

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

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IN THE MATTER OF

An Inquiry by ELIOT SPITZER,
Attorney General of the State of New York,

Index No.

Petitioner,

Pursuant to Article 23-A of the General Business
Law of the State of New York with regard to the
acts and practices of

**AFFIDAVIT IN SUPPORT OF
APPLICATION FOR AN ORDER
PURSUANT TO GENERAL
BUSINESS LAW SECTION 354**

Merrill Lynch & Co., Inc., Henry Blodget,
Justin Baldauf, Kirsten Campbell,
Virginia Syer Genereux, Sofia Ghachem,
Thomas Mazzucco, Edward McCabe and
Deepak Raj,

Respondents,

In the offer, sale, issuance, promotion, advertisement,
exchange, marketing, distribution and transfer of,
or investment advice for, securities in and from
the State of New York.

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County of New York)

ss:

State of New York)

Eric R. Dinallo, being duly sworn, deposes and says:

I am the Chief of the Investment Protection Bureau of the New York State
Department of Law and am of counsel to Eliot Spitzer, Attorney General of the State of New York.
I am familiar with the facts and circumstances of the above-captioned investigation that give rise to
the within application. The following statements are made upon information and belief based upon

an examination of records and documents in the possession of the New York State Department of Law and testimony taken before the Attorney General's Office. On behalf of Attorney General Eliot Spitzer, I submit this affidavit, together with exhibits, in support of the Attorney General's ex parte application for the attached order pursuant to Section 354 of the General Business Law ("GBL").

In June 2001, the Office of the Attorney General commenced an investigation pursuant to GBL Article 23-A (the "Martin Act") into stock recommendations issued by research analysts. The investigation includes recommendations on all stocks covered by the internet research analysts at Merrill Lynch and, very recently, has expanded to include recommendations made by analysts at several additional financial institutions.

The Office of the Attorney General has to date reviewed over 30,000 documents, comprising over 100,000 pages, including thousands of e-mails. It has examined close to twenty witnesses under oath, and has consulted with other witnesses, their lawyers, and experts. While Merrill Lynch has been cooperative in producing evidence, some of the witnesses examined have displayed an implausible lack of recollection of key conversations and documents, even when they authored or received such document and it was placed before them. This lack of recollection often related to events and documents that one would be unlikely to forget. The credibility of these witnesses is consequently suspect. Thus, further testimony is sought under judicial supervision and with public scrutiny.

The Attorney General, having determined to commence an action pursuant to GBL Article 23-A, seeks this relief pursuant to GBL §354, which provides that the Attorney General may apply for an ex parte order to obtain respondents' testimony, books and records when he believes the same to be "material and necessary" to his investigation of their activities in the offer, sale, and

purchase of securities, and investment advice for such securities, within and from the State of New York. GBL §354 further provides that the Supreme Court shall grant such application as a matter of course, along with a preliminary injunction or stay, as is “proper and expedient.”

The public testimony, books and records of respondents in this proceeding are material and necessary to the investigation being conducted by the Attorney General. Further, as detailed below, information has come to the attention of the Attorney General that establishes the need for immediate equitable intervention by this Court to prevent further fraud, to protect the rights of the investing public, and to educate it about the enclosed material pending completion of the Attorney General’s investigation into Merrill Lynch and other financial institutions.

I. INTRODUCTION

Since late 1999, the internet research analysts (the “internet group”) at Merrill Lynch have published on a regular basis ratings for internet stocks that were misleading because: (1) the ratings in many cases did not reflect the analysts’ true opinions of the companies; (2) as a matter of undisclosed, internal policy, no “reduce” or “sell” recommendations were issued, thereby converting a published five-point rating scale into a de facto three-point system; and (3) Merrill Lynch failed to disclose to the public that Merrill Lynch’s ratings were tarnished by an undisclosed conflict of interest: the research analysts were acting as quasi-investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purpose of attracting and keeping investment banking clients, thereby producing misleading ratings that were neither objective nor independent, as they purported to be.

Behind these ratings was a serious breakdown of the separation between the Merrill Lynch banking and research departments, a separation that was critical to the integrity of the recommendations issued to the public by Merrill Lynch. Though Merrill Lynch's stated policies reflect an understanding that this separation is critical, the evidence reveals that at least with respect to the internet group, there was insufficient divide between research and banking.

Our investigation to date reveals that the compensation system for internet analysts was a significant factor contributing to the breakdown between the internet group and investment banking departments. Research analysts knew that the investment banking business they generated or participated in would impact their compensation, and management encouraged them to produce investment banking business. Analysts curried favor with potential or actual investment banking clients by giving them special treatment. At times, officers of clients or prospective clients were allowed to redraft their own coverage, write quotations in which the analysts would tout their companies, and indicate which ratings would be acceptable to them.

The pressures put on the Merrill Lynch internet group to appease both investment bankers and clients led the group to ignore the bottom two categories of the five-point rating system ("reduce" and "sell") and to use only the remaining ratings ("buy", "accumulate" and "neutral"). The absence of clear guidance from Merrill Lynch management on how to resolve the conflicts created by these pressures led respondent Henry Blodget, the head of the internet group, in a moment of candor, to threaten to "start calling the stocks (stocks, not companies)... like we see them, no matter what the ancillary business consequences are." (ML 68401) (emphasis added).¹

¹ Submitted herewith is a volume of exhibits reflecting the following categories: "ML" refers to documents produced to the Attorney General's Office by Merrill Lynch; "OV" refers to documents produced by Overture Services, Inc.; "KC" refers to documents produced by Kirsten

Based upon the foregoing and as explained below, the Attorney General seeks relief as described in the annexed proposed order.

II. PARTIES

The petitioner, Eliot Spitzer, is Attorney General of the State of New York. Pursuant to Article 23-A of the General Business Law, the Attorney General oversees the offer, sale, issuance, promotion, advertisement, exchange, marketing, distribution and transfer of, or investment advice for, securities within and from the State of New York, and has authority to seek judicial intervention when fraudulent activities have occurred or are about to occur. The Attorney General's principal office for oversight of the securities industry in New York State is located in New York County.

Respondent Merrill Lynch & Co Inc. ("Merrill Lynch") is an international investment firm that provides investment banking services to businesses, engages in retail and institutional sales to its customers, and publishes research reports and ratings on stocks. Merrill Lynch's corporate headquarters are located in New York City.

Respondent Henry Blodget ("Blodget") was, until his departure from Merrill Lynch in December 2001, a managing director and head of the Internet Research group in New York City. Mr. Blodget reported to respondent Deepak Raj and Andrew Melnick.

Campbell. "Tr." refers to transcript of testimony taken by the Attorney General's Office; "Exhibit" refers to documents introduced at testimony taken by the Attorney General's Office.

Respondent Justin Baldauf (“Baldauf”) is an analyst in the Internet Research group at Merrill Lynch in New York City. Mr. Baldauf reported to respondent Blodget, and became head of the Internet Research group upon Mr. Blodget’s departure from Merrill Lynch.

