The Promise of Unfavorable Research: Ramifications of Regulations Separating Research and Investment Banking for IPO Issuers and Investors

By Benjamin J. Catalano[1]

The trend in Securities and Exchange Commission and Financial Industry Regulatory Authority rulemaking and enforcement to insulate research from investment banking influence has led to the removal of research analysts from the underwriting process with adverse consequences for new issuers and their investors. The approach conflicts with the congressional objective under the Jumpstart Our Business Startups (JOBS) Act to incorporate research fully in public offerings for emerging growth companies, which now comprise the vast majority of IPO issuers. Faced with these competing objectives, broker-dealers should have written policies and procedures that are carefully crafted to service their underwriting and investor clients appropriately and to take advantage of the JOBS Act privileges with respect to research.

"[M]arket efficiency in pricing is significantly enhanced by [research analysts'] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983).

FINRA[2] Rule 2241, which went into effect in December of 2015,[3] replacing NASD Rule 2711, requires that member broker-dealers more actively manage

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2. FINRA is the Financial Industry Regulatory Authority, a national securities association of brokers and dealers ("broker-dealers") registered with the Securities and Exchange Commission ("SEC") under section 15A of the Securities Exchange Act of 1934 (the "Exchange Act"). FINRA is an industry self-regulatory organization ("SRO"). In 2007, FINRA assumed the SRO responsibilities of the former National Association of Securities Dealers, Inc. ("NASD") and SRO member regulation and enforcement responsibilities of the New York Stock Exchange, Inc. ("NYSE"). *See* Order Approving Proposed Rule Change to Amend the By-Laws of NASD, Exchange Act Release No. 34-56145, 72 Fed. Reg. 42169, 42169 (July 26, 2007), http://www.gpo.gov/fdsys/pkg/FR-2007-08-01/pdf/E7-14855.pdf.

3. *See* Order Approving a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports), Exchange Act Release No. 34-75471, 80 Fed. Reg. 43482 (July 16, 2015), http://www.gpo.gov/fdsys/pkg/FR-2015-07-22/pdf/2015-17971.pdf.

conflicts of interest between equity research and investment banking.[4] The new rule incorporates all of the previous rule's core provisions, with some modifications; however, it goes significantly further by requiring members to identify and prevent new and unspecified conflicts. The broader mandate makes the specific prescriptions in the rule the baseline for expectations on compliance. Together with recent enforcement actions that dispensed with the culpability standards in legacy provisions prohibiting research analysts from soliciting investment banking business and members from promising favorable research, the new regime is poised to achieve the complete separation of research from investment banking to ensure that it remains objective.

Unfortunately, the regulatory effort to isolate research has prevented issuers from taking full advantage of their underwriters' expertise in initial public offerings ("IPOs") and diminished the important role research analysts traditionally have played in the IPO underwriting process. The consequences for issuers and investors are manifest in IPO pricing inefficiency and in research by underwriters that often conflicts with their recommendations to buy the stock on the offering.

The approach undermines the congressional objective of the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act")[5] to instill research as an integral part of the IPO process for emerging growth companies ("EGCs"), which now constitute the vast majority of all IPOs. For FINRA member firms that want to rely on the JOBS Act privileges with respect to research, it is critical to have carefully considered written policies and procedures governing analysts' involvement in the IPO underwriting process that reconcile those allowances with Rule 2241.

The Original Equity Research Conflict Rules and Broader Restrictions on Major Underwriters Under the Global Settlement

The equity research conflict rules originated in the wake of the "dot-com" crisis when it was widely believed that compromised research by some investment banks contributed to the technology stock bubble of the late 1990s and its inevitable deflation beginning in 2001.[6] The rapid expansion of the Internet at the end of the millennium led to a plethora of IPOs by start-ups and spin-offs focused on the new telecommunications medium and its application to existing businesses.[7] These companies had little revenue and no profits, and conven-

4. *Id.*

5. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.) [hereinafter JOBS Act].

6. See NYSE/NASD IPO Advisory Comm., Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the Request of the U.S. Securities and Exchange Commission (2003) http://www.finra.org/sites/default/files/Industry/p010373.pdf [hereinafter NYSE & NASD 2003 Report], for an analysis of market practices, including alleged biased recommendations by research analysts, during the stock market bubble of the late 1990s and early 2000s.

7. *See* Arvin Ghosh, *The Rise and Fall and Rise Again of the United States IPOs*, 1 Global J. Bus. Res. 11, 11 (2007).

tional measures of valuation such as price-to-earnings ratios were inapposite.[8] The opinions of Wall Street analysts who specialized in the nascent technology were essential to decipher the companies' prospects and to help to value their stocks. Some of these analysts achieved celebrity status with retail investors who followed them on popular news outlets and gobbled up the new IPOs they recommended.[9] Broker-dealers relied on them heavily to win IPO business.[10] The weight of the research department's efforts shifted from supporting sales and trading to assisting investment banking. The investment banking department acquired a say in evaluating analysts' performance and the firms compensated analysts for underwriting business.[11] The analysts' interests became more aligned with the firm's investment banking clientele than its retail and institutional "buy-side" clients as traditionally had been the case.[12]

As the bubble expanded and prospects for the increasing number of new technology companies became more limited, or were missing altogether, some analysts appeared to have overlooked these deficiencies to ensure the continued flow of IPO business they were paid to promote.[13] Sometimes a "strong buy" or "market outperform" rating masked the analyst's privately held view that the stock was, instead, "a powder keg" or "a piece of junk," or that there was "no reason to own it."[14] Some analysts assigned strong buy recommendations to IPO stocks that had already appreciated greatly in aftermarket trading, suggesting that the favorable coverage had been prearranged.[15] Ostensibly, the result was some recklessly contrived research and, in certain instances, opinions that the analysts simply did not believe, leading to enforcement actions by the SEC, NASD, NYSE, the New York State Attorney General, and the North American Securities Administrators Association against some of the largest investment banks that were resolved through remedial agreements that came to be known as the "Global Settlement."[16]

8. *See* Richard Swedberg, *On the Conflicts of Interest in the Corporate Scandals of 2001–2002* 7 (Ctr. for Study of Econ. & Soc'y, CSES Working Paper Series, Paper No. 2, 2003), http://www.economyandsociety.org/wp-content/uploads/2013/08/wp2_swedberg_03.pdf.

9. *See, e.g.*, *id.*; *see also* Lori Richards, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Analysts Conflicts of Interest—Taking Steps to Remove Bias (May 8, 2002), http://www.sec.gov/news/speech/spch559.htm.

10. See Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (2005), http://www.finra.org/sites/default/files/Industry/p015803.pdf [hereinafter NASD & NYSE 2005 Report], for a discussion of the role of analysts in IPO transactions during the dot-com era; *see also* Swedberg, *supra* note 8.

11. *See* NASD & NYSE 2005 Report, *supra* note 10, at 2 ("[R]esearch analysts were compensated based on their contributions in support of investment banking transactions and the profitability of that unit. . . . [I]nvestment bankers at some firms evaluated research analysts for compensation purposes, particularly bonuses.").

12. *See* Richards, *supra* note 9.

13. *See* Swedberg, *supra* note 8.

14. *See* Joint Press Release, U.S. Sec. & Exch. Comm'n, N.Y. Attorney Gen., N. Am. Sec. Adm'rs Ass'n, NASD & NYSE, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), http://www.sec.gov/news/press/2003-54.htm, and the underlying settlements therein [hereinafter Global Settlement].

15. *Id.*

16. *Id.*

Initially, New York's Attorney General, Eliot Spitzer, sought to remove research analysts to separate firms, "thereby achieving a complete separation between analysts and underwriters."[17] The industry objected, arguing, among other things, that investment banking should not be deprived of the analysts' expertise in vetting prospective clients, performing due diligence, and advising on transactions.[18] The proposal was rejected.[19] Instead, after the SEC and the SROs determined that the primary cause of compromised research lay in the analysts' compensation for underwriting business,[20] the NASD promulgated Rule 2711 and the NYSE amended its rules to eliminate payments to analysts for investment banking business and to address certain other managerial influences by investment banking over research.[21] In addition, new SEC rules promulgated as Regulation AC—Analyst Certification required analysts to represent in research reports that they were not compensated in relation to their specific recommendations or views, or to disclose such compensation, and to certify that their opinions accurately reflected their views, rendering them liable for their statements.[22]

17. *See* John C. Coffee, Jr., *Competitive Federalism: The Rise of the State Attorneys General*, COLUMBIA L. SCH. (Sept. 2003), http://www.law.columbia.edu/media_inquiries/news_events/2005_older/2003/September_2003/coffee_nylj_sep ("[T]he original proposal made by Mr. Spitzer (and quickly dropped) [was] that underwriting firms spin-off their securities analysts into a separate subsidiary . . . ").

18. *See* Letter from Robert C. Dinerstein, Chairman, Sec. Indus. Ass'n, to Margaret H. McFarland, Deputy Sec'y, Sec. & Exch. Comm'n (Mar. 10, 2003), http://www.sifma.org/issues/item.aspx?id=1011 [hereinafter 2003 Dinerstein Letter] (The industry also posited that research could not pay for itself apart from investment banking and brokerage, which would result in less research in the marketplace.).

19. *See* Coffee, Jr., *supra* note 17; *see also* Swedberg, *supra* note 8, at 21.

20. *See Oversight Hearing on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies" Before the S. Comm. on Banking, Hous. & Urban Affairs*, 107th Cong. (2002) (statement of The Honorable Arthur Levitt, Jr., Former Chairman of the Securities and Exchange Commission), http://www.banking.senate.gov/02_02hrg/021202/levitt.htm ("For years, we've known that analysts' compensation is tied to their ability to bring in or support investment banking deals. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say."); *see also* NYSE & NASD 2003 REPORT, *supra* note 6, at 2 ("With their compensation and promotion tied to the success of their firms' investment banking business, some research analysts apparently agreed to issue and maintain 'buy' recommendations on certain stocks despite aftermarket prices that jumped to multiples of their IPO prices.").

21. *See* Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc., Exchange Act Release No. 34-45908, 67 Fed. Reg. 34968 (May 10, 2002), http://www.gpo.gov/fdsys/pkg/FR-2002-05-16/pdf/02-12207.pdf; *see also* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc. Relating to Exchange Rules 344, 345A, 351, and 472 and by the National Association of Securities Dealers, Inc. Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-48252, 68 Fed. Reg. 45875 (July 29, 2003), http://www.gpo.gov/fdsys/pkg/FR-2003-08-04/pdf/03-19730.pdf. Among other things, the rules prohibited investment bankers' involvement in the evaluation, compensation, or supervision of research analysts. *See, e.g.*, NASD Rule 2711(b). The SRO Rules were fashioned to comply with Title V of the Sarbanes-Oxley Act of 2002, which added section 15D to the Exchange Act requiring the SEC or, on its authority, the SROs to promulgate rules redressing conflicts pertaining to research analysts and research reports. *See* Pub. L. No. 107-204, § 501, 116 Stat. 745, 791–93 (codified as amended at 15 U.S.C. § 78o-6 (2012)).

