

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 05-57

May 5, 2005

JOHN B. HOFFMANN
FORMER RESEARCH ANALYST

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Violated Exchange Rules 342 and 476(a)(6) by failing to supervise the activities of a Firm analyst during the period in which he published fraudulent and misleading research on certain telecommunications companies – Consent to censure, a total penalty of \$120,001 and a 15 month supervisory suspension.

EXCHANGE HEARING PANEL DECISION 05-58

KEVIN J. McCAFFREY
REGISTERED REPRESENTATIVE

Violated Exchange Rules 342 and 476(a)(6) by failing to supervise the activities of a Firm analyst during the period in which he published fraudulent and misleading research on certain telecommunications companies – Consent to censure, a total penalty of \$120,001 and a 15 month supervisory suspension.

Appearances:

For the Division of Enforcement
Linda S. Riefberg, Esq.
Suzanne R. Elovic, Esq.
David L. Friedman, Esq.

For the Respondent
John B. Harris, Esq.
(For John B. Hoffmann)
Guy Petrillo, Esq.
(For Kevin J. McCaffrey)

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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 ("Enforcement") and John B. Hoffmann ("Hoffmann"), a former research analyst with Salomon Smith Barney, Inc. and Kevin J. McCaffrey ("McCaffrey"), a registered representative with the Firm. Without admitting or denying guilt, Hoffmann and McCaffrey consented to separate findings by the Hearing Panel that they violated Exchange Rules 342 and 476(a)(6) by failing to supervise the activities of a firm analyst during the period in which he published fraudulent and misleading research on certain telecommunications companies.

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

Background and Jurisdiction

1. Hoffmann entered the securities industry in 1964 as a research analyst with Smith Barney, then a member of the NASD.
2. He became director of U.S. Equity Research at Smith Barney in approximately 1988 and director of Global Research in 1995.
3. After Smith Barney merged with Salomon Brothers in 1997 to form Salomon Smith Barney, Inc. (now Citigroup Global Markets, Inc.) (“SSB” or the “Firm”), Hoffmann was director of Global Equity Research of SSB until February 2003. He was a member of the executive committee at SSB. He retired from Citigroup Global Markets in May 2003.
4. McCaffrey entered the securities industry in 1988 as a general securities representative.
5. He joined Smith Barney as head of New York Institutional Equity Sales in 1994 and became deputy director of U.S. Equity Research in 1995.
6. When Smith Barney merged with Salomon Brothers, McCaffrey became director of U.S. Equity Research and held that position until October 2002.
7. In 2000 and 2001 (the “relevant period”), Hoffmann, as the director of Global Equity Research, and McCaffrey, as director of U.S. Equity Research at SSB, were supervisors of Jack Grubman, once one of the most prominent research analysts at SSB and on Wall Street.
8. Hoffmann and McCaffrey failed to supervise Grubman adequately with a view to preventing him from publishing fraudulent research on “ABC” and “DEF”, and from publishing research on “GHI,” “JKL,” “MNO,” “PQR,” and “STU, that violated Exchange Rule 472 relating to communications with the public.
9. Each of these companies was an SSB investment banking client.
10. In particular, with respect to these companies, Hoffmann and McCaffrey failed to respond adequately to red flags that Grubman made unreasonable research assumptions that led him to publish unrealistically bullish ratings and price targets.
11. During the relevant period, Hoffmann and McCaffrey were aware of potential conflicts of interest posed by Grubman’s involvement in the Firm’s telecommunications (“telecom”) investment banking activities and were aware of Grubman’s importance to the Firm’s telecom investment banking franchise.
12. Hoffmann and McCaffrey failed to respond adequately to red flags concerning investment banking pressure on Grubman not to downgrade the Firm’s banking clients.

