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PAGE ONE

Citigroup Has New Worry: What Grubman Will Say

Interests of the Ex-Analyst And His Old Firm Diverge

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As **Citigroup** Inc. tries to resolve multiple investigations of its securities underwriting and stock advice, it faces an uneasy new reality: The interests of the company and its former star telecom analyst, Jack Grubman of Salomon Smith Barney, are diverging.

Mr. Grubman, who helped inflate the telecom bubble by cheerleading for upstart companies that soared and then failed, has been under the microscope of New York Attorney General Eliot Spitzer. But now Mr. Spitzer is broadening his focus to include the role that Salomon and Citigroup had in the rosy ratings. And in doing so, the prosecutor has developed a key ally: Mr. Grubman himself.

Citigroup and its ex-analyst are also at odds in a National Association of Securities Dealers action. The NASD accused Citigroup and Mr. Grubman of setting an unreasonably high price target on a telecom stock. Citigroup settled the allegations but Mr. Grubman is fighting them. To do so, he is trying to prove that Citigroup wouldn't let him change his stance on the telecom company because it was a banking client.

Mr. Grubman isn't exactly turning state's witness in these cases. "We're not going to give you scalps," his lawyer has told the New York attorney general's office, according to someone familiar with the matter. But this person says the

ANALYZING THE ANALYSTS

2

See **complete coverage**[3] of the heightened scrutiny of stock analysts.

Read on **a primer**[4] on what the NASD uncovered in internal Salomon e-mails.

See **a list**[5] of some recent stories about Salomon and Grubman.

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SEEKING TO SETTLE

- Citigroup Names Fulton to Head U.S. Stock Research[7]
- Citigroup Would Create Unit for Stock-Research Activities[8] 09/30/02
- Citigroup Is Ready to Settle Probes Into Stock Research[9] 09/27/02
- Salomon Agrees to Pay $5 Million to Settle NASD Probe[10] 09/24/02

BLAMING THE SYSTEM

Goldman CEO Faults Firms for Conflicts Analysts Face[11]

ON AT&T AT THE TIME

- Grubman Downgrades AT&T,

lawyer, Lee Richards, added that "we'll be happy to show you how Jack was part of a bigger problem." It's understood Mr. Richards has talked with the Spitzer office about bankers' influence on analyst ratings and is discussing a possible Grubman deposition.

Such cooperation could be troublesome for Citigroup, because senior executives at the financial giant repeatedly pressed Mr. Grubman to tailor his assessment of telecom stocks to suit Citigroup's banking interests, people familiar with its workings say. Among items Mr. Spitzer is reviewing: an apology Mr. Grubman wrote after he had omitted a Salomon banking client, **AT&T** Corp., from a list of the top telecom players of the future. The analyst addressed his note of regret to Citigroup's chairman, Sanford I. Weill -- who, according to people close to the situation, had demanded the apology.

Citigroup says "Mr. Weill never told any analyst what he or she had to write." A spokeswoman declined to comment further because Citigroup is "in active settlement discussions with regulators."

Reversing Position[12]
10/09/00

• Missed Call on AT&T Could Affect Salomon Analyst[13]
10/04/00

• Will Upgrade of AT&T Stock Help Salomon?[14]
12/06/99

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The analyst-banker overlap being probed by Mr. Spitzer, the NASD and the Securities and Exchange Commission goes to the heart of Citigroup's business model. That model is a joining together under one roof of a host of financial services, from investment banking to commercial lending. The linkage offers synergies but also potential conflicts of interest, which is why it was barred for decades by the now-repealed Glass-Steagall Act. The profit-making synergies were long at center stage as Mr. Weill built his groundbreaking financial conglomerate. But in this year of Wall Street exposes, the conflicts are.

Citigroup faces a withering spotlight. Congress has released documents showing how its Salomon unit helped Enron Corp. craft several deals that allegedly disguised loans as trading revenue. Several investigators have focused on allegations of IPO "spinning" at Salomon -- allotting lucrative initial-public-offering shares to executives who help determine who gets their company's banking business. Citigroup also paid $215 million to settle allegations of deceptive marketing by a consumer lending business, which occurred before Citigroup acquired it.

