9-14-2010

Agenda for Financial Crisis Inquiry Commission Telephonic Business Meeting on Tuesday October 12, 2010

Phillip Angelides

Bill Thomas

Wendy Edelberg

Gary Cohen

Brooksley Born

See next page for additional authors

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Agenda for Financial Crisis Inquiry Commission Telephonic Business Meeting of Tuesday October 12, 2010
12:00-1:30pm EST
Conference Dial-In Number: 866-692-3582
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Agenda Item	**Presentation**
1) Call to Order	**Chairman Angelides**
2) Roll Call	**Chairman Angelides**
3) Approval of Minutes of Telephonic Business Meeting of September 14, 2010 *(Attached)*	**Chairman Angelides**
4) Approval of Minutes of Business Meeting/ Retreat of September 29, 2010 *(Attached)*	**Chairman Angelides**
5) Chairman's and Vice Chairman's Report	**Chairman Angelides and Vice-Chairman Thomas**
6) Executive Director's Report	**Wendy Edelberg, Executive Director**
7) Update on the Report	**Wendy Edelberg, Executive Director**
8) Referrals to Justice *(Attached)*	**Gary Cohen, General Counsel**
9) Clayton and Moody's Letters *(see attached PDF)*	**Chairman Angelides, Vice-Chairman Thomas, and Wendy Edelberg and Gary Cohen**
10) Comments and Questions from Commissioners	**All Commissioners**
11) Other Items of Business	**All Commissioners**

12) Adjournment **Chairman Angelides**

Financial Crisis Inquiry Commission

Agenda Item 3 for Telephonic Business Meeting of October 12, 2010
Minutes of Telephonic Business Meeting of
September 14, 2010

Agenda Item 1: Call to Order

Chairman Angelides called the telephonic business meeting to order at 12:04pm EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Heather Murren, John W. Thompson, and Peter Wallison. Commissioner Hennessey joined the call midway into Agenda Item 10. Commissioner Graham and Holtz-Eakin were absent.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; Scott Ganz, assistant to Vice Chairman Thomas, and Shaista Ahmed, assistant to Wendy Edelberg. Mina Simhai joined the meeting during Agenda Item 10

Agenda Item 3: Approval of Minutes of Meeting, August 17, 2010

Chairman Angelides introduced the minutes from the FCIC meeting of August 17, 2010.

MOTION: Born moved and Wallison seconded a motion to adopt the meeting minutes (attached).

APPROVED: 7-0 (Commissioners Graham, Holtz-Eakin, and Hennessey absent)

Agenda Item 4: Chairman's and Vice Chairman's Report

Chairman Angelides provided the Commission a general update on Commission matters, including a brief update on the initial draft sections of the report; an overview of the field hearings, and staff efforts to wrap up investigations and research. Chairman Angelides and Vice Chairman Thomas emphasized the importance of time tables and the need for continued discussions to inform the Commission where there are agreements and disagreements on report material.

Agenda Item 5: Executive Director's Report and Agenda Item 6: Update on the Report

Executive Director Wendy Edelberg combined her report with Agenda Item 6 – an update on the report. She apprised the Commission of the selection of a senior editor (Mike Bryan) and a website design firm. Edelberg gave an overview of the various sections of the report and which writers are assigned to each section as well as when Commissioners can expect to review material. She noted production toward the final Commission products is moving forward, including the archiving of materials. Edelberg will provide the Commission an estimated schedule of production for draft sections and Commissioner review of these materials.

Agenda Item 7: Upcoming September 28-29 Meeting

Chairman Angelides and Vice Chairman Thomas will flesh out an agenda for the upcoming retreat soon and inquired if Commissioners had thoughts on the most productive way to make progress on coming together on a report. Vice Chairman Thomas raised concerns about the staff's desire to receive input from outside experts, academics and economists and share the document on a confidential basis for the purposes of fact checking and to ensure that seminal events were not missed. Chairman Angelides said there would be value in this to make sure there are not glaring errors, omissions, or mistakes – and asked that staff limit this to only checking facts and not garnering broad opinions.

Agenda Item 8: Field Hearings – Overview of Bakersfield and Las Vegas; and upcoming hearings in Miami and Sacramento

Vice Chairman Thomas informed the Commission that he thought the first two field hearings (Bakersfield and Las Vegas) were interesting and useful and noted the outrageous behavior of lenders as heard from testimony at the local level. Commissioner Murren also noted the value in the field hearings in illuminating the issue of stalled mortgage modifications and resolutions and recommended that the Commission take action on this matter. Chairman Angelides recommended that this topic be covered in Section 4 and Section 2 of the report. Commissioner Georgiou commented on the testimony received in Las Vegas on the impact of the financial crisis on local governments and community services.

Agenda Item 9: Approval of Extension to Execute Agreements and Contracts on behalf of the Financial Crisis Inquiry Commission

General Counsel Gary Cohen introduced the extension to execute agreements and contracts on behalf of the Commission and noted that this would be the last extension.

MOTION: Murren moved and Born seconded a motion to adopt the extension (attached).

APPROVED: 7-0 (Commissioners Graham, Holtz-Eakin, and Hennessey absent)

Agenda Item 10: Referral to Justice Memo

Gary Cohen introduced the referral to justice memo to the Commission and noted that as stated in the memo, if the Commission comes across any potential violations of the law, we are directed to refer these matters to the Attorney General. He noted that some of the seven items outlined in the memo are currently being investigated by other entities, but we have a responsibility to share the information we have with the Department of Justice. Cohen emphasized that this is a referral not a recommendation for prosecution and that if staff are directed to proceed, staff would compile documents in our possession. It was also noted that this referral is strictly confidential during the course of the Commission and after the Commission concludes.

Vice Chairman Thomas expressed concerns about the timing of the referral memo. Commissioner Wallison asked staff to also look into the matter of Fannie and Freddie and mortgage quality reporting and requested that the cover letter does not specify that we are recommending legal action be taken. Vice Chairman Thomas asked that the Commission wait to take action on this matter until at least the upcoming retreat on September 28th and 29th. Commissioner Hennessey asked that the referrals be considered individually rather than as a block.

MOTION: Georgiou moved and Thompson seconded a motion to hold this item over until the retreat of September 28th and 29th.

APPROVED: 8-0 (Commissioners Graham and Holtz-Eakin absent)

Edelberg requested that Commissioners forward preliminary questions via email to Cohen and will organize a separate informational conference call for Commissioners that have questions and concerns on this matter.

Agenda Item 11: Comments and Questions from Commissioners

No comments were brought up or questions asked by the Commissioners.

Agenda Item 12: Other Items of Business

No other items of business were brought up by the Commissioners.

Agenda Item 13: Adjournment

Chairman Angelides requested a motion to adjourn the meeting at 1:30pm.

MOTION: Georgiou moved and Murren seconded a motion to adjourn the meeting.

APPROVED: 8-0 (Commissioners Graham and Holtz-Eakin absent)

Financial Crisis Inquiry Commission
Agenda Item 3 for Telephonic Business Meeting of October 12, 2010
Minutes of Telephonic Business Meeting of
September 14, 2010

ATTACHMENT
Approved Minutes of Telephonic Business Meeting of
August 17, 2010

Agenda Item 1: Call to Order

Chairman Angelides called the telephonic business meeting to order at 12:05pm EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Bob Graham, Keith Hennessey, Doug Holtz-Eakin, and John W. Thompson. Commissioner Wallison joined the call midway into Agenda Item 4 and Commissioner Murren joined midway through Agenda Item 7.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; and Scott Ganz, assistant to Vice Chairman Thomas.

Agenda Item 3: Approval of Minutes of Meeting, July 13, 2010

Chairman Angelides introduced the minutes from the FCIC meeting of July 13, 2010. Commissioner Hennessey asked for a revision to the minutes: at the end of the section for Agenda Item 6, insert before the last sentence: “Commissioner Hennessey described a possible alternate structure for the report.”

MOTION: Holtz-Eakin moved and Thompson seconded a motion to adopt the meeting minutes (attached) and the insertion requested by Commissioner Hennessey subject to verification by staff.

APPROVED: 8-0 (Commissioners Wallison and Murren absent; Commissioner Georgiou abstained as he was not present at the July 13th meeting.

Agenda Item 4: Chairman’s and Vice Chairman’s Report

Chairman Angelides and Vice Chairman Thomas briefed the Commissioners on the selection of Little Brown as publisher of the official report of the Commission. The Commission was informed during the last retreat (July 28th and 29th) of the process for selecting a publisher and the use of literary agents. The literary agents proposed two finalist candidates for publisher and the Chairman and Vice Chairman mutually agreed upon Little Brown. It was noted that this publisher particularly excelled in the field of e-books. Chairman Angelides noted that the financial terms of the agreement have not yet been made public and a formal contract has not been executed.

Chairman Angelides and Vice Chairman Thomas then spoke broadly about the different facets of the report: a physical book/report; an e-book with hyperlinks to expanded material and sources; and a virtual library of documents, interviews, video clips, etc. for review by scholars, reporters, and other interested parties. Discussion ensued on how to construct a user friendly electronic library.

Chairman Angelides advised the Commissioners that the forthcoming hearing on "Too Big to Fail" (September 1st) might be split into two days but would maintain the same amount of time for Commissioner deliberations during the upcoming retreat (September 2nd and 3rd). The Commissioners will focus on areas of agreement and disagreement with the aim to help guide on the writing of the report.

Agenda Item 5: Executive Director's Report

Executive Director Wendy Edelberg informed the Commissioners that Congress has approved an additional appropriation to the Commission in the amount of $1.8 billion. This appropriation will be used to hire additional staff, conduct additional document review, and provide additional resources to the staff. Edelberg also updated the Commission on the hiring of additional writers and reporters.

Agenda Item 6: Update on the Report

Executive Director Wendy Edelberg briefed the Commission on the progress being made on the report and noted that internal deadlines are in place to ensure the Commissioners receive a high quality product for their review in September.

Agenda Item 7: Upcoming September 2-3 Meeting

Chairman Angelides and Vice Chairman Thomas led a broad discussion on what outcomes the Commissioners wish to see from the September 2nd and 3rd retreat meetings. There was general agreement that the Commissioners would focus on major issues that need agreement wherein disagreement might lie and that the Commissioners would prioritize these issues by importance to the final product.

Agenda Item 8: Approval of Continuation of Designation Of Commissioners as Special Government Employees

General Counsel Gary Cohen introduced the resolution to continue the designation of Commissioners as Special Government Employees. He noted that some Commissioners may have exceeded the maximum number of days worked as special government employees, but this does not disqualify Commissioners from continuing as special government employees as our Commission terminates in February and Commissioners are highly unlikely to exceed the 130 day maximum.

