

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 04-128
DEUTSCHE BANK SECURITIES INC.
MEMBER ORGANIZATION

August 2, 2004

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Violated Exchange Rule 476(a)(6) and Exchange Rule 401 by engaging in acts and practices that created and/or maintained inappropriate influence by investment banking over research analysts, therefore imposing conflicts of interest on its research analysts, and failing to manage these conflicts in an adequate or appropriate manner, issuing research reports that were affected by the conflicts of interest imposed on its research analysts, receiving payments for research, directly or indirectly from underwriters and issuers, without disclosing receipt of the payments as required by Section 17(b) of the Securities Act of 1933, as amended, failing to disclose or cause to be disclosed in offering documents or elsewhere payments for research to other broker-dealers in connection with underwriting transactions; violated Exchange Rule 476(a)(11) by failing to timely produce e-mail records requested in connection with the investigation of the Firm's research and investment banking practices; violated Exchange Rule 472 relating to communications with the public by issuing research reports that contained recommendations and/or rating that were exaggerated or unwarranted claims and/or contained opinions for which there was no reasonable basis, failing to disclose payments it received for research as required by Section 17(b) of the Securities Act of 1933, as amended, failing to disclose or cause to be disclosed in offering documents or elsewhere payments for research to other broker-dealers in connection with underwriting transactions; violated Exchange Rule 342 by failing to establish and maintain adequate policies, systems, and procedures for supervision and control of its Research and Investment Banking Departments reasonably designed to detect and prevent the foregoing investment banking influence and manage the conflicts of interest, including a separate system of follow-up and review to assure compliance with applicable Exchange Rules – Consent to censure, a total payment of \$87,500,000 and an undertaking.

Appearances:

For the Division of Enforcement
Susan L. Merrill, Esq.
Robert A. Marchman, Esq.
Linda S. Riefberg, Esq.
Jeanne R. Elmadany, Esq.
Suzanne R. Elovic, Esq.
Penny Rosenberg, Esq.
James E. Shipley, Jr., Esq.

For the Respondent
David B. Hennes, Esq.
Carmen J. Lawrence, Esq.
Richard Walker, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Deutsche Bank Securities Inc, a member organization (the "Firm"). Without admitting or denying the allegations in the Stipulation of Facts and Consent to Penalty, the Firm consented to a finding by the Hearing Panel that it:

- I. Violated Exchange Rule 476(a)(6) by engaging in conduct inconsistent with just and equitable principles of trade by:
 - A. Engaging in acts and practices that created and/or maintained inappropriate influence by investment banking over research analysts, therefore imposing conflicts of interest on its research analysts, and failing to manage these conflicts in an adequate or appropriate manner.
 - B. Issuing research reports that were affected by the conflicts of interest imposed on its research analysts.
 - C. Receiving payments for research, directly or indirectly from underwriters and issuers, without disclosing receipt of the payments as required by Section 17(b) of the Securities Act of 1933, as amended.
 - D. Failing to disclose or cause to be disclosed in offering documents or elsewhere payments for research to other broker-dealers in connection with underwriting transactions.
- II. Violated Exchange Rule 476(a)(11) by failing to timely produce e-mail records requested in connection with the investigation of the Firm's research and investment banking practices.
- III. Violated Exchange Rule 401 by failing to adhere to the principles of good business practice in the conduct of its business affairs by:
 - A. Engaging in acts and practices that created and/or maintained inappropriate influence by investment banking over research analysts, therefore imposing conflicts of interest on its research analysts, and failing to manage these conflicts in an adequate or appropriate manner.
 - B. Issuing research reports that were affected by the conflicts of interest imposed on its research analysts.
 - C. Receiving payments for research, directly or indirectly from underwriters and issuers, without disclosing receipt of the payments as required by Section 17(b) of the Securities Act of 1933, as amended.
 - D. Failing to disclose or cause to be disclosed in offering documents or elsewhere payments for research to other broker-dealers in connection with underwriting transactions.

- IV. Violated Exchange Rule 472 relating to communications with the public by:
- A. Issuing research reports that contained recommendations and/or ratings that were exaggerated or unwarranted claims and/or contained opinions for which there was no reasonable basis.
 - B. Failing to disclose payments it received for research as required by Section 17(b) of the Securities Act of 1933, as amended.
 - C. Failing to disclose or cause to be disclosed in offering documents or elsewhere payments for research to other broker-dealers in connection with underwriting transactions.
- V. Violated Exchange Rule 342 by failing to establish and maintain adequate policies, systems, and procedures for supervision and control of its Research and Investment Banking Departments reasonably designed to detect and prevent the foregoing investment banking influence and manage the conflicts of interest, including a separate system of follow-up and review to assure compliance with applicable Exchange Rules.

