Citigroup Uses Mutual Funds as `Dumping Grounds' for Clients

By David Dietz and Adam Levy

April 29 (Bloomberg) -- On June 28, 2000, Citigroup Inc. and 10 other investment banks were paid $75 million to manage the largest-ever initial public offering of an Internet company, selling $1.9 billion in shares of Genuity Inc., which provided high-speed Internet access to companies.

Over the next eight months, Citigroup mutual funds and private investment partnerships became the largest owners of Genuity. By March 2001, the bank held 24 million shares, or almost 14 percent of the company's 174 million shares.

Investors in Citigroup mutual funds and private partnerships -- which are loosely regulated funds for investors with at least $1 million in assets -- didn't benefit from owning Genuity shares. Genuity's stock price, unadjusted for splits, never rose above its $11 IPO value, and by the end of 2001, it had plunged 86 percent to $1.58.

Citigroup isn't the only investment bank to stuff its accounts with shares of its clients or to have held these shares even as they crashed.

From the accelerating bull market of 1999 to the bear market of 2002, Wall Street's five largest underwriters owned in their private partnerships and mutual funds a disproportionate number of shares in companies that were clients, a Bloomberg News analysis of 108,000 U.S. Securities and Exchange Commission records shows.

Shares Plummeted

Citigroup, Credit Suisse Group's Credit Suisse First Boston, Goldman Sachs Group Inc., Merrill Lynch & Co. and Morgan Stanley held hundreds of millions of shares of their own clients over four years as stock values plummeted as much as 99 percent, SEC filings show.

Each year in that four-year period, the

shares of clients accounted for at least 8 percent and as much as about 31 percent of the banks' holdings. At Citigroup, banking clients made up 30.6 percent of the shares in mutual funds, partnerships and other accounts, such as trust accounts or the bank's investments, in 2002, SEC filings show.

At the same time, funds run by managers with no investment banking activities -- including Fidelity Investments, the largest U.S. mutual fund company, and Vanguard Group, the second-largest -- often bought proportionately fewer, or none, of the shares of the investment banks' IPO clients, SEC filings show.

In the case of Genuity, Citigroup held at least 13 million shares as they plummeted by 86 percent, SEC filings show. The Internet company, based in Woburn, Massachusetts, exhausted $2 billion in cash in a futile effort to become profitable. In November 2002, it filed for bankruptcy.

`Certainly Not Good'

Bank funds hurt investors by favoring clients' shares, says Jerome Dodson, 60, president of San Francisco-based Parnassus Investments, which manages $1.2 billion in assets.

``It appears that investment banks may be pressuring their mutual fund portfolio managers to invest in the stocks of companies that are banking clients," he says. ``This is certainly not good for their mutual fund shareholders who deserve objective decision making."

The five investment banks manage a total of $419.1 billion in mutual funds, or 6.7 percent of the $6.3 trillion mutual fund industry, according to research firm Morningstar Inc. The 1999-2002 period coincided with the dot-com boom and bust as the Nasdaq Composite Index rose to a record

5133 and then fell 74 percent to 1336 by the end of 2002.

At the same time, some investment bank money managers didn't abandon banking clients even as shares plunged, SEC filings show.

Bottom Half

Such clients included Redwood City, California-based Internet software maker BroadVision Inc., a Goldman Sachs client, and Merrill Lynch client Inktomi Corp., a maker of Web search software. Each of those companies suffered a 97 percent loss in market value by the end of 2001.

Goldman Sachs comanaged a $194 million stock sale for BroadVision in November 1999 and held shares of the company until June 2002. Merrill Lynch managed a $53 million Inktomi stock sale in October 2001 and held shares of the Foster City, California-based company until the end of 2002, SEC filings show.

Stock mutual funds of four of the five largest equity-underwriting banks performed in the bottom half of 549 U.S. mutual fund companies from 2001 through 2003, according to research firm Lipper Inc. The two worst performers, finishing in the bottom third, were Citigroup and CSFB.

The funds of Citigroup subsidiary Smith Barney lost an average of 3.7 percent a year in the four years and finished 365th. Citigroup's Salomon Brothers Asset Management Inc. funds lost an average of 3.1 percent and ranked 344th. CSFB mutual funds lost an average of 3.1 percent, ranking 342nd.

Best and Worst

Morgan Stanley has two mutual fund groups: One had the best record among the five banks, and the other had the worst.

Morgan Stanley Investment Management Inc., which lost an average of 0.02 percent, performed in the top 50 percent of all fund companies, ranking 226th. Morgan Stanley Investment Advisors Inc. funds lost an average of 4 percent and ranked 385th.

Merrill Lynch mutual funds lost an average of 1.3 percent, ranking 276th. Goldman Sachs mutual funds were in the top 50 percent, ranking 256th and losing an average of 0.8 percent.

Fidelity ranked 248th and lost an average of 0.6 percent. Vanguard ranked 193rd and gained an average of 1.3 percent.

From a $10,000 investment at the start of the period, the average Morgan Stanley Investment Advisors fund would have lost $1,164 in the three years; the average Vanguard fund would have gained $401, excluding taxes, in the three years -- about a 16 percent difference.

``The performance of investment bank mutual funds can best be summed up as anemic," says Geoff Bobroff, a former SEC lawyer and now a mutual fund consultant in East Greenwich, Rhode Island.

Winning More Work

Bank funds buy clients' shares as a show of support to help win more underwriting, lending and merger work, says Edward Siedle, 49, an SEC attorney from 1983 to 1985 who helped regulate mutual funds.

``You want to show that you are not only able to sell the deal, but you're able to put away the product," he says. ``The more you can do that, the more your clients are going to be attracted to you."

Mercer Bullard, 43, an SEC attorney from 1996 to 2000 and now a law professor at the University

of Mississippi, says banks use funds to get rid of shares of client companies that others don't want to buy.

``Funds are used as dumping grounds," says Bullard, former assistant chief counsel in the SEC's investment management division.

`Information Barrier'

Four of the five banks say the desire for banking fees doesn't influence fund investment decisions.

``For years, Citigroup has had an information barrier between its sell and buy sides," says Mary Athridge, a spokeswoman at Citigroup Asset Management, which is the world's 13th-largest mutual fund manager, with $139.9 billion in mutual fund assets, according to Strategic Insight Simfund, a New York-based consulting company.

Merrill Lynch spokeswoman Megan Ochampaugh says, ``The only reason a Merrill portfolio manager chooses to invest in a company is because he or she believes that company will do well for his or her investors."

Credit Suisse Asset Management spokesman Wesley McDade says fund managers serve investors. ``We take our fiduciary duties to our clients seriously and have appropriate mechanisms in place to ensure that those duties are fulfilled and that conflicts, when they arise, are dealt with appropriately," he says.

Goldman Sachs spokesman Peter Rose says the bank holds shares of clients mostly in private partnerships, not mutual funds. Goldman as a firm and the private partnerships it manages usually invest in the companies when they're still private, and Goldman then often manages their IPOs because it knows the companies best, Rose says.

IPO Demand Soars

Goldman doesn't buy client shares after the IPO, he says. The bank generally likes to hold clients' shares for five to seven years -- even if the stock prices tumble -- because it doesn't want to hurt companies it helped to start, Rose says. ``We will subsequently sell our shares in an orderly manner," he says.

Morgan Stanley spokesman Andrew Walton declined to comment for this article. None of the banks agreed to make fund managers available for interviews.

In 1999 and the first quarter of 2000, investor demand for IPO shares soared as new technology companies increased in value by as much as 698 percent on the first day of trading. The share price for VA Linux Systems Inc., a software company based in Fremont, California, increased to $239.25 from $30 on Dec. 9, 1999.

Losses Develop

Investors complained they didn't have access to these hot IPOs, which were doled out to favored banking clients, says Jay Ritter, 50, a finance professor at the University of Florida who has published 16 articles and book chapters on IPO pricing and allocations.

From that perspective, investors in bank private partnerships and mutual funds that held IPO shares in 1999 and 2000 had reason to anticipate double- or triple-digit increases in a short time period.

As it turned out, mutual fund investors suffered losses in funds such as the Merrill Lynch Global Technology Fund. In 2001, the fund held shares in such money-losing Merrill clients as Westlake Village, California-based Homestore Inc., the biggest online home-listings company, and Fairfax,

Virginia-based WebMethods Inc., which sells software to link computers.

The fund fell 85 percent from the peak in March 2000 to the end of 2002. In that fund, 66 of the 202 companies held from 1999 to 2002 -- 33 percent -- were investment banking clients of Merrill, according to data compiled by Bloomberg.

EBay and Expedia

Some of the IPO shares investment banks put into funds and partnerships have been winners for investors. In September 1998, Goldman Sachs took EBay Inc. public in a $63 million IPO. Goldman held 351,867 shares in the San Jose, California-based company, now the world's largest Internet marketplace, in the second quarter of 1999, SEC filings show.

At the time, shares were as low as $31.67, and Goldman's stake was worth as little as $11.1 million. By the end of 2002, when the stock traded at $33.91, Goldman held 5.4 million EBay shares worth $183 million.

Morgan Stanley made gains from investments in IPO client Expedia Inc., the largest Internet travel-booking service. Expedia holdings in Morgan accounts were worth $22.9 million in June 2002, up more than 20-fold from $974,118 at the end of 1999, SEC filings show.

The share price almost doubled to $29.65 in June 2002 from $16.10 in December 1999. Expedia, based in Bellevue, Washington, was acquired last August by InterActiveCorp for $3.3 billion.

Parallel Conflicts

In 2003, Morgan Stanley, CSFB, Merrill Lynch and seven other brokerages paid $1.4 billion to settle claims by the SEC, state regulators, the National Association of Securities Dealers and the New York Stock Exchange that their stock analysts had misled investors by touting shares of companies to win investment banking work.

The settlement grew out of an investigation begun in 2000 by New York Attorney General Eliot Spitzer, who found that the so-called Chinese wall separating investment bankers from the research arms of their employers had broken down.

