U.S. Securities and Exchange Commission v. Citigroup Global Markets Inc. Doc. 25

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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

MEMORANDUM ON BEHALF OF CITIGROUP GLOBAL MARKETS INC. IN SUPPORT OF THE PROPOSED FINAL JUDGMENT AND CONSENT

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

Brad S. Karp
Theodore V. Wells, Jr.
Mark F. Pomerantz
Susanna M. Buergel
1285 Avenue of the Americas
New York, New York 10019-6064
Tel. (212) 373-3000
Fax (212) 757-3990

Attorneys for Citigroup Global Markets Inc.

Dockets.Justia.com

TABLE OF AUTHORITIES

Page(s)

CASES

Aaron v. *SEC*,
446 U.S. 680, 696 (1980) 21

AHW Inv. P'ship. v. *Citigroup Inc.*,
No. 10 Civ. 9646 (DLC) (S.D.N.Y. filed Dec. 29, 2010) 8

Allstate Ins. Co. v. *CitiMortgage Inc.*,
No. 11 Civ. 1927 (RJS) (S.D.N.Y. filed Mar. 18, 2011) 8

Brecher v. *Citigroup Inc.*,
No. 09 Civ. 7359 (SHS) (S.D.N.Y. filed Aug. 21, 2009) 7

British Coal Staff Superannuation Scheme v. *Citigroup Inc.*,
No. 11 Civ. 7138 (SHS) (S.D.N.Y. filed Oct. 11, 2011) 8

Cambridge Place Inv. Mgmt., Inc. v. *Morgan Stanley & Co.*,
No. 10-2741-BLS2 (Mass. Super. Ct. filed July 9, 2010) 8

Cambridge Place Inv. Mgmt., Inc. v. *Morgan Stanley & Co.*,
No. 11-0555-BLS2 (Mass. Super. Ct. filed Feb. 11, 2011) 8

Charles Schwab Corp. v. *BNP Paribas Sec. Corp.*,
No. CGC-10-501610 (Cal. Super. Ct. filed July 15, 2010) 8

In re Citigroup Inc. Bond Litig.,
No. 08 Civ. 9522 (SHS) (S.D.N.Y. filed Nov. 5, 2008) 7

In re Citigroup Inc. Sec. Litig.,
No. 07 Civ. 9901 (SHS) (S.D.N.Y. filed Nov. 8, 2007) 7

City of Ann Arbor Emps.' Ret. Sys. v. *Citigroup Mortg. Loan Trust Inc.*,
No. 08 Civ. 1418 (LDW) (E.D.N.Y. filed Apr. 7, 2008) 8

In re Credit Suisse Alternative Capital, LLC.,
Securities Act Release No. 33-9268,
2011 WL 4957372, ¶ 2 (Oct. 19, 2011) 14

Fed. Home Loan Bank of Boston v. *Ally Fin., Inc.*,
No. 11 Civ. 10952 (GAO) (D. Mass. filed May 26, 2011) 8

Fed. Home Loan Bank of Chicago v. *Banc of Am. Funding Corp.*,
No. 10 CH45033 (Ill. Cir. Ct. filed Oct. 15, 2010) 8

Fed. Home Loan Bank of Chicago v. *Banc of Am. Sec., LLC*,
No. LC091499 (Cal. Super. Ct. filed Oct. 15, 2010) 8

Fed. Hous. Fin. Agency v. *Citigroup Inc.*,
No. 11 Civ. 6196 (PAC) (S.D.N.Y. filed Sept. 2, 2011) 8

First Nationwide Bank v. *Gelt Funding Corp.*,
27 F.3d 763, 772 (2d Cir. 1994) 12

Int'l Fund Mgmt. S.A. v. *Citigroup Inc.*,
No. 09 Civ. 8755 (SHS) (S.D.N.Y. filed Oct. 14, 2009) 7

Kuriakose v. *Fed. Home Loan Mortg. Corp.*,
No. 08 Civ. 7281 (JFK),
2011 WL 1158028, at *14 (S.D.N.Y. Mar. 30, 2011) 12

Lentell v. *Merrill Lynch & Co.*,
396 F.3d 161, 174 (2d Cir. 2005)....................11, 12

Melgen v. *Citigroup Inc.*,
No. 11 Civ. 4788 (SHS) (S.D.N.Y. filed July 12, 2011) 8

N.J. Carpenters Health Fund v. *NovaStar Mortg., Inc.*,
No. 08 Civ. 5310 (DAB),
2011 WL 1338195, at *11 (S.D.N.Y. Mar. 31, 2011) 12

Norges Bank v. *Citigroup Inc.*,
No. 10 Civ. 7202 (SHS) (S.D.N.Y. filed Sept. 17, 2010)....................7, 8

Odom v. *Morgan Stanley Smith Barney, LLC*,
No. 11 Civ. 3827 (SHS) (S.D.N.Y. filed June 6, 2011)....................8

Plumbers & Steamfitters Local 773 Pension Fund v.
Can. Imperial Bank of Commerce,
694 F. Supp. 2d 287, 302 (S.D.N.Y. 2010)....................22

In re PXRE Grp., Ltd., Sec. Litig.,
600 F. Supp. 2d 510, 545 (S.D.N.Y. 2009)....................22

In re Sec. Capital Assurance, Ltd. Sec. Litig.,
729 F. Supp. 2d 569, 596 (S.D.N.Y. 2010)....................12

SEC v. *Bank of Am. Corp.*,
653 F. Supp. 2d 507, 508, 509, 510 (S.D.N.Y. 2009)....................10, 17

SEC v. *Bank of Am. Corp.*,
Nos. 09 Civ. 6829 (JSR), 10 Civ. 0215 (JSR),
2010 WL 624581, at **5, 6 (S.D.N.Y. Feb. 22, 2010) 5, 10