Respondent Kirsten Campbell (“Campbell”) was, until her departure from Merrill Lynch in April 2001, a vice-president and analyst in the Internet Research group in New York City. Ms. Campbell reported to respondent Blodget.

Respondent Virginia Syer Genereux (“Syer”) is a research analyst at Merrill Lynch in New York City. Ms. Syer reported to respondent Blodget.

Respondent Sofia Ghachem was an analyst in the Internet Research group at Merrill Lynch in New York City. Ms. Ghachem reported to respondent Blodget.

Respondent Thomas Mazzucco (“Mazzucco”) is a managing director of Merrill Lynch’s Investment Banking Technology group in Palo Alto, California.

Respondent Edward McCabe (“McCabe”) was, until his departure from Merrill Lynch in December 2001, a first vice president and a senior analyst in the Internet Research group in New York City. Mr. McCabe reported to respondent Blodget.

Respondent Deepak Raj (“Raj”) is head of Global Equity Research at Merrill Lynch in New York City.

III. STATUTORY FRAMEWORK

Article 23-A of the General Business Law (“GBL”) of the State of New York, commonly referred to as the “Martin Act,” and the regulations issued pursuant thereto regulate the offer and sale of securities within and from the State of New York and authorize the Attorney General to investigate the conduct of persons and entities engaged in, *inter alia*, the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or from the State of New York of any securities.

The Martin Act proscribes a wide array of practices in connection with the sale of securities. It prohibits and makes illegal any fraud, misrepresentation, deception, concealment, promise or representation that is beyond reasonable expectation while engaged in the issuance, distribution, investment advice, sale or purchase of securities within and from the State of New York. The statutory scheme also prohibits and makes illegal any artifice, device or scheme to obtain money by any means prohibited by General Business Law §352-c. Unlike the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance, or damages required elements of a violation.

GBL Section 352 (1) defines fraud and fraudulent practices as including, *inter alia*, any device, scheme or artifice to defraud or obtain money by means of any false pretense, representation or promise, fictitious or pretended purchase or sale, and any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities or offering of investment advice. It also provides, *inter alia*, that violation of any section of GBL

Article 23-A is a fraudulent practice, and authorizes the Attorney General to investigate allegations of fraud.

When, based upon a preliminary investigation, the Attorney General determines to commence an action pursuant to Article 23-A, he may seek an ex parte application from the Supreme Court, pursuant to GBL §354, for an order directing the persons and entities mentioned in the application to appear and answer questions and to produce documents that the Attorney General believes to be material and necessary. In addition, the Attorney General may include with such application a request for a preliminary injunction or stay as may be “proper and expedient.” At the conclusion of the investigation, the Attorney General is empowered, under GBL §353, to seek an injunction permanently enjoining an individual or entity from directly or indirectly engaging in the issue, sale or offer of, or investment advice for, securities within or from the State of New York, as well as restitution, and/or, under GBL §352-c, to file criminal charges against such individuals or entity.

IV. FACTS

A. The Internet Group’s Stock Ratings Were Misleading

1. **The Merrill Lynch Rating System: Theory Versus Reality**

Until June 15, 2001, Merrill Lynch had a five-category stock rating system:

1	Buy	(20% or more price growth expected)
2	Accumulate	(10% to 20% price growth expected)
3	Neutral	(10% price growth to 10% price drop expected of price)
4	Reduce	(10% to 20% price drop expected)
5	Sell	(20% or more price drop expected)

(ML 02084-85).

Each covered stock was rated for both the intermediate-term (through the next twelve months) and long-term (beyond twelve months), and assigned an investment risk ranging from “A” (least risky) through “D” (most risky).² The ratings assigned to covered companies were represented to the investing public to be independent, objective and on the merits:

Objectivity of Opinions. Opinions expressed by Analysts must be objective. Any indication that a Research opinion is less than totally objective, or that it may have been influenced by a business relationship of the Firm, could seriously damage the Firm’s reputation and lead to potential legal liability.

(ML 02063; see also ML 85893). Our investigation indicates that this was not the case with respect to ratings published by the internet group.

Although Merrill Lynch’s published rating system provided for 4s (reduce) and 5s (sell), the internet group never used 4s or 5s. The list of covered internet stocks for the second quarter of 2000, for instance, lists 24 stocks, none of which was rated less favorably than a 2. (ML 03747). From the spring of 1999 to the fall of 2001, Merrill Lynch never published a single reduce or sell rating on any stock covered by the internet group. In their sworn testimony, both Blodget and his subordinate, respondent Kirsten Campbell, confirmed that the group never rated a stock 4 or 5. (Blodget Tr. at 115-19; Campbell Tr. at 36). Thus, although represented to be a five-point system, internally it became a three-point system. In lieu of assigning reduce or sell recommendations to stocks they no longer favored, the internet group instead merely quietly stopped covering the stock, without any announcement or meaningful explanation to the retail public. (ML 87610).

² All of the stocks discussed herein were assigned a “D” rating by the Merrill Lynch internet group.

Thus, as previously covered stocks such as Pets.com, Mypoints.com, Quokka Sports, Webvan, iVillage, Buy.com, 24/7 Media, E-Toys, Internet Capital Group, and InfoSpace plummeted, sometimes all the way to zero, retail customers and the investing public were never advised to sell. (ML 51690, ML 51833, ML 51997, ML 52195, ML 52516, ML 53160, ML 53161, ML 53162, ML 53181, ML 53507, ML 53612 and ML 53760; see also ML 87610). The reason for this failure is at least in part the substantial unrevealed conflict of interest discussed below.

2. The Ratings Assigned to Stocks Did Not Comport With Their Definitions

Although perhaps comforting to investment banking clients (who could be assured their stocks would never get a reduce or sell rating because “we don’t cover anything below a 3” (OV 00276)), the de facto three-point system not surprisingly wreaked havoc amongst the various constituencies called upon to interpret and utilize the ratings, especially the retail public. While sophisticated institutional investors and equities traders may have recognized the de facto three-point scale, see (ML 55256-58) (“3-1 is a major red flag - short”), or may have specifically been told by the internet group that, despite a stock’s 3-1 rating there was nothing “interesting” about a company “except the [investment] banking fees” (ML 03806), the public and retail investors did not have such insight.

Thus, the public was unaware that while the internet group was contemplating a 3 (neutral) rating on selected stocks, internally they were saying amongst themselves that the stock was “going a lot lower,” (ML 09045), that the company was “crap,” (ML 51453, 37899), or a “dog” (ML 37700). Nor was the public told that while the internet group was contemplating a 2 (accumulate) rating on a variety of stocks, internally -- and to selected institutional investors -- the analysts were

saying that there was “[no] reason to buy more of” the stock and its business was “falling apart,” (ML 74038), “[n]o reason to own” the stock, (ML 09045), or that the group expected the stock to be “flat” over the next six months without “any real catalysts [for change]” (ML 37956). The public also was not told that the group internally disparaged other stocks rated 2 as a “piece of shit,” (ML 60903, 64372), and “such a piece of crap.” (ML 51453).