A parallel conflict exists with some investment banks and their mutual funds, says former SEC attorney Siedle. ``The SEC has accepted this fiction of Chinese walls in many different contexts, and it is the least palatable with mutual funds, because a fund adviser wears so many hats," he says.

The fund managers are promoting their funds, acting as brokers and working for the bank, he says. ``It clearly raises conflict-of-interest questions," says Siedle, a former compliance chief at Marsh & McLennan Cos.' Putnam Investments, the sixth-largest mutual fund company.

SEC Settlements

Last year, Spitzer said he was investigating mutual fund trading practices.

Regulators have been looking into more than 20 fund companies, including Alliance Capital Management Holding LP and Putnam, for giving special opportunities to hedge funds or other big investors, allowing them to profit from fund purchases after markets closed or from rapid-fire fund trading -- both of which are forbidden to ordinary shareholders.

In December, Alliance paid $250 million to settle with the SEC and Spitzer and agreed to cut fees by $350 million. Alliance neither admitted nor denied wrongdoing. In April, Putnam agreed to pay $110 million to settle federal and state allegations that it failed to disclose improper trading. Putnam

neither admitted nor denied wrongdoing.

Bloomberg News researched SEC filings by the five banks, Fidelity and Vanguard from 1999 to 2002.

Finding The Holdings

Each quarter, the SEC requires institutional money managers to report all of their holdings. That filing, called a 13F, doesn't require the holders to identify whether the shares are in mutual funds or private partnerships or are some other type of investment -- such as shares held by the bank itself or securities traded on behalf of outside private partnerships.

Every six months, the SEC requires mutual fund companies to list their funds' holdings and their values in an SEC filing called an N-30D.

Determining how many shares the five banks held involved searching hundreds of filings over a period of at least three years.

Sometimes, these filings deliberately -- and legally -- mask the truth. Under SEC rules, when an institution files a 13F, it may omit holdings of certain shares even if it holds millions of them. That's because the SEC allows institutions temporary confidentiality to protect against others following their trading practices.

A 1997 13F filing by Warren Buffett's Berkshire Hathaway Inc. illustrates how SEC rules can affect investor decisions.

Investor Confusion

Berkshire was San Francisco-based Wells Fargo & Co.'s biggest shareholder, owning 7 million shares. On Aug. 21, 1997, Berkshire filed a 13F that reported no Wells Fargo holdings.

Shares of Wells Fargo, the fourth-largest U.S. bank by assets, fell as much as 6 percent that day, as it appeared Berkshire had sold all of its shares in the company. Wells Fargo issued a statement that Buffett's company ``remains a substantial stockholder'' of the bank.

Berkshire later said it had asked the SEC to keep its Wells Fargo stake confidential in the 13F filing as part of ``an active trading strategy.'' In amended filings later, Berkshire said it had actually increased its Wells Fargo holdings to 7.9 million shares in 1997.

Under SEC rules, an institution must file amended 13F reports within a year of the original reports to disclose its actual holdings for each quarter. In determining the holdings of the five banks and Fidelity and Vanguard, Bloomberg News researched all 13F filings and amended filings from 1999 to 2002, as well as amended filings in 2003.

`Very Serious Disclosure Issue'

SEC rules don't require bank funds to declare which holdings are clients. ``There's a very serious disclosure issue here,'' says Tamar Frankel, 78, a law professor at Boston University who specializes in mutual funds.

She suggests the SEC should compel bank funds to disclose when they hold shares in client companies that pay fees to the bank.

The 13F is the best document to use to analyze bank fund holdings, says Edward O'Neal, a research economist who specialized in fund management and analysis while at the SEC in 1997 and 1998.

The filing is flawed because it includes only what a bank held in the final minute at the end of a quarter, he says. ``Unfortunately, there is no other way to look at what these funds hold,'' he says.

``The method is perfectly sound."

O'Neal, 40, is now a professor at Wake Forest University's Graduate School of Management in Winston-Salem, North Carolina.

Clients In Funds

CSFB and Merrill Lynch are the only two of the five banks that filed separate 13Fs for asset management divisions as well as one for the rest of the banks' holdings.

CSFB's bank holdings show that shares of clients rose to 15.9 percent in 2002 from 11.2 percent in 1999. The percentage of clients in CSFB's asset management division rose to 16.7 percent in 2002 from 11 percent in 1999.

For Merrill Lynch, the percentage of clients in the bank's holdings rose to 22 percent in 2002 from 15.1 percent in 1999, filings show. The percentage of Merrill clients in its asset management unit was almost the same. It rose to 20.3 percent in 2002 from 15.2 percent in 1999.

Goldman Sachs and Morgan Stanley included all holdings in one 13F each quarter. The banks use different classifications for identifying generally where shares are held. By examining only the listings for managed assets, it's possible to identify and analyze fund holdings for the two banks.

Growing Share

Goldman Sachs's percentage of clients in total holdings and asset management were almost identical: 17.1 percent of its total holdings were clients in 2002, up from 12.1 percent in 1999. In Goldman's asset management divisions, 16 percent of its holdings were clients in 2002, up from 11.6 percent in 1999.

Morgan Stanley's percentage of clients in funds was 75 percent higher than the percentage of clients in the bank's total holdings. In 2002, Morgan Stanley reported that 12.7 percent of its entire holdings were clients, up from 9 percent in 1999. The percentage of Morgan Stanley clients in funds in 2002 was 21.3 percent, up from 17.9 percent in 1999.

Citigroup's 13F filing for the fourth quarter of 2003 listed 40 divisions, and not all asset management units are clearly identified. As a result, it's not possible to accurately analyze fund holdings in the 13F. Citigroup's Athridge declined to say which of the 40 divisions were involved in asset management.

When bank funds hold client shares, banks often gain extensive work from those companies, Siedle says. After Citigroup took Genuity public, it became one of the company's bankers, loaning it $265 million from a $2 billion credit line approved by a group of lenders in 2000.

Genuity Shares

Citigroup's ownership of Genuity shares included 9.4 million held by its mutual funds at the end of 2001, 11 months before Genuity sought protection from creditors, SEC N-30D filings show.

The value of Genuity shares, which were reverse split 1 for 20 in 2002, fell 83 percent to $19.9 million in Citigroup funds and partnerships in March 2002 from $115 million in December 2000.

Fidelity Investments never held Genuity shares. Vanguard held 1.5 million shares, or 93 percent fewer shares than Citigroup held, in September 2001, filings show. Genuity was bought out of bankruptcy by Level 3 Communications Inc., a Broomfield, Colorado-based fiber-optic network company, in 2003.

The same month Genuity sought protection from creditors, Spectrasite Holdings Inc., a Cary, North Carolina-based owner and operator of wireless communications towers, also filed for

bankruptcy. Goldman Sachs and Morgan Stanley had taken Spectrasite public in February 2000.

Laws Forbid Favoritism

Goldman accounts steadily increased their holdings of the company in 2000 and 2001 to 1.8 million shares from 98,450 at the IPO, SEC filings show. As Spectrasite's stock price fell to 18 cents in June 2002 from a record high of $28.38 in June 2000, the stake in Goldman accounts fell in value by 92 percent to $84,000 from $7.8 million.

Vanguard Group's holdings peaked at 946,980 shares in September 2001. Merrill Lynch, which had no banking relationship with Spectrasite, never held more than 280,734 shares.

The Securities Act of 1933 and the Investment Advisers Act of 1940 ban mutual fund managers from putting company interests ahead of clients' and require them to use care and prudent judgment in buying securities.

James Cox, a professor at Duke University's School of Law in Durham, North Carolina, says the percentage of client holdings in funds suggests investors may be taking a backseat to banking profits.

No Bias Seen

``These numbers seem to indicate that the banks are propping up underwriting -- which has lucrative fees -- at the expense of their fund management arm, which is less lucrative," he says.

A Harvard Law School graduate, Cox, 60, has testified in Congress about financial market reform and coauthored two textbooks, including ``Securities Regulations: Cases and Materials" (Aspen Law and Business, 1977).

Philip Kirstein, 58, a former senior vice president and general counsel at Merrill Lynch Asset Management, says he doesn't believe investment bank fund managers intentionally favor their firms' investment banking clients.

``We're talking about a period during a bubble -- when all sorts of people, including fund managers, thought they were geniuses and were eager to load up on what were perceived as `hot stocks,'" he says. ``Plus, there is a fair amount of legal protection from laws written in 1933 and 1940."

Link Expected

Kirstein, now an attorney with Kirkpatrick & Lockhart LLP in New York, says the phenomenon of hot IPOs might explain why Morgan Stanley funds were steeped in Morgan IPOs or why Goldman Sachs funds would hold shares of client companies.

``I'd expect a strong correlation between Morgan Stanley and Goldman Sachs's fund holdings and their investment banking roster in, say, technology, since Morgan and Goldman were very large participants in this sector as an investment banker," he says. ``That doesn't mean one was unduly swayed by another part of the firm."

Goldman Sachs spokesman Rose says the company's investment decisions aren't based on potential investment banking relationships. ``We look for situations where we can work alongside existing management to increase the value of the company," he says.

Morgan Stanley managed the February 2001 IPO of McLean, Virginia-based computer consulting firm BearingPoint Inc., a spinoff of New York-based accounting firm KPMG LLP. Morgan held 3.9 million shares at the end of 2002, SEC filings show, after BearingPoint shares fell 62 percent to $6.90 from the IPO price of $18.

Fund Lost Value

Morgan also helped advise on a $1.2 billion acquisition by BearingPoint of three of KPMG's European units in August 2002. By comparison, at the end of 2002, Goldman Sachs, which had no role in the IPO, held 1.9 million shares, SEC filings show. Vanguard held none.

The Morgan Stanley Technology Fund had the lowest return among 96 U.S. technology funds in 2001, losing 48 percent of its value, according to Bloomberg data.

In February 2001, five of that fund's top 10 holdings were banking clients. They included Spectrasite and Mountain View, California-based Intuit Inc., a maker of accounting software and a Morgan client in three stock sales, according to SEC filings.

