

NEW YORK STOCK EXCHANGE, INC.

**EXCHANGE HEARING PANEL DECISION 03-182**

October 1, 2003

CITIGROUP GLOBAL MARKETS INC. f/k/a SALOMON SMITH BARNEY INC.  
MEMBER ORGANIZATION

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**Violated Exchange Rule 342 in that it failed to adequately ensure that certain activities were reasonably supervised – Consent to censure and \$1,000,000 fine.**

**EXCHANGE HEARING PANEL DECISION 03-183**

MICHAEL J. GRACE  
FORMER BRANCH OFFICE MANAGER

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**Violated Exchange Rule 342 in that he failed to reasonably supervise certain activities in his branch – Consent to censure and three month supervisory suspension.**

**Appearances:**

For the Division of Enforcement  
David P. Doherty, Esq.  
Susan Light, Esq.  
Steven J. Brostoff, Esq.  
Daniel M. Labovitz, Esq.  
Aida Vernon, Esq.

For the Respondent  
Jeffrey L. Friedman, Esq.  
Brett A. Rogers, Esq.  
(For Citigroup)  
Walter E. Jospin, Esq.  
(For Grace)

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Citigroup Global Markets Inc. f/k/a Salomon Smith Barney Inc., a member organization (the "Firm") and Michael J. Grace, a registered representative and formerly a branch office manager with the Firm. Without admitting or denying guilt the Firm consented to a finding by the Hearing Panel that it violated Exchange Rule 342 in that the Firm failed to adequately ensure that certain activities of the XYZ Brokers in a branch of the Firm were reasonably supervised.

Without admitting or denying guilt Mr. Grace consented to a finding by the Hearing Panel that he violated Exchange Rule 342 in that he failed to reasonably supervise certain activities of the XYZ Brokers in his branch at the Firm.

For the sole purpose of settling this disciplinary proceeding, without adjudication of any issues of law or fact, and without the Firm or Grace admitting or denying any of the facts or matters referred to in the Stipulation of Facts and Consent to Penalty, the Division of Enforcement, the Firm and Mr. Grace stipulate to certain facts, the substance of which follows:

### **Background and Jurisdiction**

#### **The Firm**

1. The Firm is a member organization of the Exchange. During the period 1998 - 2001 (the "Relevant Period"), the Firm operated under the name Smith Barney Inc. and subsequently under the name Salomon Smith Barney Inc. The Firm provided services including investment banking, underwriting debt and equity securities and advising corporations, governments and institutions, as well as acting as a full-service global broker-dealer engaged in, among other things, retail brokerage of stocks and market making. Since late 2002, a business division of the firm known as Smith Barney has provided certain retail brokerage and research services. In April 2003, Salomon Smith Barney Inc. was renamed Citigroup Global Markets Inc.
2. The Firm provides some of its corporate clients with administrative services in connection with the corporate clients' employee stock option plans. Beginning in January 1998, the Firm became the primary service provider for the employee stock option plan of XYZ, Inc. (the "XYZ ESOP").
3. On or about June 18, 2001, the Exchange received a Submission of Required Information Pertaining to Members, Member Organizations, Allied Members, Registered and Non-registered Employees and Approved Persons (Form RE-3) reporting that registered representative RR had been subject to a customer complaint by an employee participant of the XYZ ESOP. RR, who was employed in the Firm's Branch Office #373 in Atlanta, Georgia (the "Branch"), headed up a group of brokers in the Branch (the "XYZ Brokers") who handled some of the stock option exercises and related transactions by XYZ employees participating in the XYZ ESOP.
4. The Firm subsequently received and reported to the Exchange more than 100 additional customer complaints by XYZ employees. Those complaints allege, among other things, that the Firm, RR and/or other XYZ Brokers made unsuitable investment recommendations and failed to properly advise the complainants as to the risks of certain transactions.

