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Recommended Citation
Arthur E. Wilmarth, Jr., Citigroup: A Case Study in Managerial and Regulatory Failures, 47 IND. L. REV. pp. 69-137.

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CITIGROUP: A CASE STUDY IN MANAGERIAL AND REGULATORY FAILURES

ARTHUR E. WILMARTH, JR.*

"I don't think [Citigroup is] too big to manage or govern at all . . . [W]hen you look at the results of what happened, you have to say it was a great success."

Sanford "Sandy" Weill, chairman of Citigroup, 1998-2006[1]

"Our job is to set a tone at the top to incent people to do the right thing and to set up safety nets to catch people who make mistakes or do the wrong thing and correct those as quickly as possible. And it is working. It is working."

Charles O. "Chuck" Prince III, CEO of Citigroup, 2003-2007[2]

"People know I was concerned about the markets. Clearly, there were things wrong. But I don't know of anyone who foresaw a perfect storm, and that's what we've had here."

Robert Rubin, chairman of Citigroup's executive committee, 1999-2009[3]

"I do not think we did enough as [regulators] with the authority we had to help contain the risks that ultimately emerged in [Citigroup]."

Timothy Geithner, President of the Federal Reserve Bank of New York, 2003-2009; Secretary of the Treasury, 2009-2013[4]

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* Professor of Law and Executive Director of the Center for Law, Economics & Finance, George Washington University Law School. I wish to thank GW Law School and Dean Greg Maggs for a summer research grant that supported my work on this Article. I am indebted to Eric Klein, a member of GW Law's Class of 2015, and Germaine Leahy, Head of Reference in the Jacob Burns Law Library, for their superb research assistance. I am also grateful for helpful comments provided by Anat Admati, Peter Conti-Brown, Anna Gelpern, Robert Hockett, Robert Jenkins, James Kwak, Saule Omarova, and participants in conferences at the Indiana University Robert H. McKinney School of Law and the University of Ottawa Faculty of Law and a joint program hosted by the Section on European Law and the Section on Financial Institutions and Consumer Financial Services of the Association of American Law Schools. Unless otherwise indicated, this Article includes developments through October 31, 2013.

1. Timothy L. O'Brien & Julie Creswell, *Laughing All the Way from the Bank*, N.Y. TIMES, Sept. 11, 2005, § 3, at 31 (quoting Mr. Weill, and noting that Mr. Weill served as CEO of Citigroup from 1998 to 2003).

2. Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1 (quoting a statement by Mr. Prince in 2006).

3. Nelson D. Schwartz & Eric Dash, *Where Was The Wise Man?*, N.Y. TIMES, Apr. 27, 2008, § BU, at 1 (quoting Mr. Rubin), *available at* http://www.nytimes.com/2008/04/27/business/27rubin.html?pagewanted=all, *archived at* http://perma.cc/ARZ3-CUC7.

4. THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT:

INTRODUCTION

Citigroup has served as the poster child for the elusive promises and manifold pitfalls of universal banking. When Citicorp merged with Travelers to form Citigroup in 1998, supporters of the merger hailed Citigroup as the first modern American "universal bank"—i.e., the first U.S. banking organization since 1933 that could offer comprehensive banking, securities and insurance services to its customers.[5] Citigroup's leaders asserted that the new financial conglomerate would offer unparalleled convenience to its customers through "one-stop shopping" for a broad range of banking, securities, and insurance services.[6] They also claimed that Citigroup would have a superior ability to withstand financial shocks due to its broadly diversified activities.[7] Supporters of the Travelers-Citicorp merger further argued that U.S. banks needed universal banking powers in order to compete with European and Asian banks that already possessed "the ability to offer an array of banking and insurance products under one corporate umbrella."[8] Travelers' chairman Sandy Weill declared, "We are creating the model financial institution of the future. . . . In a world that's changing very rapidly, we will be able to withstand the storms."[9]

By 2009, those bold predictions of Citigroup's success had turned to ashes.[10] Citigroup's high-risk, high-growth strategy proved to be disastrous.[11] As a result

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FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 303 (2011) [hereinafter FCIC REPORT] (quoting testimony of Mr. Geithner on May 6, 2010), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, *archived at* http://perma.cc/XVK2-L8FG.

5. Yvette D. Kantrow & Liz Moyer, *Citi, Travelers: A Global Leader Takes Shape*, AM. BANKER, Apr. 7, 1998, at 1, *available at* http://www.americanbanker.com/175/citi-travelers-a-global-leader-takes-shape-1041890-1.html, *archived at* http://perma.cc/U3PW-WDK2; Michael Siconolfi, *Big Umbrella: Travelers and Citicorp Agree to Join Forces in $83 Billion Merger*, WALL ST. J., Apr. 7, 1998, at A1.

6. Steven Lipin & Stephen E. Frank, *The Big Umbrella: Travelers/Citicorp Merger—One-Stop Shopping Is the Reason for Deal*, WALL ST. J., Apr. 7, 1998, at C14.

7. Siconolfi, *supra* note 5 (reporting that Citicorp CEO John Reed and Travelers CEO Sandy Weill "are betting that the broad services of the huge new firm could weather any future market swoons").

8. Timothy L. O'Brien & Joseph B. Treaster, *A $70 Billion Pact*, N.Y. TIMES, Apr. 7, 1998, at A1.

9. Kantrow & Moyer, *supra* note 5 (quoting Mr. Weill).

10. Bradley Keoun, *Citigroup Board Says Pandit Deserved Bonus for 2009 'Progress,'* BLOOMBERG.COM, Mar. 1, 2010, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aKWvUvCwZng0, *archived at* http://perma.cc/L8JT-VGDG (reporting that Citigroup incurred a net loss of $27.7 billion during 2008 and a further net loss of $1.6 billion during 2009).

11. Brian Collins & Terry Peters, *Citi Takes Huge Hit*, NAT'L MORTGAGE NEWS, Jan. 21, 2008, at 1 (reporting that Citigroup incurred a net loss of $9.8 billion during the fourth quarter of 2007).

of that strategy, the bank recorded more than $130 billion of write-downs on its loans and investments from the second half of 2007 through the end of 2009.[12] In order to prevent Citigroup's failure, the federal government injected $45 billion of new capital into the bank and provided the bank with $500 billion of additional help in the form of asset guarantees, debt guarantees, and liquidity assistance.[13] The federal government provided more financial assistance to Citigroup than to any other bank during the financial crisis.[14]

This Article describes Citigroup's rapid growth and sudden collapse during the decade following its creation. As explained below, Citigroup's managers and regulators repeatedly failed to prevent or respond effectively to legal violations, conflicts of interest, excessive risk-taking, and inadequate risk controls within the bank's complex, sprawling operations. Those repeated failures reflected a broader mindset—both on Wall Street and in Washington—that placed great faith in the ability of financial institutions and markets to discipline themselves while disdaining government regulation as misguided and counterproductive.

Citigroup was an arbitrage vehicle at its inception, because its founders (assisted by friendly government officials) exploited a statutory loophole to place great pressure on Congress to repeal the Glass-Steagall Act of 1933 and authorize universal banking.[15] Citigroup's key corporate predecessors—Citicorp and Salomon Brothers—had high-risk cultures, and both institutions flirted with failure during the decade preceding Citigroup's formation.[16] From 2000 to 2004, Citigroup was embroiled in a series of high-profile scandals, including tainted transactions with Enron and WorldCom, biased research advice, corrupt allocations of shares in initial public offerings (IPOs), predatory subprime lending, and market manipulation in foreign bond markets.[17] In 2005, Citigroup's bank regulators—the Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC)—imposed a moratorium on further large acquisitions until Citigroup improved its corporate compliance and risk management procedures.[18] That temporary moratorium appears to have been the only meaningful constraint imposed by regulators before Citigroup collapsed at the end of 2008.[19]

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12. *See infra* Part II.

13. *See infra* Part II.B.

14. *See infra* Part II.B; YALMAN ONARAN, ZOMBIE BANKS: HOW BROKEN BANKS AND DEBTOR NATIONS ARE CRIPPLING THE GLOBAL ECONOMY 83-87, 92-93 (1st ed. 2011) (explaining that Citigroup and Bank of America received the largest amounts of financial assistance from the federal government).

15. *See infra* Part I.A.

16. *See infra* Part I.A.

17. *See infra* Part I.B.

18. Citigroup Inc., Federal Reserve System (Mar. 16, 2005) (order), at 11 [hereinafter FRB Citigroup-FAB Order] (imposing moratorium as a condition to FRB's approval of Citigroup's acquisition of First American Bank in March, 2005), *available at* http://www.federalreserve.gov/boarddocs/press/orders/2005/20050316/attachment.pdf, *archived at* http://perma.cc/N2RZ-YBLV.

19. *See infra* Parts I.B.5; III.B.1.

Citigroup pursued an expansion strategy premised on internal "organic growth" until the FRB and OCC lifted their moratorium on large acquisitions in 2006.[20] Citigroup then made a series of rapid-fire purchases of foreign and domestic financial firms.[21] Citigroup also pursued a wide range of high-risk activities, including leveraged corporate lending, packaging toxic subprime loans into residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDOs), as well as dumping risky assets into off-balance-sheet conduits for which Citigroup had contractual and reputational exposures.[22] By the summer of 2007, Citigroup faced crippling losses from its aggressive risk-taking, and it was forced to accept multiple bailouts from the federal government to avoid failure.[23]

Post-mortem evaluations of Citigroup's near-collapse revealed that neither the bank's senior executives nor its regulators recognized the systemic risks embedded in the bank's far-flung operations.[24] Those findings strongly indicate that Citigroup was not only "too big to fail" (TBTF), but also too big and too complex to manage or regulate effectively. Citigroup's history raises deeply troubling questions about the ability of bank executives and regulators to supervise and control today's megabanks.[25]

I. CITIGROUP'S FORMATION AND TROUBLED HISTORY THROUGH 2004

A. Citigroup Was Created as an Arbitrage Play on Congress

Advocates of universal banking applauded the formation of Citigroup in 1998 as a bold maneuver to force Congress to repeal Sections 20 and 32 of the Glass-Steagall Act of 1933,[26] and to modify Section 4 of the Bank Holding Company Act of 1956 (BHC Act).[27] The Glass-Steagall and BHC Acts imposed substantial restrictions on the ability of banking organizations to engage in securities and insurance activities.[28] Big banks and their supporters had pushed bills to repeal

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20. *See infra* Parts II.A; III.B.1.
21. *See infra* Part III.B.1.
22. *See infra* Part II.A.
23. *See infra* Part II.B.
24. *See infra* Part III.
25. *See infra* Part III.
26. Pub. L. 73-66, 48 Stat.162 (1933).
27. 12 U.S.C. § 1843 (2012).
28. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 219-20, 225-27 [hereinafter Wilmarth, *Transformation*] (at 215, describing Sections 20 and 32 of the Banking Act of 1933, popularly known as the "Glass-Steagall Act," which prohibited banks from affiliating with securities firms; at 226-227, describing Section 4 of the BHC Act, which barred banks from affiliating with insurance underwriters and insurance agents; at 219-20, explaining that the Gramm-Leach-Bliley Act (GLBA) repealed the foregoing anti-affiliation provisions of the Glass-Steagall Act and the BHC Act).

the Glass-Steagall Act and amend the BHC Act since the early 1980s, but political divisions among large and small banks, securities broker-dealers, insurance underwriters, and insurance agents prevented the passage of such legislation.[29]

In the late 1990s, securities firms and insurance underwriters abandoned their longstanding opposition against efforts to repeal the Glass-Steagall Act and modify the BHC Act, and they joined forces with the big banks.[30] However, insurance agents and community banks continued to block passage of the legislation.[31] In the context of this continued stalemate, the Travelers-Citicorp merger was an audacious move that placed "tremendous pressure on Congress" to authorize universal banking.[32] The legality of the merger was premised on a temporary exemption in the BHC Act, which allowed newly formed bank holding companies to retain nonconforming assets for up to five years after their creation.[33] However, as a banking lawyer noted, "[t]he exemption was intended to provide an orderly mechanism for disposing of impermissible activities, not

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29. Sandra Suarez & Robin Kolodny, *Paving the Road to "Too Big to Fail": Business Interests and the Politics of Financial Deregulation in the U.S.* (June 15, 2010) (describing unsuccessful efforts to pass legislation to repeal the Glass-Steagall Act during the 1980s and 1990s), *available at* http://ssrn.com/abstract=1625289; Charles C.Y. Wang & Yi David Wang, *Explaining the Glass-Steagall Act's Long Life, and Rapid Eventual Demise* 26-34 (Dec. 8, 2010) (same), *available at* http://ssrn.com/abstract=1722373.

30. Suarez & Kolodny, *supra* note 29, at 29-33.

31. *Id.* (explaining that (i) by 1997, large banks had made significant inroads into the securities and insurance businesses by obtaining favorable rulings from the FRB and the OCC that exploited loopholes in the Glass-Steagall Act and other banking statutes; and (ii) after failing to overturn those rulings in the courts, securities firms and insurance underwriters decided to support universal banking legislation in order to secure reciprocal rights to enter the banking business, but community banks and insurance agents continued to oppose such legislation); Kathleen Day, *Reinventing the Bank: With Depression-Era Law About to Be Rewritten, the Future Remains Unclear*, WASH. POST, Oct. 31, 1999, at H1 (same); Daniel J. Parks & Lori Nitschke, *Banking: Financial Services Overhaul Sees Home Stretch at Last*, 57 CQ WKLY. 1645, June 10, 1999 (same). In addition, jurisdictional squabbles between the FRB and the Treasury Department over which agency (FRB or OCC) should exercise primary control over the proposed new financial conglomerates created another obstacle to passage in the late 1990s. Daniel J. Parks, *Banking: Senate Passes Banking Overhaul Bill Vulnerable to a Clinton Veto; House Version Divides Committees*, 57 CQ WKLY. 1081, May 8, 1999.

32. Richard W. Stevenson, *Financial Services Heavyweights Try Do-It-Yourself Deregulation*, N.Y. TIMES, Apr. 7, 1998, at A1 (quoting Peter Wallison), *available at* http://www.nytimes.com/1998/04/07/business/shaping-colossus-regulators-financial-services-heavyweights-try-it-yourself.html?pagewanted=all&src=pm, *archived at* http://perma.cc/U2ND-UUCZ; *see also* Edward J. Kane, *Implications of Superhero Metaphors for the Issue of Banking Powers*, 23 J. BANKING & FIN. 663, 666 (1999) (contending that Citigroup's leaders "boldly gambled that they [could] dragoon Congress . . . into legalizing their transformation").

33. *See* Wilmarth, *Transformation*, *supra* note 28, at 221 (discussing Section 4(a)(2) of the BHC Act).

warehousing them in hopes the law would change so you could keep them."[34]

In addition to the fact that the Travelers-Citicorp merger "challenge[d] both the statutory letter and regulatory spirit" of existing law,[35] the merger was extraordinary because of the advance clearance it received from regulatory and political leaders.[36] As I pointed out in a previous article, "Citicorp's and Travelers' chairmen consulted with, and received positive signals from FRB chairman Alan Greenspan, Treasury Secretary Robert Rubin, and President Clinton *before* the merger was publicly announced."[37] Greenspan, Rubin, and Clinton thereby indicated their approval for the companies' decision to confront Congress with a Hobson's choice: "either [to] end these [Glass-Steagall and BHC Act] restrictions, scuttle the [Citigroup] deal[,] or force the merged company to cut back on what it offers the customer."[38] As one congressman observed, Citicorp and Travelers were "essentially playing an expensive game of chicken with Congress," but they did so with the full support of top federal officials.[39]

The creation of Citigroup is widely viewed as a key factor that persuaded Congress to adopt the Gramm-Leach-Bliley Act (GLBA)[40] in November 1999.[41] GLBA repealed the anti-affiliation provisions of the Glass-Steagall Act and the BHC Act and authorized banks, securities firms, and insurance companies to join together by forming financial holding companies—thereby ratifying Citigroup's universal banking model.[42] Citigroup played a leading role in the financial industry's lobbying on behalf of GLBA, and then-Chairman Sandy Weill helped to arrange the final political compromise that secured GLBA's passage.[43]

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34. Barbara A. Rehm, *Megamerger Plan Hinges on Congress*, AM. BANKER, Apr. 7, 1998, at 1 (quoting an unnamed "banking lawyer").

35. Kane, *supra* note 32, at 666-67. The FRB approved the merger based on the exemption in Section 4(a)(2) of the BHC Act, and the D.C. Circuit upheld the FRB's decision. Indep. Cmty. Bankers of Am. v. Bd. of Governors, 195 F.3d 28, 31-32 (D.C. Cir. 1999) (holding that the merger's "literal compliance" with Section 4(a)(2) overcame any argument that the merger violated the "purposes" of the BHC Act).

36. Wilmarth, *Transformation*, *supra* note 28, at 306.

37. *Id.*

38. O'Brien & Treaster, *supra* note 8, at A1; Daniel Kadlec et al., *Bank on Change*, TIME, Nov. 8, 1999, at 50; Rehm, *supra* note 34 (Based on his discussions with regulators, Citicorp chairman John Reed stated that "there are all indications that (the merger) will be looked at favorably.").

39. Dean Anason, *Advocates, Skeptics Face Off on Megadeals*, AM. BANKER, Apr. 30, 1998, at 2 (quoting Rep. Maurice D. Hinchey (D-NY)).

40. 113 Stat. 1338 (Nov. 12, 1999).

41. Wilmarth, *Transformation*, *supra* note 28, at 219-21; Kadlec et al., supra note 38; *see also* Daniel J. Parks, *Banking: United at Last, Financial Industry Pressures Hill to Clear Overhaul*, 57 CQ WKLY. 2373, Oct. 9, 1999 ("The need for legislation was highlighted by the recent merger of the Travelers Group and Citicorp into the Citigroup financial conglomerate. . . . Citigroup must sell off its insurance activities within the next few years unless Congress approves an overhaul.").

42. Wilmarth, *Transformation*, *supra* note 28, at 219-21, 306-07.

43. *Id.* at 306-07 (citing news reports stating that "Senator Phil Gramm [R-TX] called on

Citigroup also hired former Treasury Secretary Robert Rubin as its new co-chairman during the final congressional deliberations over GLBA, thereby gaining "a highly visible public endorsement" for the repeal of the Glass-Steagall Act.[44]

Thus, Citigroup can reasonably be identified as the poster child for GLBA's new universal banking model. Indeed, advocates for GLBA essentially repeated the same arguments that supporters had presented in favor of Citicorp's merger with Travelers: namely, that universal banks (i) would provide "one-stop shopping" convenience, lower costs, and more credit for businesses and consumers, (ii) would be more profitable, more diversified and better able to withstand economic and financial shocks, and (iii) would ensure that U.S. financial institutions could compete on equal terms with large foreign universal banks from the U.K., Europe and Japan.[45]

Consumer groups largely dismissed claims that large universal banks would provide customers with greater convenience and lower-cost services.[46] GLBA's

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Citigroup co-chairman Sandy Weill to help broker a last-minute compromise between Republican congressional leaders and the Clinton administration, thereby ensuring [GLBA's] passage"); Jake Lewis, *Monster Banks: The Political and Economic Costs of Banking Consolidation*, MULTINATIONAL MONITOR, Jan./Feb. 2005, at 31, 33 (stating that John Reed of Citicorp and Sandy Weill of Travelers were "[a]t the forefront" of lobbying efforts for GLBA); Daniel J. Parks, *Banking: Financial Services Overhaul Bill Clears After Final Skirmishing Over Community Reinvestment*, 57 CQ WKLY. 2654, Nov. 6, 1999 (reporting that "key events in this year's overhaul efforts coincided with heavy political contributions by Citigroup").

44. Michael Hirsh, *In Bob We Trust*, NAT'L J., Jan. 19, 2013, at 12, 18; *see also* Parks "United at last," *supra* note 41 (reporting that Citigroup hired Rubin as its new co-chairman on Oct. 26, 1999); Lewis, *supra* note 43, at 32 (stating that Rubin "enthusiastically promoted the [GLBA] legislation" as Treasury Secretary); Robert Scheer, *Privacy Issue Bubbles Beneath the Photo Op*, L.A. TIMES, Nov. 16, 1999, at B9 (stating that "Rubin has become co-chairman of Citigroup, a conglomeration between Citibank and Travelers Insurance that immediately benefits from [GLBA], which was strongly backed by Rubin and his Treasury Department and for which he lobbied in the months following his resignation."); *Secretaries of the Treasury*, U.S. Dep't Treas., http://www.treasury.gov/about/history/Pages/edu_history_secretary_index.aspx *archived at* http://perma.cc/DG9A-YHLW (noting that Rubin served as Treasury Secretary from Jan. 10, 1995 to July 2, 1999).

45. S. REP. NO. 106-44, at 4-6 (1999); 145 CONG. REC. S13,783-84 (daily ed. Nov. 3, 1999) (remarks of Sen. Gramm); 145 CONG. REC. S13,880-81 (daily ed. Nov. 4, 1999) (remarks of Sen. Schumer); James R. Barth et al., *The Repeal of Glass-Steagall and the Advent of Broad Banking*, J. ECON. PERSPECTIVES, Spring 2000, at 191, 198-99; Joao Santos, *Commercial Banks in the Securities Business: A Review*, 14 J. FIN. SERVS. RESEARCH 35, 37-41 (1998); Day, *supra* note 31; Lori Nitschke, *Banking: GOP Touts 'One-Stop Shopping' as Key Benefit of Overhaul Bill*, 56 CQ WKLY. 728, Mar. 21, 1998; *see also supra* notes 6-9 and accompanying text (describing similar arguments advanced in support of Citicorp's merger with Travelers).

46. Day, *supra* note 31 (noting that consumer advocates did not believe such claims, particularly as larger banks typically charged higher service fees to consumers); Nitschke, *supra* note 45; *see also* Lewis, *supra* note 43, at 33 ("Proponents of financial modernization had the

opponents argued that financial conglomerates were likely to produce financial risks and speculative excesses similar to those that occurred when large U.S. banks operated securities affiliates in the 1920s.[47] Opponents also contended that GLBA would promote greater consolidation within the financial services industry and extend the federal safety net to embrace the securities and insurance sectors, thereby aggravating the TBTF problem.[48] Some critics warned that GLBA might create the conditions for a financial crisis similar to the Great Depression.[49]

In addition to general concerns about the potential risks of universal banking, there were more specific reasons to doubt whether Citigroup could fulfill its founders' bullish projections. Two of Citigroup's key predecessor organizations—Citibank and Salomon Brothers—had aggressive risk-taking cultures, and both organizations had narrowly avoided collapses in the past.[50] Citibank suffered heavy losses in the early 1930s after its disastrous forays into the securities markets under its hard-driving and controversial chairman, Charles "Sunshine Charley" Mitchell.[51] Citibank was forced to accept a large bailout from the Reconstruction Finance Corporation in 1933 to replenish its depleted capital.[52] From the 1970s to the early 1990s, Citibank again pursued speculative business strategies under the leadership of Walter Wriston and John Reed.[53] Citibank almost failed in the early 1990s due to massive losses from its loans to

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chutzpah to attempt to sell the legislation as a boon to consumers. . . . Through the years of hearings [on the bills that led to GLBA], no one ever produced the consumers who were supposedly yearning for one-stop money shops.").

47. For arguments presented by GLBA's critics, see, e.g., 145 CONG. REC. S13,871-74 (daily ed. Nov. 4, 1999) (remarks of Sen. Wellstone); *id.* S13,896-97 (remarks of Sen. Dorgan); 145 CONG. REC. H11,530-31, 11,542 (daily ed. Nov. 4, 1999) (remarks of Rep. Dingell); Kadlec, *supra* note 38 (describing views of bank analyst Lawrence Cohn and Ralph Nader); *see also* Wilmarth, *Transformation*, *supra* note 28, at 444-76 (warning of GLBA's risks, and stating that "the growth of large financial holding companies is likely to increase the risks of contagion within and among those conglomerates, thereby creating a more fragile financial system and intensifying pressures for TBTF bailouts during financial disruptions").

48. *Id.*

49. *Id.*

50. *See infra* notes 51-59 and accompanying text.

51. Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921-33? A Preliminary Assessment*, 4 CURRENT DEV. IN MONETARY & FIN. LAW 559, 575-80 (IMF, 2005) [hereinafter Wilmarth, *Universal Banks*], *available at* http://ssrn.com/abstract=838267; Binyamin Appelbaum, *Citi's Long History of Overreach, Then Rescue*, WASH. POST, Mar. 11, 2009, at D01, *available at* http://articles.washingtonpost.com/2009-03-11/business/36891255_1_vikram-pandit-citigroup-american-banks, *archived at* http://perma.cc/CQY8-28VA.

52. Wilmarth, *Universal Banks*, *supra* note 51, at 602-04, 607-11; Martin Hutchinson, *Citi at 200: With age, Foolishness*, GLOBE & MAIL (Canada), June 12, 2012, at B12, *available at* https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20120612/GIBREAKVIEWSCITIGROUP0612ATL, *archived at* http://perma.cc/V92S-XTKY.

53. Appelbaum, *supra* note 51.

developing countries, highly leveraged corporations, commercial real estate developers, and subprime consumers.[54] The bank survived after receiving extensive forbearance from federal regulators, a highly favorable interest rate policy engineered by FRB chairman Alan Greenspan, and a large investment from Saudi Prince Al-Waleed bin Talal.[55]

Salomon Brothers had an even more aggressive and legendary risk-taking culture.[56] Salomon nearly failed in 1991 after paying a $290 million penalty for illegally rigging Treasury bond auctions, and the bank was forced to turn to Warren Buffett for help.[57] Later, Salomon suffered large losses from speculative trading in mortgage-backed securities during 1994.[58] After incurring additional trading losses, Salomon agreed to sell itself to Travelers in 1997, a year before Travelers acquired Citicorp.[59] Sandy Weill's top lieutenant at Travelers, Jamie Dimon, tried to force Salomon to cut back on its risk-taking.[60] With Weill's approval, Dimon shut down Salomon's fixed-income arbitrage trading unit after that unit suffered heavy trading losses during the Russian debt default crisis in 1998.[61] However, Weill fired Dimon in late 1998, and Salomon's aggressive culture soon reasserted itself within the new Citigroup.[62]

B. A Series of Illuminating (But Largely Ignored) Lessons: Scandals at Citigroup from 2000 to 2004

Soon after its formation, Citigroup became embroiled in a series of scandals involving Enron, WorldCom, tainted research advice, predatory consumer lending, European trading abuses, and violations of Japanese private-banking

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54. Wilmarth, *Transformation*, *supra* note 28, at 304-05, 313-15, 401; CHARLES GASPARINO, THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANAGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM 49-50 (2009); ONARAN, *supra* note 14, at 83; Appelbaum, *supra* note 51; Anthony Bianco, *What Wriston Wrought*, BUS. WK., Feb. 7, 2005, at 36; Hutchinson, *supra* note 52; Andy Kessler, *The End of Citi's Financial Supermarket*, WALL ST. J., Jan. 16, 2009, at A11.

