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Regulators Are Probing How Goldman, Citi and Others Divvied Up Bonds

Questions About Whether Some Clients Were Favored

By Justin Baer And Katy Burne
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Securities regulators have opened an inquiry into the way Goldman Sachs Group Inc., Citigroup Inc. and other banks divvy up new bond issues among investors, people familiar with the matter said.

The Securities and Exchange Commission has sent requests for information about how banks allocate corporate-bond deals and how they traded those bonds after they were sold, the people said. The regulator is examining whether banks grant some money managers too much influence in these offerings, leaving smaller bond investors at a disadvantage, said the people.

The SEC, which made its requests during the fourth quarter, sought information about several specific deals, including Verizon Communications Inc.'s record-setting $49 billion bond sale last September, said people familiar with the matter.

The probe is surfacing as Wall Street comes off a record year for issuance of corporate bonds, such as the Verizon deal and a $17 billion offering from Apple Inc.

The SEC request for information is the latest inquiry into alleged preferential treatment of clients by Wall Street in handling hot securities offerings.

The inquiry into bank dealings in Verizon bonds harks back to the Internet boom and bust around 2000, when regulators cracked down on the practice of so-called IPO spinning. In that episode, banks curried favor with prospective clients by giving executives at those firms shares in other hot initial public offerings at the offering price. Many of the firms returned the favor by sending their business to the underwriting banks.

The probe also highlights the shift of investor interest toward the bond market, which once was viewed as the stock market's stodgier cousin. At a time of near-zero interest rates and low returns on safe investments, bonds issued by some household-name American companies have become prized assets.

As returns on Wall Street's trading businesses have fallen in recent years, banks have become more eager to woo as much business as they can from asset-management firms.

Many money managers have been scrambling to snap up new debt, as bonds from newer, larger deals are the most easily bought and sold when the credit markets run into trouble. The boom has also boosted the power of the investment-management industry's biggest and savviest players, which have used their influence to extract higher yields on bond offerings than are available to investors when the bonds hit the open market.

Bigger investment firms' negotiations for lower pricing on some deals allow them to harvest a quick profit by, in some cases, selling to others after the debt prices, said people familiar with the matter.

Small investors have been grumbling for years that they don't get a fair shake when new bonds are on offer. Many investors have said they amp up the amount of new bonds they ask for from their sales representatives on trading desks, knowing they are likely to get only a fraction of what they request.

Facing new capital rules that make it more costly to store bonds on their balance sheets, banks have looked to the largest investors—and their biggest trading partners—to take on more of the debt that has come with the deluge of corporate borrowing.

"The incentive is there [for banks] to take care of their biggest clients," said **Jason Graybill**, senior managing director at Carret Asset Management LLC, who oversees $1.3 billion in fixed income. "It's harder for smaller shops to get the allocations, and it's the way it has worked for a long time."

Goldman made a disclosure on an inquiry in a regulatory filing Friday, noting for the first time that "allocations of and trading in fixed-income securities" were among the activities regulators were probing.

Goldman and other investment banks sell stocks, bonds and other securities on behalf of clients seeking to raise money in the capital markets. They allocate each offering to money managers and other investors.

Large money managers' clout in the corporate-bond market has grown in recent years as they have bought huge portions of record-breaking offerings.

Pacific Investment Management Co. and BlackRock Inc. bought a combined $13 billion of Verizon's record $49 billion bond sale last September. Investors had put in $100 billion worth of orders to buy the bonds, according to people familiar with the deal. From the moment the bonds were priced, parts of the offering rose about 14% in value in just a couple of weeks.

In the same filing, Goldman lowered the top end of its range of "reasonably possible" legal costs to $3.6 billion more than what it had already set aside in reserves. That figure stood at $4 billion in the prior quarter.

Under accounting standards, "reasonably possible" losses refer to those events whose possibility of occurring is less than likely yet more than remote.

Goldman had raised its provisions for legal and regulatory issues to $561 million in the fourth quarter, more than $400 million higher than in the third quarter.

"Every quarter, we do what is basically the best estimate in that particular quarter, and we add to the reserves," Harvey Schwartz, Goldman's chief financial officer, said during a January conference call with analysts.

Goldman also said in the filing Friday that its traders had posted net losses on 27 days during 2013. The firm also tallied more than $100 million in net trading revenue on 34 days. The firm had 16 money-losing days in 2012. On 41 occasions that year, trading revenue exceeded $100 million.

Goldman also said it also granted employees 13.8 million restricted shares in early 2014 as part their year-end bonuses.

—Jean Eaglesham and Matt Wirz contributed to this article