For the sole purpose of settling this disciplinary proceeding, prior to hearing, without adjudication of any issues of law or fact, and without admitting or denying allegations, facts, conclusions or findings referred to in the Stipulation of Facts and Consent to Penalty, the Firm consents to findings by the Hearing Panel, the substance of which follows:

Background and Jurisdiction

1. The Firm, a registered broker-dealer with its principal office located in New York, New York is a subsidiary of Deutsche Bank AG. The Firm is a member of the Exchange and the NASD.
2. The Firm provides a comprehensive range of advisory, financial, securities research, and investment services to corporate and private clients. The Firm's clients include both institutional investors and individual investors (often referred to as "retail customers"). The Firm also provides investment banking services to corporate clients.

Overview

3. From July 1999 through June 2001 (the "relevant period"), the Firm engaged in acts and practices that created and/or maintained inappropriate influence by investment banking over research analysts, thereby creating conflicts of interest for its research analysts. The Firm failed to manage these conflicts in an adequate manner.
4. During this time period, the Firm offered research coverage in order to gain investment banking business and receive investment banking fees. It also received over \$1 million from other investment banks to provide research coverage of their investment banking clients, and made payments of approximately \$10 million to other securities firms primarily for research coverage for its investment banking clients.

5. In addition, the Firm compensated its research analysts based in part upon their contributions to the Firm's investment banking business. These relationships and activities constituted substantial conflicts of interest for the Firm's research analysts.
6. The Firm failed to establish and maintain adequate policies and procedures reasonably designed to manage these conflicts of interest.
7. The Firm also failed to promptly produce copies of e-mail communications that had been requested during the investigation. Despite repeated inquiries from federal and state regulators, the Firm insisted during the investigation that its production of the e-mail was complete. In fact, the Firm had produced less than one-fourth of the responsive e-mail by April 2003. Over the next year, the Firm produced another 227,000 e-mail, more than tripling its original production and delaying completion of the investigation for over a year.

The Role of Research Analysts of the Firm

8. The Firm has a securities research department called the "equity research department," which provides its investment clients and the public with research reports on certain public companies. Research analysts at the Firm are generally assigned to review the investment outlook of specific public companies within a certain industry or sector, such as technology or biosciences. This is called "covering" a company's stock. In their research reports, analysts typically review the performance of the covered companies, evaluate their business prospects, and provide analysis and projections regarding the future prospects of the company. They also provide a rating or recommendation as to whether the company presents a good investment opportunity, and often provide a price target (the market price at which the analyst expects the stock to trade within a given time).
9. During the relevant period, Firm analysts made themselves available via telephone, electronic mail, and in person to the Firm's institutional and retail sales force to answer questions about industry sectors and companies covered by the analyst. In addition, analysts provided periodic research updates to the sales forces through "morning calls" held before the start of trading.
10. During the relevant period, the Firm had a four-point rating system: "Strong Buy"; "Buy"; "Market Perform"; and "Market Underperform." According to the firm's policy, a "Strong Buy" or "1" rating meant that "DBSI expects, with a high degree of confidence, that the securities will significantly outperform the market time frame and that the time to buy the securities is now." A "Buy" or "2" rating meant "DBSI expects that the securities will out perform the market by 10% or more over the next 12 months." A "Market Perform" or "3" rating meant that "DBSI expects that the securities will broadly perform in line with the local market over a 12-month period and the share price is likely to trade within a range of +/- 10%." A "Market Underperform" or "4" rating meant that "DBSI expects the securities to underperform against the local market by 10% or more over the next 12 months."

11. During the relevant time period, a substantial majority of the companies covered by the Firm's analysts in the technology, biotechnology, media, and telecommunications sectors received a Buy or Strong Buy rating. In contrast, only one of the more than 250 companies covered by the Firm during the time period had lower than a Market Perform. Accordingly, what the Firm held out as a four-point rating system for stocks in the above sectors was effectively a three-point system.
12. The Firm distributed its analysts' research reports internally to various departments at the firm, made the reports available to its institutional and retail customers, and disseminated the reports to subscription services such as First Call and Bloomberg. The firm's customers received the research reports through the firm's website and also through electronic mail or postal mail if they were on the firm's mailing lists. Analysts' recommendations were also reported in the U.S. financial news media.
13. The Firm held out its research analysts as providing independent, objective and unbiased information, reports, and recommendations upon which investors could rely in making informed investment decisions.

