise of the Internet. Indeed, Henry Blodget, the Merrill Lynch analyst who became a star in January 1999 by correctly predicting that Amazon.com would hit $400 per share,²¹ recently disclosed that he lost much of his own money when the Internet bubble burst the following year. The reason, according to Blodget: “in hindsight, I was a moron.”²² Elaborating on this pronouncement, Blodget explained that his decision-making was fueled in part by “years of mind-boggling stock performance” and the conviction that “the risk of not being invested in the Internet approached the risk of being invested in it.”²³

The we-were-all-suckers theory, however, only goes so far. It fails to explain the now-familiar incidents, uncovered by both federal and state regulators, of sell-side analysts privately deriding, selling, or even shorting securities while recommending the same stock to the investing public.²⁴ It was this evidence, perhaps more than anything else, that seemed to

²⁰ See Coffee Statement, supra note 17; see also John C. Coffee, Jr., Virtue and the Securities Analyst, N.Y.L.J., July 19, 2001, at 6 n.1 (29% of recommendations during the period studied were “strong buys,” 37% were “buys,” and 31% recommended a “hold.” Only 1% were “sell” recommendations and 0.4% were “strong sells.”).
²³ Id. On April 28, 2002, Blodget was barred from the securities industry for life. See infra note 67.
²⁴ See Unger Statement, supra note 16, at 6 & n.8 (SEC examiners found three instances where analysts executed trades in their personal accounts contrary to their published recommendations; Affidavit of Eric R. Dinallo, In re Eliot Spitzer, No. 02-401522 (N.Y. Sup. Ct., April 8, 2002), at 13 [hereinafter Dinallo Affidavit] (listing examples, drawn from internal Merrill Lynch emails, of analysts privately disparaging stocks that they were publicly recommending), available at http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf (last visited July 27, 2004).
convince the press, the regulators, and the public that Wall Street had an analyst conflict problem.\textsuperscript{25}

\textbf{HIDDEN IN PLAIN VIEW}

The practices that Acting Chairman Unger disclosed to the Capital Markets Subcommittee in July 2001 were all well known to market professionals, and had been for many years before the Subcommittee convened its hearings.\textsuperscript{25} Nor were they kept secret from the public. As early as 1988, the Harvard Business School Press published a well-received book-length guide to the investment banking business, explaining why firms seeking to strengthen their relationships with issuers paid analysts "deal-based bonuses."\textsuperscript{27}

Investors were not required to pore through academic texts, however, to learn about the relationship between investment bankers and sell-side analysts. The key information was all in the news pages of the \textit{Wall Street Journal} and other general-interest publications. In 1992, for example, the \textit{Journal} reported that a prominent brokerage firm had a stated policy against making "negative or controversial comments about [their] [investment banking] clients."\textsuperscript{22} Four years later, the same paper reported the preliminary results of a study conducted by two economists, noting the widespread practice of paying analysts "in part, according to their contribution to corporate finance."\textsuperscript{29} The article stated its conclusion in plain and simple terms: "The recommendations by underwriter analysts show significant evidence of bias and possible conflict of interest."\textsuperscript{30}

\begin{itemize}
\item \textsuperscript{25} See supra text accompanying notes 16 & 24.
\item \textsuperscript{26} See Sieland, supra note 1, at 531 ("Wall Street has been aware of the symbiotic relationship between investment bankers and analysts for years.").
\item \textsuperscript{27} ROBERT G. ECCLES & DWIGHT B. CRANE, DOING DEALS: INVESTMENT BANKS AT WORK 173-75 (1988).
\item \textsuperscript{28} Michael Siconolfi, At Morgan Stanley, Analysts Were Urged to Soften Harsh Views, WALL ST. J., July 14, 1992, at A1.
\item \textsuperscript{29} Roger Lowenstein, Today's Analyst Often Wears Two Hats, WALL ST. J., May 2, 1996, at C1.
\item \textsuperscript{30} Id. See also Hsiou-wei Lin & Maureen F. McNichols, Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations, 25 J. ACCT. & ECON. 101 (1998) (finding that recommendations by brokerage firms that served as lead or co-lead underwriters for the covered companies' stock offerings were significantly more favorable than those made by unaffiliated analysts); Steve Bailey & Steven Syre, Taking Analysts' Tempting Forecasts with a Grain of Salt, BOSTON GLOBE, Oct. 23, 1996, at C1 (reporting similar conclusions in yet another study were scholars at the Wharton School and the Harvard Business School: "[A]nalysts are
In 1997, yet another Wall Street Journal article explained that "at many firms, analysts are expected to bring in investment-banking deals" and then continue to keep those clients happy:

By the unwritten laws of Wall Street, brokerage houses don't handle a stock offering unless they expect to tout its stock for a while after the offering. In Wall Street parlance, a post-offering recommendation is commonly called a "booster shot."

