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Citigroup Companies to Pay $180M Over Hedge Fund Fraud.

WASHINGTON – Two Citigroup companies on Monday agreed to pay $180 million to settle charges they defrauded investors by misrepresenting that investments in two now-defunct muni-related hedge funds were safe, low-risk and suitable for traditional bond investors.

New York-based Citigroup Global Markets and Citigroup Alternative Investments raised almost $3 billion in capital from about 4,000 investors between 2002 and 2007 through the two funds — ASTA/MAT and Falcon – before they collapsed in 2008 during the financial crisis, resulting in billions of dollars of losses, according to the SEC.

Without admitting or denying the SEC's findings, CAI, the investment manager for the two hedge funds, and CGMI, which employed the financial advisors that recommended the funds to investors, agreed to disgorge more than $139. 95 million of ill-gotten gains and pay prejudgment interest of more than $39.61 million to the SEC under the settlement.

Danielle Romero, managing director of global public affairs for Citigroup, said the company is "pleased to have resolved this matter."

The SEC found the two Citigroup affiliates continued accepting additional investments and assuring investors of the funds' safety even as they started to decline in late 2007. The "misleading representations" the Citigroup companies made were "at odds with disclosures made in marketing documents and written material provided to investors," the SEC said in a release.

"Firms cannot insulate themselves from liability for their employees' misrepresentations by invoking the fine print contained in written disclosures," said Andrew Ceresney, director of the SEC's enforcement division. "Advisers at these Citigroup affiliates were supposed to be looking out for investors' best interests, but falsely assured them they were making safe investments even when the funds were on the brink of disaster."

ASTA/MAT was a municipal arbitrage fund that purchased municipal bonds and hedged interest rate risks using a Treasury or LIBOR swap. The fund employed 8 to 12 times leverage. Approximately 2,700 investors and advisory clients of CGMI bought about $1.962 billion of investments in ASTA/MAT from September 2002 through February 2007, the SEC said.

Falcon was a multi-strategy fund with 20% invested in ASTA/MAT and the rest invested in other fixed income strategies such as collateralized loan obligations and collateralized debt obligations and asset-backed securities. The Falcon fund used 5 to 6 times leverage. About 1,300 investors and CMGI advisory clients bought approximately $936 million of investments in Falcon from October 2004 through October 2007, according to the SEC.

Financial advisors assured the investors that the investments were safe, low-risk bond substitutes and in some cases encouraged them to sell their bond portfolios so they could purchase ASTA/MAT shares. At the same time, the written materials the clients received said the investments should not be viewed as bond substitutes and "carried significantly greater risk than a bond investment," according to the SEC order.

Investors also paid two tiers of advisory fees, which totaled about $212.5 million between the two funds. One fee went to the financial advisors with CGMI and one went to the fund manager and fund manager's staff with CAI. Both companies returned a total of only approximately $72.5 million to investors after the funds collapsed.

In August 2007, Falcon fund started experiencing margin calls and requested a $200 million loan from CAI. The loan request was denied and in the next two months, CAI and the financial advisors sold an additional $110 million in fund shares to investors without disclosing the liquidity problems. Then between November 2007 and March 2008, more than $8.4 billion was sold to meet Falcon fund's margin calls.

Despite the mounting liquidity issues and warnings in written documents, the fund manager and several financial advisors continued assuring Falcon fund investors the fund had adequate liquidity and was well capitalized.

The SEC found CAI lacked necessary policies and procedures to supervise how the fund manager was representing the two funds to investors. The manager had "virtually complete control" of all the information going to investors, according to the order, and the manager's staff and CGMI's financial advisors were reliant on the manager for the information that would be passed along to clients.

The Commission found CAI and CGMI willfully violated parts of Section 17(a) of the Securities Act, which prohibits fraudulent conduct in the offer or sale of securities, and that CGMI also willfully violated several parts of Section 206 of the Investment Advisors Act of 1940, on prohibited transactions by registered investment advisors.

John "Jack" Coffee, a securities law professor at Columbia Law School, said the case will get banks' counsel taking to hedge fund managers both because "next time the penalties could be higher and because the other banks don't want the reputational damage."

"I think general counsel at other banks are going to be conscious that oral statements can come to the SEC's attention and produce enforcement actions even without a claim that the written disclosures were false," Coffee said.

But Better Markets president and chief executive officer Dennis Kelleher said in a statement the SEC's timing with the order is "laughable" and "too little too late" considering the violations happened seven years ago.

"For enforcement to work as punishment and deterrence, it has to be swift, commensurate with the violations, require full disgorgement plus fines, and meaningfully punish individuals," Kelleher said. "Justice delayed is justice denied, which too often is the SEC practice. The American public expects and deserves better."

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