



stock plummeted from approximately \$20 to 14 cents. The Respondents continued to recommend the stock at this price even as the market capitalization collapsed from \$3.46 billion to \$13 million, a loss of more than 99%. In contrast to investor losses, Salomon garnered more than \$24 million in investment banking fees while it helped the company raise more than \$5.6 billion.

2. Winstar was a company that had never been profitable, continued to suffer significant losses, needed large amounts of capital to survive, and was dependent on external sources for financing. By contrast, the Winstar reports written by the Respondents failed adequately to disclose the risks of investing in Winstar stock, including important risks relating to funding and bankruptcy. The reports were uncritically enthusiastic about the company and derided analysts with contrary views. In rebutting those analysts, the Respondents made statements that were false and misleading. Nevertheless, in private e-mails and other internal documents, the Respondents were expressing contrary views. With regard to the Target Price, for example, the Respondents failed to disclose publicly that:

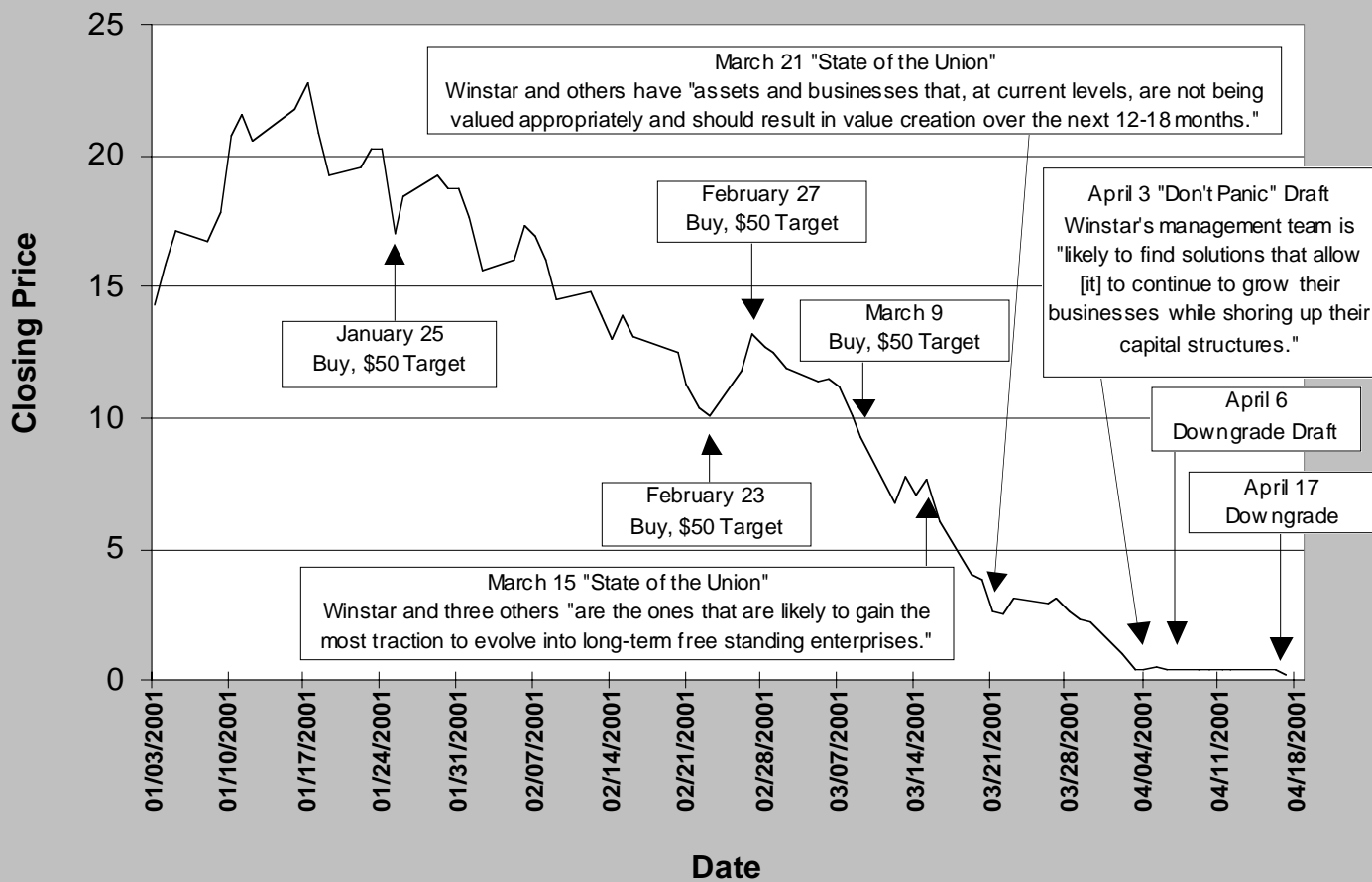
- The Target Price of \$50 was “extremely aggressive”
- The firm was unwilling to change its Target Price because of “optics”
- One of the analysts had privately told others to sell at prices far below the \$50 Target Price.