#### **Michael J. Grace**

5. Michael J. Grace ("Grace") was born on [REDACTED]. He entered the securities industry in May 1977 and has worked in the industry as follows:

<u>Dates</u>	<u>Firm</u>
May 1977-June 1979	Firm A
June 1979-June 1983	Firm B
June 1983-Present	The Firm

- Grace has been employed as a branch office manager or broker in various offices at the Firm since 1983. Grace was employed as the branch office manager of the Branch from 1990 until he resigned from that position in December 2001. As the branch office manager, Grace was responsible for supervising the activities of the XYZ Brokers. Grace continues to be employed by the Firm as a registered representative.

### Overview

- As set forth below, between 1998 and 2001, some of the XYZ Brokers recommended to certain XYZ employees that they should exercise their employee stock options and hold the resulting XYZ shares on margin. As a result of their employment at XYZ (or its predecessors), those employees held concentrated positions of XYZ options before contacting the Firm; after exercising their options, they held concentrated and leveraged positions in XYZ stock. The recommendations to exercise and hold on margin were made despite those customers' varying risk profiles, investment experience or investment objectives. When the value of XYZ shares declined, XYZ Brokers recommended that certain customers facing margin calls maintain their margined XYZ positions, even if they had to sell other assets to do so. In connection with the exercise-and-hold recommendations, XYZ Brokers gave certain customers written analyses that focused on the potential advantages of the exercise-and-hold strategy, but did not adequately describe the risks inherent in holding a concentrated position of volatile shares on margin.
- During the same period, the XYZ Brokers were not adequately supervised by the Firm and Grace. As a result, some of the XYZ Brokers' communications with customers were not adequately reviewed and approved. The XYZ Brokers installed and used an independent email system in the Branch. Grace and the Firm were aware of that email system before, or shortly after it was installed. Grace later learned of improper use of that email system, but did not, for a significant period of time, shut down the system, discipline the brokers for its use, or take sufficient steps to supervise the use of the email system. In addition, some accounts opened for XYZ option plan participants were not adequately reviewed or monitored in the Branch.
- Also during the Relevant Period, the XYZ Brokers were promoted as being "extensively trained" in handling employee stock option plans generally and in advising XYZ employees about XYZ specifically even though they did not receive specific additional training on such matters.

10. The Firm failed to adequately ensure reasonable supervision of the XYZ Brokers, and Grace failed to reasonably discharge his duties and obligations in connection with the supervision and control of the activities of the XYZ Brokers.

### **Relevant Entities and Groups**

#### **XYZ**

11. During the Relevant Period, XYZ was a global telecommunications company based in Jackson, Mississippi. Prior to 1998 (when it acquired UVW, Inc.), XYZ had approximately 30,000 employees around the world. After 1998, the total number of employees of the combined UVW/XYZ approached 80,000.
12. XYZ gave some of its employees a portion of their compensation in the form of options to purchase company stock at specified prices. During the relevant time period, more than 40,000 XYZ employees participated in the XYZ ESOP. As a result of substantial increases in XYZ's stock price during the 1990s, many of these employees chose to exercise their options to buy XYZ shares at prices below the then-current market price. In excess of 90% of those option holders sold the resulting XYZ shares immediately after their exercise transactions.
13. As of January 1, 1998, XYZ selected the Firm to become the primary servicer of the XYZ ESOP. Thereafter, most XYZ employees exercising employee stock options were required to do so through the Firm.

#### **The Corporate Client Group**

14. The Firm's Corporate Client Group, which is based in New York, specializes in servicing stock option plans for the Firm's corporate clients, including XYZ. In particular, the Corporate Client Group is responsible for the back-office and operations aspects of servicing stock option plans and for maintaining the Firm's stock plan services call centers and the corporate client services internet access site. Nationally, the Corporate Client Group services employee benefit plans for hundreds of corporate clients.

#### **The XYZ Brokers**

15. The XYZ Brokers assisted XYZ employees who contacted them in connection with the exercise of the employees' stock options and also provided other retail brokerage services to certain XYZ employees who chose to open retail brokerage accounts with the Firm. The XYZ Brokers were led by RR, who had been designated by the Firm as a "Corporate Client Specialist," and was the most senior broker in the group. RR generally directed the day-to-day activities of the other XYZ Brokers.
16. Before 1998, the XYZ Brokers consisted primarily of three brokers, including RR. By 2000, the XYZ Brokers had grown to approximately 12 brokers and four support

staff, including an assistant operations manager. In addition to servicing the XYZ plan, the XYZ Brokers also serviced ESOPs for several of the Firm's other corporate clients.