SEC v. *Berger*,
244 F. Supp. 2d 180, 193 (S.D.N.Y. 2001)....................13

SEC v. *First Jersey Sec., Inc.*,
101 F. 3d 1450, 1474–75 (2d Cir. 1996)....................13

SEC v. *Power*,
525 F. Supp. 2d 415, 419 (S.D.N.Y. 2007)....................21

SEC v. *Stoker*,
No. 11 Civ. 7388 (JSR) (S.D.N.Y. Oct. 19, 2011) 17

SEC v. *Wang*,
944 F.2d 80, 85 (2d Cir. 1991)....................5

SEC v. *WorldCom, Inc.*,
273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003)....................5

Swiss & Global Asset Mgmt. v. *Citigroup Inc.*
No. 10 Civ. 9325 (SHS) (S.D.N.Y. filed Dec. 13, 2010)....................8

The Western & Southern Life Ins. Co. v.
Residential Funding Co., LLC,
No. A1105042 (Ohio Ct. Com. Pl. filed June 29, 2011)....................9

Union Central Life Ins. Co. v.
Credit Suisse First Boston Mortg. Sec. Corp.,
No. 11 Civ. 2890 (GBD) (S.D.N.Y. filed April 28, 2011) 9

Universal-Investment-Gesellschaft MBH v. *Citigroup Inc.*,
No. 11 Civ. 314 (SHS) (S.D.N.Y. Jan. 14, 2011) 8

In re Wachovia Equity Sec. Litig.,
753 F. Supp. 2d 326, 366 (S.D.N.Y. 2011)....................12

In re Wells Fargo Mortgage-Backed Certificates Litig.,
No. 09 Civ. 1376 (LHK) (N.D. Cal. filed Mar. 27, 2009) 8

STATUTES

15 U.S.C. §§ 77t(d)(2)(A), 77t(d)(2)(B)−(C) 16

OTHER AUTHORITIES

Hon. Jed S. Rakoff, U.S. District Judge,
Southern District of New York, Keynote
Address at 16th Annual Directors' College,
Stanford Law School (June 21, 2010)....................6, 7

Jed S. Rakoff, *Corporate Indictments and the Guidelines*, N.Y.L.J. (Jan. 13, 1994)....................9, 10

Statement of the Securities and Exchange Commission Concerning Financial Penalties, SEC Rel. No. 2006-04 (Jan. 4, 2006) 15, 17

Dep't of Justice, U.S. Attorneys' Manual §§ 9-28.100, 9-28.1000 (2008) 9

Defendant Citigroup Global Markets Inc. ("CGMI" or the "Company") respectfully submits this memorandum in response to the questions set forth in the Court's October 27, 2011 Order (the "Order") and in support of the proposed Final Judgment and Consent (the "Proposed Judgment"). CGMI appreciates that many of the questions posed by the Court are directed to the Securities and Exchange Commission ("SEC") and concern SEC policies and procedures. CGMI anticipates that the SEC will provide its perspective on those issues, and submits this memorandum to address CGMI-related issues to assist this Court in its evaluation concerning whether the Proposed Judgment is "fair, reasonable, adequate, and in the public interest." For all the reasons set forth below, CGMI respectfully submits that the Proposed Judgment meets this standard. CGMI looks forward to addressing the issues discussed below, and responding to any further questions the Court may have, at the November 9, 2011 hearing.

BACKGROUND

The SEC's October 19, 2011 complaint (the "Complaint") relates to a synthetic collateralized debt obligation ("CDO") known as Class V Funding III ("Class V"), structured by CGMI nearly five years ago. A CDO is a debt security backed by assets that are pooled and held by a special purpose vehicle ("SPV"), which issues notes entitling the holders to payments derived from the underlying assets. The notes issued by the SPV are classified by "tranche." The cash flows from the SPV's assets are distributed according to rules set forth in the offering documents, which generally provide that more senior tranches have priority in receiving funds.

The assets that comprise a synthetic CDO are credit default swaps ("CDS"). The synthetic CDO SPV enters into CDS contracts that reference the performance of specific assets. The SPV serves as the long party (or "protection seller"), and agrees to provide a short

counterparty (or "protection buyer") with payments in the event of credit events experienced by the reference assets. In exchange, the long party (the SPV) receives periodic payments from the short counterparty so long as the reference assets perform; these payments are paid out to holders of the notes issued by the SPV. A CDO-squared is comprised of underlying assets that are tranches of other CDOs. The assets of a synthetic CDO-squared are the payment streams on CDS contracts that reference tranches of other CDOs.

As a result of this structure, a synthetic CDO cannot be created unless one party or a series of parties purchases protection on (or "shorts") the reference collateral. In other words, without a short counterparty, CDS contracts could not be written, the SPV could not receive a stream of payments, and the SPV could not make payment on any notes issued to investors.

Accumulating collateral for a synthetic CDO requires two distinct steps. First, in a managed transaction (such as Class V), the CDO manager must identify assets for inclusion in the portfolio— *i.e.*, identify assets that the manager would like to reference. Second, once the assets are identified, the CDO manager must source CDS from counterparties willing to buy protection on—*i.e.*, short—the selected reference assets. A CDO manager can solicit CDS counterparties in a number of ways, including by speaking directly to counterparties with which the manager has conducted prior business (such as the structuring bank), or by reviewing or posting lists published in the market soliciting trading partners.

In a typical synthetic CDO, the structuring bank acts as the initial short counterparty for all of the collateral included in the portfolio—even where the manager has identified a third party to act as the ultimate short counterparty for a particular reference obligation. This is so for several reasons, including, among others, that ratings agencies

generally prefer for CDO vehicles to face a single counterparty to control for counterparty credit risk (given that the cash flow for the CDO requires the short counterparties to make the required protection payments). In addition, facing one short counterparty allows the CDO to enter a single form of swap agreement. By acting as the initial short counterparty, the structuring bank also minimizes its risks associated with the warehousing of collateral—the accumulation of collateral for a prospective transaction in the period before it closes; the structuring bank can wait until closing to write the CDS contracts, thus avoiding exposure to the collateral in the event the deal fails to close. After the closing of a synthetic CDO transaction, the initial short counterparty has the option of holding the short positions it has acquired or entering into offsetting trades in the marketplace with other counterparties.