Another important job of the analyst, at most firms, is to generate trading volume by getting clients excited about the recommended stocks. . . . They have to work the phones, meet the clients, "pound the table" for the stocks they believe in. A great recommendation that nobody buys doesn't help the clients and doesn't make the brokerage firm any money.\(^{31}\)

And in 1998, the Journal matter-of-factly reported that 68% of the analyst recommendations tallied by a tracking firm were "strong buys" or "buys" and 31% were "holds," while less than 1% of the 2,066 ratings studied were "sells" of any shade.\(^{32}\)

A few months later, a cover article in Business Week recited similar statistics and forcefully warned its readers about sell-side analysts' not-so-hidden agenda:

The question for investors is: "Can you trust your analyst?" Unfortunately, the answer is not very much. At the major Wall Street houses, which thrive on investment banking, every analyst has a potential conflict of interest. The "Chinese Wall" that on paper still separates a firm's analysts from its investment bankers continues to crumble as analysts are encouraged to scout deals. The analyst's firm is either the investment banker for a company he or she is covering - or it's wooing the company for a piece of that juicy revenue stream.\(^{33}\)

Business Week went on to report that analysts whose firms had investment-banking ties with the companies they covered issued higher earnings forecasts and even more "buy"


recommendations than unaffiliated analysts. It also explained the multiple pressures that led to those statistics.\textsuperscript{34}

In 1999 and early 2000, the financial press continued to lay out for the public, in a fair amount of detail, just how compromised research analysts had become.\textsuperscript{35} Some publications also reported that the Chairman of the SEC, Arthur Levitt, had begun to muse publicly about the pressures analysts were under to attract and retain investment banking business.\textsuperscript{36} And the economists whose work was first reported in 1996 published their finished study, concluding that "recommendations by underwriter analysts show significant evidence of bias."\textsuperscript{37} They also showed that, although the market tended to respond with a short-term price increase after a positive recommendation from an analyst affiliated with the issuer's underwriter, the increase was lower than that following a similar recommendation from an unaffiliated analyst.\textsuperscript{38} From this data the authors concluded that the market recognized and discounted biased recommendations from underwriter-affiliated analysts, but did not recognize "the full extent of this bias."\textsuperscript{39}

Despite the abundant evidence that something was seriously amiss in the world of equity analysts, there was little or no effort to fix it so long as the market continued to rise. No Congressional hearings were held; no significant rulemaking was initiated by the Commission or the self-regulatory organizations;\textsuperscript{40} and no major enforcement actions or private lawsuits were brought to punish miscreants or compensate

\textsuperscript{34} Id.


\textsuperscript{36} See, e.g., Frog Spawn, ECONOMIST, Apr. 17, 1999, at 79.

\textsuperscript{37} Roni Michaely & Kent L. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 REV. FIN. STUD. 653 (1999).

\textsuperscript{38} Id. at 671-73, 677-78.

\textsuperscript{39} Id. at 653.

\textsuperscript{40} Regulation FD, 17 C.F.R. § 243 (2004), which became effective in October 2002, requires issuers to make full disclosure of material, nonpublic information to the public as a whole at the same time it is disclosed to any analyst. This regulation was intended to limit the ability of companies to play favorites with analysts, but did not address the fundamental conflict issues outlined above.
their victims. To the contrary: Henry Blodget was paid over $5 million in 1999.1 Meanwhile, Morgan Stanley raised the pay package of its most prominent Internet analyst, Mary Meeker, from $6 million to $15 million,42 and Salomon Smith Barney’s telecommunications analyst Jack Grubman, who received a $15 million bonus when he joined the firm in 1998, was said to earn $20 million annually thereafter.43

THE MARKET SOURS; ANALYSTS COME UNDER FIRE

The most likely explanation for the lack of any serious Congressional, regulatory or enforcement interest in analyst conflicts throughout the 1990s is also the simplest: “A runaway bull market glosses over a multitude of analysts’ sins.”41 That bull market ended on March 24, 2000, when the NASDAQ composite index briefly rose above 5000 and closed at an all-time record high of 4963. By June 2000, the NASDAQ had dropped 1000 points, only to lose another 2000 points by June 2001, and hit its lowest close of this century, at 1114, on October 9, 2002.

While the NASDAQ dropped, the percentage of “buy” recommendations issued by sell-side analysts did not. In fact, TheStreet.com reported in a much-forwarded article in March 2001 that the percentage of “buy” and “hold” recommendations had actually increased over the past ten months while the number of “sell” calls “held steady in the zero percent range.”40 While there could be good reasons for an objective analyst to remain (or become) bullish on a stock as its price drops, the overall picture painted by the industry-wide statistics was not attractive. As TheStreet.com put it, tongue in cheek: “Investors shouldn’t have sold anything since last May. Really.”46

That same day, the Wall Street Journal and other publications mentioned a novel legal theory put forward by an

