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### FCIC memo of staff interview with Michael Lombardi and Kevin Sigrist, Florida State Board of Administration

Michael Lombardi

Kevin Sigrist

Tom Krebs

Joel Miller

Steven Mintz

*See next page for additional authors*

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**Author/Creator**

Michael Lombardi, Kevin Sigris, Tom Krebs, Joel Miller, Steven Mintz, Landon Stroebel, Randall Dodd, Michael J. Pucillo, and Maureen Hazen

**Michael Lombardi and Kevin Sigrist, Florida State Board of Administration**

MEMORANDUM FOR THE RECORD (MFR)

October 19, 2010

LOCATION: By teleconference - Offices of Florida State Board of Administration (SBA), Tallahassee, FL and the offices of the FCIC, Washington, D.C.

INTERVIEWER(s): FCIC: Tom Krebs, Asst. Dir. ; Joel Miller, Research Team; Steve Mintz, Staff Writer; Landon Stroebel, Research Team; Randall Dodd, Sr. Researcher

NON-FCIC PARTICIPANTS : SBA: Michael J. Pucillo, outside counsel to the SBA, Law Firm of Berman DeValerio, Palm Beach Gardens, FL; Michael Lombardi, Sr. Portfolio Mgr, SBA; Kevin Sigrist, Dep. Exec. Dir., SBA; Maureen Hazen, General Counsel, SBA.

*The summary below includes summaries that are close to quotes and covers the following subjects: State and local government pooled funds; short term fixed income investments; money market like funds; rating agencies; ABCP; interest rate and credit rate risks; break the buck and run on the fund; and 144A securities*

**SUMMARY OF INTERVIEW:**

*Verbal consent to recording obtained from each witness by Mr. Krebs.*

*Principal witness – unless otherwise noted – Michael Lombardi*

*Principal interviewer – unless otherwise noted – Joel Miller*

- FL Local Govt. Pool (LGP) – objective to allow daily redemption at \$1 NAV to participants while providing a competitive return. In 2007, took on additional credit risk as he was unwilling at the time to take on interest rate risk.
- Does not recall that FL had the #1 yielding pooled fund in 2007.
- Dealt only with the largest 20 B/Ds; Lehman and JPM-C sold them the SIVs that ended up becoming impaired. Frequent conversations with traders who encouraged them to buy securities at potentially more attractive prices than those quoted on Bloomberg.
- Concerned about housing market, but took informed risks based upon credit ratings of the securities they bought.
- Litigation pending against Lehman and JPM for sale of securities to FL LGIP. However, basis appears to be that they sold 144A limited securities to the pool – a basis for rescission of the transaction under the securities laws.
- Fund encountered unprecedented run in November '07, following a series of articles in Bloomberg that identified mortgage related securities in their portfolio. Massive outflow prompted them to freeze the fund on 11/29/07. They could not maintain the \$1 NAV if they

continued to allow unlimited daily redemptions. Those left in fund would be stuck with least liquid, impaired securities.

Educational and work experience: Cooper Union – Civil engineering '79; MBA Fordham Univ. '88; Port Authority of NY and NJ – Treasury Department operated various funds for them. Obtained CFA. Joined FL State Treasurer's Office – overseeing fixed income managers (1999); managed fixed income portfolio and was responsible for its fixed income managers; both internal portfolio and external managers. In 2004, oversaw short term debt – local govt. pool. In 2008 transferred to Alternative Investments – oversees and hires external investment managers.

Reported to Rob Smith, who oversaw fixed income. Oversaw long term and short term (cash portfolio) desks. Oversaw five people – four on trading desk and one who oversaw the operations group and sec-lending (that was managed externally). The Local Govt. pool – he managed directly. It was a 2a-7 like portfolio. Only difference was they could buy Treasury and Agency securities with up to a two year maturity, rather than limited to 13 mo. maturities (as required by 2a-7). Guidelines to manage it similarly to a 2a-7 fund.

Eligible securities – Treasuries, agencies, and anything short-term rated A1/P-1; if long term than could have rating of A or better by national rating agency. They had a buy list of eligible programs for investment. Commercial paper – would go through eligible issuers on screen and do work to determine what issuers were about.

Q: What was process for evaluating what to buy? How did you get on approved list?

A: Straight CP – e.g., UPS. They would look at rating; then try to understand program; look at specific day's issuance. Straight CP – going with promise you'd be paid. Asset backed would look at collateral.

ABCP – needed two rating agencies at A1/P1. Then they'd look at a min. prog. size to get decent liquidity. Needed to have minimum of two dealers involved. Quite often – that was it for that security. Except for some of the larger programs with multiple dealers. Industry norm.