### **The Branch**

17. During the Relevant Period, the Branch employed approximately 65 brokers (including the XYZ Brokers). The office was supervised by Grace and his management team. Grace delegated certain portions of his supervisory duties over the Branch to the assistant branch manager, and certain related tasks to the branch compliance officer and/or the branch operations manager.
18. In addition, beginning in 1999, Grace delegated significant portions of his supervisory duties with respect to the XYZ Brokers to an assistant operations manager who was assigned specifically to work with the XYZ Brokers.

### **Summary of Customer Complaints**

19. The customers who have complained about the activities of the XYZ Brokers (the "Complainants") were, or had been, employees of XYZ (or its predecessors) and had received XYZ stock options in connection with their employment. Although some were more sophisticated than others, the size of their options portfolios did not necessarily correlate to their level of investment sophistication.
20. Most Complainants assert that during the Relevant Period, they were given advice by their XYZ Brokers to exercise XYZ stock options using margin loans to pay for the option exercise costs and taxes withheld. They further claim that they were advised by these brokers to hold the newly-acquired shares for at least one year to capture tax advantages applicable to long-term capital gains.
21. Most Complainants contend that they were not adequately informed of the nature of, or risks associated with, their margin loans. Moreover, a number of Complainants assert that they were not told of the market risks of holding concentrated positions in XYZ stock, the impact that such concentrated positions could have on their margin loans, or that there were strategies available to minimize or mitigate those risks.

### **Failure to Supervise (Exchange Rule 342)**

### **Communications with the Public**

#### *Communications that Omitted Material Facts*

22. Many XYZ employees held non-qualified stock options. With this type of option, the spread between the strike price of the option and the market price of the shares at the time of exercise is considered ordinary income for tax purposes. An estimated amount for the taxes due on that income was withheld from the employee at the time

of the option exercise. Any subsequent gains realized from the sale of those shares after the option exercise were taxed to the employee as a long-term capital gain if the shares were held for at least one year.

23. XYZ employees had three alternative methods available for them to complete an option exercise transaction: (1) they could “exercise and sell,” exercising options and selling the stock immediately at the prevailing market price and retaining the cash profits remaining after payment of the option exercise price and applicable tax withholdings; (2) they could “exercise and sell to cover,” exercising the options and selling enough XYZ shares to cover the initial costs and taxes while holding the remaining shares; or (3) they could “exercise and hold,” exercising the options and holding all of the resulting shares without selling any in the market. To fund the costs and taxes due on the exercise-and-hold transactions, the complainants could: (1) deposit cash; (2) sell stock or other assets held in or deposited to the account; or (3) borrow the necessary funds from the Firm on margin, using the XYZ stock or other securities deposited in the account as collateral for the loan.
24. To assist in the explanation of two of those alternatives, RR created a template for a document entitled “Exercise Hold vs. Exercise Sell Analysis” (collectively, the “Exercise Analyses”), which could be customized for individual option holders. Between early 1998 and October 2000, RR and certain of the XYZ Brokers sent approximately 70 such documents to approximately 30 of the Complainants.
25. The Exercise Analyses compared the effects of exercising options on margin and then holding the shares for at least one year versus exercising and selling the shares in a single transaction after one year had passed. The analyses typically included a page summarizing the hypothetical results, under various stated assumptions, in a graph and accompanying table.
26. The Exercise Analyses assumed that XYZ’s stock price increased from the then-current price. Under the assumed facts of the analyses, if the XYZ employee exercised the options, held the shares for one year and then sold at prices above a certain point, the XYZ employee would receive greater proceeds, after taxes, than if he or she exercised the options after twelve months and then sold the shares. By contrast, the analysis showed that if the stock price stayed the same or increased only slightly during that year, the XYZ employee would make less money, because of the interest charged on the margin loan, by using the exercise-and-hold strategy.
27. For example, customer A held approximately 60,000 stock options with strike prices ranging from \$9.85 per share to \$25.46 per share, at a time when XYZ stock was trading at \$45 per share. In February 2000, an Exercise Analysis was prepared for A that showed the different results under the two alternative strategies if XYZ shares traded up from \$45 per share to \$105 per share. The analysis assumed that A would exercise and hold all 60,000 shares on margin for the required one-year holding period necessary to qualify the increase in value as capital gains for tax purposes. According to the analysis, if XYZ stock reached \$105 per share in the year after

