

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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IN RE MERRILL LYNCH & CO., INC. : 02 MDL 1484
RESEARCH REPORTS SECURITIES :
LITIGATION :
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This document relates to: : 02 Civ. 6645 (MP)
:
In Re MERRILL LYNCH & CO., INC. :
eTOYS, INC. RESEARCH REPORTS : **CONSOLIDATED AND AMENDED**
SECURITIES LITIGATION : **CLASS ACTION COMPLAINT**
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INTRODUCTION

1. This action arises from a massive, uniform and pervasive scheme to defraud the investing public in connection with the purchase and sale of the publicly-traded securities of numerous Internet-related companies, including eToys, Inc. ("eToys"). The scheme was motivated by the desire to obtain and maintain lucrative investment banking business for Merrill Lynch and handsome compensation for its analysts covering Internet companies (the "Internet Group"). The scheme relied, in part, upon the "star-quality" public reputation of chief Merrill Lynch Internet research analyst defendant Henry Blodget ("Blodget"). The centerpiece of the scheme was the public issuance and maintenance of false and misleading Analyst Reports containing ratings, recommendations, and price targets for Internet stocks, which were not objective, but, rather, the product of the conflicted and compromised Internet Group at Merrill Lynch. Indeed, Merrill Lynch's entire stock rating system was grossly misleading. Whereas Merrill Lynch publicly claimed that it had a five tier rating system (ranging from "Buy" to "Sell"), it routinely violated its own rating criteria and in actual practice never utilized the bottom two tiers of "REDUCE" and "SELL." Even prior to formal discovery, Plaintiff cites direct evidence, in the form of admissions in internal Merrill Lynch communications and testimony of Blodget, that the Merrill Lynch analysts were corrupt and

themselves did not believe in their own recommendations and ratings. The uniform and pervasive conduct of the Defendants provides strong circumstantial evidence leading to a strong inference that the analysts were biased, unreliable, not independent, and based their recommendations on the effect they would have on Merrill Lynch obtaining and maintaining investment banking business.

2. The fraudulent scheme was characterized by undisclosed material conflicts of interest, the disclosure of which would have made the scheme impossible to carry out by revealing the lack of independence, objectivity and reliability of Merrill Lynch's Internet analysts and their reports and recommendations including Merrill Lynch's undisclosed efforts to provide favorable, bullish analyst reports to Internet companies as an incentive to direct investment banking business to Merrill Lynch, and the undisclosed sharing of investment banking fees among Merrill Lynch's investment bankers and its Internet analysts. By contrast, Merrill Lynch issued negative reports when the covered company failed to include Merrill Lynch in its investment banking business.

3. On April 8, 2002, the Office of the Attorney General of the State of New York (the "Attorney General") in an Application for an Order Pursuant to [New York] General Business Law Sec. 354 (the "Application"), which it filed in the Supreme Court of the State of New York, County of New York, revealed its findings regarding Merrill Lynch's conflicts of interest and misleading stock rating system. In support of the Application, the Attorney General filed an affidavit sworn to by Eric Dinallo, Chief of the Investment Protection Bureau of the New York State Department of Law (the "Dinallo Affidavit" or "Dinallo Aff.").¹

¹ A copy of the Dinallo Affidavit and the exhibits thereto have been filed with the Court under the title "Exhibits Incorporated by Reference to certain Consolidated Amended Complaints, and it is incorporated herein in full by reference thereto. As described in the Dinallo Affidavit, the Office of the Attorney General conducted an investigation of "...all stocks covered by Internet research analysts at Merrill Lynch..." including, to date, examination of close to twenty witnesses under oath, including Blodget, and review of "...over 30,000 documents, comprising over

4. As alleged by the Attorney General and as attested to in the Dinallo Affidavit, Merrill Lynch's Analyst Reports and recommendations of the Internet companies covered by the Internet Group were the product of a compromised and misleading "research" system that routinely violated its own rating criteria in order for Merrill Lynch to obtain lucrative investment banking business and for its analysts to achieve inflated bonuses which were directly linked to Merrill Lynch's investment banking success. Indeed, the Dinallo Affidavit highlights examples of individual Internet company stocks that Defendants recommended to investors even though, internally, Merrill Lynch and its analysts actually had negative opinions of those stocks.

5. The Dinallo Affidavit, citing testimony and documentary evidence, contains many such references to individual stocks in which the Internet Group issued positive recommendations despite holding negative and contrary opinions about the same stock. The examples provide a window through which to observe Defendants' scheme and the operations of the Internet Group. Specifically, the examples of misleading Analyst Reports contained in the Dinallo Affidavit reveal Defendants' complete disregard of the negative ratings in its own five-tier rating system in favor of a scheme that put Merrill Lynch's desire to obtain investment banking fees over its duty and obligation to issue truthful and honest ratings on covered securities in its Analyst Reports. Based upon the investigation detailed in the Dinallo Affidavit, the Attorney General concluded that Defendants knowingly or recklessly issued false and misleading statements:

The foregoing summary ... 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

100,000 pages, including thousands of e-mails." (Dinallo Aff. at 2). As of the date of filing of this Amended Consolidated Complaint, Plaintiff has not yet had an opportunity to review these documents in full.

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.**

(Dinallo Aff. at 36) (emphasis added.)

6. In an April 26, 2002 Associated Press article issued after the Attorney General's probe of Merrill Lynch's scheme became public, David Komansky, Merrill Lynch & Co., Inc's Chief Executive Officer, admitted to and apologized for Merrill Lynch's betrayal of trust to investors:

Merrill Lynch & Co. Chief Executive Officer David Komansky on Friday **apologized for the firm's role** in a Wall Street probe of conflicts of interest that the state attorney general called a betrayal of trust to millions of investors.

"We have failed to live up to the high standards that are our tradition," Komansky said in a statement to shareholders. "I want to take this opportunity to publicly apologize to our clients, our shareholders and our employees.

"I want to do more than just apologize. I commit to you today that we are addressing this problem squarely," he said. "We will take meaningful and significant actions to restore investor confidence."

New York Attorney General Eliot Spitzer welcomed the statement, **but said it doesn't necessar[il]y fulfill his requirement in negotiations for the firm to admit wrongdoing. . . .**

"I think it's a step forward," Spitzer said. "One necessary aspect of resolution has always been contrition ... (the statement) is a beginning." [Emphasis added.]

7. As demonstrated below, Defendants' scheme to defraud the investing public in connection with the purchase and sale of the publicly-traded securities of numerous Internet-related companies, including eToys, by issuing false and misleading positive Analyst Reports and recommendations had the effect of causing Plaintiff and the Class to purchase eToys common stock at a price inflated above the price that would have otherwise prevailed in a fair and open market during the Class Period.

8. Moreover, Defendants carried out a uniform plan, scheme and course of conduct which was intended to and did artificially inflate and maintain the market price and trading volume of eToys common stock and induced Plaintiff, and members of the Class, to purchase eToys common stock at artificially inflated prices.

JURISDICTION AND VENUE

9. This Court has jurisdiction over the subject matter of this action pursuant to Section 27 of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §78aa, and 28 U.S.C. §1331. This action arises under Sections 10(b) and 20(a) of the Exchange Act, 15 U.S.C. §78j(b) and §78t(a), and the rules and regulations promulgated thereunder, including SEC Rule 10b-5, 17 C.F.R. 240.10b-5.

10. Venue is proper in this District pursuant to Section 27 of the Exchange Act (15 U.S.C. §78aa) and 28 U.S.C. §§1391(b) and (c), since Merrill Lynch has its principal place of business in this District, and many of the acts and practices complained of herein, including the dissemination of the false and misleading statements to the investing public, occurred in substantial part in this District.

11. In connection with the acts, transactions and conduct alleged herein Defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, including, but not limited to, the United States mails, interstate telephone communications, and the facilities of the national securities markets.

PARTIES

12. Lead Plaintiff Dennis Fortin purchased shares of eToys during the Class Period, as attested to in the certification previously filed with the Court, and has been damaged thereby.

13. Defendant Merrill Lynch & Co., Inc. ("ML & Co.") describes itself as one of the world's premier investment banks. ML & Co., a Delaware corporation, has its headquarters in this District at 4 World Financial Center, New York, New York. ML & Co. is a holding company, which operates through its wholly owned subsidiaries, and claims to be one of the world's leading financial management and advisory companies, with offices in 36 countries and total client assets of about \$1.3 trillion. As an investment bank, ML & Co. claims to be a leading global underwriter of debt and equity securities and a leading strategic advisor to corporations, governments, institutions, and individuals worldwide. ML & Co. also claims to be one of the world's largest asset managers, with \$462 billion in assets under management. Through its Global Securities Research & Economics Group, ML & Co. claims to rank among the leading research providers in the industry, with analysts and other professionals in 19 countries that cover approximately 3,200 companies. The Analyst Reports were issued in ML & Co.'s own name, and that of its Global Securities Research & Economics Group.

14. Defendant Merrill Lynch, Pierce, Fenner & Smith Inc. ("MLPF&S" and, with ML & Co., "Merrill Lynch") is a wholly owned subsidiary of ML & Co. MLPF&S is a licensed

broker/dealer in the United States, operates as the brokerage unit of ML & Co., and is controlled by ML & Co., through stock ownership, contracts and related officers and directors. MLPF&S, a Delaware corporation, has its principal office in this District. MLPF&S provides investment-banking services to businesses, and engages in retail and institutional sales to its customers. MLPF&S prepared and issued the Analyst Reports itself or through one of its affiliates, and claims the copyright in the Analyst Reports issued by Merrill Lynch.