ABCP – bank sponsor – guarantor that they'd be paid. Then needed to understand the collateral. If no bank guarantee, would look at the collateral in that program.

Q: ABCP – 2007 – what type of docs would you look at before you purchased the security? Offering docs; investor presentations – printout of underlying collateral?

A: No, not always – sometimes just the restrictions on the collateral;. If an existing program, would get copies of monthly reports – that they met restrictions and guidelines.

Q: Particular characteristics you looked for vs. deal killers?

A: Nothing was necessarily a deal killer. Most that came through had AAA collateral. Gave them a lot of comfort.

Q: ABCP – what was nature of collateral?

A: AAA tranche of a residential MBS. Diversified portfolio gave them comfort that it was predominantly all AAA underlying.

Q: Did you reject any securities after drilling down to look at underlying collateral.

A: Some were rejected outright due to lack of transparency or lack of guaranty. Does not recall that it was the collateral that had them back off.

Q: Newsletters – March and June 2007 Newsletters – Local Govt Pool Newsletters – correct that he wrote byline. In both of them - starting in March 2007 you pointed out that you had fewer Treasury and Agency securities than before, but focusing on less than 3 mo. Securities so you could accept more credit risk and minimize interest rate risk. Felt he could handle some additional credit risk if he kept duration/maturity short.

Q: From 2005-Summer 2007, portfolio's concentration from Treasury/Agency debt from about 25% to 2% of the portfolio. Why the change in the composition of the portfolio?

A: Correct. Most of it was unwillingness to take interest rate risk. Trade off of how he managed taking on more credit risk. Taking on more credit risk would lead to higher returns. Taking more interest rate risk would lead to higher returns. Here trading one risk for another. Instead of buying a discount agency notes for a week, he bought CP for a week. Govt. would have lower credit risk than CP issuer – even though they were A1 or better. In 2007 made conscious effort to get lower maturity due to concern with direction of interest rates.

Dodd Q: Rising interest rate environment?

A: Not sure if it was comparable return – trying to avoid losses. If int. rates really rose, he'd have to take some losses. At same time couldn't reinvest at higher rate. By staying short – could reinvest at higher returns. If he felt int. rates were going to come down. Then he would have bought long credit. Trying to manage risk – keep it manageable – taking credit risk; not taking int. rate risk.

Pucillo: Duration – fluctuations month to month in the fund. Explain that.

A: Pool was extremely seasonal. Inflows/outflows. Set it up so securities would mature at certain times. Bulk coming in from property taxes – 3<sup>rd</sup> week of Nov. into January. After that, slow bleed out. Anticipating that – would determine week to week investments. Needed to keep same day redemptions available. Didn't know on any particular day how much to have available. In November – run on the fund.

Q: Prior to Nov. '07, were there any unanticipated runs or major withdrawals.

A: Participants were amazingly predictable in their cash flow in and out.

Q: June – 2<sup>nd</sup> Q – '07 – written in July '07 – rising delinquencies – you wrote - “the housing market contagion is leaking at the seams.”

A: Saw Bear Stearns portfolios in March – lower tranches of subprime that they leveraged. They took a lot of risk and it didn't work out. Housing is softening. Still did not see that coming into AAA tranches of any securities. Housing prices had fallen off; bubble no longer expanding. But bubble had not burst. Prices not coming off at any kind of alarming numbers. Maybe in California – but at that point – no indication that it was system wide; still anecdotal. Sure seemed that the big expansion was kind of finished.

Q: Did you have conversations with brokers at Lehman or other firms?

A: Used Bloomberg screens to compare offerings from multiple brokers. Everything was in competition. B/Ds would also have salespersons who would call directly. They would indicate different pricing for different size transactions. Yes, they had regular conversations with regard to what there was to buy.

Everything they saw was an indication of interest; they negotiated prices. If quote was 5.30 and they wanted 5.40 – they had option to accept or reject

All prices were actionable – they chose to call up and negotiate price. Bloomberg – you could hit if you wanted to – could you renegotiate through terminal or phone – both.

Typically used terminal; if trader wasn't giving the level they wanted; pleas their case and they might get better price.

Sales people would point out they had certain paper on the screen. They promote what they have available. Might lead them to believe trader having trouble placing paper –

Q: Did you take advantage of those arrangements.

A: They negotiated all day. Whether through the terminal or in discussions. Could go either way – on screen or calling up – they had the ability to do large size. Others with smaller portfolios wouldn't get time of day from a broker. With a large fund, they had more negotiating power.