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41 See Charles Gasparino, Merrill is Paying in Wake of Analyst’s Call on Tech Stock, WALL ST. J., July 20, 2001, at C1 [hereinafter Merrill Settles].
42 See Peter Elkind, Where Mary Meeker Went Wrong, FORTUNE, April 30, 2001, at 68.
44 Laderman, supra note 33, at 148.
46 Id.
They were shocked, shocked investor who had filed an arbitration claim against Merrill Lynch. Debases Kanjilal, a pediatrician, claimed that he had lost over $500,000 (later reports put the loss at over $1 million) investing money he was saving for his children's college tuition in an Internet start-up called InfoSpace based on the positive recommendation of Merrill's star analyst Blodget.\footnote{Charles Gasparino, \textit{All-Star Analyst Faces Arbitration After Internet Pick Hits the Skids}, \textit{WALL ST. J.}, Mar. 2, 2001, at C18 [hereinafter \textit{All-Star Analyst}].} According to Kanjilal, Blodget violated SEC Rule 10b-5\footnote{17 C.F.R. § 240.10b-5 (2004).} when he issued his InfoSpace recommendations because they "lacked a reasonable basis in fact" and failed to disclose "a serious conflict of interest" – namely, that Merrill was advising another Internet company, Go2Net, that was acquired by InfoSpace.\footnote{All-Star Analyst, supra note 47.} Had InfoSpace's stock price fallen, Kanjilal alleged, it would have jeopardized the acquisition and hence Merrill's fee.\footnote{Id.}

A few months later, in July 2001, Merrill and Blodget settled the Kanjilal arbitration for $400,000 – a small sum, but a significant concession in the eyes of many commentators.\footnote{Merrill Settles, supra note 41. See also Carol Vinzant, \textit{Merrill to Pay Investor $400,000 in Settlement}, \textit{WASH. POST}, July 21, 2001, at E1 ("[P]laintiff's lawyers believe the case will pave the way for other investors to claim they're owed money because analysts maintained 'buy' recommendations on sinking stocks."); Andy Kessler, \textit{Manager's Journal: We're All Analysts Now}, \textit{WALL ST. J.}, July 30, 2001, at A18 ("Now every Tom, Dick and Fidelity will want similar reparations from the Internet wars.").} Professor Coffee likened the settlement to "putting out warm milk for a stray cat that meows. You get 30 more cats the next night."\footnote{George J. Siegel, \textit{Using the Law for Competitive Advantage} 8 (2002) (footnote omitted), \textit{available at} http://media.wiley.com/product_data/excerpt/36/0787956227/0787956236.pdf (last visited Oct. 21, 2004).}

\textbf{Enter Spitzer}

Merrill told the public that it settled the Kanjilal case "to avoid the expense and distraction of protracted litigation."\footnote{Merrill Settles, supra note 41.} What it may not have realized at the time was that it would later face considerably more expense and distraction in the
form of an investigation by the Attorney General of New York, Eliot Spitzer, under the Martin Act.\(^{54}\)

On April 8, 2002, after investigating for approximately ten months and reviewing thousands of internal firm emails, Spitzer's office commenced a Martin Act proceeding against Merrill Lynch, Blodget, and seven other Merrill employees. The action was based primarily on an affidavit by Assistant Attorney General Eric R. Dinallo.\(^{55}\) The Dinallo Affidavit explained the ways in which pressure from the Merrill Lynch investment banking group compromised the objectivity of the firm's analysts. In addition, the Dinallo Affidavit described and quoted from numerous emails (none of them intended for public consumption and some of them rather crude) in which Merrill analysts aired distinctly uncomplimentary views about the stocks that they were rating "buy" or "accumulate."\(^{56}\) In some cases, according to the Attorney General, analysts shared these unvarnished opinions with selected institutional investors—but withheld them from the firm's retail customers and the public.\(^{57}\) And at no time, Spitzer charged, did Merrill explain to the public that its 5-point rating scale (where a "1" was "buy" and a "5" was "sell") existed only on paper. In practice, the Internet group, which covered dot-coms and other high-technology, Internet-dependent companies, "never rated a stock 4 or 5."\(^{58}\)

Thanks to the Dinallo Affidavit, the Attorney General's office obtained an *ex parte* order on April 8, 2002 enjoining Merrill Lynch, during the pendency of the Martin Act inquiry, from issuing any equity research reports without making a

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\(^{54}\) The Martin Act, N.Y. GEN. BUS. LAW § 352 et seq. (McKinney 1996), is New York's securities statute, and like other such statutes it prohibits fraud in connection with the sale of securities. *Id.* §§ 352(1), 352-c. But in other respects the Martin Act is quite different from other blue sky laws, particularly with respect to the power granted to the Attorney General. For example, under the Martin Act—unlike comparable statutes in other states—the Attorney General may commence an action by obtaining, from any supreme (trial) court justice in the state, an *ex parte* order directing the respondents to appear and produce documents and testimony. Moreover, the statute specifies that the requested order "shall" be granted, "with such preliminary injunction or stay as may appear to such justice to be proper and expedient." *Id.* § 354.

\(^{55}\) Dinallo Affidavit, *supra* note 24.

\(^{56}\) *Id.*, at 10–13. One of the stocks publicly touted but privately trashed was InfoSpace, which Blodget called a "piece of junk" in October 2000. *Id.* at 12.

\(^{57}\) *Id.* at 10–11.

