II. Misbehaving Bankers: Desperate Analysts, FINRA Fines, and the Toys'R'Us IPO

A. Introduction

When a conglomerate of investors, including private equity giants Bain Capital, KKR & Co., and Vornado Realty Trust, purchased Toys'R'Us in 2005, the toy retailer was already in financial trouble.[1] The lower prices of "big-box stores" like Wal-Mart and Target had cost Toys'R'Us a large portion of its market share.[2] The new owners tried several tactics to improve the company's fortunes, including an initial public offering ("IPO"), for which they filed a registration statement in 2010.[3] However, Toys'R'Us abandoned its IPO plans in March of 2013,[4] due to sharply declining profits over the previous year and CEO Gerald Storch's departure from the company the previous month.[5]

Toys'R'Us halting the IPO was surely unwelcome news to the investment banks that had sought to underwrite the offering. In December 2014, the Financial Industry Regulatory Authority ("FINRA") announced that it had fined ten of the banks involved in the Toys'R'Us IPO process a combined total of $43.5 million as a result of their conduct during the deal.[6] FINRA found that each of the banks involved had allowed their research analysts to make presentations to the Toys'R'Us owners as part of the banks' attempts to win

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[1] *See generally* Charlie Devereux, *Toys 'R' Us Withdraws Plan for IPO First Filed in 2010*, BLOOMBERG (Mar. 30, 2013, 9:45 AM), http://www.bloomberg.com/news/2013-03-29/toys-r-us-pulls-ipo-first-filed-in-2010-amid-leadership-shift.html, *archived at* http://perma.cc/25ML-XA5Q.
[2] *Id.*
[3] *Id.*
[4] *See id*.
[5] *Id*.
[6] 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), *available at* http://www.Finra.org/Newsroom/NewsReleases/2014/P602059, *archived at* http://perma.cc/Q8NE-U8N8. The firms that FINRA fined are Barclays Capital Inc., Citigroup Global Markets Inc., Credit Suisse Securities (USA), LLC, Goldman, Sachs & Co., JP Morgan Securities LLC, Deutsche Bank Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Stanley & Co., LLC, Wells Fargo Securities, LLC, and Needham & Company LLC. *Id.*

Toys'R'Us's investment banking business.[7] This practice violated the existing FINRA and New York Stock Exchange ("NYSE") rules governing the issuance of securities.[8] FINRA further found that six of the banks lacked the internal procedures required to prevent this type of behavior.[9] These sorts of actions by the banks are highly reminiscent of the so-called "Global Settlement" of 2003, in which then-New York Attorney General Eliot Spitzer levied $1.4 billion in fines against several banks for similar conduct.[10]

This Article proceeds as follows. Section B will discuss the Global Settlement of 2003 and the rule changes that resulted from that enforcement action. Section C will discuss the conduct barred by National Association of Securities Dealers ("NASD") Rule 2711 in particular. Section D will examine the events surrounding the Toys'R'Us IPO. Section E will outline FINRA's response to those events. Section F will discuss whether the current regulations are adequate to prevent further incidents of this kind.

B. Global Settlement

In 2003, Eliot Spitzer charged ten Wall Street firms with corruption and fraud.[11] The problem, in short, arose from the fact that most large Wall Street firms are not merely brokers, analysts, or investment bankers, but are actually highly diversified businesses that compete in a large number of discrete service markets.[12] Often, competition in one practice area compromises the integrity of the company's operations in another.[13] For example, where several firms are competing for underwriting business for an IPO, the company

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[7] *Id.*

[8] *See id.*

[9] *Id*. Those firms include "Barclays, Citigroup, Credit Suisse, Goldman Sachs, JP Morgan and Needham." *Id.*

[10] Antoine Gara, *Investment Banks Fined $43.5 Million for Spitzer-Era Solicitations on Pulled Toys "R" Us IPO*, FORBES (Dec. 11, 2014, 11:53 AM), http://www.forbes.com/sites/antoinegara/2014/12/11/investment-banks-fined-43-5-million-for-spitzer-era-solicitations-on-pulled-toys-r-us-ipo/.

[11] *See generally* Rebecca Leung, *The Sheriff of Wall Street: Eliot Spitzer Takes on the Brokers and Wins*, CBS NEWS (May 23, 2003), http://www.cbsnews.com/news/the-sheriff-of-wall-street/, *archived at* http://perma.cc/M4BR-7BKR.