Merrill Lynch's SEC filings show that Merrill also held client shares even as stock prices crashed. Merrill kept 1.1 million shares of Internet Capital Group Inc., a Wayne, Pennsylvania-based company that buys and sells Web companies, at the end of 2001, when the stock had fallen to $1.21 from a high of $212 in December 1999.

Lawsuits

Mutual fund shareholders -- including Michal Merritt of Randallstown, Maryland, and Ronald and Judith Mierzwiak of Summerfield, Florida -- filed at least 10 lawsuits against Merrill Lynch and Morgan Stanley in 2002, accusing the firms of using their mutual funds as a device to win investment banking work.

The suits allege the banks had conflicts of interest in their investment strategy, hurting investors. Judge Milton Pollack of U.S. District Court in New York consolidated the Merrill Lynch suits into one and dismissed it in July 2003.

The 97-year-old judge said investors had filed suit too long after their losses. He also said the funds had no legal obligation to tell investors they held shares of bank clients. The case is now under appeal.

Merrill, Morgan Stanley

Merrill said in court papers before the suit was dismissed that the plaintiffs' case was too vaguely drawn and failed to show Merrill had misled anyone. Merrill's Ochampaugh says the company doesn't discuss strategies for pending litigation. ``We believe Judge Pollack ruled correctly,'' she says.

Merrill Lynch is a passive, minority investor in Bloomberg LP, the parent of Bloomberg News.

The suits against Morgan Stanley, also consolidated, are pending. Morgan spokesman Walton declined to comment on active litigation.

One of the suits said Merrill Lynch sought banking work from InfoSpace.com Inc., a Bellevue, Washington-based maker of Web and wireless telephone software, in the middle of 2000, as Merrill mutual funds held 996,000 shares of the company.

InfoSpace was the third-largest shareholding of one of the funds, SEC filings show. At the time, Merrill was advising InfoSpace on the acquisition of Pasadena, California-based Go2Net Inc., which operated a group of consumer Web sites, according to the lawsuit.

`Parking Stock'

``This company is very important to us from a banking perspective,'' said an internal e-mail written by a member of Merrill's Internet research group to a Merrill broker in May 2000. The

complaint didn't name the writer or recipient of the e-mail. Ochampaugh declined to comment on the e-mail.

``The fund manager bought and sold because Merrill did the underwriting," says Darren Blum, an attorney for a plaintiff suing Merrill. ``It was like they were parking stock in the fund."

Merrill Lynch led Internet Capital's IPO, for which Merrill was paid the bulk of $12.5 million in fees. Merrill also earned $16.3 million in fees for a second sale of stock and a convertible bond offering, and the firm earned a $1 million fee for advising on an acquisition, according to the lawsuit.

Internet Capital has reported a per-share profit in just four of 23 quarters, and its shares haven't closed higher than $1 in two years.

Investment Company Act

As the bear market persisted in the first quarter of 2002, Merrill Lynch held 1 million shares, less than 1 percent of the company's outstanding stock, SEC filings show. Fidelity held no shares in March 2002, and Vanguard owned 1,371, according to SEC filings.

Investment bank mutual funds were barred from buying shares of underwriting clients by the Investment Company Act of 1940. SEC officials told legislators at a Congressional hearing leading up to the act that funds were being used to dump shares of money-losing companies, according to a transcript of the hearing.

``There were concerns about back-scratching between the early funds and the investment banks, so laws were put in place to protect investors," says Boston University law professor Frankel.

The SEC first permitted the buying of client shares in 1958, limiting the share amounts to 3 percent of an underwriting. Shareholders in bank funds should have the same access to bank clients as other investors, the banks argued, according to the SEC.

Lobbied the SEC

The Investment Company Institute, a mutual fund trade group; Merrill Lynch; and other banks lobbied the SEC in the 1970s and 1980s, as the popularity of mutual funds grew, to allow them to buy more shares of their clients for funds, says Kathryn McGrath, 60, former chief of investment management at the SEC.

The banks made the same argument at that time as they did in the 1950s, she says. Mutual fund assets rose almost 1,000-fold from 1970 to 2003 as total assets increased to $7.6 trillion --including exchange-traded and closed-end funds, which are bought and sold as stocks on an exchange -- from $7.6 billion.

In 1979, the SEC increased the percentage of bank client shares allowed in bank mutual funds to 4 percent. In the 1980s, when Ronald Reagan was president, Shearson American Express, Merrill Lynch and other banks intensified pressure on the SEC to further increase the limit, SEC records show.

``There was heavy lobbying," says Siedle, the former SEC attorney, who sat in on 1985 meetings between lawyers for Shearson and regulators. ``This was a very high priority for the firms."

Limit Increased Sixfold

Siedle is now president of Lighthouse Point, Florida-based Benchmark Cos., which represents pension funds and other institutional investors with complaints against money managers.

Citigroup, which acquired Shearson when Citigroup predecessor Citicorp and Travelers Group Inc. merged in 1998, and Merrill Lynch declined to comment on the lobbying efforts.

Arthur Levitt was SEC chairman and Bill Clinton was president in 1997, when the SEC increased the limit sixfold to 25 percent.

Even as the increase was being approved, Citicorp, Merrill Lynch and Morgan Stanley advocated in letters to the commission that there should be no limit to purchasing client shares.

``The substantial growth in assets under management over the last few years, combined with the fact that available supply of securities has not always kept pace, has made the quantitative provisions of the rule more problematic than in the past," Lawrence Kaplan, then chief counsel of Salomon Brothers Asset Management, wrote in a 1996 letter to the SEC.

`Sticky' Securities

Baltimore-based T. Rowe Price Group Inc., the largest publicly traded manager of U.S. equity funds, opposed going beyond 25 percent.

``Without such limits, underwriters could easily dump unwanted or `sticky' securities in affiliated accounts during a down market," Chief Counsel Henry Hopkins said in a 1996 letter to the SEC.

Levitt, 73, says he doesn't recall the exact circumstances leading to the increase to 25 percent. ``I'm not prepared to say we went too far," Levitt says. ``I think it's something the staff has to look at on an ongoing basis. Whether it's 4 percent or 25 percent, there's still a potential conflict."

Levitt is now a director of Bloomberg LP.

Banks have made use of the 25 percent rule.

During the fourth quarter of 2000, Citigroup held 1.45 million shares of XO Communications Inc., a Reston, Virginia-based telephone and Internet access company. The stock traded as high as $34.63 that quarter, making the stake worth $50.2 million.

Stake Increases

Citigroup increased its holdings of the company's shares to 2.1 million in the fourth quarter of 2001, when the stock traded no higher than $1.72, SEC filings show. The value of the bank's stake fell to $3.6 million. Citigroup comanaged both XO's $258 million IPO and $578 million secondary sale of stock to the public.

In the fourth quarter of 1999, SEC filings show, Citigroup held 2.86 million shares of Metromedia Fiber Network Inc., a White Plains, New York-based fiber-optic network operator. The stock traded as high as $24.94 that quarter, so Citigroup's stake was worth as much as $71.3 million.

At the end of the first quarter of 2001, Citigroup held 2.87 million shares, when the stock traded at $5.48. Citigroup's Metromedia stake was then worth $15.7 million -- a 78 percent loss over six quarters.

Sprint PCS

Citigroup also comanaged the $610 million public stock sale of Sprint PCS, the mobile phone unit of Sprint Corp., the third-biggest U.S. long-distance company, in February 1999. Citigroup increased its Sprint PCS holdings to 67.1 million shares in the fourth quarter of 2002, up from 63.2 million shares in the first quarter.

As Citigroup holdings of Overland Park, Kansas-based Sprint PCS went up in 2002, the share price plummeted by 93 percent to $1.75 on Sept. 30 from $25.20 on Jan. 2.

Fidelity sold Sprint PCS shares in each quarter of 2002. It held 18.4 million in the fourth quarter, down from 51.6 million in the first, SEC filings show.

Citigroup's Athridge says the banks' funds aren't laggards. ``The strong track record of our fund

managers, who are compensated on investment performance, has been achieved by conducting their own analysis based on each fund's investment objectives," she says.

She adds that 2002 was ``the only bad year Salomon's ever had" and cites a February 2002 Barron's article that found Salomon mutual funds ranked fifth out of 88 fund families in 2001. She says 2002's results accounted for the losses from 2001 through 2003.

IPO Shares Held

At Goldman Sachs, in the third quarter of 2000, the bank held more than 9.1 million shares of eight different companies it brought public in 1999 and 2000: Allied Riser Communications Corp., Corio Inc., GigaMedia Ltd., Net2000 Communications Inc., NorthPoint Communications Group Inc., Organic Inc., Rediff.com India Ltd. and Webvan Group Inc.

In that same three-month period, Fidelity held fewer than 910,000 shares of stock in two of those companies -- about 10 percent of Goldman's stake. Fidelity didn't hold any shares in the other six companies.

In October 1999, Goldman Sachs helped bring public Dallas-based Allied Riser, which runs fiber-optic networks that provide companies with high-speed data and video links, in a $284 million IPO.

In January 2000, Goldman added Allied to its list of 89 ``favorite stocks" for the year ahead. A year after the IPO, Goldman was the sole manager of a $150 million convertible bond offering for Allied.

Value Plummets

Goldman Sachs held 4.06 million shares of Allied worth more than $141 million on March 31, 2000 -- up from 948,000 shares worth about $19.6 million at the end of 1999 -- according to SEC filings. By the end of 2000, Goldman held almost 4.7 million shares of Allied, filings show.

The value of Allied Riser shares in Goldman accounts fell 97 percent at the end of 2000 to about $9.5 million. Allied Riser shares fell to $2.03 at the end of 2000, after trading as high as $48.75 in March 2000.

Cogent Communications Group Inc., an Internet service provider based in Washington, acquired Allied Riser in 2002.

In April 2002, CSFB mutual funds held 200,000 shares of E.piphany Inc., a San Mateo, California-based software developer, after the stock lost 97 percent of its value, SEC N-30D filings show.