\(^{58}\) *Id.* at 9. In addition to rating stocks "1," "2" or "3," Merrill Lynch assigned each stock it covered an "investment risk" ranging from "A" (least risky) to "D" (most risky). *Id.* All of the stocks discussed in the Dinallo Affidavit—including InfoSpace—were assigned a "D" rating. *Id.*
number of court-ordered disclosures. Among other things Merrill Lynch was required to disclose: (i) any investment banking relationship between the firm and the issuer for the past three years; (ii) whether the firm was currently attempting or had attempted to form an investment banking relationship with the issuer; and (iii) the aggregate distribution, on a percentage basis, of the various rating categories for all stocks in the applicable sector by the firm—that is, the grading curve.\footnote{Order Pursuant to General Business Law Section 354, \textit{In re} Spitzer, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002), http://www.oag.state.ny.us/press/2002/apr/apr08b_02_attach.pdf (last visited Oct. 11, 2004).}

As was his practice, Spitzer held a press conference and issued a release to announce the initiation of the Martin Act proceeding, noting that he had already sent subpoenas to other Wall Street firms looking for similarly explosive material.\footnote{See Press Release, Office of New York State Attorney General Eliot Spitzer, Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest, \textit{at} http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (Apr. 8, 2002).} According to the press release, Merrill Lynch’s activity “was a shocking betrayal of trust by one of Wall Street’s most trusted names.” The Attorney General went on to state, “the case must be a catalyst for reform throughout the entire industry.”\footnote{Id.}

And it was. In the space of six weeks, Spitzer reached a settlement with Merrill Lynch and its personnel. As part of the agreement, the firm agreed to continue making detailed disclosures concerning its investment banking ties with the companies its analysts covered.\footnote{See Press Release, Office of New York State Attorney General Eliot Spitzer, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices, \textit{at} http://www.oag.state.ny.us/press/2002/may/may21a_02.html (May 21, 2002).} Merrill also agreed to set up a Research Recommendation Committee to monitor the work of its analysts and ensure their objectivity, to put an end to all input, direct or indirect, that the investment banking department had into compensation determinations for analysts, and to pay a $100 million civil penalty, with $48 million of that going to New York and the rest split among the other states and the North American Securities Administrators Association (NASAA).\footnote{Id. See also Agreement between the Attorney General of the State of New York and Merrill Lynch, Pierce, Fenner & Smith, Inc., \textit{at} http://www.oag.state.ny.us/investors/merrill_agreement.pdf (May 21, 2002).}
JOINT INVESTIGATION AND GLOBAL SETTLEMENT

Not to be outdone, on April 25, 2002 the SEC, the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE) and NASAA announced that they were conducting a joint investigation with Spitzer into research analysts and their potential conflicts of interest. The SEC's news release quoted Chairman Pitt as stating that this investigation was the "next step . . . in the Commission's year-long review of analyst practices." However, the Chairman gave credit to Eliot Spitzer, acknowledging that "[t]he recent disclosures that resulted from the investigation by the New York State Attorney General . . . reinforced the Commission's conclusion that further inquiry is warranted."

The joint investigation produced what is now known as the "Global Settlement" among the regulators, ten Wall Street firms (including Merrill Lynch), and two individuals (Blodget and Grubman). The Global Settlement was announced in principle on December 20, 2002, finalized on April 28, 2003, and approved by a United States District Judge on October 31, 2003. Under the Global Settlement, the settling firms agreed to pay a total of approximately $1.4 billion: $875 million in penalties and disgorgement (that figure includes Merrill Lynch's previous payment of $100 million in connection with

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65 Id.
the Spitzer settlement), $433 million to fund independent research, and $80 million to fund and promote investor education.\textsuperscript{70} Approximately half of the new penalty money ($399 million by the time judgment was entered in October 2003) is earmarked for restitution to customers of the settling firms injured as a result of their research misconduct.\textsuperscript{71}

In addition to the monetary assessments, 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.\textsuperscript{72} 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.\textsuperscript{73}

While some commentators believe that the reforms implemented by means of the Global Settlement and recent rulemaking do not go far enough,\textsuperscript{74} Attorney General Spitzer has repeatedly declared his optimism (if not wholesale confidence) that "analytical work will be better, investment decisions will be sounder, investors won't be led astray."\textsuperscript{75}

MAKE THAT 150 CATS

Although the Global Settlement includes an investor restitution mechanism, it does not bar private civil lawsuits by

\textsuperscript{70} See Top Investment Firms, supra note 66.

\textsuperscript{71} SEC, 2003 WL 22466156, at *2. See also Top Investment Firms, supra note 66.

\textsuperscript{72} See Top Investment Firms, supra note 66.

\textsuperscript{73} Id.

\textsuperscript{74} See, e.g., Sieland, supra note 1, at 569 (arguing that the SEC should require brokerage firms to characterize their research reports as "sales literature" and confer the label of "independent analyst" on those who meet certain criteria).

customers who believe they were injured by the misconduct of compromised sell-side analysts or their employers. To the contrary: Spitzer expected that the Dinallo Affidavit and other materials made public as a result of the investigation and settlement would be utilized by the private bar on behalf of customers seeking damages.\textsuperscript{6}

His expectations have been fully met. By November 2002, over 150 securities fraud class actions were pending against Merrill Lynch alone, based primarily on analyst conflict allegations.\textsuperscript{7} Most of them followed on the heels of Spitzer’s Martin Act investigation and rely heavily on the Dinallo Affidavit. A few cases, however, were filed as early as the summer of 2001, after the Kanjilal settlement was announced.\textsuperscript{8} Other large Wall Street firms have also attracted multiple cases. Many of them were filed after the Global Settlement was announced in April 2003, at which point the SEC publicly released the internal emails and other evidence that it had gathered from the settling firms.\textsuperscript{9}

\section*{EARLY RESULTS ARE MIXED}

\subsection*{Actionable Misrepresentations}

Typically, the analyst-conflict class actions are brought under SEC Rule 10b-5, which prohibits fraud in connection with the purchase or sale of a security.\textsuperscript{10} The plaintiffs claim

\textsuperscript{6} See id. ("We have made public the information that they need to bring a lawsuit.").