22. 17 C.F.R. § 242.501(a) (2016); *see also* Regulation Analyst Certification, Exchange Act Release No. 34-47384, 68 Fed. Reg. 9482, 9493 (Feb. 27, 2003), http://www.gpo.gov/fdsys/pkg/FR-2003-02-27/pdf/03-4576.pdf; *see* Charles P. Grom, Exchange Act Release No. 77150 (Feb. 17, 2016), https://www.sec.gov/litigation/admin/2016/34-77150.pdf (SEC charged research analyst with certifying a rating on a stock that was inconsistent with his private opinion).

In addition to the changes in compensation and management, the new SRO rules restricted analysts' participation in investment banking pitches and efforts to market public offerings and other investment banking transactions to customers with an investment banker or the issuer present.[23] They explicitly forbade members from arranging favorable research in exchange for underwriting business[24] and imposed "quiet periods" after an offering during which underwriters were not permitted to publish research.[25] Research reports were required to contain disclosures of specific conflicts pertaining to the firm or the analyst.[26]

The regulators thus considered but rejected taking research analysts out of the investment banking process altogether, in favor of the specific prescriptions in the SRO rules and the federal certification requirement. The regulatory regime was carefully crafted to allow analysts to continue to participate in underwriting functions that were considered beneficial to issuers and investors and not prejudicial to research by realigning the interests of analysts with their original buy-side constituency.

The Global Settlement took a more restrictive approach. The agreements with the settling firms included a number of remedial measures that went beyond the administrative reforms in the SRO rules.[27] Most significantly, *all* communications between bankers and analysts were prohibited unless expressly permitted.[28] (Under SRO rules, communications that were not prohibited were permitted.) One exception to the embargo allowed bankers to consult the analyst on the structure and pricing of an IPO, but only after the firm had been retained as an underwriter.[29]

23. *See, e.g.*, NASD Rule 2711(c). Sub-paragraph (2) also limited the review of a draft research report with the subject company.

24. *See, e.g.*, NASD Rule 2711(e).

25. *See, e.g.*, NASD Rule 2711(f). The rule imposed a forty-day quiet period after an IPO for firms participating as managers or co-managers in the offering, and a twenty-five-day quiet period for non-managing underwriters or dealers. The rule also imposed a ten-day quiet period after a secondary offering. The idea was that the disinterested research already in the market would, by comparison, deter disingenuous coverage by the underwriters. The quiet periods were eliminated for offerings involving EGCs in response to the JOBS Act, *see* NASD Rule 2711(f)(5), and later reduced for offerings involving other companies in new Rule 2241, which took effect in September 2015, *see* FINRA Rule 2241(b)(2)(I). *See also* NASD Rule 2711(b)(2) (limiting the review or approval of a research report by non-research personnel, including investment bankers); NASD Rule 2711(c)(2) (limiting an analyst's ability to review a draft research report with the subject company).

26. *See, e.g.*, NASD Rule 2711(h).

27. *See* Global Settlement, *supra* note 14, add. A., sec. III, subsec. 1. For example, firms were required to provide independent research to customers to compare against their own. *Id.*

28. *Compare id.* add. A, sec. I, subsec. 10 ("So as to reduce further the potential for conflicts of interest or the appearance of conflicts of interest, the firm must create and enforce firewalls between Research and Investment Banking reasonably designed to prohibit *all* communications between the two except as expressly described . . . ." (emphasis added)), *with id.* add. A, sec. I, subsec. 10(g) ("Communications between Research and Investment Banking personnel that are not related to investment banking or research activities may take place without restriction.").

29. *Id.* add. A, sec. I, subsec. 10(d) (The NASD and the NYSE took the position that bankers could consult the analyst on valuation and other issues in advance of the engagement. *See* Exchange Act Release No. 34-45908, *supra* note 21, at 34972 (noting that restrictions in NASD Rule 2711 on communications between bankers and analysts were limited to the review of draft research reports and did not affect other interdepartmental communications).) Guidance by the SEC staff left open the possibility that the issuer could obtain the analyst's views on valuation and pricing in direct communications with the analyst alone before hiring the firm as an underwriter. *See* SEC Interpretive Letter

In 2005, the NASD and the NYSE audited the effectiveness of the new rules.[30] They determined that the prescriptions, in conjunction with Regulation AC, had worked to restore the independence of research. Among other things, the SROs found that member firms more frequently commenced coverage on companies they brought public with less than a buy recommendation.[31] They observed, though, that some neutral or negative ratings occurred without a rise in the price of the stock after the IPO.[32] In those instances, the lesser recommendations were attributed to "other factors" not identified in the SROs' report.[33]

There were no enforcement actions against major underwriters charging the types of violations that gave rise to the research conflict rules and the Global Settlement until the end of 2014.

Research Inconsistent with Underwriters' Recommendations Signals Disruption in Communications Between Issuers and Analysts

Before the SROs' research rules and the Global Settlement, IPO underwriters were highly unlikely to start research coverage on the company only a short time after the offering with less than a strong buy rating unless the price of the stock had appreciated substantially by then. (The advice would have conflicted with the underwriter's recommendation to buy the stock on the offering.)[34] Ordinarily, the analyst's views on valuation and other issues were taken into account to ensure consistency in the research. Moreover, customers were expected to consult the analyst prior to investing, so it was important that the analyst agreed on major issues related to the offering. Understandably then, some issuers were confounded when, after the reforms, underwriters initiated coverage with neutral or negative ratings although little had changed since the offering.

In one instance, Robert Benmoshe, the outspoken CEO of American International Group, protested to *The Wall Street Journal* that the lead underwriters of AIG's initial offering after its government bailout in 2008 resumed or initiated coverage with neutral ratings.[35] The newspaper reported that the analysts "expressed skepticism about the company's ability to meet various profitability and cost-cutting goals that its executives had mapped out to investors" in its

to Dana Fleischman, Cleary, Gottlieb, Steen & Hamilton (Nov. 2, 2004), http://www.sec.gov/divisions/marketreg/mr-noaction/grs110204.htm [hereinafter Cleary Gottlieb Letter] (response to Question 19).

30. NASD & NYSE 2005 Report, *supra* note 10.

31. *Id.* at 34 ("[T]he SRO staffs recently have observed more circumstances where managers and co-managers have been neutral or even negative with their initial post-quiet period report. . . .").

32. *Id.* (noting that only some of the lesser ratings were based on price appreciation).

33. *Id.*

34. Of course, the analyst's opinion could change with negative developments later on. In the near term, however, material events or conditions not discovered during due diligence that could affect the underwriter's views in research just forty days after the offering would be unusual. For the most part, research on companies that traded in the secondary market for some time carried lesser recommendations due to negative developments that occurred well after their IPOs.

35. *See* Serena Ng, *AIG Gets Tough on Analyst Views*, Wall St. J. (Aug. 26, 2011), http://www.wsj.com/articles/SB10001424053111904009304576530401273378720.

May 2011 offering.[36] Mr. Benmoshe complained that the analysts did not "fully understand the company and its value."[37] He said that while he did not demand the underwriters publish favorable research, he did not expect them to portray the company in a way that was inconsistent with its message during the offering.[38] For the next issuance, he vowed to ensure that there was a "clear understanding [firm-wide] of who AIG is and our trajectory, and why AIG is a stock that investors should own."[39] Those criteria were not unreasonable under the traditional underwriting model that reconciled the views of investment bankers and analysts.

The article caught the attention of regulators. But instead of exploring the conditions that caused some member firms to express conflicting opinions about the same transaction, FINRA issued a regulatory notice admonishing all members to repudiate any effort by an issuer to pressure the firm to support an offering in research at the risk of promising favorable coverage for underwriting business in violation of NASD Rule 2711(e).[40]

As the SROs had observed, what happened to AIG was occurring frequently by then. Broker-dealers were initiating research on companies they brought public a short time earlier with less than a buy recommendation even though the price of the stock had not increased. There were at least fourteen IPO transactions in 2010 in which one or more lead or co-managing underwriters initiated coverage between forty and sixty days after the offering with less than a buy rating when the stock was trading at a price that was essentially unchanged from the offering price or, in some cases, well below that level. In five instances, the research included a projected future price target that was 10 to 25 percent *lower* than the offering price. The large majority of instances involved Global Settlement firms with greater restrictions on communications between investment bankers and research analysts.[41]

The analysts' views on valuation were not reflected in the offering prices. And if the issuers, like AIG, were taken aback by the coverage, then those views were not being communicated to them in advance of the IPOs.

The Toys "R" Us Cases Extend FINRA Restrictions on Communications Between Issuers and Analysts

In June 2010, a story appeared in the *New York Post* alleging that some analysts felt pressured about stock valuation in interviews with management of toy retailer Toys "R" Us while the company was considering underwriters for its

36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *See* Fin. Indus. Regulatory Auth., Regulatory Notice 11-41, Research Analysts and Research Reports (Sept. 2011), http://www.finra.org/sites/default/files/NoticeDocument/p124422.pdf.
41. The results are from an examination of thirty-nine IPO transactions that occurred in 2010.

planned IPO.[42] The story prompted an investigation by FINRA and subsequent enforcement actions against ten broker-dealers for their analysts' involvement in efforts that helped to obtain underwriting business.[43] The cases were equated to the compromised research arrangements a decade earlier—another example of recidivist behavior by an unreformed investment banking industry.[44] "It takes us back to the financial scandal of the early 2000s involving corrupt Wall Street research," a prominent columnist for *The New York Times* observed. According to FINRA, she wrote, "[f]louting these rules was the norm for every one of the firms."[45]

In reality, the firms' and their analysts' efforts to pursue the Toys "R" Us offering bore little resemblance to the investment banking pitches with research in tow that permeated the dot-com era. In the Toys "R" Us Settlements, the findings indicated the investment bankers and analysts largely acted independently, were motivated differently, and did not behave dishonestly. The stated violations went well beyond the plain meaning of Rule 2711 to restrict virtually all communications between a member firm and management of an issuer looking to go public that could enable management to learn the firm's research analyst's views about the company in the time leading up to its selection of underwriters.

While evaluating potential underwriters, Toys "R" Us management asked to meet separately with each firm's research analyst.[46] Management wanted to know whether the analyst's views about the company matched the opinions of the firm's investment bankers who had pitched for the business a short time earlier. Some of the company's private equity shareholder representatives said they had been "burned" before by negative research after an IPO.[47] Apparently, they wanted to avoid the same result in the Toys "R" Us offering.[48] Each analyst was

42. *See* Josh Kosman, *Name Your Price*, N.Y. POST (June 3, 2010), http://www.nypost.com/2010/06/03/name-your-price/.

43. *See* FINRA Letter of Acceptance, Waiver and Consent, No. 2013037819801 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683801 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683601 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683701 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683301 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683401 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2011030683501 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2013037819901 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2013037818301 (Dec. 10, 2014); FINRA Letter of Acceptance, Waiver and Consent, No. 2013037820001 (Dec. 10, 2014) (collectively, the "Toys 'R' Us Settlements").

The author represented a respondent in the Toys "R" Us Settlements.