MOTION: Born moved and Holtz-Eakin seconded a motion to adopt the delegation of continuation of Commissioners as Special Government Employees.

APPROVED: 10-0

Agenda Item 9: Revised Future Meeting Schedule

Chairman Angelides and Vice Chairman Thomas introduced the revised meeting schedule. Commissioners did not raise questions or objections.

Agenda Item 10: Comments and Questions from Commissioners

Commissioner Thompson raised concerns in regard to the recent electronic communications among Gary Cohen, Chairman Angelides and Commissioner Wallison concerning Mr. Cohen's opinion that Commissioner Wallison had violated the Ethics Guidelines for Commissioners by providing an internal staff memo to Mr. Edward Pinto. Commissioners Georgiou, Born, and Murren also expressed concerns regarding the actions taken by Commissioner Wallison. Chairman Angelides reaffirmed that Commissioners must operate by the Commission's adopted procedures for release of information and/or documents to the public. Cohen pointed out that the Ethics Guidelines for Commissioners require that the Chair or the full Commission agree to the release of confidential information, and various Confidentiality Agreements to which the Commission is a party require that either the Chair and the Vice Chair, or the full Commission, agree to the release of such information. No staff products or other confidential information are to be released without compliance with these procedures. Cohen also informed that Commissioners that he has reached out to Mr. Pinto who has agreed not to share this document with anyone, and that he has provided a Confidentiality Agreement to Mr. Pinto. Commissioner Wallison announced he understood the Commission's policies and will comply in the future.

Agenda Item 11: Other Items of Business

No other items of business were brought up by the Commissioners.

Agenda Item 12: Adjournment

Chairman Angelides requested a motion to adjourn the meeting.

MOTION: Thompson moved and Georgiou seconded a motion to adjourn the meeting.

APPROVED: 10-0

Financial Crisis Inquiry Commission

Agenda Item 3 for Telephonic Business Meeting of October 12, 2010
Minutes of Telephonic Business Meeting of
September 14, 2010

ATTACHMENT

Delegation to execute agreements and contracts
on behalf of the Financial Crisis Inquiry Commission

Pursuant to the authority set forth in Public Law 110-21(d)(3) that allows the Financial Crisis Inquiry Commission to enter into contracts to enable the Commission to conduct its business; and,

Now, pursuant to the unanimous written consent provisions of the Commission's adopted procedures, it is:

Hereby delegated to the Chairman of the Commission the authority to enter into agreements on behalf of the Financial Crisis Inquiry Commission in order to facilitate the work of the Commission. This delegation is effective until termination of the Commission, unless revoked earlier.

The Chairman may delegate this authority to the Vice-Chairman in order to expedite the business of the Commission. If the Chairman does delegate to the Vice-Chairman, the delegation shall remain in effect until termination of the Commission, unless revoked earlier.

In addition, any actions taken by the Chairman and the Vice-Chairman in order to establish the Commission, and agreements signed by the Chairman or the Vice-Chairman, are hereby ratified by the Commission.

Financial Crisis Inquiry Commission
Agenda Item 4 for Telephonic Business Meeting of October 12, 2010
Minutes of Business/Retreat Meeting of September 29, 2010

Agenda Item 1: Call to Order

Chairman Angelides called the business meeting to order at 9:20am EDT.

Agenda Item 2: Roll Call

Chairman Angelides asked Gretchen Newsom to call the roll of the Commissioners. Present were Phil Angelides, Bill Thomas, Brooksley Born, Byron Georgiou, Bob Graham, Heather Murren, John W. Thompson, and Peter Wallison. Commissioner Hennessey and Holtz-Eakin were absent.

Also participating in the meeting were: Wendy Edelberg, Executive Director; Gary Cohen, General Counsel; Gretchen Newsom, assistant to Chairman Angelides; Scott Ganz, assistant to Vice Chairman Thomas, Rob Bachmann, assistant to Chairman Angelides, and Courtney Mayo, Assistant to Vice Chairman Thomas. Chris Seefer joined the meeting during Agenda Item 3.

Agenda Item 3: Commissioner Deliberations and Vote on FCIC Memo of Referrals to the Department of Justice

Chairman Angelides introduced the referral to justice memo as distributed for the previous business meeting and the supplemental memo distributed on September 28th by Gary Cohen. Mr. Cohen noted that an informational call open to all Commissioners occurred wherein Commissioners Wallison and Born participated and asked questions pertaining to this matter of FCIC staff, including Mr. Chris Seefer. Commissioner Wallison asked that each referral be considered individually and one at a time by the Commission. Mr. Cohen informed the Commission that staff may have 1-3 additional referrals and that the memo before the Commission is current and up to date.

MOTION: Born moved and Murren seconded the adoption of the recommendation i.e. that the Commission should find that in these matters the persons or corporations indicated may have violated the law of the United States in relation to such crisis.

DISSCUSSION: The Commission discussed the referral memo and the timing of taking action today and the timing of sending materials to the Department of Justice.

Mr. Seefer advised the Commission of 1-3 additional referrals that may be forthcoming.

The Chairman divided the motion into two motions – whether to move forward today or wait until a later time and then the consideration of each referral item individually.

MOTION: The Chairman called the vote on the motion to act in favor of moving the referral memo forward today with a ROLL CALL VOTE.

APPROVED: 6-2 (ROLL CALL VOTE)
AYE: 6 - *Angelides; Born; Georgiou; Graham; Murren; Thompson*
NAY: 2 - *Thomas; Wallison*
(Hennessey and Holtz-Eakin absent)).

The Chairman called for individual votes on each referral referenced in the referral memo.

MOTION: Graham moved and Born seconded the recommendation to make the finding and transmit Item Number 1 of the referral memo to the Department of Justice: "Potential Fraud: False and Misleading Representations about Loan Underwriting Standards by UBS and Other Issuers"

APPROVED: 6-0-1-1 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NAY: 0
PRESENT: 1- *Thomas*
NOT PRESENT: 1- *Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Graham moved and Murren seconded the recommendation to make the finding and transmit Item Number 2 of the referral memo to the Department of Justice: "Potential Accounting Fraud and False Certifications: Fannie Mae"

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6 - *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NOT PRESENT: *2 - Thomas, Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Graham seconded the recommendation to make the finding and transmit Item Number 3 of the referral memo to the

Department of Justice: “Moody’s Appears to Have Made Selective Disclosures of Imminent Ratings Downgrades; UBS and Possibly Other Recipients of this Information Fail to Disclose Upcoming Downgrades to Purchasers of Their Securities”

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*
NAY: *1- Wallison*
NOT PRESENT: *2 - Thomas; Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Graham seconded the motion that the Commission finds that the persons described in Item 4 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States**:** “Potential Fraud and False Certifications: Citigroup”.

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NAY: *0*
NOT PRESENT: *2 - Thomas; Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Georgiou moved and Born seconded the motion that the Commission continue Item 5 of the referral memo until the following meeting or when the Commission considers future referral items: “Potential Fraud by Goldman Sachs in Connection with Collateral Calls on AIG”.

APPROVED: 6-0-2 (Voice vote. Note Present: *Thomas and Thompson. (Hennessey and Holtz-Eakin absent)).*

MOTION: Born moved and Murren seconded the motion that the Commission finds that the persons described in item 6 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States**:** “Potential Fraud in AIG Investor Calls”.

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NAY: *0*
NOT PRESENT: *2 - Thomas; Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Murren moved and Born seconded the motion that the Commission finds that the persons described in item 7 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States**:** "Potential Fraud by Goldman Sachs in Connection with Abacus 2007-18 CDO".

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*
NAY: *1- Wallison*
NOT PRESENT: *2 - Thomas; Thompson*
(Hennessey and Holtz-Eakin absent)).

Chairman Angelides asked for a motion to clarify that the Commission made the finding and refers the matter to the Attorney General for Items 1, 2, and 3 of the referral memo and requested that the motion be divided between Items 1 and 2 and Item 3.

MOTION: Born moved and Graham seconded the motion to clarify the motion pertaining to Items 1 and 2 of the referral memo, that the Commission finds that the persons described in Items 1 and 2 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States**:** "Potential Fraud: False and Misleading Representations about Loan Underwriting Standards by UBS and Other Issuers" and "Potential Accounting Fraud and False Certifications: Fannie Mae".

APPROVED: 6-0-2 (ROLL CALL VOTE)

AYE: 6- *Angelides; Born; Georgiou; Graham; Murren; Wallison*
NAY: *0*
NOT PRESENT: *2 - Thomas; Thompson*
(Hennessey and Holtz-Eakin absent)).

MOTION: Born moved and Murren seconded the motion to clarify the motion pertaining to Item 3 of the referral memo, that the Commission finds that the persons described in Item 3 may have violated the laws of the United States in relation to the financial crisis and that the Commission refer this to the Attorney General of the United States**:** "Moody's Appears to Have Made Selective Disclosures of Imminent Ratings Downgrades; UBS and Possibly Other Recipients of this Information Fail to Disclose Upcoming Downgrades to Purchasers of Their Securities".

APPROVED: 5-1-2 (ROLL CALL VOTE)

AYE: 5- *Angelides; Born; Georgiou; Graham; Murren;*
NAY: *1- Wallison*
NOT PRESENT: *2 - Thomas; Thompson*

(Hennessey and Holtz-Eakin absent)).

Commissioner Wallison asked staff to again look into the matter of Fannie and Freddie mortgage quality reporting. Chairman Angelides asked that this matter be brought back to the Commission for our next business meeting on October 12th.

Commissioner Wallison requested that staff share a copy of the final referral memo to the Department of Justice with the Commission before it is submitted. Staff expressed that extra security precautions will be taken for the review of this document due its highly confidential nature.

Agenda Item 4: Commission Comments on tone and approach of sample report section and timeline

The Commission provided staff general comments on the tone and approach of the draft section that was provided for their review, including how the "why" of the financial crisis will be incorporated into the report. Overall, the Commissioners were pleased with the tone and writing of the sample draft section.

Agenda Item 5: Adjournment

Chairman Angelides requested a motion to adjourn the meeting.

MOTION: Thompson moved and Georgiou seconded a motion to adjourn the meeting.

APPROVED: 8-0 (Commissioners Hennessey and Holtz-Eakin absent)

Financial Crisis Inquiry Commission
Agenda Item 4 for Telephonic Business Meeting of October 12, 2010
Minutes of Business/Retreat Meeting of
September 29, 2010

ATTACHMENT
Confidential Referral Memorandum

FROM: Financial Crisis Inquiry Commission Legal Staff

TO: Commissioners of the Financial Crisis Inquiry Commission

Cc: Wendy Edelberg

DATE: September 12, 2010

RE: Confidential Referral Memorandum

Pursuant to section 5(c) (4) of the Fraud Enforcement and Recovery Act of 2009, one function of the Financial Crisis Inquiry Commission is to:

> refer to the Attorney General of the United States and any State attorney general any person that the Commission finds may have violated the laws of the United States in relation to such crisis.