Investment Banking at the Firm

14. The Firm's investment banking division assists companies with raising capital through initial public offerings ("IPOs"), "follow-on" offerings (subsequent offerings of stock to the public), and private placements of stock. It also assists companies with negotiating and brokering other corporate transactions, such as mergers and acquisitions. During the relevant period, investment banking was an important source of revenue for the Firm, accounting for approximately 29.2% of its total revenues.
15. The Firm generally competes with other investment banks for selection by issuers and other sellers of securities as lead underwriter or "bookrunner" on securities offerings. The lead underwriters receive the largest portion of the investment banking fees, called underwriting fees; accordingly, there are significant financial rewards to being selected as the lead underwriter. The lead underwriters also establish the allocation of shares in a securities offering and typically retain the greatest number of shares for themselves. The typical IPO generates significant investment banking fees for the lead underwriters. During the relevant period, the Firm was the ninth largest underwriter in the U.S. securities market, receiving about \$1.15 billion in investment banking fees.
16. In addition to their research responsibilities, analysts assisted investment bankers in performing due diligence on investment banking transactions.

The Firm's Research Structure Contained Conflicts of Interest

17. Because the Firm did not charge for its research, the Americas Equity Research Department at the Firm was a "cost center." Its costs were substantially funded by the firm's departments responsible for institutional clients and investment banking. During the relevant period, the equities department funded 50% of the research department's expenses, the investment banking department funded 43%, and the retail department funded 7%.

18. Investment banking considerations were an important factor in deciding what research coverage to provide and how much research analysts were paid. As stated below, the Firm's compensation structure rewarded analysts for investment banking deals consummated in their sectors. Investment banking interests also played a role in determining which companies would be covered by the firm's analysts and which would be dropped.

Analysts' Compensation Was Determined in Part by the Analysts' Contribution to Investment Banking Revenues

19. In order to "align" the interests of the analysts with the interests of the other departments at the firm whose revenues funded the research department, the Firm created an "analyst performance matrix" that ranked all of the Firm's analysts based upon several criteria. Beginning in 2000, the Firm determined bonuses for its research analysts based upon this matrix. These bonuses, which ranged from hundreds of thousands to millions of dollars, made up the vast majority of most analysts' compensation.
20. In 2000, under the matrix, one-third of an analyst's ranking was based upon the analyst's contribution to investment banking, one-third upon his or her contribution to the institutional investor franchise, and one-third upon the research director's subjective assessment. In 2001, a fourth equally-weighted category – the analysts' ranking in independent surveys, such as the All American Institutional Investor Poll – was added to the matrix.
21. Analysts received "credit" for all investment banking deals in their sector (regardless whether they worked on the deal), as well as for deals outside their sector to which they contributed personally. This amount was then adjusted upward or downward by 25-30% based upon the reviews provided by the investment bankers who worked with the analyst. Thus, if an analyst was helpful to investment bankers in the analyst's sector by, for example, generating deals for his sector, the analyst could get a high rating from the investment banker and thus increase his rating in the matrix and, potentially, the size of the analyst's bonus.
22. Investment bankers rated analysts based on a scale of 1 ("Analyst Extremely Important To A Majority Of Investment Banking Revenue. Without The Analyst, Our Revenue Would Have Been More Than 50% Below What We Generated.") to 5 ("Analyst Had A Negative Impact On Investment Banking Revenue."). Analysts at the top of the matrix – and thus who received the largest bonuses – typically received all 1's or 2's from investment bankers, as well as scored highly in other areas of the matrix.
23. The Firm's research management circulated draft quarterly investment banking deal reports to analysts to verify the investment banking deals for which analysts were to receive credit. Analysts were encouraged to, and did, respond to these reports with additional examples of deals in their sector or on which they had worked.

24. In these responses and in the yearly performance self-evaluations that analysts completed, many analysts identified the importance of their work in bringing investment banking business to the Firm and the value of that work to the firm. For example, analysts stated in their self-evaluations:
- a. “Won two lead managed IPO mandates ... Won one secondary offering ... as a result of relationship with management team (our investment bankers did not have any previous relationship with the Company). ... DBAB generated a \$400K (roughly) fee. Participated in winning mandate on ... convertible debt offering despite previous ... analyst leaving DBAB. ... DBAB earned a \$10M (roughly) fee.... My previous management relationships allowed the firm to make equity investment in a number of promised private communications equipment companies.”;
 - b. “Completed 8 banking deals ..., generating an estimated \$8-10 million in fees; 7 of the 8 were either research driven or solely research driven ... Were invited to pitch ... the \$2-3 billion ... IPO; I started the ball rolling.”
25. In certain instances, research management requested that analysts complete “business plans,” such as when transitioning coverage from one analyst to another. Analysts discussed the investment banking imperatives that they had addressed through coverage of certain areas or companies or otherwise. For example, in an April 2001 e-mail exchange between two analysts, one analyst said that he was told one of his goals for the year was to “generate at least as much in banking fees as he did last year.”
26. Research management based promotion decisions in part upon the analyst’s assistance to the firm’s investment banking business.
27. In sum, research analysts at the Firm were compensated millions of dollars in part for their contribution in winning the business of investment banking clients, for whom they issued reports and recommendations.