exercise, A would earn \$842,800 more from the exercise-and-hold strategy than if he waited until the stock reached \$105 per share to do an exercise-and-sell transaction. The Exercise Analysis also showed that if the stock price did not increase and remained at \$45 one year later, A would make \$121,818 less by using the exercise-and-hold strategy than he would by doing an exercise-and-sell at that time.

28. Exchange Rule 472.30 required, in pertinent part, that communications with the public could not omit material facts. In addition, Firm policy during the Relevant Period required that documents distributed to Firm customers contain “a balance between describing the risks and the potential rewards of any investment” and that “the level of risk must always be disclosed in any investment that is being proposed to a client.”
29. The Exercise Analyses did not comply with the above-referenced requirement of Exchange Rules. In particular, the analyses failed to depict certain risks of holding the shares on margin, because they did not calculate the impact on the hypothetical transactions if the stock fell below the then-current value and they did not describe the risk of potential losses that could result from future market declines.
30. Therefore, the Exercise Analyses presented an incomplete view of the potential results under the two alternative strategies. In addition, in many cases, there were mathematical errors or incorrect assumptions in the analyses that made it difficult to extrapolate the downside risk accurately from the graph.
31. Exchange rules and Firm policy during the Relevant Period required that the Exercise Analyses should have been reviewed and approved by Grace, or one of his delegates, before they were distributed outside the Firm. Grace advised RR that the document would have to be approved by the Firm before it could be used in that manner. The Exercise Analyses, however, were not reviewed and approved by management prior to being sent to XYZ option plan participants.
32. As a result of correspondence from a customer in February 2000, Grace should have known as early as that time that some of the XYZ Brokers had sent the Exercise Analyses to customers without approval. After that time, he did not stop the brokers from using the Exercise Analyses or notify the Firm’s compliance department of the problem. Grace also did not investigate or supervise the matter himself.

#### *Unapproved and Unsupervised Use of Email System*

33. Exchange rules and Firm policy during the Relevant Period required that systems for communicating with customers be approved and supervised by the branch office manager or his delegates.
34. During 1999 and 2000, the XYZ Brokers set up and used an email system (the “Independent Email System”) that was separate from the Firm’s internal email system. The Independent Email System was accessible from computers located on

the desks of the XYZ Brokers at the Firm. It was operated through a commercial internet service provider, and had no automatic mechanism for oversight by the Firm.

35. The Independent Email System was not approved for sending communications to individual customers or potential customers. At various times during the Relevant Period, certain of the XYZ Brokers used the Independent Email System to send Exercise Analyses to XYZ employees and to exchange other communications with Firm customers. Neither Grace nor his delegates reviewed or approved those communications.
36. Grace was aware of the existence of the Independent Email System either before or shortly after it was set up in February 1999. At or about that time, Grace was advised by RR that the Corporate Client Group had authorized the XYZ Brokers to install the Independent Email System to communicate with the Corporate Client Group and the XYZ ESOP staff. He was told by RR that it would not be used to communicate with individual customers or potential customers. The Corporate Client Group, however, had not authorized the XYZ Brokers to install the Independent Email System.
37. Grace learned later that some of the XYZ Brokers had used the Independent Email System to communicate with customers and potential customers. In April 2000, Grace instructed the XYZ Brokers not to use the Independent Email System anymore. Grace, however, did not disconnect it and did not investigate the matter further or notify the Firm's compliance department of possible violations of Firm policy or Exchange rules.
38. Between April 2000 and February 2001, Grace learned that some of the XYZ Brokers had disregarded his prohibition against using the Independent Email System. Nevertheless, he did not investigate or pursue the matter further at that time. Grace did not order the Independent Email System to be shut down until February 2001.

