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NASD Prepares Action Against A Star Analyst

Salomon's Grubman Faces Allegations He Touted Winstar Despite Red Flags

By CHARLES GASPARINO

The National Association of Securities Dealers is preparing to take regulatory action against Jack Grubman, a Salomon Smith Barney research analyst whose bullish telecom calls had made him a star on Wall Street. The move marks the first major crackdown by federal securities regulators investigating how big securities firms obtained investment-banking business with overly rosy stock picks.

The NASD's regulatory arm has notified Mr. Grubman that its enforcement staff is prepared to allege that he and his firm violated securities rules over his research on Winstar Communications Inc., a former Wall Street darling that filed for bankruptcy protection in April 2001.

At issue for Mr. Grubman and the Citigroup Inc. unit are allegations by regulators that the analyst misled investors by touting shares of Winstar, a Salomon Smith Barney investment-banking client, amid evidence that the company was in deep financial trouble, people familiar with the matter say.

Jack Grubman

A Salomon Smith Barney spokeswoman said in a statement "as always we will cooperate with any inquiry." She said "Mr. Grubman's calls on Winstar were part of a consistent and reasonable investment thesis held in good faith for many years. There was no intent to mislead investors."

Mr. Grubman, 49 years old, said through the spokeswoman that he had no comment, but a recent regulatory filing describing the NASD's actions indicates that he "denies having engaged in any such violation."

Mr. Grubman had been a big backer of Winstar, which provided phone and high-speed data services to companies and government agencies, right up to the firm's Chapter 11 bankruptcy filing last year, defending the firm even as strong evidence

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emerged that questioned the company's ability to survive, records show. If a case is filed—the NASD typically files civil administrative actions, not lawsuits—Mr. Grubman would be the first major analyst to be taken to task by federal securities regulators during their current crackdown on the Wall Street research business.

The NASD, Wall Street's main self-regulatory agency, is considering a range of allegations against both Mr. Grubman and Salomon Smith Barney, the people close to the matter say, including securities fraud and violations of NASD rules that bar analysts from making misleading statements to investors. Although no final decision has been made, Mr. Grubman and his firm could also face a wide array of sanctions, including millions of dollars in fines and other penalties, such as a suspension or a bar from the securities industry.

Over the past decade, Mr. Grubman has come to symbolize the changing face, and growing clout, of Wall Street analysts. Acting as a filter between the stock market and investors, analysts once toiled in obscurity, writing reports on companies, making earnings forecasts and recommending which stocks investors should buy or sell.

Mr. Grubman helped change all that. Instead of simply assessing stocks, Mr. Grubman and his peers increasingly promoted them, and focused on helping bring in investment-banking deals for their firms. A few top analysts evolved into Wall Street's equivalent of rock stars, reaping huge bonuses and investor adulation. Mr. Grubman, for instance, recently told Congressional investigators that his annual pay averaged about $20 million during the past several years. This made him one of Wall Street's highest-paid executives.

Any NASD action could be costly to Mr. Grubman. The analyst could be forced to give back as much as $15 million of a forgivable loan he received from Salomon Smith Barney if a regulatory charge led to his departure from the firm, according to his employment contract. The contract adds that Mr. Grubman would be able to appeal that penalty straight to the top: Citigroup Inc. Chairman and Chief Executive Officer Sanford I. Weill.

Grubman's Votes of Confidence

- **January 25, 2001:** Winstar closes at $17.00. Mr. Grubman takes issue with a competitor's analysis that the company may face financial difficulties in the near future. His price target: $50
- **March 9, 2001:** Winstar closes at $9.22. Mr. Grubman attacks short seller Manuel Asensio, who publishes a negative report on the company. His price target: $50.
- **March 15, 2001:** Winstar closes at $7.63. Mr. Grubman publishes his "State of the Union" research report on the telecom industry. "We think the business metrics at (Winstar) continue to exceed expectations and are quite robust." Mr. Grubman says the "noise" surrounding the company's ability to make debt-interest payments "is just that." He says Winstar should issue stock to shore up its balance sheet, like other telecom companies, that have made "huge money for equity holders. We think that is the situation (Winstar) is in today." Price target: $50.
- **April 17, 2001:** Winstar closes at 14 cents. Mr. Grubman issues a report saying that the company late the previous night "announced... that it did not make approx. $75 million interest payments on its senior debt" due the day before. Mr. Grubman said the firm hired the Blackstone Group to help on restructuring its debt and is considering filing for Chapter 11 bankruptcy protection. His price target: not available.