[12] *Id.*

[13] *See id.*

going public may pressure each firm to write positive recommendations for their stock to investors.[14] A positive recommendation would increase that firm's chances of being selected for the highly profitable underwriting work available when the stock went public.[15] The problem was that such recommendations were supposed to be written by personnel not involved in the IPO process, who could provide an unbiased recommendation for retail investors.[16]

For a financial firm, investment banking work is far more profitable than providing investment advice to retail investors, and in 2003 Wall Street firms reacted accordingly.[17] Firm analysts began providing favorable reviews of companies' stock to retail investors, in an effort to win the companies' investment banking business, despite holding far more subdued opinions of the stock's actual worth.[18] Merrill Lynch analyst Henry Blodget famously rated the stock of one company, Lifeminders, as a "P-O-S" on his home computer while plugging that same stock to investors as a solid buy.[19] In another instance, Blodget told an investor that there was "nothin" interesting about a particular stock apart from the investment banking fees it would generate.[20] At one point, he received correspondence from a colleague who felt guilty about their practice. "We are losing people money and I don't like it," the colleague wrote.[21] The colleague continued, and pointed out that "John and Mary Smith are losing their retirement because we don't want [an investment banking client] to be mad at us."[22]

After Spitzer's investigation, the Securities and Exchange Commission ("SEC"), the NYSE, and the NASD all brought actions against the firms involved, and the civil penalties that resulted were extensive.[23] In all, the terms of the Global Settlement between the firms

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[14] *Id.*
[15] *Id.*
[16] *See id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *See* Press Release, Sec. & Exch. Comm'n, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm, *archived at* http://perma.cc/5KU9-RNS9.

and the enforcement agencies required the firms to pay $1.4 billion in penalties, including disgorgement to defrauded investors, support money for independent research, and funding for programs intended to promote investor education.[24] According to the SEC, "[t]he civil penalties in these actions [were] among the highest . . . ever imposed in civil securities enforcement actions."[25]

Additionally, the terms of the Global Settlement required the firms to institute stringent internal regulations to "separate[e] the research and investment banking departments at the firms."[26] The settlement mandated: (1) physically separating the firms' research and investment banking departments, (2) setting the research department's budget without input from the investment banking department and without regard to its profits, (3) setting research analyst compensation without input from investment bankers and without regard to investment banking profits, (4) prohibiting investment bankers from having any role in the firm's decision to provide investment research on a specific company, (5) prohibiting research analysts from having any role in the solicitation of investment banking business or helping to market the transaction, and (6) requiring firms to create "firewalls" between their research and investment banking visions.[27] The settlement further required that the firms involved furnish investors with at least three different sets of independent research for a period of five years, and make public each of their analysts' "historical ratings and price target forecasts."[28] Finally, the ten firms voluntarily agreed to restrict "spinning."[29] "Spinning" refers to the practice of investment banks "allocat[ing] . . . securities in hot IPOs—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and directors" in hopes of winning their investment banking business.[30]

The Global Settlement's reforms were designed to punish firms for their conduct and prevent similar violations in the future.[31]

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[24] *Id.*
[25] SEC. & EXCH. COMM'N, SEC FACT SHEET ON GLOBAL ANALYST RESEARCH SETTLEMENTS (2003), *available at* http://www.sec.gov/news/speech/factsheet.htm, *archived at* http://perma.cc/RSM8-ERMT.
[26] *See* Press Release, Sec. & Exch. Comm'n, *supra* note 23.
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *See id.*

Dick Grasso, the NYSE Chairman and CEO, commented that "[t]his historic settlement establishes a clear bright line—a banker is a banker and an analyst is an analyst. The two shall never cross."[32] Another commenter suggested that, "[i]f the Street follows both the spirit and the letter of this settlement, it will change the way business is done on Wall Street. Investors—not investment banking fees—will come first. And analysts will be beholden to the truth, not the IPO business."[33]

C. NASD Rule 2711

Though securities issuers and underwriters must comply with a litany of laws and regulations, the rule most relevant to both the Global Settlement and the Toys'R'Us IPO is NASD Rule 2711.[34] The NASD adopted this rule in the wake of the Global Settlement and Congress's passage of the Sarbanes-Oxley Act of 2002, and the rule is designed to encapsulate many of the Global Settlement's provisions.[35] Generally, Rule 2711 establishes barriers between the research analysts and investment banking personnel in a firm, with the goal of ensuring investors access to accurate research untainted by conflicts of interest.[36]

Of particular interest are subsections (c)(4), (e), (h), and (i). Rule 2711(c) places restrictions on the communications that a research analyst may have with a company they are reviewing, and Rule 2711(c)(4) bars research analysts from participating in the investment banking solicitation process.[37] Rule 2711(e) prohibits firms from offering favorable research "as consideration or inducement for the

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[32] *Id.* (citation omitted) (internal quotation marks omitted).