15. Defendant Henry Blodget was, at all relevant times, a First Vice President of Merrill Lynch and was Merrill Lynch's primary analyst for companies in the Internet sector. As discussed below, Blodget was retained by Merrill Lynch to bring investment banking business to Merrill Lynch, and earned many millions of dollars as Merrill Lynch's premier analyst of Internet stocks, the majority of which was based on the amount of investment banking business that he generated. Merrill Lynch reportedly paid him in excess of \$5 million in 2000 and approximately \$12 million in 2001 -- with some estimates as high as \$20 million per year -- in addition to a \$2 million buy-out when Blodget left Merrill Lynch in November 2001. The eToys Analyst Reports indicated that they were authored by Blodget.

16. Defendants Merrill Lynch & Co., MLPF&S, and Blodget are collectively referred to herein as the "Defendants."

CLASS ACTION ALLEGATIONS

17. Plaintiff brings this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of a Class consisting of all persons or entities who purchased eToys securities from June 17, 1999 through November 8, 2000, inclusive (the "Class Period"), and who were damaged thereby.

18. Excluded from the Class are Defendants, members of their families, any entity in which any defendant is a trustee or has a controlling interest, and any of their parents, subsidiaries, affiliates, officers, directors, legal representatives, heirs, predecessors, successors and assigns.

19. The members of the Class are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to Plaintiff at this time and can only be ascertained through appropriate discovery, Plaintiff believes that there are thousands of members of the Class located throughout the United States. Throughout the Class Period, eToys securities were actively traded on NASDAQ, an efficient market.

20. Plaintiff's claims are typical of the claims of other members of the Class as all members of the Class are similarly affected by Defendants' wrongful conduct in violation of federal law that is complained of herein.

21. Plaintiff will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class and securities litigation.

22. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Class are:

- a. Whether the federal securities laws were violated by Defendants' acts and omissions as alleged herein;
- b. Whether Defendants participated in and pursued the illegal course of conduct complained of herein;
- c. Whether statements disseminated to the investing public during the Class Period made misrepresentations or omissions of material information as alleged herein;

- d. Whether Defendants manipulated the market for eToys stock;
- e. Whether the market price of eToys securities during the Class Period was artificially inflated due to the conduct complained of herein; and
- f. To what extent the members of the Class have sustained damages and the proper measure of damages.

23. A class action is superior to all other available methods for the fair and efficient adjudication of this controversy since joinder of all members is impracticable. As the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it impossible for members of the Class individually to seek redress for the wrongs done to them. There will be no difficulty in the management of this suit as a class action.

**APPLICABILITY OF PRESUMPTION OF RELIANCE:
FRAUD-ON-THE-MARKET DOCTRINE**

24. Plaintiff will rely, in part, upon the presumption of reliance established by the fraud-on-the-market doctrine in that:

1. the Defendants made misleading statements and material omissions during the Class Period;
2. eToys securities traded on Nasdaq, which is in an efficient market;
3. stock analysts and the media covered eToys and its business during the Class Period;
4. the misrepresentations and material omissions alleged in this Complaint would tend to induce a reasonable investor to misjudge the value of the eToys stock; and

5. Plaintiff and the other Class members purchased their eToys stock between the time the Defendants made the misleading statements and material omissions and the time that the true facts were disclosed, without knowledge of the omitted facts.

25. The market for eToys securities promptly digested current information regarding eToys from all publicly available sources and reflected such information in eToys stock price. Under these circumstances, all purchasers of eToys securities during the Class Period suffered similar injury through their purchase of eToys securities at artificially inflated prices and a presumption of reliance applies.

26. Based upon the following, Plaintiff and members of the Class are entitled to the presumption of reliance upon the integrity of the market.

SUBSTANTIVE ALLEGATIONS

Merrill Lynch Hires Blodget to Market Its Internet Group in an Effort to Obtain Lucrative Investment Banking Business

27. Prior to and throughout the Class Period, Blodget was repeatedly recognized in the financial and general media as the preeminent analyst of Internet companies. Blodget was regularly the subject of newspaper, magazine and Internet news service articles and references, and he appeared repeatedly on business-oriented television programs. Indeed, before starting at Merrill Lynch, Blodget acquired virtual "celebrity status." Merrill Lynch decided to hire Blodget to increase the influence and impact of Merrill Lynch's claimed research power and analyst coverage of Internet companies. Its undisclosed aim was to use this coverage as a marketing tool to obtain investment banking business from the companies which were the subject of its analyst coverage.

28. Blodget's extraordinary influence as an Internet analyst was solidified on December 16, 1998, while he was an analyst at CIBC Oppenheimer ("CIBC"). Towards the end of

his employment at CIBC, Blodget set what he even described at the time to be an "outlandish" price target for Amazon.com stock of \$400 per share. The market reacted swiftly to Blodget's price target, and in three short weeks investors had bid up Amazon.com stock to over \$400 per share.

29. While Blodget was setting an extraordinary price target for Amazon.com, Jonathan Cohen, Merrill Lynch's then head Internet analyst, publicly disagreed with Blodget and countered with a target price of \$50 per share for Amazon.com stock.

30. Merrill Lynch was concerned that, because of Cohen's negative opinion of Internet companies, Merrill Lynch was not obtaining as much investment banking business as it could from Internet companies. To remedy this problem, Merrill Lynch embarked on a scheme to trade favorable Analyst Reports for covered companies' agreements to give Merrill Lynch investment banking business. The key to the scheme was hiring Blodget. With Blodget as the leader of the Internet Group and as Merrill Lynch's Internet cheerleader, Merrill Lynch secretly abandoned its objectivity, transformed its analysts into a marketing arm of the firm, and assured the Internet companies that its loyalty was to its investment banking clients and not to its brokerage clients.

31. In January 1999, Cohen left and Merrill Lynch replaced him with Blodget a month later.

32. Merrill Lynch hired Blodget because of his high-profile reputation and because it wanted Blodget to market favorable reports to Internet companies, and publish those reports in order to generate lucrative investment banking deals for Merrill Lynch. Merrill Lynch assured the Internet companies that it would give priority to providing research coverage to its investment banking clients.

33. Upon his arrival and at Blodget's direction, Merrill Lynch immediately set in place a structure in which the Internet Group's analysts would play an important role in investment banking matters by requiring that each analyst devote at least 50 percent of his or her time to investment banking.

34. Under Blodget, Merrill Lynch "prioritize[d]" its research coverage for stocks according to whether the company had an investment banking relationship with Merrill Lynch. Within weeks of joining Merrill Lynch as head of the Internet Group, Blodget distributed to the Co-Heads of U.S. Equity Research and senior investment bankers a memorandum entitled, "Managing the Banking Calendar for Internet Research." The memorandum unapologetically described Blodget's expectation that at least 50 percent of his and his analyst 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."

35. An example of Merrill Lynch using Blodget's reputation and his bullish reports to obtain investment business and lucrative investment banking fees, was seen in Merrill Lynch's effort to be appointed lead underwriter for a stock issuance by a company called GoTo.com. Merrill Lynch admitted that its investment bankers used Blodget's past bullishness regarding GoTo.com as a selling point when it tried to persuade GoTo.com to retain Merrill Lynch as the lead underwriter for its stock offering.

36. Defendants initiated coverage of GoTo.com on January 11, 2001, because Merrill Lynch was competing to be appointed lead underwriter for a new stock offering to be made by GoTo.com. In support of its efforts to be appointed, Defendants issued another analyst report, dated

April 25, 2001, in which they raised their rating of GoTo.com to "ACCUMULATE" and "Long Term BUY."

37. On June 6, 2001, GoTo.com announced that it had selected Credit Suisse First Boston, a competitor of Merrill Lynch, as the lead underwriter for its stock offering. Incredibly, only a few hours after the GoTo.com announcement, Blodget issued another GoTo.com research report in which he downgraded GoTo.com stock to a "NEUTRAL."

38. In e-mails, Blodget admitted what Defendants kept from the public – that Defendants' Analyst Reports were false and misleading and not based on material information Defendants had at the time they issued the reports:

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.

(Dinallo Aff. at 25) (emphasis added).

39. Once Defendants realized that their scheme was not going to yield results – investment banking business – with respect to GoTo.com, they downgraded the stock:

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

H [Henry Blodget]

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 [deleted]).

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

(Dinallo Aff. at 29-31) (emphasis added).

Blodget's Reputation as an Analyst of Internet Companies

40. Blodget's ascension to the upper echelon of Internet analysts began when he was an analyst at CIBC Oppenheimer. In October 1998, Blodget put a 12-month, \$150 per share price target on Amazon.com stock. But by mid-December, Amazon.com was trading at \$242 per share. So, on December 16, 1998, Blodget set a target price for Amazon.com stock of \$400 per share.

41. Once word of Blodget's target reached the market, Amazon.com stock immediately traded higher, closing up nearly 20% for the day. Three weeks later, on January 6, 1999, the stock closed even higher than Blodget's \$400 per share target. One month later, Blodget replaced Jonathan Cohen as Merrill Lynch's head Internet analyst.

42. The circumstances of Blodget's rise to "household-name" status because of his Amazon.com prediction were later described in an April 2, 2000 edition of *The Washington Post* in an article entitled "Analyst With a Knack for Shaking up Net Stocks; Henry Blodget Is Wall Street's Link Between Online Firms, Investors":

[I]t ... took [Blodget's] bold move with Amazon to make him a household name in the world of Internet stockholders. The retailer

was at its most controversial then, full of swaggering ambition and bleeding red ink. It was also a hot stock, one that had doubled and redoubled. Two months earlier Blodget had put a 12-month price target of \$150 on it. The stock quickly breezed by that to close on Dec. 15 at \$242.