The electronic communications of the internet group feature many such exchanges. For example, on August 30, 1999, the group initiated coverage on the stock of Internet Capital Group (ICGE), an investment banking client, with a 2-1 rating. The stock closed on October 4, 2000 at \$15.69, down from a high of \$212 on December 22, 1999. On October 5, 2000 with the stock at \$12.38, in an e-mail exchange with another senior analyst, Blodget predicted the stock was, “going to 5.” (ML 63900). The next day he wrote in an e-mail: “No helpful news to relate [regarding ICGE], I’m afraid. This has been a disaster... there really is no floor to the stock.” (ML 63901). But even with these prognostications, the public rating remained 2-1 and, when eventually downgraded on November 9, 2000, was changed only to a 2-2. The result was a continued recommendation to the investing public to purchase a stock about which the head of the internet group was obviously exceptionally and accurately pessimistic, and for which he anticipated a drop of an additional 60 percent. (ML 63900-01; ML 64077; ML 53507). Despite this pessimistic outlook, ICGE was on Merrill Lynch’s list of the top ten technology stocks (“Top Ten Tech” list), as late as September 12, 2000. (ML 62490-01).

Under this regime, even a 1-1, Merrill Lynch’s highest investment rating, could not be trusted. In one example, while a company’s stock price was \$96.50, the analysts, while reviewing

a research note reiterating the 1-1 rating, wrote of the stock's prospects: "could go very low," "could hit \$50 or \$60 I think." (ML 63652).

Merrill Lynch maintained a list of its highest recommended stocks, selected from all of the stocks Merrill Lynch covered -- not just internet stocks. To be selected for this list (the "Favored 15"), to which retail brokers and the public had access, a stock had to have a 1-1 rating. (ML 09639). InfoSpace was on the "Favored 15" List from at least August 2000 until December 5, 2000, even though Blodget had acknowledged as early as July 2000 that the stock was a "powder keg" and that "many institutions" had raised "bad smell comments" about it, and in October had referred to it as a "piece of junk." (ML 06413-14, ML 06578). Oddly enough, Blodget was unaware that the stock he had been covering for months carried the imprimatur of the "Favored 15." (ML 61728, ML 61784-85). When a broker eventually complained on October 20, 2000, about Blodget's price objective and rating of the stock, Blodget contacted a fellow analyst: "[c]an we please reset this stupid price target and rip this piece of junk off whatever list it's on. If you have to downgrade it, downgrade it." (ML 06578). InfoSpace however, was not removed from the "Favored 15" until December 5, 2000 (ML 06700) and was not downgraded until December 11, 2000. (ML 00388; see also ML 61784-85).

Below is a chart of examples demonstrating discrepancies between the numerical investment ratings assigned by the internet group and the group's contemporaneous internal analysis or opinions.

Company	Date	Contemporaneous Analyst Comments	Published Rating
Aether System (AETH)	03/15/01	“might have announcement next week ... which could pop stock...but fundamentals horrible” (ML82578)	3-1
Excite @home (ATHM)	12/27/99 12/29/99	“we are neutral on the stock” Six month outlook is “flat”, without any “real catalysts” for improvement seen (ML 37899; ML37956)	2-1
Excite @home (ATHM)	06/03/00	“such a piece of crap” (ML51453)	2-1
GoTo.Com (GOTO)	1/11/01	Nothing interesting about company “except banking fees” (ML03806)	3-1
InfoSpace (INSP)	7/13/00	“this stock is a powder keg, given how aggressive we were on it earlier this year and given the ‘bad smell’ comments that so many institutions are bringing up” (ML06413)	1-1
InfoSpace (INSP)	10/20/00	“piece of junk” (ML06578)	1-1
Internet Capital Group Inc. (ICGE)	10/05/00	“Going to 5” (closed at \$12.38) (ML63901)	2-1
Internet Capital Group Inc. (ICGE)	10/06/00	“No hopeful news to relate...We see nothing that will turn this around near-term. The company needs to restructure its operations and raise additional cash, and until it does that, there is nothing positive to say.” (ML64077)	2-1
Lifeminders (LFMN)	12/04/00	“POS” (piece of shit) (ML60903)	2-1
24/7 Media (TFSM)	10/10/00	“piece of shit” (ML64372)	2-2

3. Merrill Lynch Did Not Disclose The Analysts' Critical Conflicts of Interest

(a) The internet research group was not independent of investment banking

The evidence establishes that the internet research analysts were far from independent of their investment banking colleagues, and that their tortured relationship helped drive both the selection of covered stocks and the ratings ultimately assigned.

Tension between the various departments in a single firm is nothing new. At a securities firm, this tension is usually addressed by the establishment of a “Chinese Wall” – an internal relationship barrier by which investment bankers are prevented from sharing with other firm employees material, non-public information received by the bankers from their publicly-traded company clients. Thus, a banker generally should be barred from discussing such inside information with a research analyst who is disseminating to the public a research report on the same company. Another form of “Chinese Wall” attempts to prevent investment bankers from influencing analysts' ratings for the stock of existing or potential investment banking clients.

The compensation structure of a securities firm can exacerbate the potential for an analyst to be conflicted. Where analysts' compensation is affected, directly or indirectly, by the analysts' contribution to investment banking, analysts' objectivity and independence can be seriously eroded.

Merrill Lynch's Policies and Procedures Manual for the Research Department (ML 02039, 02049) does not address the conflict raised by the compensation issue. Indeed, research analysts at Merrill Lynch were actively involved in evaluating and effectuating investment banking transactions. Moreover, analysts' compensation was tied to the success of their efforts in this regard.

The analysts in the internet group at Merrill Lynch knew very well that investment banking business translated into compensation for them personally and the firm generally, and that their research played a role in attracting and keeping that investment banking business. (ML 29830, ML 03806, ML 09544-51). In one revealing e-mail exchange, an analyst and investment banker discussed how to attract investment banking business of a company from a competitor. The banker proposed a formula that had apparently worked in the past with another banking client: “we should aggressively link coverage with banking - that is what we did with Go2Net (Henry [Blodget] was involved)...[I]f you are very bullish (b/c they will love you), they are not happy with GS [Goldman Sachs] and are going to be active, we can probably get by on a ‘handshake.’” (ML 05229-30). This e-mail lays bare the understanding that Merrill Lynch intended the prospect of affirmative research to attract investment banking clients.

One way Blodget “prioritize[d]” research coverage for stocks was whether the company had an investment banking relationship with Merrill Lynch. (Blodget, Tr. at 207-08). Consistent with this agenda, Blodget, within weeks of joining Merrill Lynch as head of the internet research group, distributed a memorandum entitled, “Managing the Banking Calendar for Internet Research,” which he sent to the Co-Heads of U.S. Equity Research, and senior investment bankers. The memorandum unapologetically described Blodget’s expectation that at least 50 percent of his and his team’s time would be allocated to investment banking matters. In addition to discussing “banking transactions [] in the pipeline” and “promising deals,” the memorandum described Blodget’s work schedule for one week as being divided “85% banking, 15% research.” (ML 34660-61). Blodget’s own time allocation reveals that Merrill Lynch viewed research as a sales tool for investment banking.