Although FCIC staff has been primarily focused on our overall mission of examining and reporting to Congress, the President and the American people on the causes of the financial crisis, our inquiry has nonetheless generated information that the Commission should consider referring to the Department of Justice. Because FCIC staff has focused on understanding the causes of the financial crisis, rather than developing cases for prosecution, all of the referral matters will require further investigation by the Department of Justice. Nonetheless, the matters presented below constitute serious indications of violation of a number of laws.

At a meeting of the Commissioners held on May 18, 2010, a process for referrals was presented to the Commissioners for consideration and review. Further to that process, this memorandum describes certain items FCIC staff believes meet the standards of our enabling statute and therefore should be considered by the Commission for potential referral. This is not a full elaboration of the matters, but rather highlights possible items, and is based on conversations with senior Commission investigators. We also note that our statute does not limit our referrals to only criminal matters, thus we have broadly interpreted the statutory provision.

It is the staff's recommendation that these items be delegated to Commission investigators for preparation of a referral memorandum on each subject (which memorandum will be based on investigations already completed by the Commission staff) for presentation to the Attorney General.

Our plan, should the Commission determine to proceed, would be to send a letter to Attorney General Holder which will include detailed summaries for each of the matters with appropriate attachments such as e-mails, other documents and interview transcripts.

Although there is no established template for referrals, we have typically seen packages from investigative agencies seeking criminal prosecutions or civil enforcement filings that consist of: (1) a referral memo containing an overview of the investigation (why started, what investigative steps, comments about motivations and credibility of witnesses) and an analysis of the facts and law that indicate that there may be a violation; (2) reports of investigative interviews prepared by investigators (similar to our MFRs) and (3) any reports, documents or other evidence that might support the proposed referral. As to (2), in the event that we have recordings or transcripts, it would be appropriate to include these in the referral package.

We well understand that some of these matters are under investigation by federal agencies and departments; may have been the subject of investigations, or may have been resolved in whole or in part, e.g., the SEC's recent settlement with Citigroup and Goldman Sachs. However, since the Commission is not privy to the full record of these investigations(for example, the FCIC has not been given access to information about on-going criminal investigations), and our statute does not provide a carve-out for matters that may be under investigation by others, we nonetheless recommend consideration of referrals based on our inquiry as follows:

1. **<u>Potential Fraud: False and Misleading Representations about Loan Underwriting Standards by UBS and Other Issuers</u>**

UBS, like a number of other financial institutions, used Clayton Holdings to assess the quality of the mortgages it was purchasing for resale in the form of Residential Mortgage-Backed Securities (RMBS). Typically UBS, or the other financial institutions, bid on packages consisting of a thousand or more mortgages from originators like Countrywide or Fremont.

From these large pools of mortgages, UBS would require Clayton Holdings to examine 5% to 10% of the mortgage pool to ascertain whether the mortgages met underwriting guidelines. In its RMBS offering documents, UBS disclosed its loan underwriting standards used in making the loans. These disclosures were designed to assure the prospective investor that the mortgages were of high quality and reasonably secure. However, after five or more pages explaining these criteria, UBS would state—typically in a single sentence--that ***some number*** of the mortgages constituting the pool for its RMBS did not meet these criteria.

UBS did not disclose that the number of loans sampled by Clayton that did not meet UBS's underwriting standards was substantial. For example, in 1Q07, 62% of the loans sampled by Clayton did not meet UBS's underwriting standards, an unusually high failure rate. But UBS waived enough of these failures to result in a failure rate of a little more than 10%. To protect itself from possible liability, Clayton kept records of the re-marked mortgages, noting them as 2-W's, that is, mortgages that were upgraded from failing to meet underwriting standards to meeting these standards based on a waiver of the underwriting criteria by UBS.

While our investigative record is not as complete for other companies, we have received documents from Clayton that disclose loans to be acquired by the following companies had substantial failure rates—that is rates at which samples of loans did not meet established underwriting criteria-- in the full year of 2006 and the first half of 2007. However, in order to get to even these numbers, companies waived their established underwriting criteria:

Company	Total Loans Sampled	Waiver Rate[1]	Final Failure Rate[2]
Credit Suisse	56,306	33%	21%
Citigroup	6,205	31%	29%
Freddie Mac	2,985	60%	14%
Goldman	111,999	29%	16%
JPMorgan	23,668	51%	13%
Lehman	70,137	37%	16%
Merrill	55,529	32%	16%
Societe Generale	4,781	33%	31%
UBS	27,618	33%	13%
WaMu	35,008	29%	19%[3]

The large percentage of mortgages in significant samples that did not meet initial underwriting standards appears to be material because there is "a substantial likelihood that the disclosure [of this information] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4] Specifically, one would assume that the fact that a significant percentage of mortgages in a sample of a population of mortgages being packaged into an RMBS failed to meet underwriting criteria would be useful in predicting the performance of the RMBS. The failure to disclose this information potentially violates both the

[1] To achieve the final failure rate.
[2] After waivers.
[3] All Clayton Trending Reports, 1st Quarter 2006 – 2nd Quarter 2007
[4] *Basic Inc. v. Levinson*, 485 U.S. 224, 232 (1988).

1933 and 1934 Securities Acts. In addition, depending on the means of communications employed, material omissions may also constitute mail fraud or wire fraud.

2. Potential Accounting Fraud and False Certifications: Fannie Mae

A March 8, 2008 e-mail from a White House economic analyst Jason Thomas to Undersecretary of the Treasury for Domestic Finance Robert Steel attached a report that stated:

> Any realistic assessment of Fannie Mae's capital position would show the company is currently insolvent. Accounting fraud has resulted in several asset categories (non-agency securities, deferred tax assets, low income partnership investment) being overstated, while the guarantee liability is understated. These accounting shenanigans add up to billions of exaggerated net worth.

Subsequent findings by the Federal Housing Finance Agency ("FHFA"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Reserve all indicate, (during 2007 and 2008), that Fannie Mae may have overstated assets, earnings and capital through various accounting improprieties. FHFA detailed the overuse of historic losses against potential gains as part of the firm's capital.[5] It also found that liabilities had increased dramatically, to the point that the firm was found to be "in an unsafe or unsound condition to transact business."[6]

The OCC found that Fannie was not fully recognizing losses associated with its HomeSaver program.[7] It also criticized Fannie for using 2003 loss data to estimate then-current market values of its portfolio of subprime securities. We understand that allegations of inflating assets and understating liabilities are currently under investigation by the Securities and Exchange Commission and the U.S. Department of Justice.

Failure to accurately report financial results could violate a number of securities laws, including sections 11 and 12 of the 1933 Act and section 10b-5 of the 1934 Act. During 2008, Fannie raised new capital. As a consequence, it may have also violated section 11 of the 1933 Act. However, it should be noted that the company's auditors, Deloitte and Touche LLP, signed off on its 2007 financial statements, and that Fannie has still not restated its financial statements for that year. The possibility of accounting improprieties was cited in the FCIC's draft preliminary Fannie Mae investigative report as a matter warranting further investigation.[8]

FHFA's memorandum supporting conservatorship also provides details about long-time failures of risk management at Fannie Mae. The memorandum notes that prior government assessments, not provided to the markets, repeatedly warned of significant, systemic risk management problems going back at least to 2005.[9]

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[5] Memorandum from Christopher Dickerson, Acting Deputy Director, Division of Enterprise Regulation to James B. Lockhart, Director, Federal Home Finance Agency, September 6, 2008, re: Proposed Appointment of the Federal Housing Finance Agency as Conservator for the Federal National Mortgage Association at 19. (hereinafter "Conservator Memo").
[6] Conservator Memo at 21.
[7] OCC5-00076169, Office of the Comptroller of the Currency, Observations-Allowance Process and Methodology at 2.
[8] FCIC, Preliminary Draft Investigative Findings on Fannie Mae, March 31, 2010, at 57.
[9] Conservator's Memo at 6 (2005 condition), 8 (2006 condition), 11 (2007 condition) and 13-15 (2008 condition).

This suggests two potential legal violations. The first is a failure to disclose accurate information about the state of risk management at Fannie Mae. Assuming this information is material, this is a violation of 10b-5 of the 1934 Act.

Second, as with any other publicly traded company, the CEO and CFO of Fannie Mae certified the firm's annual and quarterly financial statements as disclosing all material information under section 302 of the Sarbanes-Oxley Act. These certifications presume that the CEO and CFO have reviewed and put in place adequate risk management systems.

3. Moody's Appears to Have Made Selective Disclosures of Imminent Ratings Downgrades; UBS and Possibly Other Recipients of this Information Fail to Disclose Upcoming Downgrades to Purchasers of Their Securities

Downgrades of ratings on mortgage-based securities led to drops in their market value. Internal e-mails between UBS Investment Bank executives indicate that UBS—and possibly other investment banks--received advance notice of potential downgrades by Moody's. In a July 5, 2007 e-mail from David Goldstein to Dayna Corlito, the MBS/ABS Manager of UBS, captioned "ABS Subprime & Moody's downgrades," Goldstein writes (emphasis added):

> I just got off the phone with David Oman…Apparently they're meeting w/Moody's to discuss impacts of ABS subprime downgrades, etc. Has he been in touch with the Desk?
>
> It sounds like Moody's is trying to figure out when to start downgrading, and how much damage they're going to cause—**they're meeting with various investment banks**
>
> David[10]

Five days later on July 10, 2007, Moody's downgraded 299 CDOs; the market value of these securities immediately dropped.

UBS is alleged to have sold three of its soon to be de-rated CDOs to Pursuit Partners, a hedge fund. In a Connecticut state court action, Pursuit has claimed that UBS violated *state* law by continuing to sell these CDOs knowing they were about to be de-rated, which it knew would drastically reduce their value. In a 2009 trial court decision, UBS was ordered to set aside $35 million because the judge found probable cause that the plaintiff would prevail at trial.[11]

These facts potentially implicate three provisions of federal securities law. First, as to UBS and any other firms that were informed of the potential downgrades and failed to disclose the imminent downgrade of their CDOs, SEC Rule 10b-5 prohibits "any person… [t]o make any untrue statement or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading…in connection with the purchase or sale of any security."