So he set an "outlandish" new target-\$400. "I was trying to say, 'Stop asking me the price target. There's plenty of upside,'" he says. "But it was like I threw gasoline on a bonfire."

* * *

A Bloomberg News reporter got a tip on Blodget's aggressive forecast, and wrote a story about it. A couple of minutes later, CNBC picked up the story, noting Amazon stock was already up \$10 in early-hours trading. A few minutes after that it hit the chatboards, provoking hundreds of messages during the course of the day.

At 9:30 a.m., the market opened with Amazon at \$259, up \$17. It continued rising all day, the commentary making the stock climb, which in turn provoked more commentary. It was as if Blodget had been understood to say Amazon was going to go to \$400 that day.

The stock closed at \$289, up nearly 20 percent, on quadruple its normal volume. Those who thought Amazon was worthless seemed personally insulted by the rise. Jonathan Cohen, at the time the Merrill Lynch Internet analyst, said the stock was worth less than a quarter of its current price.

On Jan. 6, 1999, Amazon closed at \$138. Since it had split three-for-one in the meantime, that works out to be \$414. The stock had done in three weeks what Blodget said would take a year. The next month, Blodget replaced Cohen at Merrill Lynch, for a salary that he declines to discuss but is reported to be \$4 million.

The events still bemuse him. He quotes Jay McInerney, who explained how he abruptly became famous with his novel "Bright Lights, Big City" in 1984: "I plucked the chords of the Zeitgeist."

43. Blodget, in his role as Merrill Lynch's premiere Internet analyst, frequently appeared on television business news reports, where he would set forth his bullish opinions and predictions regarding the stocks of various Internet companies. In 1999 and 2000, Blodget appeared on

television at least 77 and 46 times, respectively, often on CNBC and CNN. These programs had great influence on the financial markets in general, and on the prices of the stocks discussed on the programs. This influence was illustrated in a March 15, 1999 article in *The Wall Street Journal* entitled "Abreast of the Market: What Moves Markets: New Forces Are Now Powering Surging Stocks: Ordinary Joes Move Market Toward Dow 10,000 Mark With Aid From TV, Internet," which stated in relevant part:

The pros keep an eye not just on their banks of quote machines, but also on television screens. "In my fixed-income trading room and my stock trading room, CNBC is on all during the day," says Henry Herrmann, chief investment officer at Overland Park, Kan., mutual-fund group Waddell & Reed. He put in televisions two years ago, when he was upgrading the bond trading room. "It is just another tool but it is a tool," he says. When Prudential's Mr. Acampora turned bearish in August and CNBC relayed his warning of a sharp market drop, the prediction proved self-fulfilling and helped push stocks down. The experience indicated that, at the right time, television appearances by any of a variety of market players can hit the market just as hard as a warning from the Fed's Mr. Greenspan. And television can turn once-unknown analysts, such as Merrill's Mr. Blodget, into instant celebrities.

44. Blodget's reputation as an Internet analyst was cemented by his selection as one of three all stars in the Internet category of *The Wall Street Journal's* "All-Star Analysts 1999 Survey," as reported in the publication's June 29, 1999 edition.

45. In an October 4, 1999 article entitled "Digital 50 The Most Important People Shaping Technology Today," *Time Magazine* confirmed Blodget's extraordinary power and influence over the technology industry. Although Blodget was a securities analyst covering Internet companies, *Time* identified Blodget as one of the most important people shaping technology. Included with such technology luminaries as Bill Gates, the founder of Microsoft, Steve Case, the founder of America On-Line, and Jeff Bezos, the founder of Amazon.com, *Time* virtually gushed about Blodget:

Henry M. Blodget The Forecaster Merrill Lynch Senior Internet and e-commerce analyst AGE: 32 WEB: www.ml.com

It takes a certain cachet to make financial-market types swoon. Henry Blodget, arguably the most influential voice on Internet stocks in the world, is so hot right now that his late arrival to a recent bigwig luncheon prompted this announcement: "Elvis has entered the building." The 1989 Yale grad was a managing director and senior Internet analyst at CIBC Oppenheimer when he made the call that shot him into the spotlight and one of the most prestigious jobs on Wall Street. Amazon.com's share price was hovering around \$200; pundits were proclaiming that the party was over. But Blodget remained bullish on the online bookseller and said the stock would hit \$400 in 12 months--and then it hit the stratosphere. By March, he was at Merrill--and he's been getting the kind of attention shown in those old E.F. Hutton ads ever since. [Emphasis added.]

46. Blodget also had a strong reputation as an Internet stock analyst with the institutional investment community. In its October 1999 issue, *Institutional Investor* placed Blodget on its Third Team for its 1999 All-America Research Team. In its October 2000 issue, *Institutional Investor* named Blodget to the "First Team" of its 2000 All-America Research Team in two categories, E-Commerce and New Media.

47. Merrill Lynch actively promoted Blodget's reputation and used his recognition to enhance Merrill Lynch's status in the industry. For example, Merrill Lynch placed the following advertisement in the June 27, 2000 issue of *The Wall Street Journal*, the *San Jose Mercury News* and on its website:

TechTalk.

* * *

**Limited-Time Offer:
Tune in to see Henry Blodget and David Peterschmidt**

TechTalk is exclusively for our clients -- except for **this special opportunity to catch a recent edition featuring Henry Blodget, the most-read Internet analyst** anywhere....**

All his picks rose. Amazon.com jumped 3 7/8, to 113 1/8; America Online 1 11/16, to 99 3/16, and Yahoo 6 3/16, to 145 1/16. His other picks were eToys, Excite@Home, Lycos, Inktomi and Barnesandnoble.com.

(Emphasis added.)

50. Blodget's influence was again on display when *The Wall Street Journal's* August 19, 1999 "Heard on the Street" column reported:

...electronic-commerce stocks got a sudden boost yesterday after Merrill Lynch analyst Henry Blodget told clients in a conference call that he believes sentiment is turning back toward those issues....

"We are throwing our hat into the ring," Mr. Blodget said. He advised buying some down-and-out Internet retailers, including Amazon.com, Barnesandnoble.com and eToys, along with service providers such as America Online and Yahoo!, on the theory that they will benefit from a strong back-to-school and holiday season.

"This has been a rocky summer for this sector. But if you are committed to holding until December and you buy them at this level, you'll probably make significant money," Mr. Blodget said. He even put together a "holiday basket" with eight Internet stocks he thinks will "benefit disproportionately from strength" in the sector later this year. His list included not only Yahoo, Amazon.com, America Online and Barnesandnoble.com, but also eToys, Lycos, Excite At Home and Inktomi.

Mr. Blodget's picks got a lift yesterday amid an overall rally in Internet stocks. Yahoo closed at 145.0625, up 6.1875; Inktomi closed at 119, up 3; Amazon.com closed at 113.125, up 3.875.

(Emphasis added.)

51. The effect of Blodget's price targets on the stocks he covered was described in a January 12, 2000 article in *The Wall Street Journal* entitled "Huge Price-Target Boosts Lifted Web Stocks; Now Analysts Try Same Move in Other Sectors":

There is nothing that jump-starts an Internet stock like a big price-target boost by a Wall Street analyst.

* * *

There is nothing too risky about sticking an eye-popping price target on a stock anymore either. Everyone laughed last year when Merrill Lynch's Henry Blodget nearly doubled his price target for Amazon.com, then trading at 230 a share, to 400. (The stock has since split.) The move looked pretty smart, however, within just weeks, and Mr. Blodget is now one of the highest-paid Internet analysts on Wall Street.

Says Mr. Blodget: "If you are looking at stocks with this kind of volatility, you need extreme returns to justify the risk." Further, he says "a lot of analysts are just measuring reality and giving investors a sense of where a stock might go."

52. In the same *The Wall Street Journal* article, Blodget recognized the power of his "price targets":

"The quick reaction to price targets is being driven by thinly traded stocks and an incredible amount of retail money that, when they see a new price target, they drive the stock there and past it," [Blodget] says....

53. Another example of Blodget's influence was reported in an article in the May 23, 2000 edition of *The Wall Street Journal*:

The biggest chunk of the recovery in the session took place in the beleaguered Internet camp. Shares of eBay (Nasdaq), weakened in intraday trading, turned around, ending the session 18 points better at 136 3/16. The reversal came after the online auction concern's chief executive, Meg Whitman, continuing to campaign for the company's stock, which has fallen sharply from its March highs, spoke with Merrill Lynch Internet analyst Henry Blodget on an investment program Merrill conducted on the Internet.

Merrill Lynch's Compensation Structure Rewarded Blodget And The Other Analysts in Its Internet Group For The Investment Banking Fees They Generated

54. Merrill Lynch reportedly paid Blodget in excess of \$5 million in 2000 and approximately \$12 million in 2001 -- with some estimates as high as \$20 million per year -- in addition to a \$2 million buy-out when Blodget left Merrill Lynch in November 2001.

55. Blodget's compensation, as well as the compensation of the other Merrill Lynch Internet analysts, was directly related to the investment-banking fees Merrill Lynch obtained because of the Internet analyst reports Blodget and his Internet Group issued.

