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# Davis Polk

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July 21, 2015

Re: In the Matter of Citigroup Global Markets, Inc. (HO-11492); In the Matter of Citigroup Global Markets, Inc. and Morgan Stanley Smith Barney LLC, Certain Principal Transactions (HO-11569)

Via Electronic Mail and Hand Delivery

Sebastian Gomez Abero  
Chief, Office of Small Business Policy  
U.S. Securities and Exchange Commission  
100 F Street, NE, 3rd Floor  
Washington, DC 20549-3628

Dear Mr. Gomez Abero:

This letter is submitted on behalf of our client, Citigroup Global Markets Inc. ("CGMI"), the settling respondent in the above-captioned administrative proceedings brought by the United States Securities and Exchange Commission (the "Commission"). CGMI and its affiliates act or may act in the future in one or more of the capacities subject to the disqualification set forth in Rule 506 of Regulation D of the Commission promulgated under the Securities Act of 1933 (the "Securities Act"). Accordingly, CGMI hereby requests, pursuant to Rule 506(d)(2)(ii) of Regulation D, waiver of any disqualification from relying on exemptions under Rule 506 of Regulation D that will be applicable to CGMI, any of its affiliates, and other associated issuers that have retained or may retain CGMI and its affiliates in connection with transactions that rely on these exemptions, as a result of the entry of an order against CGMI (the "Order") in connection with the above-captioned matters, which is described below.

## **Background**

The Enforcement Staff has engaged in settlement discussions with CGMI in connection with the above-captioned administrative proceeding and has determined that CGMI has violated Section 15(g) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 206(4)-7 thereunder. Without admitting or denying the findings included in the Order, except as to the Commission's jurisdiction over it and the subject matter of the proceedings, CGMI has consented to the entry of the Order, which institutes administrative and cease-and-desist proceedings pursuant to Sections

15(b) and 21C of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act and imposes remedial actions.

Pursuant to the Order, CGMI has been censured and will pay a civil monetary penalty in the amount of \$15 million. CGMI has also been ordered to comply with an undertaking to retain or continue to retain a consultant to conduct a comprehensive assessment of CGMI's trade surveillance program and order handling in relation to transactions for which CGMI acts as an investment adviser.

*CGMI's Trade Surveillance: Loan Watch List and Restricted Trading List ("RTL")*

As set forth in the Order, the Enforcement Staff has found that, for a number of years, monitoring of CGMI's trading, including proprietary trading, was inadequate because it did not monitor a portion of the trades executed by certain of its trading desks. Due to certain technical errors, the electronic trade reports that CGMI personnel used for daily surveillance of trading against its Loan Watch List and RTL were missing data concerning relevant trades executed on certain trading platforms.

CGMI's Loan Watch List concerns several CGMI trading desks that primarily trade corporate loans and conduct trading on behalf of both CGMI and its customers (customer trading can be solicited or unsolicited). In some instances the loan agreement associated with these loans permits CGMI to access public and nonpublic information about the borrower through web sites run by third-party vendors. At CGMI, if a loan desk trader wants to access nonpublic information through such a web site, the trader is required to obtain permission from the Control Group to access nonpublic information. Once such permission is granted, the trader is permitted to access nonpublic information about the borrower, whose name is added to the Loan Watch List. Once a borrower is on the Loan Watch List, the loan desks may not trade securities of that borrower, and CGMI's Information Barrier Surveillance Group ("IBSG") personnel conduct surveillance for compliance with that policy.

Between 2002 and 2009, the trade reports that IBSG staff used to review trading by the loan desks were populated by a data feed that contained only loan trades and not the loan desks' securities and swaps trades. As a result, IBSG did not monitor a portion of the trading by a majority of the loan desks -- of the loan desks' 3 million securities and swap (not loans) trades over a 42-month sample (January 2008 through June 2011), there were approximately 12,000 trades in the securities of 16 different issuers that were on the Loan Watch List at the time of the trades but were not subjected to surveillance at the time.

CGMI's RTL applies to all CGMI trading firm-wide, and its primary purpose is to restrict firm and employee trading for regulatory and business policy reasons. IBSG conducted firm-wide surveillance to monitor compliance with the RTL using two exception reports -- the "002 report" and the "282 report" -- that identify, respectively, trades and position changes for issuer names that were on the RTL. To conduct this surveillance IBSG personnel manually reviewed transactions from one of two legacy platforms in the 002 report and position changes from both legacy platforms in the 282 report.