Second, as to these same firms, any person who had access to this information and sold stock or other securities may have traded on confidential insider information in violation section 10 of the

[10] UBS-CT 021485 (PSI Exh. 94o).
[11] Memorandum of Decision on Plaintiffs' Application for Prejudgment Remedy, *Pursuit Partners, LLC v. UBS AG,* Stamford Superior Court No. XO5CV084013452S (Complex Litigation Docket).

1934 Act. Determining whether such trades took place will require further investigation by the agency to which the matter is referred.

Finally, as to Moody's, SEC Rule FD, issued under the 1934 Act, prohibits selective disclosure of material nonpublic information. Either as a direct violation of the terms of this regulation or the more general standards of the 1934 Act, Moody's may be subject to an enforcement action.

4. Potential Fraud and False Certifications: Citigroup

The Securities and Exchange Commission recently concluded a $75 million civil settlement with Citigroup, its former chief financial officer and the head of investor relations arising from affirmative statements to the markets in 2007 that the company had only $13 billion in subprime exposure when, in fact, the company ultimately disclosed $55 billion in subprime exposure.

The SEC's complaint, filed in conjunction with the settlement, does not name the CEO, the chair of the Executive Committee of the Board of Directors, other members of the Board who were briefed on these exposures or the president of the firm's Citi Markets and Banking unit, Citigroup's investment bank, even though they all were aware of this information well before it was disclosed to the public

Based on FCIC interviews and documents obtained during our investigation, it is clear that CEO Chuck Prince and Robert Rubin, chair of the executive committee of the Board of Directors knew this information. They learned of the existence of the super senior tranches of subprime securities and the liquidity puts no later than September 9, 2007.

On October 15, 2007, the same day markets were told that Citi's subprime exposure amounted to $13 billion, members of the Corporate Audit and Risk Management Committee of the Board were advised that: "The total sub-prime exposure in Markets and Banking was $13bn with an additional $16bn in Direct Super Seniors and $27bn in Liquidity and Par Puts."[12] This information was shared with other members of the Board of Directors.

Two weeks later, on November 4, 2007, after a steep decline in subprime valuations, Citigroup announced that it had subprime exposures amounting to $55 billion; the value of these assets had declined by $8 to $11 billion and CEO Chuck Prince had resigned.

Based on the foregoing, the representations made in the October 15, 2007 analysts call appear to have violated SEC Rule 10b-5, which makes it unlawful for "any person, directly or indirectly" using any means of interstate commerce to "omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" in connection with "the purchase or sale of any security."

The SEC's civil settlement ignores the executives running the company and Board members responsible for overseeing it. Indeed, by naming only the CFO and the head of investor relations, the SEC appears to pin blame on those who speak a company's line, rather than those responsible for writing it.

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[12] CITI-FCIC 00002793, "Risk Management Review: An Update to the Corporate Audit and Risk Management Committee," October 15, 2007.

The former CEO, Mr. Prince, the former chairman of the Board, Mr. Rubin, and members of the Board may have been "directly or indirectly" culpable in failing to disclose material information to the markets in violation of section 10b-5 of the 1934 Act.

In addition, section 302 of the Sarbanes-Oxley Act requires the CEO and the CFO to certify that annual and quarterly reports do "not contain any untrue statement…or omit to state a material fact. In carrying out this certification obligation, the "signing officers" are responsible for establishing "internal controls" that "ensure that material information…is made known" to the officers during the time they are preparing the report.[13]

Although financial statements were routinely signed by the CEO and the CFO during the lead up to Citigroup's ultimate disclosure of $55 billion in subprime exposure, internal controls were facially inadequate. As noted in a Federal Reserve Board report,

> …there was little communications on the extensive level of subprime exposure posed by Super Senior CDSs, nor on the sizable and growing inventory of non-bridge leveraged loans, nor the potential reputational risk emanating from SIVs which the firm either sponsored or supported. Senior management, as well as the independent Risk Management function charged with monitoring responsibilities, did not properly identify and analyze these risks in a timely fashion."[14]

Since the CEO and CFO are responsible under the Act for accurate quarterly and annual reports, as well as the adequacy of the risk management systems needed to make those reports accurate, referrals for violations of section 302 of the Sarbanes-Oxley Act appear warranted.

5. Potential Fraud by Goldman Sachs in Connection with Collateral Calls on AIG

By the end of 2006, Goldman Sachs decided to reduce its exposure to subprime real estate and throughout 2007, it maintained a "net short" or close to "net short" position on real estate-related assets. Therefore, it was in Goldman's interest for "marks" on CDOs to be as low as possible because gains on its "short" positions would exceed losses on "long" positions. In addition, lower marks would require AIG to post larger amounts of collateral under its CDS contracts with Goldman.

The CDOs on which Goldman purchased CDS protection from AIG were illiquid instruments that could not be valued by obtaining prices from trades. Instead, they were primarily valued by looking at trades of other securities, indices like the ABX, and the use of models. Marks for CDOs were often referred to as marks-to-model, and frequently required extrapolation of very limited data to estimate a market price.

Goldman was consistently the most aggressive firm on Wall Street in setting low marks. In fact, in May 2007, Goldman's CRO Craig Broderick wrote in an email to Dan Sparks that the firm was "in the process of considering making significant downward adjustments to the marks [on CDOs]" and that "this will potentially have a big P&L impact on us., but also to our clients due

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[13] 15 U.S.C. § 7241.
[14] FCIC-Citi-000198, letter from the Federal Reserve Board of New York to Vickram Pandit and the Board of Directors of Citigroup, April 15, 2008, at 8.

to the marks and associated margin calls on…derivatives."[15] Other evidence indicates Goldman may have known its marks were too low. For example:

- Marks sent to Bear Stearns in June 2007 value securities in the BSAM funds at 50-60 cents on the dollar compared to higher marks provided by other dealers.[16] These marks caused BSAM's NAV to decline from approximately a discount of 6.75% to a discount of 19%.
- Goldman lowered its initial $1.8 billion collateral demand to AIG to $1.2 billion after AIG pointed out that the demand was based on "bid" prices rather than "mid" prices.[17] Goldman Co-CEO Michael Sherwood recounted that Goldman "didn't cover ourselves in glory" in this incident.[18]
- AIG countered Goldman's marks with marks from another investment bank, noting that the other institution was marking the specific CDOs at 80-95% while Goldman was marking at 55-60%.[19]
- Societe Generale withdrew a collateral call on AIG based on Goldman's marks when told AIG would dispute the marks.[20]
- Goldman's Sherwood reportedly told Cassano that "the market's starting to come our way," apparently recognizing that prior marks were too low.[21]

These facts raise potential legal issues that merit further exploration. First, with respect to the May 2007 e-mail previewing the fact that Goldman was about to significantly reduce its marks, this would be material information to anyone purchasing securities from Goldman. If Goldman knew it was about to lower the values of the securities it was selling, pursuant to an offering circular, or if Goldman had a fiduciary relationship with any of the buyers, this could represent a violation of the 1934 Act or other laws arising from the failure to disclose this information to potential buyers. Second, this could also be a 1933 Act violation if this information was omitted from an offering document concerning the securities being sold.

6. <u>Potential Fraud in AIG Investor Calls</u>

On a December 5, 2007, investor call, CEO Sullivan and Financial Services unit president Cassano assured participants with respect to its super senior portfolios that they "were highly confident that we will have no realized losses on these portfolios during the life of these portfolios." AIG executives reported that there was an estimated $1.5 billion unrealized valuation loss on the super senior credit default swap portfolio. However, it was not revealed that AIG's calculations included (1) a $3.6 billion "negative basis" adjustment which reflected the difference between the value of the "synthetic" super senior credit default swap portfolio and the underlying "cash" bond that was being valued and (2) a $732 million "structured mitigant" adjustment.

[15] GS MBS-E009978118, e-mail from Craig Broderick to Dan Sparks, May 11, 2007.
[16] Complaint, *SEC v, Ralph R. Cioffi and Matthew M. Tannin*, Civ. No. 08-2457, June 19, 2008.
[17] AIIIG SEC 2035262, e-mail from Andrew Forster to Joseph Cassano, August 2, 2007.
[18] MFR of Joseph Cassano (June 25, 2010) at 3.
[19] AIG SEC2152433, e-mail from Andrew Forster to Joseph Cassano (with attached spreadsheet), November 9, 2007.
[20] AIG FCIC00382794, e-mail from Tom Athan to Joseph Cassano, January 1, 2008.
[21] MFR of Joseph Cassano (June 25, 2010) at 4.

Without the undisclosed adjustments, the unrealized valuation loss on the super senior credit default swap portfolio would have been $5.9 billion. On February 11, 2008, AIG disclosed the $3.6 billion negative basis adjustment, the $732 million "structured mitigant" adjustment, and material weakness in the company's risk management system. The result was the largest full-day decline in AIG's share price since the general stock market crash of 1987.

The failure to disclose this information on the December 5, 2007, investor call presents, at a minimum, a potential violation of section 10b-5 of the 1934 Act. A potentially more interesting question is who might be penalized for this violation.

One reason Mr. Cassano testified at our hearing was that the Department of Justice and the Securities and Exchange Commission decided not to prosecute him because he had disclosed the negative basis adjustment to Mr. Sullivan, the CEO, Mr. Bensinger, the CFO, and the firm's auditors, PriceWaterhouseCoopers ("PWC") before the December 5 call. Evidence of these disclosures include notes of a meeting prepared by PWC attended by Sullivan, Bensinger and the auditors on November 19, 2007,[22] and a December 1, 2007 e-mail from Cassano describing the derivation of the negative adjustment.[23]

Mr. Sullivan and Mr. Bensinger may be an appropriate focus of an enforcement action because they (1) knew about the problems with the $1.5 billion figure (although Mr. Sullivan testified before us that he does not recall this part of the November meeting); (2) they had the power to direct an adequate disclosure, but didn't use that power; and (3) personally participated in the December call.

PWC may also be exposed on these facts. PWC was not present at the 12/5/07 investor call and therefore did not make any representations. But the auditors may be liable as aiders and abettors of the false representations. Although private plaintiffs cannot invoke aider and abettor liability, the SEC retains this authority.[24]

Mr. Sullivan and Mr. Bensinger may also be liable under section 302 of the Sarbanes-Oxley Act. As discussed in the sections on Citigroup and Fannie Mae, this section requires both the certification of accuracy and the certification of an appropriate risk management section.