55. *Id*.

56. *See, e.g.,* GASPARINO, *supra* note 54, at 13-22, 28-37, 69-76, 83-84; FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 12-15, 84-111 (2003).

57. GASPARINO, *supra* note 54, at 83-84; PARTNOY, *supra* note 56, at 107-11.

58. RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 52-76 (2007); GASPARINO, *supra* note 54, at 136-40.

59. BOOKSTABER, *supra* note 58, at 52-76; GASPARINO, *supra* note 54, at 136-40.

60. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

61. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

62. BOOKSTABER, *supra* note 58, at 77-88, 91-93, 97-101, 125-34; GASPARINO, *supra* note 54, at 140-46.

rules.[63] Those scandals seriously damaged Citigroup's reputation and stock market price.[64] In view of the gravity of Citigroup's offenses, the regulatory responses were clearly inadequate. Agencies imposed corporate sanctions on Citigroup, but no top-level executives were punished.[65] The responses of Citigroup's management were equally ineffective. A widely-publicized campaign to transform Citigroup's culture proved to have little impact on the organization's actual behavior.[66]

1. Citigroup's Involvement with Enron and WorldCom.—Citigroup suffered extensive financial and reputational harm from aiding and abetting the fraudulent schemes of Enron and WorldCom.[67] Citigroup engineered three types of fraudulent transactions for Enron. First, Citigroup entered into prepaid commodity swaps ("prepays") that enabled Enron to obtain nearly $4 billion of disguised loans while reporting the proceeds of those transactions as cash flow from operating activities.[68] As a practical matter, "prepays enabled Enron to inflate its reported cash flow and to disguise its actual debt obligations."[69] Second, Citigroup arranged "Project Nahanni" and other "minority interest transactions," which provided additional disguised loans to Enron while allowing Enron to report the financing transactions as cash flow from "merchant investment" activities.[70] Third, Citigroup helped Enron to structure "Project Bacchus" and other fictitious "sales" of assets to special-purpose entities (SPEs) controlled by Enron.[71] Citigroup financed those asset "sales" by providing de

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63. Ryan Chittum, *200 Years of Citi*, COLUM. JOURNALISM REV. (Mar. 9, 2012), http://www.cjr.org/the_audit/an_alternate_history_of_citigr.php?page=all, *archived at* http://perma.cc/ANR9-Y724.

64. Bruce Mizrach & Susan Zhang Weerts, *Does the Stock Market Punish Corporate Malfeasance: A Case Study of Citigroup*, 3 CORP. OWNERSHIP & CONTROL No. 4 (Summer 2006), at 151; Peter Lee, *What Citigroup Needs to do Next*, EUROMONEY, July 1, 2005, at 64.

65. *See* Chittum, *supra* note 63 (summarizing Citigroup's misdeeds and corresponding regulatory responses, which did not include any penalties against Citigroup's management).

66. Mitchell Pacelle, *Moving the Market: Citigroup Works on Its Reputation*, WALL ST. J., Feb. 17, 2005, at C3 (describing Citigroup's implementation of ethics and code-of-conduct training program in 2005); *see infra* Part II.A (discussing Citigroup's continued pursuit of high risk strategies after 2005).

67. Arthur E. Wilmarth, Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks During the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom* 4, 10, 24-25, 29, 42-44 (Geo. Wash. Univ. Law Sch. Pub. L. & Leg Theory, Working Paper No. 234, 2007) [hereinafter Wilmarth, *Conflicts of Interest*], *available at* http://ssrn.com/abstract=952486.

68. *Id.* at 12; *see also* In re Citigroup, SEC Admin. Proc. No. 3-11192 (July 28, 2003), at 15-21 [hereinafter SEC Citigroup-Enron Order], *available at* http://www.sec.gov/litigation/admin/34-48230.htm, *archived at* http://perma.cc/443K-CCDA. Citigroup also arranged similarly fraudulent prepays for Dynegy, another Texas energy company. *Id.* at 21-27.

69. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 12.

70. *Id.* at 12-13; SEC Citigroup-Enron Order, *supra* note 68, at 9-13.

71. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 13-14; SEC Citigroup-Enron Order,

facto loans to the SPEs, and Enron fraudulently reported the "sales" as operating earnings (while guaranteeing that the SPEs would repay their loans to Citigroup).[72]

Citigroup's officers recognized the fraudulent nature of the complex structured transactions that the bank arranged for Enron.[73] For example, Citibank's Capital Markets Approval Committee acknowledged that a prepay requested by Enron was "effectively a loan, [but] the form of the transaction would allow [Enron] to reflect it as 'liabilities from price risk management activity' on their [sic] balance sheet and also provide a favourable [sic] impact on reported cash flow from operations."[74] Citigroup's managers similarly described Project Nahanni as "year-end window dressing" and "an insurance policy for [year-end] balancing."[75] Another Citigroup officer explained that "Enron's motivation [in Project Bacchus] now appears to be writing up the asset in question from a basis of about $100MM to as high as $250MM, thereby creating earnings."[76]

David Bushnell, Citigroup's head of global risk management, objected to a transaction that was designed to refinance Project Nahanni because "[t]he GAAP accounting is aggressive and a franchise risk to us if there is publicity."[77] However, Citigroup went forward with the transaction because it wanted to maintain its lucrative relationship with Enron.[78] Citigroup received almost $200 million in fees from Enron and ranked Enron as "one of the highest revenue clients within Citigroup."[79] After Project Bacchus was completed, a Citigroup officer remarked, "Sounds like we made a lot of exceptions to our standard policies. I am sure we have gone out of our way to let them know that we are bending over backwards for them . . . let's remember to collect this iou when it really counts."[80]

Citigroup paid more than $100 million of civil penalties to settle allegations of securities law violations filed by the Securities and Exchange Commission

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supra note 68, at 13-15.

72. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 13-14; SEC Citigroup-Enron Order, *supra* note 68, at 13-15.

73. *See infra* notes 74-80 and accompanying text.

74. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 17-18 (quoting the Enron bankruptcy examiner's Third Report, which quoted the Citibank Committee's minutes of June 22, 1999).

75. *Id.* at 19 (quoting the Enron bankruptcy examiner's Third Report, which quoted from an undated "Citigroup Exposure Spreadsheet" and an email from James Reilly dated July 24, 2001).

76. *Id.* (quoting the Enron bankruptcy examiner's Third Report, which quoted emails from James Reilly dated Nov. 28 and Dec. 6, 2000).

77. *Id.* (quoting the Enron bankruptcy examiner's Third Report, which quoted an internal memorandum prepared by David Bushnell).

78. *Id.* at 20-21.

79. *Id.* (quoting Enron bankruptcy examiner's Third Report, which quoted a Citigroup interoffice memorandum of Sept. 24, 2001).

80. *Id.* at 20 (quoting Enron bankruptcy examiner's Third Report, which quoted an email from Steve Wagman dated Dec. 27, 2000).

("SEC") related to Citigroup's transactions with Enron.[81] Citigroup also entered into consent agreements with the Federal Reserve Bank of New York ("New York Fed") and the OCC, under which Citigroup agreed to take corrective measures designed to prevent similarly abusive structured financial transactions in the future.[82] However, the New York Fed, the OCC, and the SEC did not file Enron-related charges against any of Citigroup's officers or employees, and Citigroup neither admitted nor denied any of the agencies' charges.[83] Citigroup subsequently paid $3.7 billion to settle claims by Enron's investors and Enron's bankruptcy estate.[84]

Like Enron, WorldCom proved to be a very expensive client for Citigroup. Citigroup was a lead underwriter for several of WorldCom's public offerings of equity and debt securities.[85] For example, Citigroup acted as co-lead underwriter for an $11.9 billion public offering of bonds that WorldCom issued in May 2001, even though Citigroup and other lead underwriters had serious concerns about WorldCom's long-term viability.[86] Citigroup, together with its predecessors—Salomon Brothers and Salomon Smith Barney (collectively as "Salomon")—also provided extensive personal benefits to WorldCom's CEO, Bernie Ebbers, to solidify its status as WorldCom's most highly-paid bank.[87] From 1996 to 2002, Salomon and Citigroup received more than $140 million in fees from WorldCom.[88] During the same period, Salomon and Citigroup made preferential allocations of stock to Ebbers (a practice known as "spinning") in

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81. SEC Citigroup-Enron Order, *supra* note 68, at 28-30.

82. Citigroup Inc. & Fed. Res. Bank N.Y., Bd. of Governors of Fed. Res. Sys. (Jul. 28, 2003) [hereinafter New York Fed written agreement] (written agreement) (written agreement with the New York Fed that did not require Citigroup to pay any penalties), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20030728/attachment.pdf, *archived at* http://perma.cc/WL5J-NMKV; Citibank, N.A. & Off. Comptroller of Currency, Dep't of Treas. Comptroller of Currency (July 28, 2003) [hereinafter OCC written agreement] (written agreement with the OCC that similarly did not require Citigroup to pay any penalties), *available at* http://www.occ.gov/static/enforcement-actions/ea2003-77.pdf, *archived at* http://perma.cc/A29R-HWY9.

83. New York Fed written agreement, *supra* note 82; OCC written agreement, *supra* note 82; SEC Citigroup-Enron Order, *supra* note 68, at 1-2.

84. Mitchell Pacelle & Robin Sidel, *Citigroup Accord to End Enron Suit May Pressure Others*, WALL ST. J., June 13, 2005, at C1 (reporting that Citigroup "agreed to pay $2 billion to settle a class-action lawsuit brought by investors in Enron"); Kristen Hays, *Citigroup settles in Enron case: Accord Results in Largest Total Recovered in Bankruptcy*, HOUS. CHRON., Mar. 27, 2008, 2008 WLNR 5799282 (reporting that Citigroup agreed to pay $1.7 billion to settle claims filed by Enron's bankruptcy estate).

85. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 30-31, 34-35.

86. *Id.* at 34-35; CHARLES GASPARINO, BLOOD ON THE STREET: THE SENSATIONAL INSIDE STORY OF HOW WALL STREET ANALYSTS DUPED A GENERATION OF INVESTORS 175-77 (2005) [hereinafter GASPARINO, BLOOD ON THE STREET].

87. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 32.

88. *Id.*

more than twenty initial public offerings (IPOs) and secondary offerings of stock by clients of Salomon and Citigroup.[89] Ebbers received almost $13 million of trading profits from those preferential stock allocations.[90] Citigroup also arranged more than $500 million of loans to Ebbers and one of his personally controlled companies.[91]

Citigroup cemented its strong relationship with WorldCom by encouraging Jack Grubman—Citigroup's top research analyst for telecommunications ("telecom") firms—to serve as an advisor to Ebbers and WorldCom's board while also touting WorldCom's stock in his research reports.[92] Grubman promoted WorldCom more aggressively than any other telecom firm, and he continued to maintain a "buy" rating on WorldCom's stock until a few months before WorldCom filed for bankruptcy in mid-2002.[93] Citigroup subsequently paid $2.6 billion to settle a class-action lawsuit filed by WorldCom investors.[94] In addition, as described in the following section, Citigroup paid $400 million to settle the SEC's allegations of securities law violations arising out of Citigroup's biased research advice and "spinning."[95]

2. Citigroup's Tainted Research Advice and "Spinning."—Citigroup promoted Enron, WorldCom, and other investment banking clients by pressuring its research analysts to issue bullish reports that urged investors to buy the stock of those clients.[96] In 1999 Citigroup fired Don Dufresne, a well-known research analyst, after he angered Enron's executives by publishing reports that criticized Enron.[97] In contrast, Citigroup paid more than $48 million to Grubman between 1999 and 2001 after he helped Citigroup to generate almost $800 million in fees from WorldCom and other telecom firms.[98]

Citigroup told its research analysts that they would be compensated based on their ability to help Citigroup's investment bankers attract business from existing and new clients.[99] Citigroup also told analysts that investment bankers would participate in determining whether the bank should pay bonuses to analysts for

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89. *Id.*

90. *Id.* at 32-33.

91. *Id.* at 33-34.

92. *Id.* at 39.

93. *Id.* at 36-41 (noting, inter alia, that Grubman urged investors to "load up the truck" with WorldCom stock in August 1999 and also encouraged investors to take advantage of WorldCom's "dirt cheap" stock price after WorldCom's market value declined sharply during 2000 and 2001); GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 73-75, 84-95, 173-85.

94. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 42-43.

95. *Id.* at 24.

96. *Id.* at 23.

97. *Id.* at 23, 50 n.85.

98. Complaint, ¶¶ 37-43, SEC v. Citigroup Global Markets, Inc., S.D.N.Y. Apr. 28, 2003, 03 Civ. 2945 (WHP) [hereinafter SEC-Citigroup Research Analyst Complaint], *available at* http://www.sec.gov/litigation/complaints/comp18111.htm, *archived at* http://perma.cc/8PRP-PYR8.

99. *Id.* ¶¶ 3, 18.

supporting the bank's securities activities.[100] Thus, Citigroup's compensation system exerted great pressure on research analysts to compromise their objectivity by issuing overly optimistic research reports that boosted Citigroup's clients.[101]

In a notable example of such pressure, Sandy Weill persuaded Jack Grubman to raise Grubman's rating for AT&T's stock from neutral to "buy" in November 1999.[102] Weill urged Grubman to upgrade AT&T in order to improve Citigroup's chances of winning a lucrative underwriting mandate for AT&T's $10.6 billion offering of wireless tracking stock.[103] Grubman's upgrade also helped Weill to convince AT&T's CEO—C. Martin Armstrong—who was also a director of Citigroup, to support Weill's ouster of John Reed as Citigroup's co-CEO in early 2000.[104] In return for Grubman's assistance, Weill facilitated the admission of Grubman's children into the highly selective 92nd Street Y preschool.[105] To ensure that outcome, Weill interceded on Grubman's behalf with a Y board member and also arranged for the Citigroup Foundation to make a $1 million donation to the Y.[106]

The SEC charged Citigroup with securities law violations for having pressured Grubman to boost AT&T's research rating.[107] The SEC also alleged that Grubman published fraudulent research reports in 2001 on two telecom firms (Focal Communications and Metromedia), and that Grubman refrained from downgrading Focal and five other telecom providers in April 2001 because of pressure from Citigroup's investment bankers.[108] The SEC's complaint quoted

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100. *Id.*

101. *Id.* ¶¶ 16-36. In January 2001, Citigroup's head of Global Equity Research attended an equities management meeting that reviewed stock recommendations by Citigroup's research analysts. His presentation at that meeting showed that, out of 1179 stock ratings, Citigroup's analysts had no "Sell" ratings and only one "Underperform" rating. In handwritten notes attached to the presentation, the officer described Citigroup's research ratings as "ridiculous on face" and observed that there was a "rising issue of research integrity" and a "basic inherent conflict between IB [investment banking] and retail [investment sales]." *Id.* ¶ 32. Notwithstanding that presentation and similar complaints voiced by the head of Citigroup's private client (retail) division, Citigroup's research analysts maintained no "Sell" ratings and only 15 "Underperform" ratings among their ratings for more than 1000 U.S. stocks at the end of 2001. *Id.* ¶¶ 33-34.

102. *Id.* ¶¶ 7-8.

103. *Id.* ¶¶ 7-8, 103-29 (noting that AT&T named Citigroup as the lead underwriter for AT&T's public offering of wireless tracking stock in early 2000 after Grubman raised his rating for AT&T).

104. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 168-69, 286-87; Charles Gasparino, *Grubman Boast: AT&T Upgrade Had an Altogether Different Goal*, WALL ST. J., Nov. 13, 2002, at A1.

105. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 154-60.

106. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶ 123-25; GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 154-60.

107. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶126-29.

108. *Id.* ¶¶ 63-102.

internal emails sent by Grubman to colleagues in which he called Focal a "pig" and acknowledged that "most of our banking clients are going to zero and you know I wanted to downgrade them months ago but got huge pushback from banking."[109]

From 1996 to 2002, due in large part to Grubman's bullish research reports, Citigroup earned $1.2 billion in fees from telecom firms and underwrote $190 billion of their debt and equity securities, representing a quarter of all telecom stocks and bonds issued during that period.[110] Grubman's view that customer demand for broadband capacity would continue to grow exponentially proved to be badly mistaken. The frenzied installation of broadband networks by Grubman's clients and their rivals produced a massive glut of transmission capacity by 2001.[111] By August 2002, when Grubman resigned from his position at Citigroup, WorldCom and several of his other major telecom clients—including Global Crossing, Metromedia Fiber Networks, Rhythms Netconnections, Winstar, and XO Communications—had all filed for bankruptcy.[112]

In addition to the SEC's allegations of biased research advice, the SEC charged Citigroup with unlawful "spinning" by making preferential allocations of shares in "hot" IPOs to Ebbers and other individuals affiliated with existing or potential clients of Citigroup.[113] The SEC alleged that Citigroup's spinning practices provided $40 million of trading profits to executives of WorldCom (including Ebbers) and four other telecom firms.[114]

In April 2003, Citigroup paid $400 million to settle the SEC's charges.[115] Grubman entered into a separate settlement with the SEC under which he paid a $15 million penalty and agreed to a lifetime ban from the securities industry.[116] Citigroup did not admit or deny the SEC's allegations, and the SEC did not file charges against Weill or any other top Citigroup executive.[117]

3. Citigroup's Subprime Lending Abuses during the Early 2000s.— Citigroup's origins and its subsequent expansion were closely linked to subprime lending. In 1986, Sandy Weill acquired Commercial Credit, a subprime

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109. *Id.* ¶¶ 61, 68.

110. Wilmarth, *Conflicts of Interest*, *supra* note 67, at 38-39.

111. *Id.* at 39.

112. *Id.* at 38-39; Gretchen Morgenson, *Bullish Analyst of Tech Stocks Quits Salomon*, N.Y. TIMES, Aug. 16, 2002, at A1.

113. SEC-Citigroup Research Analyst Complaint, *supra* note 98, ¶¶ 142-58 (quote at ¶ 148).

114. *Id.*¶ 158.

115. Wilmarth, *Conflict of Interest*, *supra* note 67, at 24.

116. *Id.* at 42.

117. SEC Litigation Rel. No. 18111 (Apr. 18, 2003), *available at* www.sec.gov/litigation/litreleases/lr18111.htm, *archived at* http://perma.cc/NS3G-UDVH. The settlement required Weill to issue a public apology in which he stated, "certain of our activities did not reflect the way we believe business should be done. That should never have been the case, and I am sorry for that." Randall Smith & Susanne Craig, *Wall Street's Payout: Too Little and Late?*, WALL ST. J., Apr. 29, 2003, at C1.

consumer finance company.[118] Weill subsequently used Commercial Credit as the springboard to build his financial empire.[119] After Travelers acquired Citigroup, Citigroup established CitiFinancial as a separate subsidiary to conduct its subprime lending activities.[120] In 2000, Citigroup significantly expanded its subprime operations by acquiring Associates First Capital, a large subprime consumer finance company that was under investigation for predatory lending by federal and state agencies.[121] By 2002, CitiFinancial's activities (including Associates) accounted for 8% of Citigroup's total profits.[122]

When it acquired Associates, Citigroup promised to reform its subprime lending practices to avoid the abuses allegedly committed by Associates.[123] However, consumer advocates criticized Citigroup's promised reforms as "cosmetic" and inadequate.[124] The Federal Trade Commission ("FTC") and consumer plaintiffs subsequently filed lawsuits against Citigroup and Associates alleging predatory conduct.[125] Citigroup settled those suits in 2002 by paying $240 million in penalties and restitution.[126]

Citigroup's subprime problems did not end with its settlement of the claims against Associates. Federal investigators found evidence that Citigroup did not carry out the subprime lending reforms it had agreed to make in 2000 and 2001.[127] Citigroup promised to use "mystery shoppers" to monitor performance by CitiFinancial's employees, but Citigroup undermined the effectiveness of that monitoring by giving advance warning to CitiFinancial's regional managers about upcoming visits by "mystery shoppers."[128] In addition, despite its pledge to the contrary, CitiFinancial continued to include high-cost, single-premium credit insurance in the closing costs it charged to subprime borrowers.[129]

In 2004, the FRB issued a cease-and-desist order and imposed a $70 million

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118. Marc Hochstein, *Associates Deal Another Subprime Stroke for Citi*, AM. BANKER, Sept. 7, 2000, at 9.

119. *Id.*; Timothy L. O'Brien & Julie Creswell, *Laughing All the Way From the Bank*, N.Y. TIMES, Sept. 11, 2005, at 31; Richard A. Oppel Jr. & Patrick McGeehan, *Along With a Lender, Is Citigroup Buying Trouble?*, N.Y. TIMES, Oct. 22, 2000, at 31.

120. Hochstein, *supra* note 118.

121. *Id.*; Oppel & McGeehan, *supra* note 119.

122. Paul Beckett, *Efforts by Citigroup to Reform Subprime Unit Raise Questions*, WALL ST. J., July 18, 2002, at C1.

123. Richard A. Oppel Jr. & Patrick McGeehan, *Citigroup Revamps Lending Unit to Avoid Abusive Practices*, N.Y. TIMES, Nov. 8, 2000, at C1.

124. *Id.*

125. *See* Laura Mandaro, *In Focus: Citi Moving Fast to Put Associates Suits to Rest*, AM. BANKER, Dec. 13, 2002, at 1.

126. *Id.*; FCIC REPORT, *supra* note 4, at 92; Rob Blackwell, *Citi Exec on FTC Settlement: It's Not About Golden State*, AM. BANKER, Sept. 20, 2002, at 1.

127. Beckett, *supra* note 122.

128. *Id.*

129. *Id.*

civil penalty against Citigroup and CitiFinancial.[130] The FRB alleged that (i) CitiFinancial forced spouses or other persons to co-sign loans for which the applicants alone were qualified, because CitiFinancial wanted to sell credit insurance to multiple borrowers, (ii) CitiFinancial converted unsecured personal loans into home equity loans without adequately evaluating the borrowers' ability to repay those loans, and (iii) CitiFinancial's employees tried to mislead the FRB's examiners during their investigation of abusive practices.[131] Citigroup did not admit or deny the FRB's allegations, and the FRB did not take action against any of Citigroup's officers or employees.[132]

4. Citigroup's Scandals Involving European Bond Trading and Japanese Private Banking.—In 2004, Citigroup became embroiled in two additional scandals. On August 2, 2004, Citigroup's bond traders in London executed a bond-trading strategy called "Dr. Evil," in which they (i) made large sales of European government bonds, causing bond prices to fall, (ii) purchased bonds 30 minutes later, at substantially lower prices, and (iii) profited when prices returned to normal.[133] Citigroup sold more than 12.4 billion euros of bonds, bought back 3.8 billion euros of bonds, and reaped trading profits of more than $17 million.[134] Citigroup's bond traders concocted their trading scheme after "a senior Citigroup Inc. executive in London told traders on the European government-bond desk they weren't making enough money for the firm and ordered them to come up with new trading strategies."[135] Citigroup subsequently paid $25 million to settle allegations by the U.K. Financial Services Authority ("UKFSA") that Citigroup failed to supervise its traders and also failed to conduct its business with "due skill, care and diligence."[136]

In September 2004, the Japanese Financial Services Authority ("JFSA") ordered Citibank to shut down its private banking operations at four Japanese branches after finding numerous violations of Japanese law.[137] The JFSA's order

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130. Citigroup Inc., Bd. of Governors of Fed. Res. Sys. (May 27, 2004) (order), *available at* http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20040527/attachment.pdf, *archived at* http://perma.cc/A7FW-U8JY.

131. *Id.*

132. *Id.*; Erick Bergquist, *Citi-Fed Pact On Subprime: Opening Act?*, AM. BANKER, May 28, 2004, at 1; Timothy L. O'Brien, *Fed Assesses Citigroup Unit $70 Million in Loan Abuse*, N.Y. TIMES, May 28, 2004, at C1.

133. Adam Bradbery, *Moving the Market: Citigroup Faces a Fine in Britain For Lapses Linked to Bond Trade*, WALL ST. J., May 31, 2005, at C3.

134. *Id.*; Eric J. Lyman, *Citigroup Bond Trades Probed by Italian, Other European Regulators*, 37 SEC. REGULATION & L. REPORT (BNA) 273 (Feb. 14, 2005).

135. Silvia Ascarelli, *Bond Trading Strategy Haunts Citigroup*, WALL ST. J., Feb. 3, 2005, at C1.

136. David Reilly, *Moving the Market: Citigroup to Take $25 Million Hit in 'Dr. Evil' Case*, WALL ST. J., June 29, 2005, at C3 (noting that the UKFSA decided not to charge Citigroup with "market manipulation, a more serious offense").

