

NASD DISPUTE RESOLUTION AWARD
NASD DISPUTE RESOLUTION

CASE: 03-00286

Patrick & Patricia Sweeney, Claimants v. Citigroup Global Markets, Inc., f/k/a Salomon Smith Barney, Inc., and Jack B. Grubman, Respondents.

ATTORNEYS:

For Claimants, Patrick & Patricia Sweeney, ("Claimants"), appeared James Richard Hooper, Esq., Hooper & Weiss, L.L.C., Orlando, FL.

For Respondents, Citigroup Global Markets, Inc., f/k/a Salomon Smith Barney, Inc., and Jack B. Grubman, ("Respondents"), appeared Bradford D. Kaufman, Esq., Greenberg & Traurig, P.C., West Palm Beach, FL.

NATURE OF THE DISPUTE: Customer v. Member and Associated Person

DATE FILED: January 13, 2003

CASE SUMMARY: Claimants contend in their Statement of Claim that they were defrauded by Respondents as a result of deliberate and willful fraudulent practices in issuing misleading research reports, in failing to disclose material conflicts of interest, in breaching their fiduciary duties, in denying Claimants all benefits of independent and objective analysis and failure in meaningful compliance and supervision. They seek recovery for breach of contract; for breach of fiduciary duties of care, loyalty, full disclosure, fair dealing and good faith; for violation of Section 10b and Rule 10b-(5) of the Securities Exchange Act of 1934; common law fraud; constructive fraud; violations of SRO Conduct Rules; violations of Florida Blue Sky Laws; negligence; failure to supervise; and *respondeat superior*.

OTHER ISSUES: On June 16, 2003, Claimant filed an Amended Statement of Claim reducing the amount of damages requested. Accordingly, the hearing session deposit has been reduced from \$250.00 to \$125.00. In the pleadings, Claimants offered argument in opposition to a Motion to Dismiss the pleadings, which may or may not have been contained in the Answer to Amended Statement of Claim and in Respondents' Supplement to Answer to Amended Statement of Claim. To the extent any motion to dismiss at the pleading stage was contained in the pleadings, it is denied.

Attached as exhibits to the Statement of Claim and Amended Statement of Claim, and offered as evidence, were Assurances of Discontinuance in the New York Attorney General's actions against each of the Respondents. Also attached and offered was the First Interim Report of the Bankruptcy Examiner appointed in the WorldCom bankruptcy. Respondents object to the admissibility of those documents. Respondents are correct in their contention that even if arbitrators may not be bound by formal rules of evidence, nevertheless the evidentiary preclusions against hearsay and the even stronger evidentiary preclusion against admitting settlement agreements are founded in very solid reasons and should not be ignored. The reality is, however, that in order to determine whether the documents are admissible, an arbitrator is required to read them. Once they are read, they are "in evidence" whether formally admitted or not. Therefore, the objection is overruled and the several documents are received in evidence.

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Acceptance of the document in evidence is not a determination it is or is not entitled to probative value. I will assign them such weight and probative value as they merit.

ARBITRATOR'S REPORT:

I find in favor of the Respondents and dismiss all of the claims of the Claimants, with prejudice. The reasons for this decision are enunciated below. Although reasoned awards are unusual in arbitration cases, and were not specifically requested by the parties in this case, the facts and issues presented were extraordinarily complicated and a rigorous analytical approach appeared to be the only way to reach a resolution. The parties may benefit from the results of that analysis.

Claimants' First Count, sounding in contract, necessarily fails as to Respondent Grubman because there are simply no allegations of a contractual relationship between Claimants and Respondent Grubman personally. Nor has a contract, or the terms thereof, been specifically alleged between Claimants and Respondent Citigroup, or its predecessor, Salomon, Smith, Barney. Undoubtedly, there would have been new account agreements, and there are other possible agreements which may have existed depending on the type of account. Unfortunately, none of those agreements were attached to the Statement of Claim. Thus, absent the ability to determine what express contractual duty may have been violated, there is no basis for award of a breach of contract. To the extent the contractual duty violated is the underlying duty of good faith and fair dealing implicit in virtually any contract and in the broker-client relationship, that remedy would be provided, if at all, under the relief requested in Claimants' Second through Seventh Counts.