7. <u>Potential Fraud by Goldman Sachs in Connection with Abacus 2007-18 CDO</u>

Abacus 2007-18 was one of a series of synthetic CDOs developed by Goldman Sachs. Goldman took the short side and sold the long side. It then sold a portion of its short position to FrontPoint LLC and others. Steve Eisman, the principal deal maker at FrontPoint, reported that a few months after the transaction was concluded, Goldman's Jonathan Egol and David Lehman met with him, at his request, to further explain the deal and Goldman's role in it. According to Eisman, the explanation was "half English and half jargon," so he asked them to tell him "if I'm right. Eisman then said:

[22] AIG-SEC5981397-99
[23] PWC-FCIC 000381-383 at 381.
[24] *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. __, 128 S.Ct. 761 (2008), citing *Alexander v. Sandoval*, 532 U.S. 275, 290 (2001).

> so you put this stuff together and you went to the agencies to get a rating and the biggest issue with the rating is the correlation of loss, and you presented a correlation analysis that was lower than you actually thought it was but the rating agencies were stupid, so they'd buy it anyway. So assuming your correlation analysis was correct, you took the short side, sold it to the client and then [did the deal with me to get a mark].[25]

Eisman stated that Egol responded, "well, I wouldn't put it in those terms exactly."

Egol's reported response indicates that he was not disputing Eisman's characterization. This is a species of adoptive admission, the scope of which turns on the degree to which "exactly" is interpreted as acceptance of Eisman's statement.

Assuming that Egol did agree with Eisman, this could raise legal issues for Goldman. First, if Goldman did deliberately mislead the rating agencies through the use of an inaccurate correlation, more of the security may have been rated AAA than should have been. In this event, this could be a material omission for purposes of the 1934 Act. It could also implicate the 1933 Act if the offering documents on Abacus 2007-18 did not include material information that disclosed how much of the security should have been AAA.

Eisman went on to say that he believed that Goldman, "wanted another party in the transaction so if we have to mark the thing down, we're not just marking it to our book." He commented further that, "Goldman was short, and we [FrontPoint] were short. So when they go to a client and say we're marking it down, they can say well it wasn't just our mark."

This suggests that Goldman was expecting to lower the value of the security when it was created by Goldman. This would require the long investor to make payments to the short investors. Having other short investors would allow Goldman to show the long investors that Goldman was not the only beneficiary of the marks, which would make the marks appear to be more genuine than if Goldman were the sole short investor. If this was done deliberately by Goldman, it raises a potential 10b-5 violation of the 1934 Act.

Note Concerning the Failure Objectively to Assess Internal Controls and Procedures

The Commission's ultimate report is likely to include discussions of failures of internal controls and risk management systems which should have revealed problems to senior management, investors and regulators. These problems are similar to those that brought down Enron and Worldcom, which the Sarbanes-Oxley Act ("SOX") was designed to address. Section 404 of SOX requires senior management to (1) accept responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, (2) assess the effectiveness of these systems and (3) provide that the firm's auditor also attest to management's assessment of these systems. Furthermore, Section 302 of SOX (and the rules promulgated by the SEC there under), require issuers to maintain disclosure controls and procedures designed to ensure that information required to be disclosed in the issuer's reports filed with the SEC under the Exchange Act (e.g. Forms 10-Q and Form 10-K) is accumulated and communicated to the

[25] MFR of Steve Eisman (April 22, 2010, April 28, 2010) at 11.

issuer's management (including its CEO and CFO), in order to allow timely decisions regarding required disclosure. Section 302 further requires CEOs and CFOs to make a number of certifications in their quarterly and annual reports.

Given the failure of financial reporting and risk management systems at some of the firms mentioned above (Fannie Mae, Citigroup and AIG), after further review by the staff of potential violations of section 404, in addition to the violations of section 302 already discussed, section 404 violations may be included in the referral letter to the Attorney General as well.

Supplement to referral memo
(Sent by Gary Cohen on 9/28/2010)

1. Material Misstatements and Omissions in various RMBS Offering documents.

The securities laws require sellers to adequately describe for potential investors what they are offering, including the risks which may be associated with making such an investment. If the seller makes a false or misleading statement of (or omits to state) a material fact in a prospectus, it can result in the issuer of the securities and underwriters being liable to investors and becoming subject to federal prosecution. The prospectuses and other offering materials used in connection the sale of residential mortgage backed securities in a substantial number of offerings between 2006 and 2007 (and maybe before), may have contained false statements and omissions relating to disclosures about the credit risks and origination standards of the underlying mortgage loans.

Regulation AB promulgated by the SEC in late 2004 specifically requires that investors in mortgage backed securities be provided with information regarding the underwriting criteria used to originate the loans in the pools.[26] Each prospectus is also subject to Rule 408, as follows:

> In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

In response to these requirements, a typical prospectus often concludes its description of the originator's underwriting guidelines to the effect that:

> "On a case-by-case basis [the originator] may determine that, based on *compensating factors*, a prospective mortgagor not strictly qualifying under the underwriting guidelines warrants an *underwriting exception*. Such guidelines may include, but are not limited to, low debt-to-income ratio, good mortgage payment history, an abundance of cash reserves, excess disposable income, stable employment and time in residence at the applicant's current address." (*Emphasis supplied)*

> "[Some] [A substantial number] [A significant number] of the mortgage loans included in the loan pool will represent such exceptions."

[26] See Section 1111 of Regulation AB.

On its face, the language indicates that with regard to all of those loans which do not meet the stated guidelines, there are *compensating factors* which make up for the fact that the guidelines weren't met. *If there were no compensating factors, then this was a false statement.* And if the statement was material, there could be a violation of the federal securities laws. The quoted language also omits to state what the compensating factors were. *This omission could also be material and a breach of the securities laws.*

The Staff has gathered evidence of cases where the underwriter of the securities had little or no evidence that every loan which did not meet underwriting guidelines had compensating factors allowing it to be included in the loan pool.

As part of the due diligence review, a broker needs to check the origination files of the underlying loans. In some cases this was done by the broker's quality assurance personnel. In others it was done by a third party vendor of due diligence services, such as Clayton.

The Staff has discovered that these reviews used samples of the loan pools to test whether the loans met guidelines (a Grade 1 Event), failed to meet guidelines but were approved due to compensating factors (a Grade 2 Event) or failed to meet guidelines (a Grade 3 Event). The Staff has also learned that the percentage of loans to be reviewed within a pool was almost always less than one-third of the total loan pool, and often much less. The size of the sample was often negotiated between the loan originator and the buyer of the loan pool. When loans to securitize were in high demand, the loan pool originator could insist on only a limited review of 5% to 10%, or even lower percentages, of the loans within the pool. When the review was conducted by quality assurance personnel of the originator/broker the sample sizes were sometimes even smaller.

The number of Grade 3 Events however, as a percentage of loans reviewed, was substantial. When Clayton tested samples of loan pools in 2006 and the first six months of 2007, it found that of 911,039 loans it tested for a variety of brokers, 28% of the loans were Grade 3 Events (did not meet underwriting guidelines and did not have sufficient compensating factors). Some of these Grade 3 Events were waived by the broker for various reasons.

The table below shows information regarding the Grade 3 Events and waivers as calculated by Clayton for various brokers for the period of testing running from January 1, 2006 through June 30, 2007:

Broker	**Total Loans Sampled**	**Clayton Grade 3 Events**	**Broker Waiver Rate**[27]	**Final Grade 3 Event Rate**[28]
Credit Suisse	56,306	32.0%	33%	21%
Goldman	111,999	22.9%	29%	16%
Citigroup	6,205	41.6%	31%	29%
JPMorgan	23,668	26.7%	51%	13%
Lehman	70,137	25.8%	37%	16%

[27] To achieve the final failure rate.
[28] After waivers.

Merrill	55,529	23.2%	32%	16%
UBS	27,618	19.6%	33%	13%
WaMu	35,008	26.9%	29%	19%[29]
Total All Banks	911,039	28.1%	39%	17%

Statistically, if the samples tested were indicative of the remainder of the loan pool, then a similar proportion of Grade 3 Events would be expected for the non-tested portion of the loan pools from which the tested samples came. Since, as the Staff has been told by various brokers, the loans in the portion of the loan pool which were not tested went directly into the pool supporting a residential mortgage-backed securities offering, the part of the prospectus which said all loans that did not meet underwriting guidelines had compensating factors, was not based on a review of all the loans that were waived into compliance.

As testified to by Clayton witnesses, Clayton's due diligence review was never designed to give investors in the total loan pool adequate information concerning all the underlying loans in the pool. Using this sampling method of due diligence for prospectus purposes may have resulted in disclosure which was untrue (e.g. that all loans either were written to underwriting guidelines or there were compensating factors).

The question thus becomes did the falsehood or omission relate to a material fact. If it did, there was a violation of Section 11.

Investors in residential mortgage-backed securities rely to a great extent on overcollateralization and subordination for comfort that their securities will be paid. When a large number of loans are of low quality from the time of origination, and this is not disclosed in the prospectus, overcollateralization and the benefits from subordination are overstated. From the percentages which appear in the table above, there is little doubt that the statement that "all loans which did not meet underwriting guidelines had compensating factors" was likely to be material and false (and not apparently appropriately caveated with reference to the sampling techniques used).

Nevertheless the pattern evidenced by our investigation of Clayton, one of Clayton's competitors, and a number of underwriters is indicative of two possible areas of misrepresentation meriting consideration for referral. Failure to disclose the gross numbers waivers of underwriting standards, and inaccuracy in disclosing that not all waived loans had confirmed compensating factors. These matters and underlying evidence will be part of the referral package.

[29] All Clayton Trending Reports, 1st Quarter 2006 – 2nd Quarter 2007

Financial Crisis Inquiry Commission
Agenda Item 8 for Telephonic Business Meeting of October 12, 2010

Confidential Referral Memorandum Supplement

FROM: Financial Crisis Inquiry Commission Legal Staff

TO: Commissioners of the Financial Crisis Inquiry Commission

Cc: Wendy Edelberg

DATE: October 11, 2010

RE: Confidential Referral Memorandum Supplement

Pursuant to section 5(c) (4) of the Fraud Enforcement and Recovery Act of 2009, one function of the Financial Crisis Inquiry Commission is to:

> refer to the Attorney General of the United States and any State attorney general any person that the Commission finds may have violated the laws of the United States in relation to such crisis.

This Confidential Referral Memorandum Supplement is further to our prior Memorandum of September 12, 2010, discussed at the Commission's Telephonic Business Meeting of September 14, 2010 .

Merrill Lynch & Co., Inc. Evidence discovered during the investigation of Merrill Lynch & Co., Inc. ("Merrill") indicates

> (1) that former CEO Stanley O'Neal and former CFO Jeffrey Edwards may have violated the federal securities laws by making materially false and misleading representations and omissions about (a) Merrill's exposures to retained CDO positions, (b) the value of those positions and (c) the firm's risk management.
>
> (2) that Merrill may have made materially false and misleading representations in the offering documents related to the $1.5 billion Norma CDO issued in March 2007.