137. Toshio Aritake, *International Developments: Japan Orders Citibank to Close Private Banking Operations*, 36 SEC. REGULATION & L. REPORT (BNA) 1722 (Sept. 27, 2004).

represented "the most severe administrative punishment of a foreign financial institution" operating in Japan.[138] The JFSA alleged that Citibank (i) provided loans that were used by clients to manipulate stock prices, (ii) made a "bogus" one-day loan that enabled a customer to receive an improper government grant, (iii) allowed a client to engage in money laundering, (iv) failed to perform background checks on new clients to ensure that they were not criminals, (v) misrepresented the risks of complex structured investments sold to clients, (vi) overcharged clients for publicly-traded derivatives, and (vii) failed to safeguard the confidentiality of client information.[139] An internal investigation commissioned by Citigroup found that "many private bankers" in Citibank's Japanese offices were "not candid" with the JFSA during its probe of Citibank's operations.[140]

A senior JFSA official noted that "one of the main reasons" for Citibank's misconduct was that "salaries and performance evaluations were closely linked to sales targets" for Citibank's private banking employees in Japan.[141] Similarly, Citigroup's internal investigation found that senior Citibank officers set "successively higher net-income goals for the [Japanese private banking] unit," and the unit's managers "pressed to bring in more revenue."[142]

5. Inadequate Responses by Citigroup's Managers and Regulators to the Scandals Occurring from 2000 to 2004.—Citigroup's senior management and board of directors took a number of actions in response to the scandals that occurred between 2000 and 2004.[143] However, those measures failed to change Citigroup's entrenched culture of aggressive risk-taking.[144] Although Citigroup's executives repeatedly stated their intention to create a culture of compliance, those statements were undermined by management's primary focus on achieving rapid growth in Citigroup's revenues and profits.[145]

Sandy Weill faced increasing demands from investors, analysts, and

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138. *Id.*

139. *Id.*; *see also* Mayumi Negishi, *Citibank Japan Ordered to Close Four Offices over Legal Breaches*, JAPAN TIMES, Sept. 18, 2004 (available on Lexis); Mitchell Pacelle et al., *Mission Control: For Citigroup, Scandal in Japan Shows Dangers of Global Sprawl*, WALL ST. J., Dec. 22, 2004, at A1; Mikayo Takebe, *Moving the Market: Citigroup Unit Faces Discipline by Japanese Watchdog Agency*, WALL ST. J., Sept. 15, 2004, at C3; Todd Zaun, *Japan Shuts Unit of Citibank, Citing Violations*, N.Y. TIMES, Sept. 18, 2004, at C1.

140. Pacelle et al., *supra* note 139 (quoting findings from an internal investigation by Promontory Financial Group, led by former Comptroller of the Currency Eugene Ludwig).

141. Zaun, *supra* note 139 (quoting Toshihide Endo, director of JFSA's supervisory bureau).

142. Pacelle et al., *supra* note 139 (reporting on findings from Promontory's internal investigation).

143. Pacelle, *supra* note 66 (noting Citigroup's adoption of a "five-point" plan to "beef up the company's ethics").

144. *See infra* Part II.A (describing Citigroup's continued pursuit of high-risk strategies after 2005).

145. *See infra* Part II.A (describing Citigroup's continued pursuit of high-risk strategies after 2005).

Citigroup's directors to establish a succession plan following the Enron, WorldCom, and research analyst scandals.[146] He agreed to step down as CEO in 2003 but continued to serve as chairman of Citigroup until 2006.[147] Weill's successor as CEO was Charles "Chuck" Prince.[148] Prince had led Citigroup's efforts to resolve its legal problems in his prior roles as general counsel and head of Citigroup's corporate and investment bank.[149] In February 2005, following the additional scandals involving European bond trading and Japanese private banking, Prince "unveiled to [Citigroup's] employees a 'five-point plan' for beefing up the company's ethics," including annual "ethics and code-of-conduct [sic] training" programs for all employees as well as stronger internal controls and enhanced compliance training and review procedures for managers.[150] Prince continued to emphasize his compliance reform program throughout 2005.[151]

At the same time, Citigroup's senior management made clear that the new legal compliance program would not interfere with Citigroup's primary goal of achieving higher growth in its revenues and profits.[152] Prince assured investors (as he had done since late 2003) that he would produce "organic growth" by transforming Citigroup into a "distribution company" that would "push more

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146. Heather Timmons, *Citi: Time for a Succession Plan*, BUS. WK., Dec. 2, 2002, at 48.

147. Anthony Bianco et al., *Citi's New Act*, BUS. WK., July 28, 2003, at 31; *see also* GASPARINO, *supra* note 54, at 187-88 (reporting that New York Attorney General Eliot Spitzer may have secured Weill's agreement to step down as Citigroup's CEO in exchange for not naming Weill as a defendant in Spitzer's enforcement actions against Citigroup and Grubman for tainted research advice and IPO spinning). Weill retained substantial influence within Citigroup's senior management during the first year after he stepped down as CEO. However, by August 2005 Chuck Prince (Weill's successor as CEO) was firmly in control of Citigroup's management, and several senior executives who were close associates of Weill had left Citigroup. Todd Davenport, *Strategy and Tactics: The Book on a New Citi*, AM. BANKER, Aug. 26, 2005, at 1.

148. Monica Langley, *Course Correction—Behind Citigroup Departures: A Culture Shift by CEO Prince*, WALL ST. J., Aug. 24, 2005, at 1.

149. GASPARINO, *supra* note 54, at 187-89; Bianco et al., *supra* note 147; Langley, *supra* note 148.

150. Pacelle, *supra* note 66; *see also* Pacelle et al., *supra* note 139 (discussing Prince's decision to institute new compliance and training programs after the Japanese private banking scandal).

151. Davenport, *supra* note 147 (quoting Mr. Prince's statement that "there is no way given our size that we can really hope to have substantial growth if we basically have a tarnished reputation"); Langley, *supra* note 148 (quoting Mr. Prince's remark that "[y]ou can never sacrifice your long-term growth, your long-term reputation, to the short term").

152. Lee, *supra* note 64 (quoting comment by Robert Druskin, head of Citigroup's corporate and investment bank, that "[r]evenues have to grow . . . [w]e don't believe a greater focus on reputational risk issues should have any impact on revenues"); Todd Davenport, *Risk Concerns Dominate Citi Meeting*, AM. BANKER, May 27, 2005, at 20 (reporting on Mr. Druskin's statement that "concerns about reputation would not reduce [Citigroup's] revenue goals" or prevent Citigroup from being "willing, ready, and able to take intelligent risk").

financial products and advice" to customers within Citigroup's domestic and international consumer operations, as well as its global corporate and investment bank.[153] Prince's five-point compliance and ethics plan was also conveniently timed, since he issued his plan shortly before the FRB imposed a moratorium on further large acquisitions by Citigroup until the bank corrected its "deficiencies in compliance risk management."[154]

Until the financial crisis broke out in mid-2007, Prince continued to push "organic growth" in Citigroup's consumer, corporate, and investment banking operations as his primary strategy for producing higher revenues.[155] However, investors and analysts repeatedly criticized Prince's leadership between 2005 and 2007 because Citigroup's expenses grew at a faster rate than its revenues and Citigroup's stock price lagged behind the stock market values of its big-bank peers.[156] As a result, Prince and his management team were under intense pressure to generate significantly higher profits.[157] As discussed below, Prince and Rubin decided to produce higher profits by taking greater risks in Citigroup's consumer, corporate and investment banking operations.[158] Citigroup's pursuit of high-risk activities proved to be disastrous and led to Citigroup's collapse and

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153. Mara Der Hovanesian, *Rewiring Chuck Prince*, BUS. WK., Feb. 20, 2006, at 75, 78 [hereinafter "Rewiring Chuck Prince"]; *see also* Mara Der Hovanesian, *Chuck Prince's Citi Planning*, BUS. WK., Sept. 5, 2005, at 88; Lee, *supra* note 65; *infra* note 167 and accompanying text (discussing Prince's decision to adopt an "organic growth" strategy when he succeeded Weill as CEO in late 2003).

154. Prince announced his compliance and ethics plan in February 2005, and the FRB cited Citigroup's new plan when it issued its moratorium the following month. Pacelle, *supra* note 66; Lee, *supra* note 64 (quoting Citigroup Inc., FRB Citigroup-FAB Order, *supra* note 18, at 11; *see also* Lee, *supra* note 64, at 9-10 (noting that Citigroup "is in the process of implementing enhanced compliance policies and procedures" and "has introduced an enhanced corporate-wide ethics awareness program with an expanded orientation program and annual training sessions"); *see also infra* notes 408-11 and accompanying text (discussing the FRB's decision in April 2006 to lift its moratorium on additional large acquisitions by Citigroup).

155. *Rewiring Chuck Prince*, *supra* note 153; Tim Mazzucca, *Prince Puts 'Virtual' Growth on Citi Agenda: Post-deal Ban, CEO Still Emphasizing Organic Expansion*, AM. BANKER, Apr. 5, 2006, at 1; *see also* Mara Der Hovanesian, *Leadership: Cleaned Up but Falling Behind*, BUS. WK., Oct. 16, 2006, at 39 (reporting on Prince's desire to expand Citigroup's consumer banking operations); Clint Riley, *Citigroup to Focus on Investment Bank*, WALL ST. J., Jan. 20, 2007, at A2 (reporting on Prince's decision to invest additional resources in Citigroup's investment bank).

156. Todd Davenport, *Is Citi Rep-Damage Control Turning into a Distraction?*, AM. BANKER, July 19, 2005, at 2; Der Hovanesian, *supra* note 155; Clint Riley et al., *Shake-Up Puts Citigroup's CEO on the Hot Seat: Challenge for Prince is to Revitalize Big Bank*, WALL ST. J., Jan. 23, 2007, at A1; Robin Sidel & David Enrich, *For Citi, Cost-Cutting is only Half the Battle: Investors, Analysts Want Higher Rate of Revenue Growth*, WALL ST. J., Apr. 12, 2007, at C3.

157. *See* sources cited *supra* note 156; *see also* Clint Riley, *Citigroup Investors Agitate for Improvement*, WALL ST. J., Dec. 11, 2006, at C1.

158. *See infra* Part II.A.

multiple bailouts in 2008 and early 2009.[159]

Thus, Citigroup's managers failed to heed the lessons from the repeated mistakes and scandals that plagued the company from 2000 to 2004. A single-minded pursuit of higher earnings remained the overriding business strategy for Citigroup's leaders, regardless of the disasters that strategy had created in the past. The compliance and ethics training programs that Prince instituted in 2005 had no discernible impact on Citigroup's culture of aggressive risk-taking.[160] In response to pressure from financial industry analysts and Citigroup's investors, senior management kept pushing employees to find new ways to increase earnings without regard to the potential hazards of those methods.[161] As explained in Part II.B., the reckless actions of Citigroup's employees between 2004 and 2007 were similar to the conduct that damaged Citigroup and tarnished its reputation between 2000 and 2004.

Like Citigroup's management, the bank's regulators failed to respond adequately to Citigroup's repeated misconduct between 2000 and 2004. Regulators imposed about $800 million of penalties on Citigroup between 2002 and 2004 for its involvement in scandals related to Enron, WorldCom, tainted research analysis, IPO spinning, and predatory lending.[162] However, Jack Grubman was the only Citigroup employee who was the subject of an official enforcement action, and the regulatory penalties assessed against Citigroup paled in comparison to the $33 billion of profits that Citigroup amassed in 2002 and 2003.[163] In March 2005, as noted above, the FRB imposed a moratorium on further acquisitions until Citigroup improved its "deficiencies in compliance risk management."[164] However, the FRB removed that moratorium in April 2006, a misguided step that allowed Citigroup to expand its balance sheet and the magnitude of its risk-taking during the final and most frenzied period of the credit boom.[165]

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159. *See infra* Part II.B.

160. *See* authorities cited *supra* notes 150-55.

161. *See infra* Part II.A.

162. *See supra* notes 81, 95, 126, 130, 136 and accompanying text.

163. Bianco et al., *supra* note 147, at 31 (reporting that Citigroup earned $15.3 billion of profits in 2002); Robert Julavits & David Boraks, *Records at Citi, Wells; U.S. Bank Falls Short*, AM. BANKER, Jan. 21, 2004, at 2 (reporting that Citigroup had $17.85 billion of net income in 2003).

164. FRB Citigroup-FAB Order, *supra* note 18, at 11.

165. *See infra* notes 408-24 and accompanying text (discussing the impact of the FRB's lifting of its moratorium in April 2006).

II. CITIGROUP'S HIGH-RISK STRATEGY LED TO THE COMPANY'S COLLAPSE AND MULTIPLE BAILOUTS

A. Prince and Rubin Followed a Fatally Flawed Strategy That Sought to Generate Higher Profits by Assuming Greater Risks

In October 2003, when Chuck Prince succeeded Sandy Weill as CEO of Citigroup, Prince and his management team decided that Citigroup could no longer rely on large acquisitions to produce higher profits.[166] Instead, Prince adopted a new strategy of "growing organic revenues" by improving the efficiency and productivity of the universal banking "platform" that Weill had created.[167] Prince and Robert Rubin sought to increase Citigroup's earnings by expanding its involvement in "proprietary trading"— an area that Weill had sharply reduced after Salomon suffered large losses during the Russian debt default crisis in 1998.[168] Prince also enlarged Citigroup's subprime mortgage and home equity lending operations by purchasing Washington Mutual's consumer finance unit in November 2003.[169]

As discussed below, Citigroup pursued high-risk strategies in three major areas between 2003 and 2007—(i) originating and securitizing subprime loans, (ii) creating and marketing collateralized debt obligations (CDOs), and (iii) originating and securitizing leveraged corporate loans.[170] Citigroup's activities in all three areas produced huge losses that crippled Citigroup and forced it to accept a series of government bailouts in 2008 and 2009.[171]

1. Citigroup Pursued a Risky Strategy of Originating and Securitizing of Subprime Loans.—During the housing boom of the 2000s, Citigroup was a leading participant in the origination and securitization markets for subprime mortgages. CitiFinancial became a major subprime lender when it acquired Associates First Capital in 2000.[172] CitiFinancial ranked among the top twelve

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166. Robert Julavits, *Big Deals Out, Growing Organically In at Citi*, AM. BANKER, Nov. 5, 2003, at 2 (reporting that Prince replaced Weill as CEO in October 2003, and quoting Prince's statement that "[t]he era of the transformational merger . . . is over. . . . The platform we have is a terrific one, and we need to grow organic revenues off that platform.").

167. *Id.*

168. Jason Singer & Mitchell Pacelle, *Heard on the Street: Citigroup to Expand Its Trading*, WALL ST. J., Nov. 19, 2003, at C1; *see also supra* notes 60, 61 and accompanying text (discussing Weill's and Dimon's decision to shut down Salomon's bond arbitrage trading unit in 1998).

169. Mitchell Pacelle, *Citigroup Spends $1.25 Billion To Enlarge Subprime Presence*, WALL ST. J., Nov. 25, 2003, at C12 (reporting that the acquisition would "add 409 [storefront] locations in 25 states to the approximately 1,600 existing branches of CitiFinancial").

170. *See infra* Parts II.A.1., II.A.2., II.A.5.

171. *See infra* Part II.B.

172. KATHLEEN ENGEL & PATRICIA MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 202 (2011); *see also supra* notes 121, 122 and accompanying text (discussing Citigroup's acquisition of Associates).

subprime lenders in the U.S. from 2004 to 2007.[173] CitiFinancial pushed for even higher subprime lending volumes after 2006, when the FRB lifted the cease-and-desist order it had issued against CitiFinancial in 2004 for predatory lending abuses.[174] Citigroup nearly doubled the share of its mortgage business devoted to subprime loans from 10% in 2005 to 19% in 2007, and it also increased the percentage of subprime loans it originated with high-risk features such as low down payments, "piggyback" second mortgages, "stated income" mortgages with little or no documentation of the borrowers' income, and loans made to investors who intended to "flip" the houses they purchased.[175]

In addition to its origination business, Citigroup was deeply involved in the securitization market for subprime mortgages.[176] Citigroup provided warehouse lines of credit to leading nonbank subprime lenders, including Ameriquest and New Century.[177] Citigroup purchased large volumes of subprime and Alt-A loans originated by those and other nonbank lenders, and Citigroup packaged those loans into nonprime residential mortgage-backed securities ("RMBS") that were sold to investors.[178]

In September 2007, when the subprime mortgage market was already in turmoil, Citigroup decided to expand its subprime securitization business by purchasing the wholesale lending and servicing businesses of ACC Capital Holdings (Argent), the parent company of Ameriquest.[179] When the Argent deal was announced, a Citigroup executive declared, "We're big believers in the whole

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173. Paul Muolo, *Top Subprime Lenders & Their Owners*, NAT'L MORTGAGE NEWS, May 16, 2005, at 1 (table showing that CitiFinancial was the eighth-ranked subprime lender in 2004); Paul Muolo, *Top Subprime Lenders in 2005*, NAT'L MORTGAGE NEWS, May 15, 2006, at 1 (table showing that CitiFinancial was the twelfth-ranked subprime lender in 2005); ENGEL & MCCOY, *supra* note 172, at 202 (stating that CitiFinancial was "the eleventh largest subprime lender in 2006"); Paul Muolo, *Top Subprime Lenders in 2007*, NAT'L MORTGAGE NEWS, May 12, 2008, at 1 (table showing that CitFinancial was the seventh largest subprime lender in 2007).

174. ENGEL & MCCOY, *supra* note 172, at 202-03; *see also supra* notes 130-32 and accompanying text (discussing the 2004 order issued by the FRB against CitiFinancial).

175. ENGEL & MCCOY, *supra* note 172, at 203; FCIC REPORT, *supra* note 4, at 110-11; *see also 2ds Weaken at Citigroup*, NAT'L MORTGAGE NEWS, July 30, 2007, at 1 (reporting that "15% of [Citigroup's] $147 billion first mortgage portfolio consists of loans to borrowers with FICO scores below 620, and another 13% have scores between 620 and 660"; and also stating that Citigroup held $69 billion of second mortgages of which none were made to borrowers with FICO scores below 620); *see also infra* note 212 (stating that subprime borrowers typically had FICO scores below 640).

176. *See infra* notes 178-83 and accompanying text.

177. FCIC REPORT, *supra* note 4, at 113.

178. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 191-92; FCIC REPORT, *supra* note 4, at 113, 115, and 168; *see also* FCIC REPORT, *supra* note 4, at 71-72, 110-11 (describing an RMBS deal underwritten by Citigroup in 2006 that was backed by a pool of subprime mortgages of very poor quality, which Citigroup had purchased from New Century).

179. Harry Terris, *Citi-ACC: A Bet Vertical Integration Still Has Legs*, AM. BANKER, Sept. 13, 2007, at 1.

vertical integration of this part of the capital markets," and he emphasized that the deal would give Citigroup a new conduit for subprime securitization.[180] The deal soon proved to be disastrous, and Citigroup shut down the acquired unit in early 2008.[181]

In an interview with the Financial Crisis Inquiry Commission ("FCIC"), in March 2010, Prince admitted that the subprime securitization process "could be seen as a factory line," and he further acknowledged:

> As more and more of these subprime mortgages were created as raw material for the securitization process, not surprisingly in hindsight, more and more of it was of lower and lower quality. And at the end of that process, the raw material going into it was actually bad quality, it was toxic quality, and this is what ended up coming out the other end of the pipeline. Wall Street obviously participated in that flow of activity.[182]

Citigroup was a leading participant in the subprime securitization market during the mid-2000s.[183] Citigroup steadily lowered its standards for originating and purchasing subprime mortgages as the housing bubble stopped expanding in late 2005 and began to deflate soon thereafter.[184] The decline in Citigroup's underwriting standards was confirmed by its dealings with Clayton Holdings, a leading provider of third-party due diligence services to Wall Street firms that purchased subprime mortgages for securitization.[185] Clayton rejected 42% of the subprime mortgages that it reviewed for Citigroup between January 2006 and June 2007 because those loans did not meet Citigroup's underwriting guidelines.[186] However, Citigroup "waived in" nearly a third of the mortgages that Clayton had rejected.[187]

Richard Bowen was a senior CitiFinancial officer who was responsible for overseeing the reviews of mortgage loans that CitiFinancial purchased from third-

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180. *Id.* (quoting Jeffrey A. Perlowitz, head of global securitized markets in Citigroup's fixed-income, currencies and commodities unit); ENGEL & MCCOY, *supra* note 172, at 170.

181. ENGEL & MCCOY, *supra* note 172, at 170.

182. FCIC REPORT, *supra* note 4, at 102-03 (quoting interview with Mr. Prince on Mar. 17, 2010).

183. *Id.* at 71-72, 111, 113-18; Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 990 n.100 (2009) [hereinafter Wilmarth, *Dark Side*] (stating that Citigroup was one of the top twelve underwriters of private–label RMBS in 2007); *see also id*. at 1019 n.280 (reporting that Citigroup ranked among the top ten underwriters of RMBS in both 2003 and 2004).

184. FCIC REPORT, *supra* note 4, at 165-69, 172; *see also id.* at 111 (quoting testimony by Richard Bowen, a senior officer in CitiFinancial's consumer lending group, who said that Citigroup decided in 2005 that "[w]e're going to have to hold our nose and start buying the stated income [mortgage] product if we want to stay in business" in underwriting subprime RMBS).

185. *Id.* at 166.

186. *Id.* at 167.

187. *Id.*

party originators through its correspondent lending channel.[188] Bowen told the FCIC that he repeatedly warned senior management in 2006 and 2007 that CitiFinancial was ignoring Citigroup's stated criteria for buying subprime loans that would be packaged into RMBS.[189] Citigroup's chief risk officer for securitizations of mortgage loans overturned many of the decisions made by Bowen's team, and the same officer changed "large numbers of underwriting decisions on mortgage loans from 'turned down' to 'approved.'"[190]

Bowen also testified that most of the "prime" mortgages that CitiFinancial purchased from correspondent lenders and sold to Fannie Mae, Freddie Mac and other investors in 2006 and 2007 did not conform to the representations and warranties that Citigroup provided to those investors.[191] According to Bowen, Citigroup's management placed "significant corporate emphasis . . . upon the need for growth and market share" in originating, selling and securitizing mortgages.[192] Citigroup also "dramatically reduced the number of employees" who reviewed mortgages for conformity with quality standards.[193]

Bowen's supervisors disregarded his repeated warnings.[194] Finally, on November 3, 2007, Bowen sent an email to Robert Rubin, David Bushnell (Citigroup's chief risk officer), Gary Crittenden (Citigroup's chief financial officer) and Bonnie Howard (Citigroup's chief auditor).[195] Bowen warned the four senior executives about breakdowns in internal controls and "resulting significant but possibly unrecognized financial losses existing within Citigroup."[196] He provided a detailed description of Citigroup's systematic failures to follow its quality control standards while purchasing huge volumes of prime and subprime loans for sale to investors.[197] After Bowen sent his email, his responsibilities were reduced from supervising 220 employees to supervising only two, his bonus was cut, and he received a downgrade on his next

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188. *Id.* at 168.

189. *Id.* at 19.

190. *Hearing on Subprime Lending and Securitization and Government Sponsored Enterprises: Before Financial Crisis Inquiry Commission*, 111th Cong. (2010) (written testimony of Richard M. Bowen, III) [hereinafter Bowen Testimony], at 1-2, 4, 7-9, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-04-07%20Richard%20Bowen%20Written%20Testimony.pdf, *archived at* http://perma.cc/8EXG-67U8; *see also* FCIC REPORT, *supra* note 4, at 168 (citing Mr. Bowen's testimony).

191. Bowen Testimony, *supra* note 190, at 1-2, 7-8 (stating that "over 60%" of the "prime" mortgages purchased and sold by Citigroup in 2006 did not conform to Citigroup's representations and warranties to Fannie Mae, Freddie Mac and other investors, and the percentage of "defective mortgages" rose to "over 80%" in 2007).

192. *Id.* at 3.

193. *Id.*

194. *Id.* at 1-2, 7-8, 13-17.

195. *Id*. at 2.

196. *Id*. (quotation omitted).

197. *Id.* at 2, 13-14, 19-20 (Exhibit I) (text of email message).

performance review.[198] He left Citigroup in early 2009.[199]

Sherry Hunt was a member of Bowen's team, and she received comparable treatment when she raised similar warning flags.[200] Hunt supervised 65 mortgage underwriters at CitiMortgage's headquarters in Missouri.[201] Beginning in 2006, she told her supervisors that Citigroup was buying large volumes of defective mortgages from third-party lenders that included "doctored tax forms, phony appraisals and missing signatures."[202] Hunt eventually shared her concerns with Bowen, and Bowen relied in part on Hunt's information when he sent his email message to Rubin and the other senior Citigroup officers.[203] Citigroup's lawyers subsequently interviewed Hunt, but CitiMortgage did not change its business methods.[204] Instead, CitiMortgage removed Hunt as a supervisor and sent her to work as an ordinary employee in the "quality-control unit."[205]

In her new position, Hunt identified large numbers of defective mortgages "with issues such as obviously forged signatures, whited-out income lines on tax forms or misspelled bank names on borrower bank statements."[206] CitiMortgage responded by creating a team "whose mission was to challenge the findings of Hunt's quality-control group," and a CitiMortgage executive ordered Hunt's group to reduce its percentage of rejected loans "by brute force."[207] After another CitiMortgage executive threatened in early 2011 to fire Hunt and one of her colleagues if they did not reduce their rejection rates, Hunt filed a whistleblower lawsuit against Citigroup.[208] The federal government joined Hunt's suit, and Citigroup agreed in 2012 to pay $158 million to settle charges that it sold thousands of nonconforming mortgages to the Federal Housing Administration.[209]

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198. FCIC REPORT, *supra* note 4, at 19.

199. *Id.*

200. Bob Ivry, *Woman Who Couldn't Be Intimidated by Citigroup Wins $31 Million*, BLOOMBERG MARKETS MAG., May 31, 2012, *available at* http://www.bloomberg.com/news/2012-05-31/woman-who-couldn-t-be-intimidated-by-citigroup-wins-31-million.html, *archived at* http://perma.cc/V3MR-DGAU.

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.* (quoting email in November 2010 from Ross Leckie); *see also* Bob Ivry et al., *Citigroup Whistle-Blower Says Bank's 'Brute Force' Hid Bad Loans from U.S.*, BLOOMBERG, Feb. 16, 2012, http://www.bloomberg.com/news/2012-02-16/citigroup-whistle-blower-says-bank-s-brute-force-hid-bad-loans.html, *archived at* http://perma.cc/F5DE-XPT3 (reporting that CitiMortgage issued "Star Player Awards" in January 2011 to "workers who had successfully challenged negative reviews during meetings with quality-assurance workers and others").