From June 2009 through March 2012, the 282 report contained only data from one of the legacy platforms and omitted data from the other legacy platform. The problem resulted from a coding error that occurred as changes were being made in 2009 as a result of CGMI's joint

venture with Morgan Stanley. An IBSG analyst noticed the issue in mid-2009 and alerted her IBSG supervisors who engaged in efforts with CGMI's Information Technology ("IT") staff to resolve the issue. By late 2009, IBSG staff believed the report was fixed but, in fact, it was not. The issue was not repaired until 2012, when the 002 report was changed to include trades placed through both legacy platforms instead of the previously-used version containing only one platform.

#### *Principal Transactions Executed Through Affiliated Market Maker ATD*

The Order also sets forth the Enforcement Staff's findings that, for a period of approximately two and a half years, certain advisory orders were inadvertently routed to one of CGMI's affiliated market makers, Automated Trading Desk Financial Services LLC ("ATD"), on a principal basis. CGMI should not have allowed these orders to be routed to ATD and executed on a principal basis, and CGMI's trade surveillance did not detect that principal transactions were being executed through ATD.

In October 2007, Citigroup purchased OTC market maker ATD. Prior to the acquisition, CGMI routinely routed advisory orders to ATD for execution. However, when ATD became a Citigroup affiliate, any CGMI advisory orders executed by ATD for its own account resulted in principal transactions. Accordingly, CGMI adopted two procedures to attempt to identify advisory orders and route them away from ATD: 1) manual advisory account coding; and 2) database cross-referencing.

With respect to manual advisory account coding, CGMI instructed its employees that all advisory orders entered into a certain front-end order-entry system should be designated as such by manually typing the code "MMA" (meaning "money managed account"). However, employees often failed to input the MMA code, and by July 2008, CGMI realized that not all advisory orders were being manually coded as required and it automated the coding process. Despite its knowledge that some advisory orders had not been coded correctly, CGMI did not search for unauthorized principal transactions arising before the automation of the MMA coding.

With respect to its database cross-referencing procedures, CGMI's order management system ("OMS") checked all entered orders to determine if there was a match between the account information on the order and the account information in its advisory account database. If there was a match, the system concluded that the order came from an advisory account and marked the order "DNC." Such orders were routed away from ATD for execution; however, if there was no match, the system allowed it to be routed to ATD. This process was ineffective because the database did not contain all of the advisory accounts. Although CGMI learned in or around March 2008 that the advisory account database was not being updated properly, it failed to conduct a review of previous transactions to determine whether any of them were executed on a principal basis with ATD.

These issues were compounded when CGMI implemented new programming that was designed to permit more efficient use of CGMI's router for wholesale order flow. When this programming change was introduced in March 2008, it inadvertently caused the system to remove the DNC tags associated with advisory orders. Without the Do Not Cross tag, advisory account orders could be routed improperly to ATD for execution unless manually coded MMA.

Because CGMI did not test compliance with its manual MMA coding policy, did not ensure that its advisory account database was updated regularly, and did not adequately test how new programming affected advisory orders, CGMI inadvertently routed advisory orders to ATD that resulted in more than 467,000 principal transactions. Further, CGMI's trade surveillance failed to

detect these principal transactions for more than two years because it relied on an exception report that was not designed to capture transactions resulting from orders that CGMI handled as agent but then routed to an affiliated broker – such as ATD – that then executed the orders on a principal basis.

### Discussion

CGMI understands that entry of the Order will disqualify CGMI, its affiliated entities, and other issuers that have retained or may retain CGMI and its affiliates in connection with transactions from relying on the exemptions available under Rule 506 of Regulation D. Should CGMI be deemed to be an issuer, predecessor of the issuer, affiliated issuer, general partner or managing member of an issuer, solicitor, or underwriter of securities or acting in any other capacity described in Securities Act Rule 506, CGMI and other entities with whom CGMI is associated in one of these listed capacities will be prohibited from relying upon the Rule 506 offering exemptions when issuing securities.

The Commission has the authority to waive disqualification from the Regulation D exemptions upon a showing of good cause that such disqualification is not necessary under the circumstances. See 17 C.F.R. §§ 230.506(d)(2)(ii). CGMI requests that the Commission waive any disqualifying effects that the Order will have with respect to CGMI, its affiliates, or any issuer that engages CGMI as a placement agent or in any other capacity on the following grounds:

#### Nature of the Conduct At Issue

1. CGMI's conduct as set forth in the Order does not relate to the offering or sale of securities. Rather, the Order concerns certain technological errors that caused CGMI's surveillance for trading in violation of legal requirements and firm policies to be inadequate.
2. As described in the Order, the technological errors at issue continued for various periods of time. CGMI's inadvertent exclusion of non-loan trades from its LoansQT data feed and, consequently, its surveillance for trading against the Loan Watch List, began in 2002 and was discovered and repaired in 2009. During this time, IBSG personnel did not notice that the daily trade reports used for Loan Watch List surveillance did not include securities and swaps trading. The reports did not expressly state the type of product being traded and the employees who performed surveillance primarily were focused on the issuer names, not on the types of products traded. The data feed was promptly repaired to capture non-loan products following discovery of the issue.

