NASD
1. LETTER OF ACCEPTANCE, WAIVER AND CONSENT
2. NO. ##

TO: Department of Enforcement
NASD

RE: Salomon Smith Barney Inc.
CRD No. 7059

Pursuant to Rule 9216 of the NASD Code of Procedure, Respondent submits 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 Salomon Smith Barney Inc. ("Salomon" "Respondent" or "the firm") alleging violations based on the same factual findings.

Salomon 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"), 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 Salomon; and

3. If accepted:

    a. this AWC will become part of Salomon's permanent disciplinary record and may be considered in any future actions brought by the NASD or any other regulator against Respondent;

    b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about 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. Salomon 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 Respondent's testimonial obligations or right to take legal positions in litigation in which the NASD is not a party.

Salomon also understands that its 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:

> Salomon 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. During the first half of 2001, twenty-five percent of its revenue came from investment advisory and underwriting fees. Salomon has no disciplinary history relevant to this matter.

I.

WAIVER OF PROCEDURAL RIGHTS

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

A. To have a Formal Complaint issued specifying the allegations against it;

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, Salomon 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.

Salomon 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

A. Salomon hereby accepts and consents, without admitting or denying the allegations, 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, to the entry of the following findings by NASD:

Introduction

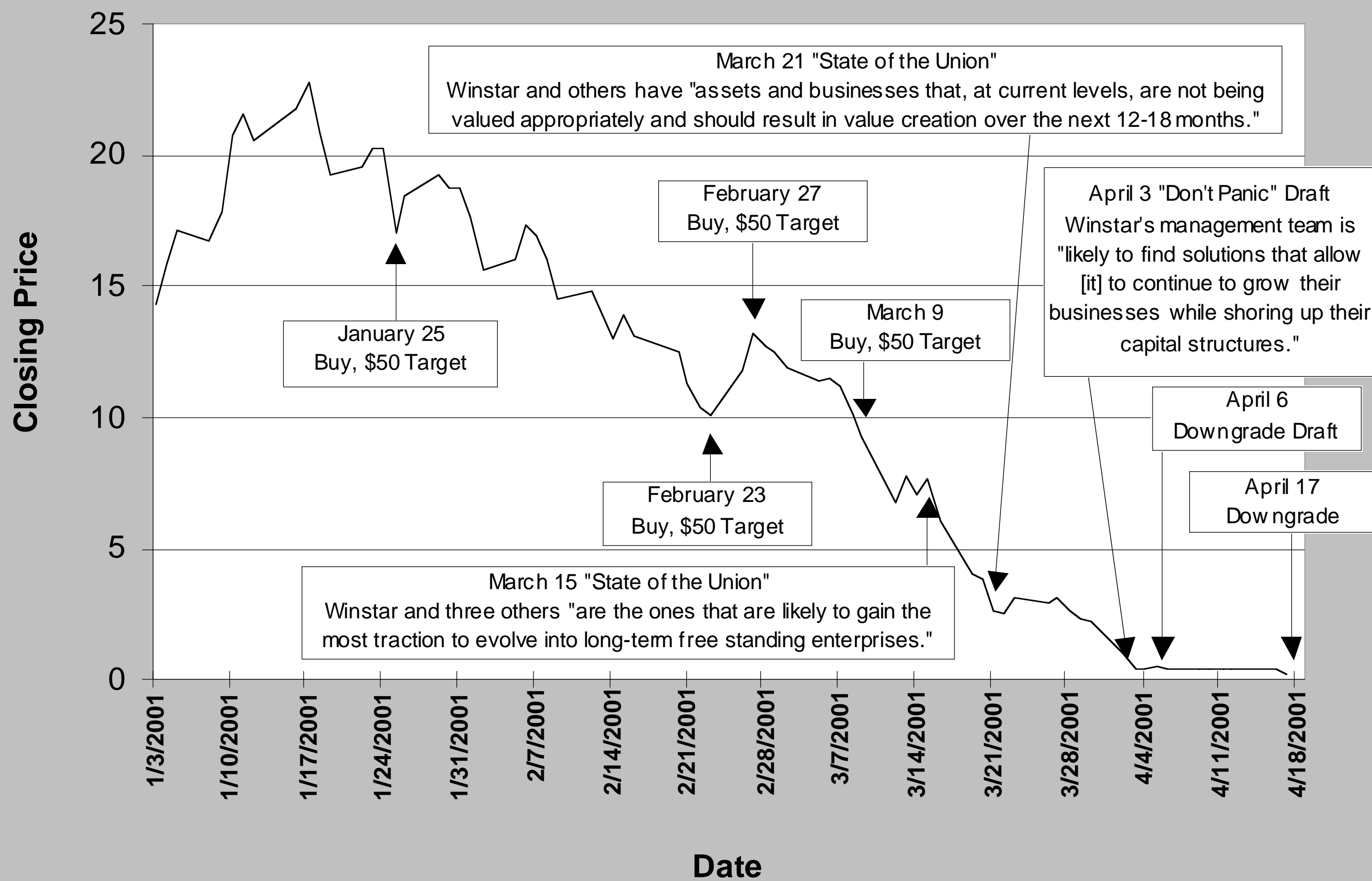
Salomon Smith Barney Inc., acting through two analysts in its Equity Research Department, wrote and published research reports during 2001 that contained misleading statements regarding Winstar Communications, Inc. (Winstar), a broadband telecommunications service provider. The reports recommended the purchase of the common stock of Winstar with a "Buy" rating – Salomon's highest rating – and with a 12-18 month Target Price of $50 per share even as the stock plummeted from approximately $20 to $0.14. Salomon 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.

