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What's Good for Business, If No One Else

WILLIAM H. DONALDSON'S abrupt exit last week as chairman of the Securities and Exchange Commission brought cheers from those who think that less regulation means more benefits for investors. They are eagerly embracing President Bush's nominee for the job, Representative Christopher Cox, a California Republican who is a big-business advocate.

While the deregulationistas get ready to rumble, a lawsuit brought by the S.E.C. against [Citigroup](#) - which was settled last Tuesday - reminds us why the very rules that are despised by business are in fact good for investors. Without admitting or denying wrongdoing, Citigroup agreed to pay \$208 million to settle the case.

The S.E.C.'s complaint involved Citigroup's asset management arm and its in-house mutual fund operation, Smith Barney Fund Management. It demonstrates unambiguously why investors are best served by mutual funds that are run by an independent chairman. Requiring an independent chairman was one of Mr. Donaldson's signature regulations, and it drew loud boos from business leaders and fund companies. It went into effect last July.

But the Citigroup matter also shows why the Depression-era legislation known as Glass-Steagall, written to eliminate the kinds of conflicts that financial supermarkets present, should not have been dismantled.

Our story begins in 1997, when, according to the S.E.C., the Smith Barney funds began exploring alternatives to their transfer agent, the [First Data Corporation](#). Transfer agents process investors' trades and perform administrative duties like distributing proxy materials and calculating net asset values daily. First Data had been the transfer agent to the Smith Barney funds for a decade.

Smith Barney's fund operation is big: it offered about 105 funds to its customers at the time of the case and its assets under management were around \$100 billion, the S.E.C. said. None of the funds' directors were affiliated with the fund company except the chairman, Heath B. McLendon, an officer of Citigroup Asset Management.

Because most Smith Barney funds are sold by the firm's brokers, the work performed by the funds' transfer agent was less onerous than usual - First Data did not have to deal with customers' questions, for

example. As a result, the Smith Barney funds generated rich profits for First Data.

With the First Data contract set to expire in 1999, Citigroup hired Deloitte & Touche Consulting to analyze whether the funds should rehire the company or go a different route. Fearful that it might lose the Smith Barney business, First Data in March 1998 offered a \$25 million "fee concession" to Citigroup if it renewed.

First Data also said it would allow Smith Barney brokers to use its proprietary accounting system to charge investors a processing fee on sales of non-Smith Barney funds, generating an estimated \$40 million in revenue for Smith Barney each year. At the same time, First Data reminded Citigroup that it had provided \$9 million in investment banking fees, asset management fees and other revenues to the firm, according to the complaint.

In April 1998, Citicorp and Travelers proposed their historic merger, creating the world's premier financial supermarket and proving once and for all that Glass-Steagall was for fuddy-duddies.

CITIGROUP, meanwhile, continued negotiating with other companies interested in taking over as transfer agent to Smith Barney's funds. First Data offered yet more concessions: half off its fees on revenue up to \$80 million and 60 percent discounts on fee revenue beyond that. Citigroup estimated that it would earn profits of \$258 million over five years under the rebate deal. Take note: under the arrangement, the rebates would go not to the funds but to Citigroup.

On top of all that, First Data agreed to provide Citigroup Asset Management with enough assets to generate \$1.5 million in management fees a year, and said it would make Salomon Smith Barney its "investment banker of choice," generating at least \$3 million in banking fees annually.

Because the concessions were going to Citigroup and not its funds, Deloitte questioned the deal and said that it "may not be legally viable," according to the S.E.C.'s complaint.

But Citigroup went ahead. It made its own trust company the transfer agent and gave First Data a secondary role, as so-called subtransfer agent. That way, the rebates did not go directly to Citigroup Asset Management, but to its affiliated transfer agent.

Deloitte objected, but according to an internal Citigroup memo cited in the S.E.C.'s complaint, the chairman for the boards of the Smith Barney funds was "comfortable that the new First Data arrangement is supportable to the Fund boards."

The chairman did not inform the directors of the guarantees from First Data and the full extent of the rebates to Citigroup, the S.E.C. said, and the memo to the directors stated that the arrangement was in the best interest of the funds.

Mr. McLendon, the funds' chairman at the time, did not return a phone call seeking comment.

Linda Chatman Thomsen, director of enforcement at the S.E.C., said: "This a very basic principle - that fiduciaries protect the financial interests of those to whom they owe an obligation. The services here were not some sort of cash cow that they were allowed to divvy up."

Yet that is just what Citigroup did, the S.E.C. said. From October 1999 through Sept. 30 last year, Citigroup made \$104 million from the arrangement, less than had been projected because of the market decline beginning in 2000. Citigroup affiliates received an additional \$17 million under the revenue guarantees.

In addition to repaying what it made in the deal, Citigroup will pay \$80 million in penalties and \$19 million in interest. Under the terms of the settlement, the firm also agreed that if one of its affiliates wants to act as transfer agent for any of its mutual funds, the adviser to the funds must also seek competitive bids from outside transfer agents. An independent monitor must oversee the bidding.

Mark K. Schonfeld, director of the S.E.C.'s Northeast office, said the competitive bidding requirement was a first. "We included that because one of the problems here was the lack of transparency to the board," Mr. Schonfeld said. "We wanted to open up the process to the boards and ensure a fair bidding process."

ROBERT B. WILLUMSTAD, president and chief operating officer of Citigroup, said in a statement: "Our most important mission is to assure our clients that their assets are secure in our care and that they can trust us to manage them with their interests at the forefront. We recognize that aspects of the transfer agency arrangements entered into six years ago did not reflect the way we think business should be done, and that is unacceptable."

It's a shame that the firm waited until the S.E.C. came calling to notice that the arrangement was unacceptable. As the commission said in its complaint, Citigroup kept the deal going until Sept. 30, 2004, well after conflicts of interest at mutual funds had appeared on the national radar screen.

Just another reason investors should be wary of those who claim that the free markets - not regulators - are best at making conflicts go away.

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