44. *See* Press Release, Fin. Indus. Regulatory Auth., FINRA Fines 10 Firms a Total of $43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection with Toys "R" Us IPO (Dec. 11, 2014), http://www.finra.org/newsroom/2014/finra-fines-10-firms-total-435-million; Gretchen Morgenson, *At Big Banks, a Lesson Not Learned*, N.Y. TIMES (Dec. 12, 2014), http://www.nytimes.com/2014/12/14/business/at-big-banks-a-lesson-not-learned.html; Telis Demos & Alexandra Scaggs, *Big Banks Slapped for Offering Glowing Research to Win IPO*, WALL ST. J. (Dec. 11, 2014), http://www.wsj.com/articles/finra-fines-10-firms-over-coverage-of-toysrus-ipo-1418313315.

45. Morgenson, *supra* note 44.

46. *See generally* Toys "R" Us Settlements, *supra* note 43.

47. *Id.*

48. *Id.*

asked to deliver a presentation on topics identified by management.[49] The subjects included the outlook for the retail toy industry, comparables to Toys "R" Us, and the analyst's method for valuing the company.[50] Some analysts gave full presentations on the subjects.[51] Others limited their discussions to industry or market conditions or the firm's research capabilities, but did not address Toys "R" Us in particular.[52] (One did little more than express his enthusiasm for the opportunity to meet with management.)[53] On the company's instructions, no investment bankers were present at any of the meetings.[54] Notwithstanding the overall positive feedback it received from the analysts, management perceived differences of opinion between some of them and their investment banking colleagues over how much Toys "R" Us was worth.[55] The company asked all but one of the firms to submit a "firm-wide" valuation backed by the analyst, which each one returned.[56] Separately, some investment bankers or executives touted the firm's research capabilities, the analyst's credentials, or emphasized the analyst's agreement with the bankers' perceptions of the company.[57] The transaction was later abandoned, and the firms never published any research.

There was no finding that any firm was not in compliance with the structural separations required by Rule 2711. No investment banker or other non-research professional was found to have exerted undue influence over an analyst—either with regard to the analyst's meeting with management or his or her support for the firm's valuation. Communications between investment bankers and the analyst were chaperoned by legal or compliance professionals. There was no suggestion that any analyst was compensated for the Toys "R" Us transaction or any other investment banking business. (Indeed, if the analysts were paid in the usual way it was to get their research right.)[58]

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49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. Since the research conflict rules, analysts generally have been compensated based on the accuracy of their recommendations, measured by evaluations provided by sales representatives and buy-side clients. In 2015, *The Wall Street Journal* reported that approximately 60 percent of a broker-dealer's commission revenue is attributable to research, with more of it paid to analysts who are ranked highly by customers. Margot Patrick, Juliet Samuel & Alexandra Scaggs, *Banks Forced to Shake Up Analyst Research Business*, Wall St. J. (Feb. 9, 2015), http://www.wsj.com/articles/new-rules-poised-to-reshape-analyst-research-sector-1423514292; *accord* FINRA Rule 2241(b)(2)(F) (requiring members to have policies and procedures for internal committee review of analysts' compensation that include consideration of the quality of the analyst's research, the correlation between the analyst's recommendations, and the performance of the securities and the overall ratings received from clients, sales force, non-investment banking group peers, and independent ratings services); NASD Rule 2711(d)(2) (requiring member firms to consider, among other things, "the overall ratings received from clients, sales force, and peers independent of the member's investment banking department, and other independent ratings services" when determining their analysts' compensation).

The settlements, nevertheless, averred that the analysts participated in efforts to solicit investment banking business in violation of NASD Rule 2711(c)(4), and that the firms implicitly offered favorable research in exchange for the business contrary to Rule 2711(e).

Rule 2711(c)(4) provided that:

> No research analyst may participate in efforts to solicit investment banking business. Accordingly, no research analyst may, among other things, participate in any pitches for investment banking business to prospective investment banking clients, or have other communications with companies for the purpose of soliciting investment banking business.

The NASD observed at the time that the amendment was intended:

> to further the goals of research objectivity and investor confidence by eliminating all participation by research analysts in solicitation efforts, which could suggest a promise of favorable research in exchange for underwriting business.[59]

The rule was deemed to prohibit an analyst from attending an investment banking pitch even if the analyst did not participate in the presentation.[60] Otherwise, without investment bankers present, it prohibited only meetings or communications with a company for the purpose of soliciting investment banking business. The term "soliciting" itself implied purposeful conduct, as well as initiative and persistence.[61] In the securities business, "to solicit" meant "to attempt . . . to produce a sale by urging or persuading another to act."[62] In the context of paragraph (c)(4), then, it suggested substantial efforts by an analyst consciously di-

59. Order Approving Proposed Rule Changes by the NYSE and the NASD to Prohibit Participation by a Research Analyst in a Road Show Related to an Investment Banking Services Transaction and to Require Certain Communications About an Investment Banking Services Transaction to Be Fair, Balanced and Not Misleading, Exchange Act Release No. 34-51593, 70 Fed. Reg. 22168, 22170 (Apr. 28, 2005), http://www.gpo.gov/fdsys/pkg/FR-2005-04-28/pdf/E5-2002.pdf.

60. *See Jumpstart Our Business Startups Act, Frequently Asked Questions About Research Analysts and Underwriters*, U.S. SEC. & EXCH. COMM'N (Aug. 22, 2012), http://www.sec.gov/divisions/marketreg/tmjobsact-researchanalystsfaq.htm [hereinafter *JOBS Act FAQ*] (response to Question 4). The narrower reading might have originated from the NASD staff's comment that the rule as it was originally proposed was intended "to prevent research analysts from *attending 'bake-off' meetings* or otherwise communicating with a subject company where the intention is to pitch the member's investment banking services." Notice of Filing of Proposed Rule Changes by the NYSE and by the NASD Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-47110, 68 Fed. Reg. 826, 835 (Jan. 7, 2003), http://www.gpo.gov/fdsys/pkg/FR-2003-01-07/pdf/03-223.pdf (emphasis added). The latter part of the statement, however, implies some involvement by the analyst in the pitch presentation. Perhaps it could be said that the analyst's presence among investment bankers was *prima facie* evidence of his or her objective to solicit investment banking business. Later, meetings together to perform due diligence (investment banking or research) also were prohibited. *See* FINRA Rule 2241(b)(1)(C).

61. *See* THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1715 (3d ed. 1992) (defining "solicit" to mean "[t]o seek to obtain by persuasion, entreaty, or formal application; [t]o petition persistently, importune").

62. Meadows v. SEC, 119 F.3d 1219, 1225 (5th Cir. 1997). By contrast, an "unsolicited" brokerage transaction is a transaction that originates with the customer, not the broker. Various provisions of the securities laws, including the broker's exemption under section 4(a)(4) of the Securities Act, and Rule 144 under the Securities Act, explicitly recognize that a transaction is not solicited where a broker responds to a previous indication of interest by the customer. *See* 15 U.S.C. § 77d (2012); 17 C.F.R. 230.144(g)(3) (2016).

rected to achieve the sale of investment banking services (at least where no investment bankers were present to do so) on the analyst's initiative or as part of a broader undertaking by the firm.[63] The provision did not restrict communications with the company for other reasons, including to evaluate it as a potential underwriting candidate or to acquire information in anticipation of research.[64] An analyst was not prevented from working behind-the-scenes to help the investment banking team prepare for a pitch or the engagement.[65] Early on, in the context of the Global Settlement, the SEC staff also suggested that an analyst could respond to management's questions about valuation and pricing for a potential offering before the company engaged the firm as an underwriter.[66]

63. *See* Rodman & Renshaw, LLC, FINRA Letter of Acceptance, Waiver and Consent, No. 20110260605 (Aug. 22, 2012) (Research analysts deliberately solicited investment banking business by, among other things, doubling as investment banker, using code words to conceal investment banking activities, and receiving or expecting to receive compensation for investment banking business.).

As initially proposed, Rule 2711(c)(4) would have prohibited an analyst from issuing research if the analyst had engaged in any communication with the subject company "*in furtherance of obtaining investment banking business*." Exchange Act Release No. 34-47110, *supra* note 60, at 832 (emphasis added). Although the NASD suggested at the time that the provision was meant to prohibit conduct that was intended to solicit investment banking business, *id.* at 835 ("The purpose of this provision is to prevent research analysts from attending 'bake-off' meetings or otherwise communicating with a subject company where the *intention* is to pitch the member's investment banking services." (emphasis added)), some commenters objected to the language as overly broad. The NASD modified the proposal to address their concerns, and the industry understood that the language had been changed to allow communications "in furtherance of" investment banking business "which may be made by the analyst in the ordinary course of visiting companies in the industry he or she covers . . . *but which may unintentionally happen to further investment banking objectives*." 2003 Dinerstein Letter, *supra* note 18 (emphasis added).

Arguably, it was not necessary for the analyst to have intended to solicit investment banking business if his or her efforts were part of an initiative by investment bankers or others at the firm who intended to solicit the business. However, since the rule referred to conduct by the analyst, who could be held individually liable for violating its terms, the more reasonable interpretation attributed the state of mind to the analyst in order to put him or her on notice of the behavior that was prohibited.

64. At the time the rule was adopted, the NASD confirmed that it did not preclude an analyst from meeting with a prospective investment banking client to perform activities "traditionally associated with research functions that do not involve solicitation of investment banking business." Exchange Act Release No. 34-48252, *supra* note 21, at 45879; *see also* Letter from Philip A. Shaikun, Assoc. Gen. Counsel, Nat'l Ass'n Sec. Dealers, to James A. Brigagliano, Assistant Dir., Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n (July 29, 2003), http://www.finra.org/sites/default/files/RuleFiling/p000362.pdf.

65. NYSE Rule 472(d)(5), the NYSE counterpart to Rule 2711(c)(4), expressly referred to pitch "meetings," suggesting that the rule pertained to analysts' direct interactions with the client. The narrower interpretation was more reasonable since any assistance by an analyst that was not obvious to the company could not create the perception of favorable research by the analyst that the rule was intended to avoid.

66. The SEC staff was asked whether a provision in the Global Settlement analogous to NASD Rule 2711(c)(4) prevented a research analyst from attending a pre-mandate meeting requested by an issuer without investment bankers present to "respond to questions posed by the company, including, for example, questions regarding the analyst's views as to pricing and valuation." Cleary Gottlieb Letter, *supra* note 29 (response to Question 19). The staff allowed that the analyst could participate absent an effort to solicit investment banking business—presumably other than by opining on pricing or valuation. *Id.* Later, the SEC staff suggested that an analyst would not be deemed to be soliciting investment banking business merely by explaining to management the analyst's methodology for covering a company. *See JOBS Act FAQ*, *supra* note 60 (response to Question 4).