Q: SIVs – KKR, Axim, Ottimo. What were advantages; risks – Spring, Summer '07

A: KKR Atlantic – had been buying it for well over a year. Nothing extraordinary. They came up with KKR Pacific program – Spring '07 – similar program. No issues at all. Ottomo – similar to KKR's. Other programs with residential mortgages as their collateral = everything was AAA tranche as collateral Did not think housing would impact them.

Q: Discussion with Lehman regarding the collateral; expections for performance?

A: Still receiving monthly reports – didn't seem like any issue with portfolio requirements. No specific discussion with Lehman about collateral or securities.

Q: KKR Atlantic and Pacific –discussion with trader that you could get particularly good price?

Does not recall anything special about those securities.

Q: Any memorialization of discussion – difference between quote on screen and price he paid – no documents that reflect. No e-mail?

A: Confirm – would show price. Wouldn't show original offering price. Screen price would change all day also,. No memorization of those discussions.'

Q: What about JPM – Ottimo and Axum. Any discussions in which those securities were discussed. Was someone describing those securities in a way that made them sound better than they were?

A: No – didn't hear anything different about them.

Q: Does SBA have any actions against JPM and Lehman based upon sales of those securities?

Lawyer answering – filed claim in B/R with Lehman; tolling agreements in place with JPM. Is there a lawsuit that you initiated with JPM regarding these same securities. Tolling agreement in place – Krebs and counsel discussed this already.

Pucillo: any lawsuits? – filed a claim vs Lehman; JPM no current lawsuit – tolling agreement in place.

Krebs – one certainly being considered depending upon facts. If you're engaged in negotiations regarding settlement – then it's confidential.

JM – we are requesting copy of Lehman B/R claim.

Q: Whether representations made from Lehman and JPM regarding these particular securities.

A: No – they were not hyping g these securities.

Q: Were there other securities that Lehman, JPM, other firms would try to sell you on?

A: Occasionally, new programs – they'd show materials.

Krebs – you had been dealing with these folks for quite a while?

Q: Since 2005; if salesmen knew what they were doing they knew better than to shop things they weren't interested in.

A: Correct. There were other salesmen who might show 2 yr corporate paper – e.g. There were more aggressive less informed people who tried to sell anything. If you weren't in the top 20 – couldn't put them on the approved broker list.

Krebs: Why the top 20 league tables, as opposed to a specialist.

A: Pool couldn't buy CDOs or RMBS straight up. Small regionals sourced their offerings from top 20 dealers – went directly to traders.

Q: Yield – Interrogatory #2 – was it to enhance LGIP yield? Answer: was safety and short term duration and then returns? How was it you were able to maintain a fairly high yield for fund?

A: Overwhelming reason they had a fairly competitive return – they were charging 1.5 to 2 bp – as compared to commercial MM fund managers. Had an advantage right from the start.

Q: When compared to a MMF, what about comparing your state pool with comparable pools in other states?

A: Does not recall comparing themselves with other state pools. In July '07, the FL LGIP fund was the #1 yielding fund.

A: Does not recall that.

Q: For Kevin Sigrist – yield – were you aware that FL fund was either the highest yielding or among the top few.

A: Did some diagnostics later – David Evans at Bloomberg also highlighted that in Fall '07. Comparison – is on a net of fee basis. Because fees were so low, made their fund look high. Graphic for 3<sup>rd</sup> Q Newsletter – graphic on front page – annualized participant returns – iMoney net – on a gross basis – not net – could see longer term performance – shorter term 5 bp between pool and imoney net institutional peer group and 10 bp difference between S&P gross index.

Q: Was there a conscious effort to ensure pool participants were getting among the highest yields available.

A: Was not in competition with other state pools. Sometimes calls from local banks - how can you offer these returns. Fee schedule 2 bp – they'd hang up. Size on their size to get a few bp on each trade. Didn't think there was anything extraordinary about it?

Dodd: Q: What was different about FL fund from other state and local funds?

A: Nothing all that different – but doesn't know if there's was all that different. E.g., competition within state of California – L.A. County vs. State pool.

Q: Concentration in Countrywide CDs – summer 2007 –

A: recalls only having bank debt. Ltd to 5%; typically held individual issuances to 3%.

Q: Countrywide in news quite a bit – why take on new debt?

A: Would have spoken to guys on long term desk. Felt more comfortable with bank debt rather than corporate holding. Turned out OK.

Q: Analyzing a place like Countrywide – how frequently would you have discussions about the company; risks?

A: No set schedule – open floor; general discussions all the time. If someone saw something that gave them pause they'd have discussions about it.

Q: Bloomberg articles – November 2007.

