

The Massachusetts Securities Division Settlement with Citigroup: What Does It Mean?

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A recent Massachusetts Securities Division \$30 million settlement with Citigroup Global Markets Inc. (“CGMI”) provides a public glimpse into a less-widely known form of non-public information – a research analyst’s preview of his soon-to-be published research report – and CGMI’s hedge fund clients aggressively probing CGMI’s research analyst for this information.

Significantly, the Consent Order did not allege violations of the Commonwealth’s securities fraud statute, i.e., insider trading, but rather violations of the Commonwealth’s securities laws prohibiting “unethical or dishonest conduct” and requiring reasonable supervision of CGMI’s employees. In addition, the October 2, 2013 Consent Order only targeted CGMI, which neither admitted nor denied violations of law, and not the research analyst or any of CGMI’s hedge fund clients. Neither of these facts is surprising: from the allegations in the Consent Order it is doubtful whether insider trading violations could be proven. Most notably, the Consent Order fails to identify any evidence that the information was conveyed in “breach of a fiduciary duty or other relationship of trust and confidence,” in exchange for a “personal benefit,” or even that the information was “material,” given the mix of information already in the market.

However, it signals an aggressive application of Massachusetts securities laws by the Secretary of the Commonwealth, as regulators continue to monitor communications of non-public information and painstakingly analyze potential violations of the insider trading laws.

iPhone Forecasts Go Up...Up...DOWN

At issue in the CGMI matter were the research views of Kevin Chang, an analyst with Citigroup Global Markets Taiwan Securities Co. Limited, a CGMI affiliate that covered Asian issuers. Mr. Chang covered Apple iPhone supplier Hon Hai Precision Industry Co., Ltd. (“Hon Hai”). Prior to December 14, 2012, Mr. Chang and CGMI published the following:

- On November 13, 2012, Mr. Chang issued a “Buy” rating for Hon Hai and forecasted fourth quarter sales of 50 million iPhones.
- On November 28, 2012, CGMI issued a “Buy” rating for Apple, forecasting sales of 47 million iPhones in the fourth quarter and 40 million in the first quarter. Mr. Chang was not directly involved in this research.
- On December 10, 2012, Mr. Chang published a supplemental research report on Hon Hai, increasing expected first quarter iPhone sales to 45 million. Then, on December 13, 2012, Macquarie Group (“Macquarie”), a competitor to CGMI, issued a substantially revised forecast for Hon Hai, downgrading its first quarter iPhone forecast to 26 to 28 million, a reduction of almost 40 percent from its previous reports.

In response to the Macquarie report, some of CGMI’s larger hedge fund clients sought Mr. Chang’s research views directly or through CGMI affiliates. The Massachusetts Securities Division quoted some of the more descriptive emails in the Consent Order’s Statements of Facts, including:

- An email citing Macquarie’s downgrading of Hon Hai based on weak demand and asking, “*Have you picked up any checks that would suggest this is the case? I think when we exchanged emails a bit earlier you were still pretty bullish about March estimates?*”
- An email referencing reports of iPhone 5 projections “*coming down drastically in Q1 for shipment in the following quarters. Not sure if this is what you’ve heard. . .*”
- An email inquiring, “*Kevin, What did your companies say about iPhone shipment in 4Q and 1Q? Are you around for a chat?*”

- An email requesting, “can u send me everything u you have on the entire iPhone 4/4s/5 supply chain?”

Staggered Dissemination of Mr. Chang’s Hon Hai Research

On December 13, 2012, Mr. Chang distributed an early “preview” of his revised Hon Hai research to some of these larger hedge fund clients. To these select investors, Mr. Chang disclosed substantially downgraded first quarter iPhone sales of 33 million.

A day later, on December 14, 2012, Mr. Chang published his Hon Hai research to all CGMI clients and indicated, for the first time publicly, expected first quarter sales of 34 million, a reduction of 11 million units from his December 10th research report.

Implications for CGMI, Other Broker-Dealers, and Investors

Responding to the foregoing factual allegations, CGMI settled claims with the Massachusetts Securities Division that it “willfully violated or willfully failed to comply with any provision of this chapter,” under M.G.L. c. 110A, § 204(a)(2)(B), “engaged in any unethical or dishonest conduct or practices in the securities, commodities or insurance business,” under M.G.L. c. 110A, § 204(a)(2)(G), and “failed reasonably to supervise agents, investment adviser representatives or other employees to assure compliance with this chapter,” under M.G.L. c. 110A, § 204(2)(J). Indeed, CGMI’s own policies – like those of most other broker-dealers – cabin the use of non-public information and require the simultaneous distribution of research reports to all clients. So what does it mean going forward?

On its face, the CGMI settlement sends a message that the Secretary of the Commonwealth wants to be viewed as aggressive. Referencing his office’s \$2 million settlement with CGMI in 2012 regarding pre-IPO information-sharing, the Secretary was clear: “The purpose of the penalty is to deter the conduct. If \$2 million didn’t do it, maybe \$30 million will.” Certainly, Massachusetts regulators are not looking simply at cases of pure insider trading--as indeed, this was not such a case.

Operating in the background is the suggestion that regulators are reviewing all communications of non-public information with a fine-tooth comb, and therefore will be giving a hard look at all parties involved in such communications, including investors. Indeed, in quoting in detail investors’ emails to Mr. Chang, the Consent Order seems to imply that these larger investors, while not engaging in illegal conduct, nonetheless sought an untoward benefit by seeking to exploit a commercial relationship with CGMI. Whether liability may be imposed against investors under more incriminating facts remains an open question.

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