Class V was a synthetic CDO-squared transaction with a total notional value of approximately $1 billion that closed on February 28, 2007. The synthetic collateral consisted of CDS referencing single-A rated tranches of other CDOs. Of the $1 billion final notional portfolio, 87% consisted of CDS referencing 49 unique CDOs and 13% consisted of nine unique cash positions (single-A rated tranches of other CDOs). The notes issued in the Class V transaction were offered in a private placement pursuant to Rule 144A and Regulation S of the Securities Act of 1933 to a handful of sophisticated institutional investors.

In fact, the ultimate investors in Class V—the alleged victims of the conduct described in the SEC's Complaint—were among the most sophisticated commercial players in the global financial markets, all with extensive experience investing in and, in many cases, managing CDO transactions. These investors included investment advisors, hedge funds, and asset management firms.

As set forth in the offering materials, CGMI and certain of its affiliates structured and underwrote Class V and acted as the Initial CDS Asset Counterparty—meaning that a CGMI-related entity took the initial short position on all of the reference collateral included in the transaction. Credit Suisse Alternative Capital Inc. ("CSAC") served as the collateral manager.

The SEC alleges that CGMI negligently failed to disclose to the investors that purchased the Class V notes that it (i) influenced the selection of certain of the collateral underlying Class V, and (ii) maintained a short interest in certain of that collateral following the close of the transaction. Although CGMI does not admit or deny the allegations set forth in the Complaint, CGMI notes that the extensive record developed by the SEC in this multi-year inquiry—which includes the review of over 30 million pages of documents and testimony from several current and former CGMI employees—underscores the complexity of the transaction and, we respectfully submit, gives rise to a number of substantial factual and legal issues that would need to be litigated in the absence of a settlement.

For instance, the Class V offering documents provide specific disclosures concerning CGMI's and its affiliates' roles in the transaction, although the SEC alleges that those disclosures were incomplete. Among other things, the offering materials informed investors that, in its role as the initial short counterparty, CGMI "*may be expected to have interests that are adverse to the interests of the Noteholders.*" (Offering Circular at 46 (emphasis added).) The disclosures further stated that CGMI "may provide CDS Assets as an intermediary with matching off-setting positions requested by the Manager or *may provide CDS Assets alone without any off-setting positions.*" (Offering Circular at 88 (emphasis added); *see* Compl. ¶ 43.)

Moreover, the Complaint does not allege that any CGMI-related employees acted with scienter or intentionally misled investors in connection with Class V. Instead, the Complaint and the SEC's Memorandum in Support of Proposed Settlement, filed October 19, 2011, assert only that CGMI acted negligently in failing to ensure that the disclosures made to these sophisticated investors provided complete information regarding CGMI's role in the transaction. (Compl. ¶¶ 6, 55.) Most significantly, Citigroup did not predict or profit from the subprime crisis, the collapse of housing prices, or the collapse of the CDO market. Precisely to the contrary: over a period of 18 months beginning in late 2007, *Citigroup's CDO-related losses totaled more than $30 billion*—more than any other financial institution in the world. Notwithstanding the $160 million in profits CGMI allegedly earned in connection with the Class V transaction, Citigroup lost tens of billions of dollars in its CDO-related investments during this period because it retained significant *long* positions in the CDOs it structured.

STANDARD OF REVIEW

The standard for judicial review and approval of a proposed consent judgment in an SEC enforcement action is whether the settlement is fair, reasonable, and adequate. *See SEC* v. *Wang*, 944 F.2d 80, 85 (2d Cir. 1991); *SEC* v. *WorldCom, Inc.*, 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003). Moreover, the Court is required "to give substantial deference to the SEC as the regulatory body having primary responsibility for policing the securities markets, especially with respect to matters of transparency." *SEC* v. *Bank of Am. Corp.*, Nos. 09 Civ. 6829 (JSR), 10 Civ. 0215 (JSR), 2010 WL 624581, at *6 (S.D.N.Y. Feb. 22, 2010); *WorldCom, Inc.*, 273 F. Supp. 2d at 436 (same).

Questions 1 and 2

> Why should the Court impose a judgment in a case in which the SEC alleges a serious securities fraud but the defendant neither admits nor denies wrongdoing?
>
> Given the SEC's statutory mandate to ensure transparency in the financial marketplace, is there an overriding public interest in determining whether the SEC's charges are true? Is the interest even stronger when there is no parallel criminal case?

CGMI defers to the SEC with respect to its enforcement policies and practices, and agency decisions, regarding when and under what circumstances to resolve matters through settlement.

CGMI respectfully submits that, as a general matter, the "public interest" is served by sophisticated litigants compromising complicated matters in a manner that avoids wasteful litigation and exposing both parties to extreme results. In evaluating whether the Proposed Judgment is fair, reasonable, adequate, and in the public interest, we respectfully submit that the Court should consider the potential impact on Citigroup Inc.'s shareholders of any outcome other than a negotiated, "no admit, no deny" settlement.[1] Here, Citigroup's management and Board exercised their business judgment in choosing to settle the matter on these terms and avoid a litigated proceeding with the SEC and the host of adverse collateral consequences that course would entail.

This Court has cataloged the many risks faced by a public company that chooses to engage in protracted litigation with its regulators, including private litigation risk, reputational harm, and the risk of collateral regulatory consequences. *See* Honorable Jed S. Rakoff, U.S. District Judge, Southern District of New York, Keynote Address at 16th Annual Directors'

[1] Citigroup Inc. ("Citigroup") is CGMI's ultimate parent company.