\textsuperscript{8} See, e.g., Pludo v. Morgan Stanley Dean Witter & Co., No. 01 Civ. 7072, Fed. Sec. L. Rep. (CCH) ¶ 91,541 (S.D.N.Y. 2001). These figures do not include the numerous individual arbitration claims filed by customers alleging analyst-related injuries.

\textsuperscript{9} See, e.g., DeMarco v. Lehman Bros., 309 F. Supp. 2d 631, 634 (S.D.N.Y. 2004) (noting that the case was filed shortly after the SEC released emails showing that a Lehman analyst advised an institutional investor to short RealNetworks while maintaining a "buy" recommendation on the stock).

that the defendants' research reports were materially false or misleading in that: (i) they made recommendations that were inconsistent with the analysts' true opinions; (ii) they lacked any reasonable factual basis or ignored contrary facts; (iii) they failed to disclose the inherent conflicts built into the relationship between the research and the investment banking departments; (iv) they failed to disclose the specific conflicts stemming from the brokerage firm's relationship with the covered company; (v) they failed to disclose the truth concerning the "grading curve," that is, the high proportion of the firm's recommendations that were "buys" or the equivalent; or (vi) all of the above.  

Notwithstanding the protected position that statements of opinion generally occupy under the federal securities laws, defendants have for the most part been unsuccessful in moving to dismiss the claims against them for failure to plead actionable misrepresentations. This is because, under Virginia Bankshares, Inc. v. Sandberg, a statement of opinion that is contrary to the speaker's actual subjective view is treated as a false statement of fact. Most of the class action complaints based on analyst conflicts expressly allege that the research reports in question did not accurately reflect the views of the analysts who wrote them, and consequently are not challenged on the ground that the reports contain protected statements of opinion rather than actionable statements of fact. The complaints that have been challenged on this ground have generally survived the motion to dismiss. Some complaints,
however, have been dismissed pursuant to Rule 9(b) of the Federal Rules of Civil Procedure and/or the Reform Act for failure to plead with particularity that the research reports in question misrepresented their authors’ true views.

Statute of Limitations

Defendants have had better luck with motions based on the statute of limitations. These motions argue that in light of the wealth of information concerning analyst conflicts available to the public, securities purchasers should be deemed to have been on “inquiry notice” of those conflicts – and hence of the alleged fraud – long before they filed their claims. Merrill Lynch and its former analyst Blodget won a string of motions

87 Before passage of the Sarbanes-Oxley Act, the statute of limitations for Rule 10b-5 claims was governed by Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, which held that such claims must be filed “within one year after the discovery of the facts constituting the violation or within three years after such violation.” 501 U.S. 350, 364 (1991). Section 804(a) of the Sarbanes-Oxley Act, effective July 30, 2001, replaced the one year/three year limitations period decreed by Lampf with a two year/five year formula. See Public Company Accounting and Investor Protection Act of 2002, Pub. L. 107-204, § 804(b), 116 Stat. 745, 801 (codified in part at 28 U.S.C. § 1658(b) (2000)).
88 See text accompanying notes 28–39.
89 In the Second Circuit, a Rule 10b-5 plaintiff “will be deemed to have discovered fraud for purposes of triggering the statute of limitations when a reasonable investor of ordinary intelligence would have discovered the existence of fraud.” Dodds v. Cigna Sec., Inc., 12 F.3d 346, 350 (2d Cir. 1993). Moreover, when circumstances would “suggest” to the hypothetical reasonable investor “the probability that she has been defrauded, a duty of inquiry arises, and knowledge will be imputed to the investor who does not make such an inquiry.” Id.
to dismiss on this ground, all issued by Judge Pollack. For example, in *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*, the court dismissed claims brought by investors in eight different Internet companies covered by Merrill Lynch, holding:

The plethora of public information would have required even a blind, deaf or indifferent investor to take notice of the purported alleged “fraud.” Palpably, the plaintiffs, as well as the public regulators and indeed the whole investment community, were on inquiry notice of the asserted “fraud,” and the alleged conflict of interest, well more than two years prior to the filing of the Complaints herein.91

Just before this article went to press, Judge Holwell, also in the Southern District of New York, used the same logic to dismiss a class action brought by investors in the brokerage firm that employed the conflicted analysts. In *Shah v. Morgan Stanley*,92 the court dismissed the case under the two-year prong of the post-Sarbanes-Oxley statute of limitations, holding that the lead plaintiff was on “inquiry notice” of the alleged wrongdoing of Mary Meeker and other Morgan Stanley analysts no later than May 14, 2001, the date on which *Fortune* published a feature article93 revealing, “in no uncertain terms,” each of the allegedly “undisclosed improper business practices” described in the complaint.94