E.piphany Share Sales

Shares fell to $6.02 from $216.58 in March 2000. Vanguard held 6,228 shares of E.piphany in June 2002. Goldman, which didn't help manage the IPO, held 63,037 shares.

CSFB comanaged E.piphany's IPO in 1999, coordinated a second sale of shares for $660 million and advised on two acquisitions totaling $1.6 billion in 2000.

In October 2001, the Credit Suisse Small Cap Growth Fund and three other CSFB mutual funds held a total of 107,500 shares of New York-based cable operator Insight Communications Co., SEC filings show. At that time, Insight's shares sold for $20.50, down 33 percent from a high of $28.63 in September 1999.

CSFB sold Insight bonds, and in 1999, Donaldson Lufkin & Jenrette Inc., which CSFB bought in 2000, brought the company public. CSFB's total holdings peaked at 1.4 million shares in March 2002, when the share price was $20.95.

In that same quarter, Morgan Stanley held 19,200 shares, according to SEC filings. Morgan co-led the IPO. Fidelity --which bought 1.7 million shares at the IPO -- didn't own any shares in March 2002.

`Fiduciary Duty'

Credit Suisse Asset Management spokesman McDade says the firm doesn't show banking fee bias in making investments. ``The guiding principle in CSAM's management of its client portfolios is the fiduciary duty we have to act in our clients' best interest," he says.

Investors should be better protected from bank mutual fund conflicts, says former SEC lawyer Bullard. The 25 percent limit on bank funds' buying of shares of underwriting clients is too high, he says. ``The wall between fund managers and investment bankers can't survive scrutiny," he says.

Frankel, the Boston University law professor, recommends that funds be required to fully report ties between the companies whose shares they hold and the investment banking firm.

``There's a pattern of deception by not fully laying out how much money another part of the firm is collecting from the stocks in these funds' portfolio," she says. Until government regulators act, there's no reason to think that pattern will change.

--With reporting by Aaron Pressman in Boston and Bob Drummond in Washington. Editors: Henkoff, Neumann

Story illustration: For articles on recent mutual fund troubles, click on {MUTU <GO>}. For a series of Bloomberg functions related to IPOs, click on {CNP01230730103 <GO>}.

To contact the reporter on this story: David Dietz in San Francisco at (1) (415) 743-3551 or ddietz1@bloomberg.net

To contact the editor of this story: Ron Henkoff at (1) (212) 318-2347 or rhenkoff@bloomberg.net

#<853975.219053>#

Senate Committee Asks SEC to Probe Bank Mutual Fund `Conflicts'

By David Dietz and Adam Levy

May 11 (Bloomberg) -- The Senate Banking Committee will ask the Securities and Exchange Commission to investigate whether Citigroup Inc., Merrill Lynch & Co. and other banks stuffed client shares into mutual funds during the three-year stock market decline, said a spokesman for Committee Chairman Senator Richard Shelby.

``Clearly, one of the key issues in mutual fund reform is eliminating the conflicts of interest that harms investors," said Andrew Gray, committee spokesman. ``This is an area we believe the SEC should pursue."

Shelby, 70, an Alabama Republican, is ``deeply concerned" by a Bloomberg News report April 29 that found that as much as 30 percent of the holdings of investment bank mutual funds were bank clients, Gray said.

Besides Citigroup and Merrill Lynch, the article examined the stocks held by funds at Morgan Stanley and Credit Suisse Group's Credit Suisse First Boston. The bank mutual funds held shares of some underwriting clients as those stocks fell by as much as 99 percent.

Shelby will discuss investment bank fund conflicts with SEC Chairman William Donaldson, 72, as soon as possible, perhaps in a letter, Gray said.

The committee and the SEC have been investigating improper trading, failure to disclose fees and other mutual fund abuses. Shelby's committee has held 10 hearings into fund practices and deferred to the SEC to come up with remedies.

SEC spokesman John Heine said the commission would have no comment on Shelby's request for an investigation.

`It'll be Done'

Mercer Bullard, an SEC attorney from 1996 to 2000 and now a law professor at the University of Mississippi, said the SEC would definitely follow the committee's request. ``If Shelby asks for it, it'll be done," said Bullard, 43.

Citigroup spokesman Edward Giltenan declined comment, as did Andrew Walton at Morgan Stanley, and Wesley McDade at Credit Suisse Asset Management. Megan Ochampaugh, spokeswoman at Merrill Lynch, didn't return two telephone calls to her office and cell phone.

Representatives of investment banks whose mutual funds were examined by Bloomberg News said in the April 29 article that their fund managers weren't influenced by client relationships in share purchases. Citigroup spokesman Mary Athridge said the bank specifically barred communication about investments between its asset managers and underwriters.

Merrill's Ochampaugh said in the April 29 article the only reason a fund manager invested in a company was because he or she believed that company would do well for investors. Credit Suisse's McDade said in the article that fund managers had fulfilled their fiduciary duties to clients.

Performance Rankings

Morgan Stanley's Walton declined to comment for the April 29 article.

Merrill Lynch is a passive minority investor in Bloomberg LP, the parent of Bloomberg News.

Stock mutual funds managed by five banks performed in the bottom half of 549 U.S. mutual fund companies from 2001 through 2003, according to research firm Lipper Inc. Citigroup and

CSFB funds were the worst performers in the group, finishing in the bottom third.

Funds of Smith Barney, a Citigroup subsidiary, lost an average of 3.1 percent in value, finishing 365th. Citigroup's Salomon Brothers Asset Management Inc. funds lost an average of 3.14 percent and ended 344th. CSFB mutual funds ranked 342nd with an average loss of 3/13 percent.

Parallel Conflict

Funds managed by Morgan Stanley ended 226th and 385th and Merrill Lynch funds ranked 276th.

In 2003, Morgan Stanley, CSFB, Merrill Lynch and seven other brokerages paid $1.4 billion to settle claims by the SEC, state regulators, the National Association of Securities Dealers and the New York Stock Exchange that their stock analysts had misled investors by touting shares of companies to win investment banking work.

The settlement resulted from an investigation started in 2000 by New York Attorney General Eliot Spitzer, who found that the so-called Chinese wall dividing investment bankers and research arms of their employers had broken down.

There's a parallel conflict with some investment banks and their mutual funds, said former SEC attorney Edward Siedle. Now president of pension adviser Benchmark Cos. of Lighthouse Point, Florida, Siedel, 49, said investment bank mutual funds buy client shares to show companies they are willing to support a stock, even if it plummets in value.

Hold and Plunge

Investment bank funds held shares of clients in 2001 and 2002 after their values had plunged as much as 99 percent because of the stock market slump, SEC filings show. Some of the companies that were owned never reported profits.

Nine Citigroup funds held 9.4 million shares, or about 5 percent, of Genuity Inc., a Woburn, Massachusetts, provider of Internet services to companies, in December 2001. At that point, the company had not reported a profit and was 11 months away from filing for bankruptcy. Genuity, the largest Internet IPO, had gone public in June 2000 with Citigroup's help.

In September 2001, the Merrill Lynch Global Technology Fund owned 334,100 shares of money-losing Homestore Inc. Merrill helped manage the IPO and a second sale of stock for the largest online home-listings company.

The fund fell 85 percent from the peak in March 2000 to the end of 2002. In that fund, 66 -- or 33 percent -- of the 202 companies held from 1999 to 2002 were investment bank clients of Merrill, according to data compiled by Bloomberg.

Investor Lawsuits

The Morgan Stanley Technology Fund was the worst performing technology fund in 2001, according to Bloomberg data. Five of the top 10 share holdings in the fund in February 2001 were Morgan Stanley clients, SEC filings show.

Investors, including Ronald and Judith Mierzwiak of Summerfield, Florida, filed at least 10 lawsuits against Merrill Lynch and Morgan Stanley in 2002. They alleged the funds had hurt performance by holding poorly performing client shares. Investors weren't told of the client holdings, they said.

Judge Milton Pollack, 97, of U.S. District Court in New York combined the suits against Merrill into one and then dismissed it, saying the actions had been filed too late. The case is on appeal. The

suits against Morgan are awaiting the appeal's outcome. Merrill and Morgan Stanley declined to comment on pending litigation.

The SEC and regulators in New York, Massachusetts and other states are investigating the mutual fund industry for giving special opportunities to hedge funds or other big investors, allowing them to profit from fund purchases after markets closed or from rapid-fire fund trading -- both of which are forbidden to ordinary shareholders.

Fund Settlements

Putnam Investments LLC, Janus Capital Group Inc., Alliance Capital Management Holding LP and three other firms have paid penalties and awarded fee cuts totaling $2.1 billion for letting hedge funds profit from fund purchases after markets closed or from rapid-fire fund trading -- both of which are forbidden to ordinary shareholders.

Alliance neither admitted nor denied wrongdoing. In April, Putnam agreed to pay $110 million to settle federal and state allegations that it failed to disclose improper trading. Putnam neither admitted nor denied wrongdoing.

Stephen Cutler, head of the SEC's enforcement division, said in January the agency was investigating eight brokerage firms and 12 mutual fund companies for hiding incentive payments that may have influenced advice given to investors.

Morgan Stanley, the second-largest securities firm by capital, and MFS Investment Management, the Boston-based money management unit of Sun Life Financial Inc., have each consented to pay $50 million in penalties for undisclosed fee agreements.

--Editors: Neumann, Henkoff, Wolfson

Story illustration: For news on the SEC and information on rules and administrative orders, see {CNP 14580240105 <GO>}. To pause on a screen, press the space bar. To resume, press GO. For more articles on mutual funds, type {MUTU <GO>}. To see related story from April 29: {NXTW NSN HWX12W07SXKX <GO>}

To contact the reporter on this story: David Dietz in San Francisco at (1) (415) 743-3551 or ddietz1@bloomberg.net

To contact the editor responsible for this story: Ronald Henkoff at (1) (212) 318-2347 or rhenkoff@bloomberg.net

#<529087.166543>#

SEC Is Examining Whether Bank Funds Favored Clients (Update1)

(Adds testimony from SEC's Lori Richards in 8th paragraph.)