56. Merrill Lynch's stock analysts, including Blodget, participated in a bonus pool that was funded, in part, from investment-banking fees Merrill Lynch received as a result of the Internet Group's participation in securing the investment banking work and the fees derived therefrom. This fact is laid bare in an e-mail authored by Blodget:

The following is a list of most of the transactions and potential transactions the Internet team has been involved in this year, as well as a list of mandates pitched, won, and under consideration. The completed deals (on the attached spreadsheet) produced about \$115 mm of revenue (including \$25mm from the issuance of two HOLDERS baskets). In some of the cases, we supported other industry groups and analysts (we were still very involved, however). As you can tell from the list, we secured far more mandates than is evident from the closed transactions. The market window for most internet-related companies closed in June, and the only transactions closed since have been M&A.

Research was heavily involved in most of the completed transactions and mandates. Typical involvement includes:

- 1) Initial meeting (sometimes two)
- 2) Positioning review/pitchbook
- 3) Pitch
- 4) Due Diligence
- 5) Marketing
- 6) Initiation and Follow-on Coverage

ML 09544 (Emphasis added).

57. Blodget was highly paid by Merrill Lynch because his reputation in the investment community as a top Internet analyst enabled Merrill Lynch to obtain numerous investment banking engagements, along with the lucrative investment banking fees from those engagements.

58. As of April 2001, two of those 20 Internet companies brought public by Merrill Lynch, including eToys, had gone out of business and 15 were trading well below their offering prices. The price of 8 of those companies had fallen 90% or more from their IPO prices. Nevertheless, in an interview published in the April 16, 2001 edition of *Business Week Magazine*, Blodget defended Merrill Lynch's performance: "Investors wanted these stocks. It's tough to tell a CEO, 'We won't take you public' when investors are shouting, 'Bring It On!'"

59. Proof that the compensation of Blodget and the other Internet analysts in his group was directly related to the investment banking fees they helped Merrill Lynch obtain and that this compensation scheme corrupted and tainted them is highlighted in the Dinallo Affidavit:

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.

(Dinallo Aff. at 20 - 21) (underline emphasis in original) (bold emphasis added).

60. Moreover, the Dinallo Affidavit highlights that Blodget and the other Merrill Lynch Internet research analysts fully understood that their compensation was tied to the investment banking dollars they helped generate for Merrill Lynch:

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.**

(Dinallo Aff. at 21) (emphasis added).

The Conflict of Interest And Merrill Lynch's Compensation Structure Destroyed The Independence of Its Analysts

61. During the Class Period, Merrill Lynch's stated policy on the objectivity of its research analyst opinions was clear:

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. Consequently, although IBK or other personnel may discuss the basis and rationale of a Research opinion with Analysts, attempts to directly or indirectly influence an opinion are prohibited and must be reported immediately to Compliance.

(Merrill Lynch's Policy and Procedures Manual at 20 (ML 02063)).

62. In order to achieve the level of objectivity promised by Merrill Lynch, securities firms typically establish "Chinese Walls" between the investment banking and research groups:

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" [One] form of "Chinese Wall" attempts to prevent investment bankers from influencing analysts' ratings for the stock of existing or potential investment banking clients.

(Dinallo Aff. at 14).

63. The "Chinese Wall" tends to break down when an analyst's compensation is affected by his or her impact upon investment banking:

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.

(Dinallo Aff. at 14). This is the manner in which the "Chinese Wall" was broken down at Merrill Lynch.

64. Moreover, Merrill Lynch's internal policies and procedures failed to deal with the conflict caused by its compensation scheme:

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.**

(Dinallo Aff. at 14) (emphasis added).

65. One of the conflicts of interest of Merrill Lynch's analysts was in the choices the analysts made regarding which companies Merrill Lynch covered. In particular, of the

approximately 30 Internet companies that the Defendants covered during the relevant time period, Merrill Lynch or its affiliates had been a manager of the most recent offering of securities of 18 of them: eToys; EarthWeb; Excite@Home; 24/7 Media; Buy.com; iVillage; Barnesandnoble.com; Pets.com; Quokka; Safeguard Scientifics; DoubleClick; Webvan; AOL; Homestore.com; Inktomi; Internet Capital Group; Multex; and Priceline.

66. The conflict caused the analysts to do more than just make their coverage choices based on investment banking concerns. The conflict also affected the substance of the opinions and recommendations issued. Indeed, throughout the relevant time period, the Internet Group linked coverage with investment banking business:

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. (ML29830, ML03806, ML09544-51). 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 [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.

(Dinallo Aff. at 15) (emphasis added).

67. Blodget furthered this linkage by prioritizing the Internet Group's coverage to those firms with which Merrill Lynch had an investment banking relationship:

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.**

(Dinallo Aff. at 15) (emphasis added).

68. The prioritization led to an erosion of objectivity when it came time for Blodget or the Internet Group to issue reports:

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 [Internet Capital Group'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).

(Dinallo Aff. at 16) (emphasis added).

69. Blodget and the Internet Group knew and intended that their coverage of, and favorable ratings for, Internet companies would benefit Merrill Lynch's investment banking business:

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,² 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).

(Dinallo Aff. at 16-17) (emphasis added).

70. Blodget and the Internet Group even let investment bankers comment and edit analysts reports before they were issued, further eroding whatever semblance of the "Chinese Wall" that existed:

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).

(Dinallo Aff. at 17) (emphasis added).

71. Merrill Lynch never disclosed the dismantling of the "Chinese Wall" between the Internet Group analysts and investment banking:

² "Pursuant 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 0915 1.) See also ML 02053." (Footnote in original).

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.** (ML02054). Indeed, **Blodget claimed not to even know of this prohibition.** (KC013). 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 wi[th] 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).

(Dinallo Aff. at 22) (emphasis added).

72. Merrill Lynch's scheme, including its rewards to the Internet Group analysts for generating investment banking business, not only created a significant conflict of interest, but it also led to substantial revenues for Merrill Lynch:

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).

(Dinallo Aff. at 16).

73. In short, as attested to in detail in the Dinallo Affidavit, Blodget and the rest of the analysts in the Internet Group were far from independent of their investment banking colleagues, and their tortured relationship helped drive both the selection of covered stocks and the ratings ultimately assigned.

74. As a result, the integrity, objectivity, credibility and reliability of Merrill Lynch's Internet Group was compromised, a fact never disclosed to investors throughout the Class Period. Had investors known of the lack of integrity, objectivity, credibility and reliability of Merrill Lynch's Internet Group, they would not have purchased those stocks at the prices that they paid, if they would have bought them at all.

75. Defendants' failure to issue objective and independent research reports violated numerous industry regulations. For example, National Association of Securities Dealers ("NASD") Rule 2210 (Communications with the Public) provides, in pertinent part, that:

(1) General Standards

(A) All member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading.

(B) Exaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members. In preparing such communications, members must bear in mind that inherent in investment are the risks of fluctuating prices and the uncertainty of dividends, rates or return and yield, and no member shall, directly or indirectly, publish, circulate or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.

76. Similarly, NASD Rule 2120 (Use of Manipulative, Deceptive or Other Fraudulent Devices) provides that:

No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

77. NASD Rule IM-2310-2 (Fair Dealing with Customers) provides, in pertinent part, that “[i]mplicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing.”

Defendants’ False and Misleading Ratings Definitions in Analyst Reports

78. During the Class Period, Merrill Lynch had a published uniform, company-wide rating system to be used by its analysts, including Blodgett. Each Analyst Report was to set forth the analyst’s “Opinion of Potential for Intermediate-Term Appreciation (0-12 Months)” and the analyst’s “Opinion of Potential for Long-Term Appreciation (More Than One Year).” The recommendations or ratings for each of those time periods purportedly was one of the following:

- 1 - BUY;
- 2 - ACCUMULATE;
- 3 - NEUTRAL;
- 4 - REDUCE;
- 5 - SELL; or
- 6 - NO RATING

79. The Defendants often described their ratings of a company by stating the Intermediate-Term rating, followed by a slash, followed by their Long-Term rating. For example, the ratings of a company that the Defendants rated an Intermediate-Term “ACCUMULATE” and a “Long-Term BUY,” would be denoted “ACCUMULATE/BUY.”

80. The Defendants also described their ratings using the numerical values assigned to each rating, as set forth above, by stating the number for the Intermediate-Term rating, followed

by a dash and then stating the number for their Long-Term Rating. For example, the ratings of a company that the Defendants rated an Intermediate-Term "ACCUMULATE" and a "Long-Term BUY," would be denoted "2-1."

81. Merrill Lynch and Blodgett misleadingly represented that their ratings criteria for the combined Intermediate-Term and Long-Term ratings on the Internet stocks that they rated, including eToys, were as follows:

Buy/Buy (1-1):

- Dominant leader with a clean story in a sector with strong growth prospects.
- Profitable or on a clear path to profitability within 2-3 quarters (in the more mature sectors).
- Strong cash position: enough to reach profitability with plenty left over for discretionary investment.
- Valuation attractive, or at least justifiable, on a multiple of visible earnings or cash flow ("expensive" is okay, if fundamentals remain strong).
- Stock that we believe has a high likelihood of appreciating more than 20% within a year.
- High level of conviction about sector, company, management, and stock.

Accumulate/Buy (2-1):

- Strong company with good growth prospects in a promising sector, or dominant sector leader with issues that we expect to be resolved.
- Profitable or on a clear path to profitability within the next 12-18 months (again, in the more mature sectors).
- Solid near-term cash position -- enough to reach profitability.
- Valuation justifiable on a multiple of visible earnings or cash flow, or too expensive to be a 1-1.
- Stock that we believe has a high likelihood of appreciating more than 20% in 1-2 years.