Other judges in the same district, however, have refused to dismiss claims against analysts and their employers on limitations grounds. In *Fogarazzo*, Judge Scheindlin distinguished *In re Merrill Lynch* on the ground that the media reports cited there “specifically identified Merrill Lynch as suffering from wide-spread conflicts of interest” and “detailed particular statements by Merrill Lynch analysts indicating a massive scheme to defraud,” while the defendants in the case before her presented no comparable materials concerning

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93 Caveat Investor, supra note 35.
94 2004 WL 2347616, at *10. The court noted that since the plaintiff class in *Shah* consisted of investors in Morgan Stanley itself (as opposed to investors in corporations that happened to be covered by Morgan Stanley’s analysts) “this action presents a more compelling case for holding that the plaintiff had inquiry notice than other actions in this district with the same holding.” Id. at *11.
Lehman Brothers, Goldman Sachs or Morgan Stanley. And in *DeMarco v. Lehman Brothers*, Judge Rakoff ruled that plaintiffs could not have known that the Lehman Brothers analyst covering RealNetworks acted with *scienter* until April 28, 2003, when the SEC released emails showing that the analyst was advising favored customers to short the stock while still urging the public to buy it.

**Loss Causation**

A Rule 10b-5 plaintiff must plead and prove both transaction causation—that is, that the defendant's conduct caused her to enter into the detrimental securities transaction—and loss causation, recently described by the Second Circuit as a "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." It is relatively easy to allege facts sufficient to satisfy the transaction causation element. A plaintiff need only assert that she relied on the defendant's false or misleading statement to purchase the stock in question. Easier still, if the case qualifies for the fraud-on-the-market presumption endorsed by the Supreme Court in *Basic, Inc. v. Levinson*, the plaintiff may simply allege that she relied on the "integrity of the market," and will then be entitled to the presumption that the price of the stock she bought was affected by all "available material information" concerning the company, such that any publicly-disseminated misleading statements defrauded her even if she never read them.

In a typical Rule 10b-5 case, involving false statements or material omissions by a company about its business or financial condition, pleading loss causation is not much more difficult. This is because the stock price inflation caused by the misrepresentation is generally cured upon disclosure of the truth, which is also when the stock price drops and the plaintiff incurs (or at least realizes) his injury. The situation is somewhat more complicated, however, in the world of analyst-
conflict litigation. In most such cases, the prices of the stocks at issue began dropping when the Internet bubble burst in 2000 — two years before Merrill Lynch’s internal emails were made public in the Dinallo Affidavit, and three years before similar materials from other firms were released in connection with the Global Settlement. Thus, plaintiffs in many of the analyst-conflict cases are unable to tie the price decline in their securities to any disclosures concerning the analysts they have sued.\textsuperscript{100}

This peculiarity puts the analyst-conflict cases squarely in the middle of a debate over loss causation that has split the circuits and is headed for the Supreme Court. The Eighth and Ninth Circuits have adopted the “purchase price disparity” approach, which does not require the plaintiff to plead a price decline upon disclosure of the facts previously misrepresented or concealed.\textsuperscript{101} It is enough, as the Ninth Circuit explained in \textit{Broudo}, for the plaintiff to allege that the false or misleading statement inflated the price of the security at the moment the plaintiff purchased it.\textsuperscript{102}

The Second, Third, Seventh and Eleventh Circuits, on the other hand, generally require a plaintiff to plead that the price of the stock declined after purchase and that the decline was caused, at least in part, by the alleged fraud.\textsuperscript{103} In the view of these courts, a “purchase-time value disparity, standing alone, cannot satisfy the loss causation pleading

\textsuperscript{100} Not all analyst-conflict plaintiffs have this difficulty. See, \textit{e.g.}, DeMarco v. Robertson Stephens, Inc., No. 03 Civ. 590 (GEL) 2004 WL 51232 (S.D.N.Y. 2004) (plaintiffs alleged, among other things, that the value of their Corvis stock dropped 16\% in May 2001, immediately after the New York Times reported a discrepancy between Robertson Stephens’ public “buy” recommendations and private sales of the same stock by the firm and some of its executives).

\textsuperscript{101} \textit{See} Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824 (8th Cir. 2003); Broudo v. Dura Pharm., Inc., 339 F.3d 933 (9th Cir. 2003), \textit{cert. granted}, 72 U.S.L.W. 3451 (U.S. June 28, 2004) (No. 03-932).

\textsuperscript{102} 339 F.3d at 938. The court stated:

\begin{quote}
[F]or a cause of action to accrue, it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred, because the injury occurs at the time of the transaction. It is at that time that the damages are to be measured. Thus, loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of the purchase was overstated and sufficient identification of the cause.
\end{quote}

\textit{Id.}

requirement." Such an allegation "amounts to nothing more than a paraphrased allegation of transaction causation," which may explain why the plaintiff bought (or bought at a particular price), "but not why it lost money on the purchase, the very question that the loss causation allegation must answer." 

