

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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U.S. SECURITIES AND EXCHANGE COMMISSION,)	
)	
Plaintiff,)	
)	11-cv-7387 (JSR)
v.)	
)	
CITIGROUP GLOBAL MARKETS INC.,)	
)	
Defendant.)	
)	

**PLAINTIFF U.S. SECURITIES AND EXCHANGE COMMISSION’S MEMORANDUM
IN SUPPORT FOR AN ORDER TO APPROVE A DISTRIBUTION PLAN FOR THE
CGMI FAIR FUND AND AUTHORIZING DISBURSEMENT PURSUANT TO THE
DISTRIBUTION PLAN**

Plaintiff United States Securities and Exchange Commission (“SEC” or the “Commission”) respectfully submits this Memorandum of Law in support of the Commission’s motion requesting from the Court an order approving the Commission’s proposed distribution plan to distribute more than \$288 million to investors that were harmed by misrepresentations and omissions of material facts made in connection with the marketing of the Class V Funding III (“Plan”) and authorizing disbursement pursuant to the Distribution Plan.

I. Case Background

On October 19, 2011, the SEC filed a complaint alleging that Citigroup Global Markets Inc. (“CGM”) violated Sections 17(a)(2) and (3) of the Securities Act of 1933 [15 U.S.C. §§ 77q(a)(2) and (3)], by, among other things, making misrepresentations regarding the selection of assets for the collateralized debt obligation (“CDO”) called Class V Funding III (“Class V”) and failing to disclose CGM’s financial interest in the transaction.

The investment portfolio for the Class V consisted primarily of credit default swaps (“CDS”) referencing other CDO securities with collateral consisting primarily of subprime residential mortgage-backed securities. Complaint, ECF No. 1, ¶ 1. Consequently, the value of the Class V and its underlying investment portfolio was directly tied to the United States residential housing market. *Id.* CGM structured and marketed this \$1 billion “CDO-squared” in early 2007 when the U.S. housing market and securities linked to the U.S. housing market were already beginning to show signs of distress. *Id.* CDO-squared transactions such as the Class V were designed to provide leveraged exposure to the housing market; accordingly this magnified the severity of losses when the United States housing market experienced a downturn. *Id.*

CGM’s marketing materials for the Class V represented that the assets for the CDO were selected by Credit Suisse Alternative Capital, Inc. (“CSAC”), a registered investment adviser that was promoted as having experience and expertise in analyzing credit risk in CDOs. ECF No. 1, ¶ 2. The marketing materials distributed to investors failed to disclose that CGM influenced the selection of \$500 million of the assets in the Class V; and that CGM had bought protection against approximately \$500 million of the CDO securities, representing half of the Class V investment portfolio. *Id.*

The Class V closed on February 28, 2007. ECF No. 1, ¶ 4. On or about that date and in the following weeks, CGM sold the Class V notes to approximately fourteen (14) institutional investors, including hedge funds, investment managers and other CDO vehicles, all of whom received some or all of the marketing materials for the Class V. *Id.* On or about March 16, 2007, Ambac Credit Products LLC (“Ambac”), an affiliate of Ambac Assurance Corporation, a monoline insurance company, agreed to sell protection to an affiliate of CGM on the \$500 million super senior tranche of the Class V. *Id.* The transaction with Ambac was intermediated

by BNP Paribas (“BNP”), a European financial institution. *Id.* Essentially, through a series of CDS transactions between CGM, Ambac and BNP, Ambac assumed the credit risk of the super senior tranche in exchange for premium payments. ECF No. 1, ¶¶ 52, 53.

By November 6, 2007, approximately 83% of the CDOs in the Class V investment portfolio had been downgraded by rating agencies, and the Class V declared an event of default on November 19, 2007. Complaint ¶ 5. As a result investors lost several hundred million dollars. *Id.* The SEC alleged that CGM violated Sections 17(a)(2) and (3) of the Securities Act of 1933 [15 U.S.C. §§ 77q (a)(2) and (3)] by negligently misrepresenting the process by which the investment portfolio was selected and CGM’s financial interest in the transaction and sought as relief an injunction, disgorgement of profits, prejudgment interest, and civil penalties from the defendant. ECF No. 1, ¶ 6.