By David Dietz and Adam Levy

May 12 (Bloomberg) -- The U.S. Securities and Exchange Commission early this year began examining whether investment bank mutual funds are overloaded with shares of companies that are banking clients, SEC spokesman John Nester said.

Nester said the commission's compliance office is in the preliminary stages of the review, which was undertaken as part of a continuing check of possible conflicts of interest in the mutual fund industry.

The Senate Banking Committee on Monday said it would ask the SEC to conduct an investigation into whether banks stuff mutual funds with client shares. The request came after an April 29 report by Bloomberg News that found funds offered by Citigroup Inc., Merrill Lynch & Co. and two other banks contained up to 30 percent of client shares as the stock market surged and then plummeted between 1999 and 2002.

``Several months ago the SEC initiated an examination review of mutual fund firms affiliated with investment banks as part of its ongoing review of conflicts of interest in the mutual fund industry," Nester said.

An SEC review is an informal process, different from a formal investigation. The Banking Committee said it would ask the SEC to do a more formal investigation.

``It's encouraging and we support it," committee spokesman Andrew Gray said of the SEC review. He said he didn't know whether the Senate committee staff was aware of the SEC effort when the committee decided to request an SEC probe.

Mutual Fund Changes

SEC Chairman William Donaldson told the banking committee last month the agency I is studying mutual fund operating changes in the aftermath of a trading scandal that has enveloped more than 20 companies, including Putnam Investments LLC and Janus Capital Group Inc.

Lori Richards, director of the Office of Compliance Inspections and Examinations at the SEC, testified at a March 10 Banking Committee hearing, saying her office was conducting ``targeted mini-sweeps" of various mutual fund abuses.

The April 29 Bloomberg News article examined the makeup of funds at Morgan Stanley and Credit Suisse Group's Credit Suisse First Boston, as well as those at Citigroup and Merrill. Bank funds held shares of some underwriting clients as those stocks fell by as much as 99 percent.

Representatives of investment banks whose mutual funds were examined said in the April 29 article that their fund managers weren't influenced by client relationships in share purchases.

--Editor: Neumann, Wolfson, Neumann

Story illustration: Story illustration: For news on the SEC and information on rules and administrative orders, see {CNP 14580240105 <GO>}. To pause on a screen, press the space bar. To resume, press GO. For more articles on mutual funds, type MUTU <GO>. To see related story from April 29, click on {NXTW NSN HWX12W07SXKX <GO>}

To contact the reporter on this story: David Dietz in San Francisco at (1) (415) 743-3551 or ddietz1@bloomberg.net

To contact the editor responsible for this story: Ronald Henkoff at (1) (212) 318-2347 or rhenkoff@bloomberg.net

#<529087.166543>#
#<675851.1310157>#

SEC Letters Query Banks in Fund Inquiry, Person Says (Update1)

(Updates share prices in last paragraph.)

By David Dietz and Adam Levy

July 29 (Bloomberg) -- The U.S. Securities and Exchange Commission sent letters last month to Citigroup Inc., Merrill Lynch & Co., Morgan Stanley, Credit Suisse First Boston and Goldman Sachs Group Inc., asking how their mutual funds avoid conflicts in buying shares of bank clients, a person familiar with the requests says.

The letters are part of an examination by the SEC into whether bank mutual funds were stuffed with shares of companies that pay the banks millions of dollars in fees for underwriting work and merger advice.

The letters, sent by the SEC's Office of Compliance Inspections and Examinations, asked the banks to explain procedures required by the SEC to ensure that investment banking activities are kept separate from management of funds sold to the public, according to the person familiar with the inquiry.

``They're looking for the smoking gun," said Edward Siedle, 49, a former SEC enforcement attorney, now head of the Center for Investment Management Investigations in Lighthouse Point, Florida. ``They're looking at what procedures fund boards have adopted to see that mutual fund shareholders aren't harmed."

The letters are part of an SEC fact-finding effort in its early stages and short of an investigation that could lead to discipline by the commission, the person familiar with the letters said.

Banks Denied Wrongdoing

SEC spokesman John Nester declined comment on the agency's requests to the banks. He said in May the SEC had begun checking possible fund favoritism toward banking clients earlier this year.

Merrill Lynch spokeswoman Megan Frank and Goldman Sachs spokesman Peter Rose said their banks don't comment on regulatory matters. Citigroup spokeswoman Mary Athridge, Morgan Stanley spokeswoman Andrea Slattery and Credit Suisse Asset Management spokesman Wesley McDade declined to comment.

Bloomberg News reported on April 29 that funds offered by Citigroup, Merrill Lynch, Morgan Stanley and Credit Suisse Group's Credit Suisse First Boston contained as much as 30 percent of client shares as the stock market surged and then plunged between 1999 and 2002.

Representatives of investment banks whose mutual funds were examined in the April 29 article said then that their fund managers weren't influenced by client relationships in share purchases.

Investor Interests

Citigroup's Athridge said in the April 29 article that the bank specifically barred communication about investments between its asset managers and underwriters. Merrill's Frank and Credit Suisse Asset Management's McDade said fund managers invest solely in the best interests of investors.

Goldman Sachs spokesman Rose said in the article that Goldman typically holds shares of clients it brings public in private equity funds, not in mutual funds. Such private investments are loosely regulated funds for investors with at least $1 million in assets, and aren't subject to SEC rules governing mutual funds.

Rose said the investments are usually held in the private funds from five to seven years, even if values plunge, because the bank doesn't want to hurt companies it starts.

Fund Holdings

Some bank mutual funds held shares of banking clients after values had plummeted by as much as 99 percent, hurting fund performance, data compiled by Bloomberg showed. The Merrill Lynch Global Technology Fund fell 85 percent in value from March 2000 to the end of 2002. From 1999 to 2002, 66 of the 202 companies held by the fund, or 33 percent, were Merrill banking clients, data showed.

The Senate Banking Committee, citing the April 29 story, asked the SEC in May to look into whether fund managers may have been influenced to favor banking clients. The Securities Act of 1933 and the Investment Advisers Act of 1940 require fund managers to act prudently and forbid them from putting banking client interests ahead of fund shareholders.

Senator Richard Shelby, 70, an Alabama Republican and chairman of the banking committee, said he wants the SEC, under Chairman William Donaldson, 73, to investigate mutual fund abuses. ``As the SEC's actions to date indicate, Chairman Donaldson continues to be aggressive in his efforts to address abuses in the mutual fund industry," Shelby said.

`Get the Ball Rolling'

Mercer Bullard, a former SEC attorney and now a law professor at the University of Mississippi, said one purpose of the SEC letters is to likely find out whether fund managers and directors are following SEC rules on limits on holdings of underwritings. Under the regulations, the percentage of shares of a banking client can't exceed 25 percent of a fund.

He said the SEC likely wants to know whether fund boards are regularly monitoring holdings of client shares, as required by the SEC, and whether proper records are kept on transactions.

``It sounds like they're just starting to get the ball rolling," he said. Bullard said further inquiries about procedures are likely, depending on answers the SEC gets. If violations of securities laws are suspected, the case would be referred to SEC enforcement staff, he said.

Siedle said in the April 29 article that funds at investment banks buy shares of banking clients to prop them up and help underwriters and merger advisers gain additional work from the clients.

Similar Conflicts

He said fund managers have conflicts similar to securities analysts. In 2003, Morgan Stanley, CSFB, Merrill Lynch and seven other brokerages paid $1.4 billion to settle claims by the SEC, state regulators and the National Association of Securities Dealers that analysts misled investors by touting shares of companies to win investment banking work.

The settlement arose from an investigation started in 2000 by New York Attorney General Eliot Spitzer. His office found breakdowns in the so-called Chinese wall dividing investment bankers and securities research arms. Siedle said a similar divide that's supposed to exist between fund managers and bankers also is weak.

Investment bank funds held millions of shares of clients, many of them technology companies that went public during the stock market boom, as the stock mark slumped in 2001 and 2002, SEC filings show. Some of the companies that were owned never reported profits.

Fidelity, Vanguard

Mutual funds run by managers with no investment banking activities -- including Fidelity Investments, the largest U.S. mutual fund company, and Vanguard Group, the second-largest -- often bought proportionately fewer, or none, of the shares of the investment banks' IPO clients, SEC filings show.

Nine Citigroup funds held 9.4 million shares, or about 5 percent, of banking client Genuity Inc., a Woburn, Massachusetts, provider of Internet services to companies, in December 2001. At that point, the company had not reported a profit and was 11 months away from filing for bankruptcy on Nov. 27, 2002. Genuity, the largest Internet IPO, had gone public in June 2000 with Citigroup's help.

In September 2001, the Merrill Lynch Global Technology Fund owned 334,100 shares of money-losing Homestore Inc. Merrill helped manage the IPO and a second sale of stock for the largest online home-listings company.

Among 549 mutual fund companies, stock funds managed by Citigroup, Merrill Lynch, one of two Morgan Stanley units and Credit Suisse First Boston performed in the bottom half from 2001 through 2003, according to research firm Lipper Inc.

Lawsuits Pending

Class-action lawsuits are pending in federal courts in New York against Merrill Lynch and Morgan Stanley over poor performance of funds containing client shares. Investors, including Ronald and Judith Mierzwiak of Summerfield, Florida, say in the suits, filed in 2002, that holdings of client shares should have been disclosed.

Harvey Pitt, former SEC chairman, said in May he favored requiring funds to reveal client holdings.

Citigroup shares were up 57 cents to $44.28 at 4:01 p.m.; Goldman Sachs shares rose 98 cents to $89.69 at 4:16 p.m.; Merrill shares rose 17 cents to $50.36 at 4:00 p.m.; and Morgan Stanley shares rose $1.10 to $49.90 at 4:01 p.m. in New York Stock Exchange trading. Credit Suisse Group shares were up 75 centimes to 41.75 francs in Zurich.