[33] Christine Bruenn, President, N. Am. Sec. Adm'rs Ass'n, President's Remarks at SEC Regarding Global Settlement (Apr. 28, 2003), *available at* http://www.nasaa.org/459/presidents-remarks-at-sec-regarding-global-settlement/, *archived at* http://perma.cc/JT4R-CR85.

[34] *See generally* FINRA R. 2711 (2012), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3675, *archived at* http://perma.cc/6CNT-H3MY.

[35] Anna T. Pinedo & Nilene R. Evans, *Frequently Asked Questions About Separation of Research and Investment Banking*, MORRISON & FOERSTER LLP 2 (2013), http://media.mofo.com/files/Uploads/Images/Frequently-Asked-Questions-about-Separation-of-Research-and-Investment-Banking.pdf, *archived at* http://perma.cc/92ZZ-WEG6.

[36] *See id.*

[37] FINRA R. 2711(c).

receipt of business."[38] Rule 2711(h) requires firms to disclose to investors any material conflicts of interest they have with a company on which they are providing research for the investor.[39] Rule 2711(i) requires each firm to implement internal procedures to ensure that the firm follows the other provisions of Rule 2711.[40]

D. The Toys'R'Us IPO

The IPO market was slow when Toys'R'Us began its IPO registration process in 2010.[41] As a result, several firms competed fiercely to win the underwriting job.[42] Additionally, the Toys'R'Us owners vetted the bidding firms aggressively.[43]

During the vetting process, as is often the case, Toys'R'Us requested an evaluation of the rating that each firm's analysts gave the Toys'R'Us stock.[44] Toys'R'Us asked for this information to make sure that the underwriter's analysts did not take a negative view of the stock after the underwriting work had been performed.[45] Companies generally want their IPO share price to be as high as possible, and positive analyst views on the stock will help to increase the price.[46] Negative analyst projections, conversely, could push the IPO price lower.[47]

In an effort to assess each firm's research analysts' opinions, the Toys'R'Us owners required that the firms share their "earnings forecasts and comparables that would govern their valuation of

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[38] FINRA R. 2711(e).
[39] FINRA R. 2711(h).
[40] FINRA R. 2711(i).
[41] Telis Demos & Alexandra Scaggs, *Finra Fines 10 Banks Over Their Pursuit of an IPO's Business—4th Update*, NASDAQ (Dec. 11, 2014, 5:24 PM), http://webcache.googleusercontent.com/search?q=cache:GcOkVgiyB5kJ:m.nasdaq.com/article/finra-fines-10-banks-over-their-pursuit-of-an-ipos-business--4th-update-20141211-01056+&cd=2&hl=en&ct=clnk&gl=us.
[42] *See id.*
[43] *See id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *See* Henry Blodget, *Here's the Inside Story of What Happened on the Facebook IPO*, BUSINESS INSIDER (May 22, 2012, 5:30 PM), http://www.businessinsider.com/exclusive-heres-the-inside-story-of-what-happened-on-the-facebook-ipo-2012-5, *archived at* http://perma.cc/87SB-UPCQ.

[Toys'R'Us]" during the IPO.[48] More importantly, Toys'R'Us required that each firm's research analysts give presentations to Toys'R'Us as part of the solicitation process, and made it clear that they would award investment banking work based on the research analysts' projections.[49] Well aware of the situation, investment bankers urged the research analysts to make sure their projections were "'tightly coordinated' and 'consistent' with [the firm's] underwriting pitches."[50] Credit Suisse told Toys'R'Us that the firm had "approached this [IPO] process in complete alignment, having pursued a vigorous vetting process before our meeting . . . amongst banking, equity capital markets and research."[51] In an email, Citigroup bankers told Toys'R'Us that the retailer could "count on Citi's firmwide support and advocacy for the Toys story and valuation."[52]

The research analysts, in turn, jockeyed to make their enthusiasm for the deal as palpable as possible.[53] Prior to a meeting with Toys'R'Us, one Citigroup research analyst emailed a supervisor that she "so want[ed] the bank to get this deal!"[54] An analyst at Needham & Co. was even more explicit.[55] "My whole life is about posturing for the Toys R Us IPO," the analyst wrote in one email.[56] "I would crawl on broken glass dragging my exposed junk to get this deal," the analyst wrote in another.[57]

In the end, "each of the firms . . . offered favorable research coverage in return for a role in the I.P.O.," according to FINRA.[58]