Even within the Second Circuit, where most of the analyst-conflict class actions are venued, district judges have not applied the price decline approach uniformly. In a pair of much-quoted opinions relying on Robbins and Emergent Capital, Judge Pollack dismissed a series of cases filed against Merrill Lynch on the pleadings, complaining that the plaintiffs conflated transaction causation and loss causation and that, because they attempted to allege price inflation only, they failed to satisfy the latter element. Moreover, according to Judge Pollack, the Merrill Lynch plaintiffs could not logically allege that disclosure of the truth about analyst biases caused the stock price drops that injured them. Those drops, he pointed out, occurred primarily when the Internet bubble burst in 2000, whereas the plaintiffs all claimed (for purposes of the statute of limitations) that they — and hence the market — could not have known about the analyst conflicts until the Dinallo Affidavit was released in April 2002.

Other judges in the same district have reached different conclusions. In In re WorldCom, the plaintiffs alleged not only that Grubman's research reports on WorldCom concealed his "conflicted position," but also that these reports affirmatively misrepresented "WorldCom's true financial condition." Moreover, plaintiffs alleged, Grubman was not just any analyst — at the time, he was the industry's leading telecommunication analyst. Accordingly, revelations concerning his "compromised relationship" with WorldCom were enough in and of themselves to affect the company's stock price and even "the

104 Emergent Capital, 343 F.3d at 198.
105 Id.
107 See, e.g., In re Merrill Lynch, 289 F. Supp. 2d at 421.
economic health of Worldcom itself." On these somewhat unusual facts, Judge Cote denied defendants' motion to dismiss, finding that plaintiffs adequately alleged that “the subsequent disclosure of accurate information about these two issues [Grubman’s conflicts and WorldCom’s financial position] caused the price of WorldCom’s securities to drop.”

In DeMarco v. Lehman Brothers, Judge Rakoff applied a substantially more lenient legal standard to find plaintiffs’ loss causation allegations adequate." Insofar as can be discerned from the opinion, the analyst in that case, Michael Stanek, was not accused of misrepresenting RealNetworks’ finances but merely of misrepresenting his own opinion. Moreover, unlike the In re WorldCom plaintiffs, the plaintiffs in DeMarco did not allege that Stanek was such a force in the industry that revelations concerning his biases would be sufficient to move the market. Nonetheless, Judge Rakoff denied Lehman Brothers’ motion to dismiss on loss causation grounds, noting that the price of the stock declined when “the market was finally apprised of the negative information concerning RealNetworks that had earlier led Stanek to take a secretly negative view of the stock.” Although this standard does require the plaintiffs to plead a price decline, and does require that the decline be linked in some way to the challenged research report, Judge Rakoff’s logic would seem to obliterate the distinction that Emergent Capital was at such pains to draw. Under the DeMarco rule, analyst conflict cases would go forward even where the stock drop has nothing to do with the disclosure of the truth about the analyst (as opposed to the truth about the company).

The difficulty in applying the price decline approach to loss causation in the analyst conflict context is perhaps best illustrated by Fogarazzo v. Lehman Brothers, where the plaintiffs alleged that defendants’ bullish research reports on RSL Communications misstated the authors’ true opinions and inflated RSL stock. Judge Scheindlin carefully reviewed recent Second Circuit case law and held, consistently with

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109 Id. at 405, 428.
110 Id. at 428.
112 Id. at 634–35.
113 Id.
114 Id. at 636–37.
Emergent Capital, that in such a case the stock decline must be "attributable to the very thing that the defendants allegedly lied about."\textsuperscript{116} She then held that the plaintiffs satisfied the Second Circuit's loss causation test by alleging that RSL failed "because of the very facts that [defendants] misrepresented: that RSL was in financial difficulty and that the entire "internet telephony' sector was collapsing."\textsuperscript{117}

But a closer look at the opinion reveals that defendants did not in fact lie about RSL's finances, or at least did not do so by "withhold[ing] information about RSL's debts or assets or about any important financial events in the life of RSL" (all of which were "available for the world to see").\textsuperscript{118} Instead, the defendants in Fogarazzo, as in many of the analyst conflict cases, were alleged simply to have "misstate[d] [their] true opinions of the impact of these events."\textsuperscript{119} In order to squeeze this fact pattern through the loss causation door, the court simply recharacterized the allegations of the complaint, transforming lies about defendants' opinions - the disclosure of which, standing alone, is not alleged to have caused any drop in RSL's stock price - into lies about RSL's finances. The court's conclusion is not only inconsistent with the underlying factual allegations from which it is drawn, it threatens to wreak havoc with the basic notion that Rule 10b-5 requires a misrepresentation (or omission) of fact.\textsuperscript{120}

\textit{Fraud on the Market}

As noted above, since the court is required to accept as true all well-pleaded factual allegations in the complaint, the applicability of the fraud-on-the-market doctrine to a class action based on analyst conflict allegations has not been seriously challenged at the pleading stage.\textsuperscript{121} But the real utility of the doctrine to a class action plaintiff comes at the class certification stage, because, absent a blanket presumption of reliance, each class member would be required to prove that he or she personally relied on the defendant's alleged

\textsuperscript{116} Id. at *10.
\textsuperscript{117} Id. at *11.
\textsuperscript{118} Id. at *12.
\textsuperscript{119} Id.
\textsuperscript{120} 17 C.F.R. § 204.10b-5(b) (2004).
misrepresentations, which in turn would make class certification impossible.\textsuperscript{122}