CGMI's omission of certain data from the reports used to monitor compliance with the RTL was first noticed in mid-2009. The issue was brought to the attention of certain IBSG supervisors, who communicated with CGMI's IT staff in a different office and overseas to repair the issue. However, communication among the groups was ineffective. By late 2009, the IBSG staff believed that the report had been fixed, but, in fact, it had not. In early 2012, one of the reports was changed to include trades placed through both legacy platforms (instead of the previously-used version containing only one platform) and became CGMI's primary surveillance for monitoring trades against the RTL.

During the time that the Loan Watch List and RTL surveillance reports were missing data, CGMI used a number of other surveillances to monitor for potential misuse of material non-

public information and other violations of law, including event-driven deal reviews and other bespoke lookback reviews, surveillance of firm and personal trading by employees designated “over-the-wall,” pre-clearance requirements, and daily surveillance reports covering employees’ personal trading activity. Perhaps as a result of these compensating surveillances, as noted below, a third-party review of transactions that were not subject to surveillance did not identify any instance of insider trading.

CGMI’s inadvertent routing of transactions on behalf of advisory clients to ATD occurred from approximately October 2007 through February 2010. However, the incidence of managed account orders routed to ATD diminished markedly as a result of systems improvements that CGMI introduced in July 2008, so that 90% of the misrouted orders preceded July 2008, and only 10% took place during the period between August 2008 and February 2010.

3. None of the trade surveillance technological errors at issue in the Order – all of which occurred at least two years ago – has resulted in any criminal charge or conviction and do not constitute any scienter-based violation.
4. The Order does not attribute responsibility for the technological errors at issue to any individual. Furthermore, the conduct as set forth in the Order has not resulted in any charge, proceeding, or conviction of any individual. The IBSG supervisors who were advised of the RTL issue in mid-2009 are no longer employees of CGMI.

#### Remedial Measures

5. CGMI has taken a number of voluntary steps to address the technological errors that were the source of the violations discussed in the Order. Each of the technological issues described above and in the Order was repaired more than two years before the date of the Order.
6. In addition to repairing the technological issues, CGMI has invested significant resources over the past two and a half years to assessing and enhancing its IBSG surveillance program. First, CGMI has made a number of proactive global investments to enhance its technology and operational systems, including the development of strategic surveillance platforms, the implementation of an alert-based case management application to manage surveillances and facilitate workflow, and significant increases in Compliance Technology support staff. Second, CGMI has relocated certain of its IBSG functions and positions from Buffalo, New York to Jersey City, New Jersey, allowing for geographical proximity between the relocated IBSG functions and senior IBSG and Compliance management, as well as the personnel whose activities are being monitored. The relocation also included many personnel changes, including the addition of new personnel with additional qualifications and significant compliance and industry experience.

These changes have resulted in significant improvements to CGMI’s IBSG surveillance program, including the identification and repair of additional issues involving trade surveillance. For example, CGMI determined that certain reports did not include some foreign employees operating in the United States and some employees’ personal accounts held at brokerage firms other than CGMI and has repaired that issues. The investments that CGMI has made with respect to its surveillance processes and

personnel have resulted in a more efficient surveillance program that is administered by experienced personnel with dedicated technical support. Through these ongoing efforts to enhance its surveillance program, CGMI has made adjustments designed to prevent technological issues and to facilitate effective identification, escalation, and repair when such issues arise.

CGMI also conducted a historical review of transactions that were not subjected to Loan Watch surveillance and engaged a third-party consultant, Navigant Consulting Inc., to conduct a historical review of transactions that were not subjected to RTL surveillance. These reviews did not identify any instance of insider trading. Additionally, CGMI voluntarily retained a third-party consultant, Deloitte & Touche LLP ("Deloitte"), to conduct a comprehensive review of its IBSG practices and to recommend improvements to CGMI's surveillance practices and the technology used to implement its trade surveillance. Deloitte's review is ongoing and Deloitte has not yet provided any final recommendations to CGMI.