(3) Merrill may have aided and abetted fraud or breaches of fiduciary duty by collateral managers to the investors in the CDOs they managed by purchasing CDO tranches from Merrill without performing sufficient due diligence because Merrill told the collateral managers that they would not be retained as collateral managers unless they purchased collateral from Merrill for the CDOs they managed.

Possible False and Misleading Statements and Omissions About Merrill's Risk Management, Retained CDO Positions and the Value of the Retained CDO Positions

Buildup of Retained CDO Positions. Documents produced by Merrill to the FCIC staff, including a 9/26/07 Market Risk Management Update show that Merrill's "net" exposures to ABS CDOs increased from $7.2 billion as of 8/31/06 to $32.2 billion as of 7/07.

Merrill ABS CDO Positions – Net (in millions)

Date	High Grade	Mezzazine	CDO^2	Total
8/06	5,580	1,610	0	7,190
9/06	7,210	2,075	0	9,285
1/07	12,810	4,524	0	17,334
2/07	15,175	4,737	370	20,282
3/07	18,620	6,109	700	25,429
4/07	23,220	6,192	1,340	30,752
5/07	22,310	6,117	440	28,867
6/07	22,310	6,423	1,620	30,353
7/07	24,120	6,438	1,505	32,158
8/07	18,286	6,228	1,201	25,715
9/07	18,158	6,173	1,201	25,532

A December 3, 2007 presentation to the Merrill Board of Directors showed that Merrill's "net" ABS CDO exposures varied from the amounts shown in the September 26, 2007 presentation and certain earnings calls: $18.9 billion as of September 30, 2006 (not $9.3 billion), $28.5 billion as of December 31, 2006, $31.5 billion as of March 31, 2007 (not $25.4 billion), $33.9 billion as of June 30, 2007 (not $30.4 billion), $15.8 billion as of September 30, 2007 (not $25.5 billion), and $14.6 billion as of October 31, 2007.

Dow Kim, the former co-president of Merrill's Global Markets and Investment Banking ("GMI") segment told FCIC staff that the buildup of the retained CDO positions was part of a strategy begun in late 2006 to reduce the firm's warehouse exposure to subprime.

In a 3/30/07 memo prepared by the SEC's Office of Prudential Supervision and Risk Analysis ("OPSRA"), it was reported that Merrill was "actively pushing their subprime mortgage inventory into several ABS CDO deals" because there was an increase in the demand for lower rated tranches of ABS CDOs, particularly from hedge funds. It was also reported that Merrill was "experiencing difficulty in placing the higher rated product, causing the desk to bump up against its limits."

An "ABS Warehouse/CDO Inventory Chronology" produced by Merrill reported deterioration in the ABS CDO market from 3/07 to 5/07 and further increases in ABS CDO inventory. Specifically, it was reported that from 3/07-5/07 (1) Merrill began an active risk-mitigation strategy, (2) Merrill's warehouse declined to $3.5 billion while inventory increased to $30.7 billion as the firm actively reduced the warehouse by printing deals, (3) Merrill was required to retain senior and mezzanine tranches to complete deals, (4) Merrill had to enhance mezzanine tranches to the detriment of senior tranches to complete deals, (5) there was a market for selling senior and mezzanine tranches but at a loss, and (6) $10 billion of deals were completed with Merrill taking significant senior and mezzanine tranches into inventory.

During a July 22, 2007 Finance Committee Meeting and a July 23, 2007 Board of Directors meeting, it was reported that Merrill's retained CDO interests were approximately $32 billion due to a risk transformation strategy begun in 12/06 that reduced substantial warehouse risk by securitizing and hedging the warehouse. Both meetings were attended by Mr. O'Neal and Mr. Edwards. Mr. O'Neal told FCIC staff this was the first time he learned of the retained CDO positions but the initiation of the risk transformation strategy in 12/06, the buildup of retained CDO positions shortly thereafter and other documents indicate he may have known earlier. For example, during an April 26, 2007 Board meeting, it was reported that Merrill was pursuing an active risk mitigation strategy that included (1) reducing warehouse loans, (2) discontinuing whole loan purchases, (3) reducing originations by First Franklin, and (4) limiting the level of retained residual interests which were $1.5 billion as of 4/07 and projected to be $1.6 billion in 6/07.[30] In addition, it was reported in a summary of a 11/29/07 meeting between Merrill executives (including CFO Edwards) and the Federal Reserve that "senior executives were involved in key determinations about the subprime-related businesses at Merrill ***throughout 2007"*** and that "senior executives get regular risk reports as a matter of course and were involved in discussions about the business, particularly focused on First Franklin in the first half of the year and later the CDO business."[31]

1Q07 Earnings Conference Call. On April 19, 2007, Merrill reported 1Q07 results - its second highest quarterly revenues ever and record net revenues from the FICC (Fixed Income, Currencies and Commodities) business (the business housing the increased retained ABS CDO positions) but Merrill failed to disclose the increase in the ABS CDO positions or the fact that the firm was only able to sell senior and mezzanine CDO tranches at a loss even though analysts asked about Merrill's exposure to subprime.

During the conference call, then CFO Edwards indicated that Merrill's results would not be adversely affected by the dislocation in the subprime market because "revenues from subprime mortgage-related activities comprise[d] less than 1% of our net revenues" over the last five quarters, and because Merrill's "risk management capabilities are better than ever, and crucial to our success in navigating turbulent markets." He provided further assurances, stating, "we

[30] 4/27/07 U.S. Residential Mortgage Update, BAC-ML-CDO-000076828-6861, at 6847-54.
[31] 11/29/07 Senior Supervisors Meetings, Merrill Lynch, November 29, 2007; FCIC-125522-527 at 125523 and 125525.

believe the issues in this narrow slice of the market remain contained and have not negatively impacted other sectors."

Analysts indicated that they understood the message to be that the dislocation in the subprime market had not adversely impacted Merrill but asked Edwards if Merrill was changing its risk appetite. Edwards said nothing about the increase in retained ABS CDO positions or the fact that Merrill was selling ABS CDOs at a loss, repeated the importance of Merrill's risk management and said the FICC business "powered right through" the dislocation in the subprime market.

> Well, let me make a couple of points about that. Certainly risk management, as I said in the prepared remarks, is a crucial aspect of our business. I think we have done a very good job in negotiating these markets as a result of that. So how are we approaching that? We are certainly looking at new ways to do business where there are opportunities for us to either share risk or pre-sell some of the risk and still do good business. So I think we are approaching it in a prudent way given the environment.
>
> But let me just reiterate that in these markets, in these asset classes, it is important to recognize that there are going to be periods of dislocation. This particular quarter, there was one in the U.S. subprime business and it's, as you point out, it is important to react to that. But its is going to – as part of a broader portfolio of businesses, you are able to deal with those types of markets. As you can see, the fixed income business just powered right through that.

Edwards responded to a question about CDO trends that Merrill was able to price 28 CDO transactions during the quarter but said nothing about the increase in retained ABS CDO positions or the fact that ABS CDO tranches were being sold at a loss.

In response to a question about whether there were "any big shifts since the beginning of the year" in "the level of [] overall retained interest for mortgage securitizations," Edwards failed to disclose the increase and stated that the majority of retained interests were "investment grade rated securities that are either part of our CDO warehouse or the result of securitizations that are effectively in inventory, that we intend to sell on to investors" and that there was "only a small part that reflects the sub-prime residuals."

2Q07 Earnings Conference Call. On July 17, 2007, Merrill reported 2Q07 results including "very strong net revenues, net earnings and earnings per diluted share for the second quarter of 2007, which enabled the company to achieve record net revenues, net earnings and net earnings per diluted share for the first half of 2007." During the conference call, CFO Edwards repeated the results reported in the press release and after completing his prepared remarks, UBS analyst Glenn Schorr asked Edwards to provide some color on Merrill's exposure to retained ABS CDO positions. Similar to the 1Q07 earnings conference call, Edwards stressed Merrill's risk management and the fact that the CDO business was a small part of Merrill's overall business.

He also said that there were significant reductions in Merrill's exposures to lower-rated segments of the market. However, the "net" exposure of Merrill's ABS CDO retained interests had increased from $17.3 billion in January 2007 to $25.4 billion in March 2007 and to $30.4 billion in June 2007. Edwards failure to disclose the increase in CDO exposure could be construed as material information that made his statements about reductions in exposures to lower-rated segments of the market misleading.

Deutsche Bank analyst Mike Mayo asked Edwards to disclose the level of assets related to subprime mortgages, CDOs and warehouse lines so he would know how much of the firm's capital was at risk from these asset classes but Edwards responded that "we don't disclose our capital allocations against any specific or even broader group."

3Q07 Earnings Call and Disclosure of CDO Losses but Refusal to Provide Gross Exposures. On 10/24/07, Merrill reported 3Q07 results including a net loss from continuing operations of $2.3 billion, or $2.85 per diluted share. The results included write-downs of $7.9 billion related to the retained CDOs ($6.9 billion) and U.S. sub-prime mortgages ($1.0 billion). Merrill also reported for the first time its net exposures to retained CDO positions, which were $15.2 billion. The disclosure of the retained CDO exposures and related write-downs indicate that the statements made by Edwards during the 1Q07 and 2Q07 earnings calls may have been materially false and misleading. In addition, O'Neal and Edwards may have made materially false and misleading representations or omissions during the 10/24/07 conference call. First, the amount of subsequent write-downs indicates that it is possible Edwards and O'Neal knew that the reported 3Q07 write-downs were insufficient. As shown below, Merrill reported more than $20 billion of additional CDO-related write-downs over the next 5 quarters.

