

NEW YORK STOCK EXCHANGE, INC.

**EXCHANGE HEARING PANEL DECISION 04-83**

May 19, 2004

PETER JOHN CARUSO

FORMER REGISTERED REPRESENTATIVE

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**Disclosed material information to third parties, that he planned to downgrade his rating and lower his estimates on a stock, prior to public dissemination of the information – Consent to censure, 4 month bar and \$25,000 fine.**

**Appearances:**

For the Division of Enforcement  
Simon Swidler, Esq.  
Lara M. Posner, Esq.  
Craig P. Hammond, Esq.

For the Respondent  
Eric R. Levine, Esq.  
Jeffrey Plotkin, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Peter John Caruso, a former registered representative with Merrill Lynch, Pierce, Fenner & Smith Inc. (the "Firm"). Without admitting or denying guilt, Mr. Caruso consented to a finding by the Hearing Panel that he engaged in conduct inconsistent with just and equitable principles of trade by disclosing material information to third parties, that he planned to downgrade his rating and lower his estimates on a stock, prior to the public dissemination of that information.

For the sole purpose of settling this disciplinary proceeding, the Division of Enforcement and Mr. Caruso stipulate to certain facts, the substance of which follows:

**Background and Jurisdiction**

1. Peter John Caruso ("Caruso") was born on March 12, 1958.
2. Caruso entered the securities industry in April 1982 when he joined the Firm as a Research Assistant. Caruso worked as a Research Assistant until in or about 1984 when he joined the Firm's Corporate Accounting Office. In or about 1985, Caruso became a Junior Research Analyst in the Retailing Research Group at the Firm and in or about 1994 he became a Research Analyst. Caruso was promoted to Senior Analyst in or about 1995. Caruso passed his Series 7 examination in December 1996. Caruso continued to work as a Senior Analyst at the Firm until the Firm terminated his employment on August 20, 2002. Caruso is currently employed at a non-member firm.

3. On October 29, 2003, Enforcement issued a Charge Memorandum in this matter. Caruso submitted an Answer to the Charge Memorandum on February 3, 2004.

### **Overview**

4. On July 11, 2002 (“July 11”), after receiving approval for a ratings change, but prior to the public release of the report by the Firm, Caruso disclosed information to clients of the Firm leading some of the clients to believe that he was going to downgrade his rating and lower his estimates on the common stock of XYZ. Caruso’s research report was published after midnight on July 12, 2002 (“July 12”).
5. As set forth in detail below, Caruso engaged in conduct inconsistent with just and equitable principles of trade by disclosing material information to third parties, that he planned to downgrade his rating and lower his estimates on a stock, prior to the public dissemination of that information.

### **The Firm’s Policies**

6. At all relevant times, the Firm had the following policies to prevent the misuse of market-sensitive information relating to research reports by any person associated with it:

“Knowledge of a pending recommendation or change in opinion or estimates is considered to be ‘market-sensitive information.’ Pending initial opinions, estimate or opinion changes, and decisions to issue research reports or comments may not be disclosed by any means to anyone, either inside or outside of the Firm, until the information is disseminated in the appropriately prescribed manner. ... This prohibition is intended to avoid the misuse of market sensitive information and the appearance of impropriety.” (Merrill Lynch Research Policy and Procedures Manual, Section III, paragraph C)

7. At all relevant times, Caruso was subject to and required to abide by these policies.
8. Pursuant to the Firm’s policy, Caruso had a duty to maintain in confidence information about a pending change in an analyst’s rating and/or estimates until that information was disseminated in the appropriately prescribed manner.

### **Peter Caruso’s Decision To Downgrade His Rating on XYZ**

9. As a Senior Analyst for the Firm, Caruso covered Hard-Line Retail stocks such as XYZ and UVW. Caruso was, at all relevant times, an influential analyst with a well-known reputation in the stocks that he covered. Institutional Investor magazine had rated Caruso the number one analyst in the retailing/hard-goods category for a period of six years.
10. Prior to July 11, and as far back as September 1997, Caruso’s rating on XYZ had been a “Strong Buy” for the Intermediate and Long-Term. The Intermediate-Term

investment rating at the Firm is an indicator of expected total return within the 12-month period from the date of the initial rating. The Long-Term investment rating is an indicator of fundamental company factors demonstrating potential total return during the three-year period from the date of the initial rating. The range of investment ratings for both were: “Strong Buy”, “Buy”, “Neutral” and “Reduce/Sell”.