College, Stanford Law School (June 21, 2010), http://rockcenter.stanford.edu/wp-content/uploads/2010/07/Keynote-Speech-by-Jed-Rakoff-Directors-College-2010.pdf. These concerns, while present in virtually every SEC enforcement action, are magnified for financial institutions in today's punitive market environment, where litigating with a regulator may have devastating consequences (regardless of the strength of the institution's defenses). Consider the events that followed the April 16, 2010 filing of the SEC's CDO-related complaint against Goldman, Sachs & Co. ("Goldman"). As publicly reported, Goldman's share price dropped more than ten percent in the first thirty minutes of trading following the announcement of the filing of the SEC's complaint, and dropped a total of twenty-four percent in the three months between the date of filing and the resolution of the matter. The market reaction to the SEC's filing of the Goldman complaint stands in contrast to the stability of JPMorgan Chase & Co.'s stock after the announcement on June 21, 2011 of its decision to settle the SEC's investigation of its CDO-related business activities.

Citigroup's management and Board also appropriately considered the potential substantial adverse collateral consequences to Citigroup if it chose to litigate (and ultimately were to lose) a lawsuit against the SEC or settle in a manner in which it was required to "admit" liability. CGMI and its affiliates are defending several class action lawsuits and a number of related litigations asserting claims arising out of the subprime and credit crisis, including allegations specifically related to CGMI's CDO-related business practices. *See In re Citigroup Inc. Sec. Litig.*, No. 07 Civ. 9901 (SHS) (S.D.N.Y. filed Nov. 8, 2007); *In re Citigroup Inc. Bond Litig.*, No. 08 Civ. 9522 (SHS) (S.D.N.Y. filed Nov. 5, 2008); *see also Brecher* v. *Citigroup Inc.*, No. 09 Civ. 7359 (SHS) (S.D.N.Y. filed Aug. 21, 2009); *Int'l Fund Mgmt. S.A.* v. *Citigroup Inc.*, No. 09 Civ. 8755 (SHS) (S.D.N.Y. filed Oct. 14, 2009); *Norges Bank* v. *Citigroup Inc.*, No. 10

Civ. 7202 (SHS) (S.D.N.Y. filed Sept. 17, 2010); *Swiss & Global Asset Mgmt.* v. *Citigroup Inc.* No. 10 Civ. 9325 (SHS) (S.D.N.Y. filed Dec. 13, 2010); *AHW Inv. P'ship.* v. *Citigroup Inc.*, No. 10 Civ. 9646 (DLC) (S.D.N.Y. filed Dec. 29, 2010); *Universal-Investment-Gesellschaft MBH* v. *Citigroup Inc.*, No. 11 Civ. 314 (SHS) (S.D.N.Y. Jan. 14, 2011); *Odom* v. *Morgan Stanley Smith Barney, LLC*, No. 11 Civ. 3827 (SHS) (S.D.N.Y. filed June 6, 2011); *Melgen* v. *Citigroup Inc.*, No. 11 Civ. 4788 (SHS) (S.D.N.Y. filed July 12, 2011); *British Coal Staff Superannuation Scheme* v. *Citigroup Inc.*, No. 11 Civ. 7138 (SHS) (S.D.N.Y. filed Oct. 11, 2011).

These civil litigations rest on allegations that Citigroup misled investors by making false statements concerning its subprime exposure and concealing its involvement in the CDO market. In electing to settle this matter pursuant to the SEC's longstanding "no admit, no deny" policy, Citigroup's management and Board appropriately prioritized its current shareholders' interests in minimizing the collateral consequences associated with being adjudicated at fault in this matter and thereby enhancing the risk of an adverse outcome in the numerous pending subprime-related litigations.[2]

---

[2] CGMI also faces additional litigation exposure arising out of the subprime and credit crisis unrelated to its CDO structuring activities—for instance, litigation concerning residential mortgage-backed securities ("RMBS"). *See, e.g.*, *City of Ann Arbor Emps.' Ret. Sys.* v. *Citigroup Mortg. Loan Trust Inc.*, No. 08 Civ. 1418 (LDW) (E.D.N.Y. filed Apr. 7, 2008); *In re Wells Fargo Mortgage-Backed Certificates Litig.*, No. 09 Civ. 1376 (LHK) (N.D. Cal. filed Mar. 27, 2009); *Allstate Ins. Co.* v. *CitiMortgage Inc.*, No. 11 Civ. 1927 (RJS) (S.D.N.Y. filed Mar. 18, 2011); *Fed. Home Loan Bank of Boston* v. *Ally Fin., Inc.*, No. 11 Civ. 10952 (GAO) (D. Mass. filed May 26, 2011); *Fed. Hous. Fin. Agency* v. *Citigroup Inc.*, No. 11 Civ. 6196 (PAC) (S.D.N.Y. filed Sept. 2, 2011); *Cambridge Place Inv. Mgmt., Inc.* v. *Morgan Stanley & Co.*, No. 10-2741-BLS2 (Mass. Super. Ct. filed July 9, 2010); *Charles Schwab Corp.* v. *BNP Paribas Sec. Corp.*, No. CGC-10-501610 (Cal. Super. Ct. filed July 15, 2010); *Fed. Home Loan Bank of Chicago* v. *Banc of Am. Sec., LLC*, No. LC091499 (Cal. Super. Ct. filed Oct. 15, 2010); *Fed. Home Loan Bank of Chicago* v. *Banc of Am. Funding Corp.*, No. 10 CH 45033 (Ill. Cir. Ct. filed Oct. 15, 2010); *Cambridge Place Inv. Mgmt., Inc.* v. *Morgan Stanley & Co.*, No. 11-0555-BLS2 (Mass. Super. Ct. filed Feb. 11,