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[48] *See* Gara, *supra* note 10.
[49] *Id.*
[50] *Id.*
[51] *See* Telis Demos & Alexandra Scaggs, *Big Banks Slapped for Offering Glowing Research to Win IPO,* WALL ST. J. (Dec. 12, 2014, 12:04 AM), http://www.wsj.com/articles/SB21830305763020394591204580331010098062090.
[52] *Id.*
[53] *See id.*
[54] *Id.*
[55] *See id.*
[56] *Id.*
[57] *Id.*
[58] *10 Wall Street Firms Fined over Conflicts in Toys 'R' Us I.P.O.*, N.Y. TIMES DEALBOOK (Dec. 11, 2014, 11:56 AM), http://dealbook.nytimes.com/2014/12/11/10-wall-street-firms-fined-over-conflicts-in-toys-r-us-i-p-o, *archived at* http://perma.cc/Q6A6-AM7A.

E. FINRA Response

In response to these actions, FINRA levied a total of $43.5 million in fines against the ten firms involved.[59] FINRA fined Barclays, Citigroup, Credit Suisse, Goldman Sachs Group, and JPMorgan Chase $5 million each.[60] FINRA fined Deutsche Bank, Bank of America, Morgan Stanley, and Wells Fargo $4 million each.[61] FINRA fined Needham & Co. $2.5 million.[62] The $43.5 million total is believed to be one of the largest penalties in a single case since the Global Settlement.[63]

The charges against each firm were fairly similar, as they all involved violations of various portions of NASD Rule 2711.[64] FINRA charged each bank involved with a violation of Rule 2711(c)(4), which bars research analysts from participating in the solicitation of investment banking business.[65] Rule 2711(c)(4) also bars research analysts from communicating with issuers during the solicitation period, except to gather information about the issuer as part of a due diligence effort.[66] FINRA found that each firm's research analysts' presentations to Toys'R'Us during the solicitation period violated this rule as well.[67]

Each of the firms also violated Rule 2711(e), which prohibits research analysts from offering favorable research coverage to induce investment banking business.[68] FINRA found that each firm engaged in precisely this sort of conduct in an effort to win a piece of the IPO underwriting work.[69]

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[59] Press Release, Fin. Indus. Regulatory Auth., *supra* note 6.
[60] Gara, *supra* note 10.
[61] *Id.*
[62] *Id.*
[63] *See* Demos & Scaggs, *supra* note 51.
[64] *See, e.g.*, Goldman, Sachs & Co., FINRA Letter of Acceptance, Waiver, and Consent, Case No. 2011030683301, at 3 (Dec. 10, 2014), *available at* http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=38175, *archived at* http://perma.cc/8Y8R-NX6B.
[65] *Id.*
[66] FINRA R. 2711(c)(4) (2012), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3675, *archived at* http://perma.cc/6CNT-H3MY.
[67] *See, e.g.*, Goldman, Sachs & Co., *supra* note 64, at 6.
[68] *Id.*
[69] *Id.* at 7.

FINRA also found that six of the ten banks violated Rule 2711(i), which requires the banks to "adopt and implement supervisory procedures reasonably designed to ensure that the member and its employees comply with the provisions of [Rule 2711]."[70] Essentially, FINRA found that each of the six firms lacked internal compliance processes that would have prevented their research analysts from becoming involved with the IPO solicitation process.[71]

Finally, FINRA charged Needham & Co. with a violation of Rule 2711(h), which "requires members and research analysts to disclose in research reports certain financial and compensation relationships with subject companies so as to inform readers of potential conflicts of interest."[72] FINRA found that between January 1, 2010 and September 30, 2013, Needham & Co. omitted more than 1,000 such disclosures from several hundred research reports, and failed to disclose that "its research analysts received compensation based upon (among other factors) Needham's investment banking revenue."[73]

In consenting to the settlement of the matter and the entry of FINRA's findings, "the 10 firms neither admitted nor denied the charges."[74]

F. Are the Current Safeguards Adequate?

The revelation that many high-profile Wall Street firms have continued to mix their research and investment banking departments has raised questions about whether the changes instituted in the wake of the Global Settlement were truly effective.[75] At the very least, predicating investment banking business on a research analyst's projections

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[70] *Id.* at 8. FINRA found the following banks in violation of Rule 2711(i): Credit Suisse, JP Morgan Securities, Goldman Sachs, Barclays, Citigroup, Wells Fargo, and Needham & Co. Press Release, Fin. Indus. Regulatory Auth., *supra* note 6.

[71] *See, e.g.*, Goldman, Sachs & Co., *supra* note 64, at 8.