A: Personal response was there was a lot of misinformation and it appeared to be pretty inflammatory – didn't see why he was making those statements. Never interviewed.

Kevin – talked with him – can't recall whether it was on record or not – guesses it was off the record.

Q: Within a couple weeks – fund had to be shut down.

Kevin: Process – in October 2007, a lot of public record requests. All encompassing; everything pertaining to the pool. Sat down with David Evans – want to be responsive but time and \$ cost to retrieve it all. Winnowed down to what he was interested in. Context for talking to him .

In the meantime – worked on expansive Newsletter that came out in late October early November – gone through some downgrades of indie. Securities; restructuring; KKR – A&P had been restructured; Axon not yet in default; Ottimo problems. 3<sup>rd</sup> Q Newsletter – expanded upon – finalized report for 11/14/07 presentation on exposure across various portfolios.,

Same day as Bloomberg's first article. \$2.2 bil. everything disclosed across all portfolios – not just local govt pool. From that point forward – ramping up their outreach. Number of calls to pool participants to discuss contents of Newsletter and answer Qs about what was happening.

Monitoring cash flows on a close basis throughout November for fear there might be higher outflows. Day to day basis – Michael would manage liquidity of pool

Michael – when they saw more outflows than normal. Had no problem meeting them. Sold a few hundred million in paper that hadn't matured yet. There's a limit to redemptions. Proved out liquidity of the portfolio.

Q: At what point did you recognize there was not unlimited liquidity.

Kevin - A: Decision made 11/28/07, emergency meeting of trustees – next morning 11/28 trustees had discussion about investments; depositor flows; and decided to close pool. Went to Blackrock – 3<sup>rd</sup> party adviser- to decide what to do about pool.

Mike – pool normally closed after 11 a.m. every morning. Honored all redemptions through that morning.

Kevin – building flooded that morning. Pool phone line shut down; emergency meeting; discomfort of participants. Lost significant amount of assets 21% that morning.

Q: Could pool have remained open and met the requests for redemption going forward.

A: Would have to speculate. Could have gone a few more days – but could not handle much more outflows. Would have to sell securities that had not matured. If not at par, then less money available for everyone.

Inherently that's the flaw of a co-mingled account – no portfolio set up for everyone to have their money all at once.,

Q: Dodd – was there such a penalty? Present value greater than par? What was it about early liquidation that generated insolvency?

A: Needed to be at least 99.5, if you're selling at 97 or 98 cents, there won't be enough. Even securities with 3 months maturity won't be at par

CP bought at discounts – 3 mo later should be valued at 99.5; price in market then taking an accounting loss. No adverse interest rate movements.

Dodd: Fed starting easing in Aug '07, interest rate movements going down. Why would securities result in accounting losses?

Counsel – speculation at this point – nothing was sold at a loss. What if you had stayed open and what if you had sold pool's securities? Fact is redemptions were met; what would have happened if pool were not closed by trustees. Did not go into market to

A: Mike - Certainly demand for ABCP had fallen off – so to try to sell in secondary mkt would not be easy. Pool went from \$27 bil to \$14 bil in three weeks – pretty liquid. Maybe could have gotten to \$10 bil. People left with the \$10 bil have greater concentration of illiquid assets.

Q: Dodd – market wide drop in these assets. Potential losses.

Portfolio value based on 3<sup>rd</sup> party data – pretty high level – when you tried to execute at those prices you couldn't get those marks.

Q: Interrogatory #4 – 11/30/07 – 99.13 what did you use to value the assets with?

A: Value portfolio monthly based on third party marks? Did not value entire portfolio daily.

Q: How did different events impact each other? E.g. Bear Stearns funds in March '07 – In Nov. 2007, with calls you had from investors in fund

A: Municipalities – heard nothing from them about the market. Typically they would electronically put in redemptions or talk with someone in financial ops who handles that function.

Kevin – one person call center – takes calls from pool participants. If investment Q – they'd go to Michael. If Ops Q, they'd handle.

Michael – Very few Qs –

Q: electronic run on the fund.

A: Pretty much .. A few calls from people – mostly in response to newsletter. Had no idea who would pull money out each day. Would find out each day –

Had a small screen that would show inflows and outflows. To ensure they'd be able to meet flows – they'd guaranty til 11 am. MM mkt typically closed at 11 or 11:30. Didn't want to be caught up with too much cash – but needed to be able to honor redemptions.

As month went through, anticipated there could be more money going out.

Q: Steven – quality of ratings – did you look at all ratings agencies interchangeably? Any gradations of quality among the three?