Rule 2711(e) provided that:

> No member may directly or indirectly offer favorable research, a specific rating or a specific price target, or threaten to change research, a rating or a price target, to a company as consideration or inducement for the receipt of business or compensation.[67]

The rule prohibited the firm from offering a particular rating (such as a "buy," "strong buy," or "market outperform"), a projected price target or range for the stock, or favorable coverage in exchange for underwriting business.[68] The rule forbade the offer if it was made intentionally to obtain the engagement.[69] In addition, if the reference to "consideration" meant that the overture could be measured by the standard in contract—recognizing, perhaps, that companies operate according to principles of agency and contract law—it precluded conduct that reasonably could be perceived to be an offer of favorable research regardless of the intention of anyone associated with the firm.[70] However, any discretion the NASD—later FINRA—had to find fault by the objective standard was limited to what the company's representatives reasonably would have understood to be an offer of favorable research under the circumstances. The regulator did not have authority to apply an arbitrary or stricter measure of liability.[71] If the offer was made, it did not matter whether any research was published.[72]

67. The NASD already considered the behavior to be a violation of just and equitable principles of trade and possibly the anti-fraud provisions of the federal securities laws. *See* Notice of Filing of Proposed Rule Changes by the NASD and NYSE Relating to Research Analyst Conflicts of Interest, Exchange Act Release No. 34-45526, 67 Fed. Reg. 11526, 11534 (Mar. 14, 2002), https://www.gpo.gov/fdsys/pkg/FR-2002-03-14/pdf/02-6159.pdf; *see also* NASD & NYSE 2005 Report, *supra* note 10, at 2–3. Rule 2711(e) made the prohibition explicit. Exchange Act Release No. 34-48252, *supra* note 21, at 45879 n.36. A firm that offered favorable research before conducting due diligence and assessing the company's prospects in light of the information, or the offering price (which had yet to be determined), or the price of the stock at the time of the research, might be considered at least negligent if not reckless or dishonest.

68. The rule also prohibited a threat to lower an existing rating, price target or opinion.

69. *See* The American Heritage Dictionary of the English Language 921 (3d ed. 1992) (defining "inducement" to mean "something that helps bring about a *desired* result" (emphasis added)).

70. *See* Restatement (Second) of Contracts § 5 (1981); Restatement (Third) of Agency § 1.03 (2005).

An objective standard for measuring the conduct arguably was consistent with the NASD's broader comment that the prohibition in paragraph (c)(4) was designed to promote investor confidence by eliminating even the "suggestion" of an offer of favorable coverage. *See* Exchange Act Release No. 34-51593, *supra* note 59, at 22170. The benefit of the stricter standard was questionable, however, since investors were not privy to the firm's communications with the company. The fact is, if an analyst or anyone else capable of fulfilling the promise did not *intend* to issue fraudulent research then none would result. Even if the issuer had reason to believe that the firm had contracted to deliver favorable coverage, public policy likely would have prevented its enforcement. *See* Restatement (Second) of Contracts § 179. Meanwhile, the objective measure created potential liability for innocent statements or expressions by an analyst or other person associated with the firm.

71. Even under the stricter standard, absent direct evidence of intention to offer favorable research for business, if the research was not justified by the company's performance or stock price, the report itself and other objective criteria could have been considered as evidence of the analyst's (or other person's) state of mind—*albeit* measured in relation to the person in particular, not the ordinary prudent person of legal extraction. *See* Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

72. *See* Exchange Act Release No. 34-45908, *supra* note 21.

According to FINRA, the analysts' meetings with Toys "R" Us management violated Rule 2711(c)(4) because the firms *knew* that management would consider their presentations in selecting underwriters.[73] FINRA did not find it necessary to demonstrate that the analyst (or anyone else at the firm) specifically *intended* to solicit the underwriting business by accommodating management's request for the interview.[74] The fact that Toys "R" Us management initiated the meeting—not the analyst or the firm—made no difference.[75] The analyst was found to have solicited investment banking business even though he or she did not request that Toys "R" Us hire the firm as an underwriter or discuss the firm's underwriting services (or even the offering itself in most cases), but, instead, limited his or her presentation to the questions raised by management on subjects that the SEC staff previously had indicated or later would suggest were not inappropriate in a setting that otherwise complied with Rule 2711(c)(4)—valuation and the analyst's methodology for covering a company, if not the company itself.[76]

73. *See* Toys "R" Us Settlements, *supra* note 43. The settlements provided that "[e]ach firm understood that [Toys 'R' Us] would consider the firm's analyst's views in determining whether the firm would receive an underwriting role in the [Toys 'R' Us] IPO." *Id.* While some settlements contained facts suggesting that the analyst had the same understanding, all but one of the agreements expressly attributed that knowledge to the firm. *Id.* ("[Toys 'R' Us] made clear to each *firm* that its analyst's presentation would be a factor in [the company's] determination of whether the firm would be awarded a role in the IPO." (emphasis added)).

74. The settlements included a number of comments by research analysts and others suggesting that they knew that the analysts' views would be considered by management in selecting underwriters. Comments by some of the analysts expressed hope that the firm would win the mandate or that the analyst would do well at his or her meeting to enhance the firm's chances. However, just because the analyst (or someone else) *knew* that the analyst's views would affect the company's decision did not mean that the person *intended* to solicit the underwriting business by accommodating management's request to learn the analyst's views. The law has long recognized the distinction between conduct performed with the intention to achieve a particular result and that done with the knowledge that the result would likely follow. *See* United States v. Bailey, 444 U.S. 394, 404 (1980) ("[A] person who causes a particular result is said to act purposefully if he consciously desires that result, whatever the likelihood of that result happening from his conduct, while he is said to act knowingly if he is aware that that result is practically certain to follow from his conduct, whatever his desire may be as to that result." (internal quotations omitted)); *see also* N.Y. PENAL LAW § 15.05 (McKinney 2015) ("A person acts *intentionally* with respect to a result or to conduct described by a statute defining an offense when his conscious objective is to cause such result or to engage in such conduct. A person acts *knowingly* with respect to conduct . . . described by a statute defining an offense when he is aware that his conduct is of such nature . . . ." (emphasis added)); United States v. Dollar Bank Money Mkt. Account, 980 F.2d 233, 240 (3d Cir. 1992) ("'Purpose,' being synonymous with 'intent,' is the highest degree of culpability found in penal statutes."). Absent initiative by the analyst, or, perhaps, the firm, to pursue the meeting as an integral part of the firm's investment banking pitch—and with no financial incentive or other institutional imperative for the analyst to pursue the business—the *purpose* of the meeting simply might have been to answer management's questions.

75. FINRA later discounted the idea that the issuer's initiation of the inquiry was exculpatory in determining whether the analyst's communication was a solicitation. *See Research Rules Frequently Asked Questions (FAQ)*, FIN. INDUS. REGULATORY AUTH. (May 28, 2015), http://www.finra.org/industry/faq-research-rules-frequently-asked-questions-faq [hereinafter *FINRA 2015 Research Rules FAQ*] (response to Solicitation and Marketing Question 1) ("In FINRA's view, [the] risk management considerations exist during a solicitation period, irrespective of who initiates a meeting or communication or the setting . . . . [T]he same [risk management] considerations would apply whether an issuer initiates a meeting at which it requests the analyst's views as part of the issuer's underwriter selection process or a research analyst initiates a meeting for *bona fide* due diligence purposes where the issuer then asks for the analyst's views.").

76. *See supra* note 66 and accompanying text.

In addition, each investment bank that permitted its research analyst to speak positively about Toys "R" Us, the firm's research capability, or the analyst's own ability (or whose non-research personnel made positive statements in relation to research) was found to have implicitly offered favorable research in violation of Rule 2711(e). It did not matter that the information pertained to the offering—not to future research coverage, which was not discussed.[77] And all of the firms that provided firm-wide valuations backed by the analyst were deemed to have promised favorable research, even though the valuation was conditional—subject to unanticipated developments, including findings on due diligence.[78]

Specifically, with regard to the offer of favorable research, the settlements provided that:

> Where the issuer has stated that it will consider an analyst's views as part of the underwriter selection process, a firm cannot indicate to a prospective investment banking client its analyst's positive views of the company or the company's prospects, even if honestly held, or the positive prospective valuation the analyst may give the company.[79]

In this way, Rule 2711(e), which by its terms prohibited communications manifestly intended to trade favorable research for underwriting business in consideration of the disingenuous bargains of the past, was reinterpreted to assign strict liability to positive comments about a company by an analyst, or communication of the analyst's favorable opinion of the company or assessment of its worth by anyone associated with the firm, to management in the time leading up to its selection of underwriters, even if those expressions were genuine. Later guidance extended the prohibition beyond the time for vetting underwriters, referred to as the "solicitation period," into the "post-mandate period" for as long as the underwriters' roles or allocations could be affected by the analysts' positions—throughout the offering or until the issuer could no longer act on the information.[80] FINRA's

77. *See* Toys "R" Us Settlements, *supra* note 43. Some analysts spoke in favorable terms about aspects of Toys "R" Us's business or its management that they said they would emphasize to investors in apparent reference to communications with customers about the IPO—not to research after the offering. *Id.*

78. *Id.* Presumably, then, if the stock appreciated beyond a level supported by the valuation, the analyst was free to change his or her opinion about whether to buy it. The purpose of Rule 2711(e) was not to prohibit a member firm from communicating to an issuer the valuation that its analyst could support in good faith; it was to prevent the firm from supporting the stock in research regardless of the valuation. *See supra* notes 15 & 24 and accompanying text.

79. *See* Toys "R" Us Settlements, *supra* note 43. The findings did not distinguish between a "positive" prospective valuation and any other kind under the circumstances.

80. In its guidance after the Toys "R" Us Settlements, FINRA made clear that the risk of violating the rules by disclosing the analyst's views on valuation and other issues does not end with the selection of underwriters. *FINRA 2015 Research Rules FAQ*, *supra* note 75 (response to Solicitation and Marketing Question 3) ("FINRA notes that there is no safe harbor in a post-mandate period, and therefore firms must consider the context and issuer expectations in evaluating the permissibility of communications with the issuer."). Instead, FINRA said the risk is reduced to a level that the regulator suggested can be managed by the firm. *Id.* The guidance cautioned, however, that it may be impermissible to share the information before the underwriters' roles and allocations have been settled. *Id.* ("Assuming the issuer has made a *bona fide* award of the underwriting mandates, FINRA

interpretation effectively barred communication of the analysts' views to the company,[81] preventing the issuer from basing its decision on research. At the time Rule 2711(c)(4) was adopted, the NASD staff commented that:

> [T]he prohibition on analysts' involvement in solicitations of investment banking business is intended to support the prohibition on promising favorable research as a marketing tool to prospective investment banking clients of members, *and is designed to encourage issuers to choose an investment banking firm based on the merits of the firm's underwriting capabilities*.[82]

Read "underwriting capabilities" to mean "distribution capacity" and the interpretation and its extension advanced the regulator's secondary objective, *obiter*, to cause issuers to consider distribution to the exclusion of research when selecting underwriters and awarding their roles and allocations.

The regulatory imperative to curtail further research analysts' communications with an issuer based on the Toys "R" Us cases is purely speculative: The analysts' input did not lead to disingenuous research and no one was alleged to have said anything that was not true. Meanwhile, the more restrictive policy effectively excludes analysts from IPO pricing.