--Editors: Neumann, Henkoff, Siler, Neumann.

Story illustration: For news on the SEC and information on rules and administrative orders, see {CNP 14580240105 <GO>}. To pause on a screen, press the space bar. To resume, press GO. For more articles on mutual funds, type MUTU <GO>. To see related stories from April 29: {NXTW NSN HWX12W07SXKX <GO>}.

To contact the reporter on this story: David Dietz in San Francisco at (1) (415) 743-3551 or ddietz1@bloomberg.net

To contact the editor responsible for this story: Ronald Henkoff at (1) (212) 318-2347 or rhenkoff@bloomberg.net

Company news: C US <Equity> GENUQ US <Equity> CSGN VX <Equity> MER US <Equity> MWD US <Equity> MAGTX US <Equity> 5079Z US <Equity> 5125Z US <Equity>

#<675851.1310157>#

Citigroup, Morgan Stanley Funds Bought Sinking Client Shares

By David Dietz and Adam Levy

Oct. 1 (Bloomberg) -- As Wall Street analysts cheered for WorldCom Inc. in October 2000, forensic accountant Howard Schilit scoffed.

Schilit, 52, head of Rockville, Maryland-based Center for Financial Research & Analysis Inc., wrote in a report to billionaire Julian Robertson's Tiger Management LLC and about 100 other clients that WorldCom was playing accounting tricks to embellish profits.

Citigroup Inc., WorldCom's principal banker, stood by the company. In the months before WorldCom filed the largest ever U.S. bankruptcy in July 2002, fund managers at Fidelity Investments, the world's largest mutual fund company, sold 76 percent of their WorldCom shares; Vanguard Group Inc., the second largest, sold 98 percent, according to federal filings.

In that period, Citigroup mutual funds and private investor accounts bought 8.8 million additional shares of WorldCom, according to federal filings and Citigroup. From 1996 to 2002, New York-based Citigroup, the world's biggest financial services company, collected $107 million in fees for bank services from the Clinton, Mississippi-based company, according to U.S. Bankruptcy Court records.

Citigroup wasn't the only bank whose asset managers bought or held shares of client companies approaching bankruptcy, according to filings with the U.S. Securities and Exchange Commission.

Morgan Stanley

Morgan Stanley reported to the SEC that it had bought 700,000 Global Crossing Ltd. shares in 2001, giving its asset management division a year-end total of 3.4 million shares, a month before the Hamilton, Bermuda-based fiber-optic-network company filed for the sixth largest U.S. bankruptcy.

Goldman Sachs Group Inc. held 897,972 Global Crossing shares in asset management accounts in the last three quarters of 2001, just before the collapse, SEC filings show.

The findings come from an examination of bank mutual funds and private investor account holdings of 10 telecommunications and technology companies whose market values soared in the late 1990s before fraud or excessive debt drove them into bankruptcy.

Morgan Stanley and Goldman Sachs did fee-generating work for Global Crossing, with Morgan Stanley earning more than $50 million in fees from Global Crossing, SEC filings show. At the same time, Fidelity sold 10.7 million of its 11 million Global Crossing shares and Vanguard sold all of its 11 million shares.

The banks say all their fund managers are independent.

Independence and Merit

``Citigroup asset management is a completely separate unit from the firm's investment banking and underwriting business," Citigroup spokesman Edward Giltenan says. ``Our portfolio managers invest strictly on the merits of each security and their performance objectives. Their compensation reflects that performance."

Morgan Stanley spokesman Chad Peterson says, ``Our policy is that all purchase and sale decisions are made independently by portfolio managers on their merits based on the best interest of fund shareholders."

Goldman Sachs spokesman Lucas van Praag says all investment decisions by Goldman are made on merit. ``In no event did the activity have anything to do with our work as a banker," van Praag says. He says the Global Crossing shares held through the bankruptcy were locked in by investments in private accounts for the bank's wealthiest

clients, not mutual funds.

Van Praag says the investors in those funds, not Goldman asset managers, put the Global Crossing shares into the accounts.

$987 Million in Fees

Investment bankers courted telecommunications companies as use of the Internet and cell phones surged and after federal deregulation of the telephone industry in 1996. From 1997 to 2001, Citigroup's Salomon Smith Barney led all bankers by collecting $987 million in fees from telecommunications companies for underwriting and merger work, according to Thomson Financial data.

Bank funds flout investor trust by favoring fee-producing clients, says U.S. Senator Peter Fitzgerald, 44, an Illinois Republican and sponsor of a bill to increase mutual fund disclosure and make fund managers more accountable to shareholders.

``This is a conflict of interest that until now there's been no discussion of," he says. ``It's a conflict of interest at least as great as the analysts on Wall Street were shown to have when they were pushing dog stocks that were underwritten by their firms."

Citigroup and Goldman Sachs say there is no conflict. ``Bloomberg's assertions are completely without merit," Citigroup's Giltenan says. Goldman Sachs's van Praag says, ``Given the facts, I am at a loss to understand what basis Senator Fitzgerald had for saying that the share purchases showed favoritism."

`A Detailed Inquiry'

Filings showing that banks buy or hold client shares before a bankruptcy present an opportunity for the SEC to look into bias, says Harvey Pitt, 59, SEC chairman from August 2001 to November 2002, an appointee of President George W. Bush.

``There is certainly at least a basis to make a detailed inquiry into these patterns -- whether there was direct or indirect, subtle or overt pressure for fund managers to buy certain stocks," says Pitt, now head of Washington-based Kalorama Partners LLC, which advises clients on securities regulations. ``It's hard to believe it's fortuitous."

Bloomberg News reported in April that shares of banking clients of Credit Suisse Group's Credit Suisse First Boston, Merrill Lynch & Co., Citigroup, Goldman Sachs and Morgan Stanley made up as much as 30 percent of the banks' mutual funds or private partnerships as the stock market soared and then plummeted from 1999 to 2002.

Making a Pitch

Private partnerships are loosely regulated funds for individuals with a net worth of at least $1 million. Citigroup also invests shares of clients in what it calls ``separately managed accounts" for wealthy individuals.

While banks often held on to the shares as they fell, nonbank funds usually sold their holdings or didn't buy any in the first place, SEC filings show.

Merrill Lynch spokeswoman Megan Frank and CSFB spokesman Wesley McDade declined to comment for this article. Merrill Lynch is a passive, minority investor in Bloomberg LP, the parent of Bloomberg News.

It's no surprise bank funds buy client shares because underwriters use the funds' buying power to pitch for banking work, says Patrick Byrne, 41, chief executive officer of Overstock.com Inc., a Salt Lake City-based company that sells discounted clothing and other merchandise via the Internet.

He says underwriters from two of the largest investment banks promised support from their fund managers if he let them take Overstock public in 2002.

`It Was Clear'

``They made it clear that they'd bring us out only if the research analysts were positive

on the company, and then we could be confident that the fund managers also would be confident about the company," Byrne says, declining to identify who made the promises.

``It was clear to me what they were saying," Byrne says. ``They did everything but expressly say out loud that the funds would be buying our company."

The bankers' pitches offended him, Byrne says. Overstock eventually sold shares directly to the public via an auction in May 2002. Internet search engine company Google Inc. of Mountain View, California, held a similar auction sale in August.

The approach bypasses the traditional system in which bankers first buy the shares from the company and then resell them to the public, collecting fees.

`Built-in Demand'

Underwriters tout in-house funds to win banking work just as they stress to corporate clients the importance of access to loans and to the share-selling power of a bank's retail force, says Richard Bove, 63, a financial services analyst at New York-based investment bank Punk, Ziegel & Co.

``The banks can point to asset management as built-in demand for their clients' stock, but they're not playing fair with the investors who put their money in these funds," says Bove, who has worked for Dean Witter, Piper Jaffray Cos. and Raymond James Financial Inc., covering Wall Street companies and the banking industry.

``We categorically do not suggest that the firm will buy shares for our funds or client accounts," Goldman Sachs's van Praag says. ``Our asset management business is entirely different from our banking and sales and trading operations."

The Laws

The U.S. Securities Act of 1933 and the Investment Advisers Act of 1940 prohibit fund managers from favoring their own company's interests ahead of those of investors, by requiring care and prudent judgment in buying securities.

``It shall be unlawful for any investment adviser to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client," the law governing fund managers says.

In May, the Senate Banking Committee asked the SEC to investigate potential conflicts in bank funds. In June, the SEC sent letters to the five banks asking them to explain procedures for buying client shares, a person familiar with the examination says.

Pitt says the SEC may next ask the investment banks for all correspondence between a brokerage firm's investment banking and asset management officials and may then ask for testimony from bank officials. SEC Commissioner William Donaldson, who succeeded Pitt as chairman in February 2003, declined to comment.

The government hasn't alleged any of five banks violated the 1933 or 1940 laws in connection with its examination.

The SEC, securities regulators in seven states and the NASD, formerly the National Association of Securities Dealers, have been investigating the $7.5 trillion mutual fund industry since last year for abuses ranging from improper trading of fund shares to funneling undisclosed bonus payments to fund salesmen.

$3.5 Billion in Fines

Janus Capital Group Inc.; Pilgrim, Baxter & Associates Ltd.; and Putnam Investments are among more than a dozen firms that have paid a total of about $3.5 billion in fines to settle regulatory complaints. Each of those companies neither admitted nor denied wrongdoing.

Banking work for sinking clients is at issue in a lawsuit against Goldman Sachs by Malik Hasan, 66, retired CEO of Health Net Inc., a health insurance company based in Woodland

Hills, California.

Hasan sued Goldman in U.S. District Court in Denver in June. He says his $4 million investment in two private Goldman Sachs funds lost $1 million in value because the partnerships held shares of such Goldman clients as Enron Corp. and WorldCom. In 2002, Houston-based energy trader Enron filed for the second-largest bankruptcy in U.S. history.