3. The Winstar reports written by the Respondents did not comply with principles of fair dealing and good faith; did not provide a sound basis for evaluating facts; contained exaggerated, unwarranted, unbalanced or misleading statements or claims about Winstar and opinions such as

the target price for which there was no reasonable basis; and omitted material facts or qualifications which caused the reports to be misleading.

4. The following graph shows Winstar's rapidly falling stock price against Salomon's continued Buy recommendations:

### Winstar's Price and Salomon's Reports



## **RESPONDENTS**

5. Respondent Grubman, CRD No. 1505636, age 48, was first associated with a member firm in January 1985, and he became registered as a general securities representative in approximately September 1999. He was associated with Salomon from March 1994 until August 2002.

6. Grubman was one of Wall Street's most influential telecommunications analysts and was one of the highest paid analysts in the securities industry. When he testified before Congress on July 8, 2002, Grubman stated that his total compensation from Salomon over the past four years averaged approximately \$20 million a year. According to Grubman's testimony before the NASD, he received compensation of approximately \$18 million for the year 2000 and compensation of approximately \$3 million for the year 2001. On August 15, 2002, Grubman resigned from Salomon, and he received a compensation package worth approximately \$32 million.

7. In addition to Winstar, many of the companies that Grubman recommended as "Buys" had strong and profitable investment banking relationships with Salomon. Many of those companies also declared bankruptcy during 2001 and 2002. For example:

- Global Crossing Ltd. – Declared bankruptcy in January 2002
- McLeodUSA Inc. – Declared bankruptcy in January 2002
- Adelphia Business Solutions, Inc. – Declared bankruptcy in March 2002
- FLAG Telecom Holdings Ltd. – Declared bankruptcy in April 2002
- Williams Communications Group, Inc. – Declared bankruptcy in April 2002
- Metromedia Fiber Network, Inc. – Declared bankruptcy in May 2002
- XO Communications, Inc. – Declared bankruptcy in June 2002
- WorldCom, Inc. – Declared bankruptcy in July 2002

8. Respondent Gochuico, CRD No. 2794210, age 33, was first associated with a member firm in May 1995, and she became registered as a general securities representative in approximately September 1996. She assisted Grubman in analyzing and writing research reports on telecommunications companies. She and Grubman jointly wrote the Winstar reports.

### **OTHER PARTIES**

9. Salomon Smith Barney Inc. has been registered as a member since 1936. The firm has more than 700 retail branches and employs over 23,000 registered persons. Salomon's income is derived from a full line of services, and during the first half of 2001, twenty-five percent of its revenue came from investment advisory and underwriting fees.

10. Winstar, which traded on the Nasdaq National Market using the symbol WCII, was a provider of broadband telecommunications services. It competed in the capital-intensive competitive local exchange carrier, or CLEC, industry with "Baby Bells" to provide "last-mile" networks to businesses. Winstar offered local and long distance voice services, broadband data services and web hosting, among other services. It specialized in fixed wireless technology and was attempting to build a national network.

11. During the period relevant to this proceeding, Winstar suffered significant losses, needed large amounts of capital to operate and was heavily dependent on external sources for financing. As Winstar explained in its November 14, 2000, Form 10-Q:

"We have incurred significant operating and net losses, due in large part to the development of our network and the growth of our sales and marketing organization. We anticipate that such losses will continue over the near term as we execute our growth strategy. We are pursuing the continued expansion of services offered to our current 60 U.S. markets. We are also planning to offer our services in up to 50 foreign markets by the end of 2004. This expansion will require significant amounts of capital to finance capital expenditures as well as anticipated losses."

12. In addition, Winstar's Form 10-Q disclosed a number of specific risk factors,

including:

- “the willingness of the marketplace to accept fixed wireless services generally, and our Wireless Fiber(SM) services in particular, as an acceptable alternative to other available communications technologies and rapid technological innovation bringing on constant enhancements in communications;
- “our ability to penetrate our targeted markets, which are dominated by much larger entrenched competitors, and attract and retain a sufficient revenue-generating customer base;
- “our ability to obtain sufficient capital to finance the buildout of our domestic and international telecommunications network, fund our projected operating losses and service our debt obligations, which may be dependent on the state of the financial and capital markets;
- “the general condition of the economy and the financial markets, particularly within the telecommunications and technology sector which has historically been even more volatile than the markets as a whole;
- “changes in the regulatory environment which may directly affect: the breadth of services which we and our competitors may offer and the terms of those services, the size and number of our competitors, our ability to obtain necessary access to customer buildings in order to provide our services, and our use of our spectrum assets;
- “the impact of capital market volatility and other events or circumstances affecting our customers, including those of our large accounts solutions business, and our major suppliers”

13. Winstar sustained significant losses. As of September 30, 2000, Winstar had over \$2 billion in accumulated deficits. Moreover, for the quarter ended September 30, 2000, it reported a loss of \$227.4 million or (\$2.50) per share. For the year ended December 31, 2000, Winstar had revenue of \$759.3 million, a net loss of \$894.2 million, and (\$9.67) in earnings per share. Net loss to common stockholders totaled more than \$1 billion.