Prosecutors routinely consider similar factors in determining whether to seek the criminal indictment of corporations or, alternatively, to resolve such matters in a manner that does not require the admission of liability. In addition to the longstanding practice of the SEC and other agencies of accepting settlements in which the defendant neither admits nor denies liability, Section 9-28.100 of the United States Attorneys' Manual counsels federal prosecutors to take into account the reality "that corporate prosecutions can potentially harm blameless investors, employees, and others." Dep't of Justice, U.S. Attorneys' Manual (2008). Section 9-28.1000 explains that "[p]rosecutors may consider the collateral consequences of a corporate criminal conviction or indictment in determining whether to charge the corporation with a criminal offense and how to resolve corporate criminal cases." *Id.* The Manual suggests that, where the collateral consequences of a corporate conviction for innocent third parties would be significant, it may be appropriate to consider a non-prosecution or deferred prosecution agreement, both of which are rarely—if ever—accompanied by the full public disclosure of a factual record or subjected to scrutiny by a court. *See also* Jed S. Rakoff, *Corporate Indictments*

2011); *The Western & Southern Life Ins. Co.* v. *Residential Funding Co., LLC*, No. A1105042 (Ohio Ct. Com. Pl. filed June 29, 2011).

Notably, on November 4, 2011, plaintiffs in one of those actions—*Union Central Life Ins. Co.* v. *Credit Suisse First Boston Mortg. Sec. Corp.*, No. 11 Civ. 2890 (GBD) (S.D.N.Y. filed April 28, 2011)—sought permission to file an *amicus curiae* brief in response to this Court's October 27 Order, for the limited purpose (as it was represented to CGMI on November 4) of seeking the release of the entire investigative record developed by the SEC in this matter. The interest of the *Union Central* plaintiffs here—notwithstanding the distinctly *different* legal and factual issues implicated by their complaint—and their transparent efforts to make an end-run around the discovery protections afforded to CGMI under the Private Securities Litigation Reform Act, further illustrate Citigroup's wisdom in seeking to resolve this matter through settlement. Credit crisis plaintiffs of all stripes—including those involved in the matters cited here (and in many additional cases)—likely will seek to use any litigated proceedings in this matter to gain a tactical advantage in those unrelated matters.

and the Guidelines, N.Y.L.J. (Jan. 13, 1994) (noting "the U.S. Attorneys' queasiness about visiting the sins of a few executives on thousands of innocent shareholders and employees").

Finally, we respectfully submit that approval of the Proposed Judgment is consistent with this Court's precedent. As this Court explained in its Order ultimately approving the *Bank of America* settlement, "among the major reasons the Court rejected the earlier proposed settlement" was that "a fine assessed against the Bank, taken by itself, penalizes the shareholders for what was, in effect if not in intent, a fraud by management on the shareholders." *SEC* v. *Bank of Am. Corp.* ("*BofA II*"), Nos. 09 Civ. 6829 (JSR), 10 Civ. 0215 (JSR), 2010 WL 624581, at *5 (S.D.N.Y. Feb. 22, 2010). The Court expressed concern that the original proposed settlement would require "the victims of the violation [to] pay an additional penalty for their own victimization." *SEC* v. *Bank of Am. Corp.* ("*BofA I*"), 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009).

These concerns articulated by the Court are not present in this case. Here, the SEC has not alleged that Citigroup's shareholders were injured by the conduct described in the Complaint. Rather, the SEC alleges that CGMI negligently failed to provide adequate disclosures regarding a privately offered security sold to a small group of highly sophisticated and experienced institutional investors.

Furthermore, CGMI notes that, unlike in *Bank of America*, where the Court was concerned that the originally proposed settlement allowed "the very management that is accused of having lied to its shareholders to determine how much of those victims' money should be used to make the case against the management go away," *id.* at 510, Citigroup's current senior management team, and the majority of its Board of Directors, were installed after the events at issue in this matter. *See* Response to Question 4, *infra*. CGMI respectfully submits that

Citigroup's new management team and Board should be afforded the opportunity to exercise their business judgment to determine how best to protect Citigroup's shareholders in this matter.

Question 3

> What was the total loss to the victims as a result of Citigroup's actions? How was this determined? If, as the SEC's submission states, the loss was "at least $160 million" *see* Plaintiff's Memorandum in Support of Proposed Settlement ("Pl. Mem.") at 3, what was it at most?

CGMI acknowledges that, like most CDOs backed by subprime-related collateral, the notes issued by Class V have lost the great majority of their value in the wake of the subprime and credit crisis. That said, CGMI is not aware of the extent of the losses suffered by the Class V institutional investors. Among other issues, those investors, particularly given their market savvy, may not have retained the positions they purchased, and may have engaged in hedging or other risk management tools mitigating against potential losses.

Moreover, the Complaint alleges that CGMI played a role in selecting *only a portion* of the Class V portfolio. In other words, even under the SEC's allegations, a significant portion of the Class V portfolio was selected by CSAC, with no influence by CGMI. The collateral selected by CSAC, like the collateral selected with the alleged influence of CGMI, suffered near complete losses and therefore contributed to any losses incurred by the Class V investors.