208. Ivry et al., *supra* note 200.

209. *Id.* (reporting that Jeffery Polkinghorne allegedly told Hunt and her colleague in March 2011 that the number of loans they classified as defective must fall or it would be "your asses on the line"); Ivry et al., *supra* note 207 (reporting on Citigroup's agreement to settle lawsuit filed by

Citigroup subsequently agreed to pay more than $1.3 billion to settle similar claims that it sold 3.7 million defective mortgages to Fannie Mae and Freddie Mac between 2000 and 2012.[210]

Thus, Citigroup disregarded repeated warnings from both external and internal quality control monitors and continued to pursue unsound mortgage lending practices long after the financial crisis broke out in the summer of 2007. After suffering heavy losses in the second half of 2007, Citigroup reduced, but did not terminate, its involvement in making and securitizing subprime and Alt-A mortgages.[211] In early 2008, Citigroup stopped buying mortgages from brokers and also stopped funding the most risky types of subprime mortgages, including adjustable-rate mortgages (ARMs) with low introductory "teaser" rates.[212] Citigroup continued, however, to originate and securitize subprime mortgages for borrowers with FICO scores as low as 580.[213]

In 2008, Citigroup merged CitiFinancial into CitiMortgage, thereby consolidating its prime and nonprime operations.[214] The head of CitiMortgage explained that the new combined organization would work closely with Citigroup's investment bank to create "an end-to-end U.S. residential mortgage business that includes origination, servicing, and capital markets securitization."[215] In view of Citigroup's decision, in the midst of the mortgage crisis, to generate additional fee income by continuing to securitize risky mortgages, it is not surprising that Citigroup originated and sold many defective mortgages that did not meet its stated underwriting criteria.

2. Citigroup Recklessly Packaged and Marketed CDOs.—Along with Merrill Lynch ("Merrill"), Citigroup dominated the market for CDOs during the peak of

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Hunt and joined by the federal government).

210. Dakin Campbell, *Citigroup to Pay Freddie Mac $395 Million to End Mortgage Claims*, BLOOMBERG, Sept. 25, 2013, http://www.bloomberg.com/news/2013-09-25/citigroup-to-pay-freddie-mac-395-million-tied-to-mortgages-1-.html, *archived at* http://perma.cc/SQ8X-F6L8; Hugh Son & Donal Griffin, *Citigroup Will Pay Fannie Mae $968 Million on Faulty Loans*, BLOOMBERG, July 1, 2013, http://www.bloomberg.com/news/2013-07-01/citigroup-to-pay-968-million-to-fannie-mae-on-faulty-mortgages.html, *archived at* http://perma.cc/WM3M-2GBS.

211. Paul Muolo, *Citi Reducing Holdings 20%*, NAT'L MORTGAGE NEWS, Mar. 10, 2008, at 1.

212. *Id.* (reporting that Citigroup would continue making subprime loans with a "minimum FICO score" of 580, but would stop funding "higher-risk products" such as "2/28 and 3/27 ARMs" and "investor properties on three and four-unit rentals"); *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1015-17, 1020-22 (describing subprime and Alt-A mortgages, noting that subprime borrowers typically had FICO scores below 640, and explaining the heightened risks of subprime ARMs with 2/28 and 3/27 amortization terms and low introductory "teaser" rates).

213. *Id.*

214. Matthias Ricker, *Citi Shift Means Less Capital for Mortgages: Slashing Origination Efforts to Primarily "What We Can Sell,"* AM. BANKER, Mar. 7, 2008, at 1.

215. *Id.* (quoting Bill Beckmann, President of CitiMortgage, and reporting that Citigroup planned to reduce its mortgage portfolio by $45 billion, or 20%, while keeping "just 10% of [mortgage] originations on its books, down from about 65%").

the subprime credit boom between 2005 and 2007.[216] CDOs played a crucial role in promoting higher volumes of subprime lending and securitization, because they served as the primary purchasers for the "mezzanine" tranches of subprime RMBS.[217] Institutional investors typically wanted to buy the "senior" tranches of subprime RMBS because they carried "AAA" credit ratings and paid higher yields than other types of AAA-rated securities.[218] The senior tranches usually accounted for the top 75-80% of the tranches in subprime RMBS deals.[219] Either Wall Street underwriters or hedge funds usually bought the unrated junior or "equity" tranches, which represented 5% or less of the tranches in typical subprime RMBS deals.[220] Relatively few investors wanted to buy the mezzanine tranches, which ranked below the senior tranches and carried relatively low credit ratings of "A" or "BBB."[221] Most investors did not view the yields of mezzanine tranches as being high enough to justify the additional risk.[222]

In response to the lack of investor demand for mezzanine tranches of RMBS, Citigroup and other Wall Street firms "created the investor" by constructing cash flow CDOs, also known as ABS CDOs.[223] Wall Street underwriters acquired large pools of unsold mezzanine tranches of subprime RMBS (and other debt instruments) and re-securitized those pools by creating ABS CDOs.[224] About 80% of the tranches of ABS CDOs were assigned "senior" status with AAA credit ratings.[225] ABS CDOs became the dominant buyers of mezzanine tranches of subprime RMBS after 2003 and thereby provided an essential source of demand for continued subprime lending and securitization.[226]

Thus, Wall Street firms used ABS CDOs to perform a kind of "alchemy" in which (i) pools of high-risk subprime mortgages were packaged into subprime RMBS, and (ii) the low-rated and unwanted mezzanine tranches of subprime RMBS were repackaged and transformed into senior AAA-rated tranches of

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216. *See infra* notes 241-42, 245 and accompanying text.

217. FCIC REPORT, *supra* note 4, at 71-73, 115-17 (describing the structure of a typical subprime RMBS deal that Citigroup underwrote in 2006); Wilmarth, *Dark Side*, *supra* note 183, at 984-90 (describing the securitization process used by Wall Street firms to create subprime RMBS).

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.*

223. FCIC REPORT, *supra* note 4, at 130 (quoting statement by Credit Suisse banker Joe Donovan at a conference for securitization bankers in February 2002); *id.* at 127 n.* (explaining that ABS CDOs is a term used to describe "cash CDOs backed by asset-backed securities (such as mortgage-backed securities)"); Wilmarth, *Dark Side*, *supra* note 183, at 990 (providing a similar description of ABS CDOs).

224. FCIC REPORT, *supra* note 4, at 127.

225. *Id.* at 129-33.

226. *Id.* at 116, 117, 127-30, 132-33.

CDOs.[227] Two classes of institutions played essential roles in helping Wall Street to accomplish that alchemy. First, insurance companies, including American International Group (AIG), Ambac, and MBIA, issued credit default swaps (CDS) and other guarantees that protected the senior tranches of CDOs against losses.[228] Second, credit ratings agencies (CRAs) issued AAA ratings for those tranches in reliance on flawed financial models that overstated both (i) the diversification of risk within the underlying pools of mezzanine tranches of subprime RMBS and (ii) the value of protection provided by insurance company guarantees.[229] The financial models used by CRAs proved to be disastrously wrong in calculating the risks inherent in ABS CDOs.[230]

The generous fees paid by Wall Street underwriters to insurance companies and CRAs helped to persuade both classes of institutions to ignore any doubts those institutions might have had about participating in Wall Street's CDO alchemy.[231] A senior official of the Federal Reserve System (Fed) later concluded that "the whole concept of ABS CDOs had been an abomination" that helped to produce an unsustainable boom in subprime mortgages.[232]

As the subprime credit boom reached its peak, ABS CDOs became the leading buyers not only of mezzanine tranches of RMBS but also of mezzanine tranches of other CDOs.[233] The FCIC found that "[b]y 2005, CDO underwriters were selling most of the mezzanine tranches [of CDOs] . . . to other CDO managers, to be packaged into other CDOs."[234] An investigative report by Jake Bernstein and Jesse Eisinger similarly concluded that

> in the last years of the boom, CDOs had become the dominant purchaser of key, risky parts of other CDOs, largely replacing real investors like pension funds. By 2007, 67 percent of those slices were bought by CDOs, up from 36 percent just three years earlier. . . .
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> . . . .
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> . . . Crucially, such deals maintained the value of mortgage bonds at a

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227. *Id.* at 127-29, 148 (quoting Kyle Bass); *see also id.* at 193 (quoting analyst James Grant's description of the "mysterious alchemical processes" by which "Wall Street transforms BBB-minus-rated mortgages into AAA-rated tranches of mortgage securities" through the production of CDOs).

228. *Id.* at 132.

229. *Id.* at 127-29, 139-42, 146-50, 200-04, 206-12, 265-74, 276-78.

230. *Id.* at 127-29, 146-50, 206-12.

231. *Id.* at 139-42, 146-50, 200-02, 206-12; Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 967-71 (2011) [hereinafter Wilmarth, *Dodd-Frank*] (describing the "CRAs' pervasive conflicts of interest [that] encouraged them to issue credit ratings that either misperceived or misrepresented the true risks embedded in structured-finance securities").

232. FCIC REPORT, *supra* note 4, at 129 (quoting interview with Patrick Parkinson in March 2010).

233. *Id.* at 132.

234. *Id.*

time when the lack of buyers should have driven their prices down.[235]

Bernstein and Eisinger reported that Citigroup was one of the three most active banks (along with Merrill and UBS) in creating networks of CDOs that were used as dumping grounds for mezzanine tranches of other CDOs those banks sponsored.[236]

Citigroup also underwrote synthetic CDOs, which held portfolios of CDS that represented bets on the performance of designated tranches of subprime RMBS.[237] Citigroup frequently took "long" positions on those bets by retaining the "super senior" tranches of synthetic CDOs it underwrote, although it obtained protection from AIG and monoline insurance companies for some of those exposures.[238] Synthetic CDOs "multiplied the effects" of the collapse in the subprime mortgage market because they created additional bets on the performance of subprime RMBS and the underlying mortgages.[239]

When Prince became CEO of Citigroup in late 2003, he and Rubin pushed Tom Maheras (the head of Citigroup's fixed-income trading activities) to produce more trading profits and larger volumes of CDOs.[240] In 2004, Citigroup underwrote $7 billion of CDOs and ranked fifth among CDO underwriters.[241] That performance represented a significant rise from Citigroup's fourteenth-place ranking in 2003, but the bank's CDO production was still less than half of the amount generated by top-ranked Merrill.[242]

In early 2005, Prince and Rubin developed a new strategic plan for

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235. Jake Bernstein & Jesse Eisinger, *The Wall Street Money Machine: Banks' Self-Dealing Super-Charged Financial Crisis*, PROPUBLICA (Aug. 26, 2010), http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis, *archived at* http://perma.cc/5USS-JLAW.

236. *Id.* (quoting a shareholder lawsuit alleging that "Citigroup's CDO operations during late 2006 and 2007 functioned largely to sell CDOs to yet newer CDOs created by Citi to house them," and also citing reciprocal purchases of CDO tranches that were made among three CDOs created by Citigroup—Octonion, Adams Square Funding II and Class V Funding III).

237. FCIC REPORT, *supra* note 4, at 142-46 (describing synthetic CDOs); *id.* at 190, 194-96 (describing Citigroup's significant role in underwriting synthetic CDOs and in retaining the "super senior" tranches of those CDOs).

238. *Id.*

239. *Id.* at 146 (quoting interview with Patrick Parkinson); *see also* Wilmarth, *Dodd-Frank*, *supra* note 231, at 965-67 (describing how synthetic CDOs and CDS enabled investors to place "multiple layers of financial bets" on the performance of subprime mortgages, thereby creating an "inverted pyramid of risk" that inflicted losses on investors that were much larger than the face amounts of the defaulted mortgages).

240. Schwartz & Dash, supra note 3.

241. Kevin Donovan, *Merrill's CDO Investment Pays Off with No. 1 Ranking*, ASSET SECURITIZATION REP., Jan. 10, 2005.

242. *Id.* (reporting that Merrill underwrote $15 billion of CDOs in 2004); *see also* FCIC REPORT, *supra* note 4, at 198 (stating that Citigroup ranked fourteenth among CDO underwriters in 2003).

Citigroup.[243] That plan called for generating higher profits by expanding Citigroup's fixed-income trading operations (including CDOs) and assuming greater risks in those operations.[244] Citigroup implemented the plan by ramping up its CDO production to $18.5 billion in 2005, $36.6 billion in 2006 and $35.7 billion in 2007, and its ranking as a CDO underwriter rose to third in 2005, second in 2006 and first in 2007.[245]

Citigroup earned large amounts of fees for creating and marketing CDOs.[246] In addition, the Citigroup executives responsible for CDO production received handsome rewards for their apparent success. In 2006, Tom Maheras (co-head of Citigroup's investment bank) earned $34 million in salary and bonus, while Randolph Barker (co-head of global fixed-income) was paid $21 million, and Nestor Dominguez and Janice Warne (co-heads of global CDOs) each received $7.4 million.[247]

3. Citigroup Used Off-Balance-Sheet Conduits as Dumping Grounds for Unsold CDO Tranches and Other Risky Securities.—Citigroup assumed ever-greater risks as it sought to become the top-ranked producer of CDOs. From 2003 to 2006, Citigroup sold $25 billion of "super senior" AAA-rated CDO tranches to off-balance-sheet conduits.[248] The conduits paid for the tranches by issuing short-term asset-backed commercial paper (ABCP) to investors.[249] Citibank provided "liquidity puts" to support Citigroup's sale of CDO tranches

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243. Schwartz & Dash, *supra* note 3 (noting that Rubin helped Prince to persuade Citigroup's board of directors to approve the plan).

244. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 190-92; Ken Brown & David Enrich, *Rubin, Under Fire, Defends His Role at Citi*, WALL ST. J., Nov. 29, 2008, at A1; Dash & Creswell, *supra* note 2; Schwartz & Dash, *supra* note 3; Notes on Senior Supervisors' Meetings with Firms: Confidential Supervisory Information: Citigroup, Office of Comptroller of Currency, Nov. 19, 2007, at 5 [hereinafter Senior Regulators 2007 Citigroup Meeting Notes] (confidential notes of meeting among representatives of Citigroup, New York Fed, FRB, OCC and SEC, which recorded that "Citigroup's Board of Directors approved the Management plan accepting Citigroup 'needed to take on more risk.'"), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2007-11-19_OCC_Notes_on_Senior_Supervisors_Meeting_with_Firms.pdf, *archived at* http://perma.cc/6WTR-9LWX.

245. Gabrielle Stein, *Market Sees Murky Outlook for U.S. CDOs in 2008*, ASSET SECURITIZATION REP., Jan. 7, 2008 (providing data for CDO underwriters in 2006 and 2007, and noting that Merrill ranked first in 2006 and second in 2007); Allison Pyburn, *U.S. CDO Market Posts Gains Through 2005*, ASSET SECURITIZATION REP., Jan. 9, 2006 (providing data for CDO underwriters in 2005, and noting that Merrill and Wachovia ranked first and second in that year).

246. FCIC REPORT, *supra* note 4, at 138 (stating that Citigroup's CDO desk typically earned a fee of about $10 million for each $1 billion CDO it created, and Citibank usually charged $1 to $2 million each year for providing "liquidity puts" to purchasers of AAA-rated tranches of CDOs); Dash & Creswell, *supra* note 2 (reporting that Citigroup earned $500 million from its CDO business in 2005).

247. FCIC REPORT, *supra* note 4, at 198.

248. *Id.* at 138-39.

249. *Id.*

to the conduits.[250] The liquidity puts guaranteed that Citibank would buy the ABCP if investors refused to roll over their holdings of the short-term paper.[251] In 2006, after Citibank's treasury department refused to allow any more liquidity puts, Citigroup's CDO trading desk began to retain large amounts of super senior CDO tranches that it could not sell to investors because of the relatively low yields on those tranches.[252] By September 2007, Citigroup's investment bank held $18 billion of unsold super senior tranches, thereby increasing its total super senior exposure to $43 billion.[253] In addition, Citigroup's investment bank held almost $12 billion of subprime mortgages and RMBS in its "warehouse" while waiting to package those instruments into new CDOs.[254] Thus, Citigroup had $55 billion of combined exposures to subprime CDO-related assets in the fall of 2007.[255]

Citigroup compounded its exposure to CDOs and other illiquid investments by creating structured investment vehicles (SIVs) as another type of off-balance-sheet dumping ground for those investments. SIVs were off-balance-sheet entities that purchased a variety of investments (including RMBS and CDOs) from their sponsoring banks and funded those purchases by issuing short-term ABCP and medium-term notes (MTNs).[256] SIVs were somewhat different from ABCP conduits because SIVs used a longer-term funding model and did not rely on liquidity puts from their sponsoring banks.[257] However, while SIVs did not have explicit liquidity support from their sponsoring banks, any default by an SIV would create significant reputational risks for its sponsor.[258]

Citigroup was the largest global sponsor of SIVs.[259] In December 2007,

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250. *Id.*

251. *Id.* at 137-39, 195-96; FED. RES. BANK OF N.Y., SUMMARY OF SUPERVISORY ACTIVITY AND FINDINGS: CITIGROUP, JAN. 1, 2007 – DEC. 31, 2007, at 3, 17 [hereinafter NEW YORK FED 2007 CITIGROUP EXAM REPORT].

252. FCIC REPORT, *supra* note 4, at 138-39, 196-97 (explaining that Citigroup had perverse incentives to provide liquidity puts and retain super senior tranches in order to complete CDO deals, because federal bank regulators had adopted capital rules that allowed banks to maintain very low levels of capital with respect to such commitments).

253. *Id.* at 196.

254. Carrick Mollenkamp & David Reilly, *Why Citi Struggles to Tally Losses*, WALL ST. J., Nov. 5, 2007, at C1.

255. *Id.*

256. FCIC REPORT, *supra* note 4, at 252-53 (explaining that MTNs were bonds maturing in one to five years).

257. *Id.*

258. *Id.*; VIRAL V. ACHARYA & PHILIPP SCHNABL, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 83, 86-94 (Viral V. Acharya & Matthew Richardson eds. 2009); *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1033 (describing "reputation risk" faced by sponsors of SIVs despite the sponsors' lack of explicit contractual commitments to support their SIVs).

259. Shannon D. Harrington & Elizabeth Hester, *Citigroup Rescues SIVs With $58 Billion Debt Bailout (Update 5),* BLOOMBERG (Dec. 14, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&refer=home&sid=aS0Dm.iV5BCI, *archived at* http://perma.cc/PK8G-

Citigroup's seven SIVs collectively held about $50 billion of assets, including a substantial amount of subprime RMBS and CDOs.[260] Despite Citigroup's lack of any "contractual obligation" to support its SIVs, Citigroup felt compelled for reputational reasons to bring the assets of its SIVs back onto its balance sheet in order to prevent the SIVs from defaulting on $58 billion of debt securities the SIVs had issued.[261]

4. Citigroup's Executives Disregarded the Risks Created by Its Subprime RMBS and CDO Activities.—As Citigroup aggressively expanded its business of packaging RMBS and CDOs, Chuck Prince and Robert Rubin ignored the growing risks of that business and other aspects of Citigroup's capital markets operations.[262] Rubin was viewed as Citigroup's "resident sage" based on his experience as head of arbitrage trading and as chairman of Goldman Sachs before serving as Treasury Secretary during the Clinton Administration.[263] Rubin encouraged Prince and Citigroup's board of directors to assume more risk in order to keep up with Goldman Sachs and other key Wall Street competitors.[264] He especially "pushed to bulk up [Citigroup's] high-growth fixed-income trading, including the C.D.O. business."[265] A Citigroup banker described Rubin as "like the Wizard of Oz behind Citigroup . . . . He certainly was the guy deferred to on key strategic decisions and certain key business decisions vis-à-vis risk."[266]

Rubin "knew what a CDO was," but he claimed that he and Citigroup's board of directors properly relied on the bank's fixed-income executives and risk managers to oversee the CDO business.[267] Rubin and Prince told the FCIC that they did not know about Citigroup's $43 billion exposure to subprime CDOs (via

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SVFC (reporting that Citigroup's SIVs held about 13% of their assets in RMBS and CDOs).

260. *Id.* (reporting that Citigroup's SIVs held about 13% of their assets in RMBS and CDOs).

261. *Id.* (reporting that Citigroup was assuming responsibility to pay $10 billion of ABCP and $48 billion of MTNs issued by the SIVs.); Robin Sidel et al., *Citigroup Alters Course, Bails Out Affiliated Funds*, WALL ST. J., Dec. 14, 2007, at A1; *see also* NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 3, 17 (finding that Citigroup failed to consider "the potential impact of supporting Citi-advised [SIVs] for reputational reasons" until the SIVs were threatened with default).

262. *See supra* notes 216-17, 236-61 and accompanying text.

263. Dash & Creswell, *supra* note 2; *see also* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 145-46, 190-91; Brown & Enrich, *supra* note 244. Weill, Prince and other Citigroup executives sought Rubin's advice on a regular basis. Raymond McGuire, a former co-head of global investment banking at Citigroup, described his meetings with Rubin as "a little like visiting Yoda . . . You go and get a dose of wisdom." Schwartz & Dash, *supra* note 3.

264. Dash & Creswell, *supra* note 2.

265. *Id.*; *see also* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 145-46, 190-91; Brown & Enrich, *supra* note 244; Schwartz & Dash, *supra* note 3.

266. Schwartz & Dash, *supra* note 3 (quoting unnamed banker).

267. Brown & Enrich, *supra* note 244 (quoting Mr. Rubin); *see also* Schwartz & Dash, *supra* note 3 (quoting Mr. Rubin's statement that "[t]here is no way you would know what was going on with a risk book unless you're directly involved with the trading arena . . . . We had highly experienced, highly qualified people running the operation.").

liquidity puts and retained super senior tranches) until September 2007.[268] Prior to that time, they relied on assurances provided by Tom Maheras (co-head of Citigroup's investment bank) and David Bushnell (Citigroup's chief risk officer) that Citigroup did not have significant exposures to losses from subprime CDOs.[269] Maheras told Citigroup's senior management that "[w]e are never going to lose a penny on these super seniors," while Bushnell said that housing prices would have to fall 30% nationwide before Citigroup would have any "problems" with its CDO exposure.[270]

Prince and Rubin claimed that they acted reasonably in relying on Maheras and Bushnell as highly respected professionals.[271] However, their reliance was highly questionable in both cases. Many Citigroup employees knew that Maheras pursued extremely aggressive trading strategies with his own funds as well as Citigroup's money.[272] Some senior bond traders and salesmen questioned Maheras' high-risk strategies, but they eventually left Citigroup because senior management supported Maheras and eventually made him co-head of Citigroup's investment bank.[273]

Bushnell's reliability should also have been suspect. He was a longstanding friend of Maheras and Randy Barker, one of Maheras' top deputies.[274] Maheras and Barker frequently persuaded Bushnell to loosen or remove risk limits on Citigroup's trading operations.[275] Risk managers in Citigroup's fixed-income trading division reported to both Maheras and Bushnell, thereby undermining the independence of those managers.[276] Bushnell admitted to the FCIC that his risk management division "did approve higher risk limits when a business line was growing . . . [due to] a 'firm-wide initiative' to increase Citigroup's structured-products business."[277] According to some reports, the "close" friendship among

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268. FCIC REPORT, *supra* note 4, at 262-65.

269. *Id.*; Dash & Creswell, *supra* note 2.

270. FCIC REPORT, *supra* note 4, at 262 and 264 (quoting Mr. Prince's recollection of statements made by Maheras and Bushnell).

271. *Id.* at 261-64; GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 191, 282-83 (noting that in 2007 Maheras had "become the odds-on favorite to replace Prince" as CEO of Citigroup).

272. *See* GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 88, 137-38, 146-50, 238-39, 282-83, 305-06 (discussing Maheras' well-known reputation for speculative trading).

273. *Id.* at 142-43, 146-50, 282-82, 358 (stating that William Heinzerling, a senior bond trader, left Citigroup in 2005 and Citigroup's top three bond salesmen left between 2004 and 2007, due to their disagreements with Maheras' trading strategies).

274. Dash & Creswell, *supra* note 2.

275. GASPARINO, *supra* note 86, at 285, 305 ("Maheras had a built-in advantage when it came to risk-taking—his chief risk manager, Dave Bushnell, was a close friend, and his other close friend, Randy Baker, the co-head of all of fixed income, had consistently leaned on Bushnell to approve increasingly complex trades.").

276. Dash & Creswell, *supra* note 2.

277. FCIC REPORT, *supra* note 4, at 261 (summarizing and quoting from an interview with Mr. Bushnell, and also noting that Citigroup's risk officers increased the authority of the CDO desk to retain subprime RMBS and CDO tranches in the first half of 2007).

Maheras, Barker and Bushnell—and Bushnell's resulting lack of independence—was widely known within Citigroup.[278]

A careful analysis should have led Citigroup's management to question Bushnell's view that super senior tranches of CDOs were protected against any outcome less severe than a 30% drop in nationwide housing prices. Many CDO portfolios were stuffed with mezzanine tranches of subprime RMBS, and some analysts and investors had determined by 2006 that AAA-rated tranches in those CDOs would begin to suffer losses if national home prices fell by just 4%.[279] Nevertheless, Citigroup put "blind faith" in the seniority and AAA ratings of its super senior tranches and failed to perceive the risks embedded in the subprime collateral underlying the CDO tranches.[280]

In June 2007, Citigroup told SEC examiners that it was excluding the $43 billion of CDO liquidity puts and super senior tranches from its publicly disclosed subprime exposures because it viewed the "risk of default" on those AAA-rated obligations as "extremely unlikely."[281] Citigroup omitted the liquidity puts and super senior tranches from its disclosures of subprime holdings in several earnings reports and calls with investors between July and October 2007.[282] Citigroup finally disclosed its liquidity puts and super senior tranches to the public in November 2007.[283] The bank subsequently paid $665 million to settle an SEC enforcement action and a shareholder lawsuit alleging that Citigroup's

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278. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 285, 305 (indicating that Prince was aware of the "close" relationship among the three men); Dash & Creswell, *supra* note 2 (reporting that the friendship between Bushnell and Barker "raised eyebrows inside the company among those concerned about its [risk] controls," and quoting a former senior Citigroup executive who stated, "Because [Bushnell] has such trust and faith in [Maheras and Barker], he didn't ask the right questions").

