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FCIC Memo from Donna Norman re FINRA Citi Enforcement

Donna Norman

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**DRAFT
MEMORANDUM**

To: File
From: Donna Norman
Date: February 25, 2010
Re: Meeting with FINRA Regarding Ongoing Citigroup Enforcement Matters
This is not a transcript of the meeting and should not be quoted as such

FCIC Staff present: Brad Bondi, Donna Norman

FINRA Staff present: Jim Shorris, Julie Bauer, Matt Shimkus, Jeanne Elmadany (NY-enf)

On February 24, 2010 from approximately 10:00 to 1:00, Brad Bondi and I met with FINRA executives to discuss ongoing FINRA enforcement investigations relating to Citi. Brad began by explaining the mission of the FCIC and reiterating the need for absolute confidentiality.

In late 2007, FINRA opened an investigation of 10 member firms, including Citi, regarding potential misrepresentations and false disclosures related to sales of RMBS. FINRA's initial focus was: sales literature and claims (including due diligence in underwriting underlying loans); representations regarding performance (prospectus, term sheets, kick-outs); supplemental performance information provided by and to members (including information from the RMBS servicers and trustees); and risk disclosures (including the inappropriate use of conditional language). FINRA also explored potential insider trading by insiders dumping RMBS prior to the collapse. The insider trading investigations have been largely fruitless. Finally, FINRA looked at valuation issues (*i.e.*, whether firms were using consistent valuation methodologies) and the adequacy of the member firms existing policies, procedures and internal controls. FINRA's enforcement team has not look into the CDO business of Citi or other member firms.

The core 10-firm investigation is now focused on 7 of the original 10 and FINRA expects it may ultimately charge 3 or 4 of the firms. FINRA is currently entering the equivalent of its Wells process and expects to be in a position to bring its enforcement actions in late Fall 2010. The actual actions that FINRA will be bringing related to RMBS sales will likely be technical violations involving faulty Reg AB disclosure on the member firms' websites.¹ Notably, FINRA currently believes the faulty disclosures were sloppy and negligent, not intentional. Additionally, FINRA has materiality issues, as the faulty disclosures related only to a relatively small number of loan defaults. FINRA also conveyed that many of the issues at Citi were business issues, not *scienter*-based fraud. There were a number of large market participants with similar issues.

¹ Reg AB became effective in January 2006 and essentially requires broker-dealers to maintain a public website where investors can compare performance data of classes of securities to prior issuances.

The remainder of this memo focuses specifically on what FINRA has learned about Citi's RMBS business. FINRA's current Citi investigation is focused on Citi Bank, N.A.'s failure to accurately report, *as trustee*, known underlying loan defaults in RMBS. FINRA relies on an April 2006 8-K, among other documentation that Citi was aware as early as spring 2006 of faulty Reg AB reporting. FINRA is focused on 16 deals. Susan Mills signed the Trustee reports to investors for Citi Bank, N.A. Cathy Johnson at Citi worked for Mills and was also involved in Citi Bank's trustee business. Much of the RMBS involved is believed to be RMBS which was purchased and securitized and sold by CMB (presumably Mill's desk), however FINRA is not concerned or exploring that aspect of Citi's business.

FINRA has jurisdiction over Citi's CMLTI shelf RMBS business because it was functioning in its broker-dealer capacity.

FINRA walked us through its understanding of Citi's basic RMBS securitization process, as follows. Citi MBS business is structured into: (1) Business folks who maintain contacts with banks and mortgage originators (function is to maintain relationships to buy pools of loans); and (2) Securitization Group, which structures the products (including interest rates, margins and collateral/ overcollateralization), runs the valuation models, and works with rating agencies to ensure product secures ratings required by clients (*i.e.*, rating agency may require additional collateral or margin to achieve a certain rating). The Securitization Group we focused on is Susan Mills' desk, and in particular the CMLTI shelf. In doing diligence on purchased pools of loans, Citi underwrote to the standards of the loan originator, which was standard industry practice. Citi did not impose its own underwriting standards on pools it purchased to securitize. For example, Citi purchased loan pools from New Century and underwrote a sampling of a prospective pool purchase to the issuing standards of New Century. Like other major market participants, Citi outsourced the majority of its due diligence to firms such as Clayton (*f.d.b.*, Murray Hill). When Clayton did underwriting for Citi, Citi set all of the parameters for review, including sampling methodology and ratios and criteria for acceptance (*i.e.*, FICO score, loan to value, income, *etc.*). Clayton had no input into the criteria and exercised no discretion in applying it. FINRA spoke to a number of Clayton employees, as well as to Matt Bollo. FINRA believes that Clayton did as it was directed and does not believe Clayton had any incentives to recommend approval of a high percentage of the loans it underwrote. FINRA was simply paid based on the number of loans it underwrote, not the number it recommended Citi approve. Although Clayton reported to Citi whether loans met the criteria which Citi directed Clayton to use (*i.e.*, that of the loan originator), Clayton did not ultimately approve any loans. It merely reported its results to Citi, which then decided whether to reject loans which did not meet the criteria or whether to "except" such loans and purchase them anyway.