CGMI further submits that any losses incurred by investors in Class V did not result from CGMI's conduct, but rather from extrinsic market events—in particular, the devastating effects of the subprime and credit crisis, which swept away "good" collateral and "bad" collateral alike. "'[W]hen the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by

the fraud decreases,' and a plaintiff's claim fails when 'it has not adequately ple[]d facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events.'" *Lentell* v. *Merrill Lynch & Co.*, 396 F.3d 161, 174 (2d Cir. 2005) (quoting *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994)). Taking into account the devastating effects of the subprime and credit crisis, numerous courts in this District have dismissed securities fraud actions due to plaintiffs' inability to allege adequately the required elements of scienter and/or loss causation.[3]

CGMI further notes that the $160 million figure does not purport to represent investor *losses*, but rather the amount of *profits* that the SEC alleges CGMI obtained in connection with Class V. CGMI understands that this figure consists of several components, including: (i) fees earned by CGMI in connection with its structuring role; (ii) profits earned by CGMI on the short positions it retained on certain of the Class V synthetic collateral, offset by

---

[3] *See, e.g.*, *N.J. Carpenters Health Fund* v. *NovaStar Mortg., Inc.*, No. 08 Civ. 5310 (DAB), 2011 WL 1338195, at *11 (S.D.N.Y. Mar. 31, 2011) ("While the Court is aware that Plaintiff is not required to meet the heightened pleading requirement under Rule 9(b), more is required than what Plaintiff has done here: 102 pages of 'the subprime market melted down and Defendants were market participants, so they must be liable for my losses in my risky investment.'"); *Kuriakose* v. *Fed. Home Loan Mortg. Corp.*, No. 08 Civ. 7281 (JFK), 2011 WL 1158028, at *14 (S.D.N.Y. Mar. 30, 2011) ("Considering that the price of Freddie Mac's stock was clearly linked to the 'marketwide phenomenon' of the housing price collapse, there is a decreased probability that Plaintiffs' losses were caused by fraud.") (quoting *Lentell*, 396 F. 3d at 174); *In re Wachovia Equity Sec. Litig.*, 753 F. Supp. 2d 326, 366 (S.D.N.Y. 2011) ("The more compelling inference, at least based on the facts as they are alleged in the complaints, is that Defendants simply did not anticipate the full extent of the mortgage crisis and the resulting implications . . . ."); *In re Sec. Capital Assurance, Ltd. Sec. Litig.*, 729 F. Supp. 2d 569, 596 (S.D.N.Y. 2010) ("Defendants, like so many other institutions floored by the housing market crisis could not have been expected to anticipate the crisis with the accuracy Plaintiff[s] enjoy[ ] in hindsight. . . . Defendants were woefully unaware of the true risk presented by their investment in CDOs, and did not know the facts or have the information necessary to know that their statements might be inaccurate.") (citations omitted).

amounts CGMI paid in the form of protection payments to Class V in relation to those positions; (iii) losses CGMI incurred on offsetting trades into which it entered related to those short positions; and (iv) profits and losses CGMI and its affiliates earned in connection with the sale and retention of other Class V notes.

The SEC has exercised its discretion in this matter to require CGMI to disgorge its alleged profits from its involvement in Class V. "The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains," and not to compensate the victims of the fraud. *See SEC* v. *First Jersey Sec., Inc.*, 101 F. 3d 1450, 1474–75 (2d Cir. 1996) ("Since disgorgement is a method of forcing a defendant to give up the amount by which he was unjustly enriched, it is unlike an award of damages . . . ."); *SEC* v. *Berger*, 244 F. Supp. 2d 180, 193 (S.D.N.Y. 2001). We respectfully submit that the $160 million figure, which reflects the profits allegedly earned by CGMI, represents an appropriate measure of disgorgement in this matter, in light of the SEC's allegations.

Question 4

> How was the amount of the proposed judgment determined? In particular, what calculations went into the determination of the $95 million penalty? Why, for example, is the penalty in this case less than one-fifth of the $535 million penalty assessed in *SEC v. Goldman Sachs & Co.*, No. 10 Civ. 3229, at *1 (S.D.N.Y. July 20, 2010) (BSJ)? What reason is there to believe this proposed penalty will have a meaningful deterrent effect?

CGMI's understanding of the methodology underlying the SEC's disgorgement order is set forth in response to Question 3, *supra*. CGMI defers to the SEC with respect to the methodology it used to determine the appropriate penalty in this and other related enforcement matters, but offers the following observations regarding the facts and circumstances present in

this matter that the Company respectfully submits mitigate against imposition of a larger civil penalty.

First, the SEC's Complaint does not allege that CGMI deceived CSAC with respect to the Company's role in the transaction. The SEC alleges that CGMI influenced CSAC's selection of certain of the collateral for the transaction—but does not allege that CGMI concealed from CSAC its intentions or the role it was playing in the transaction. In fact, in the related administrative proceeding brought by the SEC against CSAC, the SEC asserts that "CSAC understood that Citigroup was seeking to short assets into Class V either for itself or its customers . . . and thus that Citigroup was representing economic incentives potentially adverse to those of Class V III and its investors." *In re Credit Suisse Alternative Capital, LLC.*, Securities Act Release No. 33-9268, 2011 WL 4957372, ¶ 2 (Oct. 19, 2011).

Second, and significantly, CGMI is not accused of attempting to influence CSAC to adversely select collateral, of exercising a "veto" over the collateral selected by CSAC, or of betting against the transaction as a whole. The SEC alleges that CGMI shorted only a portion of the Class V collateral—and in fact suffered losses in connection with Class V notes that it retained.

Third, as set out above, the offering materials expressly disclosed that CGMI was expected to serve as the ultimate short counterparty for certain of the Class V collateral.

CGMI respectfully submits that the proposed penalty and other conditions of the Proposed Judgment (described in greater detail, *infra*, in response to Question 5) are sufficient deterrents to future misconduct in this case, particularly given the significant changes implemented by Citigroup under new management in the wake of the subprime and credit crisis. Since the period at issue in the Complaint, Citigroup has been under the stewardship of a new

Board, including nine members added since early 2008, and a new executive management team, led by Vikram Pandit, who was appointed Chief Executive Officer in December 2007.

In particular, Citigroup has taken significant steps to enhance risk management under the leadership of a new Chief Risk Officer and independent risk team. Among other improvements to its risk management function, Citigroup has established a separate Risk Management and Finance Committee, with primary oversight responsibility for Citigroup's risk management framework, including the policies, procedures, and practices used in managing credit, market, and certain other risks. In addition, Citigroup has taken steps to enhance the role played by the risk committee with oversight over its institutional trading, sales, and marketing activities, as well as the role played by its product approval committee in evaluating the risks—including risks posed to its customers—associated with those activities (including in relation to securitization activities).