279. FCIC REPORT, *supra* note 4, at 194-95 (quoting a newsletter article by James Grant in October 2006, and describing similar views held by several hedge fund managers). Mezzanine tranches of a subprime RMBS deal were exposed to losses after the junior or equity tranches (typically representing 3% or less of the total tranches) were wiped out. As a result, after defaults occurred on more than 3% of the pooled subprime mortgages in an RMBS deal, those losses were likely to impair the value of mezzanine tranches of the deal. As the value of mezzanine tranches of RBMS declined, so would the value of any CDOs that either held those tranches or contained CDS representing "long" positions on those tranches. *Id.* at 127-33, 193-95.

280. Dash & Creswell, *supra* note 2; *see also* FCIC REPORT, *supra* note 4, at 260 (noting that Mr. Prince cited the AAA ratings of CDO tranches as a reason for his initial lack of concern about Citigroup's exposure to those tranches); *id.* at 262 (quoting Citigroup risk officer Ellen Duke, who admitted that she was "seduced by structuring [that justified high credit ratings] and failed to look at the underlying collateral").

281. FCIC REPORT, *supra* note 4, at 262 (quoting Citigroup presentation to the SEC in June 2007, and noting that national housing prices had fallen by 4.5% and 16% of subprime ARMs were delinquent by that date); *see also* Dash & Creswell, *supra* note 2 (describing Citigroup's explanation to the SEC's examiners as to why the bank did not disclose its CDO positions).

282. FCIC REPORT, *supra* note 4, at 263.

283. *Id.* at 265.

failure to disclose the liquidity puts and super senior tranches violated federal securities laws.[284]

Citigroup's misplaced reliance on credit ratings gave the bank's traders a convenient rationale to keep running their CDO machine. Meanwhile, as indicated above, "Citigroup's risk models never accounted for the possibility of a national housing downturn."[285] Both mistakes seem glaring in retrospect, but the mistakes are more understandable when one considers the enormous financial incentives that spurred Citigroup's executives to continue creating CDOs and engaging in other high-risk capital markets activities.[286] As one banker explained, "senior managers got addicted to the revenues and arrogant about the risks they were running . . . . As long as you could grow revenues, you could keep your bonus growing."[287]

Prince and Rubin were also strongly inclined to overlook the risks incurred by Citigroup's capital markets activities because they relied so heavily on those operations to produce the earnings growth they kept promising to Wall Street.[288] For example, Citigroup's corporate and investment bank was praised as "the

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284. *Id.*; SEC Litigation Release No. 21605, July 29, 2010 (announcing that Citigroup had agreed to pay $75 million to settle the SEC's enforcement action, and alleging that Citigroup's "senior management" was aware of the liquidity puts and super senior tranches "as early as April 2007"), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21605.htm, *archived at* http://perma.cc/Q2MR-4LVA; Jessica Silver-Greenberg, *Citigroup in $590 Million Settlement of Subprime Lawsuit*, N.Y. TIMES, Aug. 30, 2012, at B4 (reporting on Citigroup's payment of $590 million to settle the shareholder lawsuit). Citigroup's chief financial officer, Gary Crittenden, and its head of investor relations, Arthur Tildesley, paid a total of $180,000 to settle SEC charges arising out of the same alleged disclosure violations. However, the SEC did not file charges against Prince, Rubin or other senior executives of Citigroup. SEC Administrative Release No. 34-62593, July 29, 2010 (announcing settlement of SEC charges against Crittenden and Tildesley), *available at* http://www.sec.gov/litigation/admin/2010/34-62593.pdf, *archived at* http://perma.cc/7PVM-94SA.

285. Dash & Creswell, *supra* note 2.

286. FCIC REPORT, *supra* note 4, at 138-39, 196-97.

287. *Id.*; Dash & Creswell, *supra* note 2 (quoting unnamed banker who with Citigroup's CDO group); *see also supra* note 247 and accompanying text (describing the very high compensation paid to Maheras, Barker and the co-heads of Citigroup's global CDO business); *infra* notes 382-83 and accompanying text (discussing the very high compensation received by Prince and Rubin).

288. GASPARINO, BLOOD ON THE STREET, *supra* note 86, at 190-91 (suggesting that Rubin saw risk-taking in Citigroup's capital markets operations as "Citi's sole savior" and "a tool to grow profits"); Riley, *supra* note 155, at A2 (reporting that Prince "expected to boost competitiveness at [Citigroup's] investment bank this year," and "[s]ince 2004, Citigroup's corporate and investment bank has served as a revenue growth engine for the company"); Der Hovanesian, *supra* note 155, at 41 (reporting on Prince's claim in October 2006 that "investments he made three years ago in Citi's capital markets business are now paying off nicely"); *see also supra* notes 152-53, 155-57 (discussing Prince's repeated pledges to produce larger earnings through "organic growth," especially in Citigroup's capital markets operations, to satisfy Wall Street's demands for higher profits).

company's main profit engine" in the second quarter of 2007, when the unit reported what appeared to be record results for revenues and net income.[289] Similarly, Citigroup's capital markets and investment banking operations reported strong revenues and earnings during the first quarter of 2007, and Prince publicly expressed his "thanks and gratitude" to Citigroup's traders.[290] Thus, Citigroup's top executives tolerated aggressive risk-taking by Maheras and his subordinates because they viewed the investment bank as "the key to Citigroup meeting Wall Street's quarterly profit expectations."[291]

5. Citigroup Assumed Major Risks in Syndicating Corporate Loans for Leveraged Buyouts.—Citigroup was a leading provider of loans for corporate leveraged buyouts (LBOs).[292] Large commercial and investment banks underwrote about $5 trillion of leveraged loans between 2003 and 2007, and many of those loans were used to help finance $1.8 trillion of LBOs that were completed in global markets between 2004 and 2007.[293] More than a tenth of those leveraged loans were pooled to create collateralized loan obligations (CLOs), which sold CLO securities to investors around the world.[294]

As the LBO boom reached its peak between 2004 and mid-2007, the quality of leveraged loans declined and their risks increased sharply.[295] Only 10% of leveraged loans that were issued between 2000 and 2003 carried the most risky credit rating ("CCC").[296] However, the percentage of CCC-rated leveraged loans rose above 40% in 2004 and reached 50% in 2006.[297] During the height of the LBO boom, Citigroup and other banks underwrote large amounts of leveraged loans that contained interest-only, "covenant lite," and "payment in kind" features, all of which imposed greater risks on the lenders.[298]

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289. David Enrich, *Citigroup Shows Its Strength: Investment Bank Powers 18% Jump in Earnings, Easing Pressure on CEO*, WALL ST. J., July 21, 2007, at A3.

290. Tim Mazzucca, *1Q Earnings: Upbeat Sign: Citi's Revenue Outgains Costs*, AM. BANKER, Apr. 17, 2007, at 19.

291. Robin Sidel & David Enrich, *Citigroup CEO Shakes Up Ranks: Prince Taps Pandit to Run Merged Investments Unit; Veteran Maheras Departs*, WALL ST. J., Oct. 12, 2007, at A3 (reporting on the departure of Thomas Maheras, co-head of the investment bank, after Citigroup reported significant trading losses, and noting that Maheras had "spearheaded Citigroup's push to trade a broader array of products" and "had been considered a potential successor to Mr. Prince").

292. DEALBOOK, *Citi Chief on Buyouts: 'We're Still Dancing,'* N.Y. TIMES (Jul. 10, 2007), http://dealbook.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing/, *archived at* http://perma.cc/USR4-92BS.

293. Wilmarth, *Dark Side*, *supra* note 183, at 1039-40.

294. *Id.* at 990-91 (describing CLOs as a type of CDO backed by syndicated leveraged corporate loans); *id.* at 1039 (stating that between $500 billion and $700 billion of leveraged loans were packaged into CLOs between 2002 and 2007).

295. FCIC REPORT, *supra* note 4, at 174-75.

296. Wilmarth, *Dark Side*, *supra* note 183, at 1040.

297. *Id*.

298. *Id.* at 1040-41 (explaining that (i) interest-only loans allowed borrowers to defer repayments of principal, (ii) "covenant-lite" loans exempted borrowers from standard covenants

As I noted in a previous article, "[t]he risky features of leveraged loans during the LBO boom resembled the interest-only, negative amortization and low- or no-documentation provisions of nonprime residential mortgages that [large financial institutions] issued during the simultaneous housing boom."[299] The "spread" between interest rates for leveraged loans and interest rates for low-risk debt like Treasury bonds or interbank loans fell to record low levels in early 2007, thereby indicating that lenders were underestimating the inherent risks of leveraged loans.[300]

Demand by investors for leveraged loans began to decline during the second quarter of 2007.[301] Citigroup and other major banks tried to offset weak investor demand by making "bridge loans" that provided "temporary financing for LBOs until investors could be found to purchase the requisite number of leveraged loans and junk bonds" to complete the deals.[302] Bridge loans helped Citigroup and other lenders to generate fees by completing additional LBO deals. However, bridge loans created the same type of retention risks that Citigroup assumed when it provided liquidity puts and kept super senior tranches on its balance sheet in order to complete CDO deals.[303]

Citigroup ranked third among underwriters of leveraged loans in 2007, a very significant rise from its thirteenth place ranking in 1999.[304] In early 2007, Citigroup's senior management decided to double the bank's portfolio limits for leveraged loans "in pursuit of earnings" and also to defend Citigroup's leading position in the leveraged-loan market.[305] Citigroup's regulators subsequently determined that "Citigroup's risk appetite was to maintain its 15-20% market share . . . As far as leveraged lending was concerned, Citigroup believed it had to be in all the roughly 6-7 mega deals that were put together in 2007, to maintain

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that typically would have limited the amount of their outstanding debt and mandated minimum levels of cash flow coverage and interest payment coverage, and (iii) payment-in-kind loans allowed borrowers to defer paying interest by issuing new debt to cover accrued interest).

299. *Id.* at 1041. Thus, "[a]s a practical matter, the LBO financing packages underwritten by [large financial institutions] represented the same kind of 'Ponzi finance' as nonprime residential mortgages, because many LBO firms and homeowners with nonprime mortgages could not satisfy their debts unless they were able to refinance those debts on more favorable terms." *Id.*

300. FCIC REPORT, *supra* note 4, at 174-75; Henny Sender & Serena Ng, *Market Pressures Test Resilience of Buyout Boom*, WALL ST. J., June 8, 2007, at A1.

301. Robin Sidel et al., *Banks on a Bridge Too Far? As Risk Rises in LBOs, Investors Start to Balk*, WALL ST. J., June 28, 2007, at C1; Sender & Ng, *supra* note 300.

302. Wilmarth, *Dark Side*, *supra* note 183, at 1042; Sidel et al., *supra* note 301.

303. Wilmarth, *Dark Side*, *supra* note 183, at 1042.

304. Bradley Keoun, *Citigroup Slips After 10 Years as Biggest U.S. Bank (Update 2)*, BLOOMBERG, Mar. 24, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a0w.04p3qtyY&refer=finance, *archived at* http://perma.cc/8ZGJ-HND2; *see also* Sidel et al., *supra* note 301 (reporting that JPMorgan Chase, Citigroup and Bank of America were "the biggest players in the leveraged-loan business").

305. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2, 4.

its market leadership."[306]

At the end of June 2007, the credit markets were unsettled by the threatened collapse of two hedge funds managed by Bear Stearns ("Bear").[307] Both hedge funds had invested heavily in subprime mortgage-related securities, including CDOs underwritten by Citigroup.[308] Analysts saw the problems at Bear's hedge funds as "emblematic of the widening fallout from the nation's housing downturn,"[309] and reporters noted that "investors were wondering how much longer the era of easy corporate credit can last."[310]

Notwithstanding growing concerns about the viability of LBO deals, Chuck Prince denied rumors that Citigroup was "pulling back" from those deals in an interview published in the *Financial Times* on July 9, 2007.[311] In that interview, Prince gave his now-famous explanation of why Citigroup remained fully committed to providing LBO loans: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[312]

Prince also declared that "[t]he depth of the pools of liquidity is so much larger than it used to be that a disruptive event now needs to be much more disruptive than it used to be."[313] He pointed out that "big Wall Street banks" were acquiring "troubled subprime mortgage lenders," thereby providing "an example of how 'liquidity rushes in' to fill the gap as others spot a buying opportunity."[314] Prince's comments indicated that Citigroup viewed its continued commitment to leveraged lending as a risk-taking "opportunity" that was similar to Citigroup's misguided decision to acquire Argent (the parent company of subprime lender

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306. *Id.* at 6.

307. Michael Hudson, *Stock Market Quarterly Review: Is Corporate-Credit Party Almost Over?*, WALL ST. J., July 2, 2007, at C5, *available at* http://search.proquest.com/docview/399080199/C40C4FAA2BF942B3PQ/75?accountid=11243.

308. Kate Kelly et al., *Two Big Funds At Bear Stearns Face Shutdown: As Rescue Plan Falters Amid Subprime Woes, Merrill Asserts Claims*, WALL ST. J., June 20, 2007, at A1, *available at* http://search.proquest.com/docview/399090137/A53B6F6CEA1541C6PQ/9?accountid=11243.

309. *Id*.

310. Hudson, *supra* note 307.

311. Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-outs*, FT.COM, July 9, 2007.

312. *Id.*

313. *Id.* (reporting that Prince acknowledged that "[a]t some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go other way"; however, Prince added, "I don't think we're at that point.").

314. *Id.*; *see also* Wilmarth, *Dark Side*, *supra* note 183, at 1018, 1018 n.273 (describing how large commercial and investment banks purchased "nonbank subprime lenders in 2006 and 2007, as nonbank lenders encountered increasing problems with delinquencies and defaults," including Bear Stearns' acquisition of Encore Credit, Morgan Stanley's purchase of Saxon Mortgage, Deutsche Bank's acquisition of Mortgage IT, Merrill Lynch's purchase of First Franklin, and Citigroup's acquisition of Argent).

Ameriquest) in September 2007.[315]

Prince reaffirmed Citigroup's confidence and its commitment to leveraged lending in another interview published in the *New York Times* in early August.[316] Prince acknowledged that "[w]e see a lot of people on the Street who are scared," but he insisted, "We are not scared. We are not panicked. We are not rattled. Our team has been through this before."[317] Despite the "disruption" that many perceived in the credit markets, Prince maintained that "[w]hat we are seeing now is a pullback into a range of more normal kinds of credit experiences."[318] He added—in a comment that ranks alongside his "still dancing" statement of the previous month—"I think our performance is going to last much longer than the market turbulence does."[319]

At the time Prince made his bullish statements about leveraged lending, he recognized the dangers created by the overheated LBO market and declining standards for leveraged loans.[320] Prince attended a dinner with then-Treasury Secretary Hank Paulson on June 26, 2007.[321] Prince asked Paulson "whether given the competitive pressures there wasn't a role for regulators to tamp down some of the riskier practices," and "isn't there something you can do to order us not to take all these risks?"[322] Thus, Prince clearly understood the grave risks lurking in the LBO market, but Citigroup did not pull back from leveraged lending until the LBO market collapsed.[323]

Prince was not alone in having misgivings about leveraged lending or in failing to act on them. In a May 2007 speech, Bank of America ("BofA") CEO Kenneth Lewis admitted that "[w]e are close to a time when we'll look back and say we did some stupid things. . . . We need a little more sanity in a period in which everyone feels invincible and thinks this is different."[324] However, in the same speech Lewis boasted that BofA had participated in seven of the fifteen largest LBO deals during 2006, and he also declared, "There is tremendous value in being able to provide a strong balance sheet to arrange large, complex financial transactions."[325]

Thus, Prince and Lewis were both willing to keep dancing as long as the LBO band kept playing. Given their decisions to continue financing LBO deals despite

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315. *See supra* notes 179-81 and accompanying text (discussing Citigroup's disastrous acquisition of Argent).

316. Eric Dash, *Is the Dance Over? Citigroup Is Upbeat*, N.Y. TIMES, Aug. 3, 2007, at C1.

317. *Id.*

318. *Id.*

319. *Id.*

320. THOMAS G. STANTON, WHY SOME FIRMS THRIVE WHILE OTHERS FAIL: GOVERNANCE AND MANAGEMENT LESSONS FROM THE CRISIS 116 (2012).

321. *Id.*

322. *Id.* at 166 (quoting Mr. Prince).

323. *Id.*

324. Greg Ip, *Fed, Other Regulators Turn Attention to Risk in Banks' LBO Lending*, WALL ST. J., May 18, 2007, at C1.

325. *Id.*

their clear appreciation of the risks, it is not surprising that Citigroup and BofA were both forced to accept massive bailouts from the Troubled Asset Relief Program ("TARP"), and to rely on extensive liquidity support from the Federal Reserve.[326]

By September 2007, the markets for LBO funding had largely shut down.[327] At that point, Citigroup was left holding commitments to provide $69 billion of leveraged loans for LBO transactions.[328] Citigroup's LBO pledges represented a very significant share of the $300 to $400 billion in outstanding commitments by leveraged lenders in late 2007.[329] Through write-offs and sales to hedge funds and private equity funds, Citigroup reduced its leveraged-lending commitments to $43 billion at the end of 2007 and $26 billion at the end of April 2008.[330] Even so, as discussed below, Citigroup's leveraged-lending spree contributed to the

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326. *See infra* notes 336-49 and accompanying text (noting that Citigroup received $45 billion of TARP capital infusions and more than $300 billion of asset guarantees from the federal government); OFF. SPECIAL INSPECTOR GEN. TARP ("SIGTARP"), EMERGENCY CAPITAL INJECTIONS PROVIDED TO SUPPORT THE VIABILITY OF BANK OF AMERICA, OTHER MAJOR BANKS, AND THE U.S. FINANCIAL SYSTEM, SIGTARP-10-001 (Oct. 5, 2009) 1-2, 26-29 (explaining that BofA received $45 billion of TARP capital infusions, and federal regulators agreed to provide almost $120 billion in asset guarantees to BofA) [hereinafter "SIGTARP BofA Assistance Report"], *available at* http://www.sigtarp.gov/Audit%20Reports/Emergency_Capital_Injections_Provided_to_Support_the_Viability_of_Bank_of_America.pdf, *archived at* http://perma.cc/K82F-WN44. Citigroup and BofA also ranked second and third among financial institutions that received the largest amounts of emergency liquidity assistance from the Federal Reserve. Citigroup and BofA obtained $99.5 billion and $91.4 billion of emergency loans, respectively, and those amounts were exceeded only by the $107.3 billion that the Federal Reserve provided to Morgan Stanley. Bradley Keoun & Phil Kuntz, *Wall Street Aristocracy Got $1.2 Billion in Secret Fed Loans*, BLOOMBERG.COM, Aug. 22, 2011).

327. Dana Cimilluca & David Enrich, *Deal-Making Ties Unravel: Underwriters Retreating from Backing Buyouts*, WALL ST. J., Sept. 18, 2007, at C1; Dennis K. Berman, *Mood Swing: Deal Boom Fizzles as Cheap Credit Fades; Wall Street Mulls End of Golden M&A Era*, WALL ST. J., Sept. 6, 2007, at A1; Tom Lauricella, *Credit Crunch: Investors Flee Bank-Loan Funds*, WALL ST. J., Aug. 24, 2007, at C2; Shawn Tully, *Why the Private Equity Bubble Is Bursting*, FORTUNE, Aug. 20, 2007, at 30; *see also* FCIC REPORT, *supra* note 4, at 175 (explaining that the leveraged-lending market shut down soon after the subprime CDO market collapsed in the summer of 2007).

328. Pierre Paulden & Cecile Gutscher, *Pandit's "Closer to End" Means No Escaping LBO Loans (Update 4)*, BLOOMBERG.COM, Apr. 29, 2008 (providing figure for Citigroup in the fall of 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a73YZLrx84jQ&refer=bond, *archived at* http://perma.cc/7X9G-ZT63.

329. *Id.*; FCIC REPORT, *supra* note 4, at 175 (indicating that about $300 billion of commitments for LBO loans were outstanding in the fall of 2007); *compare* Wilmarth, *Dark Side*, *supra* note 183, at 1042 (stating that "nearly $400 billion of commitments to provide bridge financing for pending LBOs" were outstanding in the fall of 2007).

330. David Reilly, *Banks Use Quirk as Leverage Over Brokers in Loan Fallout*, WALL ST. J., Feb. 27, 2008, at C1 (providing figure for end of 2007); Paulden & Gutscher, *supra* note 328 (providing figure for end of April 2008).

very large losses that the bank reported between the fourth quarter of 2007 and the end of 2008.[331]

B. Prince's and Rubin's Aggressive Strategy Inflicted Huge Losses on Citigroup and Forced Citigroup to Accept Three Bailouts from the Federal Government

Citigroup's high-risk lending and capital markets activities produced massive losses between the summer of 2007 and the spring of 2010.[332] During that period, Citigroup recorded more than $130 billion in credit losses and write-downs on investments, a lamentable record that was exceeded only by Fannie Mae.[333] Chuck Prince resigned as CEO at the end of October 2007, after Citigroup publicly disclosed losses of about $10 billion on its subprime and CDO assets.[334] From the fourth quarter of 2007 through the end of 2009, Citigroup reported total net losses of almost $40 billion.[335]

Citigroup received its first government bailout on October 14, 2008.[336] On that date, the Treasury Department announced that it would buy $25 billion of Citigroup's preferred stock as part of Treasury's first round of TARP capital infusions into nine major banks.[337] Vikram Pandit, Citigroup's new CEO, eagerly welcomed Treasury's assistance because it provided "very cheap capital" to Citigroup.[338]

The federal government's first bailout was not sufficient to persuade the

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331. *See infra* notes 350-51 and accompanying text.

332. *See infra* Part II.A.

333. VIRAL V. ACHARYA ET AL., REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 147 (Tbl. 6.1) (Viral V. Acharya et al., eds. 2011) (showing that Citigroup recorded "Write-Downs and Credit Losses" of $130.4 billion between June 2007 and March 2010, a total that was exceeded only by Fannie Mae).

334. FCIC REPORT, *supra* note 4, at 265; Robin Sidel et al., *Two Weeks That Shook the Titans of Wall Street*, WALL ST. J., Nov. 9, 2007, at A1; Bradley Keoun & Edgar Ortega, *Weill's Profit Machine Breaks Down on Citi Writedowns (Update 6)*, BLOOMBERG.COM, Nov. 5, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ausU0j47QGsE&refer=home, *archived at* http://perma.cc/NEV8-XE8D.

335. Collins & Peters, *supra* note 11 (reporting that Citigroup incurred a net loss of $9.8 billion during the fourth quarter of 2007); Keoun, *supra* note 10 (reporting that Citigroup incurred a net loss of $27.7 billion during 2008 and a further net loss of $1.6 billion during 2009).

336. DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 236-40 (2009).

337. *Id.*; SIGTARP, EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC. 5 (2011) [hereinafter SIGTARP Citigroup Assistance Report], *available at* http://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf, *archived at* http://perma.cc/EFJ9-JHNY.

338. WESSEL, *supra* note 336, at 238-39 (quoting Mr. Pandit and noting that Treasury's terms for TARP preferred stock were "generous," including a dividend rate of only 5% for the first five years).

financial markets that Citigroup could survive the financial crisis.[339] On October 16, 2008, Citigroup reported a fourth consecutive net quarterly loss after incurring $13 billion of loan losses and write-downs on investments, bringing its total credit losses and write-downs to more than $70 billion since the summer of 2007.[340] In November 2008, Citigroup's stock price was undercut by significant short selling, and its "share price fell from around $13.99 at the market's close on November 3, 2008, to $3.05 per share on November 21, 2008, before closing that day at $3.77."[341] The cost of buying CDS protection against a default on Citigroup's outstanding debt rose sharply during the same period, indicating that "the market was increasingly concerned that Citigroup would not be able to make good on its debts."[342] In mid-November, depositors, investors, lenders, and other counterparties began to "'pull back from Citigroup' [sic] because of perceived decline in the bank's creditworthiness."[343]

From November 20 to 23, 2008, federal regulators reviewed Citigroup's rapidly deteriorating financial health.[344] Citigroup's management submitted a proposal for "additional Government assistance" on November 22.[345] The Fed, FDIC, and Treasury concluded that Citigroup would collapse without further help, and such a collapse would have "implications that reached beyond the bank itself, including serious adverse effects on domestic and international economic conditions and financial stability."[346] Based on those findings, Treasury Secretary Paulson issued a "Systemic Risk Determination,"[347] which authorized the federal government to provide extraordinary assistance to prevent Citigroup's failure and thereby protect all of its depositors and other creditors.[348]

The second bailout of Citigroup included (i) the Treasury's use of TARP funds to purchase an additional $20 billion of preferred stock from Citigroup and (ii) an agreement by the Treasury, FDIC, and New York Fed to protect Citigroup against catastrophic losses from a pool of more than $300 billion of the bank's troubled assets.[349] As originally proposed, Citigroup's troubled asset pool would

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339. *See infra* notes 340-43 and accompanying text.

340. Bradley Keoun & Josh Fineman, *Citigroup Posts Fourth Consecutive Loss on Writedowns (Update 2)*, BLOOMBERG.COM, Oct. 16, 2008.

341. SIGTARP Citigroup Assistance Report, *supra* note 337, at 8.

342. *Id.* at 9.

343. *Id.* at 11.

344. *Id.* at 13-14.

345. *Id.* at 13-16.

346. *Id.*

347. *Id.* at 15 (stating that Mr. Paulson consulted with President Bush before making his Systemic Risk Determination, and that Mr. Paulson concluded, "If Citi isn't systemic, I don't know what is.").

348. *Id.*; *see also* Wilmarth, *Dodd-Frank*, *supra* note 231, at 1001 (describing the "systemic risk exception" contained in 12 U.S.C. § 1823(c)(4)(G) (2012), under which "the Treasury Secretary can authorize the FDIC to provide full protection to uninsured creditors of a bank in order to avoid or mitigate 'serious effects on economic conditions or financial stability'.").