Accumulate/Accumulate (2-2):

- Good growth prospects.
- Improving financial performance.
- Valuation justifiable.
- Some uncertainties or reservations remain.

Neutral/Buy (3-1):

- Significant issues relating to intermediate-term outlook.
- A business model which we believe fundamentally “works.”
- Long-term should be okay.

Neutral/Accumulate (3-2):

- Challenging sector, or growth rate less than sector growth rate.
- Not yet clear when able to turn profit.
- Needs additional cash to turn profitable.
- Significant uncertainties or reservations remain.

82. Unbeknownst to investors, during the Class Period, the Internet Group had the policy and pursued the practice of never giving an Internet stock a rating or recommendation of “REDUCE” or “SELL.” Indeed, throughout that entire period of time, even as a number of stocks he covered declined substantially, Blodget never issued a single report in which he gave the covered company a “REDUCE” or “SELL” recommendation or rating.

83. Indeed, at his August 1, 2001 deposition taken by the Attorney General, Blodget stated under oath as follows:

Q. Do you ever recommend in any of your research reports that one of the companies you cover should be a sell rating in Merrill Lynch?

A. No.

Q. Did any of the companies you cover, did Merrill Lynch go down in price?

A. Many.

Q. Did they go down dramatic in price, some of them?

A. Yes.

Q. Did you ever make those sell recommendations?

A. No.

Blodget Tr. at 116-17.

84. The Defendants maintained and concealed from the investing public that policy and practice because Defendants believed that giving an Internet stock a rating or recommendation of "REDUCE" or "SELL" would have jeopardized Merrill Lynch's efforts to obtain investment banking and underwriting engagements and fees from the Internet companies they covered.

85. Because Defendants avoided the bottom two tiers of its rating system – reduce and sell – Merrill Lynch's five-point system was a de facto three-point system:

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. (ML87610).**

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).

(Dinallo Aff. at 9) (emphasis added.)

86. Defendants went to great lengths to avoid the bottom two tiers of Merrill Lynch's stock rating system. One such dramatic example was their handling of ratings for Internet Capital Group:

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).**

(Dinallo Aff. at 11-12) (emphasis added).

87. The effect of avoiding the bottom two tiers of their rating system, as evidenced by the treatment of Aether Systems, was that the Internet Group rarely issued Analyst Reports that reflected their true opinions but rather were issued as part of the overall scheme to attract investment banking business:

The Aether [Systems] 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 68402-02)

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.

(Dinallo Aff. at 19 - 20) (underline emphasis in original) (bold emphasis added).

88. Instead of issuing objective Analyst Reports in accordance with Merrill Lynch's published rating system, the Internet Group invariably looked to investment banking interests when deciding what ratings to give stocks. Defendants' disregard, non-compliance with, and manipulation of the rating system is again dramatically evidenced by their actions with regard to Aether Systems:

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 Virginia Sayer 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 095445). When the comments were e-mailed to a large number of recipients, Blodget chastised Eric Welland of Merrill Lynch's London office for "blast[ing] the contents out to the whole sales force". (ML 63333-35). Sayer 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.

(Dinallo Aff. at 17-18).

89. The Attorney General's office concluded that the reason for this failure to disclose was, at least in part, "the substantial unrevealed conflict of interest" involving Merrill Lynch's research analysts acting as investment bankers for the companies at issue, often initiating, continuing, and/or manipulating research coverage for the purposes of attracting and keeping investment banking clients, thereby producing misleading ratings that were neither objective, independent credible or reliable, as they purported to be. (Dinallo Aff. at 10.)

Defendants' Internal Documents Demonstrate That Defendants Based Their Analyst Reports' Recommendations on Merrill Lynch's Ability to Obtain or Maintain Underwriting and Investment Banking Business

90. As a result, the Internet Group's Analyst Reports were deceptive and misleading because the Defendants failed to disclose that they had based their decisions as to which companies to cover and what to say about those companies on Merrill Lynch's chances to obtain underwriting and investment banking engagements from those companies or others.

91. The Internet Group's Analyst Reports, and particularly, the Defendants' "ACCUMULATE" and "BUY" recommendations were materially misleading because they failed to disclose that Merrill Lynch and Blodget had a policy and practice of virtually never issuing an

analyst report on an Internet company, including, for example, eToys, in which their rating or recommendation with respect to the stock of that company was "REDUCE" or "SELL." Defendants maintained that policy and practice, regardless of whether there was any rational economic basis for those recommendations, because if the Defendants had assigned an Internet company a rating of "REDUCE" or "SELL," it would have jeopardized Merrill Lynch's ability to obtain underwriting or investment advisory engagements from those companies or others.

92. The Analyst Reports were materially misleading because the Defendants did not disclose in the reports the scheme to defraud the investing public in connection with the purchase and sale of the publicly-traded securities of numerous Internet-related companies by issuing false and misleading positive Analyst Reports.

93. The Internet Group's Analyst Reports were deceptive and materially misleading because they failed to disclose that Defendants' recommendations and the price targets lacked a reasonable basis in fact.

94. The Dinallo Affidavit also sets forth testimonial and documentary evidence regarding the materially misleading nature of the Defendants' Analyst Reports on other Internet companies, and the Defendants' scienter in issuing those reports. That evidence demonstrates that the Defendants, during the Class Period, engaged in a pattern and practice of and a scheme of issuing false and deceptive Analyst Reports on Internet companies. That evidence provides further support for the claims herein that Defendants acted knowingly, purposely and with the intent to defraud when they issued the Analyst Reports.

95. As Defendants continued to issue favorable Analyst Reports for Internet companies, its Internet Group analysts concealed from the public their true opinions of the covered companies:

...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).

(Dinallo Aff. at 10-11) (emphasis added).

96. Though the Defendants purported to issue objective reports and ratings for covered companies throughout the Class Period, internally it was known that Merrill Lynch's professed objectivity and five-tier rating system was a sham:

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).

(Dinallo Aff. at 17) (emphasis added).

97. Merrill Lynch not only failed to disclose the lack of independence of Blodget and the other Merrill Lynch research analysts, and their conflicts of interest, but Merrill Lynch also instructed Blodget to directly and overtly lie to the public on television, in order to maintain the appearance that its research analysts, including Blodget, were independent of Merrill Lynch's investment banking group. For example, as attested in the Dinallo Affidavit:

...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 [Blodget] appearing on television, he was reminded.

CNN called and wanted to know if we are in the 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)

(Dinallo Aff. at 20) (underline emphasis added in the original) (bold emphasis added).

Blodget's Resignation as a Merrill Lynch Internet Analyst

98. On November 14, 2001, it was announced that Blodget, who accepted Merrill Lynch's offer to buy him out for approximately \$2 million, was resigning from Merrill Lynch.

99. Post mortems on Blodget's resignation recounted that Merrill Lynch hired Blodget because his high profile, bullish reports on Internet stocks would help Merrill Lynch obtain investment banking and underwriting business in the Internet sector:

Jonathan Cohen, the man he replaced at Merrill Lynch, ended up being right. Henry ended up being wrong. Merrill had always been looking for real strength in technology banking especially, where they had a weakness to a certain extent. They felt that by hiring Blodget, such a cheerleader for the Internet sector, they would position themselves well with many companies. They did get some underwriting business out of it. Unfortunately, many of those issues did not do much of anything.

(November 15, 2001, the CNBC television program "Squawk Box")

Merrill Lynch's Settlements with the New York State Attorney General

100. On April 18, 2002, Merrill Lynch entered into a \$100 million agreement with the New York State Attorney General to settle claims concerning its research analysts' conflicts of interest and the firm's publication of inflated stock ratings in Analyst Reports. As part of the settlement Merrill Lynch agreed to increase its disclosures regarding its Analyst Reports as follows:

- By April 24, 2002, Merrill Lynch will implement a website that will disclose, for companies covered in research reports, those companies which have engaged in publicly announced equity underwritings and merger and acquisition transactions over the prior 12 months, for which Merrill Lynch has received, or is entitled to receive, compensation. Language directing readers to the website will be included in research reports.
- By June 3, 2002, Merrill Lynch will replace its website disclosure by stating in equity research reports whether it has received, or is entitled to receive from the covered company, compensation from publicly announced equity underwriting and merger and acquisition transactions over the prior 12 months.
- By June 3, 2002, Merrill Lynch will include language on the first page of equity research reports stating that investors should assume that Merrill Lynch is seeking, or will seek investment banking and other business from the covered company.
- By June 3, 2002, Merrill Lynch will include in equity research reports specific disclosure, on a percentage basis, for the intermediate-term "strong buy," "buy," "neutral," and "reduce/sell" ratings for stocks in the following categories:
 1. All stocks in the sector or industry group applicable to the covered company.
 2. All stocks in the applicable sector or industry group from which Merrill Lynch has received or is entitled to receive compensation for publicly announced equity underwriting and merger and acquisition transactions over the prior 12 months.
 3. All stocks covered by Merrill Lynch Global Equity Research.

4. All stocks covered by Merrill Lynch Global Equity Research from which Merrill Lynch has received or is entitled to receive compensation for publicly announced equity underwriting and merger and acquisition transactions over the prior 12 months.

(Merrill Lynch April 18, 2002 Press Release).