When Citi purchased and securitized a pool of RMBS, it sold them either: 1) "servicing sold;" or (2) "servicing retained." Servicing refers to the administrative duties of taking in the monthly payments and accounting for them as received. The servicer was also responsible for staying on top of any payment delinquencies, and as appropriate pursuing alternative payment arrangements and if ultimately necessary foreclosure. The

servicer was compensated a % of the total balance of loans serviced, and is reported in the underlying prospectus. [Citi was one of many potential RMBS servicers: Wells Fargo, JP Morgan, Countrywide all provided RMBS servicing also]. The servicer has an economic interest in the loans performing because the servicer may have to front money if payments are delayed.

In addition to a servicer, all RMBS had to have an appointed trustee. The trustee does not bear any risk, it simply provides two administrative services: (1) payment distribution to bondholders; and (2) reporting to regulators and investors. The servicer transfers all collected monies to the trustee, which in turn makes payments to the bond holders in order of their seniority. The servicer also reports any payment delinquencies; EPDs and defaults to the trustee. The trustee is responsible for the monthly Reg AB reporting of the RMBS' ultimate performance. The Trustee is paid a fee based upon the size and composition of the RMBS.

FINRA believes Citi [CMB] almost always appointed Citi Bank, N.A. as trustee in RMBS it sold. **[confirm with Citi]**. The signator on such trustee agreements was Susan Mills in her dual hat, Assistant VP, trustee, Citi Bank, N.A. **[confirm with Citi: always/often?]**

In addition to a servicer and a trustee, each RMBS vehicle also had a Risk Manager. The risk manager issues monthly reports on the RMBS pools performance *to the trustee*. The risk manager's job is to highlight risks (*e.g.*, high percentage of loans are affected by hurricane Katrina, property values falling, *etc.*) and to ensure that both the servicer and trustee are fulfilling their obligations to the bond holders. The risk manager is compensated on a fee-based arrangement. In Citi's RMBS deals the two main risk managers were Clayton and Pent-Alpha **[confirm]**.

FINRA has identified multiple instances in which risk manager Clayton identified discrepancies in the delinquencies and EPDs reported by the servicer and the trustee, Citi Bank. Clayton made these reports directly to trustee Citi Bank. FINRA believes, Citi Bank largely ignored the risk reports identification of discrepancies in reported defaults and the Reg AB information always tracked the (lower) delinquency rates reported by the trustee.

FINRA described the Clayton risk reports as "excellent."

One particular deal that FINRA is focused on is HE-III. The Clayton September and October 2006 risk reports contain a chart that identifies large differences in the delinquency rates reported by the servicer and trustee. Citi did not produce the December 2006 risk report fro HE-III. Notably, the January 2007 risk report for HE-III does not contain any comparative information on the delinquency rates reported by the servicer and the trustee. FINRA did not recall the name of the point person at Clayton on the HE-III risk manager reports. Five months into the deal, HE-III was in default based on both triggers set forth in its prospectus. Citi asked the credit rating agency for a "no change"

in rating letter. The rating agency declined. Citi allegedly decided it was not material enough to report.

Sometime in March 2006 (FINRA has related email), Susan Mills became aware that there were reporting discrepancies by servicers on a few. This time period corresponds to the time period in which Mills set up the surveillance unit to identify EPD trends. However, Mills told FINRA the surveillance unit was unrelated to any heads up on reporting discrepancies or risk manager reports to Citi Bank. Mills set up the surveillance unit very quickly and retained an outside consultant to expedite the process. FINRA took Jim Xanthos' recorded testimony.

Citi made an "unhelpful" presentation to FINRA on these issues. Additionally, Citi has been a mixed bag of cooperation during the entire two-year investigation. After more than a one year delay, in the last couple of months Citi has produced several thousand risk reports, originally obtained from January -October 2006, to FINRA.

FINRA believes that Citi retained some residual interests in RMBS; but is not aware of the amount or whether it was Citi's objective to retain an interest or whether Citi simply retained what it was unable to distribute.

FINRA has agreed to have a follow up call to discuss additional issues and to provide us with Citi org charts and some helpful core documents relating to the information described above.

Finally, this morning I reached out to Matt Shimkus requesting a meeting with Susan Vogel and the FINRA Risk Oversight and Operational Regulation ("ROOR") which conducted a joint FINRA/SEC Subprime sweep in fall 2007. See February 25, 2010 memo to file re: *Meeting with SEC OCIE Citi Teams*.