*Unapproved and Unsupervised Use of Fax Machines*

39. All Firm fax machines are required by the Exchange rules and Firm policy to be kept in a central and secure point within the branch office. Nevertheless, the XYZ Brokers had access to a fax machine that generally was not secured in a restricted-access area.
40. On occasion, some XYZ Brokers used the fax machine to send Exercise Analyses and/or other documents, without receiving prior supervisory approval.

**Review of Margin Usage in Customer Accounts**

41. During the Relevant Period, the new account documentation for several Complainants included information reflecting relatively low incomes or other factors that should have been considered in evaluating the appropriateness of their margin usage. Nevertheless, some of those Complainants inappropriately established and maintained

- relatively high margin debit balances throughout much of the time their accounts were held with the Firm.
42. For example, customer B opened an account on May 5, 1999. At the time, B, who was a senior executive at XYZ, was 41 years old and was married, with four children. According to his new account form, his primary source of income was compensation of \$150,000. At that time, B had a moderate risk tolerance, and investment objectives of growth and tax deferral. He had approximately two years of experience investing in stocks and his liquid net worth, excluding the potential equity value in his XYZ stock options, was approximately \$250,000 and his total net worth, excluding the XYZ options, was approximately \$450,000.
  43. In July 1999, B exercised options to purchase 337,000 shares of XYZ on margin, resulting in a margin debit balance of approximately \$5 million and a net equity of approximately \$6.4 million (44% debt-to-equity ratio). The account consisted of almost exclusively XYZ shares. By July 2000, the debt-to-equity ratio had increased to 80%, resulting in the forced sale of approximately 121,000 shares. By November 2000, when the account was closed, the equity value of B's XYZ holdings had been eliminated by the substantial decline in the market value of the stock and he owed the Firm an additional debit balance of \$14,709. Between July 1999 and November 2000, B paid approximately \$516,000 in margin interest. The annualized cost/equity ratio for the account was approximately 17.8%. (All share amounts are adjusted to reflect a 3:2 split in XYZ's stock in December 1999.)
  44. Customer C opened an account in November 1999. At the time, C was 56 years old, and was married, with two children. C had recently retired from a mid-level management position at XYZ. C, who had a high-school education, had a moderate risk tolerance, and his investment objectives were growth and current income. C's liquid net worth was approximately \$400,000, exclusive of his XYZ options.
  45. In November 1999, C exercised options to purchase 90,150 shares of XYZ stock on margin, resulting in a margin debit balance of approximately \$2.5 million, and a net equity of approximately \$3 million (45% debt-to-equity ratio). The account consisted almost entirely of XYZ shares. By May 2000, the debt-to-equity ratio had increased to 81.98%, resulting in the forced sale of approximately 22,000 shares. By August 2000, further declines in the value of C's account resulted in the forced sale of most of the remaining shares. Between November 1999 and August 2000, when C paid off the margin debit, C paid approximately \$103,000 in margin interest, and the annualized cost/equity ratio in the account was approximately 25%.
  46. Firm policy during the Relevant Period required the branch manager or his delegates to review accounts for, among other things, activity that is inconsistent with the client's investment objectives, income, net worth or previous investment activity.

47. Grace failed to adequately monitor margin usage in the accounts of certain Complainants to ensure that the levels of margin and concentrations of XYZ stock were consistent with those customers' objectives and risk profiles.