McCaffrey and Hoffman Were Supervisors of Grubman

13. During the relevant period, Respondents were supervisors of Jack Grubman. All U.S. equity research analysts, including Grubman, reported directly to McCaffrey, as director of U.S. Equity Research, and McCaffrey reported to Hoffmann, as director of Global Equity Research. Hoffmann was a member of the management committee at SSB.
14. Hoffmann and McCaffrey both participated in the process of Grubman's annual performance review and in determining Grubman's salary and bonus.
15. Investment banking revenue generated from companies in an analyst's sector was a significant factor in determining analyst's compensation at SSB.
16. Respondents understood that Grubman was among the most prominent research analysts at SSB and that he played a significant role in attracting investment banking business for SSB from telecom companies he covered. During 2000, SSB earned approximately \$331 million and in 2001 it earned approximately \$101 million in investment banking fees from telecom companies Grubman covered. Grubman earned approximately \$20.2 million in salary, bonus, and deferred compensation in 2000 (approximately \$14 million in salary and bonus and \$6.2 million in deferred compensation) making him the highest paid analyst at SSB. In 2001 Grubman's compensation was reduced to approximately \$6.5 million (approximately \$3.5 million in salary and bonus, and \$3 million in deferred compensation). (Pursuant to a 1998 contract with SSB, Grubman was awarded deferred compensation in 2000 and 2001 and received a loan of \$15 million to be forgiven over five years. Neither Respondent signed or negotiated the 1998 contract.)

**Grubman Issued Fraudulent and Misleading Research
On Certain Telecommunications Companies**

17. As the NYSE previously found, Grubman and SSB issued fraudulent research reports on two companies, "DEF" and "ABC," that, among other things, presented an unrealistically optimistic picture that overlooked and minimized the risk of investing in these companies, predicted substantial growth in these companies' revenues and earnings without a reasonable basis, did not disclose certain material facts about these companies, and contained material misstatements about these companies, all in violation of Sections 15(c)(1) and (2) of the Exchange Act, Rule 15c1-2 thereunder. Grubman also published research on "GHI," "JKL," "ABC," "MNO," "PQR," and "STU" that violated Exchange Rule 476(a)(6), and caused the Firm to violate Exchange Rules 472 and 401. Each of these seven companies was an investment banking client of SSB. *See* HPD 03-075, Stipulation and Consent, GRUBMAN, JACK BENJAMIN (April 23, 2003); HPD 03-072, Stipulation and Consent, CITIGROUP GLOBAL MARKETS INC. (April 22, 2003).

18. As described below, Respondents were aware of red flags concerning Grubman's research with respect to these companies but did not respond adequately to such warnings signs.

**Respondents Failed to Respond Adequately to Red Flags
Concerning Grubman's Investment Ratings**

19. Each research report SSB issued included an investment rating that reflected the analyst's opinion of the relative attractiveness of the company to the investors.
20. During the relevant time period, SSB advised its customers that it utilized the following five-point investment rating system:
- 1 – Buy
2 – Outperform
3 – Neutral
4 – Underperform
5 – Sell
21. In practice during the relevant period, however, SSB's research analysts rarely rated companies a 4 (Underperform) and never a 5 (Sell).
22. At an SSB equities management meeting in early 2001, Hoffmann recognized this imbalance, noting that out of a total of 1179 stock ratings maintained by SSB analysts as of January 29, 2001, there were no Sell ratings and only one Underperform rating. He observed that there was a "rising issue of research integrity" and an inherent conflict with investment banking at SSB.
23. Respondents failed to respond adequately to red flags that certain of Grubman's ratings were unreasonably positive.
24. For example, Hoffmann and McCaffrey knew that certain stocks Grubman covered, particularly the seven companies noted above, lost over 90% of their value during the relevant period. Respondents were also aware that, even as the share prices of these stocks dropped precipitously, Grubman maintained SSB's highest rating – a "Buy" (1) – on those companies.
25. Respondents were also aware that Grubman never rated a company a "Sell" during the relevant period. In October 2000, an analyst who reported to Grubman e-mailed McCaffrey and told him:
- The sentiment on the buy side is that the sell side [telecommunications] analysts are tools for the bank . . . Therefore going forward, we are going to have to be far more selective on deals and tougher on ratings or we risk losing all credibility.
26. Further, an analysis done in the spring of 2001 of Grubman's "buy" rated stocks by a person who reported to McCaffrey concluded that there was "not a single

rating change that I can see from 1/1/01 [to] 5/31/01” and that Grubman’s stocks significantly underperformed other SSB “buy” rated stocks. For the first six months of 2001, according to the analysis, the price of Grubman’s “buy” rated stocks fell 16.83 percent while all other SSB “buy” rated stocks rose 6.9 percent.