349. SIGTARP Citigroup Assistance Report, *supra* note 337, at 17-22 (explaining that

have included $85 billion of second-lien mortgages (including unfunded loan commitments), $57 billion of subprime and Alt-A mortgages held by Citigroup's retail mortgage business, $17.1 billion of subprime and Alt-A mortgages held in Citigroup's securitization warehouse, $12.2 billion of CDO assets, $8.6 billion of assets from SIVs, and $16.3 billion of leveraged loans.[350] Thus, Citigroup remained exposed in November 2008 to massive losses from its high-risk activities, including nonprime lending, CDOs, and leveraged lending, even though Citigroup had already recorded more than $70 billion of write-downs and losses on those assets.[351]

The second bailout of Citigroup also proved to be inadequate to stabilize the company. On January 16, 2009, Citigroup announced a fifth consecutive quarterly net loss after recording "a staggering $25.2 billion in write-offs and losses in both its consumer and investment bank."[352] The new write-offs and losses more than offset the $20 billion capital infusion that Citigroup received from Treasury in the second bailout. Citigroup's tangible common equity ("TCE") declined to 1.5% of its total assets, and its share price fell to a 16-year low of $3.50 per share as Citigroup's losses "wiped out any margin for error that

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Citigroup agreed to assume a "first loss position" of $39.5 billion on the $300 billion pool of troubled assets and "to absorb 10% of any losses in excess of $39.5 billion," while the Treasury, FDIC and New York Fed provided various protections to guarantee Citigroup against further losses on those assets); *see also* SHEILA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 122-26 (2012) (describing the FDIC's participation in the second bailout of Citigroup).

350. As shown by the FDIC's summary of the original proposal for Citigroup's troubled asset pool, the subprime and Alt-A mortgages held as "mark-to-market" assets in Citigroup's securitization warehouse had been written down from their original value of $29.2 billion, while Citigroup's CDO assets, SIV assets and leveraged loans had been written down from their original values of $23.4 billion, $12.4 billion and $22.1 billion, respectively. In addition, the originally proposed troubled asset pool included $37 billion of commercial real estate loans, $29.1 billion of loans to the "Big 3" automakers, $19.7 billion of retail auto loans, $11 billion of "prime" mortgages for securitization, $9.5 billion of auction-rate securities, and $4.5 billion of exposures to monoline insurance companies. *See* Memorandum from James R. Wigand and Herbert J. Held to the FDIC Board of Directors regarding Citibank and Citigroup 3 ("Ring Fenced Portfolio" Tbl.) (Nov. 23, 2008) *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-11-23%20Memo%20to%20the%20FDIC%20Board%20fromJames%20R.%20Wigand%20and%20Herbert%20J.%20Held%20re%20recommendation%20for%20systemic%20risk%20determination%20for%20Citigroup.pdf, *archived at* http://perma.cc/FA5H-YX4S.

351. *See* Keoun & Fineman, *supra* note 340 and accompanying text (reporting that Citigroup incurred more than $70 billion of write-downs and loan losses between the summer of 2007 and October 2008). Federal regulators and Citigroup subsequently revised the composition of the troubled asset pool by eliminating CDOs, reducing the amount of commercial real estate loans and loans to automakers, and increasing the amount of residential mortgage loans. SIGTARP Citigroup Assistance Report, *supra* note 337, at 27-29.

352. Eric Dash, *Citigroup's Big Losses and Breakup Plan*, N.Y. TIMES, Jan. 16, 2009, at B8 (stating that Citigroup reported a net loss of $8.29 billion for the fourth quarter of 2008).

Citi might have to . . . weather the storm."[353]

Treasury announced in February 2009 that it would provide a third bailout to boost Citigroup's TCE and reassure investors.[354] In that transaction (which was completed in June 2009), the Treasury converted $25 billion of its preferred stock into common stock at a price of $3.25 per share, while other Citigroup shareholders converted $33 billion of their preferred stock into common stock on the same terms.[355] As a result, Citigroup's TCE increased significantly, and the federal government became the owner of 33.6% of Citigroup's common stock.[356]

Citigroup's condition stabilized after the third bailout, and it agreed with federal regulators on a two-part plan to remove the government's ownership stake in the bank.[357] First, in December 2009, Citigroup repurchased $20 billion of preferred stock held by the Treasury.[358] Second, from April through December 2010, the Treasury sold its holdings of Citigroup common stock in a series of transactions.[359]

In addition to its three TARP-financed bailouts, Citigroup received large amounts of additional help from the federal government. The Fed provided

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353. Bradley Keoun & Josh Fineman, *Citigroup's Pandit Tries to Save the Little That's Left to Lose*, BLOOMBERG.COM, Jan. 17, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aN81uQ4nU4e8, *archived at* http://perma.cc/TBR2-TCL7 (quoting James Ellman, president of money manager Seacliff Capital LLC).

354. SIGTARP Citigroup Assistance Report, *supra* note 337, at 30-31; SIGTARP, EXITING TARP: REPAYMENTS BY THE LARGEST FINANCIAL INSTITUTIONS 36-37 (2011) [hereinafter SIGTARP Exit Report], *available at* http://www.sigtarp.gov/Audit%20Reports/Exiting_TARP_Repayments_by_the_Largest_Financial_Institutions.pdf, *archived at* http://perma.cc/X76S-P4AC; David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout—Government Puts Itself on Hook for More Losses*, WALL ST. J., Feb. 28, 2009, at B1; Bradley Keoun & Rebecca Christie, *Citi Gets Third Rescue as U.S. Plans to Raise Stake (Update 2)*, BLOOMBERG.COM, Feb. 27, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=as8R7HbWch.o&refer=home, *archived at* http://perma.cc/D53K-LM58.

355. SIGTARP Citigroup Assistance Report, *supra* note 337, at 30.

356. SIGTARP Exit Report, *supra* note 354, at 37; David Enrich et al., *Citi Deal Clears Way for Greater U.S. Sway*, WALL ST. J., June 10, 2009, at C1; Josh Fineman, *Asia Day Ahead: Citigroup Begins $58 Billion Share Conversion*, BLOOMBERG.COM, June 11, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOe5cAa0zTGI, *archived at* http://perma.cc/J24B-Q3YV; *see also* BAIR, *supra* note 349, at 165-73 (describing the FDIC's involvement in negotiations for the third bailout of Citigroup).

357. SIGTARP Exit Report, *supra* note 354, at 34.

358. *Id.* at 37.

359. *Id.* at 42-43; Bradley Keoun, *Citigroup to Repay $20 Billion of Government Bailout (Update 2)*, BLOOMBERG.COM, Dec. 14, 2009, http://www.businessweek.com/bwdaily/dnflash/content/dec2009/db20091214_757347.htm, *archived at* http://perma.cc/54C-2FSY; Aaron Lorenzo, *Capital Purchase Program: Treasury Completes Common Citigroup Stock Divestiture; Bailout Profit Rises to $12 Billion*, 95 BANKING REP. (BNA) 1069 (2010); *see also* BAIR, *supra* note 349, at 205-06 (describing the FDIC's involvement in negotiations related to Citigroup's repurchase in December 2009 of $20 billion of preferred stock held by the Treasury).

emergency loans to Citigroup that peaked at $99.5 billion in January 2009 (an amount exceeded only by Morgan Stanley).[360] Citigroup also issued $64.6 billion of debt that was guaranteed by the FDIC under the Temporary Liquidity Guarantee Program ("TLGP").[361] Citigroup was the largest issuer of FDIC-guaranteed debt and therefore received the greatest subsidy under that program.[362] Moreover, Citigroup sold $32.7 billion of commercial paper (short-term debt) to the Fed's Commercial Paper Funding Facility ("CPFF"), which placed Citigroup among the top ten participants in the CPFF.[363] The fact that Citigroup was compelled to draw on such massive amounts of assistance from multiple federal programs demonstrated the drastic nature of Citigroup's predicament in 2008 and 2009.

III. CITIGROUP'S COLLAPSE REVEALED FAR-REACHING FAILURES BY ITS MANAGERS AND REGULATORS

A. Managerial Failures Were a Fundamental Cause of Citigroup's Devastating Problems

As described above, Citigroup experienced repeated problems and reported enormous losses during the first decade of its existence. Sandy Weill stepped down as CEO in 2003 after presiding over a long series of scandals that included Enron and WorldCom.[364] After taking the reins from Weill, Chuck Prince and Robert Rubin pursued a high-risk growth strategy that produced catastrophic losses and forced Citigroup to accept three bailouts from the federal government.[365] As shown below, federal regulators and outside analysts identified two major shortcomings by Citigroup's senior executives and business unit managers during the period leading up to the financial crisis: (1) a single-minded focus on revenue growth that ignored the risks created by Citigroup's aggressive expansion into speculative activities, and (2) a failure to establish and implement an effective risk management system.

1. Citigroup's Obsession with Revenue and Profit Growth.—As noted above, Prince and his management team were under constant pressure from Wall Street

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360. Keoun & Kuntz, *supra* note 326.

361. CONGRESSIONAL OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 6-9, 35-39, 58-63, 74-75, 76 (Fig. 10) (2009), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT53348/pdf/CPRT-111JPRT53348.pdf, *archived at* http://perma.cc/X3D5-34U6 (describing the TLGP).

362. *Id.* at 76 (fig. 11) (showing that Citigroup issued the largest amount—$64.6 billion—of FDIC-guaranteed debt under the TLGP, followed by BofA with $44 billion of such debt).

363. Linus Wilson & Yan Wendy Wu, *Does Receiving TARP Funds Make it Easier to Roll Your Commercial Paper onto the Fed?*, J. ECON. LIT., Aug. 22, 2011, at 3-4, 29 (Tbl. 7, Panel A) (showing that Citigroup sold the tenth-largest amount of commercial paper to the Fed under the CPFF).

364. *See supra* Part I.B.

365. *See supra* Part II.

analysts and investors to produce consistent improvement in Citigroup's profitability.[366] In response to that pressure, Citigroup's executives gave top priority to increasing revenues and earnings and ignored the risks created by the bank's strategy of rapid growth.[367] The OCC determined that Citigroup's management "was focused on short-term performance and profitability along with achieving top industry rankings across many major products rather than on risk or potential loss."[368] In the OCC's view, Citigroup's CDO problems resulted from "a fundamental strong push for generating income. The apparent need to generate quarterly income triggered a ramping up in [CDO] risk exposure."[369] Similarly, the New York Fed observed that "[m]anagement's focus was primarily on revenue generation until it became clear that the credit market conditions had changed so significantly that the ability of the business to operate in a 'business as usual' mode was being seriously disrupted."[370] Thus, Citigroup's regulators agreed that the bank's senior management consciously adopted a policy of taking greater risks in order to produce "earnings growth."[371]

The Fed and the OCC determined that Citigroup's executives focused on expanding its leveraged lending and CDO businesses while overlooking the potential hazards of both activities. For example, Citigroup's managers approved increases in "pipeline limits" for leveraged loans (i.e., risk ceilings on loan commitments that Citigroup had not yet sold to investors) from $35 billion in June 2005 to $100 billion in March 2007.[372] Management allowed the leveraged

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366. *See supra* notes 152-53, 155-57 and accompanying text.

367. *See infra* Part II.A.

368. Letter from John C. Lyons, Examiner-in-Charge, to Vikram Pandit, Citigroup CEO, Comptroller of the Currency 2 (Feb. 14, 2008) [hereinafter OCC 2008 Citigroup Exam Report], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-02-14_OCC_Letter_from_John_C_Lyons_to_Vikram_Pandit_Serious_Problems_at_Citibank.pdf, *archived at* http://perma.cc/EPE8-D3FT.

369. Memorandum from Michael Sullivan and Ron Frake to John Lyons, OCC Examiner-in-Charge, *Subprime CDO Valuation and Oversight Review – Conclusion Memorandum* (Jan. 17, 2008) at 3 [hereinafter OCC 2008 Citigroup CDO Memo], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2008-01-17_OCC_Letter_from_Michael_Sullivan_and_Ron_Frake_to_John_Lyons_Re_Subprime_CDO_Valuation_and_Oversight_Review_Conculsion_Memorandum.pdf, *archived at* http://perma.cc/4WBJ-6B38.

370. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 8; *see also* Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 7 (stating that "Citigroup focus had been on earnings growth and not balance sheet utilization. This focus on earnings growth was also not risk adjusted.").

371. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 5 ("Citigroup's Board of Directors approved the Management plan accepting [that] Citigroup 'needed to take on more risk.' . . . [M]anagement acknowledged that internal incentives focused too much on earnings growth and not enough on balance sheet usage."); *see also* BAIR, *supra* note 349, at 122 ("Citi had essentially bought into all the gimmicks to generate short-term profits: poorly underwritten loans, high-risk securities investments, and short-term, unstable liquidity.").

372. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2-3.

loan "pipeline" to grow rapidly in order "to maintain league leadership positions."[373] Meanwhile, "underwriting standards [for leveraged loans] were allowed to be diluted with senior management's acquiescence in an effort to remain a leader within the industry."[374]

Based on a similar desire to boost profits, Citigroup's executives decided to retain the "super senior" tranches of CDOs because these CDOs were "hard to sell in the primary issuance market[s] . . . and the bank was reluctant to give up some of the [deal] inception profits."[375] Regulators confirmed that Citigroup relied on an "originate to distribute" strategy for both CDO tranches and leveraged loans, and management ignored the risks that Citigroup would face if it could not sell its loan commitments or CDO tranches at prices close to their face values.[376] Regulators concluded that Citigroup "did not have meaningful hedges. Risk management believed that the leverage lending exposures would be syndicated and the CDO exposures would be sold."[377]

Citigroup's compensation policies encouraged excessive risk-taking by top executives, business unit managers, and traders.[378] In his testimony before the FCIC, Prince acknowledged that "[t]he compensation structure on Wall Street is one that many people have criticized over the years. It is for traders, for bankers and so forth, a compensation model that is based on revenue growth, not even profit growth."[379] Citigroup evidently followed a similar compensation model despite the flaws recognized by Prince. According to one news report, "[b]onuses doubled and tripled for CDO traders" as Citigroup's CDO business expanded, and one Citigroup banker said that "[a]s long as you could grow revenues, you could keep your bonus growing."[380]

Senior executives were the largest beneficiaries of Citigroup's policy of paying for growth. Sandy Weill received almost $1 billion in compensation from Travelers and Citigroup before he stepped down as Citigroup's chairman in April 2006.[381] Chuck Prince was awarded $158 million of cash and stock between 2003 and 2007, [382] while Robert Rubin received $126 million of cash and stock

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373. New York Fed 2007 Citigroup Exam Report, *supra* 251, at 6, 9.

374. *Id* at 3, 6.

375. OCC 2008 Citigroup CDO Memo, *supra* note 369, at 5; *see also* Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 6 ("[M]anagement found that it was unable to distribute the super-senior tranches at favorable prices. As management felt comfortable with the credit risk of these tranches, it began to retain large positions on balance sheet.").

376. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 3, 6-7, 8-9.

377. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 4.

378. *See supra* notes 247, 286-87 and accompanying text.

379. STANTON, *supra* note 320, at 85 (quoting Prince's testimony on April 8, 2010).

380. Dash & Creswell, *supra* note 2.

381. Roddy Boyd, *Sandy's Goodbye: Praise and Poems at Citi Giant's Farewell*, N.Y. POST, Apr. 19, 2006, at 33; *see also* O'Brien & Creswell, *supra* note 1 (reporting in September 2005 that "[o]ver the last decade, [Weill] has hauled in $953 million in compensation from the companies he has run").

382. Eric Dash, *Fixing Citigroup Will Test Rubin*, N.Y. TIMES, Nov. 5, 2007, at A1.

between 1999 and 2009.[383]

Business unit managers prospered as well. In 2006, Tom Maheras and Randy Barker (senior executives in Citigroup's investment bank) received combined pay of $55 million, while Nestor Dominguez and Janice Warne (co-heads of Citigroup's CDO unit) received total compensation of almost $15 million.[384] Several scholars have concluded that the very large cash and stock awards given by Citigroup and other large financial firms during the 2000s encouraged senior executives to take aggressive risks without adequate concern for the long-term viability of their companies.[385] In addition, anthropologist Karen Ho has suggested that Wall Street executives and traders focused on short-term, high-risk, high-return activities to compensate for the likelihood that they might have relatively short tenures in their positions.[386]

2. Citigroup's Failures in Risk Management.—Regulators found that Citigroup's risk management system was inadequate and ineffective for three main reasons. First, risk management "had insufficient authority or failed to exercise its authority to constrain business activities."[387] Citigroup's individual business units "possessed too much power, and independent risk management

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383. Eric Dash & Louise Story, *Rubin Leaving Citigroup; Smith Barney for Sale*, N.Y. TIMES, Jan. 9, 2009, at B1.

384. *See supra* note 247 and accompanying text.

385. *See, e.g.,* STANTON, *supra* note 320, at 84-87; Lucian Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 259-61, 273-77 (2010) (finding that the bonuses and stock awards given to the top executives of Bear Stearns and Lehman Brothers between 2000 and 2008 encouraged them to take excessive risks, because they received $1.4 and $1 billion of such compensation, and those amounts substantially exceeded the $300 million and $600 million of company stock they already held in 2000); Sanjai Bhagat & Brian J. Bolton, Misaligned Bank Executive Incentive Compensation 1-4, 17-21 (June 11, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2277917 (similarly concluding that the bonuses and stock awards given to CEOs of Citigroup and 13 other very large U.S. financial institutions between 2000 and 2008 encouraged them to pursue high-risk strategies, and noting that those CEOs collectively received net cash flow benefits that were $650 million higher than the losses they incurred from stock price declines during 2008); *see also* FCIC REPORT, *supra* note 4, at xix ("Compensation systems—. . . too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. . . . This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.").

386. STANTON, *supra* note 320, at 87 (quoting analysis by Ms. Ho, who pointed to the "rampant insecurity" resulting from "Wall Street's pay-for-performance bonus system" and argued that "bonuses are also seen [by bankers and traders] as symbols of coming to terms with the riskiness of their jobs"); *see also* FCIC REPORT, *supra* note 4, at 8 ("On Wall Street, where many of these [subprime] loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, 'I'll be gone, you'll be gone.' It referred to deals that brought in big fees up front while risking large losses in the future.").

387. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2.

was marginalized."[388] As a result, "risk management played the role more of enabling management to incur what proved to be untenable risks for the sake of profitability."[389] Thus, a crucial flaw was that "Independent Risk Management did not have sufficient stature . . . to be an effective control mechanism in limiting risk taking by the business lines."[390] In fact, Citigroup's senior risk officer did not report directly to the CEO until *after* the bank publicly disclosed major losses in November 2007.[391]

Second, Citigroup's risk managers relied on highly optimistic assumptions that ignored "tail risks" (i.e., the likelihood of extremely adverse outcomes).[392] For example, Citigroup's managers placed great weight on the "AAA" credit ratings assigned to super senior tranches of CDOs, and they did not consider the possibility that Citigroup (i) might be unable to sell its CDO tranches or leveraged loan commitments to investors, or (ii) might be forced to honor its liquidity puts or to bring SIV-held assets back onto its balance sheet.[393] Citigroup's risk limits for individual business units "did not address extreme scenarios that hit the tails," and Citigroup's risk managers admitted that they needed a "better understanding of tail events."[394] Similarly, "Citigroup did not perform comprehensive, firm-wide consolidated stress tests" in order to evaluate the impact of extreme outcomes on the entire bank.[395] All of these shortcomings were consistent with the regulators' finding that risk managers repeatedly granted

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388. OCC 2008 Citigroup CDO Memo, *supra* note 369, at 3; *see also* OCC 2008 Citigroup Exam Report, *supra* note 368, at 4 (stating that "decisions on risk . . . routinely deferred to the senior business unit management's wishes" because risk management did not have "the same level of authority and influence as the business units").

389. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2; *see also id.* at 3 ("In none of the major problem areas (subprime, leveraged lending, trading) did independent risk management play a discernible role in tamping down risk appetite or risk levels.").

390. NEW YORK FED 2007 CITIGROUP EXAM REPORT, *supra* note 251, at 7; *see also supra* notes 274-78 and accompanying text (discussing evidence that the independence of David Bushnell, Citigroup's chief risk officer, was compromised by his close friendship with Tom Maheras and Randy Barker, who were top executives in Citigroup's investment bank).

391. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 8 (noting that Citigroup's new senior risk officer "will report directly to the CEO. This is a higher stature than previously.").

392. *See infra* notes 393-95 and accompanying text.

393. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 6 ("Citigroup 'bought into the credit agency ratings'" and "saw holding Super Senior AAA tranches as remote disaster insurance"); *id.* at 4 ("Risk management believed that the leveraged lending exposures would be syndicated and CDO exposures would be sold"); *id.* at 10 ("management had no expectation that exposures could come back on balance sheet, nor was this captured in its funding or liquidity plans").

394. *Id.* at 13, 15. *See supra* notes 270, 279-80 and accompanying text (discussing chief risk officer David Bushnell's mistaken assumption that housing prices would have to fall by 30% nationwide before Citigroup would be exposed to losses on its super senior CDO tranches.).

395. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 14.

higher risk limits to accommodate the desire of senior executives and business unit managers for faster revenue growth.[396]

Third, due to Citigroup's highly fragmented structure, the bank "did not have an adequate, firm-wide consolidated understanding of its risk factor sensitivities."[397] By 2008, Citigroup was a sprawling financial conglomerate that held more than $2 trillion in assets, owned more than 2000 subsidiaries, operated in more than 100 countries, and employed more than 300,000 people.[398] Sandy Weill and Chuck Prince failed to integrate their many acquisitions into a coherent whole. Consequently, Citigroup's business units and foreign subsidiaries operated on a decentralized, quasi-independent basis, and those entities used multiple data processing systems that were not compatible and did not communicate with each other.[399] As banking analyst Meredith Whitney observed, "[Prince] inherited a gobbledygook of companies that were never integrated, and it was never a priority of the company to invest. The businesses didn't communicate with each other. There were dozens of technology systems and dozens of financial ledgers."[400]

Regulators found that the "decentralized nature of [Citigroup] created silos" and resulted in "[p]oor communication across businesses."[401] For example, the various business lines dealing with subprime mortgage-related assets–including consumer mortgage lending, securitization, CDO underwriting and CDO trading–did not share information effectively.[402] As a result, Prince and Rubin did not receive detailed information about Citigroup's total subprime-related exposures until September 2007.[403] Given those conditions, it was not surprising

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396. *Id.* at 2-6, 16; OCC 2008 Citigroup Exam Report, *supra* note 368, at 2-4.

397. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 3; *see also id.* at 7 ("Risk management did not adequately bring together total risk of [the] firm by risk factor.").

398. Josh Fineman, *Citigroup Falls to Lowest Since Bank Formed in 1998 (Update 1)*, BLOOMBERG.COM, July 15, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aDV0R9M9Edu4, *archived at* http://perma.cc/FX9X-U6G8 (providing data regarding assets, employees and foreign operations in 2008); *see also* STANTON, *supra* note 320, at 126 (tbl. 6.2) (showing that Citigroup had more than 2,400 subsidiaries at the end of 2006).

399. STANTON, *supra* note 320, at 125, 127; Lisa Kassenaar, *Citi Unravels as Reed Regrets Universal Model (Update 2)*, BLOOMBERG.COM, (July 21, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVwxSMeM0MnA, *archived at* http://perma.cc/M4TM-32PP; Bradley Keoun & Lisa Kassenaar, *Pandit Dismantles Weill Empire to Salvage Citigroup*, BLOOMBERG.COM, Jan. 14, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPe0BmS_BI_w, *archived at* http://perma.cc/WAF3-BNME.

400. Dash & Creswell, *supra* note 2 (quoting Ms. Whitney); *see also* BAIR, *supra* note 349, at 124 (stating that, in November 2008, "Citigroup's management information systems were so poor that [the FDIC] really couldn't be certain which operations were in [Citibank], and thus subject to the FDIC's powers, and which were outside the bank, and thus beyond our reach.").

401. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2.

402. *Id.* at 2, 4.

403. FCIC REPORT, *supra* note 4, at 260-65; Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2-7, 17 (explaining that Citigroup "missed the "mortgage correlation"" among

that Citigroup lacked "a comprehensive view [of the] credit, market, liquidity and financial/accounting risks of its various businesses."[404]

B. Federal Regulators Failed to Stop Citigroup from Taking Excessive Risks

In previous articles, I have described numerous regulatory failures that contributed to the severity of the financial crisis and the resulting harm to the U.S. economy.[405] I will not repeat the findings of those articles here. However, I will comment on supervisory failures by Citigroup's three most important regulators—the Fed (including the FRB and the New York Fed), the OCC and the SEC—and suggest possible reasons for those failures.[406]

1. The Fed, OCC and SEC Failed to Restrain Excessive Risk-Taking by Citigroup Despite Their Awareness of the Bank's Rapid Growth and the Inadequacy of the Bank's Risk Management Systems.—In response to a series of scandals involving Citigroup between 2000 and 2004, federal regulators imposed relatively modest penalties and brought an enforcement action against only one Citigroup employee (Jack Grubman).[407] In March 2005, the Fed imposed a moratorium on Citigroup's ability to make additional large acquisitions.[408] However, the Fed lifted that moratorium only one year later.[409] In an internal memorandum recommending that action, Fed staff members stated that Citigroup had made "substantial improvements in its compliance and control infrastructure."[410] Because staff members believed that Citigroup had made

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its various business units that originated, securitized, and traded subprime assets and observing that the bank "historically ran its business on a decentralized basis" and there was no dialogue across businesses) (quotations at 7, 17).

404. Senior Regulators 2007 Citigroup Meeting Notes, *supra* note 244, at 2.

405. *See, e.g.,* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Washington*, 81 U. CIN. L. REV. 1283, 1328-59 (2013) [hereinafter Wilmarth, *Blind Eye*]; Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. LAW 881, 926-40 (2012) [hereinafter Wilmarth, *Misguided Quest*]; Arthur E. Wilmarth, Jr., *The Dodd-Frank's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 897-919 (2011) [hereinafter Wilmarth, *Dodd-Frank's Expansion*].

406. *See* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 60-61, 136, 600-01 (5th ed. 2013) (explaining that the OCC is the primary regulator for national banks, the Fed is the primary regulator for bank holding companies and financial holding companies, and the SEC is the primary regulator for securities broker-dealers, including those that are affiliates of banks); *see also* FCIC REPORT, *supra* note 4, at 198 (describing the same division of responsibilities among the OCC, the Fed, and the SEC with regard to their respective roles in supervising Citibank, Citigroup, and Citigroup Global Markets).