From December 1999 to November 2000, the internet group was involved in investment banking deals that -- on its own estimate -- produced approximately \$115 million of revenue to Merrill Lynch. The list of the group's activities for that year included participating in the bankers' sales pitch to potential clients; marketing transactions to institutional investors once the bankers had obtained the assignment; and then initiating and doing "follow-on" research coverage. This list is eight single-spaced pages long and contains scores of banking deals. (ML 09544-51, Campbell Tr. at 73-83).

The evidence examined to date confirms that the analysts' decisions about whether a stock should get coverage and what type of coverage it should receive were made neither objectively nor independent of the investment banking group. In one instance, an analyst stated that "part of the reason we didn't highlight [a risk] is because we wanted to protect ICG's banking business." (ML 60807). In another communication, an analyst worried about the impact of a particular rating on the relationship with investment banking or its venture capitalists. (ML 60725). So pervasive was the tie between investment banking and research coverage, that when a competitor unexpectedly initiated coverage on the stock of a potential investment banking client, it prompted one Merrill Lynch analyst to respond, "they are angling for the M&A business too!" (ML 09032).

Analysts conveyed to one another that they would "win brownie points" from investment banking if the investment bankers could assure a company that the analysts would cover its stock. (ML 99103). Implicit in this was that "coverage" would always be favorable. Bankers, in turn, attempted to use the analysts to move the price of a stock to a level where research could be initiated, and so fulfill the promise of research coverage in exchange for banking work. One banker, who was frustrated by a stock's failure to reach the requisite price level of \$10 before coverage could

commence,³ implored the internet group to let the company speak at the group's upcoming conference that would be attended by many institutional investors -- to promote Merrill Lynch's "active banking agenda" with the company and alleviate the company's unhappiness with the "research tie up" at Merrill Lynch. (ML 29750).

Investment banking also was involved in criticizing and editing the internet group's reports for client companies, opining on whether a particular rating would be acceptable and, in at least one instance, apparently opposing a proposed rating because "[there is no] interest in seeing initiation [of research coverage] at a 3-2 [rating]." (ML 03799). Analysts openly discussed the conflict in e-mails, stating "the whole idea that we are independent from banking is a big lie -- without banking this would be [rated] a 3-2." (ML 09045).

Research management itself acknowledged that "we are off base on how we rate stocks and how much we bend backwards to accommodate banking etc." (ML 64239). A host of e-mails demonstrate research management's knowledge and understanding of the conflicts, pressures, and confusion. See, e.g., (ML 66935, ML 60847, ML 60865-66, ML 03607-08, ML 87610).

The conflicts and pressures that the research group experienced became particularly acute at the end of 2000 with respect to the mobile internet company, Aether Systems ("AETH"). As of September 27, 2000, Merrill Lynch was doing a secondary equity offering for the company, and the internet group was involved. (ML 09546). During what was supposed to be a confidential telephone conversation about the mobile internet sector, Merrill Lynch research analyst respondent

³Pursuant to a consent decree entered into with the Securities and Exchange Commission in the 1970's, Merrill Lynch is prohibited from initiating coverage on stocks trading below \$10. (Abbott, Tr. at 84-85; ML 09151.) See also ML 02053.

Virginia Syer discussed Aether, InfoSpace (“INSP”) and Phone.com (“PHCM”), but chose Phone.com – on which Merrill Lynch then had no coverage and to which it then provided no banking services – as having the “the best real business opportunity.” (ML 63333-35, ML 09544-51). When the comments were e-mailed to a large number of recipients, Blodget chastised Eric Wellmann of Merrill Lynch’s London office for “blast[ing] the contents out to the whole sales force”. (ML 63333-35). Syer concurred, “it could impair our relations w/ those companies we do cover. We are marketing a big secondary for AETH [], and we were [banking] advisor in its sale to INSP. This is the sort of email that gets forwarded by a salesperson, and could very well get [] sent directly to any of these companies.” The internet group’s desire that accurate assessments be distributed to the public was clearly subservient to the desire to maintain investment banking’s relationship with Aether.

Two months later, with Merrill Lynch fresh off the secondary offering of Aether, Syer drafted a downgrade of stocks in the mobile internet sector she covered, which included Aether, InfoSpace and Openwave (“OPWV”), from 1-1s to 2-1s, and forwarded the draft to research management, saying, “I want to be sure I am doing what research management wants here.” She described four choices in handling the sensitive downgrade:

First, we can downgrade to 2-1, and go out with the [draft] belowSecond, we can keep Aether at 1-1...and downgrade OPWV and INSP for the reasons cited. (People would invariable [sic] ask the question why aren’t we downgrading Aether.) Third, we can downgrade OPWV and INSP and say nothing about Aether. Fourth, we can keep them all at 1-1s and write press releases for research. (I sound flip but I am not being so -- If banking is our top concern I’d just like us all to agree on it.)

(ML 06688).

Andrew Melnick, a then head of Global Equity Research at Merrill Lynch, responded, “THE ONE CHOICE WE CANNOT DO IS DOWNGRADE THE OTHER COMPANIES AND LEAVE AETHER A 1-1. WE ARE NOT IN THE BUSINESS OF WRITING PRESS RELEASES.” (ML 06688) (capital letters in original).

But Merrill Lynch did downgrade the others and left Aether at 1-1. On December 11, 2000, InfoSpace and Openwave were each downgraded to a 2-1. (ML 00384-87); Bloomberg News December 11, 2000 (“Openwave Systems cut to near-term ‘accumulate’ at Merrill”) (ML 53507). Aether was not downgraded until February.

The Aether situation culminated in a general indictment by Blodget of the internet group’s ratings. At the end of 2000, Blodget threatened to start to rate the stocks honestly, no matter what the investment banking consequences were. His ultimatum was prompted by a long-time broker who felt burned by late downgrades of covered stocks. (ML 68401-02), and an e-mail from research management regarding downgrades. Blodget wrote:

The more I read of these, the less willing I am to cut companies any slack, regardless of predictable temper-tantrums, threats, and/or relationship damage that are likely to follow.

If you believe that this stance is a bad business decision for Merrill Lynch, please raise this with [senior management]. We all had to spend (waste) an unbelievable amount of time on the latest situation....If there are no new email forthcoming from Andy [Melnick] on how the instructions below should be applied to sensitive banking clients/relations, we are going to just start calling the stocks (stocks, not companies), including AETH, like we see them, no matter what the ancillary business consequences are.

(ML 68401-02) (emphasis added). Thus, by Blodget's own admission, as late as the end of 2000, the internet group was not calling stocks as they saw them, but was permitting ancillary business consequences to taint their coverage.

Merrill Lynch has never publicly acknowledged the improper influence of investment banking on research. To the contrary, the public was specifically told that the internet group analysts were independent, objective and unbiased. (ML 85893; see also ML 02039, 02063). Knowing that such conflicts existed, and that members of the research group routinely acted as quasi-investment bankers, Merrill Lynch pretended there was a clear division, thereby enhancing the analysts' credibility. Thus, prior to the head of the internet group appearing on television, he was reminded,

CNN called and wanted to know if we are in AOL deal as an advisor. Head of media relations gave them a no comment. If you are asked on Moneyline interview about that say something to the effect that you are not in the loop on that as you are in research not banking.