Claimants' central thesis as to the Second through Seventh Counts is relatively clear. Claimants contend that Respondents owed Claimants fiduciary duties of care, loyalty, good faith, full disclosure and fair dealing. At least as regards Respondent Citigroup, Claimants are correct. Let us assume, *arguendo*, that Mr. Grubman also owed those same duties, even though there is no direct contractual relationship between Claimants and Mr. Grubman. Claimants contend that Respondents violated those duties by failing to advise the investing public in general, and Claimants in particular, that (1) SSB underwrote a large number of offerings of WorldCom stock, and in fact SSB underwrote a substantial majority of the offerings of WorldCom stock to the exclusion of other brokers; (2) SSB received very substantial revenue from its investment banking business in general, and from WorldCom offerings in particular, which may have influenced SSB to support a dubious offering; (3) Mr. Grubman had an unusually close relationship with Bernard Ebbers, the CEO of WorldCom, which was not disclosed but which might have somehow influenced his reports; (4) Mr. Grubman was highly compensated because of earnings made by SSB from investment banking business, which could have influenced him to overstate the desirability of the particular investment for which SSB was the investment banker; (5) Mr. Ebbers had loans owed to Respondent's parent company which were collateralized by WorldCom stock, and thus Respondent had the incentive to keep the stock value high; and (6) in elements also shared with allegations concerning violations of Rule 10-b-(5), common law fraud, constructive fraud, and violations of the Florida Blue Sky Laws, that SSB, acting through Respondent Grubman, failed to meaningfully and objectively disclose the true value and condition of WorldCom.

Before addressing the first five issues of nondisclosure, it is appropriate to address the contentions concerning allegations of non-disclosure or actual misstatements of the true


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condition of WorldCom. Through all of the time that Claimants owned WorldCom stock, which period ended in December of 2000, the financial reports which WorldCom issued and disseminated displayed earnings and financial performance at or above analysts' expectations. The Research Reports issued by Mr. Grubman contained carefully reasoned analyses of the company's financial statements, contained a clear explanation of the underlying assumptions on which he based his analyses, and usually contained discussion that his views were not generally shared by the investing public. There is no question that Mr. Grubman was strongly favorable in his comments about WorldCom and, in fact, his comments continued through 2001 into early 2002, well after Claimants had sold all their WorldCom stock. There is no question that his predictions proved to be wrong. However, just because hindsight tells us a prediction proved wrong does not mean the prediction was false when made. Some of the documents offered by Claimants strongly imply Mr. Grubman distorted his reports about other companies for which SSB was the investment banker, but there is no evidence in this record at all to suggest that Mr. Grubman's private beliefs about WorldCom were at variance with his published beliefs in the Research Reports and Call Reports related to WorldCom. Simply put, even if he deliberately misstated his opinion about other companies, that does not give rise to proof he did so with respect to WorldCom. In addition, there is no basis, at least in this record, to hold Respondents liable to discover a fraud perpetrated on the investment public by WorldCom. Although that fraud was ultimately revealed by WorldCom toward the end of the first quarter of 2002, no evidence is shown that the statements made by Mr. Grubman in the Research Reports were knowingly false as related to the future performance of WorldCom, or his estimates of the company or the industry.

Nor are the Research Reports responsible for any decline in value of the WorldCom shares. WorldCom stock peaked in mid-1999 and began to decline thereafter. Although there were intervening rises, generally over the ensuing period leading up to the bankruptcy (a period of almost three years), WorldCom stock demonstrated a steady downward trend. However, while WorldCom stock declined more rapidly than other telecommunications stocks, telecom stocks in general began to decline toward the latter part of 1999 and have declined steadily ever since. Only recently have those stocks begun to show any significant improvement. Also, the performance of the overall market declined significantly during that same period.

Claimants purchased roughly half their stock in the early part of 1998, and that stock rose rapidly until mid-1999, and then began to decline. Claimants bought additional stock in early 2000, possibly under a belief (shared by effectively all of the telecom analysts reporting on WorldCom stock), that the stock was undervalued, that it was basically a sound company and that its value would return. They sold all of their stock in WorldCom in mid-December of 2000, after a year-long decline in the market for telecom stock generally, and almost a year and a half decline in the value of WorldCom in particular. There is no way to discern from the record whether the decision to sell when they did was based on tax considerations or perhaps some other concerns.

