

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. CE4050006

TO: Department of Enforcement
NASD

RE: John B. Hoffmann, Respondent, CRD No. 247933
Kevin J. McCaffrey, Respondent, CRD No. 1879348

Pursuant to Rule 9216 of NASD Code of Procedure, John Hoffmann and Kevin McCaffrey (together "Respondents") submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against either Respondent alleging violations based on the same factual findings.

Each Respondent understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against him; and
3. If accepted:
 - a. this AWC will become part of each Respondent's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against him;
 - b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about each Respondent's disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. Respondents may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC

or create the impression that the AWC is without factual basis. Nothing in this provision affects either Respondent's testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which NASD is not a party.

Respondents also understand that their experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

John Hoffmann entered the securities industry in 1964 as a research analyst with Smith Barney, then a member of NASD. He became director of U.S. equity research at Smith Barney in approximately 1988 and director of Global Research in 1995. After Smith Barney merged with Salomon Brothers in 1997 to form Salomon Smith Barney, Hoffmann was director of Global Equity Research of SSB until February 2003. He retired from Citigroup Global Markets, formerly Salomon Smith Barney, in May 2003.

Kevin McCaffrey entered the securities industry in 1988 as a general securities representative. He joined Smith Barney as head of New York institutional equity sales in 1994 and became deputy director of equity research in 1995. McCaffrey became director of U.S. Equity Research at SSB after Smith Barney merged with Salomon Brothers in 1997. He continued in that position until October 2002.

Neither Respondent has any prior disciplinary history.

I.

WAIVER OF PROCEDURAL RIGHTS

Each Respondent specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against him;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, each Respondent specifically and voluntarily waives any right to claim bias or

prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Each Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II.

ACCEPTANCE AND CONSENT

Each Respondent hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by NASD:

Summary

In 2000 and 2001 (the "relevant period"), John Hoffmann, as the director of Global Equity Research, and Kevin McCaffrey, as director of U.S. Equity Research at Salomon Smith Barney, Inc. (now Citigroup Global Markets, Inc.) ("SSB"), were supervisors of Jack Grubman, once one of the most prominent research analysts at SSB and on Wall Street.

Hoffmann and McCaffrey failed to supervise Grubman adequately with a view to preventing him from publishing fraudulent research on Focal Communications Corp. and Metromedia Fiber Networks, Inc. and from publishing research on RCN Communications, Williams Communications Group, Level 3 Communications, Adelphia Business Solutions, and XO Communications that violated NASD's advertising rule (Rule 2210). Each of these companies was an SSB investment banking client. 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.

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. Hoffmann and McCaffrey failed to respond adequately to red flags concerning investment banking pressure on Grubman not to downgrade the firm's banking clients.

As a result of their failure to supervise Grubman adequately with respect to the research described herein, Hoffmann and McCaffrey violated NASD Conduct Rule 3010.

1. McCaffrey and Hoffmann Were Supervisors of Grubman

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.

Hoffmann and McCaffrey both participated in the process of Grubman's annual performance review and in determining Grubman's salary and bonus. Investment banking revenue generated from companies in an analyst's sector was a significant factor in determining analyst's compensation at SSB. 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 2000¹ (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).

2. Grubman Issued Fraudulent and Misleading Research on Certain Telecommunications Companies

As NASD previously found, Grubman and SSB issued fraudulent research reports on two companies, Metromedia Fiber Networks, Inc., and Focal Communications Corp., 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. Grubman also published research on RCN Communications, Williams Communications Group, Focal Communications, Level 3 Communications, Adelphia Business Solutions, and XO Communications that violated NASD's advertising rule, Conduct Rule 2210. Each of these seven companies was an investment banking client of SSB. See *In re Jack Benjamin Grubman*, NASD Letter of Acceptance, Waiver and Consent No. CAF 030027 (April 24, 2003); *In re Citigroup Global Markets, formerly known as Salomon Smith Barney Inc.*, NASD Letter of Acceptance, Waiver and Consent No. CAF 030018 (April 24, 2003).

¹ 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.

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 warning signs.

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

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.

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

In practice during the relevant period, however, SSB's research analysts rarely rated companies a 4 (Underperform) and never a 5 (Sell).

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.

Respondents failed to respond adequately to red flags that certain of Grubman's ratings were unreasonably positive.

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. 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.

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.

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. 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.

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.

4. Respondents Failed to Respond Adequately to Red Flags Concerning Grubman's Price Targets

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.

As noted, the share price of many of the emerging telecommunications stocks Grubman covered plummeted in 2000 and 2001. 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.

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."

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.

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.

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."

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.

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.