Citigroup says it is "aggressively instituting meaningful reform." It has offered to wall off its analysts in a separate subsidiary. But it's expected that a global settlement might require Citigroup to pay a penalty that could run as high as hundreds of millions of dollars. It isn't known how Mr. Grubman's cooperation will affect any charges Mr. Spitzer may eventually file.

Jack Grubman

Citigroup's history with one client company, AT&T, offers a revealing look at the tensions between the company and Mr. Grubman. Back in 1995, Mr. Grubman rated AT&T stock only a "hold," which in Wall Street code means you don't want to own it. The next year, when AT&T did a big stock deal -- a $3 billion spinoff of **Lucent Technologies** -- Salomon was one of only a few major Wall Street firms that didn't get a co-manager role. (AT&T notes that Salomon did have a lesser underwriting role.)

C. Michael Armstrong, who became AT&T's chief executive in late 1997, grew frustrated with the analyst. One morning in January 1998, as AT&T stock was sliding following a Grubman report on the company, Mr. Armstrong spotted the analyst on the escalator at the New York Hilton and demanded, "Why did you write that report this morning?" It's unclear how Mr. Grubman responded.

Five months later, as Mr. Grubman was waiting to appear on "Wall Street Week with Louis Rukeyser," he got a call from Salomon's powerful investment-banking chief, Eduardo Mestre. "Whatever you do, don't bash AT&T," Mr. Mestre said, according to people who were there. Mr. Grubman held his tongue. Mr. Mestre didn't return a call seeking comment.

Then in October 1998, during dinner remarks at the CompTel industry conference in San Antonio, Mr. Grubman made matters worse. He listed companies likely to be significant players in telecom during the next century, and didn't mention AT&T. Mr. Armstrong heard about the omission and made his displeasure known to Mr. Weill, say two people familiar with the situation, who add that Mr. Weill was quite unhappy about it. By this time, each CEO sat on the other's board.

Mr. Weill demanded through underlings that Mr. Grubman write an interoffice memo that might serve as the basis for an apology letter to AT&T, these people say. "It has come to my attention that a speech I made offended AT&T," read the memo, which Mr. Grubman addressed to Mr. Weill and two other executives. "Despite our current investment stance on AT&T," Mr. Grubman continued, "I view AT&T as one of the most significant companies in this industry, a company that I hope we can build a long and valued relationship with and one where I truly am open-minded about changes in investment views."

Mr. Grubman wrote that his comments had cast AT&T "in an unfavorable light, which no doubt works to the detriment of the relationship of our two firms, and to be honest, personally embarrasses us and them." He committed himself to increasing "dialogue with AT&T so that we can be in a position to appropriately assess inflection points in AT&T's process." It isn't clear what use, if any, Mr. Weill made of the memo, which Mr. Spitzer's office knows about.

Sanford Weill

From time to time, Mr. Weill and other Citigroup executives suggested that Mr. Grubman take another look at AT&T's stock, say several people familiar with the situation. In April 1999, the analyst sent a list of questions to AT&T. Dissatisfied with the response, he asked Mr. Weill to win him an audience with Mr. Armstrong, says someone familiar with the situation.

This person adds that Mr. Weill accompanied Mr. Grubman to Basking Ridge, N.J., for a meeting the analyst had with Mr. Armstrong in August 1999. The AT&T chief chided Mr. Grubman for "going out of your way to portray us as dopes," another person says. AT&T declined to comment, except to say it treated Mr. Grubman the same as other analysts.

Then in November, amid rumors AT&T was planning a mammoth stock offering that would carry giant banking fees, Mr. Grubman radically upgraded his "hold" rating on AT&T stock, all the way to the equivalent of a strong buy. The rationale: a reassessment of AT&T's plans to use cable-TV lines to offer broadband and local phone service.