101. On April 26, 2002, David Komansky, Chairman and Chief Executive Officer of Merrill Lynch, publicly “apologized” for the Defendants’ conduct described herein. Komansky, on behalf of Merrill Lynch, acknowledged that the Defendants’ conduct failed to meet professional standards. He said:

The e-mails that have come to light are very distressing and disappointing to us....They fall far short of our professional standards and some are inconsistent with our policies.

102. In his April 26, 2002 statement Komansky also admitted that Merrill Lynch’s purported policies had not been enforced by Merrill Lynch, stating that Merrill Lynch was “redoubling” its efforts to enforce its existing policies.

103. On May 21, 2002, Merrill Lynch reached a final settlement with the New York State Attorney General in connection with the Attorney General’s Section 354 proceedings against Merrill Lynch.

104. Pursuant to that settlement, Merrill Lynch agreed to pay a fine of \$100 million and agreed to the following changes in its research analyst operations:

- Sever the link between compensation for analysts and investment banking. The agreement requires Merrill Lynch to separate completely the evaluation and determination of compensation for equity research analysts from Merrill Lynch’s investment banking business.
- Prohibit investment banking input into analysts’ compensation. Merrill Lynch is forbidden from soliciting or considering any information concerning the amount of investment banking revenue received from

clients covered by the research analysts and prohibiting the analysts from being evaluated by investment bankers.

- Create a new investment review committee responsible for approving all research recommendations with strict standards and independence from investment banking and the analysts themselves.
- Establish a monitor to ensure compliance with this agreement. The appointment of the monitor is subject to the approval of the Attorney General.
- Require that upon discontinuation of research coverage of a company, Merrill Lynch will issue a report disclosing the termination of coverage and the rationale for such termination, and will notify investors that the last rating should no longer be relied upon.
- Disclose in Merrill Lynch's research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months.
- Issue a statement of contrition on the part of Merrill Lynch for failing to address conflicts of interest.

105. Pursuant to the settlement, Merrill Lynch issued the following statement:

Merrill Lynch would like to take this opportunity, as part of the agreement reached with New York State Attorney General Eliot Spitzer and other states, to publicly apologize to our clients, shareholders and employees for the inappropriate communications brought to light by the New York State Attorney General's investigation. We sincerely regret that there were instances in which certain of our Internet sector research analysts expressed views that at certain points may have appeared inconsistent with Merrill Lynch's published recommendations.

We view this situation as a very serious matter and have informed our research department personnel that such communications, some of which violated internal policies, failed to meet the high standards that are our tradition and will not be tolerated.

As a result we have taken steps to guard against such instances in the future. In addition, we are taking steps to reinforce the firewalls that separate our research department from investment banking. The

agreement we have reached with the State Attorney General is designed to accomplish these objectives....

DEFENDANTS' FALSE AND MISLEADING STATEMENTS CONCERNING eTOYS

106. According to eToys' Prospectus and Registration Statement filed with the SEC on May 20, 1999, Merrill Lynch acted as an underwriter in eToys initial public offering (the "IPO") of 8,320,000 shares, at \$20.00 per share.

107. On June 17, 1999, less than one month after Merrill Lynch acted as underwriter in the IPO, Defendants initiated coverage of eToys. This report, as well as all of the reports issued by Merrill Lynch for eToys during the Class Period, was authored by Blodget. Merrill Lynch's Analyst Report was titled "The Online Store for Children's Products," and stated "Reason for Report: Initiating Coverage." The Report rated eToys at "ACCUMULATE" and as a "Long Term BUY." The report also stated that eToys "has a strong brand, a large market opportunity, great management, and an early mover advantage." As of the date of the report, eToys stock was trading at \$37 ½ per share, and Blodget set a 12-18 month price objective of \$50 per share. eToys stock climbed \$2.50 on the favorable rating.

108. On July 12, 1999, Defendants issued another Analyst Report on eToys under the title "Introducing Children's Book Store," that stated "Reason for Report: Opening Children's Bookstore." The report again rated eToys at "ACCUMULATE" and as a "Long Term BUY." As of the date of the report, eToys stock was trading at \$43 ¾ per share.

109. On July 28, 1999, Defendants issued another Analyst Report on eToys, this time with the title "Solid Q1" that stated "Reason for Report: Quarterly Earnings Report." Although this report described eToys' first quarter results as "unspectacular," Defendants nonetheless maintained their "ACCUMULATE" and "Long Term BUY" ratings, and their 12-18 month price objective of \$50

per share. In the "Outlook and Recommendation" section of the report, Defendants indicated "[w]e continue to believe that eToys has the opportunity to become the leading online retailer of children's products. The company has focus, a good brand name, a strong management team, a deep product offering, and early-mover advantage in an exciting product category." This is essentially the same description offered in the June analyst report, wherein Defendants initiated coverage of eToys. As of the date of the report, eToys stock was trading at \$39 9/32 per share.

110. On August 18, 1999, Defendants issued an Analyst Report on Internet/Electronic Commerce entitled "Introducing the 1999 Holiday Basket" that stated "Reason for Report: Upgrading Outlook on Internet Sector." The report indicated that Defendants believed the fourth quarter would be strong for leading Internet stocks and that investors would begin to focus on the fourth quarter. The report continued:

With this in mind, we are introducing the 1999 Merrill Lynch Holiday Basket - a group of eight internet stocks that we believe offer a sound way to play the fall and holiday shopping season...

These stocks are among the highest-quality in the industry and we like them year-round-but we like them even more now that they are down 50% from their highs and we are headed into the busiest season of the year.

Defendants included eToys within their "Holiday Basket."

111. According to an article published on RedHerring.com on August 20, 1999, "Blodget sent e-tailing shares upward when he included Amazon.com, America Online (NYSE: AOL), Yahoo (Nasdaq: YHOO), Barnesandnoble.com (NYSE: BNBN), eToys (Nasdaq: ETYS), Lycos (Nasdaq: LCOS), and Excite@Home (Nasdaq: ATHM) among his 'holiday basket' list." (Emphasis added.) According to the article, "Mr. Blodget predicted that these stocks could trade 50 percent to 100

percent higher than their current levels by the end of the year and that consumers will double or triple the rate at which they buy goods online this holiday season.”

112. After Defendants issued their bullish analyst reports on eToys and after Blodget included eToys in his “holiday basket” of stock picks, eToys stock trended higher, and closed at \$55.656 per share on September 23, 1999. eToys stock continued to trend higher, and on October 11, 1999, reached a closing price high of \$84.25 per share.

113. On October 29, 1999, Defendants issued another Analyst Report on eToys. The report was titled “Solid Results, Ready For the Buying Season,” and stated “Reason for Report: Quarterly Results.” The report rated eToys as “ACCUMULATE” and as a “Long Term BUY.” As of the date of the report, eToys stock was trading at \$70 5/8 per share.

114. On March 20, 2000 Defendants issued another eToys Analyst Report. At the time the report was issued, eToys stock price was \$11 7/8 per share. In spite of the drop in stock price over the last several months, Defendants continued to rate eToys as “ACCUMULATE” and as a “Long Term BUY” and stated “Reason for Report: Company Update” and used the title “Clarification from Earlier Note – Barron’s Article on Cash Burn of Internet Companies.” Under the “Investment Highlights” section of the report, Defendants indicated that “[w]e generally agree with the [Barron’s] article’s conclusion and have argued for nearly a year that a majority of internet companies (we estimate up to 75%) will never make money and will eventually disappear, either through consolidation or business failure.” Nonetheless, Defendants made this statement while rating eToys stock at “ACCUMULATE” and “Long Term BUY,” and in the face of the ever-declining stock price.

115. Defendants remained bullish on eToys in March of 2000, issuing an Analyst Report on March 22, 2000, with ratings of "ACCUMULATE" and "Long Term BUY." The report stated "Reason for Report: Company Update," and was titled "Revising CQ1 Estimates—Now In Line with Consensus." At the time of the report, eToys stock was trading at \$11 7/16 per share.

116. Despite Defendants' public bullish stance on eToys, internally Defendants shared a much more pessimistic view on the stock. Indeed, an April 17, 2000 e-mail authored by Blodgett states:

people defended the hell out of [eToys] at 35x [revenues] vs. [Amazon] 10x [because] "focused, growing faster, blah, blah, blah". **I always thought that was a crock.** [eToys] is now trading at 3x, [Amazon] 8x.

(ML 05534) (emphasis added).

117. On April 20, 2000, Defendants issued another Analyst Report relating to eToys entitled "FQ4: What we're looking for..." that stated "Reason for Report: Company Update." The report continued to rate eToys at "ACCUMULATE" and a "Long Term BUY." At the time the report was issued, eToys was trading at \$6 1/4 per share.

118. On April 28, 2000, Defendants issued another Analyst Report relating to eToys entitled "Quarter In line; Raising Estimates" that stated "Reason for Report: Quarterly Results." The report continued to rate eToys at "ACCUMULATE" and a "Long Term BUY." At the time the report was issued, eToys was trading at \$8 per share.

119. On May 2, 2000, Defendants issued another Analyst Report relating to eToys entitled "Following Solid Quarter; Raising Estimates" that stated "Reason for Report: Company Update." The report continued to rate eToys at "ACCUMULATE" and a "Long Term BUY." At the time the report was issued, eToys was trading at \$8 1/4 per share. The report stated, "At \$8, [eToys]

valuation is now in-line with that of other e-tailing leaders...and a discount to [Amazon], so we do not expect much more relative downside.”