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believes the risks associated with subsequent communications between an analyst and issuer can be effectively managed, even where the issuer has not fully resolved the specific roles and economics for each firm. However . . . [a] firm's policies and procedures should address circumstances that could give rise to impermissible promises of favorable research, such as where the issuer suggests the final roles or economics will be based on the highest valuation given by a firm's research analyst.").

The extension of the restriction into the post-mandate period is consistent with the policy behind the settlements: If a member is prohibited from relating its analyst's views to obtain the mandate, it should be prevented from using the information to obtain a larger part of the transaction or to avoid losing its allocation. (Arguably, any risk of compromise by the analyst is greater during the post-mandate period when the firm stands to lose business than during the solicitation period when there is no business yet to lose.) However, there is no time before the offering when management is not bound by its fiduciary duty to the company to consider the analysts' views in assigning responsibility among underwriters, especially if it has a view to a follow-on offering as do many IPO issuers. The company obviously benefits by awarding more stock to an underwriter whose analyst thinks highly of the company and its worth. Less enthusiastic or negative research after the offering might compromise the IPO and jeopardize the issuer's prospects for raising money in a follow-on offering from prior investors and in general. (Indeed, one of the sponsors of Toys "R" Us complained that in a previous IPO management did not learn the underwriters' analysts' views "until it was too late," suggesting that the information might have affected its decisions concerning each firm's involvement in the offering. *See* Toys "R" Us Settlements, *supra* note 43.)

81. FINRA acknowledged that the policy effectively prevents any communication of the analyst's opinion of the company to management during this time period. In guidance after the cases, the regulator warned that "in circumstances where an issuer overtly or tacitly expresses that the selection of underwriters will be based in whole or in part on the views of a research analyst (including valuation), FINRA believes any sharing of those views by the member or the research analyst carries *unmanageable* risk." *FINRA 2015 Research Rules FAQ*, *supra* note 75 (emphasis added) (response to Solicitation and Marketing Question 1). The guidance is silent on whether a member can relate the analyst's views without any prior "overt" or "tacit" indication of interest by the company. However, the firm risks that tacit interest may be inferred from communication of the analyst's views alone. Regardless, it is unlikely that FINRA means to allow a member to communicate the analyst's views absent a request by the issuer, or to provide a safe harbor in circumstances in which the issuer apparently is indifferent to the information.

82. Exchange Act Release No. 34-48252, *supra* note 21, at 45879 (emphasis added).

While FINRA acknowledges that investment bankers can consult the analyst on valuation and other issues at any time—at least they are not strictly prohibited from doing so—they "may not convey to the issuer that a valuation is either the research analyst's valuation or a joint valuation of the bankers and research analyst" while restrictions apply. The policy fails to recognize, however, that a broker-dealer faces an ethical dilemma if it consults the analyst on valuation but cannot communicate his or her views to the company. (The analyst's assessment higher or lower cannot be conveyed to the company since it would disclose his or her "positive" valuation or the level at which there is joint support by the bankers and the analyst.) The issuer has a right to expect that the firm is not withholding information that is material to the engagement, including whether its analyst, as an expert with knowledge and experience relevant to the transaction and poised to perform functions that will affect the offering, thinks the company is worth significantly more or less than the amount it is proposing.[83] In order to comply with the guidance, the firm has little choice but to refrain from consulting the analyst and to disclose as much to the issuer.[84] There is no benefit to consulting the analyst when the analyst's views cannot affect underwriting decisions. Moreover, the investment bankers may be reluctant to engage the analyst after having put forward their own evaluation if there is the possibility that the analyst might disagree with the firm's position, damaging the firm's credibility and its standing in the syndicate.[85]

The broader restrictions deny issuers and investors the benefit of analysts' honest insight on IPO valuation, which can lead to less effective pricing potentially made worse by underwriters' research that disagrees with their recommendations to buy the stock on the offering. Investors, especially, stand to be blindsided by contradictory research by their brokerage firms immediately after the offering. They have no reason to expect that the firm's research analyst has a different opinion about the transaction, as though the analyst is in a separate firm.

In this respect, the policy is inconsistent with basic investor protection. It goes beyond the Global Settlement, which does not necessarily prevent an issuer from obtaining an analyst's views on valuation separately during the solicitation period and expressly permits bankers to consult the analyst on valuation and other subjects (and, presumably, to relate the information to the issuer) during the post-mandate

83. As the AIG and Toys "R" Us matters demonstrated, the information is material to the issuer's decision whether to hire the firm as an underwriter (and perhaps even whether to go forward with the transaction). Under principles of agency law, an agent "owes the principal a duty to provide information to the principal that the agent knows or has reason to know the principal would wish to have." RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. b (2005). The duty "extends to information about the agent when it is material to decisions the principal may wish to make." *Id.* While ordinarily the agent's duty to furnish information does not commence until the agency relationship has been established, a prospective agent is subject to a "duty to deal fairly in arranging the terms of the agency relationship." *Id.* § 8.11 cmt. c. That duty "may require a prospective agent to furnish the prospective principal with information that is . . . material to the principal's decision whether to engage the agent." *Id.*

84. *See generally* RESTATEMENT (THIRD) OF AGENCY § 8.08.

85. The analyst's views would have to be communicated to the issuer. *See* RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. c (An agent that deliberately withholds material information from the principal to further its own purposes acts contrary to its fiduciary duty of loyalty.).

period.[86] Moreover, it is fundamentally at odds with the JOBS Act, which encourages greater communications between issuers, analysts, and investors to incorporate research more broadly in the underwriting process for most companies.

The JOBS Act Promotes Pre-IPO Research and Greater Analyst Involvement in the IPO Underwriting Process for Emerging Growth Companies

The JOBS Act was passed to spur employment by facilitating investment in small and medium-size companies with greater potential for growth.[87] Among other things, the law relaxed regulatory restrictions on IPOs for "emerging growth companies,"[88] including preexisting limitations on the ability to publish research before and immediately after the offering and related constraints on analysts' communications with issuers and investors.

Like any other issuer, an EGC raising capital in an IPO relies on its underwriters to place its stock with the right investors at the appropriate price.[89] The company wants to raise as much money as possible; however, it is just as interested in selling the shares at a price that will build investor confidence and encourage additional investment in the future.[90] IPO issuers often intend to raise substantially more capital in follow-on offerings.[91] The offering is sold at a discount to allow for reasonable appreciation of the stock in the near term, even if it means leaving money on the table.[92] (One study calculated the mean IPO discount to be 18.4 percent based on first-day trading data for almost 15,000 offerings in the United States between

86. *See supra* note 29 and accompanying text.

87. *See* H.R. Res. 3606, 158 Cong. Rec. 50 (2012), http://www.gpo.gov/fdsys/pkg/CREC-2012-03-27/html/CREC-2012-03-27-pt1-PgH1586-4.htm (containing comments by Rep. Stephen Fincher, co-sponsor of the JOBS Act) ("[The JOBS Act] will allow small and mid-size companies the opportunity to save on expensive compliance costs and create the cash needed to successfully grow their businesses and create American jobs.").

88. An "emerging growth company" is defined in section 2(a)(19) of the Securities Act and section 3(a)(80) of the Exchange Act to mean "an issuer that had total annual gross revenues of less than $1,000,000,000 [adjusting for inflation] during its most recently completed fiscal year."

89. *See* NYSE & NASD 2003 Report, *supra* note 6, at 4–5 ("The pricing of an IPO is a business decision reached by the issuer in consultation with the underwriter. . . . This involves directors and management weighing key considerations regarding the transaction, including the long-term implications of various IPO pricing scenarios.").

90. *See* Ivo Welch, *Seasoned Offerings, Imitation Costs, and the Underpricing of Initial Public Offerings*, 44 J. Fin. 421, 422 (1989) ("[T]he prevalent explanation [for IPO discounting] on Wall Street is that issuers may want to leave a good taste in investors' mouths so that future underwritings from the same issuer could be sold at attractive prices." (citations and internal quotations omitted)); Steven Davidoff Solomon, *Why I.P.O.'s Get Underpriced*, N.Y. Times DealBook (May 27, 2011), http://dealbook.nytimes.com/2011/05/27/why-i-p-o-s-get-underpriced/?_r=2.

91. *See* Ivo Welch & Jay Ritter, *A Review of IPO Activity, Pricing and Allocations* 11–12 (Yale Int'l Ctr. for Fin., Working Paper No. 02-01, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=296393 ("[I]t is clear that some issuers approach the market with an intention to conduct future equity issues. . . . [Underpricing's] most appealing feature is that some issuers *voluntarily desire* to leave money on the table to create 'a good taste in inventors' mouths.'" (emphasis in original)); *see also* Welch, *Seasoned Offerings*, *supra* note 90, at 422.

92. *See* Welch, *Seasoned Offerings*, *supra* note 90, at 422.

1960 and 2001.)[93] At the same time, the company wants the stock to be sold to informed buyers. Knowledgeable investors tend to reduce the discount needed to sell the shares and to provide the stable shareholder base management desires to pursue its objectives.[94] It is part of an underwriter's role, therefore, to educate investors about the company and its goals. Most underwriters also commit to provide research coverage after the IPO to keep investors apprised of the issuer's progress with a view to follow-on offerings and to facilitate trading in the secondary market.

Research analysts play an integral part in the underwriters' efforts: by helping to evaluate the issuer, by explaining the company to investors, and by reporting on its results.[95] Recognizing the importance of analysts and their research to the success of an IPO, Congress chose to integrate them fully in the underwriting process for EGCs.

Section 105(a) of the JOBS Act amended the Securities Act to permit a broker-dealer—including a current or prospective underwriter—to distribute research on an EGC prior to an IPO or secondary offering.[96] The amendment

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93. Shmuel Hauser et al., *Initial Public Offering Discount and Competition*, 49 U. CHI. J.L. & ECON. 331, 331–32 (2006) ("Shares issued by companies going public are commonly offered below their market clearing price . . . that can be measured by the difference between the offer price and the higher price attained in early trading.").

94. *See* Solomon, *supra* note 90 ("[W]hen investment banks can allocate shares in greater measure to informed investors, the underpricing is reduced since the compensation needed to draw uninformed investors is lower."); *see also* NYSE & NASD 2003 REPORT, *supra* note 6, at 10 ("The issuer generally desires that shares be placed with long-term investors."); ANNE BEYER, DAVID F. LARCKER & BRIAN TAYAN, 2014 STUDY ON HOW INVESTMENT HORIZON AND EXPECTATION OF SHAREHOLDER BASE IMPACT CORPORATE DECISION-MAKING 1 (2014) ("Nearly all companies prefer long-term investors but about half of investors have a shorter horizon—with significant consequences for companies' strategic decisions and stock market performance.").