Shortly afterward, AT&T announced a $10.6 billion IPO of its wireless business, then the biggest American IPO ever. AT&T had already selected **Goldman Sachs** and **Merrill Lynch** as lead managers of the offering, according to several people familiar with the situation. But to the surprise of many on Wall Street, AT&T then gave Salomon a similar role. The fee for Salomon: $44.8 million.

AT&T says it selected Salomon for its "retail" stock-distribution network after an exhaustive ranking of investment banks on a "scorecard," which it has turned over to Mr. Spitzer. As for Mr. Grubman, his lawyer says the steep upgrade of AT&T was based "entirely on the merits" and entailed "extremely extensive research and ... a carefully reasoned 40-page report." A few months later, Mr. Grubman returned AT&T to a

"hold" rating, citing what appeared to be a retreat from its cable strategy.

Mr. Weill recently said he will be leaving AT&T's board in coming months.

Mr. Spitzer blames conflicts of interest at Citigroup for overoptimistic stock ratings that the New York attorney general says misled investors, costing them millions of dollars. The allegations come in a lawsuit he filed 10 days ago in New York state court seeking to strip certain telecom executives of IPO and other stock profits. The suit, which doesn't name Salomon, Citigroup or Mr. Grubman as a defendant, asserts that Salomon analysts were taught "to manipulate their financial models to support underwriting," making sure their projections were numbers that underwriting clients could meet. Salomon hasn't responded to that assertion.

'Going to Zero'

The suit doesn't spare Mr. Grubman. It includes an e-mail in which the 49-year-old analyst appears to admit giving a far higher rating to a stock, **Focal Communications**, than it deserved. Upon hearing that Focal wasn't satisfied with his report, even though it was positive, Mr. Grubman wrote: "If I so much as hear one more f-----g peep out of them we will put the proper rating (ie 4 not even 3) on this stock which every single smart buysider feels is going to zero." Focal, which was trading at $15.50 at the time, is now at about 30 cents a share.

Rosy ratings for struggling companies were nothing new for Mr. Grubman, whose onetime list of "buys" overlaps today's bankruptcy-court docket. Among favorite stocks of the analyst -- who earned some $20 million a year -- were Global Crossing, WorldCom, XO Communications and Metromedia Fiber Networks, all now close to worthless.

Mr. Grubman kept his "buy" on WorldCom as it slid to $4 from $64.50, not downgrading it until a week before the company ousted founder Bernard Ebbers this spring. Meanwhile, over four years Salomon collected $107 million in fees for advising WorldCom on 23 deals, says Mr. Spitzer's suit. Although Mr. Grubman was so close to WorldCom that he helped plan its strategy, he has said he saw no sign of the $7 billion accounting fraud now engulfing the company.

Close as he was to investment bankers, Mr. Grubman had a dicey relationship with Salomon's stockbrokers. They were a key part of the financial-supermarket synergy, because without them, analysts' "strong buy" recommendations might fall on deaf ears. But as the brokers put clients into stocks Mr. Grubman recommended, and saw them plummet, anger grew.

"Jack Grubman is not an analyst -- he is an investment banker," wrote one broker in an e-mail Mr. Spitzer included in his suit. Mr. Grubman "sold us a bill of goods on [WorldCom and AT&T], and now we're bleeding red in our clients' accounts. How about sharing some [of] the $25MM salary with our clients who bought into his glorified stories?" the e-mail said.

One of their complaints was his frequent practice of retaining his "buy" on companies as they declined. The Spitzer suit includes e-mails in which Mr. Grubman blames pressure from investment bankers for this. In one e-mail, he complains to his boss, U.S. stock research chief Kevin McCaffrey, that "most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got huge pushback from banking." (On Wednesday, Citigroup gave Mr. McCaffrey a new assignment in its e-business department, and the global stock-research chief, John Hoffmann, retired. See article[1])

Rift Over Sprint

At the same time, bankers were pressing the analyst to warm up to older telecom companies that he wasn't high on. Mr. Grubman long believed concerns like AT&T and the regional Bells would fall behind nimble young telecoms that invested heavily in fiber-optic lines, for a supposed future surge in demand. But as huge debt dragged down the upstarts, bankers began to focus on established companies that remained strong enough to do an occasional acquisition or bond sale.