Question 5

> The SEC's submission states that the SEC has "identified nine factors relevant to the assessment of whether to impose penalties against a corporation and, if so, in what amount." Pl. Mem. at 5–6 (citing *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Rel. No. 2006-04 (Jan. 4, 2006)). But the submission fails to particularize how the factors were applied in this case. Did the SEC employ these factors in this case? If so, how should this case be analyzed under each of those nine factors?

CGMI defers to the SEC with respect to its evaluation of the nine factors set forth in the *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Rel. No. 2006-04 (Jan. 4, 2006). In response to the Court's question, the Company respectfully notes that the statutory framework authorizing the SEC to collect civil penalties recognizes a lower ceiling for penalties for negligence-based violations—like those asserted

here—than violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." *Compare* 15 U.S.C. § 77t(d)(2)(A) *with id.* § 77t(d)(2)(B)–(C).

<u>Question 6</u>

> The proposed judgment imposes injunctive relief against future violations. What does the SEC do to maintain compliance? How many contempt proceedings against large financial entities has the SEC brought in the past decade as a result of violations of prior consent judgments?

CGMI defers to the SEC to comment on its enforcement and compliance processes.

<u>Question 7</u>

> Why is the penalty in this case to be paid in large part by Citigroup and its shareholders rather than by the "culpable individual offenders acting for the corporation?" *See Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Rel. No. 2006-04 (Jan. 4, 2006). If the SEC was for the most part unable to identify such alleged offenders, why was this?

CGMI defers to the SEC with respect to its determinations regarding which entities or individuals to pursue in its enforcement proceedings.

In response to the Court's inquiry regarding the appropriateness of imposing a penalty in this matter against the Company, CGMI respectfully offers the following observations. First, as noted above, the Complaint alleges that CGMI negligently failed to provide adequate disclosures to a small number of ultra-sophisticated, institutional investors that purchased Class V securities. (Compl. ¶¶ 39–46.) The Complaint does not allege that shareholders of Citigroup were harmed by CGMI's negligent conduct in relation to the Class V disclosures; it alleges, in substance, that Citigroup shareholders improperly *benefited* from the profits earned by CGMI in relation to the Class V transaction. As a result, this matter does not present a situation where

shareholders will suffer a "double injury" as a result of the proposed penalty. *See BofA I*, 653 F. Supp. 2d at 509 (noting concern that "the shareholders who were the victims of the Bank's alleged misconduct now pay the penalty for that misconduct").

We respectfully submit that the proposed settlement advances the interests of both the alleged victims of CGMI's misconduct—through disgorgement of the alleged profits (plus interest), the imposition of a penalty, and the distribution of those funds to the Class V investors through establishment of a fair fund—and Citigroup's shareholders. As discussed, the Company's management elected to resolve this matter through settlement—as opposed to litigation—precisely to avoid the potential harm that flows from litigation, including the potential loss of shareholder value in the immediate wake of the filing of a litigated complaint and potential collateral damage in pending civil litigation in the event of an adverse adjudicated result. (*See* Response to Questions 1 and 2, *supra*.) We submit that this matter—in which no CGMI employee is accused of intentional wrongdoing and the Company's senior management is not alleged to have been aware of the asserted negligence—presents the paradigmatic case where Citigroup's management and Board appropriately "exercise[d] [their] business judgment to determine how much of [the] shareholders' money should be used to settle a case brought by . . . third parties." *BofA I*, 653 F. Supp. 2d at 510.

Second, the SEC has elected to charge a mid-level CGMI employee with non-scienter-based violations of the securities laws in connection with Class V. *See* Compl., *SEC* v. *Stoker*, No. 11 Civ. 7388 (JSR) (S.D.N.Y. Oct. 19, 2011). The SEC has apparently made the enforcement judgment that Mr. Stoker is a "culpable individual offender[] acting for the corporation." *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Rel. No. 2006-04 (Jan. 4, 2006). The SEC, however, did not charge Mr. Stoker

with fraudulent conduct—and no employee senior to Mr. Stoker has been named in these proceedings.

CGMI respectfully submits that no such person appropriately could have been charged in this circumstance: based on the extensive record developed in this matter, the SEC has not identified any individual senior to Mr. Stoker who was involved in crafting the relevant disclosures and who had knowledge or information concerning the structure of the transaction necessary to correct the alleged disclosure deficiencies. As alleged in the Complaint, CGMI's CDO business activities were divided into three distinct parts: structuring, syndicate, and secondary trading.

- Professionals in the structuring area were responsible for working with managers, investors, and other parties to structure CDO transactions. This process included working with rating agencies, counsel, and other third parties involved in each transaction. The junior- and mid-level structuring professionals on each transaction typically would have had the greatest involvement in drafting the disclosures and marketing materials for each transaction. Mr. Stoker was the professional who played this role on the Class V transaction.

- Syndicate professionals were responsible for marketing and distributing CDO positions structured by CGMI, working in conjunction with CGMI's fixed-income sales force. The record developed by the SEC reflects that none of the syndicate professionals had any involvement in the drafting of the marketing or disclosure materials for Class V.

- The secondary trading desk acted as a market maker for CGMI's structuring activities. The secondary trading desk also entered into trades during the CDO warehousing period to facilitate the structuring of CDOs, including by acting as the initial short counterparty where required by a particular transaction and making decisions regarding the disposition of those positions following the close of a transaction. The record developed by the SEC reflects that the secondary trading desk professionals were not involved in the drafting of the marketing or disclosure materials for Class V.

These facts and circumstances, we respectfully submit, explain why more senior-level individuals have not been charged in this matter.

Question 8

> What specific "control weaknesses" led to the acts alleged in the Complaint? *See* Pl. Mem. at 7. How will the proposed "remedial undertakings" ensure that those acts do not occur again?