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, Salomon's Winstar reports 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, Salomon made statements that were false and misleading. Nevertheless, in private e-mails and other internal documents, Salomon's analysts were expressing contrary views. With regard to the Target Price, for example, Salomon 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"

- A Winstar analyst privately told others to sell at prices far below the $50 Target Price.

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


Winstar's Price and Salomon's Reports
Closing Price
25
20
15
10
5
0
Date
1/3/2001
1/10/2001
1/17/2001
1/24/2001
1/31/2001
2/7/2001
2/14/2001
2/21/2001
2/28/2001
3/7/2001
3/14/2001
3/21/2001
3/28/2001
4/4/2001
4/11/2001
4/18/2001
March 21 "State of the Union"
Winstar and others have "assets and businesses that, at current levels, are not being valued appropriately and should result in value creation over the next 12-18 months."
January 25
Buy, $50 Target
February 27
Buy, $50 Target
March 9
Buy, $50 Target
February 23
Buy, $50 Target
March 15 "State of the Union"
Winstar and three others "are the ones that are likely to gain the most traction to evolve into long-term free standing enterprises."
April 3 "Don't Panic" Draft
Winstar's management team is "likely to find solutions that allow [it] to continue to grow their businesses while shoring up their capital structures."
April 6
Downgrade Draft
April 17
Downgrade

Winstar Communications, Inc.

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.

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."

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"

Winstar was not profitable and, in fact, 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.

On April 5, 2001, Winstar announced a scaled-back business plan, and the layoff of 2,000 employees, or 44% of its work force. Salomon acknowledged that this scale back came about because of Winstar's funding situation. According to Salomon's 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 AND WINSTAR

The Investment Banking Relationships

Salomon had significant investment banking relationships with Winstar. Beginning in February 1999, 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.

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

Salomon initiated research coverage of Winstar with a Buy rating in January 1998. At that time, Winstar's market capitalization was almost $1 billion. Salomon maintained a Target Price for Winstar of $50 per share from October 3, 2000, when Winstar's market capitalization was 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, Salomon finally downgraded the stock from a Buy rating to an Underperform rating and suspended the Target Price.

The firm's senior Winstar analyst had known several of Winstar's senior managers since the 1980s when those managers had worked for other telecommunications companies. The Chairman and CEO of Winstar spoke at a Salomon conference in January 2001 on telecommunications, media and entertainment.

Salomon consulted Winstar's management prior to issuing at least one research report and two earnings models, documents which purportedly reflected Salomon's independent judgment and analysis. For example, in January 2001, when an analyst at another firm issued a negative report on Winstar, a Salomon analyst contacted Winstar for help in refuting the opinion of that analyst. Moreover, on at least two occasions, a Salomon analyst sent Winstar officials the financial model that Salomon created to analyze Winstar, and which yielded the Target Price. On at least one of those occasions, a Salomon analyst sent the model for approval before making it publicly available. For instance, on April 6, 2001, the analyst 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

From January 25, 2001, through April 17, 2001, Salomon 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.

Salomon's Winstar reports 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, Salomon attacked an analyst from another firm who had written, among other things, that Winstar "may not be as well funded as many believe." Salomon's report countered that the analyst, whom the firm referred to as a "competitor" who "actually does NOT follow Winstar," made statements that were "highly irresponsible" and "unfounded." After rebuking the other analyst, Salomon's report 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." The report went on to state "we would take advantage of any weakness in [the] stock."

Similarly, in March 2001, another analyst expressed several concerns about Winstar, including concerns regarding funding. Salomon attacked that analyst in its 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." The 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."