Write-Downs and Credit Valuation Allowances (in billions)

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	Total
ABS CDO Writedowns	5.80	8.70	1.80	3.50	6.40	0.40	**26.60**
Other Retained & Warehouse Exposures	1.10	1.10	(0.30)	0.20	0.20	(0.10)	**2.20**
Credit Valuation Allowances	0.00	2.60	3.00	2.90	1.30	3.20	**13.00**
Subprime Writedowns	1.00	1.60	0.30	0.50	0.40	0.10	**3.90**
Alt-A	N/R	0.40	0.40	0.50	0.50	0.00	**1.80**
USB Subprime	N/R	0.90	0.70	0.30	0.10	0.20	**2.20**
USB Alt-A	N/R	0.70	0.20	1.40	0.60	0.80	**3.70**
USB CRE	N/R	0.30	0.70	(0.30)	0.40	0.10	**1.20**
Non U.S.		0.50	0.10	0.20	1.30	0.20	**2.30**
Total	**7.90**	**16.80**	**6.90**	**9.20**	**11.20**	**4.90**	**56.90**

Merrill Lynch Net Income/(Loss) (in billions)

3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	Total
($2.30)	($9.90)	($2.10)	($4.90)	($7.50)	($16.00)	($42.70)

Further, O'Neal and Edwards may have made misleading statements about Merrill's exposures to CDOs. During the 10/24/07 conference call, CEO O'Neal and CFO Edwards refused to disclose Merrill's gross exposures despite repeated requests from analysts. In response to a request to breakdown what was sold and what was hedged, CFO Edwards stated "I just don't want to get into the details behind that." When pressed for more information on the exposures, CFO Edwards stated "let me just say that what we have provided again we think is extraordinarily high level of disclosure and it should be sufficient." Deutsche Bank analyst Mike Mayo disagreed and asked management to provide additional information but his request was rejected.

Documents obtained from Merrill and the SEC, and subsequent disclosures by Merrill after O'Neal and Edwards left the firm indicate that O'Neal and Edwards representations about Merrill's CDO net exposures may have been materially false and misleading because they failed to disclose that there were billions of dollars of hedges that they knew might not be effective.

Merrill hedged its long exposures of U.S. super senior ABS CDOs with the monolines, either through a guarantee or through a credit default swap. Documents produced by the SEC to the FCIC reveal that Merrill began to increase the amount of credit default protection purchased from financial guarantors in July 2007 to offset its long exposure to the super senior ABS CDO positions. The SEC became concerned with the viability of the financial guarantors in early Fall 2007 as rating agencies began to downgrade them and the SEC raised those concerns with Merrill because it had purchased $95.9 billion of notional credit default protection from the financial guarantors. Indeed, the SEC told Merrill that it would impose a punitive capital charge on the firm if it purchased additional credit default protection from the financial guarantors. The SEC's threat of a capital charge resulted in Merrill ceasing any further purchases.

The SEC also reported that Merrill recognized there was uncertainty about the value of the credit default protection purchased from the financial guarantors. The 11/6/07 SEC Office of Prudential Supervision and Risk Analysis memo reported that Merrill had purchased CDS protection from several financial guarantors but that Merrill was beginning to question their ability to perform under all scenarios since the financial guarantors had recently reported GAAP-based losses. As shown in the chart above, beginning in 4Q07, Merrill recorded $13.0 billion of credit valuation allowances ("CVAs") because of the deteriorating financial condition of the monolines and their inability to comply with the terms of the guarantees.

During Merrill's January 17, 2008 conference call, newly hired CFO Nelson Chai reported that Merrill's net exposure to super-senior ABS CDOs was $4.8 billion as of December 31, 2007, but was $30 billion when excluding the impact of hedges and short positions. On April 17, 2008, Merrill reported that its super senior ABS CDO exposure was $26 billion as of March 31, 2008. On July 17, 2008, Merrill reported that at the end of 2Q08 it had $20 billion of long ABS CDO positions and $16 billion of short positions, but $9.6 billion of the short positions were hedges with the monolines which were valued at just $2.9 billion. Eleven days later, Merrill reported that it had sold $30.6 billion of ABS CDOs (with a carrying value of $11.6 billion) to Lone Star Funds for $6.7 billion. Merrill's ABS CDO exposures caused Merrill to record tens of billions of dollars in write-downs and related charges (e.g., CVAs on monoline hedges) in 2007 and 2008. These facts indicate that the gross CDO exposures, particularly given the questionable value of the monoline hedges, was material information that should have been disclosed given the representations that were made by O'Neal and Edwards during the 1Q07, 2Q07 and 3Q07 earnings calls.

A. Possible False and Misleading Representations in the Norma CDO Offering Documents

The FCIC discovered evidence indicating that Merrill Lynch may have violated the federal securities laws by misstating and omitting key facts regarding its issuance of a $1.5 billion "hybrid" CDO called "Norma," which was created and marketed in March 2007. NIR Capital Management, LLC ("NIR") was the collateral manager for Norma. The Norma Preliminary Offering Circular, marketing materials and NIR engagement letter all represented that NIR, as the collateral manager, bore sole responsibility for the selection of the Norma collateral.[32] As a collateral manager, NIR was responsible for purchasing CDO assets and managing them according to specified guidelines.[33] The Norma Preliminary Offering Circular provided a specific description of NIR's role as the collateral manager, stating that the collateral manager will perform:

> certain advisory functions and certain administrative functions with respect to the Collateral pursuant to a collateral management agreement . . . the Collateral Manager will manage the Acquisition and Disposition of the Collateral Debt Securities, including exercising rights and remedies associated with the Collateral Debt Securities, Disposing of the Collateral Debt Securities and certain related functions.[34]

The Preliminary Offering Circular described the collateral management agreement with NIR, which stated that NIR "will be authorized to supervise and direct the investment, reinvestment and Disposition of Collateral Debt Securities, Equity Securities and Eligible Investments, with full authority and at its discretion (without specific authorization from the Issuer), on the Issuer's behalf and at the Issuer's risk,"[35]

While NIR was the collateral manager, Magnetar Capital LLC ("Magnetar"), a hedge fund, was an equity investor in Norma, purchasing the $50 million equity tranche in Norma for $15.5 million, the G and H tranches at par ($38 million), $9.25 million of CDS against the B tranche and receiving $4.5 million in fees.[36] During a discussion on October 4, 2010, SEC staff told

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[32] BAC-ML-CDO 000057429-782 (Offering Circular); 59222-301 (marketing materials); 59153-164 (NIR engagement letter).
[33] Suresh Sundaresan, "Fixed Income Markets and their Derivatives," Academic Press, p. 400 (2009).
[34] Preliminary Offering Circular of Norma CDO I LTD and Norma CDO I LLC dated January 18, 2007, p 5.
[35] Preliminary Offering Circular of Norma CDO I LTD and Norma CDO I LLC dated January 18, 2007, p 197.
[36] BAC-ML-CDO-000079743 (Magnetar investments in Norma); BAC-ML-CDO-000059221 (fees received).

FCIC staff that Magnetar was short about $94 million into the deal. Evidence obtained by the FCIC indicates that Merrill failed to disclose two important facts. First, Merrill did not disclose the fact that Magnetar was involved in the collateral selection process of the CDO. Second, Merrill failed to disclose that Magnetar had taken a short position in the assets it was selecting for Norma's portfolio. By concealing Magentar's role in selecting the assets and its short interest, the Preliminary Offering Circular failed to disclose to Norma's investors that assets were being selected by an investor that would profit if the value of the collateral declined.

Information obtained from counsel for Rabobank (a bank that sued Merrill to recover the balance of a $58 million loan to Norma, and settled) indicates that Merrill knew that (i) Magnetar selected collateral for the Norma CDO, (ii) Magnetar had the right to veto collateral decisions made by NIR and (iii) Magnetar would take short positions in the assets it selected for the Norma CDO. The FCIC is in the process of obtaining documents directly from Merrill that were identified by Rabobank's counsel and referenced in a letter to the court that will reportedly show the following:

> In August 2006, Magnetar assumed NIR's role in directing the collateral purchases, as evidenced by the quote of Magnetar's James Prusko ("Prusko"), Head of Structured Products, stating, "Here is the first batch of protection purchases I'm planning for NIR."[37]
>
> By November 2006, Magnetar had executed about $600 million in trades for Norma without involving NIR, as evidenced by an unattributed quote, "Apparently NIR allowed Magnetar to do some trading for their portfolio (in the area of 600MM). This accounted for a large chunk of trading that NIR originally didn't recognize."[38] In response to this statement, a Merrill corporate risk manager asked, "Dumb question. Is Magnetar allowed to trade for NIR?"[39]
>
> Magnetar exercised veto rights on the trades that NIR actually executed, as Prusko told NIR that "I definitely want to approve any CDO's that go in the deal. . . ."[40]
>
> Merrill recognized that Magnetar's short positions in Norma were more important to it than its long positions, as evidenced by an unattributed quote most likely made by a Merrill employee, stating "I think Jim [Prusko] is less worried about his deal pricings and more worried about where he can short paper in the aftermarket."[41]

The circumstances surrounding Merrill's conduct in the Norma CDO are similar to Goldman's alleged conduct in the Abacus 2007-AC1 CDO that resulted in the SEC lawsuit and subsequent $550 million settlement. In that case, Goldman represented in the ABACUS marketing materials and offering circular that ACA Management LLC acted as collateral manager for the CDO when

[37] Document provided by Rabobank's counsel, ML01395145.
[38] Document provided by Rabobank's counsel, ML01396714.
[39] Document provided by Rabobank's counsel, ML01396714.
[40] Document provided by Rabobank's counsel, ML01396692.
[41] Document provided by Rabobank's counsel, ML01486349.

in fact Paulson & Co. Inc. ("Paulson") participated in the collateral selection process and took a short position against the CDO.[42]

FCIC staff has spoken with SEC officials who have confirmed the SEC is investigating the Norma CDO. In addition, Rabobank sued Merrill on June 12, 2009, to recover the balance of a $58 million loan to Norma. The Rabobank complaint alleged that Merrill fraudulently induced Rabobank to provide a $57.7 million senior secured loan to Norma.[43] Rabobank settled its case with Merrill, and on August 6, 2010 the case was dismissed.[44] The terms of the settlement are confidential.

Possible Improprieties by Merrill and Collateral Managers to Help Merrill Sell CDOs As noted above, Merrill was retaining super senior tranches of CDO and selling the subordinate tranches in 2006 and 2007 in an effort to reduce warehouse risk. Many of the subordinate tranches were sold to collateral managers that put them in other CDOs they managed. For example, at least 10 of the 12 purchasers of the Norma tranches were collateral managers in CDOs underwritten by Merrill.[45] FCIC has obtained from Merrill a listing of 44 CDOs underwritten by Merrill from 4Q06 through 8/07 that includes (1) the purchasers of each tranche, (2) the collateral manager for each CDO, (3) the performance of the CDO and (4) a listing of Merrill's collateral managers. Many of the purchasers in these CDOs were collateral managers in CDOs underwritten by Merrill. During the July 22, 2007 presentation to the Merrill Finance Committee, it was reported that new CDO deals were contingent on managers committing to or placing equity tranches.[46] The purchase of the CDO tranches by Merrill's collateral managers may have been improper if they purchased the tranches without proper due diligence and at the request – or demand – by Merrill. It is possible that there was a quid pro quo that the collateral managers had to buy Merrill's CDOs to continue to receive collateral manager business from Merrill.