27. Because Grubman did not downgrade the ratings of certain of his stocks in 2000 and 2001 as the prices of those stocks fell, SSB’s retail brokers criticized him harshly. At year end, retail brokers were provided the opportunity to rate analysts and comment in writing as part of the analyst’s annual performance evaluation.
28. Respondents received and reviewed the numerical ratings and comments both years as part of their review of Grubman. For both 2000 and 2001, the retail sales force rated Grubman last among all SSB analysts. The retail force also gave scathing written evaluations of Grubman’s performance for both years.
29. Neither Hoffmann nor McCaffrey responded adequately to these red flags regarding certain of Grubman’s ratings. Hoffmann left it to McCaffrey to discuss ratings with Grubman. McCaffrey did not meet personally with Grubman to discuss lowering his ratings until July 2001 as part of meetings with all U.S. equity analysts to discuss ratings and price targets.

**Respondents Failed to Respond Adequately to Red Flags
Concerning Grubman’s Price Targets**

30. During the relevant period, each report Grubman published on the companies he covered contained a price target – Grubman’s prediction of where he believed the price of the company’s stock would be in 12 to 18 months.
31. As noted, the share price of many of the emerging telecommunications stocks Grubman covered plummeted in 2000 and 2001.
32. Respondents were aware that Grubman did not adequately adjust his target prices to reflect the reduced prospects of certain of the companies he covered, but did not take adequate steps to assure that certain of Grubman’s target prices were realistic.
33. In October 2000, the deputy director of U.S. Equity Research, who reported to McCaffrey, sent an e-mail to all SSB U.S. equity research analysts requesting that analysts bring price targets in line with ratings and current stock prices. Among the situations he identified as “most obvious” were “buy rated stocks that have come down a lot and are now unrealistically far below their targets,” describing stocks that had target prices two or three times the current market price as “stale.”
34. Hoffmann sent a similar memorandum to all SSB equity research analysts later in October 2000, in which he urged them to review their price targets, growth assumptions, and valuations for every stock they covered, noting that there was often a dramatic disparity between current share prices and target prices.
35. In December 2000, a person who reported to McCaffrey sent an e-mail to McCaffrey stating:

Our target prices are contributing to the confusion of our skewed ratings mix, implying as they do tons of upside potential for most of our coverage. The average appreciation potential implied by our targets on Buy-rated stocks was 94% on 12/26/00, compared with 63% in March 2000. . . . These outlandish percentages scream for careful reexamination.

36. Also, in the fall of 2000, McCaffrey received an analysis prepared by the same person that identified which analysts had the most unrealistic price targets and in particular which analysts had price targets that were too optimistic even for “buy” rated stocks. These stocks, according to the analysis, had “too much upside.”
37. The analysis specifically identified problems with Grubman’s research. From this analysis, McCaffrey was made aware that Grubman had more unrealistic price targets than any other analyst generally, and specifically had more “buy” rated stocks with “too much upside” than any other analyst. Twenty-seven of Grubman’s thirty-four price targets were identified as “problematic,” with all but one having price targets that according to the analysis were too high for a “buy” rated stock. No other analyst had more than 18.
38. The analysis stated that Grubman had five of the top 10 “buy” rated stocks that had price targets with “too much upside” and that Grubman was responsible for 13 of the top 50 “buy” stocks whose price targets were unrealistically high.
39. Among the “buy” rated stocks covered by Grubman that had unrealistic price targets were certain of the companies noted above: “JKL,” (stock price \$16, target price \$70, 340% upside), “MNO” (stock price \$34, target price \$130, 288% upside), “GHI” (stock price \$16, target price \$50, 211% upside), “PQR” (stock price \$5, target price \$15, 192% upside), “STU” (stock price \$21, target price \$60, 186% upside), and “DEF” (stock price \$19, target price \$53, 180% upside).
40. Around the time of this price target analysis, Hoffmann opined that a price target for one of Grubman’s stocks, which was 181% above the stock’s market price, appeared “unrealistic.”
41. Respondents failed to respond adequately to these red flags regarding Grubman’s price targets and Grubman maintained unrealistically high target prices on the companies noted above.
42. As noted, McCaffrey did not meet personally with Grubman to discuss price targets until he did so as part of his meetings with all U.S. equity research analysts in July 2001. And it was not until August 22, 2001 that McCaffrey sent a memo to all analysts, copied to Hoffmann, establishing a new procedure whereby the supervisory analyst reviewing a research report would not allow the report to be published if, among other things, the stock was rated a “buy” and the target price exceeded the market price by 75% or more.