CGM consented to the entry of the Final Judgment which the Court entered on August 5, 2014. The Final Judgment required CGM to pay disgorgement of \$160 million, prejudgment interest in the amount of \$30 million and a civil money penalty of \$95 million. CGM satisfied those obligations by paying \$285 million on or about August 15, 2014.¹ The Final Judgment provided that the SEC may by motion propose a plan of distribution subject to the Court’s approval pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002.

II. The Establishment of the Fair Fund and Appointment of a Distribution Agent

On May 23, 2017, this Court issued an order establishing the Citigroup Global Markets Inc. Fair Fund (hereinafter the “CGMI Fair Fund”) to distribute the disgorgement, prejudgment interest and a civil penalty totaling approximately \$288 million paid by CGM and CSAC (the “2017 Order”).

¹ The Commission brought a related administrative proceeding against CSAC which resulted in the entry of an Order requiring CSAC and an affiliate to pay \$2.55 million; these monies have been added to the CGMI Fair Fund.

The 2017 Order also appointed RCB Fund Services, LLC, (“RFS”) as the distribution agent to administer the CGMI Fair Fund. Pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act of 2002, the CGMI Fair Fund was to be distributed to investors that were harmed by misrepresentations and omissions of material facts made in connection with the marketing of the Class V. The 2017 Order directed RFS to “work with the Commission’s staff in formulating a methodology for allocating the fair fund, determining the identities of injured investors and investor harm, establishing a process to evaluate and verify claims, drafting a distribution plan and obtaining the Court’s approval of the plan, fielding inquiries from investors, and overseeing the ultimate distribution of the CGMI Fair Fund.”²

III. Relevant Background

For the CGMI Fair Fund, the Commission determined that because of the small number of potential claimants the appropriate approach was to solicit submissions from the investors in the Class V as an initial step. After analyzing all investor submissions and discussing the facts with the Commission, RFS would then draft a plan of distribution designed to apportion the CGMI Fair Fund in a fair and reasonable manner among those investors found to be eligible. Precedent supports the administration and distribution of a CGMI Fair Fund in this manner.

Federal courts have approved using this “reverse” approach in connection with other cases where a fair fund was created for the benefit of investors that suffered losses as a result of alleged misconduct in the offer and sale of CDOs. In these cases, all of which took place in the Second Circuit, the Commission has followed an approach of either detailing any disbursements as part of a final judgment or developing a distribution plan that details the eligible investors and the corresponding recovery amount for each investor.

² ECF No. 88.

In *SEC v. Goldman, Sachs & Co.*, 10-CV-3229, 2011 WL 2305988, at *1 (S.D.N.Y.), on July 20, 2010, Goldman Sachs consented to judgment, and the Final Judgment by the court ordered Goldman, Sachs & Co. to pay \$550 million in disgorgement and penalties, \$150 million of which was to be distributed to a German bank, and \$100 million distributed to a Scottish bank that suffered a loss as a result of their investment in the CDO, with the balance going to the SEC for transmittal to the United States Treasury.

In *SEC v. J.P. Morgan Securities LLC* (f/k/a J.P. Morgan Securities Inc.), 11-CV-4206 (S.D.N.Y. June 21, 2011) (Berman, J.), 2010 WL 6796637, at*1, on June 29, 2011, the court ordered JPMorgan Chase to pay \$153.6 million in disgorgement, prejudgment interest and penalties and to distribute \$125.9 million to certain mezzanine investors with the balance going to the United States Treasury. *See Id.* at *2.

In *SEC v. Mizuho Securities USA Inc.*, 12-CV-5550 (Preska, J.), 2012 SEC Lexis 2276 (S.D.N.Y. July 18, 2012), on July 26, 2012, the court ordered Mizuho Securities USA Inc. to pay \$127.5 million in disgorgement, prejudgment interest and penalties, which were aggregated pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 to create a fair fund. After the Commission identified all parties that were potentially harmed by purchasing notes based on false and misleading information, the SEC developed a distribution plan to govern the disbursement of the fair fund. On September 22, 2015, the court approved the SEC's proposed distribution plan that directed the Fund Administrator to make a payment of \$10.8 million to an Austrian bank, with the balance to go to the United States Treasury. (*See Id.* Order Approving Disbursement to Additional Injured Investor, ECF No. 22). Later, on November 13, 2017, the Court approved the disbursement of \$3.4 million to an additional investor, ACA Financial

Guarantee, as ACA had insured the super senior tranche of the CDO against losses through a credit default swap.