Lawsuit Complaints

The partnership consisted of a group of company executives put together by Goldman, with each partner investing shares of his own company. Hasan invested Health Net stock in the partnership.

The purpose of the fund was to help executives invested heavily in one stock to diversify while deferring capital gains tax.

Hasan alleges Goldman Sachs violated the Securities Exchange Act of 1934 and other federal securities laws by failing to tell him the funds would include personal shares invested by unidentified executives of WorldCom and other declining companies that were Goldman clients.

Hasan says the only details he got from Goldman Sachs about the other investors in his partnership were that Goldman analysts and bank executives knew the investors' companies. He says he wasn't told how many partners were in the group or who they were.

``Investment banking relationships never came up," Hasan says. ``If it had, I would have said, `Gee, you have a conflict of interest.'"

Other Investor Lawsuits

The suit is pending. In court papers, Goldman has asked the court to transfer the case to New York and submit it to arbitration. Goldman's van Praag says the company doesn't comment on pending litigation.

Judge Milton Pollack of U.S. District Court in New York said in a July 2003 ruling that banks aren't required to tell investors if shares in funds are those of clients. The judge's decision dismissed a mutual fund shareholder lawsuit against Merrill Lynch.

Investors including Michal Merritt of Randallstown, Maryland, and Ronald and Judith Mierzwiak of Summerfield, Florida, alleged in suits against Merrill and Morgan Stanley that the firms had used their mutual funds as a device to win investment banking work, hurting investors.

Pollack, who died on Aug. 13 at the age of 97, consolidated the Merrill Lynch suits into one and dismissed it. The shareholders are appealing the judge's decision. Merrill said in court papers before the suit was dismissed that the plaintiffs' case was vague and failed to show the firm had misled anyone.

SEC Filing Rules

A consolidated investor lawsuit against Morgan Stanley, making similar claims as the suit against Merrill, is pending in U.S. District Court in New York, awaiting the outcome of the appeal in the Merrill case.

Banks are required to report all of their stock holdings to the SEC each quarter. In so-called 13F filings, banks don't have to identify whether the shares are in mutual funds or private partnerships or are some other type of investment -- such as shares held by the bank itself or held for a trust.

In 13F filings, CSFB, Goldman Sachs, Merrill Lynch and Morgan Stanley separate which holdings are for asset management and which are for the rest of the bank's holdings.

The percentage of clients in CSFB's asset management holdings rose to 16.7 percent in 2002 from 11 percent in 1999. Goldman Sachs's percentage of clients in asset management holdings was 16 percent in 2002, up from 11.6 percent in 1999.

Best Interests of Investors

For Merrill, the percentage of clients in asset management holdings rose to 20.3

percent in 2002 from 15.2 percent in 1999. The percentage of Morgan Stanley clients in asset management holdings in 2002 was 21.3 percent, up from 17.9 percent in 1999.

In April, four of the five banks said that all of their asset management decisions are made only in the best interests of investors and are never tied to investment banking work. Goldman Sachs spokesman Peter Rose said most of the bank's client shares in managed assets are in private investor funds, not mutual funds. Morgan Stanley declined to comment in April.

Tamar Frankel, a law professor at Boston University who specializes in mutual funds, says that while the 13F is imperfect, it's a very helpful tool.

``The filings still contain important information and provide insight into the portfolio like no other document out there," says Frankel, who wrote ``The Regulation of Money Managers: Mutual Funds and Advisers" (Aspen Law and Business, 2001).

`Imperfect, Incomplete'

Citigroup's 13F filings list as many as 40 divisions, and investor money under management isn't clearly identified. Most of the divisions are divided into a series of code numbers. Some codes represent shares held in asset management; the others are for bank holdings.

The filings don't indicate which codes represent which type of holding. Citigroup spokesman Giltenan says 13F filings are ``an imperfect, incomplete source for determining asset management holdings, especially in a company as complex and diversified as Citigroup."

As much as 30.6 percent of the bank's reported total holdings were shares of clients, 13F filings show.

In the case of Citigroup, investors would struggle to find whether asset managers were buying or selling shares of Global Crossing, a bank client, as the fiber-optic-network company neared bankruptcy.

`Investors in the Dark'

In its 13F filings, Citigroup reported to the SEC it had increased its total Global Crossing shares and stock options to 28.4 million at the end of 2001, a month before the bankruptcy, from 9.9 million at the end of 2000. A stock option is a contract that sets a specific price at which an investor can buy or sell shares at a specified time.

Citigroup spokeswoman Mary Athridge says looking under the proper codes for mutual funds in the 13F filings would show the bank decreased its Global Crossing mutual fund holdings to 97,928 shares at the end of 2001 from 152,972 shares at the end of 2000.

She says separately managed accounts decreased Global Crossing holdings to 63,121 shares at the end of 2001 from 2.5 million at the end of 2000.

Edward O'Neal, a research economist who specialized in fund management and analysis while at the SEC in 1997 and 1998, says he's confused by Citigroup's not breaking down its fund holdings in 13F filings. He says the company should have because that's the purpose of the filings.

``Investors are in the dark," says O'Neal, a professor at Wake Forest Graduate School of Management in Winston-Salem, North Carolina. ``Banks could be using smoke and mirrors."

Rely on Goldman's Word

Goldman Sachs's van Praag says that while the bank's 13F filings showed that the asset management division increased its holdings of Global Crossing shares to 897,972 in 2001 from 304,882 in 1999, Goldman asset managers actually sold Global shares during that period.

There's no way to verify that from Goldman Sachs's 13F filings. Van Praag says investors will have to rely on the firm's word.

WorldCom became a symbol of the telecommunications boom in the late 1990s by buying more than 60 companies, including

MCI Communications Corp. for $47 billion in 1998, primarily using company shares.

Citigroup, though it made attempts, didn't get any WorldCom work until 1996, according to an investigation ordered into WorldCom's collapse by U.S. Bankruptcy Judge Arthur Gonzalez in New York.

`Extraordinary Financial Favors'

In that year, the bank began giving WorldCom founder and CEO Bernard Ebbers privileges to buy hundreds of thousands of shares from initial public offerings handled by Citigroup unit Salomon Smith Barney, according to the report, which was issued in January by former U.S. Attorney General Richard Thornburgh.

Ebbers, 63, sold many of the shares and made $12.8 million in profit, the report said. He declined to comment.

From that time on, Ebbers heaped business on Citigroup, Thornburgh's report said. Thornburgh, 72, is now an attorney with Kirkpatrick & Lockhart LLP in Washington.

Among Citigroup's largest fees were $32.5 million for advising on the MCI purchase and $23.1 million for handling the sale of $10 billion in bonds in 2001. Thornburgh wrote in the report that Salomon Smith Barney, which he referred to as SSB, went out of its way to help Ebbers.

``SSB gave extraordinary financial favors and assistance to Mr. Ebbers, which were intended to and did influence Mr. Ebbers to award WorldCom investment banking business to Salomon," Thornburgh wrote. Thornburgh declined to comment.

Buying Shares

While the bank did underwriting and merger work for WorldCom, its mutual funds and private accounts accumulated the company's shares, SEC filings show. As the bankruptcy approached, Citigroup's mutual funds and specially managed accounts held 27.5 million WorldCom shares, valued at as much as $436 million before the collapse.

Citigroup's telecommunications analyst Jack Grubman issued 60 `buy' ratings on WorldCom from 1997 to 2002. He became WorldCom's counselor on financial strategy and was the company's biggest booster on Wall Street, Thornburgh wrote.

``Grubman's behavior created at least the appearance of impropriety in that he seemed to have departed from the role of an independent securities analyst," Thornburgh wrote.

Grubman, 51, was barred from the securities industry for life last year and was fined $15 million after New York Attorney General Eliot Spitzer said Grubman had issued biased research reports recommending companies such as Bedminster, New Jersey-based AT&T Corp., the largest U.S. long-distance telephone company, in order to get banking work.

In the settlement with regulators, Grubman neither admitted nor denied wrongdoing. He declined to comment.

Holdings Rise, Sales Fall

The bank's WorldCom holdings rose as WorldCom's sales fell and some analysts issued warnings about accounting tactics and lower sales. At the end of 2001, six months before WorldCom's bankruptcy, Citigroup mutual funds, including the Smith Barney Appreciation Fund, held 14.7 million shares, filings show.

That was up 9 percent from 13.4 million at the end of 2000 and up more than 20-fold from 731,748 at the end of 1999.

Meanwhile, fund managers at Fidelity and Vanguard sold. In 2001, Fidelity sold 76 percent of its WorldCom holdings, keeping 7.9 million shares, down from 33.4 million in 2000. Vanguard sold 98 percent of its WorldCom shares, holding 689,000, down from 42.3 million a year earlier, SEC filings show.

Potential Conflicts

``This is just further evidence of the potential for conflicts of interest that can arise from investment banking relationships," says Brandon Rees, 29, research analyst at the AFL-CIO's office of investments, which advises on the management of $400 billion in the union's pension plan. ``To the extent this may have been a widespread practice demands regulatory scrutiny."

Fidelity spokeswoman Sophie Launay declined to discuss the company's holdings, as did Vanguard spokesman John Demming.

As Citigroup increased work for WorldCom, accountant Schilit raised the first of four written cautions to investors about the company's finances.

In a report published on Oct. 2, 2000, Schilit -- author of the book Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports (McGraw-Hill, 1993) -- said WorldCom was using accounting maneuvers to overstate earnings, especially through acquisitions, and wasn't producing enough cash to pay for operations.

``The company was exaggerating its growth and exaggerating its profits," Schilit says. ``History shows that when companies are very acquisitive, they do very well for a time. But when you look at these things a year after the fact, you usually have a company that's a disaster."

`They Were in a Nosedive'

In March 2001, securities analyst Susan Kalla, then with BlueStone Capital Partners LP in New York, joined the dissent as WorldCom's announced profits declined. Sell, she advised clients in a report.

WorldCom, the second-largest long-distance carrier in the U.S., was then 16 months from filing for bankruptcy. ``It was blatantly obvious to everyone that they were in a nosedive," Kalla says.