14. On April 5, 2001, Winstar announced a scaled-back business plan, and the layoff of 2,000 employees, or 44% of its work force. Respondents acknowledged that this scale back came about because of Winstar's funding situation. According to Respondents' April 5, 2001, report, this action was "a step in the right direction in addressing [Winstar's] funding gap. . . ." On April 18, 2001, Winstar filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code.

## **THE RELATIONSHIP BETWEEN SALOMON, RESPONDENTS AND WINSTAR**

### **The Investment Banking Relationships**

15. Salomon had significant investment banking relationships with Winstar. During the period from February 1999 through July 2001, Salomon was lead manager, joint manager or advisor on ten Winstar equity, bond and financing transactions worth more than \$5.6 billion. For those services, Salomon received fees of approximately \$24 million.

16. Indeed, even as Winstar's prospects were falling and its stock plummeting, Salomon worked with Winstar to address its funding needs. In March 2001, Winstar retained Salomon to assist it with respect to a proposed acquisition. Thereafter, Salomon and Winstar worked together in connection with a number of other actual and potential transactions. On April 2, Salomon and Winstar began to discuss a potential debtor-in-possession (DIP) financing transaction. In July 2001, Salomon served as Lead Bookrunner for a \$175 million DIP financing, receiving \$500,000 for its services.

### **The Research Relationship**

17. Respondents initiated research coverage of Winstar with a Buy rating in January 1998. At that time, Winstar's market capitalization was almost \$1 billion. Respondents

maintained a Target Price for Winstar of \$50 per share from October 3, 2000, when Winstar's market capitalization was worth approximately \$2.8 billion, until April 17, 2001. By that time, Winstar's market capitalization had fallen to approximately \$13 million, a loss of approximately \$2.787 billion, or more than 99 percent. At that point, Respondents finally downgraded the stock from a Buy rating to an Underperform rating and suspended the Target Price.

18. Grubman had known several of Winstar's senior managers since the 1980s when those managers had worked for other telecommunications companies and Grubman had worked for either AT&T Corporation or a member firm as an analyst. The Chairman and CEO of Winstar spoke at a Salomon conference in January 2001 on telecommunications, media and entertainment.

19. Respondents worked closely with Winstar management. They relied on and sought approval from Winstar's management prior to drafting their research reports and models, which purportedly reflected Respondents' independent judgment and analysis. For example, in January 2001, when an analyst at another firm issued a negative report on Winstar, Respondents contacted Winstar for help in refuting the opinion of that analyst. Moreover, on at least two occasions, Respondents sent Winstar officials the financial model that Respondents created to analyze Winstar, and which yielded the Target Price. On at least one of those occasions, Respondents sent the model for approval before making it publicly available. For instance, on April 6, 2001, Respondent Gochuico wrote the following e-mail to a Winstar official:

“Attached is our updated model which we will mail out clients next week and post to our website. I know longer term is difficult -- even year end of 2001. If atleast [*sic*] you can give me the OK on Q1 that'd be helpful since there's no turning back once its [*sic*] up on our website.”

## **OVERVIEW OF WINSTAR REPORTS**

20. From January 25, 2001 through April 17, 2001, Respondents authored research reports that recommended the purchase of Winstar stock with a Buy rating and a Target Price of \$50 per share. During this time, Winstar's stock price fell more than 99 percent -- from approximately \$20 per share on January 24, 2001 to \$0.14 per share on April 17, 2001.

21. The reports authored by Respondents omitted material facts and failed to disclose risks of investing in Winstar. In addition, the reports contained repeated statements of strong praise for Winstar while belittling and attacking other analysts who were critical of the company. For example, in the January 25, 2001 note, Respondents attacked an analyst from another firm who had written, among other things, that Winstar "may not be as well funded as many believe." Respondents countered that the analyst, whom they referred to as a "competitor" who "actually does NOT follow Winstar," made statements that were "highly irresponsible" and "unfounded." After rebuking the other analyst, Respondents sang the praises of Winstar, stating that "we do not anticipate any negative changes in 2001 guidance" from the company and Winstar "remains one of our favorite CLEC names." Respondents went on to say that "we would take advantage of any weakness in [the] stock."

22. Similarly, in March 2001, another analyst expressed several concerns about Winstar, including concerns about its funding. Respondents attacked that analyst in their March 9, 2001 report, stating that the analyst "lacks an understanding of the CLEC industry," that the concerns were "misplaced" and "misguided," and that the report "contained certain information that were [sic] either incomplete, inaccurate or inconsistent with our analysis." Respondents' report concluded by stating that Winstar "continues to remain one of our favorite names in the CLEC space, and would buyers [sic] at these levels – nearly their 52 week low."