A high-ranking banker named Frank Yeary asked Mr. Grubman to change his thinking on some of these companies for the greater good of Citigroup, according to people familiar with the matter. No way, said Mr. Grubman. "If Frank starts in I will lace into him," he e-mailed his boss. Mr. Yeary didn't return a call seeking comment.

A major rift involved **Sprint** Corp., which Mr. Grubman had downgraded in 2000 to "hold." This led to a blowup the following spring as Salomon helped underwrite a big sale of Sprint shares by **Deutsche Telekom** AG and **France Telecom** SA. A few weeks before the sale, Sprint lowered its earnings outlook. Mr. Grubman responded by sending his clients a voice message reiterating his negative view of Sprint.

The European companies' finance officers were angry, according a May 2001 e-mail from Tyler Dickson, a Salomon executive. They feared Mr. Grubman's stance could shave millions off their sale prices. Another e-mail, from Salomon banker Stephen Winningham, advised Michael Carpenter, then Salomon's chief executive, that corporate issuers of securities felt the firm's analysts should be either "supportive or silent." Messrs. Dickson, Winningham and Carpenter didn't return calls for comment.

Deutsche Telekom later floated a large global bond offering, without giving Salomon any role in managing it. Then, this year, telecom companies that Mr. Grubman had urged buying began sliding one by one into bankruptcy court. The anger of investors who had followed his advice grew, making the analyst an increasing liability for Citigroup.

In early August, Mr. Carpenter told Mr. Grubman it was time to go. He did so, walking away with about $17 million in restricted stock and options and other compensation. Mr. Grubman told the firm in parting that he "always wrote what I believed" and that all of his stock opinions were sincerely held.

Financing Winstar

In the NASD case, though, his argument is that he couldn't downgrade a stock because the firm wouldn't let him. Even as the stock, Winstar Communications, plunged to 44 cents a share in April 2001, Mr. Grubman maintained a price target of $50 on it. To settle an NASD claim that this was unreasonable, Citigroup agreed last month to pay $5 million, without admitting or denying the allegations.

Mr. Grubman, refusing to settle, has told the NASD he wanted to downgrade Winstar, but Citigroup told him he couldn't. The reason, according to the NASD complaint: the firm's banking relationship with Winstar. An arm of Citigroup was paid $500,000 to provide "debtor in possession" financing to the telecom. Mr. Grubman said his firm's compliance department told him Salomon couldn't comment on the stock at that time. In testimony, he told the NASD that it was his understanding his firm was working on a loan for Winstar. Citigroup hasn't commented on Mr. Grubman's statement.

Eliot Spitzer

Just before he resigned, Mr. Grubman went for an early-morning jog in New York's Central Park. As he was finishing his run, a fellow jogger in T-shirt and shorts stuck out his hand. "Hi, Eliot Spitzer," he said.

They chatted briefly. "People would be mad if they knew you and I were talking," Mr. Spitzer said. Mr. Grubman agreed, saying, "It's going to be nice when this is all over."

"We have a lot of issues to resolve," Mr. Spitzer said, to which Mr. Grubman responded: "Yeah, but conflicts are inherent on Wall Street, I don't know how you're going to resolve them, without some kind of general reform." To Mr. Grubman's surprise, Mr. Spitzer agreed, saying, "Yeah, you're right."

Mr. Spitzer had already begun to reassess his view of Mr. Grubman as the center of the problem, rather than as part of a larger system at Citigroup that needed serious reform. His office put out a feeler to Mr. Grubman's attorney, Mr. Richards, and soon it had the attorney's promise of at least limited cooperation.

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