407. *See supra* notes 162-63 and accompanying text.

408. *See supra* note 164 and accompanying text.

409. FCIC REPORT, *supra* note 4, at 199 (discussing the lifting of the Fed's moratorium in April 2006); Mazzucca, *supra* note 155, at 1 (same).

410. Memorandum from the Bd. of Governors, Fed. Reserve Sys., Div. of Banking

"substantial progress in strengthening its internal control structure"—a view concurred in by the OCC's examiners—the Fed staff proposed that Citigroup should be "free to pursue expansionary activity in the normal course of business."[411]

The wisdom of the Fed staff's recommendation seems very doubtful, in view of Citigroup's repeated scandals between 2000 and 2004 and the staff's acknowledgment that "many aspects of [Citigroup's] compliance risk management processes are new and that it will take time to fully demonstrate their effectiveness."[412] The OCC's decision to concur with the Fed staff's recommendation was similarly questionable. In January 2005, the OCC reviewed Citigroup's CDO business and concluded that "[e]arnings and profitability growth have taken precedence over risk management and internal control."[413] Similarly, in December 2005—only two months before the Fed staff issued its recommendation to lift the moratorium—the OCC issued a report that sharply criticized Citigroup's "Credit Derivatives Trading" operation.[414] That report stated:

> The findings of this examination are disappointing, in that the business grew far in excess of management's underlying infrastructure and control processes. Furthering our concerns is that underlying management processes in the middle office were not capturing relevant metrics to determine whether the pace of growth was sustainable and sufficient. Additionally, control functions raised questions as to the business's capacity to accommodate future growth, but warnings went unheeded. . . . Management oversight is considered less than satisfactory.[415]

The OCC's reports in 2005 clearly identified both the aggressive growth and the inadequate risk controls that were primary causes of Citigroup's near-failure two years later.[416] Indeed, the December 2005 report warned that, "[g]iven [Citigroup's] oversight failure, we are considering options that would limit the bank's ability to perform future business."[417] However, the OCC did not take

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Supervision & Regulation, to Governor Susan Bies (Feb. 17, 2006), at 1, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-02-17_FRB_Memo_from_Division_of_Banking_Supervision_and_Regulation_to_Governor_Bies_Re_Upgrade_of_Citigroups_Risk_Management_Rating.pdf, *archived at* http://perma.cc/5NEN-2M42.

411. *Id.* at 2.

412. *Id.*

413. FCIC REPORT, *supra* note 4, at 199 (quoting OCC memorandum dated Jan. 13, 2005).

414. Letter from Ronald H. Frake, OCC Examiner, to Geoffrey O. Coley, co-head, Citigroup Global Fixed Income Div. (Dec. 22, 2005) [hereinafter OCC Frake 2005 Letter], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2005-12-22_OCC_Letter_from_Ronald_H_Frake_to_Geoffrey_O_Coley_Re_Citibank_Derivatives_Examination_Findings.pdf, *archived at* http://perma.cc/7574-W42M.

415. *Id.* at 1.

416. *See supra* notes 413-15 and accompanying text.

417. OCC Frake 2005 Letter, *supra* note 414, at 2.

effective action to restrain Citigroup's growth or to insist on meaningful improvements to Citigroup's risk management systems.[418] Instead, the OCC concurred with the Fed's decision to end the moratorium on large acquisitions by Citigroup.[419]

The OCC subsequently determined that the lifting of the moratorium in April 2006 contributed to Citigroup's collapse.[420] The OCC's 2008 examination report found that "after regulatory restraints against significant acquisitions were lifted, Citigroup embarked on an aggressive acquisition program. Additionally, with the removal of formal and informal agreements, the previous focus on risk and compliance gave way to business expansion and profits."[421] Even before the Fed lifted its moratorium, Citigroup was already generating "organic growth" by expanding its internal operations.[422] After the moratorium expired, Citigroup completed a rapid series of acquisitions, including purchases of several banks and securities firms in foreign countries as well as a U.S. electronic trading firm and a large hedge fund (Old Lane Partners).[423] As a result of Citigroup's accelerated growth strategy, "[i]n two and a half years, the bank's balance sheet ballooned by 58 percent to $2.36 trillion as of Sept. 30, 2007, just before Prince was fired."[424]

The Fed's and the OCC's willingness to tolerate Citigroup's breakneck growth was one of many regulatory shortcomings with regard to Citigroup. The FCIC determined that "the OCC assessed both the liquidity puts and the [CDO] super-senior tranches as part of its reviews of [Citigroup's] compliance with the post-Enron enforcement action, but it did not examine the risks of those exposures."[425] Instead, the OCC "relied on management's assurances in 2006 that the executives would strive to meet the OCC's goals for improving risk management."[426]

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418. FCIC REPORT, *supra* note 4, at 198-99, 303.

419. *Id.* at 199.

420. *Id.*

421. OCC 2008 Citigroup Exam Report, *supra* note 368, at 2.

422. Mazzucca, *supra* note 155; *see also supra* notes 153, 155 and accompanying text (discussing Prince's adoption of an "organic growth" strategy in 2003).

423. Kate Linebaugh, *Citi's Asia Plan: Look Beyond the Elite*, WALL ST. J., Aug. 29, 2007, at C1; *Moving the Market: Citigroup to Buy Electronic Trader for $680 Million*, WALL ST. J., July 3, 2007, at C2; Aaron Lucchetti & Robin Sidel, *Moving the Market: Citigroup Is in Talks to Purchase Automated Trading Desk*, WALL ST. J., June 27, 2007, at C3; *see also* Mazzucca, *supra* note 290, at 19 ("Unleashed almost a year ago from a moratorium imposed by the Federal Reserve Board that barred major acquisitions, Citi made a number of deals in the first quarter that proved that it is once again willing to buy growth, particularly in its international businesses.").

424. Bradley Keoun & Donal Griffin, *Citigroup Ignored 2005 CDO Alarm After Shedding OCC 'Handcuffs,' FCIC Says*, BLOOMBERG.COM, Jan. 28, 2011, *available at* http://www.bloomberg.com/news/2011-01-28/citigroup-ignored-2005-bond-warning-after-shedding-handcuffs-.html, *archived at* http://perma.cc/SG72-9BJ4.

425. FCIC REPORT, *supra* note 4, at 303; *see also id.* at 263 (stating that the OCC "expressed no apprehensions about [Citigroup's] liquidity puts in 2003").

426. *Id.* at 303; *see also id.* at 198-99 (stating that the OCC had criticized Citigroup in January

Similarly, the FRB determined in December 2009 that the New York Fed's supervision of Citigroup was "less than effective" during the period leading up to the financial crisis.[427] The FRB's supervisory review found that the New York Fed "lacked the appropriate level of focus on [Citigroup's] risk oversight and internal audit functions" and also "lacked a disciplined and proactive approach in assessing and validating actions taken by the firm to address supervisory issues."[428] Timothy Geithner—who served as President of the New York Fed from 2004 to 2008 (before President Obama appointed him as Treasury Secretary)—acknowledged in testimony before the FCIC that "I do not think we did enough as an institution with the authority we had to help contain the risks that ultimately emerged in [Citigroup]."[429]

The SEC was the least active of Citigroup's regulators, as it examined Citigroup's securities broker-dealer subsidiary only once every three years, and its most recent examination prior to the financial crisis occurred in 2005.[430] At that time, the SEC's examiners saw nothing "earth shattering," but they did notice that Citigroup had "weaknesses in internal prices and valuation controls . . . and a willingness to allow traders to exceed their risk limits."[431] The SEC evidently did not take any action in response to those findings.

In June 2007, as described above, the SEC asked Citigroup to provide details about its subprime-related exposures.[432] In its response, Citigroup told the SEC that it was omitting $43 billion of liquidity puts and super-senior CDO tranches from its publicly disclosed subprime positions, because Citigroup viewed the "risk of default" on those instruments as "extremely unlikely."[433] The SEC did not order Citigroup to change its disclosures, and Citigroup did not publicly reveal until November 2007 that its total subprime exposures included those liquidity puts and CDO tranches.[434] The FCIC and other analysts have concluded that the SEC's supervision of large securities broker-dealers was generally ineffective during the period leading up to the financial crisis.[435]

2. Explaining the Fed's and the OCC's Regulatory Failures.—The SEC did

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2005 for weaknesses in "risk management and internal controls" in its CDO business).

427. FCIC REPORT, *supra* note 4, at 303 (quoting FEDERAL RESERVE BOARD, FRB NEW YORK 2009 OPERATIONS REVIEW: CLOSE OUT REPORT, at 3, *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2009_FRBNY_Operations_Review_Report.pdf, *archived at* http://perma.cc/XHQ9-EE7J.

428. *Id.*

429. *Id.* (quoting Mr. Geithner's testimony on May 6, 2010).

430. *Id.* at 198.

431. *Id.* (summarizing and quoting from FCIC interview with SEC staff members on Feb. 9, 2010).

432. *Id.* at 262.

433. *Id.*; *see also supra* note 281 and accompanying text (discussing Citigroup's meeting with the SEC's examiners in June 2007).

434. *Id.* at 262-265.

435. ENGEL & MCCOY, *supra* note 172, at 208-18; STANTON, *supra* note 320, at 153-54; FCIC REPORT, *supra* note 4, at 149-54, 283.

not maintain a significant regulatory presence at Citigroup, since it examined Citigroup Global Markets only once every three years.[436] In contrast, the Fed and the OCC maintained continuous on-site teams of examiners at Citigroup.[437] As shown above, the Fed's and the OCC's examination reports from 2007 and 2008 provided a detailed and devastating critique of Citigroup's reckless growth, highly speculative activities, and shockingly inadequate risk controls.[438] Why did the Fed and the OCC fail to identify and act on any of those shortcomings *before* Citigroup disclosed its first set of large subprime losses in November 2007?[439] While a more complete discussion of regulatory errors is contained in my previous articles,[440] three factors appear particularly relevant to the Fed's and the OCC's dealings with Citigroup.

First, the OCC and the Fed have structural flaws that make them vulnerable to influence from Citigroup and other major banks.[441] The OCC's budget is funded primarily by assessments paid by the national banks it regulates, and the largest banks pay the highest assessments.[442] The OCC therefore has "powerful budgetary incentives" to please its regulated constituents.[443] The Fed is not subject to the same budgetary pressures as the OCC, because the Fed independently finances its operations by "drawing on earnings from [its] portfolio of Treasury securities and other debt instruments."[444] "However, the banking industry exerts significant influence over the Fed through the 'unique governance structure' of the Fed's twelve regional Federal Reserve Banks (Reserve Banks)."[445] As I observed in a recent article:

> Boards of directors of Reserve Banks have "typically been dominated by senior executives of major banks, large [nonbank] financial firms and leading nonfinancial corporations that are customers of the biggest banks." . . . For example, during the peak of the [financial] crisis between 2007 and 2009, the New York Fed's board of directors included

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436. FCIC REPORT, *supra* note 4, at 198.

437. *Id.* at 198-99.

438. *See supra* Part III.B.1.

439. *See* FCIC REPORT, *supra* note 4, at 265, 302 (noting that Citigroup publicly disclosed $55 billion of subprime exposures and up to $11 billion of subprime-related losses on November 4, 2007, while the Fed and the OCC "finally downgraded the company and its main bank to "less than satisfactory" in April 2008 – five months after" Citigroup's public disclosures).

440. *See supra* note 405 (citing articles).

441. *See infra* notes 442-47 and accompanying text.

442. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 915-16.

443. *Id.*; *see also* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 93-94 (2008) (discussing the OCC's "direct financial stake in keeping its bank clients happy").

444. Wilmarth, *Misguided Quest*, *supra* note 405, at 941.

445. Wilmarth, *Blind Eye*, *supra* note 405, at 1401 (explaining that "[m]ember banks in each Fed district elect six of the nine directors of that district's Reserve Bank, and three of those bank-elected directors vote (along with three additional directors appointed by the FRB) to select the Reserve Bank's president").

> JPMorgan chairman Jamie Dimon, Lehman chairman Richard Fuld, General Electric chairman Jeffrey Immelt, and Goldman director and former chairman Stephen Friedman.[446]

Financial journalists have described the New York Fed as an institution that "is, by custom and design, clubby and opaque," with "a board dominated by the chief executives of some [major] banks."[447] During his tenure as President of the New York Fed, Timothy Geithner frequently met with top executives of major New York financial institutions for professional and private discussions.[448] He was "particularly close to executives of Citigroup," including Robert Rubin, his former mentor at the Treasury Department, and Sanford Weill.[449] Weill tried to persuade Geithner to become Citigroup's new CEO when Chuck Prince stepped down in November 2007, but Geithner declined.[450]

Second, during the 1990s and 2000s, federal banking agencies adhered to a general philosophy that "regulators should seek to minimize any interference with innovation and competition in the financial markets . . . [because] market discipline and private risk management produced better results than government regulation over the longer term."[451] FRB chairman Alan Greenspan was the best-known advocate for that view,[452] but he was hardly alone. Treasury Secretary

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446. *Id.* at 1402 (quoting Wilmarth, *Misguided Quest*, *supra* note 405, at 943).

447. Jo Becker & Gretchen Morgenson, *Geithner, as Member and Overseer, Forged Ties to Finance Club*, N.Y. TIMES, Apr. 27, 2009, at A1 ("At the New York Fed, top executives of global financial giants fill many seats on the board.").

448. *Id.* According to one published report, Geithner frequently held "one-on-one meetings" with senior executives of Citigroup, JPMorgan and other banks regulated by the New York Fed. *Id.* A former New York Fed general counsel stated that such meetings were "not the general practice of Mr. Geithner's recent predecessors" and "[t]ypically, there would be senior staff there to protect against disputes in the future as to the nature of the conversations" involving the New York Fed's president. *Id.* (quoting Ernest T. Patrikis).

449. *Id.* (explaining that Rubin, as Treasury Secretary during the 1990s, "was Mr. Geithner's mentor from his years in the Clinton administration"); *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1410-11 (stating that Rubin helped to arrange Geithner's appointments as President of the New York Fed in 2003 and as Treasury Secretary in 2009).

450. Becker & Morgenson, *supra* note 447.

451. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 903-04 (discussing views of FRB chairman Alan Greenspan).

452. *Id.*; *see, e.g.*, Alan Greenspan, FRB Chairman, Remarks at the Nat'l Ass'n of Bus. Econ. Ann. Mtg.: Economic Flexibility (Sept. 27, 2005) [hereinafter Greenspan 2005 Speech] (arguing that the "success of [deregulation] confirmed the earlier views that a loosening of regulatory restraint on business would improve the flexibility of our economy," and "[t]he impressive performance of the U.S. economy over the past couple of decades . . . offers the clearest evidence of the benefits of increased market flexibility"), *available at* http://www.federalreserve.gov/boarddocs/speeches/2005/20050927/default.htm, *archived at* http://perma.cc/95P-3JTP; *see also* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 100 (2009) (stating that there was "no truer believer in the ideology of free

Robert Rubin and his deputy and successor Lawrence Summers actively pursued a deregulatory agenda that included the enactment of GLBA (which ratified Citigroup's universal banking model) and the blocking of efforts by Commodity Futures Trading Commission chairman Brooksley Born to regulate over-the-counter derivatives.[453] Former Comptroller of the Currency Eugene Ludwig noted in 2010 that there was a "historic vision, historic approach, that a lighter hand at regulation was the appropriate way to regulate."[454]

Greenspan, Rubin, and Summers set the tone for a general regulatory "mindset" that favored deregulatory, "light touch" policies during the two decades leading up to the financial crisis.[455] As FRB General Counsel Scott Alvarez later acknowledged, "The mind-set was that there should be no regulation; that the market should take care of policing, unless there already is an identified problem."[456] Richard Spillenkothen, the FRB's Director of Bank Supervision from 1991 to 2006, agreed that regulators had "a high degree of faith that financial markets were largely efficient and self-correcting and, therefore, that counterparty and market discipline were generally more effective 'regulators' of risk-taking and improper practices than government rules and supervisors."[457]

A New York Fed self-study in 2009, which examined the reasons for supervisory failures during the period leading up to the financial crisis, concurred that regulators had placed too much faith in the assumption that "[m]arkets will always self-correct."[458] The New York Fed's self-study echoed a speech by

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markets, financial innovation, and deregulation" than Greenspan); ENGEL & MCCOY, *supra* note 172, at 192 (contending that "Greenspan made it his mission to minimize government oversight by outsourcing risk management to banks").

453. JOHNSON & KWAK, *supra* note 452, at 8-10, 98-100, 104, 133-37; Wilmarth, *Blind Eye*, *supra* note 405, at 1422.

454. STANTON, *supra* note 320, at 149-50 (quoting from an FCIC interview with Mr. Ludwig on Sept. 2, 2010).

455. FCIC REPORT, *supra* note 4, at 96, 170-73, 307-08; Wilmarth, *Blind Eye, supra* note 405, at 1421-26.

456. FCIC REPORT, *supra* note 4, at 96 (quoting from an FCIC interview with Mr. Alvarez).

457. Memorandum from Richard Spillenkothen, on the performance of prudential supervision in the years preceding the financial crisis by a former director of banking supervision and regulation at the Federal Reserve Board (1991 to 2006) (May 31, 2010), at 12 [hereinafter Spillenkothen FCIC Memo]; *see also id.* at 27 (stating that "the culture of the Federal Reserve—an agency dominated by professional economists whose mindset and intellectual biases were to enhance the workings of free markets, not to design regulations—was reinforced by a Chairman who had a strong, deep, and abiding philosophical belief that market and counterparty discipline were more effective in controlling risks than governmental regulation and oversight"), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf, *archived at* http://perma.cc/9Y57-G22N.

458. FED. RES. BANK N.Y., REP. ON SYSTEMIC RISK & BANK SUPERVISION ("Discussion Draft" of Aug. 18, 2009) 2; *see also id.* at 6 (describing "the common expectation that market forces would efficiently price risks and prompt banks to control exposures in a more effective way than

Chairman Greenspan in September 2005, when he declared,

> We appear to be revisiting Adam Smith's notion that the more flexible an economy, the greater its ability to self-correct after inevitable, often unanticipated disturbances. That greater tendency toward self-correction has made the cyclical stability of the economy less dependent on the actions of macroeconomic policymakers, whose responses often have come too late or have been misguided.[459]

The prevailing deregulatory "mindset" encouraged regulators to view bankers as "customers" who were entitled to helpful and sympathetic "customer service."[460] For example, the New York Fed called its on-site examination teams "relationship management teams,"[461] a term that suggested a very close and symbiotic connection between on-site examiners and the large banks they regulated. Not surprisingly, the New York Fed's 2009 self-study concluded that on-site examiners frequently lacked sufficient independence from the banks they regulated.[462] The study found that "relationship managers were too deferential to bank management and too dependent on the bank's goodwill and [management information systems] to gain information."[463] Bank examiners described the importance of receiving "support from senior management [at the New York Fed] when banks complain about supervisory intrusion, and how demoralizing it can be when [examiners] perceive insufficient support," and one examiner added, "Within three weeks on the job, I saw the capture set in."[464]

Senior OCC officials expressed a similar attitude of deference to banks and the financial markets. For example, Acting Comptroller of the Currency Julie Williams assured a group of bankers in 2005 that (i) the OCC's supervisory approach provided "a spacious framework, designed to accommodate change,"

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regulators. . . . Regulators faced and often shared skepticism that regulators could push for more effective practices than those required by the market for controlling firm risk.") [hereinafter NEW YORK FED 2009 SELF-STUDY], *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-09-10%20FRBNY%20Report%20on%20Systemic%20Risk%20and%20Bank%20Supervision%20draft.pdf, *archived at* http://perma.cc/CL6-8H27.

459. Greenspan 2005 Speech, *supra* note 452.

460. Wilmarth, *Blind Eye*, *supra* note 405, at 1419.

461. Caroline Salas & Bradley Keoun, *New York Fed's Dahlgren Overhauls Bank Supervision to Beef Up Oversight*, BLOOMBERG.COM, Mar. 21, 2011, http://www.bloomberg.com/news/2011-03-21/new-york-fed-s-dahlgren-overhauls-bank-supervision-to-beef-up-oversight.html, *archived at* http://perma.cc/BQ88-542U.

462. NEW YORK FED 2009 SELF-STUDY, *supra* note 458, at 8.

463. *Id.* at 19; *see also id.* at 8 ("Banks inherently have an information advantage over the supervisors. . . . Getting good, timely information is therefore dependent on the willingness and enthusiasm of bank staff in providing that information. Supervisors . . . believe that a non-confrontational style will enhance that process.").

464. *Id.* at 8, 8 n.2; *see also* STANTON, *supra* note 320, at 163 (observing that the New York Fed's 2009 self-study "found that supervisory staff often feared to speak up" and "were deferential to the banks they regulated").

and (ii) the agency's personnel were "advocates on the national stage [for] measures designed to make regulation more efficient, *and* less costly, less intrusive, less complex, and less demanding on [bankers] and [their] resources."[465] Comptroller of the Currency John Dugan testified at a congressional hearing in 2007 that the OCC strongly opposed any prohibitions against financial "innovations" because "there are many different kinds of innovations that have led to positive things and sorting out which ones are the most positive and somewhat less positive is generally not something that the Federal Government is good at doing."[466]

Timothy Geithner expressed a similar philosophy during his leadership of the New York Fed. During a meeting of the Federal Open Market Committee ("FOMC") in January 2006, he praised retiring Chairman Greenspan as "pretty terrific," and he added, "I think the risk that we decide in the future that you're even better than we think is higher than the alternative."[467] In a May 2007 speech, Geithner stated positions that were remarkably similar to those voiced by Greenspan two years earlier.[468] Like Greenspan, Geithner applauded "[c]hanges in financial markets . . . [that] have improved the efficiency of financial intermediation and improved our confidence in the ability of markets to absorb stress."[469] Geithner maintained that "[f]inancial innovation has improved the capacity to measure and manage risk" and to enable risk to be "spread more broadly across countries and institutions."[470] Geithner cautioned, as Greenspan

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465. Wilmarth, *Dodd-Frank's Expansion*, *supra* note 405, at 905 (quoting speech by Ms. Williams on May 27, 2005) (italics added).

466. ENGEL & MCCOY, *supra* note 172, at 173 (quoting Mr. Dugan's testimony in Sept. 2007).

467. Binyamin Appelbaum, *Inside the Fed in '06: Coming Crisis, and Banter*, N.Y. TIMES, Jan. 13, 2012), *available at* http://www.nytimes.com/2012/01/13/business/transcripts-show-an-unfazed-fed-in-2006.html?pagewanted=all&_r=0, *archived at* http://perma.cc/997Y-BBBK (quoting Mr. Geithner). At two FOMC meetings in late 2006, Geithner expressed little concern about emerging problems in the housing market and stated that the "fundamentals of the [economic] expansion going forward still look good." *Id.* (quoting Mr. Geithner's remarks in December 2006, and also quoting Mr. Geithner's comment in September 2006 that "[w]e just don't see troubling signs yet of collateral damage [from the housing market], and we are not expecting much").

468. *Compare* Timothy Geithner, Pres. Fed. Res. Bank N.Y., Remarks at the Fed. Res. Bank of Atlanta's 2007 Financial Markets Conference: Liquidity Risk and the Global Economy (May 15, 2007), *available at* http://www.newyorkfed.org/newsevents/speeches/2007/gei070515.html, *archived at* http://perma.cc/B9LM-FAAD [hereinafter Geithner 2007 Speech], *with* Greenspan 2005 Speech, *supra* note 452.

469. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan Speech, *supra* note 452 ("Deregulation and the newer information technologies have joined, in the United States and elsewhere, to advance flexibility in the financial sector" as well as "[f]inancial stability.").

470. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 (acclaiming "[c]onceptual advances in pricing options and other complex financial products" that "lowered the costs of, and expanded the opportunities for, hedging risks that were not readily deflected in earlier decades").

had in 2005, that financial markets remained vulnerable to unexpected "shocks," particularly after an extended period of low interest rates and comparative stability in the global economy.[471] However, Geithner, like Greenspan, remained optimistic about the strength and resilience of the banking system:

> The dramatic changes we've seen in the structure of financial markets over the past decade and more seem likely to have reduced this vulnerability [to financial shocks]. The larger global financial institutions are generally stronger in terms of capital relative to risk. Technology and innovation in financial institutions has made it easier to manage risk. Risk is less concentrated within the banking system.[472]

Geithner contended, as Greenspan had, that federal regulators "do not have the capacity to eliminate the risk of excess leverage or asset price misalignments, nor do we have the ability to act preemptively to defuse them."[473] Geithner also opposed, as did Greenspan, the use of strong regulatory measures to deal with the potential risks of financial shocks.[474] For example, Geithner saw "little prospect that supervision will have the capacity to identify and address potential concentrations in exposure to individual risk factors, whether through changes to capital charges or other means."[475] Geithner also argued that regulators "do not have the capacity to put in place a transparency regime over markets that would give people a real-time picture of the incidence and magnitude of potential risks."[476]

Instead, Geithner advocated market-friendly supervisory policies that would encourage financial institutions to maintain larger "financial cushions" and to

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471. *Compare* Geithner 2007 Speech, *supra* note 468 ("Financial innovation and global financial integration do not offer the prospect of eliminating the risk of asset price and credit cycles, of manias and panics, or of shocks that could have systemic consequences."), *with* Greenspan 2005 Speech, *supra* note 452 ("History cautions that extended periods of low concern about credit risk have invariably been followed by reversal, with an attendant fall in the prices of risky assets," due to the "all-too-evident alternating and infectious bouts of human euphoria and distress and the instability they engender.").

472. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 ("New instruments of risk dispersal have enabled the largest and most sophisticated banks . . . to divest themselves of much credit risk" and have produced a "far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago.").

473. Geithner 2007 Speech, *supra* note 468; *see also* Greenspan 2005 Speech, *supra* note 452 ("Relying on policymakers to perceive when asset bubbles have developed and then to implement timely policies to address successfully these misalignments in asset prices is simply not realistic.").

474. *See* Greenspan 2005 Speech, *supra* note 452 (advocating a reliance on "self-correction" by market forces and arguing that responses by financial policymakers to "unanticipated disturbances . . . often have come too late or have been misguided").