The facts and circumstances of this case very closely resemble the three aforementioned cases. Therefore, the Commission believes the proposed approach for this case is appropriate.

IV. The Applicable Standard

Generally, courts have given the SEC broad discretion in the design and implementation of a distribution plan that governs the disbursement of a fair fund. Historically, a court's review of a proposed distribution plan is limited to determining whether the plan is "fair and reasonable."

In *SEC v. Levine*, 881 F.2d 1165, 1181-83 (2d Cir. 1989), the Second Circuit held that the SEC has "flexibility to decide that certain groups of claimants would receive payments and others would not" and found that the district court was not "entitled to impose its own views as to the appropriate priorities among legitimate claimants and to reorder the choices made by the SEC." (*Id.* at 1182.)

In *SEC v. Wang*, 944 F.2d 80, 85 (2d Cir. 1991), the Second Circuit held that, "unless the consent decree specifically provides otherwise once the district court satisfies itself that the distribution of proceeds in a proposed SEC disgorgement plan is fair and reasonable, it's review is at an end." The Second Circuit further reasoned that the type of "line-drawing" involved in fashioning a distribution plan is appropriately left to the "experience and expertise" of the SEC, citing as an example *SEC v. Certain Unknown Purchasers*, 817 F.2d 1018 (2d Cir. 1987) (district court did not abuse its discretion in finding that SEC's proposed distribution plan limiting recoveries to "out-of-pocket" losses was fair and reasonable even though it excluded certain sophisticated investors whose profits were reduced by defendant's misconduct). The Court

stated that so long as the district court is satisfied that “in the aggregate, the plan is equitable and reasonable,” the SEC may engage in the “kind of line-drawing [that] inevitably leaves out some potential claimants.” *Wang*, 944 F.2d at 88.

In *Official Committee of Unsecured Creditors of WorldCom, Inc. v. SEC*, 467 F.3d 73, 81 (2d Cir. 2006), the Second Circuit held that this Court correctly applied the “fair and reasonable” standard in approving the fair fund distribution plan in that case. The Second Circuit emphasized that it had “long understood that the SEC’s charge to enforce the securities laws carried with it the discretion to determine how to distribute recovered profits among injured investors” and that the “Fair Fund provisions merely increases the funds that the SEC may distribute and in no way changes the SEC’s role.” (*Id.* at 84.) The Second Circuit found this Court did not abuse its discretion by approving the SEC’s fair fund distribution plan even though it excluded two classes of investors, noting that when funds are limited “hard choices” must be made. *Id.* at 84-85.

For the reasons expressed below, the SEC submits that the proposed Plan represents a fair and reasonable distribution of the CGMI Fair Fund based on the facts and circumstances of this case and should be approved.

V. The Commission’s Proposed Distribution Plan Represents a Fair and Reasonable Allocation of the CGMI Fair Fund

The Plan that the Commission developed jointly with the Distribution Agent represents a fair and reasonable apportionment of the CGMI Fair Fund.

The Commission provided the Distribution Agent with a record of all investors in the Class V, and, in turn, the Distribution Agent delivered a notice to representatives of each of the investors informing them of the existence of the CGMI Fair Fund and the potential to recover for any losses incurred as a result of CGM’s misconduct as described in the complaint (the “Notice”). *See* Notice attached as Exhibit A. The Notice provided the investors with 60 days to

make a submission to the Distribution Agent. The Distribution Agent received four submissions from Class V investors. The submissions were made by: i) Harding Advisory LLC (“Harding”); ii) Ambac Credit Products, LLC and Ambac Assurance Corporation (collectively “Ambac”); iii) BNP Paribas (“BNP”); and iv) Basis Yield Alpha Fund (Master), as investor, and Basis Capital Funds Management Limited, as investment advisor (collectively, “Basis”).

Based on its investigation and the submissions provided to the Distribution Agent, the Distribution Agent, in consultation with the Commission, has determined that three investors are eligible for a recovery from the CGMI Fair Fund (the “Eligible Investors”).³

The Fair Fund provision (15 U.S.C. § 7246(a)- Fair funds for investors) provides:

If, in any judicial or administrative action brought by the Commission under the securities laws, the Commission obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation. (Emphasis added.)