(ML 41152) (emphasis added).

(b) The analysts' compensation was linked to their investment banking work

The research analysts' objectivity and independence was further eroded by the fact that their compensation depended in part on their efforts on behalf of investment banking, as demonstrated by the following Fall 2000 request from respondent Deepak Raj, then co- head of global equity research, to all equity analysts:

We are once again surveying your contributions to investment banking during the year....Please provide complete details on your involvement in the transaction, paying particular attention the degree that your research coverage played a role in origination, execution and follow-up. Please note, as well, your involvement in advisory work on mergers or acquisitions, especially where your coverage played a role in securing the assignment and your follow-up marketing to

clients. Please indicate where your research coverage was pivotal in securing participation in high yield offering.

On November 2, 2000, Blodget and the internet research group responded to the above request. In a detailed memorandum with schedules, entitled “IBK Contributions: Internet Team.” Blodget stated that: (a) his group had been involved in over 52 completed or potential investment banking transactions; (b) the completed transactions had earned \$115 million for the firm; and (c) more transactions would have been completed had not the “market window for most internet companies closed in June.” He also identified the services his analysts typically performed for investment banking, including pitching the client, marketing the offering and, notably, initiation and follow-on research coverage. (ML 09544-51; see also ML 33856). Shortly after documenting these contributions, Blodget’s salary contract -- which contained a guaranteed minimum -- was cancelled and replaced with a substantially larger compensation package. Overall, Blodget’s agreed-annual compensation, including “guaranteed” minimum cash bonus, increased from \$3 million for 1999 to \$12 million for 2001.

(c) The analysts were not independent from the companies they covered

The internet group at times appeared more concerned with acting as consultants to the companies they covered than as objective analysts. For example, as the stock of InfoSpace plummeted, losing almost 90 percent of its value in a year, the internet group counseled a senior officer of the company on how to handle himself and whether certain decisions were good business moves. (ML 06028). When the company’s officer confided a plan to invest in a particular venture, the analyst gave investment banking advice:

We need to talk about this. While I understand your genuine enthusiasm for the company and trust your “killer deal instinct”, I am concerned that the market will not react favorable to any news that [InfoSpace] fund US Search. My BEST advice to you is to let Yahoo and Lycos win this one – there will be plenty of deals for you to do and [InfoSpace] cannot afford this kind of scrutiny right now – the stock is under a lot of pressure.

(ML 06424). Thus, as Merrill Lynch was supposedly providing the public with its objective opinion about a company’s stock, it did not reveal that it was simultaneously advising that company how to keep the stock stable.

Merrill Lynch did not disclose to the public that the internet group shared -- and at times appeared even to negotiate -- proposed ratings with the bankers and companies at issue, in clear violation of Merrill Lynch policy that analysts “may not disclose proposed investment conclusions” to company management. (ML 02054). Indeed, Blodget claimed not to even know of this prohibition. (KC 013). The results are intensely problematic: in one instance, a company agreed to a particular rating under the condition that its main competitor’s stock would be downgraded to that same rating. It clearly violates Merrill Lynch’s internal policies and illustrates that the subsequent ratings were biased when a company is given advance notice of its stock rating and a voice in a competitor’s downgrade. (ML 09061). In another e-mail, an analyst reported that management of a company “do[es] not feel comfortable with us launching coverage of their stock. . . until [we] ... [can] come out w[ith] a buy rating.” (ML 63362). The internet group even contemplated giving coverage to a stock simply as an “accommodation for an important client,” but only for six months, after which coverage would be dropped. (ML 36662).

The undisclosed influences manifested themselves in “support” for selected stocks. In one striking instance, an internet analyst drafted a report on a company and shared it with Blodget,

stating “trying to be oblique to help stock in anticipation of downgrade on wed[nesday].” (ML 43008). By failing to disclose the internet group’s candid appraisal of the stock’s immediate prospects, Merrill Lynch deprived the public of necessary information. The deception inherent in the internet group’s ratings are the group’s concerns for how their ratings and coverage would “impact . . . on the stock if we do a 3-1 so am leaning towards a 2-2 which is still our lowest rating,” (ML 60723), or how they “may piss off” company management by writing what they really thought. (ML 63399).

(d) Misleading information was widely disseminated

The investment ratings of research were continuously made available to Financial Consultants -- retail brokers -- through Merrill Lynch’s QRQ Opinion System. The system was designed to provide immediate access to the ratings by means of the broker’s quote terminal; the information was also available in hard copy. When the retail broker pulled up a particular stock on the quote terminal, it showed the investment ratings, the stock price, any changes to the price and certain historical data such as price range, price/earnings ratio, and dividend. While other information about a company may have been available to the broker, such as flash notes and the research report, the broker was not required to consult it. Research Department’s Policies and Procedures Manual, (ML 02052; ML 02083; Raj, Tr. at 164-89).

Analysts also discussed recent research reports during a morning call apparently held before the market opened. Participation in the morning call was available to the Merrill Lynch institutional and retail sales forces. (Abbott, Tr. at 126-29). Research reports were also released on Merrill Lynch on-line system(s), which were available to Merrill Lynch clients and to third party vendors such as Bloomberg and First Call who made the reports available to subscribers who were

entitled by Merrill Lynch to receive them. After a report had been released, institutional and retail clients and brokers who requested particular reports and had been “sponsored” (i.e., a sales person or analyst paid the distribution cost) were e-mailed or mailed that particular report. Id.

Finally, research analysts discussed their opinions of stocks on appearances televised to the general investing public. For instance, in 1999 and 2000, Blodget appeared on television at least 77 and 46 times, respectively, often on CNBC and CNN. (March 4, 2002 letter of Andrew Kandell, Esq., Merrill Lynch, to Eric Dinallo, Esq., New York State Attorney General’s Office).

B. Two Troubling Examples of Merrill Lynch’s Treatment of Two Stocks

1. GOTO.COM

a. Initiation of GoTo Coverage Was Linked to Banking Business

GoTo.com (“GoTo”) (now known as Overture Services, Inc.) was an internet company, from which Merrill Lynch attempted and failed to obtain investment banking business in connection with its initial public offering (“IPO”) in 1999. In 2000, Merrill Lynch again sought investment banking business from GoTo, in the form of a private placement offering for a European subsidiary of GoTo. The “pitch book” not only touted investment banking at Merrill Lynch but also heavily promoted Merrill Lynch’s research analysts, including Blodget and his internet group. (ML 17656-17657; ML 17709; ML 09279-80). By early September 2000, Merrill Lynch had received the mandate (i.e., assignment) from GoTo for the European private placement, with the fee mostly contingent upon the private placement closing. (Mazzucco, Tr. at 325-26).

In connection with Merrill Lynch’s obtaining this investment banking business, respondent Thomas Mazzucco, on behalf of Merrill Lynch investment banking, committed to Todd Tappin, Chief Financial Officer of GoTo, that Blodget would initiate research coverage of GoTo.