[72] Needham & Company, LLC, FINRA Letter of Acceptance, Waiver, and Consent, Case No. 2013037818301, at 8 (Dec. 10, 2014), *available at* http://disciplinaryactions.finra.org/viewDocument.aspx?DocNb=38171, *archived at* http://perma.cc/KX2N-UX3W.

[73] *Id.*

[74] Press Release, Fin. Indus. Regulatory Auth., *supra* note 6.

[75] *See* Gara, *supra* note 10.

appears to be a fairly common practice, despite the FINRA rules.[76] Citigroup, notably, paid $15 million to settle a similar research-related complaint mere weeks before the announcement of the Toys'R'Us settlement.[77] With the exception of Needham & Co., each of the FINRA settlement documents included a "Relevant Disciplinary History" section, which detailed each firm's history of similar violations tracing back to 2003.[78] At least one commentator has suggested that Wall Street firms see FINRA fines as simply a "cost of doing business," making those fines an ineffective deterrent against this kind of behavior.[79] This has led some commentators to call for stiffer penalties, in the hope of increasing the deterrent effect of FINRA rules.[80]

It is possible, however, that the firms' actions stemmed simply from a misunderstanding of the applicable rules. Richard Truesdell, co-head of Davis Polk & Wardwell LLP's capital-markets group, noted that he advises clients working on IPOs to "interview the [research] analysts."[81] Several Wall Street figures suggested that they understood conversations between research analysts and company owners to be allowable under certain circumstances.[82] Alan Sheriff and Ted Hatfield, co-chief executives of the IPO adviser firm Solebury Capital, said in an interview that their corporate clients often hold "informational" meetings with research analysts throughout the IPO process, though the discussion in those meetings covered only "general market trends."[83] Mr. Sheriff acknowledged that "pitching investment banking in analyst meetings is strictly off limits."[84]

Even before this settlement, though, FINRA had come under fire from the SEC for taking a "too-lenient stance" on this problem.[85] In

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[76] *See* Peter Lattman & Susanne Craig, *With I.P.O.'s on the Rise, Analysts Get New Scrutiny*, N.Y. TIMES, Aug. 12, 2013, at B1; Demos & Scaggs, *supra* note 51.
[77] Gretchen Morgenson, *At Big Banks, a Lesson Not Learned*, N.Y. TIMES, Dec. 14, 2014, at BU1.
[78] *See, e.g.*, Goldman, Sachs & Co., *supra* note 64, at 1-2.
[79] *See* Morgenson, *supra* note 77.
[80] *Id.*
[81] Demos & Scaggs, *supra* note 51.
[82] *See* Lattman & Craig, *supra* note 76.
[83] *Id.*
[84] *Id.*
[85] Jean Eaglesham, *FINRA Weighs Tougher Stance: SEC Commissioner Says Regulator's Actions are 'Financially Insignificant,'* WALL ST. J. (June 19,

a May 2014 speech, SEC commissioner Kara Stein expressed concern that FINRA's fines were "too often financially insignificant for the wrongdoers."[86] Philip Aidikoff, a "Beverley Hills . . . lawyer who represents investors in arbitration claims against brokerage firms," echoed this sentiment.[87] Mr. Aidikoff alleged that the fines are "so small compared to the kind of behavior they're trying to discourage that you scratch your head and say, 'Really?'"[88]

G. Conclusion

At the very least, the size and notoriety of the Toys'R'Us settlements appear to have caught Wall Street's attention.[89] According to some commentators, the practice of involving research analysts in the solicitation process is "not going to be able to continue."[90] FINRA, too, is conducting a review of its policies to determine if they should be modified going forward.[91] "We want to move the ball forward in terms of really bad actors," said Susan Axelrod, FINRA's Executive Vice President of Regulatory Operations.[92] "These sanctions can't be the cost of doing business; they have to send the right message to the industry," added Alexrod.[93] Whether FINRA will increase its sanctions, and actually put an end to the intermingling of research and investment banking, remains to be seen.

Graham Rogers[94]

2014, 10:56 PM), http://www.wsj.com/articles/wall-street-watchdog-finra-under-pressure-to-toughen-sanctions-1403219509.

[86] Kara Stein, Commissioner, Sec. & Exch. Comm'n, Remarks Before FINRA's Division of Market Regulation (May 29, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542039139#.VQNvI4F4qLE, *archived at* http://perma.cc/9KZU-DZ2H.

[87] Eaglesham, *supra* note 85.

[88] *Id.*

[89] *See* Demos & Scaggs, *supra* note 51.

[90] *Id.*

[91] Eaglesham, *supra* note 85.

[92] *Id.*

[93] *Id.*

[94] Student, Boston University School of Law (J.D. 2016).