SALOMON'S NON-PUBLIC COMMUNICATIONS REGARDING WINSTAR

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

For example, on February 20, 2001, when Winstar stock was trading at approximately $13 per share, a Salomon analyst 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 28th. 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 love shorting 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."

On February 26, 2001, when Winstar stock was trading at approximately $11 per share, a Salomon analyst 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."

On February 28, 2001, when the stock was trading at approximately $13 per share, an institutional investor sent the following e-mail to a Salomon analyst, 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)."

The analyst 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."

Salomon analysts used the wrong inputs and assumptions to calculate the $50 Target Price in March 2001. If the firm's analysts 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 a price of $45 per share. In addition, if the firm's analysts had used the then-current average cost of debt, the Target Price would have been reduced by more than 30%, to a price in the mid-$30s.

As explained in more detail below, Salomon's analysts drafted a report for publication on April 6, 2001 that would have lowered the Target Price to $1. However, Salomon prevented that report from being published because of the firm's investment banking activities with Winstar, thereby keeping the Target Price at $50.

The model that a Salomon analyst e-mailed to Winstar for its review on April 6, 2001, had a Target Price of between ($1.89) and $3.43. However, because Salomon did not publish a report until April 17, the published Target Price, as far as the investing public was concerned, remained at $50.

In various private communications, Salomon analysts 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.

On February 23, 2001, when Winstar's price was approximately $10 per share, an institutional investor e-mailed one of the Salomon analysts, asking, "You really believe that WCII is good value at these levels??" The analyst 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 2nd $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."

On February 26, 2001, one of analysts 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 2nd $1 bil from LU and $250 mil from CSCO are unavailable) to get to FCF+"

On April 4, 2001, Salomon issued a report entitled "Don't Panic – Emerging Telecom Model is Still Valid (MORE DETAILS)." That 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"

On April 18, 2001, one of Salomon's analysts 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 hagve [*sic*] stayed iwth [*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 an industry overview report (the March 2001 Telecom Industry reports referred to 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.

An April 17, 2001 e-mail indicates that Salomon had not performed sufficient research on Winstar:

> "After spending evening with [an institutional client] it is clear the buyside 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."

THE PRICE TARGET

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

Report Date	Target Price	Actual Price	Recommendation
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

The reports issued by Salomon stated that the firm used a discounted cash flow (DCF) analysis 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.

From February 23, 2001 forward, Salomon failed to have a reasonable basis for the Winstar Target Price contained in the reports in that, among other things:

- The growth rate assumptions used by the firm were "extremely aggressive."
- Salomon retained the Target Price at $50 and did not change it because of "optics."
- Salomon analysts used the wrong inputs and assumptions about, among other things, the cost of debt and discount rate.

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

The January 25 and February 23, 2001 Reports

Salomon's January 25, 2001 Winstar 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." Salomon's January 25 report claimed 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."

On February 23, 2002, when the price of Winstar stock was approximately $10 per share, Salomon issued 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, Salomon "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. . . ."

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.

The February 27, 2001 Report

On February 27, 2001, Salomon research reports discussed for the first time Winstar's need to raise $1 to $1.5 billion. However, in doing so, the firm 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."

The report concluded by stating: "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.

The March 9, 2001 Report

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

As described above, another analyst had expressed concerns about Winstar's funding. In response, the March 9 report 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." Salomon repeated the statement the firm 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."

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%. Salomon's March 9 report replied by stating "we do not believe that there are serious default concerns."

The other analyst, according to Salomon's report, 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." Salomon's report responded 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.

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, a Salomon analyst contacted Winstar management and stated that the analyst was "a bit fuzzy on the details" concerning the conversion of the preferred stock. In response, Salomon learned, for the first time, that the conversion would depend on the then-current price of Winstar stock. Winstar provided Salomon with 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.

Thus, by March 12, 2001, Salomon 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, Salomon never issued a report to correct its previous false and misleading statements or to explain accurately the nature of the dilutive effect of the Series A preferred stock.

The March 9 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."

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.

<u>The March 2001 Telecom Industry Reports</u>

Salomon 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 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.

These Salomon 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."

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 necessary funds.

<u>The April 3, 2001 Report</u>

On April 3, 2001, Salomon's Winstar analysts 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 from the report because of Salomon's investment banking activities with the company.

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.

None of Salomon's Winstar reports had previously disclosed that the funding gap was a risk.

The April 6, 2001 Report

In early April, Salomon's Winstar analysts proposed publishing a report titled "WCII: Halts Network Expansion & Reduces Workforce; Lowering Target." The report would have downgraded Winstar from Buy to Neutral and lowered the Target Price from $50 to $1 per share. At the time, the price of Winstar stock was approximately $0.44 per share. The report was written in reaction to Winstar's announcement 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, Salomon 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.

