Privileged & Confidential
Attorney-Client Privileged
Attorney Work Product
Investigative Material

MEMORANDUM FOR THE RECORD

Event: Interview with Merrill Lynch

Type of Event: Telephone Interview

Date of Event: February 23, 2010

Participants - Non-Commission:

- Mike Sharp
- Reginald Brown
- Dennis Milowski

Participants - Commission:

- Tom Krebs,
- Mina Simhai,
- Troy Burrus

MFR Prepared by: Troy Burrus

Date of MFR: February 23, 2010

Summary of the Interview or Submission:

This is not a transcript of the meeting and should not be quoted as such

---

1. On Tuesday, 23 February 2010 Tom Krebs, Mina Simhai and I spoke to Mike Sharp, Reginald Brown and Dennis Milowski of Merrill Lynch regarding repurchase agreements (repos). We identified ourselves to them as agents working on behalf of the Financial Crisis Inquiry Commission (FCIC). We asked them if they would be willing to speak with us regarding repos relating to Merrill Lynch. They agreed and provided the following information:

2. Repos are agreements between a borrower and a lender. The lender receives collateral for a loan to the borrower and also takes a "haircut". A haircut is a cut or fee that the lender charges for accepting the collateral from the borrower. The haircut is set and not very fluid. It is based on the type of collateral being used in the transaction. Most tri-party haircuts are between one and fifteen percent, with US Government Bonds being

between one and two percent. The haircuts did not change during the crisis. Investors pulled out of the market and certain types of collateral were removed from the list of acceptable collateral (more risky types such as asset backed securities, AAA bonds and mortgage backed securities). The agreement between the parties is made in advance so both parties know what they are getting in the deal. There is a master repurchase agreement in both tri-party and bilateral deals. In a tri-party deal a bond goes to the custodian bank, which makes sure the transaction is correct (dollar amount of the loan and the dollar amount of the collateral). The deal is confirmed by the custodian bank. Most deals are agreed to prior to the transactions. The terms are set and outlined to the parties involved with the type of collateral known to all parties.

3. The repo market is very large with the commercial banks being the biggest players in the market, both tri-party and bilateral. Tri-party involves three parties (lender, borrower and a clearing bank). Bilateral involves two parties (lender and borrower). The bulk of the market is in tri-party contracts (roughly 80%). Most of the tri-party repos go through two clearing banks (JP Morgan and Bank of New York). Merrill Lynch had $10 billion in repos at their peak and currently has about $2 billion. The bulk of Merrill Lynch collateral is US Government and Agency Bonds (seventy to eighty percent). The rest is Asset Backed Securities (ABS) and non-agency investment grade credit. By the time of the Lehman Brothers crisis, Merrill Lynch had reduced their exposure in the repo market by a significant amount. This was due mainly to the Bear Stearns crisis in March 2008. They extended their riskier obligations from overnight to longer terms (six to none months). This decreases the amount you have to borrow on a daily basis, so your repos are longer and your reverse repos are shorter. So, pre-Bear Stearns the overnight was sixty percent and post-Bear Stearns the overnight was thirty percent. They extended the term to as long as possible.

4. The repo market is made up of different types of collateral. The bulk of the market is US Government Securities (Treasury notes, bills and bonds) and US Agency bonds (Fannie Mae, Freddie Mac and Ginnie Mae). The rest is made up of Corporate Bonds, equities and mortgage backed securities. The Bear Stearns and Lehman Brothers failures had a big impact on the repo market. During the crisis US Government securities became scarce which reduced the availability of these to be used in the repo market (the scarcity was due to foreign purchase and firms desire to hold them). This constriction made it difficult for businesses to use the repo market because the more risky forms of collateral were not being accepted by lenders.

5. Hedge funds and money market funds lend dollars to the repo market instead of collateral. They also do both repos and reverse repos. Fidelity, State Street Bank, Federated Bank and Blackrock/BGI are all big players in the repo market. Hedge funds and money market funds are bigger participants in the non-traditional collateral repos.

6. There is also an anonymous dealer marketplace for repos. The broker is known to the parties, but the other party is unknown (borrower and lender are not aware of each other). The transaction is placed with the broker and the deal is then transacted. This is a more liquid market. Some of the brokers in this market are ICAF, Pre Bond, Broker Tech and Public Liberty. No market developed in this arena for non-traditional items. There are smaller commissions and haircuts in this market. This market allows businesses to transact deals without the knowledge of their competitors.

7. Non-traditional collateral slowly crept back into the marketplace after the crisis (around April or May of 2009). Strict guidelines are now in place regarding the use of non-traditional collateral. There is a close review of the parties involved and the terms are longer which makes them safer. The Federal Government opened the TSLF and PDCF windows. The PDCF window allowed Investment Banks to use non-traditional collateral for repos.

8. The crisis was not caused by the repo or reverse repo market. Over leverage by some firms caused the crisis. Other conduits and Special Investment Vehicles (SIV) created with flimsy finance structures added to the crisis. The purchase of commercial paper that was overvalued caused the Reserve Primary Fund to "break the dollar". The paper ended up being valued at 30 cents on the dollar which was an issue for them.

9. We thanked everyone for the information they had provided and the interview terminated at that point.