It is clear that the market in general caused the ultimate loss in the value of WorldCom stock through at least early 2002, and that revelation of the company's accounting irregularities in early 2002 spelled the end. It is equally clear that research reports issued by SSB, or any other analyst for that matter, did not contribute to loss in the value of the stock. To the extent of his analysis of WorldCom's financial performance and financial prospects, I do not find any knowing misstatement of a fact, an indication that Mr. Grubman's private views diverged from his public views, or any departure from reasonable performance standards an analyst should follow. Therefore, to the extent the content of the reports themselves, and specifically a




contention Respondents failed to disclose the true condition of WorldCom, I find no basis for an action against either Respondent.

But saying that the Research Reports and Call Reports did not cause the decline in value of the stock or culpably fail to disclose WorldCom's true condition is not really the central issue, and certainly does not dispose of the remaining four areas of alleged concealment. The central issue raised by Claimants is whether or not the Research Reports caused their loss. Specifically, they contend that but for the omitted disclosures in these reports, they would not, or at least might not, have purchased the stock to begin with. Claimants contend that the reports are misleading and are violative of the various statutes, not only for what they contain, but for what they do not contain. Specifically, as noted above, Claimants contend the Research Reports were fraudulent (or at the very least contained misrepresentations) because of omissions of material fact.

To prevail, Claimants have to demonstrate a number of elements, most of which are relatively easy. First, they have to demonstrate that Respondents made a statement in connection with the purchase or sale of a security. The Research Reports issued by SSB would satisfy that requirement. They seem inarguably tied to recommended sale of securities, and there is a "statement", although in this case it is actually an omission. Claimants contend correctly that if the facts prove material Respondent SSB had a clear duty to reveal them, and because he was a regulated person for purposes of this analysis we can assume Mr. Grubman did as well.


As the second element, Claimants have to demonstrate that they justifiably relied on the misrepresentations. Respondents contend they could not have relied, because a professional portfolio manager managed their account. One should note that other than a reference to the account type contained in the account statements, which is unexplained except in legal argument, there is no factual basis to determine whether the account was managed or not, and more significantly, what the scope of the manager's discretion may have been. One should also note that if it were a typical managed account, that would make the account a discretionary account, thus imposing on Respondents a heavier fiduciary burden than would be the case for nondiscretionary accounts. It is probably of minor importance to the analysis whether the account was discretionary or not. Claimants correctly point out that in cases of omission, reliance is presumed unless Respondents can rebut the presumption and offer evidence that Claimants did not rely. The only evidence before me is Claimant's statement via affidavit that he relied on the reports and would not have purchased the stock but for Mr. Grubman's enthusiastic recommendation. Thus, whether it is because of un rebutted presumption or uncontroverted evidence, the reliance element is satisfied.

The third element Claimants must satisfy for most of the causes of action is to demonstrate that their damages were the proximate result of the omission. Respondents have argued, and I have discussed above, that the Research Reports were not the cause in the decline in value. That is not, however, the issue. Claimants contend they experienced a loss because they bought a stock based on the Research Reports and they contend that had they known of Mr. Grubman's and SSB's conflicts of interest, they might not have bought the stock. In the discussion below as to the materiality of the omitted information, I have agreed with Claimants argument that the missing information was material because it might have made a difference in their decision. Extending that logic to causation is tenuous. For causation, Claimants have to demonstrate positively they would not have bought the stock had they been supplied with the missing



information. The affidavit they offer in evidence does not directly support that element. Nevertheless, I will assume, for purposes of this discussion, that the causation element is or at least can be deemed satisfied, applying the same analysis as for reliance. I note in passing that *for one of the causes of action*, rescission sought under Ch 517.301 and 517.211, Claimants do not have to show loss causation; they merely have to show negligent misrepresentation in order to rescind the sale or recover the money they paid. Unfortunately, that applies only in cases where there is privity between a seller and a buyer, and I also note that privity is not evident here.