The April 17, 2001 Report

On April 17, 2001, Salomon issued a report downgrading Winstar from a Buy rating to Underperform and withdrawing the Target Price. This 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

As part of their job duties, Salomon analysts created blast voicemail messages for distribution to certain clients of the firm.

In a February 23, 2001, blast voicemail message regarding Winstar, a Salomon analyst 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."

Winstar's financial situation on February 23, 2001 was not as described in the 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 would not remain static but instead would deteriorate over time given the company's cash burn rate. In fact, according to Salomon's financial model for Winstar, the company was projected to have cash of approximately $396 million as of February 23, 2001.

VIOLATIONS

1. JUST AND EQUITABLE PRINCIPLES OF TRADE AND STANDARDS OF COMMERCIAL HONOR

Violations of Conduct Rule 2110 [1]

As described above, Salomon publicly recommended Winstar while, through e-mails and internal documents, its analysts privately expressed doubts, discussed risks, criticized the assumptions that had been used by the firm in its analysis of the company, and recommended the sale of Winstar stock at prices far below the published Target Price. These actions were not consistent with just and equitable principles of trade and commercial fair honor. As a result, Salomon violated Conduct Rule 2110.

2. UNREASONABLE PRICE TARGET

Violations of Conduct Rules 2210(d)(1), 2210(d)(2) and 2110 [2]

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[1] Conduct Rule 2110 provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

[2] Conduct Rule 2210 (d)(1)(A) provides that "[a]ll member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed or service offered. No material fact or qualification may be omitted if the omission, in light of the context of the material presented, would cause the communication to be misleading."

Conduct Rule 2210(d)(1)(B) provides, among other things, that "[e]xaggerated, unwarranted or misleading statements or claims are prohibited in all public communications of members."

Conduct Rule 2210(d)(2) requires, among other things, that a member firm have a reasonable basis for recommendations contained in research reports.

Salomon's reports containing a Target Price of $50 per share, from February 23, 2001 until Salomon 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 which caused the Target Price to be unreasonable.

As a result, Salomon violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

3. Misleading Statements and Omissions Regarding Winstar
Violations of Conduct Rules 2210(d)(1), 2210(d)(2), and 2110

For the reasons described above, Salomon's reports on Winstar from January 25, 2001 until Salomon 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 which caused the reports to be misleading. The treatment of risks and potential benefits in the reports also was not adequately balanced.

As a result, Salomon violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

4. Misleading Statements And Omissions In Blast Voicemail
Violations of Conduct Rules 2210(d)(1) and 2210(d)(2), and 2110

For the reasons described above, the 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 which caused the statement to be misleading. The treatment of risks and potential benefits in connection with the Winstar's financial situation was also not adequately balanced.

As a result, Salomon violated Conduct Rules 2110, 2210(d)(1) and 2210(d)(2).

B. Salomon also consents to the imposition, at a maximum, of the following sanctions:

1. A censure; and
2. A fine of $5,000,000.

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

III.

3. OTHER MATTERS

A. Salomon understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Salomon understands that it 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.

B. Salomon agrees to pay any monetary sanctions imposed on it upon notice that this AWC has been accepted and that such payments are due and payable and has attached an Election of Payment form showing the method by which Salomon proposes to pay any fine imposed.

C. Salomon specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Salomon certifies that it has read and understands 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 Salomon to submit it.

______________________	__________________
Date	Respondent, Salomon Smith Barney Inc.

By: ________________________________
[Name and title]

Reviewed by:

____
Counsel for Respondent

Accepted by NASD:

__________________ _________________________

Date Department of Enforcement

Attachment

ELECTION OF PAYMENT FORM

I intend to pay the fine proposed in Section II of the Letter of Acceptance, Waiver and Consent by the following method (check one):

- ❑ A personal check or bank check for the full amount;
- ❑ Credit card authorization for the full amount;[3]
- ❑ The installment payment plan (only if approved by NASD staff and the National Adjudicatory Council).[4]

Respectfully submitted,

____________________	_________________
Date	Respondent, Salomon Smith Barney Inc.

By: ______________________
[Name and title]

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[3] Only Mastercard and Visa are accepted for payment by credit card. If this option is chosen, the appropriate forms will be mailed to you, with an invoice, by the NASD's Finance Department. Do not include your credit card number on this form.

[4] The installment payment plan is only available for fines of $5,000 or more. Certain interest payments, minimum initial and monthly payments, and other requirements apply. You must discuss these terms with the NASD staff prior to requesting this method of payment.