The Complaint alleges that CGMI made negligent misrepresentations to sophisticated institutional investors by failing to disclose that CGMI played a role in the selection of certain collateral for Class V and that CGMI would retain a short position in certain of the Class V collateral. (*See* Compl. ¶¶ 2, 6.)

In connection with this proceeding, CGMI does not admit or deny that any control weaknesses contributed to purported deficiencies in the Class V disclosures. As described above, however, the extensive record developed by the SEC suggests that individuals involved in each of the central aspects of the Class V transaction were not involved in the preparation of the marketing and disclosure materials disseminated to investors in Class V, did not play a role in the preparation of those disclosures, and thus were not in a position to evaluate whether aspects of the transaction required additional disclosure.

The remedial undertakings that the SEC has proposed, and to which CGMI has consented, would directly address this issue. Among other things, these undertakings centralize responsibility and impose accountability for the review of offering documents and marketing materials in connection with the offering or sale of residential mortgage-related securities or CDOs referencing or including such securities, such as transactions like Class V. The Proposed Judgment requires CGMI's product approval committee to review all initial offerings of such securities and to take steps to "ensure that processes are in place so that written marketing materials" for such securities are accurate and complete. (Consent ¶ 6(a).) In addition, pursuant to the Proposed Judgment, representatives of CGMI's legal or compliance department are

required to review all written marketing and offering materials and to certify that the review was completed. (*Id.* ¶ 6(b).) Similarly, outside counsel who have been engaged are required to review all written marketing and offering materials. The Proposed Judgment further requires that counsel be "provided documents sufficient to reflect all material terms of the transaction" to complete this review. (*Id.* ¶ 6(c).) In addition, the Proposed Judgment requires that CGMI "conduct an internal audit, on at least an annual basis" to ensure compliance with these requirements, and that the Company's general counsel or head of compliance certify annually in writing for a three-year period compliance with the Proposed Judgment's undertakings. (*Id.* ¶¶ 6(d)–(e).) These measures are tailored to remedy the control deficiencies alleged by the SEC; that is, these measures are designed to ensure that processes are in place to ensure that individuals involved in creating the disclosures for the offering or sale of residential mortgage-related securities have access to all necessary information regarding the transaction and are held accountable for all disclosure decisions.

CGMI further notes that, as described in greater detail in response to Question 4, *supra*, Citigroup's management and Board have been overhauled in the nearly five years since Class V was structured and Citigroup has substantially enhanced its risk management practices, among other control function improvements, in the years since the onset of the subprime crisis. This new management team and Board, and these control enhancements, will help ensure that the Company fully complies with the remedial undertakings set forth in the Proposed Judgment.

Question 9

> How can a securities fraud of this nature and magnitude be the result simply of negligence?

The Complaint charges CGMI with negligence and does not allege any scienter-based conduct. Specifically, CGMI is alleged to have violated Sections 17(a)(2) and (3) of the Securities Act, which do not require proof of scienter. *See SEC* v. *Power*, 525 F. Supp. 2d 415, 419 (S.D.N.Y. 2007) ("[P]roof of scienter is . . . not required for liability under §§ 17(a)(2) and 17(a)(3)."). As the Supreme Court has observed, "the language of § 17(a)(2), which prohibits any person from obtaining money or property 'by means of any untrue statement of a material fact or any omission to state a material fact,' is devoid of any suggestion whatsoever of a scienter requirement." *Aaron* v. *SEC*, 446 U.S. 680, 696 (1980).

The SEC's allegations relate to the sufficiency of disclosures in the Class V offering materials and the alleged negligent failure of controls relating to the crafting of those disclosures. As described in greater length in response to Questions 7 and 8, *supra*, the alleged violations charged by the SEC stem from the fact that the CGMI business people with knowledge of the trading activities relating to Class V were not involved in crafting the relevant disclosures. Similarly, the record suggests that the CGMI personnel involved in crafting those disclosures did not have adequate information regarding the trading activities engaged in by others at CGMI related to the transaction. The Complaint does not contain any allegations that CGMI intentionally misled investors or that CGMI misled CSAC, the Class V collateral manager.

Finally, with respect to the magnitude of the alleged harm, we respectfully submit that the size of the proposed settlement is a direct function of the size of the Class V transaction

and does not reflect CGMI's level of culpability. The "size of an alleged fraud alone does not create an inference of scienter." *Plumbers & Steamfitters Local 773 Pension Fund* v. *Can. Imperial Bank of Commerce*, 694 F. Supp. 2d 287, 302 (S.D.N.Y. 2010) (citations omitted); *see also In re PXRE Grp., Ltd., Sec. Litig.*, 600 F. Supp. 2d 510, 545 (S.D.N.Y. 2009).

* * * * *

If the Proposed Judgment is approved, the SEC will have achieved *by settlement*, the recovery for investors of 100 percent of CGMI's alleged profit, with interest, in connection with Class V; the recovery for investors of an additional penalty amount of $95 million; and the imposition of significant prospective remedial measures. CGMI respectfully submits that the Proposed Judgment is fair, reasonable, adequate, and in the public interest, and CGMI respectfully requests that the Court approve it. We look forward to answering the Court's questions on November 9th.

Respectfully submitted,

Dated: New York, New York
November 7, 2011

PAUL, WEISS, RIFKIND, WHARTON &
GARRISON LLP

/s/ Brad S. Karp

Brad S. Karp
Theodore V. Wells, Jr.
Mark F. Pomerantz
Susanna M. Buergel
1285 Avenue of the Americas
New York, New York 10019-6064
Tel. (212) 373-3000
Fax (212) 757-3990
bkarp@paulweiss.com
twells@paulweiss.com
mpomerantz@paulweiss.com
sbuergel@paulweiss.com

Attorneys for Citigroup Global Markets Inc.