**RESPONDENTS' NON-PUBLIC  
COMMUNICATIONS REGARDING WINSTAR**

23. Respondents made non-public recommendations that were contrary to the publicly disclosed Target Price of \$50. E-mails and other non-public documents demonstrate that Respondents' assumptions, as set forth in their public research reports and notes, were in many cases unreasonable or without basis.

a. For example, on February 20, 2001, when Winstar stock was trading at approximately \$13 per share, Respondent Gochuico sent the following e-mail, recommending that the recipient sell in the low \$20s, instead of at the Target Price of \$50:

“WCII report[s] “earnings” next week – on the 28<sup>th</sup>. They typically beat numbers. At \$13 they are trading at 1.5x net PP&E vs peers at 3x. I think I’d buy here and sell in the low \$20s. The shorts loveshorting this stock but we have some smart buyers in there. [We] recently spoke to Peter Lynch (Fidelity guru) about WCII and he seemed pretty interested. Downside from here may be \$2-3 pts.”

b. On February 26, 2001, when the stock was trading at approximately \$11 per share, Respondent Gochuico sent the following e-mail, recommending that the recipient sell Winstar stock for between \$20 and \$30 per share, and not at the Target Price of \$50:

“I think you know the exit point I have on WCII 20 to 30 although low 20s would be pretty good return. I’ll let you know if my thoughts change.”

c. On February 28, 2001, when the stock was trading at approximately \$13 per share, an institutional investor sent the following e-mail to Respondent Gochuico, questioning the use of certain assumptions in Winstar’s DCF model:

“Why do you guys use 12% perpetual FCF [free cash flow] growth for your terminal multiple?? Seems a little high to me, especially considering that the US and World economy has at best

3% LT sustainable growth rate – using 12% [Winstar’s free cash flow] is pretty soon 100% of the US GDP [gross domestic product] (actually a little over 100 yrs).”

Gochuico immediately replied:

“There really is no good reason – except the unwillingness to change our Target Price for optics; although I would admit \$50 per share is shall we say – extremely aggressive. Typically we try to keep our FCF growth rates to about 10% (by changing the terminal multiple) which would bring our target down to about \$24 (using a 9x FV[firm value]/EBITDA [earnings before interest, taxes, depreciation and amortization] multiple). At a 7x FV/EBITDA multiple (similar to Bells) the DCF value is \$15.”

d. Respondents used the wrong inputs and assumptions to calculate the \$50 Target Price in March 2001. If Respondents had used the discount rate produced by their own weighted average cost of capital calculation, the Target Price would have been reduced by 10%, to \$45. In addition, if Respondents had used the then-current average cost of debt, the Target Price would have been reduced by more than 30%, to the mid-\$30s.

24. In various private communications, Respondents highlighted risks of investing in Winstar and expressed doubts about Winstar’s ability to obtain funds. Those risks and doubts were never disclosed to the investing public.

a. On February 23, 2001, when Winstar’s price was approximately \$10 per share, an institutional investor sent an e-mail to Respondent Gochuico, asking, “You really believe that WCII is good value at these levels??” The Respondent replied, acknowledging that funding was an issue:

“I know where you stand but it might be a good time to cover your short! :) Seriously though, I hope you do make a lot of money on this one but I also hope it doesn’t go to zero since we’ve been so vocal on it.”

\* \* \*

“Funding to FCF [free cash flow positive] is an issue, though. They still need more than \$1 billion (assuming 2<sup>nd</sup> \$1 bil from LU [Lucent] and \$250 mil from CSCO [Cisco] are unavailable) to get to FCF+ [free cash flow positive]. Plus, more detail on customer mix is needed.”

b. On February 26, 2001, Respondent Gochuico wrote to another institutional investor, acknowledging the funding risks:

“On the negative side, funding to FCF is an issue. They still need more than \$1 billion (assuming 2<sup>nd</sup> \$1 bil from LU and \$250 mil from CSCO are unavailable) to get to FCF+”

c. On April 4, 2001, Salomon issued a report entitled “Don’t Panic – Emerging Telecom Model is Still Valid (MORE DETAILS).” The report was published without any references to Winstar because of Salomon’s investment banking activities with Winstar. The April 3 draft, which was not publicly disseminated, disclosed risks about investing in Winstar that were not publicly disclosed in previous reports. The April 3 draft report disclosed for the first time:

- “pressing liquidity issues”
- the need to “shor[e] up [Winstar’s] capital structures”
- “an unfortunate situation where its overleveraged balance sheet and dependency on [Lucent] has overwhelmed what had been one of the better operational stories in the CLEC space over the last 2 years”
- “its funding gap to free cash flow positive is the primary issue given the credit issues at [Lucent], which we had assumed would provide WCII with \$400 million of vendor financing during 2001, and as WCII’s stock continues to reach new lows each day”