Source: WSJ research

The NASD, which last year became one of the first regulatory agencies to look at analysts, is investigating Mr. Grubman's issuing of positive research reports on Winstar during the winter and spring of last year, even as strong evidence began to emerge from other analysts and investors that the communications company was under financial duress, people with knowledge of the inquiry say.

On Jan. 8, 2001, for instance, CIBC World Markets, a unit of Canadian Imperial Bank of Commerce, published a research report raising concerns about the company's finances. Later, on March 8, 2001, high-profile short seller Manuel Asensio blasted the company, saying in a report that the firm "will have to be restructured to have any chance of funding its continuing operating losses."

Mr. Grubman maintained a "speculative buy" recommendation and his $50 price target on the company's stock until April 17, 2001, the day after the company announced that it missed a crucial interest payment on its debt. Winstar made its bankruptcy filing a couple of days later. In various notes to investors between January and March that year, Mr. Grubman attacked Winstar's critics. Mr. Asensio, he said, "made statements which we believe were either incomplete, inaccurate or inconsistent with our analysis," Mr. Grubman wrote in a research report the day after Mr. Asensio's. "It is evident that this short seller lacks an understanding of the" industry.

The stock-market rout has led to a chorus of catcalls from investors who lost money following the stock recommendations of former stars such as Mr. Grubman. The concern is that analysts' research and banking roles created a conflict of interest, and thus they were overly bullish on stocks, fearful that they and their companies would lose banking fees if they became bearish.

According to a copy of his employment package, his $200,000 base salary was augmented by guaranteed bonuses of at least $11.8 million and $7.8 million for 1998 and 1999, respectively, with bonuses for the remainder of his contract through December 2003 left to the discretion of senior Salomon Smith Barney executives. Mr. Grubman conceded in his congressional testimony that at least part of his pay involved helping the firm win investment-banking business. Thomson Financial Securities Data, which tracks underwriting work done by Wall Street firms, estimates that Salomon made more than $10 million working on various transactions for Winstar.

The NASD, along with other stock regulators, has issued a series of proposed new rules in the past year attempting to minimize analyst conflicts—such as a controversial practice in which analysts appear at pitch meetings to help bankers win underwriting assignments. Just last week, Citigroup, in an apparent bid to quell the controversy, called for rules to further sever ties between banking and research by barring analysts from playing a major role in helping win banking business. And rival firms have taken other steps to cut the conflicts.

Mr. Grubman also maintained positive outlooks on other Salomon clients, including Worldcom Inc., Global Crossing Ltd., XO Communications and McLeod USA, even as their shares and business outlooks began to erode.

The NASD recently disclosed its intentions to both Mr. Grubman and his firm through a so-called Wells Notice, which gives both Salomon and the analyst the chance to refute the claims before the self-regulatory agency decides to take action. Mr. Grubman disclosed the NASD's intention in an amendment to his brokerage records, filed on Thursday.

The amendment states that the NASD "has informed Mr. Grubman that he is the subject of an investigation relating to research coverage of Winstar Communications Inc., and that the enforcement staff has made a preliminary determination that violations have occurred."

Mr. Grubman's brokerage records also have been updated with the NASD to include 34 complaints from customers, many of which allege that he misled investors on some of his top picks, such as WorldCom and Global Crossing, during the go-go years of the telecom boom. Many allege that Mr. Grubman failed to disclose alleged conflicts of interest involving his banking work when he issued his recommendations.

The NASD's action is sure to grab the attention of Wall Street's research community, which has come under intense scrutiny for its practices during the long bull market.

One of the most far-reaching of these inquiries comes from New York Attorney General Eliot Spitzer, who has alleged that Merrill Lynch and its former Internet analyst Henry Blodget issued misleading research on Merrill banking clients. Merrill agreed to pay a $100 million fine and make changes in its research process to settle the matter.

Recently, some senior officials in the New York Attorney General's office concluded that they have enough evidence to charge Mr. Grubman with violations of New York State law, people familiar with the matter said.

But over the long term, any NASD action could bring the most clout. In its potential case against Mr. Grubman, people close to the matter say, the NASD enforcement staff isn't necessarily looking at his motive for touting stocks, such as earning a bigger bonus for helping the firm obtain banking business. Instead, the NASD may allege that analysts can no longer hype stocks in the face of reasonable evidence to the contrary, these people say.

"Under NASD rules, an analyst or a broker must have a reasonable basis to make a recommendation to buy a stock," says securities lawyer Jacob Zamansky, who represents investors who take legal action against Wall Street firms. "If an analyst says a $10 stock is going to $70 he must have a reasonable basis for making that call, if not, it's a violation of the rules," Mr. Zamansky says.