Investment Banking Interests Influenced Coverage Decisions

28. The research department at the Firm made decisions about the stocks on which its analysts would initiate and maintain coverage based in part upon investment banking concerns. According to the director of research, investment banking opportunities were a factor in determining research coverage. For example, one analyst testified that he agreed to maintain coverage of certain companies he would otherwise drop until the banker had the opportunity to “close” the transactions the banker was hoping to win.
29. In another example, an analyst expressed her disappointment in a February 2001 e-mail that the firm had not been included in an offering by Charlotte Russe Holding Inc. The analyst stated that “the only reason we picked up coverage of the stock [Charlotte Russe Holding Inc.] was to be involved in IB flow.” The analyst had just rated the company a “Buy” on December 21, 2000.

30. Analysts also routinely identified to their investment banking counterparts private companies that might go public. Often, it was the research analyst's relationship with the company that convinced the company to use the Firm's investment banking services. If the company did indeed use the Firm for its investment banking business, the analyst would typically cover the company for the Firm. The fact that the analyst had originated the Firm's investment banking transaction with the company that he covered presented a potential conflict of interest.
31. In July 2000, a banker in the Hong Kong office of the Firm sent an e-mail to the director of research stating that "the lack of coverage [of Pacific Century Cyberworks] continues to be a major problem in our relationship, and we have been categorically assured that none of [the company owner's] (very substantial) deal flow will come our way until we make good on our promise . . ." The director of research later sent an e-mail to his assistant stating "we need to have active, co-coverage of this name in the US. been [sic] a big fee paying customer of ours that we have promised US coverage that past US research management agreed to."
32. In addition to initiating positive coverage on investment banking clients, the Firm research analysts at times maintained favorable ratings on investment banking clients' stocks, even in the face of precipitous declines in the stocks' prices.
33. For example, the Firm acted as a lead underwriter for the Webvan IPO in November 1999 and initiated coverage with a Strong Buy rating and \$50 price target shortly thereafter. At the time, the stock was trading at \$24.69. In a series of reports issued in April-July 2000, although the new analyst covering the stock recognized and discussed significant risk factors facing the company in his reports, he maintained the Strong Buy rating (with no price target) even as the stock dropped to the \$6-9 range. On September 15, 2000, with the stock trading at \$3.47, the analyst downgraded Webvan to a Buy. On January 10, 2001, with Webvan at \$0.44, the analyst downgraded it to Market Perform, and held that rating on July 9, 2001, when Webvan declared bankruptcy.
34. Similarly, in March 2000, the Firm had a Strong Buy recommendation on the stock of Peregrine Systems. At the time, the stock was trading at over \$70. In April 2000, although the stock had dropped to \$24.50, the Firm maintained its Strong Buy recommendation. The Firm continued its Strong Buy recommendation until the stock price hit \$0.24 in September 2002.

The Firm Implicitly Promised Potential Investment Banking Clients Favorable Research Coverage

35. To win investment banking business for a public company, securities firms typically put together a presentation (soliciting an issuer's investment banking business is called "pitching the company"). Investment banks make "pitches" for any kind of investment banking business, most frequently for initial public offerings ("IPOs") and follow-on offerings. The presentation material is referred to as a "pitchbook." The pitchbooks are presented to the company's management by the Firm investment bankers.