Unfortunately, there are several remaining elements of the various causes of action, and those elements are more problematic. Claimants have to demonstrate as a fourth element that facts were omitted. This element is probably the most critical for Claimants' position, was the most difficult to establish from the record, and ultimately proves most fatal to the relief Claimants seek. As noted above, Claimants contend the research reports were defective because they did not disclose that SSB had a disproportionate share of the investment banking opportunities presented by WorldCom and that the fees derived by SSB from those public offerings they underwrote were very substantial. Unfortunately for Claimants, the research reports and call reports in most cases clearly disclose that SSB participated in public offerings of WorldCom stock, and published news reports during that same period of time demonstrated the magnitude of the fees that SSB were earning in its investment banking business. Disclosure of elements such as making a market in a stock or participating in public offerings of a stock is intended to *show the possibility of bias*. SSB satisfied the requirements imposed by subsequent regulatory changes related to such disclosures, and did so prior to the time those regulations were enacted. Claimants also contend that it was not disclosed that Mr. Grubman was highly compensated because of earnings made by SSB from the investment banking business, and, more specifically, that Mr. Grubman's compensation was directly tied to those earnings. Claimants are accurate that the research reports do not directly disclose that information, and Claimants are correct that subsequent regulatory changes would make such disclosures necessary. Respondents are correct, however, that disclosure of that information was not regulatory demanded at the time, and, more significantly, that the magnitude of Mr. Grubman's compensation was hardly a secret. While the precise details of Mr. Grubman's compensation, or for that matter, SSB's degree of participation in WorldCom public offerings may not have been disclosed in the research reports and call reports, in my view there was sufficient information actually presented to inform a prospective purchaser of possible bias and cause them to act accordingly. One contention made by Claimants in the area of non-disclosure, however, leads to serious concern. Specifically, it is the Claimant's contention that loans made to Mr. Ebbers by Respondent's parent company were collateralized by WorldCom stock, that because its parent held WorldCom stock as collateral, SSB itself would be motivated to keep the value of WorldCom stock as high as possible and thus SSB may have had an incentive to over-promote the stock and that this potential conflict should have been disclosed. *If true, this conflict of interest would be of far greater significance than the other potentials for conflict*, and there is little real likelihood Claimants would learn of it apart from disclosure by Respondents. Consequently, there is much less justification for imposing on Claimants any sort of inquiry obligation or public knowledge impediment to the portion of their claim related to non-disclosure of such a business relationship. Unfortunately for Claimants, there is virtually no factual information of any kind in this record to support their contention. While there are inferences about such loans in some of the documents offered by Claimants, no matter how closely one reads them there is no direct proof and only the vaguest of hearsay that there was any kind of a business relationship between Respondent's parent company and Mr. Ebbers at all, what the precise nature of that relationship may have been, or that either SSB or




Mr. Grubman had any knowledge at all about that relationship, whatever it may have been. It is inappropriate to impose liability for failure to disclose "facts" which may not exist or about which one may have no actual or constructive knowledge.

Thus, I am unable to find that facts were omitted, either because the information was in fact supplied in sufficient detail to satisfy any need to notify Claimants of possible bias, or else because I am unable to find that the facts exist at all. I therefore find Claimants have not satisfied this element of their various causes of action.

The fifth element Claimants must satisfy is that the omitted facts were material. The logic in the preceding paragraphs relates in part to analysis of the materiality of the facts which Claimants contend are omitted. Claimants have contended, in my view correctly, that omitted facts are material if they could lead a reasonable investor to a different investment decision. As to some of the allegedly omitted information, using the analysis above I cannot find that there were any facts to begin with. As to the remainder (the degree to which Mr. Grubman's compensation was related to investment banking income of SSB, the extent of SSB's income from WorldCom offering, and the disproportionate share of WorldCom public offerings in which SSB participated), the existence of that information was either disclosed in the reports or generally available to the investing public. As will be discussed in the seventh element below, to some extent at least Claimants must be charged with information in the public domain. I concur with Claimants contention the information might influence the decision of a reasonable investor, but to the extent I can find any facts exist, they were sufficiently disclosed.