A: In MM area, S&P had plus available for their MM ratings. Rare that they'd have different ratings for same paper. Just need two ratings – two of the three. No difference; they were interchangeable. S&P had a "+" available for their MM ratings. Pretty rare they'd have different ratings for the same program.

Q: Did you question quality of ratings in financial crisis?

A: While it was going on, AAA residential mortgages were still AAA. Thought it was just market demand – causing CP prices to fall; to have problems. Not until later on – that the issue of how they were assigning AAA was an issue. Sloppy models; not doing a lot of work in terms of assigning that rating. A, AA some risk – AAA no supposed to have any risk – supposed to be bullet proof. To downgrade in 2008 a security from AAA to a C was just astounding. Disappointed when it went from AAA to single A. To go from AAA to C meant it should not have been AAA to begin with.

Q. Was AAA warranted? People treated ratings as gospel.

A: Did not do due diligence on collateral – whether they deserved AAA or not. Relied on portfolio managers at the ratings firms. to determine if it should have been AAA to begin with.

Q: Any direct contact with ratings agencies?

A: Occasionally asked about a rating. Long term debt – had contacts with analysts. To clarify a report in a research report.

Q: Taken for granted their reports were right.

A: Research reports – seemed to be appropriate conclusions.,

A: To be eligible for a 2a-7 fund, mandated by law to have these ratings Turns out they had a tougher job than they thought they did.

Q: Dodd – motivation for seeking qualified investment buyer status – 144A.

A: Counsel responded – essentially what happened, in 2000 MFs started purchasing CP 144A securities. Q raised – could the FL pools buy 144A securities even though they are not a QIB. Got a memo that since pool is not a QIB, they can't buy 144A securities. Same securities could be bought through a private placement – secondary market covered by 144A. Nov. 2000 – principles – retirement system is a QIB under securities law definitions. Effort by Michael and others buying for the pool to determine if they were buying from the issuer or in the secondary market.

These were primary transactions according to some brokers. That qualifies it for 4-2 transaction. Lehman claim clarifies this.

Q: Dodd – fact that was not true – these were primary transactions being bought from issuer; in fact they were secondary market offerings bought from the issuer. Buying off the Lehman or JPM desk. Fact that turned out to be different than their understanding at the time. Complaint vs. JP and Lehman – focus on this. Opinion letter – from Sutherland – guidance from counsel. Press reports have been somewhat less than accurate.

JM: Draft complaint and Lehman claim; and letter to Communications Dir. at SBA. Whatever materials would help us understand this we'd appreciate.

Counsel: We'll produce it.

Dodd: Q: Newspaper cited repeated efforts by SBA to obtain this exemption. Eager to make these transactions. Were dealers providing info or support to pursue the exemption?

A: Counsel – some discussion about getting a no action letter from SEC. Can't recall if they pursued it. Only effort to follow up was potentially a no action letter. B/Ds were saying this is a primary sale, not a secondary.

Krebs: Secondary market transaction – but you could avail yourself of 4a-2.

A: Lawyer at Sutherland said you could buy them under 4-2 on day one, but can't buy them on day 2 under 144A.

A: Michael – conversations with brokers – trading screens would highlight which screens are new issue and which are not. St. Pete Times refused to acknowledge – registration has nothing to do with credit quality. They were trying to buy A1 P1 whether registered or not. Registration is not linked to credit quality. They were always asking for new issues. Occasionally they would call back to break trade due to secondary market security. Sometimes he would question why breaking the trade – maybe they got a better price elsewhere?

Q: Krebs – what limits ability of SBA to buy in secondary market?

A: lawyer – pension plan is a QIB. Even though qual. Purchaser, accredited investor – pool is not a QIB – an insurance co. is and a retirement plan is – pooled plan is simply not a 144A entity.

It's not the SBA that's at issue – it is the specific plan. Pension plans – OK. Pooled fund – not.

Q: Dodd – selling these securities? Could they be sold early in case of redemption pressure?

A: counsel – if selling unregistered security, you need to have an exemption. Seller has obligation to make sure there is an exemption present.

Q: Dodd – could affect secondary market value?

A: No = both Krebs and Counsel. You should know if you're selling to a credited investor. Under 12a-1 – buyer has right of rescission.

Any secondary market transaction covered by limitation.

Is market price affected? Speculation – market of 144A securities is huge.

Dodd: Potential buyers are restricted comparing 144A and 4-2.

Michael – they would sell to the dealers. Dealers then turn around and have a slightly smaller market place – can't sell to local govt pools. Could sell to MMFs and insur. co. The few times they sold, they sold to dealers.

Krebs: Documents that will be forwarded: Lehman complaint; Sutherland memo; and counsel letter.