36. During the relevant period, the Firm implicitly promised in its pitchbooks that its research analysts would cover the company if the company gave it investment banking business. The Firm pitchbooks spoke of the firm's "commitment to research" and to the company, stating that the Firm's "commitment doesn't end with the IPO" and that the Firm would "be [the company's] leading advocate." Analysts prepared one section of the pitchbooks, entitled "Research Positioning." The Firm analysts typically prepared this section after completing some due diligence on the company and discussed in the section how the analyst would market the company to investors in research reports. Generally, the research positioning section of the pitchbook made a variety of positive statements about the company. For example, the pitchbook would sometimes state that the Firm analysts would promote the company's "compelling business model," its action in "rebuilding supply chains to provide superior value to producers and customers," or its "huge market opportunity." Pitchbooks described analysts as the "key 'Champion'" of the pitched companies.
37. In other pitchbooks, positive research coverage was suggested by reference to the Firm's positive coverage of other companies. The Firm described how the analyst had covered another company – and how the analyst's favorable ratings of the stock corresponded with the stock's rise in price. For example, the December 11, 2001 pitchbook for LeapFrog Enterprises, Inc. ("LeapFrog") identified the analyst's reports on another company – his buy and strong buy ratings of that company in frequent research reports – and graphed them against the stock price of the company to suggest that the analyst's ratings and reports assisted in the increase in the stock's price. Several months later, the Firm was selected as a co-manager for LeapFrog and received investment banking fees.
38. The Firm's pitchbooks also typically discussed the "research commitment" of the firm, stating that the analyst would engage in various activities in connection with the IPO, including pre-marketing, marketing, initial coverage, ongoing coverage, industry reports, sponsorship of visits, dinners with key investors, and investor presentations. The analyst also assisted the investment bankers in performing due diligence on the company and had a say in whether the firm would participate in the offering. If the analyst did not support the deal, the firm typically would not proceed with the offering.
39. In addition to preparing part of the pitchbook, research analysts often accompanied investment bankers on the pitches to the company. After the pitch and once the Firm was selected as the underwriter, the analyst typically worked together with the investment banker to (among other things) perform additional "due diligence" on the offering and participated in so-called "roadshows" to meet institutional investors.
40. It was understood by all parties involved – the analyst, the underwriters, and the issuer – that the analyst would typically speak favorably about the issuer when initiating coverage. Indeed, at least one pitchbook implied that the Firm would provide favorable coverage. In October 1999, the Firm marketed a European-based company called Autonomy Corp. for its U.S. IPO. (At the time, the Firm had an analyst in London covering the company for the European markets.) The pitchbook for Autonomy showed a timeline for the deal and indicated that after the "quiet period" (a period of time after an offering during which the underwriting firms cannot

- publish research), the analyst would “Raise Rating and Estimates.” After the pitch, the Firm became the lead underwriter. The analyst who was involved in the pitch began covering the company in the U.S. after its U.S. IPO at the same Buy rating that his European counterpart had used prior to the U.S. IPO.
41. In another example, an analyst sent an e-mail to an issuer stating the analyst would provide bi-monthly research coverage on the issuer “if [the Firm were] meaningfully included in [the issuer’s] financing activities.” The analyst also stated that she would present the issuer to the Firm’s salesforce once a week and to publish several in-depth reports to send out to the Firm’s institutional base.
 42. The foregoing all contributed to the Firm’s ability to win investment banking deals and receive investment banking fees from such offerings and subsequent investment banking relationships.

The Firm knew that Research was an Important Factor in Winning Investment Banking Business

43. The Firm knew that companies expected the firm to commit to provide them with research coverage before they would award the firm investment banking business. For example, in an e-mail from the Firm’s Asia office, a banker reported that a company told him that “for any future business, [they] had to have research coverage and it had to be from a U.S. analyst ... the lack of coverage continues to be a major problem in our relationship, and we have been categorically assured that none of deal flow will come our way until we make good on our promise.” Thus, in at least some cases, companies demanded research coverage before selecting an investment banker.
44. Indeed, at least one company conditioned payment of its investment banking fee to the Firm upon receiving research coverage after the transaction. Proxima ASA withheld payment to the Firm of approximately \$6 million in investment banking fees relating to its merger with another company in 2000 because the Firm had not published research on the company. After the Firm subsequently issued a September 21, 2001 research report on the company, the fee was paid.
45. In some instances, the Firm’s analysts also internally suggested conditioning the continuation of research coverage upon whether the company gave the Firm its investment banking business. One analyst e-mailed the director of research in April 2000 and asked whether he should tell a company whom he believed had misled him about its earnings report that he would drop coverage, unless they brought their recently announced financing transaction to the Firm. The director of research responded, “I think that is EXACTLY *[sic]* what you should do.” The firm ultimately did not drop coverage.

In Certain Instances, the Firm Published Exaggerated or Unwarranted Research

46. In certain instances, the Firm analysts gave advice to institutional clients or others that conflicted with their published ratings on particular stocks, thus indicating that in those instances, the Firm published research that was exaggerated, unwarranted, or unreasonable.