(Tappin, Tr. at 100-03 ; OV 01102). When, in January 2001, Merrill Lynch initiated coverage of GoTo, an institutional investor e-mailed Blodget asking, “What’s so interesting about GOTO except banking fees????” Blodget responded, “nothin.” (ML 03806). Blodget’s candid response was not included in the initiation report, nor did the report disclose that Merrill Lynch had promised research coverage in exchange for GoTo’s investment banking business.

b. The Initiation Process and Rating For GoTo Were Seriously Flawed

Shortly after Merrill Lynch received GoTo’s mandate for the European private placement, Kirsten Campbell began working on a research report for initiation of coverage of GoTo. (Campbell, Tr. at 51, 57-61). In mid-September, she e-mailed GoTo financial models and a draft initiation report containing Merrill Lynch’s proposed stock rating. Both the models and the draft report contained estimates and opinions, including Merrill Lynch’s projections of GoTo’s future financial performance. She specifically solicited the company’s comments on the drafts and the company apparently provided them. (OV 270; OV 275).

As investment banking pressed for this co-operative drafting, (ML 30009-10), the internet group’s objectivity and independence continued to be undermined. Campbell again e-mailed GoTo draft ratings, estimates and opinions in November, and again asked for comments which GoTo provided – including GoTo actually typing its changes into the draft initiation report, or in some sections, supplying the full text. (OV 00182; OV 00248; OV 00257; OV 00295; OV 00301-02).

In December, Campbell e-mailed a new financial model to GoTo, because she wanted it to “know we are cutting [GoTo’s] revenue a lot,” which would defer projected profitability out to the first quarter of 2003. (OV 01197). Russell Benaroya, GoTo’s head of corporate development, e-mailed to Tappin and another colleague:

“Based on these numbers, why would they even want to initiate on us. Todd [Tappin] should call back and pose that question. This is ridiculous and totally frustrating. Merrill will never take my company public.”

(OV 01197). GoTo called Campbell and got its way: the final published initiation research report had profitability occurring sometime in 2002 rather than in the first quarter of 2003. (Tappin, Tr. at 127-29; ML 00404-08).

Disturbing discussions about the ratings were also occurring within Merrill Lynch.

On November 16th, Campbell e-mailed Blodget that she did not “want to be a whore for f-ing management” and initiate at a 2-2 (accumulate/accumulate) rating:

if 2-2 means that we are putting half of merrill retail into this stock because they are out accumulating it then i don't think that's the right thing to do. We are losing people money and i don't like it. john and mary smith are losing their retirement because we don't want todd [Tappin, GoTo CFO] to be mad at us.

(ML 09045).

Campbell also described in part her conversation with Mazzucco about a 3-2 (neutral/accumulate) initiation rating for GoTo. Although, according to Campbell, Mazzucco said he was “fine” with a 3-2, and that banking and research were independent of each other, Campbell responded:

...the whole idea that we are independent from banking is a big lie - without banking this would be 3-2....

Id.

In his sworn testimony, Blodget conceded that the Merrill Lynch investment bankers had veto power over his initiating coverage of GoTo with a 3 rating. (Blodget, Tr. at 211-12). Although apparently agreeing to the neutral intermediate rating, investment banking prevailed in that the rating would be a 3-1 (neutral-buy) and not the 3-2 (neutral-accumulate) that Campbell said would

be appropriate but for investment banking's pressure. Hence, on November 21st, Campbell e-mailed

Blodget:

goto has gotten back to me and says they are "comfortable" with the discussions we've had with them, and with coming out at a 3-1 etc. given that we would be downgrading LOOK [GoTo's business competitor] at the same time so the ratings are the same...

(ML 09061). In the same e-mail, Campbell also informed Blodget that she had consulted with their research colleague, respondent Justin Baldauf, who covered Looksmart, and that Baldauf was not convinced that downgrading Looksmart was a good idea because there was "no reason to do now versus before." Id.

Although the plan to downgrade Looksmart made Merrill Lynch's proposed 3-1 initiation rating on GoTo sufficiently palatable to GoTo, GoTo's Benaroya expressed concern that a simultaneous Looksmart downgrade might attract unwanted attention:

I don't know if we have to have simultaneous GoTo/Look notes. Wouldn't that be a bit strange? You could probably initiate on GoTo first and come out with a LOOK note soon thereafter. Let me know.

(ML 35973-74). Campbell's response was "re: LOOK - no it wouldn't be strange." Id.

Blodget, in an e-mail to Baldauf, confirmed his intention to simultaneously initiate GoTo and downgrade Looksmart: "we are going to cut numbers for q1 and q2 and roll with a 3-1 on GoTo. would like to do the same for LOOK if it makes sense...." (ML 09145). Blodget further confirmed the plan on December 19, 2000, when he e-mailed Campbell and Baldauf:

K,
Here's the GoTo note.
Justin, We're planning to roll on this thing on Thursday at 3-1. I'd like to take the LOOK rating to 3-1 at the same time, just so we can keep them together. Probably easiest if we just cut the numbers a bit again to be conservative. Let me know your thoughts.

(ML 36007).

On December 20th, initiation at the agreed upon 3-1 ran into a stumbling block: the GoTo stock price was below \$10. On January 4, 2001, Campbell e-mailed the investment bankers, Mazzucco and Andrew Siegel, research management wanted to initiate coverage with a 3-2 (neutral/accumulate) on GOTO.” (ML 3799). Siegel vigorously opposed the 3-2 rating in a reply to Blodget and Campbell:

Please listen to my VM [voice mail] from this morning. Briefly, in talking to Ray Abbott [head of compliance] yesterday, I thought the strategy was to go out with the 3-1 as soon as the stock hit \$10; if it doesn't, I don't think anybody has an interest in seeing initiation at 3-2.

Id.

Blodget's immediate response was his “concern...that waiting for \$10 is waiting for Godot....” Id. When the stock didn't hit \$10 the next day, Mazzucco asked a research analyst if she would arrange for GoTo to have an opportunity to promote itself at an upcoming conference of institutional investors. (ML 29750). The GoTo stock finally traded intra-day at \$10 on January 10th, and Blodget initiated coverage the next day at the 3-1 rating acceptable to the investment bankers and GoTo. (ML 00404 - 08).

The final research initiation report for GoTo that was submitted to research compliance described Looksmart as rated at 3-1. Not surprisingly, compliance crossed out the 3-1 and wrote 2-1, the rating Looksmart still enjoyed as of that date. (ML 00709-18). The final research report for Looksmart, issued later that day, affected the downgrade from 2-1 to 3-1, just as GoTo had been promised. (ML 26324-25).

c. Investment Rating Downgrade of GoTo

On April 25, 2001, Blodget and respondent Ed McCabe⁴ (a senior analyst who reported to Blodget) upgraded GoTo to a 2-1 (accumulate-buy) rating. (ML 00585-88). On May 16th and 17th, 2001, Blodget and the investment bankers sponsored an investor road show for GoTo's CEO and CFO, after which GoTo's stock rose 20 percent. (ML 04058; ML 29677-78; OV 00217-18).