11. “Strong Buy” was the Firm’s highest rating. A “Strong Buy” rating for the Intermediate-Term denoted the opinion that the total return (price appreciation plus yield) within the 12-month period from the date of the initial rating would be a minimum of 20%.
12. On the morning of July 11, after speaking with representatives from Home Depot and UVW, and discussions with his colleagues, Caruso began the process of causing the Firm to downgrade its Intermediate-Term rating of XYZ by two levels, from a “Strong Buy” (by-passing “Buy”) to “Neutral.”
13. A rating of “Neutral” for the Intermediate-Term denoted the opinion that total return (price appreciation plus yield) within the 12-month period from the date of the initial rating would be 0 to 10%.
14. As well as lowering his Intermediate-Term rating on XYZ from a “Strong Buy” to a “Neutral”, Caruso also reduced his estimates on XYZ’s earnings per share for 2002 from \$1.60 to \$1.57 and for 2003 from \$2.00 to \$1.90.
15. Between 10:30 and 11:00 a.m. that same morning, Caruso called his direct supervisor, DS to get approval for the rating downgrade. On this call, Caruso received approval for the downgrade. Pursuant to Firm policy, Caruso knew that his downgrade and reduced earnings estimate would not be released until after midnight, July 11-12, 2002.
16. After this conversation with DS, Caruso dictated the supporting research report to his assistant. At the time of the downgrade approval, DS was not aware of Caruso’s prior commitments to discuss hard-lines retail, including XYZ, at a luncheon meeting and on a conference call. On July 11 Caruso did not inform DS of his previously scheduled luncheon meeting or conference call during the course of his discussions regarding his request for downgrade approval. During all relevant times discussed herein, Firm policy and procedures did not require consultation with and/or approval by a supervisor when an analyst with a pending ratings or estimate change was to speak to customer or sales groups. (The Firm is the subject of a separate Exchange disciplinary action. See Hearing Panel Decision 04-30.)

#### **Caruso’s Disclosures at a Luncheon Meeting**

17. At approximately 12:30 p.m. on July 11, Caruso arrived at the offices of ABC Bank in New York City to participate in a lunch meeting arranged by Janina Casey (“Casey”), an institutional salesperson at the Firm. (Casey is the subject of a separate Exchange disciplinary action. See Hearing Panel Decision 04-73.)

18. Casey had arranged the meeting at ABC Bank approximately four weeks in advance. The meeting was attended by Casey, two ABC Bank portfolio managers and two research analysts from ABC Bank
19. Caruso's responsibilities at the Firm included making himself available to the Firm's institutional clients to discuss the stocks he was covering. The purpose of this lunch meeting was for Caruso to provide an update regarding the various stocks he covered in the hard-line retail industry, including XYZ. The meeting lasted approximately one hour.
20. During the lunch meeting, Caruso disclosed information leading some of the attendees to believe that he was going to downgrade his rating on XYZ.
21. At the time of the meeting, the information that the Firm was going to downgrade its rating on XYZ's stock was material, non-public information.
22. At the time of the lunch meeting, the Firm had not released the downgrade to the public.

#### **Casey's Disclosures After The Luncheon Meeting**

23. Promptly after this meeting, Casey went to an empty cubicle at ABC Bank and called three institutional clients and a friend.
24. Casey informed each person she called, among other things, that she had just come from a meeting with the Firm's hard-lines analyst, Peter Caruso, and she believed that Caruso "very well could" downgrade his rating on XYZ.
25. At various times on the afternoon of July 11, after being in touch with Casey, Firm clients sold several million shares of XYZ stock prior to the release of the research report at 12:04 a.m. on July 12. The sales on July 11 were at approximately two dollars per share more than the prices at which the stock traded on July 12.

#### **Caruso's Disclosures in a Conference Call**

26. At 3:00 p.m. on July 11, after the lunch meeting, Caruso participated in a conference call to discuss sales results of companies in the retail sector. On this call, several Firm analysts spoke. At various times, the call reached a total of approximately fifty-five listeners, which included institutional clients and Firm employees.
27. During the call, Caruso was asked: "Peter, just following up on your update on XYZ and UVW, you've got, I think, the highest estimates on the street for XYZ and I'm curious, in light of your most recent update, whether you think you'd be lowering them?" Caruso responded: "Yes, you should expect to see me lowering them very shortly..."
28. At the time Caruso made that statement, the Firm had not released the research report with a downgrade and reduced earnings estimate nor had the research report been approved by a supervisory analyst.

29. At the time Caruso made that statement, the change in his earnings estimates for XYZ constituted material, non-public information that Caruso had a duty to maintain in confidence until appropriately disseminated.
30. The Firm's procedures failed to specifically address what was appropriate for an analyst to discuss at speaking engagements.

**Trading in XYZ Stock on July 11, 2002 and July 12, 2002**

31. Caruso's research report was submitted to the Firm Compliance Department at 5:42 P.M. on July 11, thereafter approved by a supervisory analyst and was released at 12:04 A.M. on July 12.
32. The trading volume in XYZ on July 11 was approximately 23 million shares. This was more than twice the average daily volume on a composite basis of approximately 8.5 million shares in 2002. On July 12 (after the report was released) the volume of shares traded was approximately 46 million shares.
33. XYZ shares closed at \$31.40 on July 11 --- down \$1.85 or 5.6%, from the day before. On July 12, XYZ stock opened at \$29.36 and closed at \$29.09, down \$2.31, or 7.4% from the July 11 close.

**DECISION**

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Mr. Caruso 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 Mr. Caruso of a censure, a bar of four months from membership, allied membership, approved person status, and from employment or association in any capacity with any member or member organization and a fine of \$25,000.

For the Hearing Panel

Vincent F. Murphy  
Hearing Officer