47. In the spring of 2001, one of the Firm's analysts met with a large institutional client of the firm to discuss the stocks that analyst covered. One of those stocks was Oracle, on which the analyst had Buy recommendations in his published research on March 1, 2001, March 15, 2001, and April 30, 2001. After meeting with the analyst in the spring of 2001, the institutional investor placed an order with the Firm to sell more than a million shares of its position in the stock. Immediately after that sale, the Firm institutional salesperson responsible for the account sent an e-mail to the director of research, commending the analyst's performance and stating that the client would be sending its *Institutional Investor* votes to the analyst. (Subscribers vote for analysts that have provided information in an annual poll of the most influential research analysts conducted by *Institutional Investor* magazine.) Other institutional salespeople also commented about the analyst's helpfulness to them, stating that he had put a "great sell on Oracle."
48. In another example, an analyst in the software application sector e-mailed an investment banker in April 2001 on another stock he covered, Eprise Corp., with a "request to drop coverage," stating that the "stock continues to trade below \$1 and these guys are permanent toast." The analyst had a January 5, 2001 Market Perform rating on the stock at the time.
49. In April 2002, an analyst communicated to an executive officer of the Firm's investment banking client, Getty Images, Inc., about the price target he had given the company in an April 5, 2002 report. He told the executive not to worry about the current price target, because he would consider raising it at another time.

I thought my approach was appropriately supportive of my favorite company, but still realistic.... My best guess is the stock stays in a trading range pending another quarter's evidence of [the client's] superior operating skills, leveraged by further improvements in the ad market. This leaves me room to boost the target price in conjunction with future increases in the earnings estimates. I certainly wouldn't want to put you under any near-term pressure by raising the bar too high. After all, I'm only thinking about you!

The Firm Received and Made Payments for Services that Included the Provision of Research

50. During the relevant time period, the Firm received over \$1 million from other investment banks for services that included research coverage of those firms' banking clients. In addition, it made payments of approximately \$10 million to other brokers for services that included research coverage of the Firm's banking clients. These payments were made from the underwriting proceeds of the transaction, and in certain instances, were directed by the issuers.
51. In a January 2000 e-mail discussing the "norm" on Wall Street, a banker stated that for transactions above \$75 million, "there are plenty of gross spread dollars to be allocated for future research coverage in the management fee."

The Firm Received Payments for Research

52. During the relevant time period, the Firm received payments on at least four deals for which it was not the lead or co-lead manager. Internal documents at the firm reflect that these payments were made for research.
53. For example, in the spring of 2001, the Firm was covering Transkaryotic Therapeutics, Inc. with a “Strong Buy” and was pitching for the company’s investment banking business. When the company selected another investment bank, the research analyst called Transkaryotic and expressed his displeasure that the Firm had not been selected to do the deal. The analyst told the company that he had spent his morning on the phone supporting the deal and that it was the analyst’s upgrade of the stock from a Market Perform to a Strong Buy several weeks before that had increased the stock price and helped make the deal a success. The company directed that the Firm receive a payment of \$300,000 from the underwriting proceeds. The analyst recorded in his self-evaluation form for that year that the firm had been “paid for our research” on this and one other deal.
54. Similarly, in October 1999, a company called Emisphere, which was not being covered by the Firm, decided to do a follow-on offering. Although the Firm did not participate in the deal, it received an \$87,500 payment from the proceeds of the deal. The deal sheet and the \$87,500 check from the lead manager both reflected that the payment was made “for research.” In fact, the deal sheet stated “Not in Deal / Received \$87500.00 for research.” Moreover, a contemporaneous internal e-mail from the Firm states that “[t]here was talk about us participating in the deal but b/c of the small size, proposed economics, etc we opted to pass. However, we did agree to pick up research coverage and a[s] result we will be getting the sales credit on 10% of the institutional pot.” (During an offering, whenever the sale of shares to large institutional clients cannot be attributed to the selling efforts of any one firm, the commissions for the sales are placed into an “institutional pot.” The credits are then divided among the firms as selling concessions.) The Firm initiated research coverage of Emisphere with a Buy recommendation on November 17, 1999, after the end of the quiet period. The research report did not disclose the \$87,500 payment.
55. The Firm also received a payment of \$150,000 in March 2000 for research on United Therapeutics, Inc. and a payment of \$375,764 in December 2001 for covering Trimeris, Inc.
56. In each of the four instances where the Firm received a payment for research, the Firm was not a member of the underwriting syndicate. (In several of the instances, the Firm was considered a member of the “selling group;” however, the selling group members do not retain any underwriting risk and the Firm did not acquire or sell any shares in these offerings.) The payments were made from the underwriting proceeds of the offerings. The payments totaled over \$900,000.

57. In each instance, the Firm issued research reports recommending the stocks of the issuers involved in the offerings. Emisphere was initiated at a “Buy”; the ratings of the three stocks already covered by the Firm did not change. However, in all four instances, the Firm failed to disclose in its research reports that the firm had received the payments and the source and amount of the payments.

