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Are the SEC and Citigroup Deceiving A Federal Judge?

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The SEC and Citigroup are trying to bully Federal Judge Jed Rakoff into rubber-stamping a sweetheart settlement for a massive fraud. That's bad enough, but the SEC has also locked arms with Citigroup to make sure as little information as possible is disclosed to the Judge and the public about the settlement and Citigroup's fraudulent deal.

That will ensure that there's no oversight or accountability of either Citigroup or the SEC, which appears to be selling out to another big, powerful, well-connected Wall Street bank. The pattern is distressingly familiar: the SEC announces a big settlement with great fanfare, discloses very little information, gets a judge to approve it with virtually no scrutiny, drops all other investigations of the bank, and moves on.

What's the SEC rush and why so little disclosure? It appears that the SEC simply doesn't want anyone looking too closely into what it is actually settling

and for how little. It discloses almost nothing and then insists that judges approve settlements quickly and without question by demanding that courts must give maximum deference to the SEC as the primary regulator of the securities markets.

But here, the settlement is so pathetically small and the disclosure is so minimal that it actually rewards securities fraud and sends the message to Wall Street that crime pays. As important, the SEC failed to inform the court of critical facts that any court should know before evaluating any proposed settlement, including that they failed to conduct much of an investigation.

In this case, using inside information, Citigroup fraudulently sold $1 billion of toxic collaterized-debt obligation (CDO) derivatives to its customers in a 2007 deal it structured to fail, which Citigroup secretly bet against at the same time with a $500 million short, according to the SEC. "Shorting" the deal meant that Citigroup believed that the deal it structured to fail would in fact fail, which it did spectacularly and fast. In fact, it was the second quickest CDO deal to fail in history, putting Citigroup in the money on its $500 million short in record time while its investors lost everything. The SEC told the court that, as a result, Citigroup had net profits of "at least $160 million."

The SEC trumpeted that it was settling this deal for a total of $285 million. The third highest Wall Street bank settlement, it touted, behind Goldman Sachs ($550 million) and State Street ($300 million). The settlement included disgorgement of $160 million, plus $30 million in prejudgment interest and a fine of $95 million.

But the SEC didn't tell the court the whole story. For example, the SEC didn't tell the court how much money Citigroup took in from this $1 billion deal, which was at least $624 million and almost certainly much more. It also didn't tell the court how it determined that Citigroup's net profits were at least $160 million or what they might have been "at most," even though the court asked for that disclosure. Additionally, it didn't tell the court that investors lost at least $847 million.

For all this, the SEC wants to fine Citigroup only $95 million, which it claims will deter Citigroup and other Wall Street firms from engaging in such fraud. That is laughable.

A $95 million fine is trivial given that investors lost at least $847 million and Citigroup took in more than $600 million. Citigroup is a huge global bank that has almost $2 trillion in assets and had more than $20 billion in revenues in just the third quarter of this year. A $95 million fine isn't even a rounding error to a corporation of that size. In fact, the bonus pool for this $1 billion deal was probably more than three times the size of the $95 million "penalty."

Citigroup and Wall Street will not be deterred from doing anything. We know this for a fact because it has recently been widely reported that such slap-on-the-wrist settlements are a routine matter for Citigroup and Wall Street, safely ignored by the banks and unenforced by the regulators.

Moreover, Citigroup was only required to "disgorge" $160 million, but took in more than $600 million. Disgorgement is critically important because it is meant to ensure that law-breakers don't profit from their fraud. That is why disgorgement has to be full and complete. Simply put, this is what makes sure that crime doesn't pay, except in this case where it appears it to have paid quite substantially.

The SEC's action also shows the involvement of many Citigroup employees from throughout the company, including many from the syndicate, trading, structuring, marketing and sales departments. Yet, the SEC is only charging one low-level employee personally for his role in the fraud. The SEC failed to hold anyone else at Citigroup accountable or to even disclose who did what when it bet against its own customers who invested in the deal that it secretly shorted.

Going after only one employee and giving everyone else a free pass will only incentivize people to engage in fraud because even getting caught doesn't have consequences. Frankly, the SEC's settlement here shows that crime pays for the corporation as well as the individuals.

However, most troubling of all is that no one told the court Citigroup's position is that, in exchange for this one settlement of this one deal and this one itty bitty fine, the SEC has agreed to drop all of its investigations into all of Citigroup's CDO deals. In 2007, Citigroup was the world's top issuer of CDOs, placing almost $50 billion. In total, Citigroup did more than $145 billion of CDO deals over the years.

No one knows how much fraud, if any, was involved in Citigroup's other $145 billion of CDO deals, and no one will ever know if the SEC stops investigating in exchange for this meaningless settlement.

One last fact that was not brought to the attention of the court: the SEC's investigation appears to have been minimal. For example, the SEC took testimony from only several current and former Citigroup employees. For a complex deal of this size and scope, that is shocking. It is inconceivable how an investigation could be thorough when taking virtually no testimony.

Better Markets tried to intervene in the case to bring these and other facts to the court's attention. The SEC fought back and, inexplicably, the court didn't allow intervention and thereby deprived itself of critically important information, which the parties will never disclose. They just want him to rubber stamp the settlement.

The SEC and other regulators failed miserably in their duty to protect the American people from Wall Street before the financial catastrophe that has devastated our country. Many had hoped that the SEC, in particular, had learned its lesson in light of the financial meltdown, missing the Madoff Ponzi scheme, bungling the Sanford scandal involving SEC staff, and its numerous other failings that are so well known. Many thought that, finally, the Wall Street cop - the SEC - was back on the beat. Sadly, this settlement looks like they are still more interested in appearing tough than being tough.

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