FCIC staff spoke to SEC officials who said that the SEC is investigating CDOs and specifically the role of these collateral managers and their purchase of CDOs for other CDOs they managed. In fact, the SEC filed charges against ICP Asset Management on 6/22/10 alleging ICP fraudulently managed multi-billion-dollar CDOs by repeatedly causing the CDOs to purchase securities at inflated prices to make money for ICP and to protect certain ICP clients from realizing losses.[47] More specifically, the SEC alleged in the complaint filed on 6/21/10 that "ICP and the other Defendants put their interests ahead of their advisory clients and improperly obtained tens of millions of dollars in fees and undisclosed profits at the expense of clients and

[42] SEC Release No. 21592 (July 15, 2010).
[43] Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A. v. Merrill Lynch & Co., Case No. 09601832 (New York Supreme Court), Complaint at ¶4.
[44] Centrale Raiffeisen-Boerenleenbank, B.A. v. Merrill Lynch & Co., Index No. 601832/09 (August 6, 2010).
[45] BAC-ML-CDO-000079743 (listing of Norma cash note purchasers) and 79752 (listing of collateral managers).
[46] BAC-ML-CDO-000076862-884, at 869-870.
[47] SEC Complaint against ICP Asset Management, LLC, ICP Securities, LLC, Institutional Credit Partners, LLC and Thomas C. Priore, filed June 21, 2010.

investors."[48] George S. Canellos, Director of the SEC's New York Regional Office, further discussed the complaint, stating that "[t]he CDOs were complex but the lesson is simple: collateral managers bear the same responsibilities to their clients as every other investment adviser. When they violate their clients' trust, we will hold them accountable."[49]

The FCIC has information produced by Merrill related to the purchasers of 44 CDO Merrill underwrote and issued from 4Q06 through 8/07 and databases of information on CDOs obtained from Moody's and S&P. We do not know if the SEC has this information and believe we should make it available given the fact the SEC is investigating collateral manager dealings with Merrill and other CDO underwriters.

[48] SEC Complaint against ICP Asset Management, LLC, ICP Securities, LLC, Institutional Credit Partners, LLC and Thomas C. Priore, filed June 21, 2010, pg 3.
[49] Press Release, SEC Charges N.Y.-Based Investment Adviser With Fraudulent Management of CDOs Tied to Mortgage-Backed Securities, June 21, 2010, p 2.

Financial Crisis Inquiry Commission
For Telephonic Business Meeting of October 12, 2010
Confidential Memorandum

TO: Commissioners of the Financial Crisis Inquiry Commission

FROM: Financial Crisis Inquiry Commission Legal Staff

Cc: Wendy Edelberg, Greg Feldberg

DATE: October 11, 2010

RE: Fannie Mae's Subprime Disclosures/Commissioner Wallison's Request

Commissioner Wallison has expressed in prior Commission meetings and to Commission staff that the disclosure of the amount of subprime and Alt-A loans held by Fannie Mae in the past raises certain concerns. We have examined the disclosure issue in certain of Fannie Mae public filings from 2004 to 2008 and agree that the issue is worthy of consideration, but conclude that we do not believe a referral is warranted in these circumstances.

Background

In its **3Q08 Form 10-Q**, Fannie Mae included the following disclosures related to its classification of subprime and Alt-A loans.

> *Alt-A and Subprime loans*. We provide information below on our exposure to Alt-A and subprime mortgage loans. We have classified mortgage loans as Alt-A if the lender that delivers the mortgage loan to us has classified the loan as Alt-A based on documentation or other features. We have classified mortgage loans as subprime if the mortgage loan is originated by a lender specializing in subprime business or by subprime divisions of large lenders. We apply these classification criteria in order to determine our Alt-A and subprime loan exposures; however, ***we have other loans with some features that are similar to Alt-A and subprime loans that we have not classified as Alt-A or subprime because they do not meet our classification criteria. (emphasis added)***

Elsewhere in the 2008 filing, Fannie Mae did discuss with some specificity the levels of its holdings with characteristics "similar" to what it was calling Alt-A and subprime, such as the amount of loans in certain FICO ranges and the percent of loans characterized by (1) the original LTV ratio, (2) the estimated mark-to-market LTV ratio, and (3) loan type including interest-only, adjustable rate or fixed, and negative amortization.

This highlighted disclosure appears to be the culmination of an evolving disclosure standard concerning Fannie Mae's subprime and Alt-A holdings from 2004 through 2008.

To illustrate the evolving nature of the disclosure, Fannie Mae's **2004 Form 10-K** (filed 12-6-2006) makes no references with respect to either FICO exposure segmentation or "subprime", or alternative underwriting and documentation guidelines, except following.

> *"Alt−A mortgage"* refers to a mortgage loan underwritten using more liberal standards such as higher loan−to−value ratios and less documentation of borrower income or assets.[50]

> "in recent years, an increasing proportion of single−family mortgage loan originations has consisted of non−traditional mortgages such as interest−only mortgages, negative−amortizing mortgages and sub−prime mortgages, and demand for traditional 30−year fixed−rate mortgages has decreased. We did not participate in large amounts of these non−traditional mortgages in 2004 and 2005 because we determined that the pricing offered for these mortgages often was insufficient compensation for the additional credit risk associated with these mortgages."[51]

In its **2005 Form 10-K**, Fannie Mae disclosed how it defined subprime and represented that the percentage in the single family credit book of business consisting of subprime loans or MBS backed by subprime mortgage loans was not material as of December 31, 2005.[52]

> "*Subprime mortgage*" generally refers to a mortgage loan made to a borrower with a weaker credit profile than that of a prime borrower. As a result of the weaker credit profile, subprime borrowers have a higher likelihood of default than prime borrowers. Subprime mortgage loans are often originated by lenders specializing in this type of business, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders. (emphasis added)

While not providing granularity within the single family book of business by LTV and FICO band, as was the case in the subsequent years, Fannie did disclose the volume of interest only and negative amortizing adjustable rate mortgages (ARM) for 2005 and 2004. Finally, disclosures regarding the extent of Fannie concentrations in loans with alternative or non-traditional underwriting and documentation guidelines were not evident in the 2005 10-K. Fannie did state it was increasing its level of participation in this space but was not specific in terms of product classification, business volume, and concentration of the single family book of business.[53]

[50] 2004 Form 10-K at 35
[51] 2004 Form 10-K at 40
[52] 2005 Form 10-K at 122, emphasis added.
[53] 2005 Form 10-K at 122

In the **2007 Form 10-K,** Fannie disclosed the subprime classification criteria that was included in the 3Q08 Form 10-Q, but did not include the bolded portion that referenced the existence of other loans which might also meet the subprime and Alt-A criteria:

> "Subprime mortgage loans are typically originated by lenders specializing in these loans or by subprime divisions of large lenders, using processes unique to subprime loans. In reporting our subprime exposure, we have classified mortgage loans as subprime if the mortgage loans are originated by one of these specialty lenders or a subprime division of a large lender."[54]
>
> Subprime mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented *less than 1%* of our single-family business volume in each of 2007, 2006 and 2005.[55]
>
> We estimate that subprime mortgage loans held in our portfolio or subprime mortgage loans backing Fannie Mae MBS, excluding re-securitized private label mortgage related securities backed by subprime mortgage loans, represented approximately *0.3% of our single-family mortgage credit book of business* as December 31, 2007, compared with 0.2% and 0.1% as of December 31, 206 and 2005, respectively.[56]
>
> As of December 31, 2007, we held or guaranteed approximately …$41.4 billion in private−label mortgage−related securities backed by subprime loans.[57]

However, Fannie also disclosed for 2007 the percent of loans acquired and overall loans by FICO band.[58] For example, Fannie reported that 5% of the conventional single-family book of business in 2005, 2006 and 2007 included loans where the borrower's FICO score was less than 620 and 10% of the conventional single-family book of business in 2005, 2006 and 2007 included loans where the borrower's FICO score was between 620 and 660.[59] Thus, although Fannie represented subprime loans as approximately 0.3% of the single family book of business at 12/31/07 using its definition of subprime, Fannie also disclosed that 15% of the single family book of business included loans with FICO scores less than 660.

Regarding Alt-A, Fannie disclosed the Alt-A classification criteria that was included in the 3Q08 Form 10-Q, ("We have classified mortgage loans as Alt-A if the lender that delivers the mortgage loan to us has classified the loan as Alt-A based on documentation or other features") but did not include the additional disclosure in the 3Q08 Form 10-Q which noted that there could be other loans held by Fannie Mae that had similar features. Fannie Mae also represented that "Alt−A mortgage loans, whether held in our portfolio or backing Fannie Mae MBS, represented approximately 16% of our single−family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively."[60]

[54] Pg 129 and 155, Fannie Mae 2007 Form 10K, emphasis added.
[55] Pg 129, Fannie Mae 2007 Form 10K, emphasis added.
[56] Pg 130, Fannie Mae 2007 Form 10K, emphasis added.
[57] Pg 93 and 130, Fannie Mae 2007 Form 10-K
[58] 2007 Form 10-K at 126-130.
[59] 2007 Form 10-K at 127.
[60] 2007 Form 10-K at 129.

But Fannie also disclosed the percent of loans acquired and overall loans by (1) the original LTV ratio, (2) the estimated mark-to-market LTV ratio, and (3) loan type including interest-only, adjustable rate or fixed, and negative amortization. For example, Fannie reported that 10% of the conventional single-family book of business in 2007 included loans with original LTV ratios between 90% and 100%, and that 1% of the conventional single-family book of business in 2007 was comprised of negatively amortizing adjustable rate loans.[61]

Fannie Mae's disclosure in its **2006 Form 10-K** was very similar to the 2007 disclosure.

Conclusion

In summary, it appears that Fannie Mae certainly could have made better disclosure of its exposure to subprime and Alt-A loans in 2005 through 2008. Even in 2008 it is arguable that the Fannie Mae definition of subprime and Alt-A could have been more expansive. However, much of the information concerning Fannie Mae's exposure to those types of loans was available in 2006 and 2007 (even if Fannie Mae did not label them as such), and by 2008 they were explicitly calling attention to the definitional issues in their criteria for these types of loans. In addition, it is problematic to use improved disclosure to show that earlier disclosure was inadequate, as to do so will make it more firms less likely to be willing to improve and enhance their disclosure as circumstances warrant. Finally, we have no information to indicate that their form of disclosure was intentionally deceptive or reckless (scienter) which is necessary for a claim under Section 10(b) of the Exchange Act .

For this reason, we conclude that this issue does not rise to the level of other issues that the FCIC has referred to the Attorney General.

4843-1279-0279, v. 4

[61] 2007 Form 10-K at 126.