The Firm Made Payments to Other Firms for Coverage

58. During the relevant period, the Firm made payments to other investment banking firms to have them, among other things, provide research coverage of the Firm’s investment banking clients. A senior executive in the Firm’s Equity Capital Markets department testified that, during the relevant time period, these payments were made on “one out of four” deals for which the Firm was the lead or co-lead manager.
59. Although in many instances the payment was made at the issuer’s direction, the Firm actively participated in the process. In its pitches for the business, the Firm advised the issuer that it would select members for the underwriting syndicate based upon that firm’s ability to provide research coverage. In at least one instance, the Firm advised its client that it would be possible to “attract specific additional Research Analysts” by offering them free retention shares.
60. During the relevant period, the Firm made these payments in at least 25 offerings where it was the lead or co-lead manager. The payments, which came from the underwriting proceeds, were made to at least 35 other broker-dealers who either were not part of the underwriting syndicate or who received a payment significantly in excess of their underwriting fee on the transaction. In many of these instances, the Firm’s internal e-mail and other internal documents recorded these payments as “research payments.”
61. For example, the Firm was the lead manager for U.S. Aggregates’ follow-on offering of 5.475 million shares of stock in August 1999. The dealer book (the document used by the Firm to track firms’ involvement in the deal) noted under one firm’s name: “RESEARCH FOR \$\$. ADDL 100M SHARES OF CREDIT.” The dealer book made similar notations for other firms.
62. Similarly, the Firm was the lead manager for Endwave Corporation’s follow-on offering of 6.9 million shares of stock in October 2000. The Firm’s dealer book reflected that another firm would receive payment as part of the deal and notes that the Firm deal captain “spoke to Jan – their going rate is \$100,000 – no less for research, she will follow with [] analyst....” On January 12, 2001, the Firm sent a \$100,000 check to the firm. The accompanying statement reflected that the payment was a “Research Payment.”
63. Although not all of the firms appear to have issued research after receiving the payments, internal e-mails indicate that the Firm policed the other firms to ensure that research was in fact issued. For example, in connection with a Firm lead-managed follow-on offering for Align Technologies, Inc. in January 2001, one of the deal captains wrote, “They [another firm] owe us on a past deal for which they promised

and got paid on research but lost the analyst prior to rollout. They are picking this up regardless with no fees associated.”

64. In all, the Firm made payments totaling over \$10 million on at least 50 deals in order to have other firms provide research coverage of the Firm’s investment banking clients. These payments were not disclosed in the prospectus or other publicly available documents disclosing the terms of the underwriting deal. The Firm did not take steps to ensure that these firms disclosed in their research reports that they had been paid to issue research. Further, where applicable, the Firm did not disclose or cause to be disclosed in the offering documents or elsewhere the details of these payments.

The Firm Failed to Reasonably Supervise Research Analysts’ Activities and to Establish Procedures to Guard Against Improper Conduct

65. The Firm failed to establish and maintain adequate policies and procedures to ensure the objectivity and independence of its research reports and recommendations. Although the Firm had written policies governing the preparation and distribution of research during the relevant period, these policies were not reasonably designed to prevent or manage the conflicts of interest that existed between research and investment banking.
66. In addition, at least several analysts were unfamiliar with or did not comply with the policies. The Firm’s written policies in effect after May 2001 prohibited research analysts from sending issuers draft reports containing the analysts’ recommendations and price targets. At least one analyst was unaware of this policy; other analysts admitted that even though they knew of the policy, they violated it by sending draft reports with recommendations and price targets to issuers for comment before the reports were published.

The Firm Failed to Promptly Produce All Electronic Mail

67. In April 2002, federal regulators requested that the Firm produce all e-mail for a two-year period for certain employees in its research and investment banking departments. At the same time, the Firm was asked to not delete e-mail or overwrite e-mail backup tapes. The Firm agreed to the requests, sent out such instructions, and began producing e-mail. State regulators joined in the investigation in coordination with the federal regulators.
68. In their review of the Firm’s production, federal and California state regulators noticed apparent discrepancies in the volume of e-mail that was being produced for various individuals. The regulators also believed that anticipated responses to certain e-mails were missing and the production appeared to be incomplete. These discrepancies were immediately brought to the attention of the Firm. The Firm repeatedly assured the regulators that its e-mail production was complete. Responding to the issues raised by the regulators, the firm stated that the variance in the volume of emails for particular individuals was attributable to a) individual practices (that is, that some people received and kept more e-mail than others), b) the fact that different entities that now comprised the Firm had differing historical e-mail