CGMI also is required to comply with certain undertakings set forth in the Order. These undertakings require, among other things: (a) CGMI to retain a consultant, or continue to retain its current consultant, to conduct a review of CGMI's current surveillance program, including its implementation and enforcement of trade surveillance policies and procedures, its surveillance report development, process of applications, change management processes and procedures, and its use of the Loan Watch List and RTL; (b) CGMI to retain a consultant, or continue to retain its current consultant, to conduct a review of CGMI's policies and procedures concerning the handling and routing of advisory orders; (c) the consultant(s) to prepare a written report that evaluates the areas reviewed and provides recommendations about how CGMI should modify or supplement its trade surveillance policies and procedures and advisory account order handling and routing policies and procedures and the implementation and enforcement of such procedures; (d) CGMI to take all necessary and appropriate steps to adopt the consultant(s) recommendations; and (e) CGMI to certify, in writing, compliance with the undertakings.

In addition to repairing the technological issues and enhancing its IBSG program, CGMI voluntarily paid \$2.5 million, representing ATD's total profits from the principal transactions at issue, to the affected advisory client accounts.

#### Impact of Disqualification

7. By impairing their ability to issue securities pursuant to these exemptions to raise new capital and for other purposes, the disqualification of CGMI and any related entities would have an adverse impact on third parties that have retained or may retain CGMI and its affiliates in connection with transactions that rely on the exemptions available under Rule 506 of Regulation D. As of July 2015, CGMI acts as placement agent for at least 30 hedge fund pooled investment vehicles that use the offering exemptions under Rule 506 for numerous transactions that have current assets under management of approximately \$3 billion. CGMI also acts as placement agent for 19 private equity and real estate funds that have completed transactions in the first half of 2015 and 9 private equity and real estate funds scheduled to complete transactions this year. Together, these 28 funds have current actual and projected assets under management of approximately \$2.6 billion. Citibank, N.A. (Citibank), an affiliate of CGMI, acts as depositary bank for 135

Global Depository Receipts programs (GDRs) totaling approximately \$16.7 billion and 556 Global Depository Notes programs (GDNs) totaling approximately \$5.9 billion, and relies on Rule 506 and Regulation S to issue GDRs and GDNs in transactions exempt from registration under the Securities Act to Qualified Institutional Buyers and to persons other than US persons, respectively. Rule 506 provides CGMI, certain of its affiliates, and other third party issuers that use CGMI and its affiliates the benefit of a safe harbor for an exempt offering. Absent a waiver, these entities will not be able to participate in certain offerings and related transactions now and in the future, creating a disadvantage to the business opportunities of CGMI, certain of its affiliates, and the third party issuers that rely on CGMI in certain offerings.

8. For a period of five years from the date of the Order, CGMI will furnish (or cause to be furnished) to each purchaser in a Rule 506 of Regulation D offering that would otherwise be subject to the disqualification under 506(d)(1) of Regulation D as a result of the Order, a description in writing of the Order a reasonable time prior to sale.

In light of the foregoing, we believe that CGMI has shown good cause that relief from the disqualification set forth in Rule 506 of Regulation D should be granted. In the past, the Commission has granted relief under Rule 506 of Regulation D in similar circumstances where entry of a settlement order pursuant to Section 15(b) of the Exchange Act and/or Section 203(e) of the Advisers Act would have disqualified the settling entity.<sup>1</sup> Accordingly, we respectfully request that the Commission, pursuant to Rule 506(d)(2)(ii) of Regulation D, waive the disqualification provision in Regulation D applicable to CGMI, its affiliates, or issuers that engage CGMI as a result of the entry of the Order.<sup>2</sup>

Please do not hesitate to call me at the above number should you have any questions. Thank you for your consideration.

Very truly yours,



Linda Chatman Thomsen

cc: Robert Cohen, SEC Division of Enforcement

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<sup>1</sup> See, e.g., Jefferies LLC, SEC No-Action Letter (pub. avail. Mar. 12, 2014); Instinet, LLC, SEC No-Action Letter (pub. avail. Dec. 26, 2013); A.R. Schmeidler & Co., Inc., SEC No-Action Letter (pub. avail. July 31, 2013); Janney Montgomery Scott LLC, SEC No-Action Letter (pub. avail. July 11, 2011).

<sup>2</sup> CGMI is not requesting waivers of the disqualifications from relying on Regulation A and Rule 505 of Regulation D at this time because it does not now use or participate in transactions under such offering exemptions. CGMI understands that it may request such waivers in a separate request if circumstances change.