120. On May 5, 2000, Defendants issued another Analyst Report relating to eToys entitled “Analyst Day – 2 New Product Categories, New Content Channels” that stated “Reason for Report: Company Update.” The report continued to rate eToys at “ACCUMULATE” and a “Long Term BUY.” At the time the report was issued, eToys was trading at \$7 per share.

121. On June 5, 2000, Blodget received an e-mail from another member of Merrill Lynch’s research department, Edward McCabe, discussing Blodget’s recent appearance on the CNBC cable news network. In reply, Blodget complained that the reporter “really went after me on that stupid eToys thing. pissed me off.” McCabe replied, “pissed you off, but you come off well b/c you don’t address it defensively...you rationally explain the scale issue and that **fulfillment is largely fixed** - how much of fulfillment is fixed vs. variable anyway?” (Emphasis added). Blodget’s response to McCabe reveals Blodget’s knowing dissemination of false information concerning eToys:

It’s mostly variable. I was bsing on that one. a big chunk ([probably] \$40mm a Q) is a prerequisite for doing business, so that’s fixed. the rest is variable, tho [sic] (about 10% of revs right now). some leverage in that, with scale and automation and inventory efficiency, but it’s still variable. long-term, total fulfillment is sposed [sic] ; to go to 7% of revs.

(ML 51509) (emphasis added.)

122. On June 13, 2000, Defendants issued another Analyst Report relating to eToys entitled “Raises \$100M in Private Placement; Quarter on Track” that stated “Reason for Report: Company Update.” The report continued to rate eToys at “ACCUMULATE” and a “Long Term BUY.” At the time the report was issued, eToys was trading at \$6 ½ per share.

123. On July 24, 2000, Defendants issued another Analyst Report relating to eToys entitled "FQ1: What we're looking for" that stated "Reason for Report: Earnings Preview." The report continued to rate eToys at "ACCUMULATE" and a "Long Term BUY." At the time the report was issued, eToys was trading at \$5 3/4 per share.

124. On July 28, 2000, Defendants issued another Analyst Report relating to eToys entitled "Solid Quarter: Maintaining Estimates and Rating" that stated "Reason for Report: Quarterly Results." The report continued to rate eToys at "ACCUMULATE" and a "Long Term BUY." At the time the report was issued, eToys was trading at \$5 1/16 per share. Despite reporting a \$0.37 per share operating loss and despite the nearly \$3 per share drop in stock price from the time Defendants reported on eToys' previous quarter, eToys was given a grade of "B" for the quarter by the Defendants.

125. On August 7, 2000, Defendants issued an Analyst Report on the Internet Sector. The report stated, "We are resetting the investment ratings for our internet universe. The purpose of the reset is not to make a new 'call' on the direction of the group but to provide a more precise differentiation of our current opinions (by using a wider range of ratings)." In the Analyst Report, Defendants "reset" the rating for eToys to 3-2, or "Neutral" and "Long Term Accumulate."

126. Finally, on September 27, 2000, Defendants issued another Analyst Report relating to eToys entitled "Analyst Day; Capacity in Place for Upcoming Holiday and Beyond" that stated "Reason for Report: Quarterly Results." The report rated eToys as "NEUTRAL" and a "Long Term ACCUMULATE." At the time the report was issued, eToys was trading at \$5 1/16 per share.

127. On November 8, 2000, Defendants downgraded eToys stock from "Long term ACCUMULATE" to "Long term NEUTRAL." In reaction to the downgrade, eToys fell 23%.

128. On November 9, 2000, *The Washington Post* published an article stating that “[i]nfluential analyst Henry Blodget warned yesterday that three prominent Internet retailers might not be able to get the cash they need to survive.” The article further stated:

Webvan, eToys and Buy.com might make it, [Blodget] wrote, and might not. Accordingly, he cut his ratings on all three, for the second time in three months. All are now “neutral,” the closest a Wall Street analyst gets to saying “sell.”

The article also noted that Blodget had seemed optimistic regarding eToys’ stock before the downgrades, quoting a December 1999 report indicating that ““We consider ETYS to be a leading online retailer and despite some near-term volatility we expect the stock to trend higher long-term.””

129. On November 14, 2000, RedHerring.com published an article on Blodget, which contained an interview. According to this article, Blodget was asked “What about the slew of downgrades, or as you put it, ‘resetting the ratings’? What took you so long?”. This appears to be a reference to the previous downgrades in August and early November. According to this article, Blodget responded as follows: “The second quarter was a time when several companies reported disappointing earnings, and it was obvious the market was starting to mature. We felt it was time to reflect that in the ratings.” As a follow up question, the interviewer asked “But the market had already done that.” Blodget responded:

These were not new calls, and we said that in the first line of our report. The resetting was to make more use of the ratings system. We just had Accumulate and Buy available to us before. Now we had a couple of Neutrals. In this sector especially, ratings are inherently frustrating to almost all participants. Investors almost all have different objectives and time horizons. And given the volatility of the sector, everyone has a different opinion of what a rating means.

The fact that Blodget openly stated that “[w]e just had Accumulate and Buy available to use before,” clearly demonstrates the false and misleading nature of the analyst reports and Merrill Lynch’s ratings system.

130. On March 7, 2001, eToys announced in a press release that it had filed a voluntary petition for reorganization pursuant to the provisions of chapter 11 of the Bankruptcy Code. Even when eToys announced that it planned to file for Bankruptcy, Defendants did not downgrade, but merely published a report announcing that Defendants has ceased coverage of eToys and switched to a "No Rating" position. Defendants indicated: "As a results [sic] we are moving to a No Rating on the stock from our previous Neutral/Neutral Rating."

**THE MATERIAL OMISSIONS FROM AND MISREPRESENTATIONS
IN THE ETOYS ANALYST REPORTS**

131. As of the issuance of the eToys Analyst Reports, Defendants possessed material, adverse, non-public information, concerning Merrill Lynch's compromised research department, as well as the compensation reaped by Blodget and the Internet Group for investment banking fees reaped by Merrill Lynch from companies covered by the Internet Group, and the lack of objectivity employed in the ratings and recommendations disseminated by the Internet Group, which reasonable investors deciding whether to invest would want to know in making their investment decision.

132. At the time Defendants published and maintained an "ACCUMULATE/BUY" rating, internally Defendants acknowledged that the valuation of eToys stock was a "crook." Rather than disclose their honest opinion of eToys stock, Defendants continued in their fraudulent scheme and course of conduct. Further, Blodget admitted internally that he was "bsing" when he stated on a CNBC show that eToys' "fulfillment" was largely fixed. Although he publicly stated that "fulfillment is largely fixed," internally he admitted that it is "mostly variable."

133. Defendants issued the eToys Analyst Reports as part of Merrill Lynch's effort to obtain or maintain substantial investment banking and advisor fees, which it would obtain as financial advisor to eToys in connection with investment banking activities.

134. The eToys Analyst Reports were deceptive and misleading because Defendants failed to disclose that Defendants had based their decisions as to which companies to cover in their Analyst Reports and as to what they would say in those reports regarding those companies, on the impact which those actions would have on Merrill Lynch's ability to obtain underwriting and investment banking engagements from those companies or others and not on the true investment value of eToys.

135. The eToys Analyst Reports, and particularly, Defendants' ratings and recommendations for eToys stock in those reports, were deceptive and misleading because they failed to disclose that Merrill Lynch and Blodgett had a policy and practice throughout the Class Period of never issuing a negative rating or recommendation on an Internet company. Defendants maintained that policy and practice, regardless of whether there was any rational economic basis for those recommendations that the applicable company's stock be acquired, because if Defendants had assigned an Internet company a negative rating it would jeopardize Merrill Lynch's ability to obtain underwriting or investment advisory engagements from those companies or others. The eToys Analyst Reports were deceptive and misleading because Defendants did not disclose in those Reports the existence of, and Defendants' reason for, the above-described rating policy and practice.

136. The eToys Analyst Reports were deceptive and materially misleading because they set forth a rating system which was purportedly a five-tier system, but which Defendants had internally converted to a three-tier system. Each of the eToys Analyst reports contained a description of the "Appreciation Potential Rating" as: "1 - Buy, 2 - Accumulate, 3 - Neutral, 4 - Reduce, 5 - Sell, 6 - No Rating." This publicly stated rating system was false and misleading given Defendants' undisclosed practice of not assigning "Reduce" or "Sell" ratings to Internet companies.

137. The eToys Analyst Reports were false and misleading in that they failed to disclose the material conflict of interest caused by Defendants' compensation structure, which rewarded the Internet Group for its participation in the process of landing and keeping investment banking business.

138. As detailed above, in each of the eToys Analyst Reports, Defendants set forth a "Reason for Report." The "Reason for Report" set forth in each of the eToys Analyst Reports was false and misleading because, in fact, the reason that Defendants had issued each of the eToys Analyst Reports was to assist Merrill Lynch in its efforts to obtain or maintain investment banking fees and to artificially inflate the price of eToys securities.

COUNT I

Against All Defendants for Violations of Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c) Promulgated Thereunder

139. Plaintiff repeats and realleges each and every allegation set forth above.

140. During the Class Period, Defendants carried out a plan, scheme and course of conduct that was intended to and did: (i) deceive the investing public, including Plaintiff and other Class members, as alleged herein; (ii) artificially inflate and maintain the market prices of eToys securities, and (iii) cause Plaintiff and other Class members to purchase eToys securities at artificially inflated prices.

141. In furtherance of this unlawful plan, scheme and course of conduct, Defendants employed devices, schemes and artifices to defraud and engaged in acts, practices and a course of business which operated as a fraud and deceit upon the investing public, in connection with the purchase of eToys securities, in violation of Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c) promulgated thereunder.