- retention practices, or c) the Firm's failure to maintain all of its e-mail for the required three-year time period, for which the firm had been fined \$1.65 million in joint actions by the Commission, the NASD, and the NYSE in December 2002.
69. The regulators continued to examine the production discrepancies. One discrepancy involved the Firm's production of e-mails for only twelve of the twenty-four months for the e-mail server located in its San Francisco office. Ultimately, on the eve of the Global Settlement in April 2003, the Firm, based on inquiries by California state regulators, determined that one or more e-mail backup tapes had not been restored to retrieve available e-mail, and so informed the regulators. The Firm subsequently learned, and informed the regulators, that in numerous instances, their production retrieval process had failed.
 70. The Firm failed to ensure that it was producing all responsive e-mail. The Firm relied upon the statements of low level supervisory and information technology personnel that all available e-mail had been produced, without confirming that such assurances were accurate. The information technology personnel who retrieved the e-mail data from backup tapes and other storage media did not have sufficient guidance and had not been adequately trained on how to respond to regulatory requests for e-mail. Despite the Firm's assurances to regulators that e-mail would not be overwritten or deleted a number of electronic backup tapes containing e-mail were discarded during the production period by an employee who believed that they contained no recoverable e-mail. Internal or external third parties with forensic data retrieval expertise were not consulted to confirm that the tapes were corrupted and to assess whether restoration was possible using different technology.
 71. In certain instances, the Firm neglected to restore backup tapes to determine whether they contained responsive e-mail. In other instances, the Firm incorrectly identified as "unavailable" backup tapes that were, in fact, available or in offsite storage facilities, and also stated that certain tapes had been overwritten when that turned out not to be the case. The Firm also discovered, after continued questioning by the regulators, that a large volume of e-mail still existed on file servers, an offline help desk server, and backup tapes that had been scrapped but not yet overwritten. Once the tapes were restored and data retrieved from them, the Firm found certain e-mail for analysts for whom the Firm had previously stated that no e-mail existed. After the Firm had informed the regulators that it was close to completing its production the Firm determined that it had the ability to retrieve certain previously-deleted e-mail which had not been retrieved by the Firm's original restoration process.
 72. The Firm's inability to reliably locate and produce e-mail in response to regulatory requests and subpoenas, which resulted from a lack of guidance to information technology personnel, a lack of adequate procedures, and a lack of proper supervision, delayed the completion of the investigation into analyst conflicts of interest at the Firm by over a year. As the investigation continued, the regulators were forced to invest considerable time and resources to probe the Firm's e-mail production failures, including taking testimony from numerous information technology personnel. In response to the problems that were identified by the regulators in April 2003, the Firm took steps to ensure that the previously overlooked e-mail was restored and produced to regulators, and revised its procedures and

protocol for gathering and producing historical e-mail. Ultimately, however, the failure of the Firm to fully and completely respond to the initial requests of the regulators significantly delayed the completion of the investigation for an unreasonable length of time.

73. Over the course of the following year, the Firm produced an additional 227,000 e-mail -- more than three times the volume that it produced during the investigation as of December 2002.
74. By failing to timely produce e-mail, the Firm breached its obligation to comply with a reasonable regulatory request for documents that it is required by law to maintain and produce for inspection to Regulators.

Violations of Exchange Rules

75. Exchange Rule 476(a)(6) prohibits member organizations from engaging in practices that constitute conduct inconsistent with just and equitable principles of trade.
76. Exchange Rule 401 requires member organizations to adhere at all times to the principles of good business practice in the conduct of its business affairs.
77. Exchange Rule 472 governs communications with the public, including requirements relating to research communications and research reports.
78. Exchange Rule 476(a)(11) requires member organizations to timely comply with requests to submit its books and records to the Exchange in connection with an investigation.
79. Exchange Rule 342 requires that member organizations maintain appropriate supervisory control over all business activities to ensure compliance with securities laws and regulations, and this includes providing a separate system of follow-up and review to guarantee the proper exercise of authority and responsibility.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a total payment of \$87,500,000, as specified in the Final Judgment ordered in a related action filed by the Securities and Exchange Commission ("Final Judgment") the payment provisions of which are incorporated by reference herein, as follows:

1. \$25,000,000, as a penalty;
2. \$25,000,000, as disgorgement of commissions, fees and other monies;

3. \$25,000,000, to be used for the procurement of Independent Research, as described in Addendum A: Undertaking to the Final Judgment (“Addendum A”), incorporated by reference herein;
4. \$5,000,000, to be used for investor education, as described in Section IX of the Final Judgment; and
5. \$7,500,000, as a penalty for violating Exchange Rule 476(a)(11).

In addition, the Firm shall complete an undertaking to ensure compliance with the terms provided in Addendum A, including an undertaking to inform the Exchange in writing that it has policies, systems, and procedures reasonably designed to ensure compliance with the provisions of Addendum A.

For the Hearing Panel

Vincent F. Murphy
Hearing Officer