**Respondents Failed to Respond Adequately to Red Flags
Concerning Investment Banking Pressure on Grubman**

43. During the relevant period, Hoffmann and McCaffrey were aware of evidence that investment banking applied pressure on Grubman with respect to his research. In a May 22, 2000 e-mail, Hoffmann stated, in response to a complaint about Grubman's research:

The degree of conflict between research and banking appears heightened when the stocks are not working as is the case in [telecommunications] right now. . . . I do think Jack is a very good analyst with very good industry knowledge. He must be much more discriminating on the stocks he recommends with the market working against him. I hope to be able to manage this process to prevent further damage to our investor client base.

44. Similarly, in a November 2000 e-mail responding to another complaint about Grubman's research, Hoffman said:

I am not sure it is entirely banking. I think Jack just missed the big call on the group and hence missed the stocks as well. Am trying to arrange a 'what do we do now[w]?' conference call with him to try to get at a balanced picture of where we stand with the major stocks. More salesmanship from Jack won't help. (emphasis added)

45. Hoffmann, however, did not participate in any such call with Grubman.
46. In April 2001, one of Grubman's stocks, "VWX," declared bankruptcy. Grubman had maintained a buy rating and a high price target on "VWX" until shortly before the company declared bankruptcy.
47. Thereafter, Grubman expressed to an investment banker and others, not including Respondents, his desire to downgrade six of the Firm's investment banking clients noted above. Grubman subsequently informed McCaffrey about investment banking pressure not to downgrade certain companies. McCaffrey testified that he conveyed this information to Hoffmann. Neither Hoffmann nor McCaffrey took sufficient steps to ensure that such pressure was not affecting Grubman's research.
48. In June 2001, McCaffrey and Grubman were slated to have dinner with investment bankers and anticipated hearing about bankers' displeasure with certain aspects of Grubman's research. Before the dinner, Grubman sent an e-mail to McCaffrey that should have alerted McCaffrey that Grubman's private views on certain of his stocks did not match his public recommendation that investors buy these stocks and that Grubman had been pressured by investment banking to maintain his positive ratings on certain stocks:

See you at dinner. If [a senior investment banker] starts up I will lace into him. . . .most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got huge pushback from banking.

49. Neither Hoffmann nor McCaffrey responded adequately to ensure that investment banking pressure was not affecting Grubman's research.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found Hoffman and McCaffrey 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 Hoffmann of a censure, a total penalty of \$120,001¹ and a suspension of 15 months from acting in any supervisory capacity with any member firm.

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by McCaffrey of a censure, a total penalty of \$120,001² and a suspension of 15 months from acting in any supervisory capacity with any member firm.

For the Hearing Panel

Vincent F. Murphy – Hearing Officer
Panelists:
Alan S. Braunshweiger
Christopher E. Raney

¹ The penalty will also include an additional \$1.00 in disgorgement. Such payment shall be made into the interest bearing Distribution Fund account as specified in the SEC's order in this matter.

² The penalty will also include an additional \$1.00 in disgorgement. Such payment shall be made into the interest bearing Distribution Fund account as specified in the SEC's order in this matter.