Kalla, now at Arlington, Virginia-based Friedman, Billings, Ramsey & Co., said in her March 2001 report that the company's reported sales, already declining, would fall further. WorldCom faced rising competition and reduced orders from companies, which accounted for 60 percent of sales, she said.

Kalla, who previously worked at Fitch Inc. in New York as a bond analyst and at Irving, Texas-based telephone company GTE Corp., turned out to be right. WorldCom's reported sales fell 12 percent to $8.4 billion in the fourth quarter of 2001 from $9.7 billion in the comparable 2000 quarter.

Global Crossing

At about the same time WorldCom was sinking, Global Crossing, which was trying to build a worldwide network of fiber-optic communication cables, followed a similar downward path.

It debuted in August 1998 in a $399 million IPO co-managed by Citigroup and Merrill Lynch, with shares selling for $19. The two banks split $23.9 million in fees for the IPO, according to SEC filings. By May 1999, the company's stock had soared more than threefold to $64.25.

Global Crossing amassed $12.4 billion of debt and filed for bankruptcy on Jan. 28, 2002. At the time, it was the largest-ever U.S. bankruptcy filing by a telecommunications company.

Since the bankruptcy, the SEC has said it was investigating whether Global Crossing inflated sales by reporting nonexistent income from so-called swaps with other telecommunications companies. The federal probe isn't yet complete, the SEC has said.

$50 Million Fee

During its three years as a solvent company, Global Crossing was an active client of investment banks, paying out a total of at least $280 million in fees, tapping the stock and bond markets for $15 billion, SEC filings show.

In addition, it planned 24 acquisitions or divestitures with a total value of $63.4 billion from 1999 to 2001, according to data compiled by Bloomberg.

In March 1998, Global Crossing spent $12 billion to acquire Rochester, New York-based Frontier Corp., then the fifth-largest U.S. long-distance telephone company. Global Crossing paid Morgan Stanley $50 million in fees for advising on the acquisition, SEC filings show.

Goldman Sachs advised Global Crossing on its October 1999, $1.65 billion purchase of Berkshire, England-based Racal Telecom, for an estimated fee of $8.4 million, based on average adviser fees for similar-size deals.

Morgan Stanley advised Global on the $1.9 billion sale of its Web-hosting division to Santa Clara, California-based Exodus Communications Inc. in September 2000. Global paid Morgan an estimated $8.5 million in fees.

Fund Companies Sell

A month before Global Crossing filed for bankruptcy, Morgan Stanley held 3.4 million Global Crossing shares for the firm's funds or private accounts, 13F filings show. Morgan held 2.7 million shares in its asset management division a year earlier, in December 2000.

Morgan Stanley reported in 13F filings that it had held no Global Crossing shares in asset management in 1999. Merrill Lynch asset managers reported holding no Global Crossing shares from 1999 through 2001.

Fidelity, Vanguard and Putnam also held big stakes in Global Crossing: In aggregate, they held 77.9 million shares during the first quarter of 2001.

By the end of the third quarter of 2001, when the investment banks had their biggest holdings, the three mutual fund companies had sold a combined 97 percent of their shares.

Second Stock Sale

Fidelity held 713,000 shares, down from 11 million in the first quarter of 2001, and Putnam held 1.3 million, down from 55.8 million six months earlier, SEC filings show. Vanguard held none, having sold its 11 million shares in 2001. Putnam spokeswoman Laura McNamara declined to discuss the company's holdings.

In April 2000, Citigroup and Goldman Sachs co-managed the $1.4 billion secondary offering of Global Crossing; each bank reported $11.9 million in fees in SEC filings. Six months later, the two banks said they would manage an IPO of Global Crossing's Asian subsidiary, which was building a trans-Pacific and pan-Asian fiber-optic network.

On Oct. 6, 2000, Goldman Sachs and Salomon Smith Barney cut Asia Global Crossing Ltd.'s IPO price for the second time in a week. The banks said they would sell shares at $7 apiece to raise $476 million.

In an amended registration filing with the SEC, the banks said they would buy 7 million shares each -- $49 million worth --with more than 20 percent of the offering slated for their own accounts.

`Keep Their Client Happy'

``I never heard of underwriters taking such a large percentage of an offering," says Donghang Zhang, an assistant professor of finance at the Moore School of Business at the University of South Carolina in Columbia who specializes in IPO research.

``To me, it shows a level of desperation," Zhang says. ``The banks wanted to get this deal done. It very well could have been a quid pro quo to keep their client happy."

The IPO share price on Oct. 6, 2000, was $7. On Dec. 4, 2000, the share price fell to $4.31. In February 2001, the shares reached an all-time high of $9.81. On Oct. 9, 2001, they crashed to a low of 45 cents.

``The decision to put our own capital at risk was considered entirely appropriate,"

Goldman's van Praag says, adding, ``The Asia Global Crossing IPO was conducted in a very difficult market, and the amended registration filing is clear evidence of our, and our co-manager's, support for our client."

Leap Wireless

Leap Wireless International Inc., a San Diego-based company that sold cell phone service to mostly low-income users, was another sinking telecommunications client favored by a bank's funds.

Morgan Stanley handled the company's $352 million IPO in February 2000, with a fee of $21.9 million, SEC filings show. As Leap reported increasing quarterly losses in 2001, Morgan Stanley's mutual funds or private accounts increased holdings to 2.3 million shares from 307,981 in 2000, SEC filings show.

The Nasdaq Stock Market delisted shares of Leap Wireless in 2002 when they traded at 22 cents, because the company's market value and share price had fallen below minimum listing requirements.

The company, which reported a per-share profit in two of its 21 quarters as a public company, declared bankruptcy in 2003.

Vanguard's holdings in 2001 dropped to 7,028 shares from 242,295, while Fidelity and Putnam increased investments. Fidelity ownership went to 37,100 from 19,100. Putnam's holdings rose 34-fold to 1.1 million from 31,600.

Banks Sometimes Sell

Not all declining clients were supported by banks before bankruptcies. Two of the three principal banks that worked for corporate Web site manager Exodus Communications sold most or all of their shares of the company before it filed for bankruptcy in September 2001.

Exodus's three largest bankers were Goldman Sachs, Merrill Lynch and Morgan Stanley.

Goldman Sachs increased its holdings of Exodus to 2.3 million shares in the second quarter of 2001, just before the bankruptcy, from 2.2 million shares at the end of 2000, SEC filings show.

Morgan Stanley reported in 13F filings that its asset management division boosted its Exodus holdings to 7.3 million shares in 2000 from 857,907 in 1999. It then sold 3.4 million shares in 2001, filings show.

Merrill Lynch asset managers sold all of their 1.1 million Exodus shares in 2000, according to SEC filings.

Selling, Buying

Goldman Sachs was lead manager from 1999 to 2001 on three sales of Exodus bonds, totaling $2.3 billion. Goldman and Merrill also co-managed a $240 million sale of company shares in 2001, with a fee of $10.8 million split by the two banks, SEC filings show.

Goldman also advised on Exodus's purchase of Global Crossing's Global Center Web-hosting unit for $1.9 billion, with an estimated bank fee of $5 million, based on the industry average for similar-size deals.

As the Exodus bankruptcy approached in 2001, Fidelity held 188,488 shares, having reduced its holdings from a high of 24.6 million shares at the end of 1999, filings show. Putnam held 4.5 million shares at the end of 1999 and had sold all of them by September 2001.

Managers More Accountable

Vanguard, like Goldman Sachs, bought more Exodus shares as the bankruptcy approached. Vanguard held 2.1 million shares in September 2001, up from 494,700 at the end of 1999.

Three years after Exodus, Global Crossing and WorldCom collapsed, the SEC has begun an examination of possible bank mutual fund conflicts as part of a crackdown on fund abuses. It has already approved 10 new fund rules -- the most extensive changes to fund

regulation since the 1940s -- and has told Congress in hearings that it's considering more.

Fitzgerald's bill is pending in Congress while the SEC finishes its work. Fitzgerald says the legislation would redress bank fund conflicts by strengthening securities laws to make fund managers more accountable for such acts as favoring banking clients.

Donald Coxe, chairman of and chief strategist at Chicago-based Harris Investment Management Inc., which handles $21 billion in assets, points out that under Canadian law, bank mutual funds can invest in companies they underwrite only with special regulatory approval.

U.S. securities laws limit purchases of IPO shares by a bank fund to 25 percent of an offering. ``There's no end of problems we have in trying to invest in our clients," says Coxe, who is chairman of Harris's Canadian affiliate, Bank of Montreal.

Identify Client Stocks

``It's a problem in Canada, which doesn't have as many equities to invest in and only has a handful of underwriters," Coxe says. However, laws prohibiting U.S. mutual fund companies from investing in companies they underwrite wouldn't hurt in this market."

Fitzgerald says he favors the current U.S. rule, arguing it's a disadvantage to bank funds to hamper stock selection. Former SEC Chairman Pitt has said he favors a change that would require bank funds to identify client stocks among their mutual fund holdings. Fitzgerald says he supports such a disclosure rule.

The Senate Banking Committee has asked SEC Chairman Donaldson to report to Congress by the end of the year on how it's fixing mutual fund abuses. Committee spokesman Andrew Gray says practices of investment bank funds are likely to be on the agenda.

--With reporting by Laurie Meisler in New York and Tom Laufer in Los Angeles. Editors: Neumann, Henkoff.

Story illustration: For articles on recent mutual fund developments, click {MUTU <GO>}. For a series of Bloomberg functions related to IPOs, click {NP01230730103 <Go>}.

To contact the reporter on this story: David Dietz in San Francisco at (1-415) 743-3551 or ddietz1@bloomberg.net or Adam Levy in Atlanta (1-404) 507-1305 or adamlevy@bloomberg.net.

To contact the editor responsible for this story: Ronald Henkoff in New York at (1-212) 318-2347 or rhenkoff@bloomberg.net.

#<115660.2256286>#

#<702010.1382599>#