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(Photo: Bloomberg News)

'Best short EVER!' ends up costing Citi $285M

Bank settles allegations that its B-D sold pool of mortgages to clients — then bet against them

By Liz Skinner
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Citigroup Inc. has agreed to pay $285 million to settle federal allegations that its broker-dealer subsidiary misled investors about a complex $1 billion mortgage investment that the company was secretly betting would fail.

The investment adviser, Credit Suisse Group AG's asset management unit, also settled Securities and Exchange Commission charges for allowing Citigroup Global Markets Inc. to choose about half the assets that were part of the collateralized-debt-obligation transaction.

The CDO, which was tied to the U.S. housing market, defaulted in November 2007 and left investors with a worthless investment, while Citigroup made $160 million in fees and trading profits earned through a $500 million short position in the specific group of assets that it had selected for the underlying investment, according to the SEC complaint filed in U.S. District Court for the Southern District of New York.

On Feb. 28, 2007, the day the transaction closed, an experienced CDO trader wrote in an e-mail that the portfolio was “dogsh*t” and “possibly the best short EVER!” the SEC said in its complaint. Another experienced investment manager said, “The portfolio is horrible,” the SEC said.

“Investors were not informed that Citigroup had decided to bet against them and had helped choose the assets that would determine who won or lost,” said Robert Khuzami, director of the SEC's enforcement division.

The agreement marks the latest in a string of SEC cases related to complex financial products tied to subprime mortgages that imploded as the housing market declined in 2007 and 2008.

The Goldman Sachs Group Inc. agreed to pay $550 million to resolve claims that it failed to tell investors in a mortgage-linked product that a hedge fund betting against the CDO helped select the underlying assets. JPMorgan Chase & Co. agreed to pay $153.6 million to resolve similar claims related to its sale of a CDO in 2007.

The SEC today also charged Brian Stoker, the Citigroup employee mostly responsible for structuring the transaction that was called Class V Funding III. After discussions began with Credit Suisse to act as collateral manager for the investment, he sent an e-mail to his supervisor saying that the adviser had agreed to terms “even though they don't get to pick the assets.”

Mr. Stoker was responsible for the pitch book and offering circular that were the primary marketing tools used to attract investors in the CDO, the SEC alleged.

His attorney, Fraser Hunter, said that the SEC shouldn't blame his client for the allegations against Citigroup, adding that his client will vigorously defend against the lawsuit.

“There is no basis for the SEC to blame Brian Stoker for these alleged disclosure violations,” Mr. Hunter said. “He was not responsible for any alleged wrongdoing; he did not control or trade the position, did not prepare the disclosures and did not select the assets.”

In Credit Suisse's settlement of SEC administrative charges, the firm agreed to pay $2.5 million in fines and restitution for allowing Citigroup to “exercise significant influence” over choosing what assets were included in the portfolio, the commission said.

“Credit Suisse also was responsible for the disclosure failures and breached its fiduciary duty to investors when it allowed Citigroup to significantly influence the portfolio selection process,” said Kenneth Lench, chief of the structured- and new-products unit within the SEC's enforcement division.

The Credit Suisse portfolio manager chiefly responsible for the transaction, Samir Bhatt, also settled SEC charges by agreeing to a six-month suspension from the industry.

Attorneys for Citigroup and Credit Suisse didn't return calls seeking comment.

Mr. Bhatt's attorney, James Masella, declined to comment.

(This story was supplemented by reporting from Bloomberg.)