The sixth element requires a showing that the omission was purposeful and made with *scienter*. *Scienter* is, for purposes of federal securities actions, established by knowing or extremely reckless statements. Section 517.301, Florida Statutes, lowers the bar and requires for *scienter* only negligent misrepresentation, but alternatively does require privity between buyer and seller, which is not required in federal securities actions. In my view, the *scienter* element for federal securities purposes is not satisfied at all. Because I do not find the record demonstrates any misrepresentation based on omission of material facts, it necessarily leads to the conclusion that there is no negligent misrepresentation. Claimants are thus unable to satisfy this element as well, based on the factual showing in this record.

Lastly, Claimants must show as the seventh element of most of these causes of action that they acted with due diligence, care and good faith to protect their own interests. This is derived from the requirement that reliance be justifiable. Under Florida law, there is no general duty of inquiry to enable one to justifiably rely on a representation, unless one knows the representation is false or its falsity is apparent. Conversely, the entitlement to rely on a representation ultimately gives way to the more specific duty to look further if the facts that are disclosed suggest a legitimate concern for the accuracy or completeness of the representation. One must tread very careful ground here, because even though in a particular case inquiry is mandated, the strong general rule in Florida favors disclosure and places the burden on the person making the representation, and the exception should not be permitted to swallow the rule. Respondents, in the Research Reports, disclosed there were potentials for bias due to the fact that SSB was making a market in the stock and had participated in public offerings. In my view, that is a sufficient basis to find Claimants thereby had sufficient notice of possible bias to impose a duty to inquire further about the possible extent of that bias, if they felt such potential bias sufficiently relevant that it might affect their decision. Moreover, it is inappropriate, in my view, to ignore the numerous articles suggesting that a sell-side analyst might have an incentive to support a



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stock whose offering was being underwritten by his employer. It should be emphasized all the allegations of omitted information related to possible sources of bias, and the existence of this particular source of potential bias is so widely reported it would be difficult for Claimant or any other investors not to have known of it. Thus, in my view, Claimants are ultimately unable to satisfy this element.

Claimants' final two causes of action, found in their eighth and ninth counts, relate to failure to supervise and liability founded on the doctrine of *respondeat superior*. Respondent SSB had an obvious duty to supervise its employees and an obvious liability for misconduct by its employees while engaging in their normal duties. Because I find no actionable conduct by Respondent Grubman, there is no basis for derivative liability imposed on Respondent SSB under either the eighth or ninth counts.

Claim Data

Claim: \$3,245.39
Interest: Unspecified
Punitive Damages: Unspecified
Attorney Fees: Unspecified
Filing Fees: Unspecified
Other: Unspecified

Award Data

Claim: \$.00
Interest: \$.00
Punitive Damages: \$.00
Attorney Fees: \$.00
Filing Fees: \$100.00
Other: \$.00

AWARD: The undersigned arbitrator has decided and determined in full and final resolution of the issues submitted for determination as follows: 1) The claims of the Claimants are dismissed in their entirety. 2) All requests for interest are denied. 3) All requests for punitive damages are denied. 4) All requests for attorney fees are denied. 5) All other relief requests are denied. 6) NASD Dispute Resolution shall retain the \$200.00 filing fee that the Claimants deposited previously. 7) Respondent Citigroup Global Markets, Inc. f/k/a Salomon Smith Barney, Inc. is liable for and shall pay to the Claimants \$50.00 as reimbursement of one-quarter of the filing fee. 8) Respondent Jack B. Grubman is liable for and shall pay to the Claimants \$50.00 as reimbursement of one-quarter of the filing fee.

OTHER FEES: Pursuant to Rule 10333 of the Code, Respondent Citigroup Global Markets, Inc. f/k/a Salomon Smith Barney, Inc. has paid to NASD Dispute Resolution the \$325.00 Member Surcharge invoiced previously.

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ARBITRATOR

Langfred W. White, Esq. - Sole Public Arbitrator

AFFIRMATION

I, Langfred W. White, Esq. do hereby affirm upon my oath as an arbitrator, that I am the individual described herein, and who executed this instrument which is my oath and award.

Langfred W White
Langfred W. White, Esq.

2/24/2004
Date

February 24, 2004
Date of Service (For NASD-DR office use only)