- “as the stock continued its downward spiral, its opportunities for sources of funding has diminished and the stock remains speculative”

d. On April 18, 2001, Respondent Grubman sent the following e-mail to a registered representative privately suggesting that investing in Winstar was risky but that investors could make money on another stock in their “basket”:

“. . . I got shutdown on WCII otherwise we would have adjusted the Target Price. To be honest we would have stayed with [sic] the stock but you know my attitude is always to have a basket of aggressive names with the notion that the one of ten who makes it (a la MCI a generation ago) will create value which dwarfs the unfortunate loss of value elsewhere[.]”

While this “basket” approach was referred to in the March 2001 Telecom Industry reports discussed below, it was not disclosed to the public in any of the Winstar-specific reports. Those reports consistently awarded Winstar a “Buy” rating, Salomon’s highest.

e. An April 17, 2001 e-mail from Grubman to Gochuico indicated that they had not performed sufficient research on Winstar:

“After spending evening with [an institutional client] it is clear the buy-side scours 10Ks et al which is why he always thought WCII was a fraud thinks [another CLEC] is fake and discovers [that another telecommunications company] owes \$600 million in unpaid cap ex. Point is we should have [our junior analyst] do this and really dig dirt. Also we do really need to examine true life cycle ROIC [return on invested capital] for our stocks taking into account sunk costs.”

f. Grubman stated in an April 20, 2001 e-mail: “Don’t get me wrong I should be held accountable for WCII.” In a May 18, 2001, e-mail, he stated: “If anything the record shows we support our banking clients too well and for too long.”

### **THE PRICE TARGET**

25. During 2001, as the price of Winstar’s stock plummeted, Respondents maintained a Target Price for Winstar of \$50 per share. The following list shows the dates of Salomon’s Winstar research reports and the price of Winstar on those dates:

<b>Report Date</b>	<b>Target Price</b>	<b>Actual Price</b>	<b>Recommendation</b>
1/25/01	\$50	\$17	Buy
2/23/01	\$50	\$10.0625	Buy
2/27/01	\$50	\$13.125	Buy
3/9/01	\$50	\$9.218	Buy
3/15/01	--	\$7.625	Buy
3/21/01	--	\$2.513	Buy
4/3/01 (Never Issued)	--	\$0.31	Buy
4/6/01 (Never Issued)	\$1.00	\$0.40	Neutral
4/17/01	Suspended	\$0.14	Underperform

26. The Winstar reports written by Respondents stated that a discounted cash flow (DCF) analysis had been used to determine the Winstar Target Price. When using a DCF analysis to compute the theoretical value per share, analysts must estimate a company’s cash flow for a given number of years into the future, estimate the additional value of the company at the end of that period (using a terminal multiple) and then discount those values back to the present using a discount rate. The discount rate is derived from, among other things, the weighted average cost of capital which is a function of the cost of debt and cost of equity.

27. From February 23, 2001 forward, the Winstar research reports written by Respondents failed to have a reasonable basis for the Winstar Target Price. As described above, Respondents failed to disclose in those reports, among other things, that:

- Respondents’ Target Price was “extremely aggressive.”

- Respondents retained the Target Price at \$50 and did not change it because of “optics.”
- Respondents used the wrong inputs and assumptions about, among other things, the cost of debt and discount rate.
- Respondents publicly reported that Winstar’s Target Price was \$50, but one of the respondents had privately told others to sell Winstar stock at far lower prices.

Moreover, as described below, given factors such as Winstar’s deteriorating stock price, its funding gap, its overleveraged balance sheet, its dependency on Lucent, and the bleak capital markets environment, the Target Price had no reasonable basis.

### **THE 2001 WINSTAR REPORTS**

#### 28. The January 25 and February 23, 2001 Reports:

a. The January 25 report was titled “Believe Competitor Report Unfounded; See Weakness As Buying Opportunity.” As noted above, this report criticized an analyst from another firm who had stated that Winstar “may not be as well funded as many believe.” The report stated that the other analyst’s comments were “highly irresponsible.” With regard to funding, the report discussed financing that Winstar had arranged in November 2000, and concluded that those arrangements “should fund them into 2002.”

b. On February 23, 2002, when the market price was approximately \$10, Respondents wrote two versions of a report titled “Reiterate Solid Outlook & Funding; View Weakness as Buying Opp.” The report was written in advance of Winstar’s anticipated February 27 fourth quarter 2000 earnings announcement. The report stated that “we wanted to remind investors that Winstar is currently funded into 2002 . . . as we believe the company continues to suffer from general market concerns over its funding situation and potentially

onerous interest payments on vendor financing.” In the report, Respondents “reiterat[ed] our solid outlook” for Winstar and “the company’s fully funded position,” stating that Winstar “remains one of our favorite names in the CLEC sector, and we believe it is dramatically oversold at current levels. We would use any weakness to be aggressive buyers. . . .”

c. The January 25 and February 23 reports failed to disclose any risks of investing in Winstar stock. In particular, the reports failed to disclose any risks related to funding, including Winstar’s need to raise additional funds, when it would need to do so, how much additional funds would be needed, and the risk that Winstar might not be able to raise the necessary funds.