This provision establishes a broad mandate that allows the Commission to direct recoveries to any party that suffered a loss as a result of the violation of a particular securities law.

In this case, the underlying theory of liability relates to alleged omissions and misrepresentations in violation of Sections 17(a)(2) and (3) of the Securities Act [15 U.S.C. §§ 77q(a)(2) and (3)] in connection with the offer or sale of securities. Specifically, CGM is alleged to have made misrepresentations in the offering and marketing materials utilized in the sale of the Class V securities. The function of the CGMI Fair Fund is to compensate investors harmed by these misrepresentations and omissions in CGM’s marketing materials for the Class V. The

³ For reasons detailed in the Plan, the submissions of Ambac, BNP and Basis are eligible for distribution; however, the Commission does not recommend making a distribution to one of the investors that made a submission, Harding. That investor did not establish that it made an investment based on CGM’s misrepresentations.

Eligible Investors all demonstrated that these misstatements and omissions in the Class V's marketing materials were a significant basis for their decision to invest in Class V and they each documented a loss as a result of the investment.

Further, all of the Eligible Investors were in the same position in February 2007, when CGM began selling the Class V notes. All three of the Eligible Investors demonstrated that the decision to invest in Class V was *based on representations* in the offering materials, and each suffered the same type of harm, proportionate to the size of their investment. Therefore, a *pro rata* distribution of the CGMI Fair Fund to the Eligible Investors is appropriate in this circumstance and represents a fair apportionment of the fund. BNP and Basis Yield Alpha Fund (Master) documented the purchase of Class V notes. Ambac documented its involvement in the Class V, via a series of CDS transactions.⁴

Based on the facts of this case and the principles detailed herein, the Commission believes the proposed Plan provides an appropriate distribution of the CGMI Fair Fund in accordance with the primary purpose of the Fair Funds provision: to provide recoveries to *victims of the underlying securities law violation* that are determined to be eligible.

⁴ Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the definition of "security" under the Exchange Act to expressly encompass security-based swaps. See Section 761(a) (2) of The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), (amending Section 3(a) (10) of the Exchange Act (15 U.S.C. 78c (a) (10)).

WHEREFORE, the Commission respectfully requests that the Court grants its Motion for an Order Approving the Distribution Plan for the CGMI Fair Fund and Authorizing Disbursement Pursuant to the Distribution Plan and grant other relief as it deems necessary and proper.

Dated: _____, 2019

Respectfully submitted,

Nancy Chase Burton (CO Bar # 101615)
Attorney for Plaintiff
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-5876
202.551.4425
burtonn@sec.gov



UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
CITIGROUP GLOBAL MARKETS FAIR FUND

**SEC v. Citigroup Global Markets Inc.,
1:11-cv-07387-JSR (S.D.N.Y. 2011)**



Distribution Agent

December 21, 2017

Ambac Assurance Corporation
c/o Thomas Kim
Sidley Austin LLP
1501 K Street, N.W.
Washington, D.C. 20005

Fair Fund Notice

Dear Investor,

This notice is to inform you of the existence of the Citigroup Global Markets Inc. Fair Fund (the "Citi Fair Fund"). The Citi Fair Fund was established May 23, 2017 by Court Order by the United States Securities and Exchange Commission ("SEC" or the "Commission") to distribute disgorgement, prejudgment interest and a civil penalty totaling approximately \$288 million paid by Citigroup Global Markets Inc. ("CGM").¹ Pursuant to the Fair Fund provisions of Section 308(a) of the Sarbanes-Oxley Act, the Citi Fair Fund will be distributed to investors that were harmed by misrepresentations and omissions of material facts made in connection with the marketing of a collateralized debt obligation ("CDO") called Class V Funding III (the "Funding").

The SEC filed a complaint in the U.S. District Court for the Southern District of New York (the "Court") against CGM alleging that it violated the antifraud provisions of the Securities Act of 1933 (Sections 17(a) (2) and (3)), by, among other things, making misrepresentations regarding the selection of assets for the Funding's CDO portfolio and failing to disclose CGM's financial interest in the transaction. CGM consented to the entry of a Final Judgment that required it to pay \$285 million.

