



Financial Industry Regulatory Authority

Examination Number: 20080128443  
June 17, 2008

**REPORT ON THE SPECIAL EXAMINATION OF**

**Citigroup Global Markets Inc.**

**New York, NY**

We have recently completed the Subprime Mortgage Special examination of your firm. Our examination is not an audit and is not designed to be a substitute for management's responsibility to comply with appropriate securities rules and regulations.

The examination included reviews of the following regulatory areas:

Financing and Collateral Management  
Independent Price Verification  
Valuation of Subprime Securities

**EXCEPTIONS:**

The following exceptions have been brought to the attention of the appropriate member organization personnel:

**1. EXCEPTION:**

The firm was not in compliance with NYSE Rule 342.23 (Offices-Approval, Supervision and Control) and NYSE Rule 401(a) (Business Conduct) with respect to internal controls and written policies and procedures over collateralized debt obligations (CDO) price verification functions.

**DETAIL:**

a. The review of the July 31, 2007 independent price verification process for CDOs revealed that CDO Product Controllers ("Controllers") relied heavily on available market observables in their monthly price verification reviews. Since summer of 2007, market observables for CDOs became nearly - and, for many positions, completely nonexistent. As a result, Controllers classified the firm's CDO inventory as "L3 Unverified." Although the inventory positions were classified as L3 Unverified, Controllers maintained the responsibility for assessing the reasonableness of traders' marks. Controllers were unable to provide evidence to illustrate the steps taken to assess the reasonableness of CDO traders' marks as of July 31, 2007. The lack of adequate documentation for the independent price verification function was an internal control

weakness. As a result, it could not be determined whether there was any material impact to the financial statements or Net Capital computation for this period.

b. In addition, Controllers were not able to provide written policies and procedures specific to the CDO price verification review in effect for July 31, 2007. On October 24, 2007, the firm provided its written "Global Structured Credit Product - CDO Desk Procedures for Price Verification Process" that specifically referenced certain September month-end price verification procedures. However, these procedures did not fully reflect the steps that Controllers used to assess the reasonableness of traders' marks for ABS CDO inventory as outlined in the October 15, 2007 memorandum provided by the firm's Capital Markets and Banking ("CMB") Legal Department (Bates stamp 001243 through 001249). The firm's inability to establish and maintain written procedures that fully reflect the independent price verification process for CDO inventory was an additional weakness in the firm's internal controls.

## **2. EXCEPTION:**

The firm was not in compliance with SEA Rule 17a-3(a)(8) (Records to Be Made by Certain Exchange Members, Brokers and Dealers), SEA Rule 17a-4 (Records to Be Preserved by Certain Exchange Members, Brokers and Dealers), NYSE Rule 342 (Offices-Approval, Supervision and Control), NYSE Rule 440 (Books and Records) and NASD Rule 3010(b) (Supervision-Written Procedures).

### **DETAIL:**

a. The review of six margin calls selected as of July 30, July 31 and August 31, 2007 disclosed that for three of the calls (CARLYLE, SAAD1, MLSL), the IREX Report Detail did not support the amount of the margin call issued. IREX is the system used to calculate margin calls. These reports are generated via a batch process and are available for the Repo Exposure Specialists to review each morning. In the instances reviewed, the customer challenged the prices of certain securities, which were ultimately modified by the firm. Once these adjustments were made, a new IREX report was run with a revised margin call amount as applicable. At the end of the day, the final IREX report reflecting the updated prices and revised margin call amounts were retained. The firm could not substantiate the details of the original margin calls made for these accounts due to its failure to retain the beginning of day IREX report.

b. During the review of the above noted three margin calls, it was noted that these margin calls were met by the repricing of securities. The firm's "Capital Markets and Private Client Group North America Operations Repo Exposure" procedures state that a salesperson may provide a new accurate price to the Repo Exposure Specialist to be input into the IREX System to obtain a new margin call amount. The firm's written procedures did not require documented approvals from management in order for a repricing to occur. This process allowed the salesperson to authorize a price change without an independent review by an individual with supervisory responsibilities.

**3. EXCEPTION:**

The firm was not in compliance with NYSE Rule 342 (Offices-Approval, Supervision and Control) and NASD Rule 3010(b) (Supervision-Written Procedures).

**DETAIL:**

The review of the "Plan of Supervision for the U.S. Finance Sales and Trading Desk" dated May 1, 2007 and the "Fixed Income Financing Product" excerpt from the Global Credit Center Website disclosed the following internal control weaknesses:

a. The firm's written procedures did not address the process in place for applying and approving margin haircuts applied to collateral. The review of two of five reverse repurchase contracts which were financed during July 2007 indicated that haircuts were applied outside of the haircut guidelines with no documented approvals required.

b. The review of two of five subprime securities selected (12489WRH9 and 57643LAG1) which were financed during July 23, 2007 through August 3, 2007 indicated that there was no change in price for seven and eight days, respectively. These securities did not appear on the July 30, 2007 or the July 31, 2007 Stale Price Reports. Further review indicated that the prices for these securities in HAMPER, the firm's pricing database, were based on a "Repo Override by Trader" (also referred to as a "hand price"). The firm could not demonstrate whether this override was the result of a hardcoding of the price in the system or an update by the trader on a daily basis for which the price had not changed. As these positions did not appear on the Stale Price Report, there appeared to be a weakness that stale prices were utilized and margin may not have been collected where appropriate.

Subsequent to the Exit meeting, it was noted that some of the transactions selected in paragraphs a. and b. may have been between a CGMI affiliate and the counterparty.

c. As a result of the omission of hand priced securities from the Stale Price Reports, the firm was unable to provide evidence of supervisory review for this activity. It was noted that the firm's "Plan of Supervision for the U.S. Finance Sales and Trading Desk" dated May 1, 2007 requires a review of the Stale Price Report on a daily basis.

**RECOMMENDATION:**

The Repo Exposure Group creates a Daily Margin Call Summary Report (referred to as "Daily MIS") via an Excel Spreadsheet. This spreadsheet is created manually and therefore, may be subject to input errors. Examiner noted that for one margin call, (FMWCOMP), on July 31, 2007 that the amount of the margin call reported was \$564,000. The actual amount should have been \$56,493. This margin call should not have been on the Daily MIS as the amount of the call was below the firm's internal

threshold. The firm should consider an automated solution to create this report to avoid manual errors in the future.

The contents of this report and the examination process were reviewed during an Exit Meeting on March 28, 2008, with the following participants:

**MEMBER ORGANIZATION PERSONNEL:**

Joanne Crisafi	Managing Director-Finance
Julius Leiman-Carbia	Managing Director-CMB Compliance
Paul D. Smith	Managing Director-Product Control
James Dougherty	Director-Finance
Katherine Kessler	Director and Counsel-CMB Legal
Daniel Staehle	Director-CMB Compliance
Anthony Vazquez (via Conference Call)	Director-Operations Management
Declan Hogan	Senior Vice President-Product Control
David Herrington	Counsel-Cleary Gottlieb Steen & Hamilton
Marla Decker	Associate-Cleary Gottlieb Steen & Hamilton

**FINRA PERSONNEL:**

Yolanda Trotman	Examination Director
Virginia Mitchell	Surveillance Director
Sally Jo Gabriel	Examination Manager
Gaetano Genovese	Senior Regulatory Coordinator
Igor Mylnarsky	Principal Examiner

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