In \textit{In re WorldCom Securities Litigation}, Judge Cote granted the plaintiffs' class certification motion, holding with respect to the analyst conflict claims that there is no reason \textit{not} to apply the fraud-on-the-market doctrine to research reports.\textsuperscript{123} However, the Second Circuit promptly granted the brokerage firm defendants' motion, made pursuant to Fed. R. Civ. P. 23(f), to hear a discretionary interlocutory appeal from the district court's class certification order.\textsuperscript{124} And while the appellate court has not yet decided the merits of that appeal, its initial opinion suggests that it is likely to focus on issues of evidence and burden of proof.\textsuperscript{125}

Most recently, in a carefully-worded opinion written in anticipation of close appellate scrutiny, Judge Rakoff focused on the same issues and held:

\begin{quote}
[T]he fraud-on-the-market doctrine may in certain conditions apply to analyst reports but . . . the plaintiffs here have failed to adduce evidence adequate to satisfy such conditions for purposes of class certification.\textsuperscript{126}
\end{quote}

Reviewing the familiar logic underlying \textit{Basic}, Judge Rakoff had no difficulty accepting the premise that "some research analysts may have the ability to influence market prices on the basis of their recommendations."\textsuperscript{127} He was quick, however, to distinguish the potential impact of a fraudulent statement made by an issuer and a statement of opinion emanating from a research analyst, holding that in the latter case 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."\textsuperscript{128} Turning to the evidence adduced by the parties in \textit{DeMarco}, Judge Rakoff

\begin{footnotesize}
\textsuperscript{122} \textit{See} Fed. R. Civ. P. 23(a)(3), 23(b)(3).
\textsuperscript{124} Hevesi v. Citigroup, Inc., 366 F.3d 70, 77 (2d Cir. 2004).
\textsuperscript{125} \textit{See id.} at 78 (noting that the district judge expressly declined to "wade into the battle of the experts" as to the existence of a causal link between Grubman's analyst reports and movements in the price of WorldCom's securities; instead, Judge Cote credited the plaintiffs' allegations that Grubman's statements of opinion changed the prices of WorldCom's securities").
\textsuperscript{127} \textit{Id.} at *2.
\textsuperscript{128} \textit{Id.} at *3.
\end{footnotesize}
found the plaintiffs' expert testimony so flawed that it did not "remotely satisfy the aforementioned burden," and denied the motion.\textsuperscript{129}

\textbf{THE NEXT PHASE}

Both the plaintiffs and the defendants in the analyst-conflict cases now winding their way through the lower federal courts are keeping a close eye on both the Second Circuit, which is presiding over appeals from the Merrill Lynch cases and \textit{In re WorldCom}, and the Supreme Court, which is expected to rule in \textit{Broudo} some time next year. If the Supreme Court agrees with the Ninth Circuit and endorses the purchase price disparity approach to loss causation, the pleading burden for analyst-conflict plaintiffs now struggling in the Second Circuit will be greatly lightened. If, on the other hand, the Supreme Court rejects the Ninth Circuit rule in favor of a price decline test like that now used in the Second Circuit, it will become more difficult for analyst-conflict plaintiffs throughout the country to survive the defendants' inevitable pleading motions.

Within the Second Circuit, the preliminary opinion in \textit{Hevesi} suggests that the appellate court may have its greatest impact on the pending analyst-conflict litigation by ruling, in a non-pleading context, on the fraud-on-the-market issue. If the Second Circuit requires proof of a causal link between the analyst's reports and price movement in the covered stock at the class certification stage, such motions may become far more significant events in an analyst conflict case than they typically are in other securities fraud class actions. Most obviously, in many cases (particularly those involving less prominent analysts or crowded fields), defendants will stand a decent chance of preventing certification altogether, which would effectively end the litigation. Moreover, the motion proceedings themselves will require that the plaintiffs preview their damages evidence and that the court evaluate it.\textsuperscript{130} Where the

\textsuperscript{129} \textit{Id.} at *4–6.

\textsuperscript{130} The plaintiffs in \textit{DeMarco} "now disclaim even an attempt to prove that the publication of Stanek's 'buy' recommendations . . . increased the price of RealNetworks' stock." 2004 WL 1506242, at *4. Instead, plaintiffs tried (and failed) to show that a "sell" recommendation would have lowered the price of the stock. \textit{Id.} While the two inquiries are closely related, they are not the same. And as a matter of logic it is the former question — whether defendants' alleged misconduct inflated the price of the stock that the plaintiff bought — that should be addressed in the context of a class
court finds that evidence weak, the plaintiffs may survive the class certification motion but find that their case has a considerably lower settlement value as a result.

certification motion turning on the applicability of the fraud-on-the-market doctrine. After all, the function of that doctrine is to supply (or substitute for) the reliance element of a Rule 10b-5 claim, also known as transaction causation. See Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc., 343 F.3d 189, 197 (2d Cir. 2003). When and if plaintiffs in analyst conflict cases are required to establish that defendants' positive recommendations inflated the price of the stocks they covered, they will come face to face with the empirical studies showing that “the market” distrusted, and therefore discounted, recommendations from the same underwriter-affiliated analysts who are now the class action defendants. See Michaely & Womack, supra note 37, at 668-69.