### **Insufficient Stock Option Training and Expertise Among the XYZ Brokers**

48. Certain of XYZ's internal materials distributed to its employees in connection with their stock options included a description of the Firm's services that stated "services for plan participants are provided by a group of specialists, trained extensively in employee stock plans." That language was presented to a representative of the Corporate Client Group, who reviewed but did not change that description.
49. The statement of ESOP expertise among the XYZ Brokers was exaggerated. Although each of the XYZ Brokers had completed at least some of the Firm's standard broker training and were Series 7 licensed, none of them had received specialized training from the Firm in advising customers regarding ESOPs or in the special issues relating to ESOP exercises. RR and another senior broker conducted some training of the XYZ Brokers, which focused largely on the mechanical aspects of executing option exercise transactions, rather than on particular issues regarding how to advise ESOP participants regarding their option transactions.
50. On several occasions, when XYZ employees contacted the XYZ Brokers to discuss exercising their stock options, some brokers in the group touted their perceived special expertise by pointing out, among other things, that they had special access to, and frequent conversations with, senior XYZ executives. Also, at times, some brokers suggested that they had special access to the Firm's research department. However, those XYZ Brokers had no special access to XYZ's senior management or the Firm's research department.

### **Lines of Supervision**

51. The XYZ Brokers were located within the Branch, but some of their activities were coordinated with the Corporate Client Group in New York. Within the Branch, the XYZ Brokers functioned largely as a separate business unit. RR often dealt directly with the Corporate Client Group in New York and with the ESOP Administration Staff at XYZ, without the involvement of Grace or other branch officials.
52. For example, some communications between and among the Branch, the XYZ Brokers, the Corporate Client Group, the Firm's Operations department and XYZ were not coordinated with or supervised by branch management officials.
53. Similarly, RR acted as an individual broker and also was designated as a branch liaison between the Corporate Client Group and XYZ employees. In this capacity, he periodically traveled to XYZ's office in Mississippi to discuss the ESOP servicing with XYZ's staff. RR also frequently worked with the Corporate Client Group and XYZ's staff on ESOP matters without review or approval by Grace.

54. RR also directed many of the day-to-day activities of the XYZ Brokers. For example, RR had the ability to assign new accounts to brokers, as well as the ability to remove a broker from the XYZ Brokers group if he felt it was appropriate.
55. At times, the XYZ Brokers were physically separated from the rest of the Branch and used a different computer system to conduct their stock plan business. The XYZ Brokers also used the computer system to maintain separate logs of contacts with customers. Grace did not have direct access to the XYZ Brokers' computer system.
56. The XYZ Brokers also were assigned a separate assistant operations manager, who had been delegated certain duties with respect to the group, such as approving transactions in restricted stock.
57. Although the XYZ Brokers were supposed to be supervised by Grace or his delegates, that was not always the case within the Branch.

#### **Failure to Properly Supervise Completion of New Account Documents**

58. Exchange rules and Firm policy during the Relevant Period required the Firm and the branch manager to adequately ensure that brokers completing new account applications for customers used due diligence to obtain the essential facts about a client.
59. In several instances during the Relevant Period, the XYZ Brokers did not gather or record all of the information required to establish new accounts. For example, on many occasions, the XYZ Brokers did not indicate what type of account was being opened. In other instances, the brokers did not gather or record the customer's bank or credit references information. Nevertheless, these customers' accounts were approved by Grace or his delegates.
60. In certain other cases, the new account documentation contained inconsistencies or errors on matters such as the accountholder's income, net worth or personal information. For example, one customer was the subject of four Account Applications between March 1999 and April 2000. Information about his income, liquid net worth and total net worth varied significantly from one new account document to the next; only one of them reflected his financial circumstances approximately correctly. Another customer had at least four new account forms filled out for him between April and June 1998. In April 1998 he was listed (correctly) as married and as having three children. In June 1998, however, he was listed as single, with no dependents. Grace or his delegates approved these account applications.

#### **Conclusion**

61. Exchange Rule 342 requires, in pertinent part, that each branch or business activity be supervised; that the person in charge of a group of employees should "reasonably

discharge his duties and obligations in connection with the supervision and control of the activities of those employees related to the business of their employer and compliance with the securities laws”; and that the Firm follow-up and review to ensure that “delegated authority and responsibility are being properly exercised.”

62. For the reasons described above, the Firm and Grace violated Exchange Rule 342.

**DECISION**

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

**PENALTY**

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a fine of \$1,000,000.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by Mr. Grace of a censure and a three month supervisory suspension.

For the Hearing Panel

Vincent F. Murphy  
Hearing Officer