29. The February 27, 2001 Report: On February 27, 2001, Respondents disclosed for the first time that Winstar would need to raise \$1 to \$1.5 billion. However, in doing so, Respondents downplayed the significance of the funding gap. The report was titled “Q4 Beats Expect; Pervasive Connectivity Drives Growth & Profitability” and it contained effusive praise for Winstar, including statements that Winstar:

- “reported very strong 4Q’00 results”;
- “continues to perform above expectations and in fact, is driving metrics that are quickly becoming the accepted industry standard”;
- has a “facilities-based footprint unmatched in terms of expansiveness of network versus the vast majority of the industry”; and
- “continues to perform superbly.”

While the report announced, for the first time, that Winstar had funding needs, it omitted any discussion of the risks associated with a need to raise such a large amount of capital:

“[W]e all understand that WCII does need to raise \$1.0-\$1.5 billion at some point in 2H’02 in order to get them to free cash flow positive by

2004. We fully expect that if WCII's results continue to perform as they've been doing, there will be no issue with WCII being able to obtain needed external financing over the course of the next 4-5 quarters."

Respondents concluded by stating that: "We continue to view WCII as one of our top core holdings in the CLEC space and we would be aggressive buyers of the stock." The report failed to disclose any risks of investing in Winstar stock, including the risks associated with the need to raise additional funds.

30. The March 9, 2001 Report: The March 9, 2001 report was titled "Contrary to Other Opinions, We Believe WCII has Ability to Finance Debt."

a. As described above, another analyst had expressed concerns about Winstar's funding. In response, Respondents stated that "We are reiterating our belief that WCII is well funded into 2002 in response to a press release from [another analyst] who has concerns about WCII's funding." Respondents repeated the statement that they had made previously regarding Winstar's need for additional funds and its ability to obtain that capital:

"It is not a secret that WCII needs to raise \$1.0-\$1.5 billion in order to get to free cash flow positive by 2004. We fully expect that operationally if WCII's continue [*sic*] to perform as they've been doing, there will be no issue with WCII being able to obtain needed external financing over the course of the next 4-5 quarters."

b. The other analyst had written that the "distressed prices [of Winstar's high yield debt] imply serious default concerns despite the bonds being subordinated only to the credit facility." According to the other analyst, Winstar's "high-yield junk bonds" were at that time trading at yields exceeding 22%. Moreover, Winstar's specific bond issues were then trading at yields between 20% to 58%. Respondents replied by stating "we do not believe that there are serious default concerns."

c. The other analyst, according to Respondents, had written that Winstar had “‘toxic’ preferreds that are convertible into an undeterminable and unlimited amount of common shares based on the stocks’ future market price, and thus, dilutes the current holdings of the common stockholders.” Respondents replied that this analysis was “simply inaccurate. One can estimate the number of shares issued from the convertible preferred stocks based on the terms of each of the preferreds which we detail below.” The report asserted that the Series A preferred stock matured on February 11, 2002, and was convertible at a price of \$16.67 per share, which meant that the company would have to issue roughly 7.2 million shares.

d. On March 12, 2001, after the issuance of the March 9 report containing statements and assertions regarding the conversion of the Series A preferred stock, Respondents contacted Winstar management and stated that they were “a bit fuzzy on the details” concerning the conversion of the preferred stock. In response, Respondents learned, for the first time, that the conversion would depend on the then-current price of Winstar stock. Winstar provided two examples: If the price at the time of conversion was \$16.67 per share, approximately 7 million shares would need to be issued, while, if the price were \$8.34 per share, approximately 14 million shares would need to be issued.

e. Thus, by March 12, 2001, Respondents knew that it could not be determined how many shares of common stock would need to be issued as a result of the conversion of the preferred stock because it was impossible to know what the price of the common stock would be in February 2002. However, even after learning that information, Respondents never issued a report to correct their previous false and misleading statements or to explain accurately the nature of the dilutive effect of the Series A preferred stock.

f. The March 9, 2001 report concluded by stating: “We believe that WCII remains well funded into 2002, and that the funding concerns of the [other analyst] are misguided. . . . WCII continues to remain one of our favorite names in the CLEC space, and would be buyers at these levels – nearly their 52 week low.”

g. The March 9, 2001 report made inaccurate statements regarding the dilutive effect of the Series A preferred stock and failed to disclose any risks of investing in Winstar stock, including risks related to funding, the risk that Winstar might not be able to raise the necessary funds, and the risks of bankruptcy.