95. Even after the dot-com crisis, the SROs preserved the analyst's role in each of these functions *albeit* with some restrictions. Rule 2711 did not prohibit investment bankers from consulting the analyst on valuation or other matters of importance to an offering at any time, *see* Exchange Act Release No. 34-48252, *supra* note 21, at 45879, although it prevented the analyst from participating in an investment banking pitch. *See* NASD Rule 2711(c)(4). The rule expressly recognized the analyst's involvement in efforts to sell the stock to investors, *see* NASD Rule 2711(c)(7), but not with the issuer or investment bankers present. *See* NASD Rule 2711(c)(5)(B). In guidance, FINRA allowed that a member could agree to provide research coverage as part of the underwriting engagement, *see* Nat'l Ass'n of Sec. Dealers, Notice to Members 02-39, Research Analysts and Research Reports: SEC Approves Rule Governing Research Analysts' Conflicts of Interest 370 (July 2002), http://www.finra.org/sites/default/files/NoticeDocument/p003620.pdf, provided the firm did not commit to favorable research and did not initiate coverage until after the relevant quiet period had elapsed. *See* NASD Rule 2711(e)–(f).

96. *See* Jumpstart Our Business Startups Act, Pub. L. 112-106, § 105(a), 126 Stat. 306. 310–11 (2012) (codified at 15 U.S.C. § 77b(a)(3) (2012)). Specifically, the provision amended section 2(a)(3) of the Securities Act to exclude research from the definition of an "offer for sale" or an "offer to sell" for purposes of the definition of a "prospectus" under section 2(a)(10) of the Securities Act and offers by means of a prospectus or otherwise under section 5(c) of the Securities Act as follows:

> The publication or distribution by a broker or dealer of a research report about an emerging growth company that is the subject of a proposed public offering of the common equity securities of such emerging growth company pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective shall be deemed for purposes of paragraph (10) of this subsection and section 5(c) not to constitute an offer for sale or offer to sell a security, even if the broker or dealer is participating or will participate in the registered offering of the securities of the issuer.

made way for research that introduces investors to the company and expounds on information in the registration statement. The law recognized that research analysts provide more comprehensive advice to investors who would benefit from seeing their facts, assumptions, and analyses in writing. Apart from that, it provided for the dissemination to all investors of information analysts were communicating orally only to selected institutional buyers.[97] Another amendment voided the quiet period after an offering to allow for uninterrupted coverage.[98]

In order to assure the conditions necessary to prepare pre-IPO research, section 105(b) amended the Exchange Act to prevent the SEC or FINRA from adopting or maintaining any rule that restricts an analyst from participating in any communication with management of an EGC that also is attended by non-research personnel.[99] The amendment clearly targeted the prohibition against an analyst participating in an investment banking pitch under Rule 2711(c)(4); however, it was not limited by subject matter or persons in attendance at the meeting. Another amendment precluded restrictions on who at the broker-dealer could arrange for communications between an analyst and a prospective investor to facilitate efforts to sell the IPO.[100]

The amendments eliminated procedural impediments. But they also safeguarded the substance of communications in line with the federal objective to promote pre-IPO research and greater involvement by analysts in the offering

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15 U.S.C. § 77b(a)(3). Prior to the amendment the research report might have constituted a premature offer—a "gun jumping" violation—under section 5 of the Securities Act and was not free from liability for offers or sales by means of a prospectus under section 12(a)(2) of the Securities Act.

Research on an EGC was allowed at any time, including during the "solicitation" and "post-mandate" periods referred to in FINRA guidance on restrictions on member firms' and analysts' communications with an issuer about research.

97. *Cf.* Rule 2241(g) ("A member must establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to . . . a particular customer or class of customers in advance of other customers that the member has previously determined are entitled to receive the research report.").

98. *See* JOBS Act § 105(d), 15 U.S.C. § 78o-6 note (2012); *supra* note 25 and accompanying text.

99. *See* JOBS Act § 105(b), 15 U.S.C. § 78o-6 (2012). The provision amended section 15D of the Exchange Act to provide that:

> [N]either [the SEC nor FINRA] may adopt or maintain any rule or regulation in connection with an initial public offering of the common equity of an emerging growth company restricting a securities analyst from participating in any communications with the management of an emerging growth company that is also attended by any other associated person of a broker, dealer, or member of a national securities association whose functional role is other than as a securities analyst.

15 U.S.C. § 78o-6(c)(2) (2012).

100. *Id.* The provision further amended section 15D of the Exchange Act to provide that:

> [N]either [the SEC nor FINRA] may adopt or maintain any rule or regulation in connection with an initial public offering of the common equity of an emerging growth company restricting, based on functional role, which associated persons of a broker, dealer, or member of a national securities association, may arrange for communications between a securities analyst and a potential investor.

15 U.S.C. § 78o-6(c)(1) (2012).

process. The legislation and the House Finance Committee Report on the bill referred to the elimination of restrictions on "communications" between issuers, analysts, and investors—not just attendance at meetings or other means by which they were made;[101] while the law expressly pertained to rules preventing analysts from actively "participating" in communications with management.[102]

A broker-dealer must perform due diligence before recommending that customers buy stock in an offering, which includes reasonable investigation of the issuer.[103] A research analyst similarly is required to test the reliability of information obtained from the company before recommending its securities in a research report.[104] Plainly, provisions in the JOBS Act that enable analysts to meet with EGC management to obtain information for pre-IPO research void restrictions that interfere with their ability to vet the information they receive.

In addition, relief that allows an analyst to participate in an investment banking pitch necessarily contemplates some contribution by the analyst that he or she expects will assist in obtaining the business—at least to the extent it is consistent with pre-IPO research. A broker-dealer is free to publish research on an EGC before the company has selected the underwriters for its offering.[105] The analyst's opinion of the issuer, his or her methodology for valuing it, and perhaps the valuation itself may be included in the research for the company as well as investors to consider. The company's management can use the information to decide whether to hire the firm as an underwriter (and to determine its allocation later).[106] The JOBS Act thus protects a broker-dealer's ability to relate

101. *See supra* note 99; H.R. Rep. No. 112-406, at 6–7 (2012) [hereinafter House Report] (The House Report on the bill states that the law is intended to "improve[] the flow of information about EGCs to investors by removing burdensome and outdated restrictions on *communications* between companies, research analysts, and investors." (emphasis added)).

102. *See supra* note 99 and accompanying text; *see also* The American Heritage Dictionary of the English Language 1319 (3d ed. 1992) (defining "participation" to mean "[t]he act of taking part or sharing in something: *Teachers often encourage class participation*."). Participation in communications ordinarily implies more than the mere presence at events in which they take place.

103. *See* 9 Louis Loss, Joel Seligman & Troy Paredes, Securities Regulation 321 (4th ed. 2013); *see also* Fin. Indus. Regulatory Auth., Regulatory Notice 10–22, Regulation D Offerings (2010), http://www.finra.org/sites/default/files/NoticeDocument/p121304.pdf ("The [SEC] and federal courts have long held that a broker-dealer that recommends a security is under a duty to conduct a reasonable investigation concerning that security and the issuer's representations about it."); U.S. Sec. & Exch. Comm'n Div. of Trading & Mkts., Guide to Broker-Dealer Registration (2008), http://www.sec.gov/divisions/marketreg/bdguide.htm ("[T]he broker-dealer has an obligation to investigate and obtain adequate information about the security it is recommending.").

104. *See* FINRA Rule 2241(c)(1)(A).

105. *See supra* note 96 and accompanying text.

106. In this regard, the JOBS Act contradicts the policy established by the Toys "R" Us cases. Pre-IPO research during the solicitation period is nothing if not an effort to solicit underwriting business by the analyst and a promise of favorable research by the firm under the rubric of the Toys "R" Us Settlements. There is no purpose for the research other than to obtain the IPO business. (It is safe to say it is not to facilitate *other* broker-dealers' efforts to underwrite the issue, and there is no secondary trading yet to support.) The research is going to be favorable. (No other kind is actionable.) Management is going to learn what the analyst thinks about the company, and his or her views on valuation and other issues addressed in the research are going to inform management's decisions about underwriters and their assignments. The firm and the analyst are going to know that the research is likely to be used by management for those purposes. These are the elements of the alleged violations in the

an analyst's views about the issuer in pre-mandate communications with the company and, consequently, management's right to inquire about those views directly with the firm or the analyst.[107]

The JOBS Act recognizes that underwriters must be able to coordinate analysts' communications with investors in order to incorporate research fully in the IPO process for EGCs. Analysts typically participate in telephone calls and meetings with customers to relate their views on a company and to elaborate on ideas expressed in research.[108] Section 105(b) underscores the importance of these communications to investors' decisions to buy stock in an IPO by ensuring that investment bankers, sales representatives, and other persons participating in the offering can arrange for investors to consult the analyst.[109] However, for an underwriter to involve its analyst effectively in efforts to sell the stock, the analyst must be able to communicate freely with the investment bankers and the issuer, if necessary, to enable the firm to incorporate the analyst's views in its message to investors. Otherwise, meetings with the analyst will not take place. Accordingly, the House Report states that the law "improves the flow of information about EGCs to investors by removing burdensome and outdated restrictions on communications *between* companies, research analysts, and investors."[110]

Pre-IPO research and the broader communications permitted by the JOBS Act benefit issuers and investors by allowing them to consider the analysts' views at the earliest possible time so their opinions can inform initial valuation decisions and contribute to discovery of the appropriate offering price. Analysts, by profession, are uniquely qualified to value the company in line with investors' expectations. Untempered by the analysts' buy-side predilections, investment

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Toys "R" Us Settlements. *See supra* note 43 & notes 73–79 and accompanying text. Yet, the JOBS Act protects and promotes the publication of pre-IPO research.

107. The federal government and industry organizations ordinarily are loath to deny consumers—even corporate consumers—the privilege of evaluating the qualifications of a commercial service provider before hiring it to perform an important function. The JOBS Act guarantees a place for research in the IPO underwriting process for EGCs. Therefore, the quality of the function is a legitimate consideration in the selection of underwriters and an appropriate subject for competition among broker-dealers for underwriting business. For EGCs, at least, management is presumed to be able to vet a broker-dealer's research capability (in addition to its distribution capacity), including the qualifications and experience of the analyst, directly with the analyst or others before making its decision about whether to hire the firm as an underwriter.

Moreover, if the effect of the Toys "R" Us Settlements and subsequent guidance is to make it more difficult for issuers to learn about underwriting candidates' research capabilities, then small and medium-size broker-dealers that rely heavily on the quality of their research to compete with the greater distribution capabilities of larger firms may find it more difficult to secure IPO underwriting positions in the future. The result may be fewer firms offering research (and, perhaps, lesser quality research from the fewer firms that do). Federal securities laws discourage SRO standards that are anti-competitive or discriminatory in their effect on member firms. *See* Exchange Act § 19(b)(5), (7), (9), 15 U.S.C. § 78s(b)(5), (7), (9) (2012).

108. *Cf.* FINRA Rule 2241(b)(1)(B)–(C) (requiring written policies and procedures for analysts' involvement in public appearances and interactions with customers).

109. *See supra* note 100 and accompanying text. The communications are especially important if the firm has not yet published research on the company.

110. House Report, *supra* note 101, at 6–7 (emphasis added). Presumably, the House Report did not refer to investment bankers because SRO rules did not expressly restrict interdepartmental communications between research and investment banking regarding an IPO transaction. *See supra* note 29.

bankers may be inclined to overvalue the issue under pressure to win the underwriting mandate and to retain the business. Indeed, it is hard to conceive of a better pricing mechanism to initiate and to inform the IPO book building process than one that attempts to reconcile the views of both investment bankers and analysts whose interests are separately aligned with the counterparties to the transaction. To the extent the IPO price reflects the analysts' views, the underwriters' research is less likely to conflict with their recommendations to buy the stock on the offering. In any event, the issuer and investors are on notice of the analysts' views in advance of the transaction.

