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Crisis-Era Muni Funds Haunt Wall Street Brokerages

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Two years after the credit-market meltdown hit a once-booming sector of the municipal-bond market, Wall Street brokerage firms are being ordered to pay millions to investors who lost big on what some thought were low-risk investments.

This month, an investor arbitration panel awarded a California family \$2.1 million, the full amount of its losses on a \$3 million investment in a fund sponsored by First Republic Securities Co., formerly owned by Merrill Lynch & Co.

In May and June, three groups of investors in funds sold by Citigroup Inc. won a total of \$2.1 million in separate arbitration proceedings. A spokesman for Citigroup, the largest sponsor of such funds, notes that three other investor claims were denied, which “supports our view the investments were appropriately sold.”

The awards are another indication of the protracted and costly cleanup under way on Wall Street in the aftermath of the financial crisis. These messes involve highly leveraged investments, which amplified losses when financial markets turned rocky.

Some of the cases raise a familiar question in many of the continuing investigations of Wall Street before and during the financial crisis: Were disclosures to investors by securities firms adequate?

The funds at issue were constructed by issuing tax-exempt short-term debt to buy longer-term municipal bonds that offered higher tax-exempt yields. The funds offered investors yields higher than municipal bonds by a few percentage points, according to lawyers for the investors. Then they attempted to use derivatives such as interest-rate swaps to hedge against adverse moves in both short- and long-term interest rates.

The Securities and Exchange Commission is examining the issue of whether fund sponsors including Citigroup understated the funds’ risk, according to people familiar with the situation. Federal prosecutors in the Eastern District of New York also are looking at the funds’ disclosures, according to people familiar with that probe. Spokesmen for the SEC and federal prosecutors declined to comment.

A spokesman for First Republic, which was sold by new Merrill owner Bank of America Corp. in a management-led buyout, said: “We strongly disagree with this finding, which is inconsistent with other legal decisions on this matter. We believe proper disclosure was made about the risks and rewards.” First Republic also noted that investors were experienced enough to understand the risks involved.

Still, when First Republic lawyers raised that argument in the arbitration, the hearing panel criticized the “glibness” of the funds’ managers and defense witnesses for their awareness of the fund’s “upsides,” such as higher yield and higher fees, without “any realistic advance recognition [of] any specific risks or patterns of risk.”

In marketing materials prepared for brokers and investors in 2006, Citigroup indicated its funds could invest \$8 for every \$1 put into the fund by its investors by borrowing the additional \$7. The funds could borrow at a short-term rate of 3.3%, with the proceeds invested at the rate of 4.2% paid by long-term bonds. The strategy could boost investor returns to 8.6%, the marketing materials indicated.

Citigroup compared the funds’ risk to other bond “alternatives” such as high-yield or emerging-market bonds. But another page labeled “risk vs. reward” indicated that the strategy was three times as risky as a bond-market index and even riskier than a stock-market index.

Funds using such borrowing tactics controlled roughly \$250 billion in municipal bonds by early 2008, according to Matt Fabian, an analyst at Municipal Market Advisors. At their peak, such funds owned roughly 10% of the \$2.6 trillion in muni bonds outstanding, and routinely snapped up as much as one-third of all new issues, Mr. Fabian estimates. “They were able to buy bonds at more aggressive levels than anyone else,” he says.

The First Republic fund raised \$34 million and acquired about \$200 million of bonds, said **Cary Lapidus**, a San Francisco lawyer whose clients won the \$2.1 million award.

One series of Citigroup funds raised \$1.9 billion from investors between 2002 and 2007, invested in an estimated \$15 billion in bonds and lost between 70% and 97% of their asset value by the end of February 2008, according to company documents. Citigroup stepped in to rescue the funds by investing more than \$650 million of its own capital.

Counting quarterly distributions, representative investors had losses of 15% to 72% through March 2009, according to a person familiar with the funds.

Bob Selan, a Calabasas, Calif., magazine publisher, invested \$1 million in a Citigroup fund in 2006 through a broker at Smith Barney. Mr. Selan said it was presented as “a safe alternative” to bonds.

“The way it was explained to me, they were going to buy triple-A bonds and you were going to get a couple of extra percentage points,” Mr. Selan recalls.

But when the subprime crisis struck the bond markets in February 2008, municipal-bond prices plummeted amid forced sales. Leveraged funds had to post more collateral against the falling market prices of the bonds. Some funds were forced to liquidate.

By mid-2008, Mr. Selan noticed that his fund was down 15%. Eventually, he lost more than 50%. In May, an arbitration panel awarded him \$550,504.96 plus interest-enough to make him whole on the investment.

Philip Aidikoff, a lawyer for Mr. Selan, said the firm has more than three dozen clients who had combined losses of more than \$100 million in the Citigroup funds. Craig McCann, an expert witness who has testified for investors in a dozen such cases, estimates that Citigroup will have to pay out tens of millions in losses from such claims.