475. Geithner 2007 Speech, *supra* note 468.

476. *Id.* ("The pace of change is too rapid, the number of positions, funds, and institutions too great, and the analytical challenge too complex to offer the promise of that type of early warning system.").

adopt other "market-led initiatives" (such as improving industry standards for reporting derivatives trades and managing counterparty credit risk) that would be "reinforced rather than imposed by supervision."[477] Geithner's adherence to Greenspan's deregulatory philosophy and Geithner's emphasis on "market-led initiatives" help to explain why the New York Fed failed to take timely or effective action to prevent Citigroup's excessive risk-taking.

In sharp contrast to Geithner's distrust of the efficacy of preventive regulation, his aversion to vigorous government action disappeared when Citigroup and other major banks faced serious threats to their survival in 2008 and 2009.[478] Geithner became the earliest and the most outspoken advocate inside the federal government for aggressive bailouts of large banks.[479] He pushed hard to secure full protection for all of the creditors of Citigroup and other major banks.[480] He strongly—and largely successfully—opposed efforts by other regulators (including FDIC chairman Sheila Bair and TARP Special Inspector General Neil Barofsky) to attach strong conditions to those rescues.[481] A leading Wall Street lawyer described Geithner as "the federal regulator who was most willing to 'push the envelope'" to prevent major bank failures.[482]

The Greenspan-Rubin-Geithner consensus, which favored regulatory deference to internal risk management systems at big banks, contributed to a third major regulatory error. During the past three decades, federal regulators increasingly focused on evaluating the risk management policies and procedures of large banks as well as the banks' "internal models" and "credit risk metrics," and regulators stopped doing traditional "full scope" examinations for major banks.[483] Traditional examinations would have required "transaction testing," including "sufficiently robust testing to determine how well in reality [internal bank control] processes did work or would work in a prolonged period of high stress."[484]

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477. *Id.*; *see also* Becker & Morgenson, *supra* note 447 (reporting that Geithner "pushed the [financial] industry to keep better records of derivatives deals . . . . But he stopped short of pressing for comprehensive regulation and disclosure of derivatives trading and even publicly endorsed their potential to damp risk.").

478. Becker & Morgenson, *supra* note 447.

479. *Id*.

480. *Id.*

481. BAIR, *supra* note 349, at 99-100, 105, 117-19, 122-26, 165-73, 201-07; NEIL BAROFSKY, BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 71-78, 98-101, 151-57, 170-74, 192-200, 226-29 (2012); ONARAN, *supra* note 14, at 81-87, 105, 117-18 (explaining that "[t]he idea for a blanket guarantee [of bank liabilities] was first brought up by Timothy Geithner . . . during the summer of 2008," at 81, and contending that Geithner worked "to save the big banks at any cost," at 105); Becker & Morgenson, *supra* note 447 ("Mr. Geithner has been a leading architect of [bank] bailouts, the activist at the head of the pack.").

482. Becker & Morgenson, *supra* note 447 (quoting H. Rodgin Cohen).

483. Spillenkothen FCIC Memo, *supra* note 457, at 10-11.

484. *Id* at 11; *see also id.* at 12, 15-16 (contending that the Basel II capital accord encouraged

Fed chairman Greenspan addressed this issue at a congressional hearing in May 1997.[485] At that hearing, he declared that the Fed was seeking to avoid "unduly intrusive" supervision by focusing on "risk management and control systems" within bank holding companies.[486] Greenspan explained that the Fed had discarded its "traditional approach" for supervising bank holding companies and was instead following "a more risk-focused/less transaction-testing approach to inspections" that placed "greater reliance on internal and external auditors."[487]

In a November 2012 speech, FDIC Vice Chairman Thomas Hoenig questioned the wisdom of the current regulatory focus on internal risk management systems at major banks.[488] He criticized the fact that "full-scope examinations have been de-emphasized in favor of targeted reviews" and "model validations."[489] He argued that the current preference for limited-scope reviews is based on the mistaken assumption that the largest banks are "too large and complex for full scope examinations."[490] In Hoenig's view, "full exams are doable" for big banks, because regulators can use reliable statistical "sampling methodologies for auditing and examining large bank asset portfolios and other operations . . . at an affordable cost."[491] In a subsequent interview, Hoenig contended that bank examiners should "spend more time studying individual files to verify the quality of a bank's internal reports about its risk management capability."[492]

The "skeptical" views expressed by banking industry consultants in response to Hoenig's comments indicate that his proposal for renewed transaction testing would threaten the current ability of big banks to conduct "business as usual" without strong regulatory oversight.[493] In my opinion, to expect bank examiners to evaluate a major bank by checking the bank's internal risk models and procedures, but without testing reliable samples of the bank's actual transactions, is as futile as asking a car mechanic to check "the computer codes that run the car" without "looking at the tires or the fluid levels or the gaskets to see if they

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"an excessive faith in internal bank risk models [and] an infatuation with the specious accuracy of complex quantitative risk measurement techniques").

485. Statement by Fed. Res. Bd. Chairman Alan Greenspan before the House Comm. on Banking & Financial Services, 83 Fed. Res. Bulletin 578 (May 22, 1997).

486. *Id.* at 582.

487. *Id.*

488. Thomas M. Hoenig, FDIC Vice Chairman, Remarks at AICPA/SIFMA FSA Nat'l Conference: Financial Oversight: It's Time to Improve Outcomes (Nov. 20, 2012), *available at* http://www.fdic.gov/news/news/speeches/chairman/spnov3012.html, *archived at* http://perma.cc/7DGG-YHBA.

489. *Id*.

490. *Id.*

491. *Id.*

492. Joe Adler, *FDIC's Hoenig Proposes 'Full Scope' Big Bank Exams*, AM. BANKER, Feb. 12, 2013, at 1 (summarizing Mr. Hoenig's comments).

493. *Id.* (reporting that some "D.C. policy watchers" were "skeptical" about Hoenig's proposal for full-scope examinations for big banks).

were deteriorating."[494] It is difficult to believe that regulators would have failed to identify the enormous risks at Citigroup between 2004 and 2007 if regulators had rigorously analyzed and tested reliable samples of actual transactions within Citigroup's subprime mortgage origination and securitization units, its CDO trading unit, and its leveraged lending business.

CONCLUSION

Citigroup's tarnished history of repeated scandals and bailouts presents a serious challenge for those who continue to defend the virtues of universal banking. For example, supporters of big diversified banks have claimed that financial conglomerates weathered the crisis better than standalone investment banks like Bear Stearns, Lehman and Merrill.[495] In fact, however, the survival of Citigroup and BofA depended on the federal government's willingness to give them enormous bailout packages, which in turn reflected the broader policy decision that "no [financial] supermarket could possibly be allowed to fail."[496]

Citigroup's many missteps have inflicted heavy losses on its shareholders. Citigroup's stock price fell by 17% under Chuck Prince (who resigned in November 2007)[497] and by a further 89% under Vikram Pandit (who stepped down in October 2012).[498] Citigroup's board of directors appointed Michael

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494. *Id.* (quoting my comments in support of Hoenig's proposal).

495. *See, e.g.*, Donna Borak, *The Case Against Restoring Glass-Steagall*, AM. BANKER (Aug. 8, 2012), http://www.americanbanker.com/issues/177_152/the-case-against-restoring-glass-steagall-1051651-1.html, *archived at* http://perma.cc/F9BY-VU8L (citing arguments made by supporters of universal banks against reinstatement of Glass-Steagall-type barriers between commercial banks and securities firms).

496. John Authers, *Markets Make Best Case for Glass-Steagall*, FIN. TIMES (July 14, 2012), http://www.ft.com/cms/s/0/14e08822-eb04-11e2-9fcc-00144feabdc0.html#axzz2jyfEAidD, *archived at* http://perma.cc/H38Q-V6ST; *see also* Devin Leonard, *Company on Fire? Light a Cigar: Why Troubled Companies Like Citigroup Keep Hiring Dick Parsons*, BLOOMBERG BUS. WK., Mar. 28-Apr. 3, 2011, at 85, 90 (reporting that Treasury Secretary Timothy Geithner told Citigroup chairman Dick Parsons that Citigroup was "too important an institution to go down") (quoting Mr. Parsons); Matt Taibbi, *Ludicrous Times Op-Ed Forgets Entire Year of Wall Street History*, ROLLING STONE (Aug. 1, 2012), http://www.rollingstone.com/politics/blogs/taibblog/ludicrous-times-op-ed-forgets-entire-year-of-wall-street-history-20120801 *archived at* http://perma.cc/3J57-9G2H ("[T]he total [government] outlay for Citigroup was $476 billion in cash and guarantees—they were the biggest single bailout recipient, . . . [with] Bank of America [receiving] $336 billion in cash and guarantees.").

497. Rich Miller & Yalman Onaran, *Rubin to Draw on Crisis Management Experience at Citi (Update 2)*, BLOOMBERG, Nov. 5, 2007, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRqfhs4RlN1g, *archived at* http://perma.cc/8BMX-7RG9.

498. Suzanne Kapner et al., *Pandit Is Forced Out at Citi*, WALL ST. J., Oct. 17, 2012, at A1; *see also* Donal Griffin & Christine Harper, *Former Citigroup CEO Weill Says Banks Should Be Broken Up*, BLOOMBERG, July 25, 2012, http://www.businessweek.com/news/2012-07-25/weill-says-banks-should-be-broken-up, *archived at* http://perma.cc/TE9-WYDR ("Citigroup's shares,

Corbat to replace Pandit,[499] and Corbat declared, "We've got to get to a point where we stop destroying our shareholders' capital."[500] Mr. Corbat's blunt statement reflected the dismal fact that Citigroup's shares were trading at only 67% of the company's declared book value in January 2013.[501]

By the end of 2008, many financial analysts concluded that Citigroup and its universal banking peers were not only TBTF but also too big to manage or regulate, and that view has persisted.[502] Regulators pressured Citigroup's management to reduce the company's size by selling or spinning off "noncore"

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which traded as high as $564.10 at the end of 2006, when adjusted for a [10:1] reverse stock split, plummeted to $10.20 during March of 2009 . . . . They closed at $25.79 yesterday."); Matt Taibbi, *When Did Sandy Weill Change His Mind About Too Big to Fail? And Why?*, ROLLING STONE, Aug. 3, 2012, http://www.rollingstone.com/politics/blogs/taibblog/when-did-sandy-weill-change-his-mind-about-too-big-to-fail-and-why-20120803, *archived at* http://perma.cc/3W3D-8ZPA (discussing an assumed decline in value of Sandy Weill's Citigroup stock from about $792 million in 2003 to about $42 million in 2012, due in part to Citigroup's 10:1 reverse stock split in May 2012).

499. Kapner et al., *supra* note 498; *see also* Jessica Silver-Greenberg & Susanne Craig, *Citi Chairman Is Said to Have Planned Chief's Exit Over Months*, N.Y. TIMES, Oct. 26, 2012, at A1.

500. Donal Griffin, *Citigroup Goal Is to Stop Shareholder Capital Destruction*, BLOOMBERG (Jan. 17, 2013) http://www.bloomberg.com/news/2013-01-17/citi-ceo-says-goal-is-to-stop-destroying-shareholders-capital.html, *archived at* http://perma.cc/VYH-2Y4S (quoting Mr. Corbat).

501. *Id.* (also noting that "Citigroup's shares have declined 92 percent in the past six years").

502. *See, e.g.*, Authers, *supra* note 496 (stating that Citigroup and BofA "proved unmanageable because of their sheer complexity. This contributed to awful errors in risk management"); Simon Johnson, *Five Facts About the New Glass-Steagall*, BLOOMBERG, July 11, 2013, http://www.bloomberg.com/news/2013-07-11/five-facts-about-the-new-glass-steagall.html, *archived at* http://perma.cc/8MFH-L45Z ("The biggest U.S. banks have become too big to manage, too big to regulate, and too big to jail."); Jessica Silver-Greenberg & Susanne Craig, *Citigroup's Chief Resigns in Surprise Step*, N.Y. TIMES, Oct. 17, 2012, at A1 ("[Citigroup] is emblematic of financial institutions that are too large to manage because of labyrinthine bureaucracy and underperforming divisions."). For earlier statements of that perspective, see, e.g., *Breaking Up the Citi*, WALL ST. J., Jan. 14, 2009, at A12 (editorial) ("A bank that consistently has to be rescued by taxpayers lest it take down the entire financial system is too big to succeed. . . . Citi's repeated brushes with death prove that its management has never figured out how to run the business."); Kevin Dobbs & Paul Davis, *Citi Spinoff: Beginning of Its Endgame*, AM. BANKER, Jan. 13, 2009, at 1 (quoting analyst Karen Shaw Petrou's statement that "the strategic value of the oligarch bank model was never proven . . . . Under current market conditions, it clearly does not work."); Kevin Dobbs, *Even After Infusion Citi Seen Needing Fix*, AM. BANKER, Nov. 25, 2008, at 1 (reporting on analyst Christopher Whalen's view that the "global model" of Citigroup was "broken" because it was "too vast to manage all the various parts effectively, . . . forcing Citi in recent years to take big risks on exotic mortgages and securities to prop up its bottom line"); Annys Shin, *Citi's Relentless Quest for Growth*, WASH. POST, Nov. 25, 2008, at D01 (stating that "Citi was too big to manage well," and quoting legal scholar Jerry Markham's observation that Citigroup's "business model – a complete financial services firm – is nothing but trouble. . . . There's always some unit having a crisis.").

assets, and Citigroup adopted a plan that reduced its assets from $2.36 trillion in September 2007[503] to $1.94 trillion in September 2012.[504] Even so, Citigroup has retained a "core" group of universal banking operations, including trading in equity and debt securities, trading in foreign exchange, securities underwriting and other investment banking activities.[505] Thus, notwithstanding Citigroup's disastrous experience with capital markets activities, it seems unlikely that the company will choose voluntarily to divest those activities and return to Citicorp's former status as a commercial bank.

The co-founders of Citigroup have admitted that the company's universal banking model failed to achieve their bullish projections of success when Citigroup was formed in 1998.[506] Former co-CEO John Reed apologized in 2009 for his role in creating Citigroup and said that Congress made a mistake when it

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503. Keoun & Griffin, *supra* note 424.

504. Kapner et al., *supra* 498; *see also* Eric Dash, *Citigroup Plans to Split Itself Up Taking Apart the Financial Supermarket*, N.Y. TIMES, Jan. 14, 2009, at B1 ("Federal regulators pushed Mr. Pandit to move faster" in adopting "a strategy that now includes whittling Citigroup's financial supermarket into a core operation . . . and a group of noncore, loss-inducing business."); David Enrich, *Citigroup Takes First Step Toward Breakup*, WALL ST. J., Jan. 10, 2009, at A1 ("In December [2008], government officials started pressing Mr. Pandit and his deputies to devise and articulate a new strategy to slim down the financial colossus."); Monica Langley & David Enrich, *Citigroup Chafes Under U.S. Overseers*, WALL ST. J., Feb. 25, 2009, at A1 (reporting that the federal government's "ongoing pressure to slim down the company has forced Citigroup executives to consider a range of unwanted options," and Citigroup agreed to "split itself into two parts, with the goal of selling additional assets and businesses"); Heather Landy, *Weighing the Future of Citi 'Holding' Pen*, AM. BANKER, Sept. 21, 2009, at 1 (describing Citigroup's decision to move $649 billion of its "noncore" assets into a new "Citi Holdings" division for eventual sale or other disposition); Michael J. Moore et al., *Citigroup Productivity Worst of Big Banks Shows Challenge*, BLOOMBERG, Oct. 25, 2012, http://www.bloomberg.com/news/2012-10-25/citigroup-productivity-worst-of-big-banks-shows-challenge.html, *archived at* http://perma.cc/XY3B-TQUQ (reporting that Citi Holdings had reduced its assets to $174 billion).

505. Donal Griffin, *Citigroup Profit Beats Estimates as Stock Trading Gains*, BLOOMBERG, July 15, 2013, http://www.bloomberg.com/news/2013-07-15/citigroup-42-profit-rise-beats-estimates-as-stock-trading-gains.html, *archived at* http://perma.cc/M84Q-Z3Z6; David Henry, *Citigroup Profit Jumps 42 Percent on Stronger Markets*, REUTERS, July 16, 2013, http://www.reuters.com/article/2013/07/15/us-citigroup-results-idUSBRE96E0BZ20130715, *archived at* http://perma.cc/V9KU-CJ9V; *see also* Donal Griffin & Bradley Keoun, *Citigroup Earnings Miss Estimates as Stock and Bond and Bond Trading Revenue Slumps*, BLOOMBERG, Jan. 18, 2011, http://www.bloomberg.com/news/2011-01-18/citigroup-net-misses-estimates-on-charges-tied-to-tighter-credit-spreads.html, *archived at* http://perma.cc/EY4Y-L5Y7 (reporting that Citigroup produced more than $3 billion of quarterly revenue from "equity-trading" and "fixed-income" trading as well as its "investment-banking operation," and stating that "investment-banking" remained one of Citigroup's "core" businesses).

506. *See supra* notes 6-7, 9 and accompanying text (discussing the bold predictions for Citigroup's success made by John Reed and Sandy Weill in 1998).

repealed the Glass-Steagall Act in 1999.[507] Reed expanded on those views in 2013, explaining that "the greatest problem [Citigroup encountered] was of clashing cultures" between traders and commercial bankers.[508] As the trading culture grew within Citigroup, that culture became "infectious" and "a more dominant part of the organization."[509] In Mr. Reed's view, the increased emphasis on trading also undermined the effectiveness of Citigroup's risk management system.[510] Risk officers were reluctant to challenge high-risk capital markets transactions because the completion of those transactions was a leading metric for determining compensation.[511] Moreover, universal banking "turned out not to produce the hoped-for savings for the bank" because Citigroup needed to hire "highly-paid" investment bankers in order to sell "sophisticated products" to customers.[512] The complexity of Citigroup's widely dispersed operations also meant that the company "became harder to manage."[513]

At first, Sandy Weill defended Citigroup and the universal banking model against Reed's criticisms.[514] He acknowledged in January 2010 that he was mistaken in assuming that Citigroup was "impregnable," but he blamed Citigroup's collapse primarily on Chuck Prince's poor management.[515]

By mid-2012, Weill had evidently changed his mind. In an interview on CNBC, he said that policymakers should "split up investment banking from banking, have banks be deposit takers, have banks make commercial loans and real estate loans, have banks do something that's not going to risk the taxpayer dollars, that's not too big to fail."[516] He called for universal banks to "be broken

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507. Bob Ivry, *Reed Says 'I'm Sorry' for Role in Creating Citigroup (Update 1)*, BLOOMBERG, Nov. 6, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=albMYVE7D578, *archived at* http://perma.cc/6WM6-PJYX.

508. John Authers, *Culture Clash Means Banks Must Split, Says Former Citi Chief*, FIN. TIMES, Sept. 8, 2013, http://www.ft.com/intl/cms/s/0/2cfa6f18-1575-11e3-950a-00144feabdc0.html# axzz32qOGqcmh.

509. *Id.* (quoting and summarizing Mr. Reed's comments); *see also* FCIC REPORT, *supra* note 4, at 265 (quoting from interview with Mr. Reed on Mar. 24, 2010, in which he said that a "culture change" occurred after Salomon Brothers combined with Citibank as part of the formation of Citigroup in 1998. According to Mr. Reed, the Salomon executives "were used to taking big risks" and "had a history of . . . [of] making a lot of money . . . but then getting into trouble"); *see also supra* notes 56-59 and accompanying text (discussing Salomon's culture of aggressive risk-taking).

510. Authers, *supra* note 508 (summarizing Mr. Reed's comments).

511. *Id.* (quoting Mr. Reed).

512. *Id.*

513. *Id.*

514. Katrina Booker, *Citi's Creator, Alone with His Regrets*, N.Y. TIMES, Jan. 3, 2010, § BU, at 1 (reporting that Mr. Weill was proud of his role as "[t]he Shatterer of Glass-Steagall" and rejected Mr. Reed's criticism of the repeal of Glass-Steagall).

515. *Id.* (also describing Mr. Weill's regret that Citigroup had "hurt the dreams of so many people").

516. Kevin Wack, *Weill Puts Glass-Steagall Back on Washington's Agenda*, AM. BANKER, July 26, 2012 (available on Lexis) (quoting Mr. Weill's statements during the CNBC interview).

up so that the taxpayer will never be at risk, the depositors won't be at risk, the leverage of the [commercial] banks will be something reasonable," while standalone investment banks would be able to "make some mistakes" without threatening a systemic crisis.[517]

The statements of Reed and Weill are consistent with Citigroup's lamentable record of managerial and regulatory failures. Citigroup's history indicates that the universal banking model is deeply flawed by its excessive organizational complexity, its vulnerability to culture clashes and conflicts of interest, and its tendency to permit excessive risk-taking within far-flung, semi-autonomous units that lack adequate oversight from either senior management or regulatory agencies.

In contrast to Reed and Weill, Robert Rubin has maintained his longstanding support for the universal banking model. During interviews with journalists in 2008, Rubin blamed Citigroup's problems not on organizational or managerial shortcomings but instead on a rare confluence of economic events that had created a "perfect storm," which nobody had foreseen.[518] Rubin strongly reaffirmed his faith in the value of large universal banks in a subsequent interview with David Rothkopf.[519] When Rothkopf asked Rubin "whether the biggest and most influential financial organizations ought to be broken up, whether 'too big to fail' was a problem to be addressed," Rubin's emphatically disagreed:

> "'No,' [Rubin] said, 'don't you see? Too big to fail isn't a problem with the system. It *is* the system. You can't be a competitive global financial institution serving global corporations of scale without having a certain scale yourself. The bigger multinationals get, the bigger financial institutions will have to get."[520]

Lobbying organizations for large financial conglomerates have echoed Rubin's claim that the U.S. needs megabanks like Citigroup in order to serve global business corporations and to compete with foreign universal banks.[521]

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517. *Id.*

518. Schwartz & Dash, *supra* note 3; *see also* Brown & Enrich, *supra* note 244 (summarizing a November 2008 interview, in which Mr. Rubin stated that he had been "a very constructive part of the Citigroup environment." He also claimed that "what came together [in the financial crisis] was not only a cyclical undervaluing of risk [but also] a housing bubble, and triple-A ratings were misguided. . . . There was virtually nobody who saw that low-probability event as a possibility."); *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1293 (citing academic studies rejecting the claim that the financial crisis was a "perfect storm" that bankers and regulators could not have foreseen).

519. DAVID ROTHKOPF, POWER, INC.: THE EPIC RIVALRY BETWEEN BIG BUSINESS AND GOVERNMENT—AND THE RECKONING THAT LIES AHEAD 266 (2012) (quoting undated recent interview with Mr. Rubin).

520. *Id*.

521. *See, e.g.*, Rob Nichols, *U.S. Can't Afford to Break up Big Banks*, DALLAS MORNING NEWS, Jan. 28, 2013 (op-ed by President and CEO of the Financial Services Forum, contending that "large banking institutions provide unique and significant value that smaller banks simply cannot provide—in the sheer size of credits they can deliver, the wide array of products and services they

However, most big bank advocates do *not* acknowledge, as Rubin did, that the TBTF policy is the price that must be paid for the continued existence of global megabanks. In my view, that price is simply too great to accept in view of the massive governmental bailouts that were required to rescue Citigroup, BofA and other global megabanks during the financial crisis (e.g., ABN Amro, Commerzbank, Fortis, ING, Lloyds HBOS, Royal Bank of Scotland and UBS),[522] as well as the enormous economic costs inflicted by the crisis.[523] Moreover, it is highly doubtful whether the U.S., U.K., and European Union would have the necessary fiscal and monetary resources to finance similar bailouts of megabanks should another financial crisis occur during the coming decade.[524]

Because the price of the universal banking model is too costly to bear, I have advocated legal reforms that would remove government subsidies currently exploited by financial conglomerates.[525] Removing those subsidies would subject universal banks to market forces similar to those that forced the breakup of many commercial and industrial conglomerates during the 1980s and 1990s.[526] Other scholars and policymakers have advocated more far-reaching measures, including maximum size caps on financial institutions and a Glass-Steagall type of separation between banks and capital markets activities.[527] While the most promising reforms are still a matter of debate, it is abundantly clear, given the unfortunate history of Citigroup and many of its megabank peers, that we cannot afford to tolerate the status quo.

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offer, and in their geographic reach. . . . Breaking up large banking companies would only send the business of corporations like AT&T, Texas Instruments and Southwest Airlines overseas" to foreign universal banks), *available at* http://www.dallasnews.com/opinion/latest-columns/20130128-rob-nichols-u.s.-cant-afford-to-break-up-big-banks.ece, *archived at* http://perma.cc/5QP4-LB9Z; The Clearing House Ass'n, *Study Examines Large Banks' Contributions to the Economy* (Nov. 7, 2011) (announcing release of sponsored study concluding that the twenty-six largest U.S. banks provide significant benefits to "consumers, companies and governments . . . in the form of economics of scale, the broad scope of products and services that large banks provide, and the spread of banking innovation."), *available at* https://www.theclearinghouse.org/publications/2011/economics-of-large-banks, *archived at* http://perma. cc/G97K-W3JY.

522. Wilmarth, *Dodd-Frank*, *supra* note 231, at 958-59, 978-79; *see also* Wilmarth, *Blind Eye*, *supra* note 405, at 1312-14, 1345-47.

523. Wilmarth, *Blind Eye*, *supra* note 405, at 1314-17.

524. ONARAN, *supra* note 14, at 4-13, 147-56.

525. *See, e.g.*, Wilmarth, *Dodd-Frank*, *supra* note 231, at 1034-52, 1056-57.

526. *Id.* (describing my "narrow bank" proposal).

527. JOHNSON & KWAK, *supra* note 452, at 208-20 (advocating the imposition of maximum size caps); Jeff Bater, *Systemic Risk: McCain, Warren Push Glass-Steagall Bill to Reduce Risks from Megabanks*, 101 BNA'S BANKING REPORT 95 (July 16, 2013) (discussing the introduction of a proposed bill, the "21st Century Glass-Steagall Act," by Senators Elizabeth Warren (D-MA), John McCain (R-AZ) and Maria Cantwell (D-WA)).