Unfortunately, pre-IPO research and broader communications between analysts, issuers, and investors contemplated by the JOBS Act are impeded by narrow interpretations given to the amendments by the SEC and FINRA, the policy stemming from the Toys "R" Us Settlements, and various provisions in new FINRA Rule 2241 that make no exceptions for EGCs.

The SEC and FINRA Curtail the Effects of the JOBS Act Reforms While IPO Pricing Inefficiency and Inconsistent Research Continue

The SEC staff gave limited range to the effect of section 105(b). It recognized that analysts could attend a broader array of meetings with EGC management about an IPO but did not accept that they could say anything more in them than existing rules allowed.[111] In particular, according to the staff, the amendments did not abrogate SRO rules prohibiting the solicitation of investment banking business or the offer of favorable research.[112] Analysts could join with bankers to save the company the expense of meeting with them separately; still, they had to avoid saying or doing anything to obtain underwriting business.[113] The staff, nevertheless, suggested that certain communications by an analyst were not solicitations by themselves, including an explanation of the analyst's research program and the factors that he or she considers in covering a company and questions in follow up to statements made by management.[114]

111. *See JOBS Act FAQ, supra* note 60 (response to Question 4) ("Prior to enactment of Section 105(b), SRO rules prohibited analysts of non-Global Settlement firms from attending meetings with issuer management that are also attended by investment banking personnel in connection with an IPO, including pitch meetings. Pursuant to Section 105(b), analysts may now attend such meetings, provided that the issuer qualifies as an [EGC]. Section 105(b) does not, however, permit analysts to engage in otherwise prohibited conduct in such meetings.").

112. *Id.* ("Section 105(b) does not . . . affect SRO rules that otherwise prohibit an analyst from engaging in efforts to solicit investment banking business . . . [A]n analyst continues to be prohibited from giving tacit acquiescence to overtures from the management of an [EGC] that attempt to create an expectation of favorable research coverage if the analyst's firm is chosen to underwrite the [EGC's] IPO.").

113. *Id.*

114. *Id.* The guidance is conservative but it should not be exhaustive. For example, if a broker-dealer is free to write research on the company, its analyst should be permitted to ask original questions—not just those to follow up on information imparted by management. *See supra* notes 103–04 and accompanying text.

FINRA, in accordance with the SEC staff's interpretation, amended NASD Rule 2711(c)(4) to permit analysts to attend joint meetings with EGC management while maintaining the substantive prohibition on soliciting investment banking business.[115] In guidance, FINRA downplayed the SEC staff's comments on permissible communications in line with the more restrictive interpretations it had given to Rule 2711(c)(4) and (e) in the Toys "R" Us matter.[116] There, FINRA reaffirmed the strict liability standard articulated in the settlements even in the case of an IPO by an EGC.[117]

The interpretations and guidance carry forward to new FINRA Rule 2241, which incorporates the former provisions in paragraphs (b)(2)(K) and (L).[118]

115. The rule was amended in response to section 105(b) of the JOBS Act to provide, in pertinent part:

> This paragraph shall not prevent a research analyst from attending a pitch meeting in connection with an initial public offering of an [EGC] that is also attended by investment banking personnel; provided, however, that a research analyst may not engage in otherwise prohibited conduct in such meetings, including efforts to solicit investment banking business.

NASD Rule 2711(c)(4).

116. *See FINRA 2015 Research Rules FAQ*, *supra* note 75 (response to Solicitation and Marketing Question 5) ("FINRA understands SEC [JOBS Act] FAQ 4 to identify *specific and narrow* examples of permissible communications by a research analyst while in attendance at an EGC IPO pitch meeting or in other meetings during a solicitation period concerning an EGC IPO with issuer management that are also attended by other associated persons of a broker dealer. . . . SEC Staff also expressly stated in Footnote 179 of the order approving FINRA Rule 2241 that the examples in SEC [JOBS Act] FAQ 4 of permissible *'ministerial statements'* were not intended to permit otherwise impermissible activities solely because they were conducted via the *ministerial* examples given in the FAQ." (emphasis added)).

117. The events in the Toys "R" Us cases occurred prior to the JOBS Act and the retail giant would not have qualified as an EGC even under the law's generous revenue threshold. FINRA subsequently advised that the interpretations given to Rule 2711(c)(4) and (e) in the settlements apply to EGCs. *Id.* ("FINRA views SEC [JOBS Act] FAQ 4 to be consistent with the risk management guidance set forth in Question 1 above, and does not view [it] to create a safe harbor for sharing a research analyst's views and valuations with an issuer during the underwriter selection process for either an EGC or non-EGC IPO or to change the risk management guidance set forth in Question 1 above, other than to allow attendance by a research analyst at a pitch meeting for an EGC IPO.").

118. FINRA Rule 2241(b)(1)(C) requires member firms:

> [to] establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to . . . the interaction between research analysts and those outside of the research department, including investment banking and sales and trading personnel, subject companies and customers.

FINRA Rule 2241(b)(2)(K) provides that:

> A member's written policies and procedures must . . . prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business or compensation.

FINRA Rule 2241(b)(2)(L) provides that:

> A member's written policies and procedures must . . . restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, including prohibiting: (i) participation in pitches and other solicitations of investment banking services transactions.

Significantly, FINRA Rule 2241(b)(2)(L)(i) eliminates language in former Rule 2711(c)(4) that referred to "communications with companies for the purpose of soliciting investment banking business." The new rule, therefore, is more compatible with the interpretation given to the previous provision in the Toys "R" Us Settlements.

Rule 2241 applies a new "principles-based" approach that requires members to develop and enforce written policies and procedures to manage the historical conflicts specified in the rule as well as unspecified extant and emerging conflicts affecting research.[119] The broader mandate makes the specific prescriptions in the rule the basis for expectations on member implemented restrictions between research analysts, investment bankers, and issuers.[120] Unfortunately, the strict liability standard imported from the Toys "R" Us Settlements and related guidance assigns increased regulatory risk to pre- and post-mandate communications between research analysts and management of EGCs that is likely to have a chilling effect on due diligence for pre-IPO research and other analyst involvement in underwriting contemplated by the JOBS Act.

While the SEC and FINRA each acknowledged that analysts must perform due diligence, neither interpreted the JOBS Act to provide the widest latitude to question management in good faith. Instead, FINRA cautioned members to prevent inquiries that "imply that the analyst is soliciting investment banking business or otherwise [sic] promising favorable research."[121] In the Toys "R" Us Settlements, the regulator set a very low threshold for conduct that violates this standard by prohibiting any communication that conveys the analyst's positive view of the company or its prospects or his or her support for a valuation.[122]

Research analysts routinely preface their questions to management on analyst calls to review the company's performance with comments like "congratulations on a great quarter," "the numbers look terrific," or "management is doing an excellent job," or ask questions to elicit confirmation of their own views on valuation or performance. Efforts to mask legitimate enthusiasm for the company or to conceal the analyst's thoughts about it can only reduce the force with which analysts perform their investigations.

Legacy provisions in FINRA Rule 2241 that restrict the pre-publication review of a research report by non-research personnel or the subject company also com-

119. *See* Exchange Act Release No. 34-75471, *supra* note 3.

120. FINRA commented that the broad imperative in Rule 2241(b)(1) "will maintain the same level of investor protection in [NASD Rule 2711] while . . . imposing additional obligations to proactively manage emerging conflicts." Exchange Act Release No. 34-75471, *supra* note 3, at 43489; *see also* Notice of Filing of a Proposed Rule Change to Adopt FINRA Rule 2241 (Research Analysts and Research Reports), Exchange Act Release No. 34-73622, 79 Fed. Reg. 69939, 69942 (Nov. 18, 2014), http://www.gpo.gov/fdsys/pkg/FR-2014-11-24/pdf/2014-27700.pdf. FINRA described the new requirement as "a significant additional obligation that does not exist in the current rules," *id.* at 43489, while adding that the express prohibitions against analyst participation in underwriting pitches, road shows, and other investment banking-related initiatives are "a *non-exhaustive* list of the types of activities that can violate this provision." Exchange Act Release No. 34-75471, *supra* note 3, at 43484 (emphasis added).

121. *Compare FINRA 2015 Research Rules FAQ*, *supra* note 75 (response to Solicitation and Marketing Question 1) ("Since [vetting and due diligence] communications are for the purposes of obtaining information from the issuer in furtherance of the analyst's research function, *depending on the facts and circumstances, they carry lower risk than where a research analyst shares his or her views or valuations with the issuer*." (emphasis added)), *with* Exchange Act Release No. 34-75471, *supra* note 3, at 43495 n.179 ("[A]n analyst may ask follow up questions in order to understand factual matters being presented *provided such questions do not imply that the analyst is soliciting investment banking business or otherwise promising favorable research*." (emphasis added)).

122. *See supra* note 79 and accompanying text.

promise due diligence in a way that may operate to prevent pre-IPO research entirely.

NASD Rule 2711 prohibited the review of a draft research report by an investment banker except as necessary to verify factual information or to identify potential conflicts of interest.[123] Under the old rule, it was permissible to share sections of the report with the subject company only to verify facts.[124] Prior to the JOBS Act, research was published only after the IPO, when all material facts about the issuer were in the public domain—the final registration statement was on file and the company was subject to continuous reporting obligations—and, arguably, the potential for undue influence by an investment banker or a company executive outweighed any benefit an analyst might have received from the banker's or the executive's input on the analyst's assumptions or reasoning.

FINRA Rule 2241 includes the same restrictions on pre-publication review of a research report by the issuer but prohibits any review of draft research by investment banking personnel.[125] Under the JOBS Act, research on an EGC is contemplated prior to the final prospectus and is permitted even before a preliminary registration statement is filed. Underwriters publishing pre-IPO research, therefore, must be able to allow their analysts to confirm factual information that resides primarily with investment bankers conducting more comprehensive due diligence for the offering. It may be just as important for the analyst to test his or her assumptions and reasoning with the bankers to ensure that the firm's analysis is consistent with its message to investors. For investment bankers, the interaction offers greater insight to investors' expectations that can inform their own thinking about the company. However, an underwriter cannot be expected to publish pre-IPO research without first vetting it with investment bankers due to the risk that the analyst's incomplete knowledge or misunderstanding of the facts will compromise the research and the offering.

Restrictions on communications that impede access to analysts' views for incorporation in the IPO make it more difficult, if not impossible, to include them in initiatives to educate investors about the company.[126] In particular, policies that restrict analysts' communications with an EGC about valuation or positive aspects of the company's business, or that prevent investment bankers from inquiring about analysts' views on pricing or other subjects because of the insoluble conflict that arises from their inability to relay the information to the

123. *See* NASD Rule 2711(b)(2)–(3). Pre-publication review of research by an investment banker was subject to intermediation by legal or compliance personnel of the member firm.