In May 2001, Mazzucco suggested to GoTo's Tappin the possibility of an equity offering by GoTo, and a meeting was set for May 31st for GoTo and Merrill Lynch to discuss this and other investment banking-related issues. (ML 08737; ML 18489-90). At about the same time, Mazzucco spoke with the CFO of idealab, GoTo's largest stock holder, (Mazzucco. Tr. at 326-30), about the possibility of monetizing idealab's GoTo stock, and that the CFO would "be pitching us as his first choice" for such a transaction. (ML 29680). In the meantime, Blodget continued to publish bullish research reports on GoTo. (ML 00639-42; ML 00643-44).⁵

On May 25th, GoTo's CEO Ted Meisel and Tappin advised Mazzucco that GoTo had decided to proceed with an equity offering, but that the company was leaning towards Credit Suisse First Boston ("CSFB") as the lead book running manager instead of Merrill Lynch.⁶ (ML 29644, Exhibit 246). This would prevent Mazzucco from having Merrill Lynch participate in any

⁴In mid-April, 2001, Campbell left Merrill Lynch and was replaced on the GoTo research coverage by McCabe.

⁵Mazzucco e-mailed a copy of this research report to the CFO of idealab, commenting: "In it Henry [Blodget] highlights the outlook for the Internet advertising market and reiterates GoTo as a focus stock." (ML 29649-52).

⁶The book runner manager of a public offering controls the stock allocations to investors. Being a book runner manager was so important to Merrill Lynch that during the relevant period, its investment banking technology group had an "informal" policy that barred the group from being an underwriter unless it was a book runner manager. (Mazzucco, Tr. at 373-74).

way in the underwriting of the offering, given the technology group's policy requiring Merrill Lynch to be a book runner manager. Upset at this sudden, adverse turn of events, Mazzucco on the same day drafted an e-mail to be sent to the Chairman and Vice-Chairman of idealab, and the manager/general partner of idealab Capital Partners, all of whom were also Directors of GoTo:

I spoke with Ted Meisel and Todd Tappin [GoTo's CEO and CFO] today and they informed me of their decision to proceed with an offering of stock from both idealab! and GoTo. We think it is a terrific idea and one that we have brought up with them over the past few weeks. I was very dismayed to learn that they were leaning toward CSFB as the lead book running manager, particularly given the tremendous effort we have put forth on the Company's behalf. Not only did Henry Blodget show leadership by initiating on the stock near its low point but he recently upgraded it and sponsored a set of investor and Merrill sales force meetings for management in New York, which dramatically moved the stock price . . . As book running manager, I am confident that we are best position to ensure that execution and therefore deliver for both GoTo and Idealab!. An alternative structure would be Merrill Lynch and CSFB as joint book-running managers...Your support would be most appreciated. . . . (Exhibit 246) (Mazzucco, Tr. at 383-86, 395-400)

Almost simultaneously, within the internet group, McCabe e-mailed Blodget a draft downgrade of GoTo's stock from its then current 2-1:

H,
I don't think I've downgraded a stock on valuation since the mid-90's. Anyway, I threw together these bullets in a note on my hard drive so that we are ready to pull the trigger quickly. Do you think we need more than bullets? I didn't think so since this downgrade would be based solely on valuation? Let me know.
Thanks.
Ed

• **GoTo has doubled since our upgrade about a month ago. We are downgrading the stock due to valuation.**

• **We believe fundamentals are intact. . .**

(ML 04097) (emphasis in original).

Blodget's immediate three-word reaction was: "beautiful fuk em." Id.

But if valuation concerns truly were driving the downgrade, the timing was inexplicable. The GoTo stock closing price on May 25th was \$22.75 – virtually the same as the price of \$23 at which Blodget in the two earlier research reports -- May 22nd and May 23rd -- had recommended the stock with a bullish 2-1 rating. (ML 00639-42; ML 00643-44).

The downgrade was not issued, but held in reserve as Merrill Lynch continued to lobby to be book running manager. (Mazzucco, Tr. at 375-81). On May 29th Mazzucco and Siegel placed GoTo's equity offering on Merrill Lynch's Grey Scan system, to note Merrill Lynch's pursuit of that banking deal. (Abbott, Tr. at 283-84, ML 02022-24). However, on the evening of May 29th, Mazzucco e-mailed Siegel that he had just learned GoTo had decided to retain CSFB as sole book running manager, and that the May 31st banking meeting with GoTo was off. (ML 29643). Further, Siegel's calendar for June 1st states: "Take GoTo off greylist for follow-on," (ML 28908), and in fact Merrill Lynch did not participate as an underwriter in the offering.

On the morning of June 6th Blodget was alerted that GoTo had announced the filing of its SEC registration statement for a proposed offering of 2,500,000 shares plus a resale of 5,000,000 shares held by idealab. CSFB was the book running manager and lead underwriter of the offering. (Exh. 46). Merrill Lynch thus had lost the underwriting for the equity offering, the opportunity to monetize GoTo stock of idealab, and the chance for other business from the now-cancelled May 31st meeting. Moreover, the European private placement of almost a year earlier had never come to fruition. (Mazzucco, Tr. at 331-33; ML 29643).

Within an hour of the announcement of the equity offering, research compliance received the proposed downgrade of GoTo that McCabe had sent Blodget on May 25th, with minor changes. Ray Abbott, head of research compliance, testified that McCabe claimed that Blodget and McCabe had been watching the GoTo stock price for several days, that the stock had exceeded their published price objective, that they were looking for an event which might cause the stock to trend downward, and that the announcement of the GoTo offering was precisely such an event. (Abbott, Tr. at 319-21;413-16). By mid-morning on June 6th, the Blodget downgrade of GoTo from 2-1 to 3-1 was released to the public in substantially the same form that had elicited Blodget's enthusiastic and blunt reaction on May 25th.

Although the downgrade purportedly resulted from the increased stock price and the announcement of the equity secondary offering, the downgrade tellingly makes no mention of the equity offering, much less that the offering would drive the GoTo stock price down. (ML 00649-50). McCabe explicitly recognized this contradiction in an e-mail he sent to Blodget two days after the downgrade: "just had to explain to a client we didn't downgrade due to offering." (ML 04124) (emphasis in original). Finally, Abbott conceded that if he had seen Blodget's May 22nd research report recommending GoTo with a robust 2-1 rating at a price of \$23 – which was already 21 percent above Blodget's published price objective – "it should have raised a red flag" about the downgrade. (Abbott, Tr. at 363-65).

2. INFOSPACE

Merrill Lynch initiated coverage of InfoSpace in December 1999 with a rating of 2-1 (accumulate-buy) and a price objective of \$160. The stock then traded at \$152.50. Shortly thereafter, Merrill Lynch upgraded the rating to 1-1. As of March 2, 2000, the price had reached

\$261, but thereafter the stock steadily dropped. Yet Merrill Lynch's internet group maintained a 1-1 rating on the stock to December 10, 2000, when the price was \$13.69.⁷ No sell rating was ever issued.