142. Defendants' fraudulent devices, schemes and artifices and deceptive acts, practices and course of business included, *inter alia*, the following: (i) issuing false and misleading research Analyst Reports concerning Internet companies covered by Merrill Lynch, including eToys, which contained recommendations and ratings that did not reflect the analysts' true opinions of the companies; (ii) as a matter of undisclosed, internal policy, not issuing "reduce" or "sell" recommendations in research Analyst Reports concerning internet companies, and using only the remaining ratings of "buy," "accumulate" and "neutral," thereby converting a published five-point rating scale into a *de facto* three-point system; (iii) permitting research analysts to act as quasi-investment bankers for internet companies covered by Merrill Lynch, by 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; (iv) disregarding Merrill Lynch's stated policy requiring separation between its research analysts and its investment banking departments, a separation that was critical to the integrity of the recommendations issued to the investing public by Defendants; (v) linking research analysts' compensation to investment banking business they generated or participated in, thereby encouraging them to produce investment banking business by currying favor with potential or actual investment banking clients by giving them special treatment, including, *inter alia*, allowing officers of clients or prospective clients to redraft their own coverage, write quotations in which the analysts would tout their companies, and indicate which ratings would be acceptable to them.

143. Defendants acted knowingly or recklessly and for the purpose and effect of attracting and keeping lucrative investment banking business from Internet companies that were clients or prospective clients of Merrill Lynch.

144. The members of the Class reasonably relied upon the integrity of the market in which eToys securities traded.

145. Plaintiff and the other members of the Class were ignorant of Defendants' fraudulent scheme. Had Plaintiff and the other members of the Class known of Defendants' unlawful scheme, they would not have purchased eToys securities or if they had, they would not have purchased them at the artificially inflated prices they paid for such securities.

146. Plaintiff and the members of the Class were injured because the risks that materialized were risks of which they were unaware as a result of Defendants' scheme to defraud as alleged herein. Absent Defendants' wrongful conduct, Plaintiff and the members of the Class would not have been injured.

147. In connection with their unlawful plan, scheme and course of conduct alleged herein Defendants used the means or instrumentalities of interstate commerce and the mails.

148. By virtue of the foregoing, Defendants each violated Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c).

149. As a direct and proximate result of Defendants' scheme to defraud, Plaintiff and the other members of the Class suffered damages in connection with their purchases of eToys securities in an amount to be proven at trial.

150. This Count is brought solely and exclusively under the provisions of Rule 10b-5(a) and (c). Accordingly, Plaintiff need not allege or prove that Defendants made *any* misrepresentations or omissions of material fact or otherwise (for which they may also be liable under Rule 10b-5(b) and/or any other provisions of law.)

151. This action is timely brought within the applicable statute of limitations.

COUNT II

Against All Defendants For Violations of Section 10(b) Of the Exchange Act and Rule 10b-5(b) Promulgated Thereunder

152. Plaintiff repeats and realleges each and every allegation set forth above.

153. During the Class Period, Defendants, and each of them, made untrue statements of material fact, and omitted to disclose material facts, that were intended to and did: (i) deceive the investing public, including Plaintiff and other Class members, as alleged herein; (ii) artificially inflate and maintain the market price of eToys securities; and (iii) cause Plaintiff and other members of the Class to purchase eToys securities at artificially inflated prices. In furtherance of this unlawful scheme, plan, and course of conduct, Defendants took the actions set forth herein.

154. The Defendants made untrue statements of material fact and/or omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading, all in violation of Section 10(b) of the Exchange Act and Rule 10b-5(b).

155. Defendants' material misrepresentations and omissions concerned, *inter alia*: (i) the fact that the ratings did not reflect the analysts' true opinions; (ii) that 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; (iii) that they failed to disclose that Merrill Lynch's ratings were tarnished by an undisclosed conflict of interest in that 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; and (iv) that they failed to comply with the rules and regulations of the SEC, NASD and other regulatory authorities regarding communications to the investing public.

156. Defendants' material misrepresentations and/or omissions were done knowingly or recklessly and for the purpose and effect of obtaining lucrative investment banking business from eToys. Defendants had no reasonable basis in fact for their recommendations and ratings and their target stock prices in the research Analyst Reports issued concerning eToys and they failed to disclose a serious conflict of interest arising out of Merrill Lynch's disregard of its stated policy requiring separation between its research analysts and investment banking division with respect to clients or prospective clients including eToys.

157. Defendants knew or recklessly disregarded that their statements concerning the integrity and objectivity of their securities research and rating system were false at the time they made these statements, because those statements were flatly contradicted by the Defendants' unlawful plan, scheme and course of conduct alleged herein.

158. Defendants were required to comply with all relevant SEC and NASD regulations, including without limitations those set forth above. In addition, said Defendants had a duty to fully disclose the truth concerning their business practices alleged herein by virtue of their issuance of research reports to investors, as a result of Defendant MLPF&S's status as a registered U.S. broker/dealer and its wrongful activities in such capacity alleged herein, and as a result of the integrated disclosure provisions of the SEC as embodied in SEC Regulations S-X [17 C.F.R. § 210.1, *et seq.*], S-K [17 C.F.R. § 229.10, *et seq.*], and other SEC regulations.

159. Throughout the Class Period, Defendants' material misrepresentations and omissions induced a disparity between the transaction price and the true "investment quality" of eToys securities. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market price of eToys securities was

artificially inflated during the Class Period and Plaintiff and the Class were deceived as to the true investment quality of eToys securities. In ignorance of the fact that the market price of eToys securities was artificially inflated, and relying directly or indirectly on the false and misleading statements made by Defendants, or upon the integrity of the market in which the securities trade, and/or on the absence of material adverse information that was known to or recklessly disregarded by Defendants but not disclosed in public statements by Defendants during the Class Period, Plaintiff and the other members of the Class acquired eToys securities during the Class Period at artificially inflated prices and were damaged thereby.

160. As a result of the dissemination of the materially false and misleading information and failure to disclose material facts, as set forth above, the market prices of eToys securities were artificially inflated. In ignorance of the fact that the market prices of eToys securities were artificially inflated, and relying directly or indirectly on the false and misleading statements made by Defendants, and/or on the absence of material adverse information that was known to or recklessly disregarded by Defendants but not disclosed in public statements by Defendants, Plaintiff and the other members of the Class purchased or otherwise acquired eToys securities at artificially inflated prices and were damaged thereby.

161. At the time of said misrepresentations and omissions, Plaintiff and the other members of the Class were ignorant of their falsity, and believed them to be true. Had Plaintiff and the other members of the Class known of the omitted material facts, Plaintiff and the other members of the Class would not have purchased or otherwise acquired eToys securities, or, if they had acquired eToys securities, they would not have done so at the artificially inflated prices which they paid.

162. Absent Defendants' wrongful conduct, Plaintiff and the members of the Class would not have been injured.

163. By virtue of the foregoing, Defendants each violated Section 10(b) of the Exchange Act and Rule 10b-5(b) promulgated thereunder.

164. As a direct and proximate result of Defendants' wrongful conduct, Plaintiff and the other members of the Class suffered damages in connection with their purchases of eToys securities in an amount to be proved at trial.

165. This action is timely brought within the applicable statute of limitations.

COUNT III

AGAINST DEFENDANT MERRILL LYNCH PURSUANT TO SECTION 20(a) OF THE EXCHANGE ACT

166. Plaintiff repeats and realleges each and every allegation set forth above.

167. This claim is asserted against Defendant Merrill Lynch for violations of Section 20(a) of the Exchange Act.

168. As set forth above, during the entire Class Period, Defendant Merrill Lynch was a "controlling person" of Defendant Blodget, within the meaning of Section 20(a) of the Exchange Act.

169. Merrill Lynch was a "controlling person" of Blodget because it had the influence and power over Blodget to cause, and it did cause, Blodget to engage in the wrongful conduct complained of herein, and because it had the power to prevent Blodget from engaging in the unlawful conduct alleged herein, but it purposely and intentionally did not use that power to do so.

170. As set forth in Counts I and II, Blodget violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by his acts and omissions as alleged in this Complaint. By

virtue of its status as a "controlling person" of Blodget, Merrill Lynch is liable, to the same extent as Blodget, for Blodget's violations of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, pursuant to Section 20(a) of the Exchange Act.

WHEREFORE, Plaintiff, on his own behalf and on behalf of the Class, prays for judgment as follows:

- A. Declaring this action to be a proper class action and certifying Plaintiff as class representatives under Rule 23 of the Federal Rules of Civil Procedure;
- B. Awarding compensatory damages in favor of Plaintiff and the other members of the Class against all of the Defendants, jointly and severally, for the damages sustained as a result of the wrongdoings by the Defendants, together with interest thereon;
- C. Awarding Plaintiff pre-judgment and post-judgment interest, as well as the fees and expenses incurred in this action, including reasonable allowance of fees for Plaintiff's attorneys, consultants and experts; and
- D. Awarding such other and further relief as the Court may deem just and proper.

JURY DEMAND

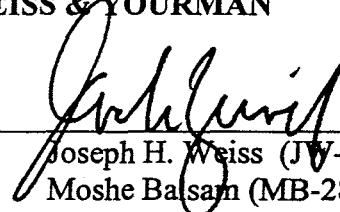
Plaintiff demands a jury trial of all issues so triable.

DATED: March 14, 2003

Respectfully submitted,

WEISS & YOURMAN

By



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