124. *See* NASD Rule 2711(c)(1)–(2). Pre-publication review of research by the issuer was subject to intermediation by legal or compliance personnel. The section could not contain a summary of the research, rating, or price target.

125. *See* FINRA Rule 2241(b)(2)(A), (N); FINRA Rule 2241.05. Significantly, section 15D(a)(1)(A) of the Exchange Act, which provides for rules restricting the pre-publication "clearance" or "approval" of research reports by investment bankers or other persons not responsible for research, does not call for any restriction on the "review" of draft research by non-research personnel. 15 U.S.C. § 78o-6(a)(1)(A) (2012).

126. *See supra* notes 108–10 and accompanying text.

issuer,[127] frustrate efforts to arrange for their participation in investor meetings to market the offering contemplated by the JOBS Act.

More than four years after the JOBS Act, the IPO market continues to perform poorly.[128] Only fifty-one IPOs came to market in the second half of 2015—the lowest level since 2012.[129] The vast majority of IPOs priced in the first three quarters of that year were trading at or below the offering price after six months.[130] The amount of money raised continued to decline and fewer IPOs were followed by secondary offerings.[131]

More than 90 percent of IPO transactions in 2015 were by EGCs.[132] Many of them found lukewarm support by their underwriters in research after the offering—published as little as twenty-five days later under the new regime. In the first half of the year, there were at least sixteen instances in which a managing underwriter initiated coverage with a neutral or negative rating with the stock trading less than 10 percent above the offering price (little more than half the ordinary discount for an IPO);[133] in one instance, the future price target was more than 10 percent below the offering price.[134]

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127. *See supra* notes 83–86 and accompanying text.

128. *See* Corrie Driebusch & Deborah Gage, *IPO Market Dries Up as Investors Retreat*, WALL ST. J. (Feb. 18, 2016), http://www.wsj.com/article_email/ipo-market-dries-up-as-investors-retreat-1455841745-lMyQjAxMTA2ODE2OTUxMzkxWj ("Of the almost 175 companies that made their U.S. stock-market debuts in 2015, more than 70 percent are now trading below their IPO prices. On average their stocks are down about 20 percent."); *see also* Corrie Driebusch, *IPO Market Comes to a Standstill,* WALL ST. J. (Jan. 30, 2016), http://www.wsj.com/articles/ipo-market-comes-to-a-standstill-1454178166 ("The number of US-listed IPOs in 2015, as well as the total money they raised, declined sharply from 2014. . . . Stock performance for recent IPOs has also faltered. Some of the biggest offerings of last year trade below their offer price. . . .").

Despite the promise of a recovery, the negative trend in the IPO market continued in 2016. New stock offerings declined significantly in the first three quarters of the year, *see* Corrie Driebusch & Maureen Farrell, *The IPO Market Is Finally Looking Up Again*, WALL ST. J., Oct. 25, 2016, http://www.wsj.com/articles/tech-shares-give-ipo-market-some-pep-1477398601 ("[T]he overall dollar-volume raised in new listings in the U.S. in 2016 is the lowest it has been in 13 years at this point in the year. . . . A scant ninety-four companies have gone public on U.S. exchanges in 2016, raising 18.4 billion through Tuesday. This year is on track to be the slowest since 2003 for money raised in IPOs, according to Dealogic."), while IPO pricing performance continued to be mixed, *see* Corrie Driebusch, *Big Week for U.S. IPOs, but Some Stumble in Trading Debuts,* WALL ST. J., Oct. 29, 2016, http://www.wsj.com/articles/big-week-for-u-s-ipos-but-some-stumble-in-trading-debuts-1477738803 ("New stock offerings raised nearly $3 billion this past week, the best stretch for the U.S. IPO market in more than a year. But some traded poorly in their debuts, underscoring that a sickly initial public offering market hasn't fully healed.").

129. PROSKAUER ROSE LLP, 2016 IPO STUDY (Mar. 2016) (on file with *The Business Lawyer*).

130. *Id.* at 2–3.

131. The aggregate deal value for IPOs fell to $30.1 billion in 2015, the lowest level since 2009; while the percentage of IPOs that included a secondary component decreased steadily from 28 percent in 2013 to 19 percent in 2015. *Id.*

132. *Id.* at 4.

133. *See supra* note 93 and accompanying text.

134. The results are based on a review of eighty-five IPO transactions. Ten transactions (approximately 12 percent of those reviewed) were the subject of at least one negative or neutral rating by an underwriter with the stock trading less than 10 percent above the offering price after twenty-five days. In six instances, a rating of less than a buy was assigned with the stock trading at or below the offering price.

The JOBS Act was intended to reverse the negative trend in the IPO market. Yet a key component of the law has not been implemented: To date, there has been no pre-IPO research by an underwriter in an offering by an EGC. Instead of facilitating analysts' involvement in IPO underwritings, recent regulatory developments have impeded it further by hardening the information barrier between investment banking and research. The continued inability to consider analysts' views from the beginning compromises IPO pricing and undercuts the stock's performance when more negative research is published after the offering. The situation undermines companies' efforts to raise capital in IPO transactions and secondary offerings and investors' purchases in IPOs, diminishing confidence in the public offering process and the securities markets in general.

The Need for Written Policies and Procedures to Resolve Conflicts Between Research and Investment Banking in Line with Issuers' and Investors' Expectations

Additional legislation may be needed to clarify the effects of the JOBS Act on NASD Rule 2711 and FINRA Rule 2241, including the solicitation aspect of Rule 2711(c)(4) and Rule 2241(b)(2)(L) and the scope of the interpretation given to provisions prohibiting the offer of favorable research for business. Broker-dealers subject to the Global Settlement may find it necessary to obtain clarification from the SEC on similar provisions under their settlement agreements, or to petition the federal courts for relief consistent with the congressional imperative to promote pre-IPO research and greater analyst involvement in underwritings for EGCs.

In the meantime, it is incumbent on broker-dealers to weigh their legal obligations to the issuer and brokerage customers when providing underwriting services and investment recommendations concerning the same transaction. Compliance with SRO requirements must be reconciled with higher obligations under federal securities laws and state statutory and common law duties affecting each of these relationships. The paucity of standards in Rule 2241 for identifying and preventing additional conflicts may lead many member firms to remove their analysts from the IPO underwriting process entirely—a result initially considered to be counterproductive.[135] Ultimately, however, the principles-based approach reaffirms a member's responsibility in the first instance to evaluate its conduct in accordance with duties owed to each constituency in the IPO transaction. The requirement that policies and procedures be in writing enables members to explain competing considerations and solutions in resolving specific conflicts that should allow for the full integration of research contemplated by the JOBS Act.

According to FINRA and the SEC, restrictions on interactions between research analysts, investment bankers, issuers, and investors under Rule 2241(b) are "not inconsistent" with the JOBS Act.[136] The regulators, nevertheless, acknowledged that the operative language in paragraph (b)(1) contemplates different protocols

135. *See supra* notes 17–26 and accompanying text.
136. Exchange Act Release No. 34-75471, *supra* note 3, at 43495.

for EGCs under the law.[137] The specific prescriptions in paragraph (b)(2) that emanate from the core provision, then, also should allow for different solutions in dealing with EGCs.[138] (Although, by its terms, the JOBS Act requires the amendment or abrogation of any rule that on its face impinges on the federal objective.) The standards articulated in the Toys "R" Us Settlements and subsequent guidance that inform compliance with Rule 2241(b)(2)(K) and (L) now are part of the risk-based regime employed by the new rule. The formula allows discretion to devise policies and procedures that address the prohibitions without compromising the firm's ability to write pre-IPO research and to service its investment banking clients and brokerage customers properly.[139]

A member firm that assumes the responsibility to underwrite an IPO must consider the reasonable expectations of both the issuer and investors that its representations about valuation, pricing, and other issues material to the offering are consistent with the views of its research analyst as an expert whose opinion will influence the transaction, or else change the parties' expectations by proper disclosure and consent as necessary.[140] The member also must ensure that the analyst can perform proper due diligence, consulting with the issuer and investment bankers as needed, or inform investors about the limitations on its ability to do

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137. In particular, FINRA and the SEC noted that the interpretation in Supplementary Material .02 prohibiting joint due diligence by investment bankers and analysts prior to a firm's engagement as an underwriter under Rule 2241(b)(1)(C) does not extend to meetings with management of an EGC issuer. *See* Exchange Act Release No. 34-75471, *supra* note 3, at 43495 ("FINRA clarified that it 'would interpret the provision to apply only to the extent it is not contrary to the JOBS Act' and '[t]hus, for example, would not interpret the joint due diligence prohibition to apply where the joint due diligence activities involve a communication with the management of an EGC that is attended by both the research analyst and an investment banker.'").

138. *See supra* note 125 and accompanying text; *see also* FINRA Rule 2241(b)(2)(B) (A member's policies and procedures must "restrict or limit input by the investment banking department into research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan." In consideration of the JOBS Act, there may be greater allowance for executive-level management or joint investment banking and research department decisions on pre-IPO research coverage for EGC offerings.).

139. Exchange Act Release No. 34-75471, *supra* note 3. Unfortunately, the FINRA staff characterized the risk of an analyst's communications with the issuer about the company during the solicitation period as "unmanageable." *See FINRA 2015 Research Rules FAQ*, *supra* note 75 (response to Solicitation and Marketing Question 1). The dearth of pre-IPO research for EGCs and the harm to issuers and investors by conflicting research in IPO underwriting transactions, however, may warrant further consideration and a more permissive standard.

The authoritative value of the Toys "R" Us cases, like all settlements, is limited. The results are confined to the facts stipulated in the agreements. There are no findings in the settlements that the firms had written policies and procedures specifically designed to evaluate the analyst's communications with prospective banking clients to prevent improper efforts to solicit investment banking business, or, with regard to the firms that permitted their analysts to speak substantively to management, documented protocols to review the analyst's presentation to ensure that it did not contain an implicit offer of favorable research. There are no findings that the firms that provided joint valuations had documented procedures to advise management that the estimate did not portend favorable coverage or to review any published research to ensure that it was not prearranged. Written policies and procedures specifically addressing these concerns might have affected the disposition of the cases.

140. According to FINRA, the specific conflicts identified in Rule 2241(b)(2)(A)–(N) cannot be remedied by disclosure alone. *See* Exchange Act Release No. 34-75471, *supra* note 3, at 43483. However, disclosure may be an appropriate part of the solution to a conflict where practical aspects of the remedy run counter to customers' expectations.

so—particularly with regard to research around an IPO where there is an expectation of coherency between the analyst, investment bankers, and the issuer on the part of investors. The firm may need to take special steps, including intermediation by legal and compliance professionals, to ensure that the analyst is not improperly marketing investment banking business or compromising the integrity of research while preserving the analyst's involvement in the transaction.

The goal of the JOBS Act to promote research as part of the IPO underwriting process for EGCs is challenged by the regulatory momentum to isolate it from investment banking. In the end, demand by issuers and investors for pre-IPO research and greater analyst participation in the offering process in line with the congressional objective should prevail to accommodate a reasoned solution if it is documented appropriately.