This notice is being sent to all investor participants in the Funding according to records provided by the SEC. This notice may also be provided, at the Distribution Agent's discretion, to any other persons that may be potentially eligible to recover from the Citi Fair Fund. We are writing to notify you that you may be able to recover from the Citi Fair Fund.

¹ The SEC brought a related administrative proceeding against Credit Suisse Alternative Capital, Inc. ("CSAC") and a CSAC affiliate which resulted in the entry of an Order requiring CSAC and an affiliate to pay \$2.55 million. These monies have been added to the Citi Fair Fund to be distributed to harmed investors.



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SECURITIES AND EXCHANGE COMMISSION
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Distribution Agent

Who is Potentially Eligible?

It has not yet been finally determined how the Citi Fair Fund will be distributed. However, investors potentially eligible for a recovery from the Citi Fair Fund may include any person (which shall include natural persons and entities) who purchased an interest in the Funding in its issuance, including super senior and subordinated interests, on or about February 28, 2007, and suffered an economic loss as a direct result of that investment. The investor must prove that he, she or it suffered an economic loss as a result of its investment in the Funding by providing documentation of the original investment(s), premium payments received, associated hedges, or any recoveries received.

The Funding investments include the following CUSIPS:

18272FAB5	18272FAG4
18272FAD1	18272KAA6
18272FAE9	18272KAC2
18272FAF6	

How Will the Process Work?

In advance of preparing a Distribution Plan, the Distribution Agent is inviting investors to provide information regarding their investments in the Funding. For clarification or to seek additional information, the Distribution Agent may meet with investors potentially eligible to recover and who have made a submission. Using the information received from these submissions, the Distribution Agent, in consultation with the SEC, will develop the Distribution Plan for the Citi Fair Fund. The Distribution Plan will be formulated in the interests of justice, with a goal of providing a fair and reasonable distribution of the Citi Fair Fund assets to those investors that suffered economic losses as a result of CGM's misconduct. The Distribution Plan will be filed with the Court and be subject to a comment period.

In order to be considered for a recovery from the Citi Fair Fund, please provide us with information regarding your transactions in the Funding. It would be helpful if you would include the following information:

1. A detailed statement with supporting documentation, where relevant, pertaining to:
 - A. Background information about the investor entity, including information such as: the entity type (*i.e.*, whether it is a bank, pension plan, insurance company, hedge fund, or other type of financial institution), the domicile of the entity, and the nature of the entity's business;
 - B. An explanation of the investment in the Funding generally, including factors such as: when the initial investment was made and the tranche, the total amount of the



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investment, how long the investor held the investment, whether the Funding assets purchased were incorporated into another CDO, and the investor's strategy in connection with the Funding investments; and

- C. The investor's role in the structured finance markets generally (*e.g.*, investor's percentage of total revenues earned from structured finance activities, investor's activity in the market, whether the investor or any of its subsidiaries or affiliates acted as a collateral manager, issuer or arranger of structure finance products).
2. Disclosure of any premium payments received by the investor (including any parent entity, subsidiary or affiliate of the investor), and the dates and the amounts of such payments;
3. Disclosure of any lawsuits or other proceedings the investor pursued to recover losses from its investments in the Funding and any payments received by the investor (including any parent entity, subsidiary or affiliate of the investor) in connection with such lawsuits or proceedings; and
4. Disclosure of any other payments received by the investor (including any parent entity, subsidiary or affiliate of the investor) that constitute a recovery for the investor's losses from its investments in the Funding (*e.g.*, insurance recoveries).

The submission may be mailed to the address provided below and/or submitted electronically at the following e-mail address: info@citicdofairfund.com. All submissions are to be made under penalty of perjury under the laws of the United States of America stating that the information supplied is true, correct, and complete, and that all documents submitted in support of the information are true and correct copies of what they purport to be.

Please also note that all submissions must be made directly to the Distribution Agent, even if the material has already been provided to Commission staff.

What is the Deadline for Making a Submission?

Submissions must be postmarked no later than 60 days from the date of this notice. If you need assistance or if you have any questions regarding this notice, please contact the Distribution Agent at info@citicdofairfund.com or visit www.citicdofairfund.com.