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Agenda for Financial Crisis Inquiry Commission Retreat
Tuesday, September 28, 2010 and Wednesday, September 29, 2010

Tuesday, September 28, 2010,

FCIC RETREAT MEETING – DAY 1
Time: **9:00pm-6:30pm EDT**
Location: **FCIC Office, Large Conference Room**
1717 Pennsylvania Avenue NW, Suite 800
Washington, D.C. 20006
Site Phone: **202-292-2799**

9:00-9:15am **Overview of Meeting**

9:15-10:30am **Session One:** *Commissioner Deliberations on Key Issues for Report*
Background materials: See Attachments 1, 2,3 and 4.

10:30-10:45am **Break for Coffee**
*** Beverages served at the conference room**

10:45-12:30pm **Session Two:** *Commissioner Deliberations on Key Issues for Report*
Background materials: See Attachments 1, 2,3 and 4.

12:30-1:00pm **Lunch**
***Lunch and Beverages served at the conference room, grab upon arrival**

1:00-3:30pm **Session Three:** *Commissioner Deliberations on Key Issues for Report*
Background materials: See Attachments 1, 2,3 and 4.

3:30-3:45pm **Break for Coffee**
*** Beverages served at the conference room**

3:45-6:30pm **Session Four:** *Commissioner Deliberations on Key Issues for Report*
Background materials: See Attachments 1, 2,3 and 4.

Wednesday, September 29, 2010,

FCIC RETREAT MEETING – DAY 2
Time: 9:00-3:00pm
Location: FCIC Office, Large Conference Room
1717 Pennsylvania Avenue NW, Suite 800
Washington, D.C. 20006
Site Phone: 202-292-2799

9:00-9:15am	**Overview of Meeting**
9:15-10:30am	**Session One:** *Commissioner Deliberations on Key Issues for Report* *Background materials: See Attachments 1, 2,3 and 4.*
10:30-10:45am	**Break** **Beverages served at the conference room**
10:45-11:45pm	**Session Two:** *Commissioner Deliberations and Vote on FCIC Memo of Referrals to the Department of Justice.* *Background materials: Attached*
(11:45-12:15pm)	**Lunch** ***Lunch and Beverages served at the conference room**
12:15-1:15pm	**Session Three:** *Commission Comments on tone and approach of sample report section and timeline* *Background materials: See Attachments 5 and 6.*
1:15-2:30pm	**Session Four:** *Commissioner Deliberations on Key Issues for Report* *Background materials: See Attachments 1, 2,3 and 4.*
2:30-3:00pm	**Session Five:** *Next Steps and Wrap Up*

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

[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).

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 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

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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.

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]

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.

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[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).
[10] UBS-CT 021485 (PSI Exh. 94o).

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 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.

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

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.

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,

[12] CITI-FCIC 00002793, "Risk Management Review: An Update to the Corporate Audit and Risk Management Committee," October 15, 2007.
[13] 15 U.S.C. § 7241.

> …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 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]

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[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.
[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.

- 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.

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.

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[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.

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

[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).

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:

> 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

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

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 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.

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

1. <u>Material Misstatements and Omissions in various RMBS Offering documents.</u>

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."

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

[26] See Section 1111 of Regulation AB.

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%

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

Citigroup	6,205	41.6%	31%	29%
JPMorgan	23,668	26.7%	51%	13%
Lehman	70,137	25.8%	37%	16%
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,

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

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.