31. The March 2001 Telecom Industry Reports: Respondents issued two versions of a “State of the Union” report on the telecommunications industry titled: “Telecom: a Growth Industry, but Structure Needs to be Worked Through.” One version was dated March 15 when Winstar’s price was approximately \$7.60 per share; another slightly different version was dated March 21, when Winstar’s price per share was approximately \$2.50. The later version also included the title: “Grubman’s State of the Union – Does he ever stop talking?”

a. The reports highlighted “A basket of [Winstar and 3 other firms as] the four CLECs we truly believe will be long term survivors and players in this industry.” Three of the four CLECs subsequently filed for bankruptcy protection.

b. The reports acknowledged, for the first time, that Winstar was “over leveraged” but nonetheless stated that Winstar had assets and business that “at current levels, are not being valued appropriately and should result in value creation over the next 12-18 months.”

c. The reports failed to disclose any risks of investing in Winstar stock. In particular, the reports failed to disclose any risks related to funding, including the risk that Winstar might not be able to raise the funds.

32. The April 3, 2001 Report: On April 3, 2001, Respondents Grubman and Gochuico proposed publishing an industry report titled “Don’t Panic – Emerging Telecom Model is Still Valid (MORE DETAILS).” At that time, Winstar’s price per share was approximately \$0.31. The report stated that Winstar and one other firm (which has also subsequently declared bankruptcy) “have management teams that are likely to find solutions that allow these companies to continue to grow their businesses while shoring up their capital structures.” Although nothing had changed with regard to Winstar’s business or financing arrangements from the time of the issuance of the other reports described above, this report disclosed for the first time the following risks:

“Winstar has gotten into an unfortunate situation where its overleveraged balance sheet and dependency on [Lucent] has overwhelmed what had been one of the better operational stories in the CLEC space over the last 2 years. . . . However, its funding gap to free cash flow positive is the primary issue given the credit issues at [Lucent], which we had assumed would provide WCII with \$400 million of vendor financing during 2001, and as WCII’s stock continues to reach new lows each day. For WCII, as the stock continued its downward spiral, its opportunities for sources of funding has diminished and the stock remains speculative.”

On April 4, the report was published without any references to Winstar. References to Winstar were deleted because of Salomon’s investment banking activities with Winstar.

33. The April 5, 2001 Report: On April 5, 2001, Salomon published a global alert with the title “WCII announces plan to halt network expansion and reduce workforce headcount.”

The report stated:

“Given current market conditions, we believe this is a step in the right direction in addressing WCII’s funding gap; however, until the company discloses the details surrounding this plan (ie. costs savings, effect on growth rates, etc.), we continue to believe that WCII’s funding gap remains a risk and the stock remains a speculative investment.

Respondents had not previously disclosed that the funding gap was a risk.

34. The April 6, 2001 Report: On or about April 6, 2001, Respondents Grubman and Gochuico proposed publishing a report titled “WCII: Halts Network Expansion & Reduces Workforce; Lowering Target.” The report would have downgraded the stock from Buy to Neutral and lowered the Target Price from \$50 to \$1 per share. At that time, the price of Winstar’s stock was approximately \$0.44 per share. Respondents wrote the report as a reaction to Winstar’s announcement on the previous day that it was going to layoff approximately 44% of its workforce. The report disclosed that “we continue to believe that the funding gap remains a risk,” although, other than the April 5 report, Respondents had not previously disclosed that Winstar’s need for additional funding was a “risk.” Because of Salomon’s investment banking activities with Winstar, the April 6 note was not published.

35. The April 17, 2001 Report: On April 17, 2001, Respondents wrote a report downgrading Winstar from a Buy rating to Underperform and withdrawing the Target Price. The report followed Winstar’s announcement that it had not made an interest payment on a senior debt, that Lucent had declared it in default of a credit facility, that it had hired a firm to advise it on restructuring, that it was considering reorganizing under Chapter 11, and that it was not going to file its Form 10-K on a timely basis. The report noted that Winstar’s “funding gap may prove to be an insurmountable obstacle that could drive WCII to Chapter 11.”

## THE “BLAST” VOICEMAIL MESSAGE

36. As part of his job, Respondent Grubman created blast voicemail messages for distribution to certain clients of Salomon.

37. In a February 23, 2001, blast voicemail message regarding Winstar, Grubman stated the following:

“Regarding their funding, their liquidity and all that, okay, first, these guys have about \$600 million in the bank, \$900 million is available for credit, and you will get their balance sheet, which was restructured about a year ago.”

38. Winstar’s financial situation on February 23, 2001, was not, in fact, as described in Grubman’s blast voice mail message. The information contained in the voicemail was based on Winstar financial statements that were almost five months old as of February 23, 2001. Winstar’s cash position did not remain static and would have deteriorated given Winstar’s cash burn rate. In fact, according to the financial model for Winstar created by Respondents, the company was projected to have cash of approximately \$396 million as of February 23.