Throughout 2000, Merrill Lynch strongly supported InfoSpace. By March 21, 2000, it had upgraded its rating to a 1-1 (buy-buy), even though the stock was down considerably from its high, and concerns about the company's accounting practices had surfaced. The price objective nevertheless was then at \$200. (ML 00002).

Around this time, Merrill Lynch was courting investment banking business from Go2Net, a technology company. On an April 5, 2000 conference call, Blodget and Mazzucco gave Go2Net a "presentation" about Merrill Lynch's investment banking and research abilities. In written materials, Blodget was promoted with a photograph and InfoSpace was listed as one of Merrill Lynch's covered stocks. (ML 09260-61; ML 09279-80).

While the internet group continued to promote InfoSpace stock with buy/buy ratings, Merrill Lynch brokers began to raise numerous and serious questions about Merrill Lynch's support of the stock in e-mails to Blodget and respondent Sofia Ghachem between April and July: "What is the deal with InfoSpace . . . [I] feel reluctant to push it these days," (ML 05795) "should we be concerned about this . . . InfoSpace reported a loss of 38 cents a share, compared to a loss of 3 cents per share a year ago . . ." (ML 05902) and "the stock continues to underperform and . . . few mutual fund managers are buying this stock . . . maybe we should re-evaluate our stance, i am really

⁷From December 1999 to December 2000, the stock split twice, each time at two for one.

concerned for our clients.” (ML 06230). Ghachem also was questioned about InfoSpace’s management selling their shares of the stock. (ML 06228-29).

By June 1, 2000, the stock price had fallen to \$43, but Merrill Lynch continued its buy/buy ratings. (ML 00049-50). On June 15, 2000, Blodget e-mailed Ghachem, confessing “enormous skepticism” about the stock. (ML 06257-58). On June 20, Ghachem e-mailed Blodget to inform him that investment banking was meeting with InfoSpace on June 27th and the bankers had promised InfoSpace that Blodget would appear. (ML 06334).

Merrill Lynch’s buy ratings continued into early July 2000. On July 10, 2000, Go2Net went on Merrill Lynch’s Grey Scan list, because Go2Net had asked Merrill Lynch to undertake a sale of Go2Net to InfoSpace. (ML 02026-27). The next day, Merrill Lynch issued a “company update” – commonly referred to as a “booster shot” – on InfoSpace reiterating its buy rating. (ML 00068-69). Unlike several other company updates on InfoSpace, no discernable reason was given for the update. In mid-July, Blodget complained to Ghachem, “I’m getting killed on this thing,” (ML 06417), yet his buy ratings for InfoSpace continued, even as the stock dropped further in price.

On October 26, 2000, Merrill Lynch completed the sale of Go2Net to InfoSpace. (ML 02027). On December 11, 2000, Merrill Lynch finally reduced its rating to accumulate; the price had hit \$13. On December 20, 2000, Merrill Lynch issued a research bulletin indicating that InfoSpace’s Vice-President had filed a lawsuit against InfoSpace’s CEO, alleging multiple securities violations and racketeering. (ML 00384-87; ML 00397).

From July 2000 through April 2001, e-mails reflect tremendous doubts by the Merrill Lynch analysts as to the future of InfoSpace and the ethics of its CEO. While Merrill Lynch’s rating

sat at 1-1 with a price objective of \$100, its analysts graphically observed that the stock “is a piece of junk” and “toast” if the CEO leaves. (ML 06578; ML 6407-08). When a Merrill Lynch broker wrote to Blodget commenting on InfoSpace’s poorly written 1999 annual report. Blodget responded, to Ghachem that he “would love to reset the price target to \$30 or something.” (ML 06577). Even after Merrill Lynch finally downgraded the stock to 2-1 in December of 2000, the stock still enjoyed an “accumulate” rating, despite the internet group’s frank internal comments about “what a sleazebag” the CEO was and how Blodget now was “officially not comfortable” with the CEO being associated with the company. (ML 00397; ML 06769-70; ML 06771-72).

The evidence suggests that business considerations influenced the internet group in maintaining its buy rating for InfoSpace as long as it did. The group regarded InfoSpace important to Merrill Lynch’s banking business, as evidenced by a May 17, 2000 e-mail to a member of the Merrill Lynch retail staff:

This company [InfoSpace] is very important to us from a banking perspective, in addition to our institutional franchise. ...

(ML 48862) (adding that “non-deal roadshows” for companies such as InfoSpace “have a tremendous effect on our banking efforts).

III. NECESSITY OF THE SECTION 354 ORDER

The foregoing summary of some of the evidence gathered by the Attorney General’s investigation to date pursuant to GBL § 352 demonstrates that profoundly troubling questions pervade Merrill Lynch’s research and rating system, as that system has been employed by the company’s internet group. Contrary to the image of objectivity that Merrill Lynch has sought to

cultivate for its research arm, the evidence shows that analysts knowingly compromised their honestly held beliefs regarding the merits of particular stocks and skewed the ratings they issued in order to promote the interests of Merrill Lynch's investment banking business, and that the analysts' involvement in that business netted them substantial monetary rewards. The investing public, of course, knew nothing of the inherent conflict of interest underlying the Merrill Lynch rating system, and was deprived of the analysts' honest opinions.

The Attorney General is charged with the responsibility of investigating the commission of fraudulent practices by securities promoters and has authority, under GBL §353, to bring a plenary action on behalf of the public to seek redress and to enjoin entities and individuals from, inter alia, committing fraudulent practices, ever directly or indirectly engaging or participating in the issuing, offering or selling of securities, or providing investment advice, within or from the State of New York. The Attorney General also may prosecute Martin Act violations criminally under GBL §352-c.

Section 354 provides that once the Attorney General has decided to commence an enforcement action under the Martin Act, he may apply to the Court for preliminary relief and judicial supervision of the continued gathering of evidence. At this stage in the investigation, the Attorney General has determined that such action is appropriate and shall be commenced against the respondents. The testimony and documents requested are material and necessary for the Attorney General to establish the full scope of the Martin Act violations revealed by the investigation to date. However, the public and the community of securities regulators need not, and should not, await the outcome of the Attorney General's investigation before they can receive preliminary relief and address the serious problems exposed by the record amassed to date.

Potential purchasers of securities are entitled to both a complete investigation of this matter and immediate injunctive relief. Unless the application herein is granted, the investing public will be deprived of knowledge and safeguards vital to the integrity of our securities industry. Accordingly, pending further development of the record, respondents should be restrained and enjoined in the manner set forth in the proposed order submitted herewith.

The Attorney General intends to continue his investigation and examine the conduct of other major participants in the securities industry. To this end, several other investment banks currently are under Martin Act subpoena to produce evidence regarding their stock research and ratings function. The Attorney General anticipates that after the evidence sought has been produced and studied further application to this Court may be warranted for broader public investigation and eventual relief.

WHEREFORE, the Attorney General respectfully requests that this Court grant the within application for an Order pursuant to GBL Section 354, with the accompanying injunctive relief, in the form annexed hereto, and for such further and other relief as the Court may deem just and proper.

Eric R. Dinallo, Assistant Attorney General

Sworn to before me this
____ day of April, 2002

Assistant Attorney General of
the State of New York