Among the "buy" rated stocks covered by Grubman that had unrealistic price targets were certain of the companies noted above: Williams Communications Group, Inc. (stock price \$16, target price \$70, 340% upside), Level 3 Communications Inc. (stock price \$34, target price \$130, 288% upside), RCN Communications (stock price \$16, target price \$50, 211% upside), Adelphia Business Solutions (stock price of \$5, target price of \$15, 192% upside), XO Communications (stock price of \$21, target price of \$60, 186% upside), and Metromedia Fiber Network (stock price \$19, target price \$53, 180% upside). 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."

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.

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.

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

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.

Similarly, in a November 2000 e-mail responding to another complaint about Grubman's research, Hoffmann 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 no[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)

Hoffmann, however, did not participate in any such call with Grubman.

In April 2001, one of Grubman's stocks, Winstar Communications, Inc., declared bankruptcy. Grubman had maintained a buy rating and a high price target on Winstar until shortly before the company declared bankruptcy. 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.

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.

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

6. Violations

As found previously by NASD, Grubman issued fraudulent research during the relevant period on Metromedia Fiber and Focal Communications and issued research on RCN Communications, Williams Communications, Focal Communications, Level 3 Communications, Adelphia Business Solutions, and XO Communications that violated NASD's Advertising Rule, Conduct Rule 2210. Hoffmann and McCaffrey each violated NASD Conduct Rules 3010(a) and 2110 by failing to supervise Grubman's activities with a view towards preventing his violations of federal securities laws and NASD Rules.

SANCTIONS

Each Respondent also consents to the imposition, at a maximum, of the following sanction:

For John Hoffmann:

- a censure;
- a total penalty of \$120,001 (\$1 as disgorgement and \$120,000 as a civil money penalty) as specified in the Order entered by the Securities and Exchange Commission in a related action ("SEC Order"). The monetary sanctions imposed by NASD shall be reduced by the amounts paid by Respondent pursuant to the SEC Order. The payment provisions of the SEC Order are incorporated by reference herein; and
- a suspension of 15 months from acting in any supervisory capacity with any member firm.

For Kevin McCaffrey

- a censure;
- a total penalty of \$120,001 (\$1 as disgorgement and \$120,000 as a civil money penalty) as specified in the Order entered by the Securities and

Exchange Commission in a related action ("SEC Order"). The monetary sanctions imposed by NASD shall be reduced by the amounts paid by Respondent pursuant to the SEC Order. The payment provisions of the SEC Order are incorporated by reference herein; and

- a suspension of 15 months from acting in any supervisory capacity with any member firm.

The sanctions imposed herein shall be effective on a date set by NASD staff.

III.

OTHER MATTERS

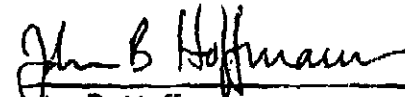
Each Respondent understands that he may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Each Respondent understands that he may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.

Each Respondent agrees to pay any monetary sanctions imposed on him upon notice that this AWC has been accepted and that such payments are due and payable. Each Respondent specifically and voluntarily waives any right to claim that he is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Each Respondent understands that if he is barred or suspended from associating with any NASD member, he becomes subject to a statutory disqualification as that term is defined in Section 3(a)(39) of the Securities Exchange Act of 1934, as amended. Accordingly, he may not be associated with any NASD member in any capacity, including clerical or ministerial functions, during the period of the bar or suspension. (See NASD Rule 8310 and IM-8310-1.)

Each Respondent certifies that he has read and understand all of the provisions of this AWC and has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce him to submit it.

April 14, 2005
Date


John B. Hoffmann
Respondent

04-20-2005 02:00pm From-STILLMAN & FRIEDMAN

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T-078 P.012/012 F-637

Reviewed by:

John B. Harris

John B. Harris, Esq.
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Counsel for Respondent John Hoffmann

Date

Kevin J. McCaffrey
Respondent

Reviewed by:

Guy Patrillo, Esq.
Dechert LLP
30 Rockefeller Plaza
New York, New York 10112
Counsel for Respondent Kevin McCaffrey

Accepted by NASD:

Date

James E. Day
Director, Chief Counsel
Signed on behalf of the Director of ODA,
by delegated authority

Reviewed by:

John B. Harris, Esq.
Stillman & Friedman, P.C.
425 Park Avenue
New York, New York 10022
Counsel for Respondent John Hoffmann

4/27/05
Date

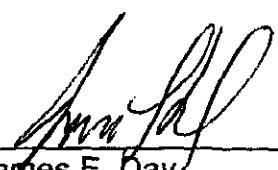

Kevin J. McCaffrey
Respondent

Reviewed by:


Guy Petrillo, Esq.
Dechert LLP
30 Rockefeller Plaza
New York, New York 10112
Counsel for Respondent Kevin McCaffrey

Accepted by NASD:

May 2, 2005
Date


James E. Day
Director, Chief Counsel
Signed on behalf of the Director of ODA,
by delegated authority