**FIRST CAUSE OF ACTION**  
**MISLEADING STATEMENTS AND OMISSIONS**  
**REGARDING WINSTAR**  
**Violations of Conduct Rules 2110,**  
**2210(d)(1), and 2210(d)(2)**  
**(By Respondents Grubman and Gochuico)**

39. The allegations set forth above in paragraphs 1 through 38 are realleged and incorporated for the purpose of this cause of action.

40. The reports written by Respondents concerning Winstar from January 25, 2001 until Respondents downgraded the stock on April 17, 2001, were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts regarding Winstar’s

business prospects and the risks of investing in Winstar, including funding risks, the risks of bankruptcy and risks regarding the dilutive effect of the Series A preferred stock. In addition, the reports contained exaggerated, unwarranted or misleading statements or claims about Winstar, and opinions for which there was no reasonable basis, while omitting material facts or qualifications causing the reports to be misleading. The treatment of risks and potential benefits in the reports was not adequately balanced.

41. By virtue of this conduct, Respondents Grubman and Gochuico violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

**SECOND CAUSE OF ACTION**  
**UNREASONABLE PRICE TARGET**  
**Violations of Conduct Rules 2110,**  
**2210(d)(1) and 2210(d)(2)**  
**(By Respondents Grubman and Gochuico)**

42. The allegations set forth above in paragraphs 1 through 41 are realleged and incorporated for the purpose of this cause of action.

43. Respondents' reports containing a Target Price of \$50 per share that were issued from February 23, 2001 until Respondents downgraded the stock on April 17, 2001, were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts regarding Winstar's Target Price. In addition, those reports contained exaggerated, unwarranted or misleading statements or claims about Winstar's Target Price, and opinions for which there was no reasonable basis, while omitting material facts or qualifications causing the Target Price to be unreasonable.

44. By virtue of this conduct, Respondents Grubman and Gochuico violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

**THIRD CAUSE OF ACTION**  
**JUST AND EQUITABLE PRINCIPLES OF TRADE**  
**AND STANDARDS OF COMMERCIAL HONOR**  
**Violations of Conduct Rule 2110**  
**(By Respondents Grubman and Gochuico)**

45. The allegations set forth above in paragraphs 1 through 44 are realleged and incorporated for the purpose of this cause of action.

46. Respondents' conduct, their e-mails and internal documents demonstrate that while Respondents publicly recommended Winstar, they privately expressed doubts, discussed risks, criticized their own assumptions and recommended the sale of Winstar stock at prices far below

their published Target Price. Such actions were not consistent with just and equitable principles of trade and high standards of commercial honor.

47. By virtue of this conduct, Salomon, Grubman and Gochuico violated Conduct Rule 2110.

**FOURTH CAUSE OF ACTION**  
**MISREPRESENTATIONS AND OMISSIONS**  
**IN BLAST VOICEMAIL**  
**Violations of Conduct Rules 2110,**  
**2210(d)(1) and 2210(d)(2)**  
**(By Respondent Grubman)**

48. The allegations set forth above in paragraphs 1 through 47 are realleged and incorporated for the purpose of this cause of action.

49. Grubman's statement in the February 23, 2002, blast voicemail message regarding Winstar's "\$600 million in the bank" was not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts regarding Winstar's financial situation. In addition, the blast voicemail message contained exaggerated, unwarranted or misleading statements or claims about Winstar's financial situation, and opinions for which there was no reasonable basis, while omitting material facts or qualifications causing the statement to be unreasonable. The treatment of risks and potential benefits in connection with the Winstar's financial situation was not adequately balanced.

50. By virtue of this conduct, Respondent Grubman violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

**PRAYER FOR RELIEF**

WHEREFORE, Complainant, the Department of Enforcement, respectfully requests:

- A. Findings of fact and conclusions of law that Respondents committed the violations charged and alleged herein;
- B. An order imposing fitting sanctions upon Respondents in accordance with NASD Procedural Rule 8310;
- C. An order imposing such costs of any proceeding as are deemed fair and appropriate under the circumstances in accordance with NASD Procedural Rule 8330; and
- D. An order granting all further relief, legal or equitable, that is warranted under the circumstances.

DATED: September 23, 2002

Respectfully submitted,

---

Brian L. Rubin, Deputy Chief  
Counsel  
Thomas B. Lawson, Chief  
Counsel  
NASD, Department of  
Enforcement  
1801 K Street, NW, Suite 800  
Washington, DC 20006  
Telephone No. 202-974-2826  
Facsimile No. 202-974-2805

Of Counsel:

Rory C. Flynn, Chief  
Litigation Counsel  
NASD, Department of  
Enforcement  
1801 K Street, NW, Suite 800  
Washington, DC 200006