Merrill Lynch

Interoffice Memorandum

To: Merrill Lynch Employees
At: Southern California District

From: Daniel P. Tully
At: Chairman and CEO
Tel:

Date: January 10, 1995

Subject: <u>The Merrill Lynch Relationship With Orange County</u>

I enjoyed meeting with you this past weekend to discuss our strategy and objectives for 1995. Rarely do we have a chance to get all of our Southern California offices together as a group, and I believe we were able to take maximum advantage of this occasion to share information and plan for the years ahead.

We covered a wide range of topics, including the Orange County situation. We all regret the concern and anxiety imposed on the residents of Orange County by the county's financial difficulties. At the same time, we all recognize that a significant amount of misinformation continues to circulate in numerous news media accounts -- particularly in Orange County -- regarding Merrill Lynch's relationship with the county and the role we played as one of the broker/dealers with which the county did business over a long period of time. This misinformation compels us to set out facts and information about our actions that you can use to respond to questions you receive from your clients and others. Once this information is known, it will be quite clear why Merrill Lynch has maintained, with confidence from the outset, that we acted properly and professionally in our relationship with Orange County.

You should be aware that Merrill Lynch repeatedly discussed with the county that it stood to incur a marked-to-market portfolio loss should interest rates rise, and we offered in 1993 to repurchase, *at a profit to the county*, all derivative securities in the portfolio that had been purchased from Merrill Lynch. We never served as Orange County's financial advisor, nor did we create or direct the county's investment strategies. Nonetheless, as with all clients, we offered the county our investment and economic outlooks, and our views with regard to risk profiles in light of our interest rate forecasts. These opinions were conveyed both verbally and in writing on a number of occasions. Among them:

- As early as February 1992, senior Merrill Lynch managers met with the Orange County Treasurer's Office to ensure that they were aware of and understood the extent of the risks involved in purchasing derivative securities and doing reverse repurchase agreements. We were reassured by the Treasurer's Office on both points.

- In mid-October 1992, Merrill Lynch sent the Treasurer's Office a cautionary letter analyzing the county's portfolio volatility, based on our understanding of what the portfolio contained in mid-July. The letter first set out that the portfolio, while having an average maturity of only 1.4 years, was exposed to the risk of greater volatility because of the various leverage strategies being used to enhance returns. The letter suggested that "Orange County constantly review the volatility in the existing portfolio and review incorporating some measure of duration [i.e. exposure to changing interest rates] as an additional portfolio guideline."

- Three weeks later, on November 3, 1992, Merrill Lynch again suggested to the Treasurer's Office that, given the relative size of Orange County's derivatives holdings and changes in interest rates and foreign markets, Orange County should re-balance its portfolio.

- In late January 1993, senior Merrill Lynch managers again met with the Treasurer's Office to detail their views on the portfolio's status, risks, and exposure in various interest rate scenarios. The Treasurer's Office reiterated that they understood the risks inherent in the portfolio and added that they believed they could foresee an interest rate increase and adjust their strategy appropriately.

- In the Fall of 1993, Merrill Lynch Chief Investment Strategist Charles Clough expressed his opinion to the Treasurer's Office that bond investors should pull back on duration because bonds were likely to retreat. Mr. Clough recommended a more defensive posture. (Mr. Clough's revised, 1993 outlook for higher interest rates was consistent, by the way, with research subsequently published by Merrill Lynch's Chief Economist, Don Straszheim, and Chief Fixed Income Strategist, Tom Sowanick.)

- On February 23, 1994, Merrill Lynch representatives met with the Treasurer's Office and provided a written presentation which emphasized the unpredictable nature of interest rates and stated: "interest rates going forward are more of a question mark than at any point in the past several years." The presentation added: "Historically the first Fed tightening has led to numerous others." The presentation also indicated that for each 100 basis point interest rate increase, an erosion of approximately $270 million in the market value of the structured securities (derivatives) in the portfolio would result. Merrill Lynch suggested several strategies that the county could implement in a rising interest rate environment.

Much attention has been focused on the fact that the Orange County portfolio contained derivatives. We have stated that securities purchased by the county from Merrill Lynch and contained in its portfolio at the time of bankruptcy were high-quality -- mainly U.S. government agency obligations and bank certificates of deposit appropriate to the county's publicly stated "buy-and-hold" investment strategy. While some of these products were structured notes, they had relatively simple interest rate structures and were not as exotic or high-risk as some accounts have inaccurately described them.

Moreover, as mentioned above, it is important for you to know that in the Spring of 1993, Merrill Lynch offered to repurchase the derivatives in the portfolio that Orange County had purchased from Merrill Lynch. These transactions would have resulted in a profit to the county. Specifically:

- On March 31, 1993, Merrill Lynch sent the Treasurer's Office a written offer to repurchase all of the derivatives which Orange County had purchased through Merrill Lynch and which remained in the portfolio. The letter noted that these securities owned by the county might be particularly volatile due to leverage.

- On April 26, 1993, the Treasurer's Office declined to accept Merrill Lynch's repurchase offer and stated: "We have always been aware of the vicissitudenary [sic] nature of the derivative securities that we have mainly bought from Merrill Lynch and others. Although there may be an alleged interest rate risk in these type of securities, we believe because of future low interest rates that the securities that we now own may be even more valuable than they are today."

- Merrill Lynch reiterated its position in a follow-up letter to the Treasurer's Office on June 16, 1993. This letter stated in part: "It was our hope to assist you in bringing the O.C. portfolio in line with a risk profile that is less leveraged and better positioned to perform in the event of unanticipated movements in interest rates."

In short, Merrill Lynch repeatedly provided the Orange County Treasurer's Office with our views regarding an evolving investment and interest rate environment, and offered real solutions to adapt to changing interest rate trends. While our views (and we presume those of others) were considered, the Treasurer's Office made it clear that they had their own outlook, that it was contrary to ours, and that they would follow their own analysis in managing the county's portfolio.

Orange County has been a client for over 20 years. Merrill Lynch chose not to abandon this client simply because it, as a sophisticated institutional investor, did not share our views on the investment outlook. We were not the sole provider of investment products and financing for the county, which would have been able to pursue its investment strategies with or without Merrill Lynch. We believed that the most responsible role we could play was the one we did pursue -- to keep the client apprised of our evolving views on interest rate trends, and to present options that Orange County could use, if it so chose, to modify the portfolio in anticipation of a more bearish interest rate environment.

In early December 1994, after the county disclosed a marked-to-market loss of approximately seven percent in its total investment portfolio, virtually all of the broker dealers except Merrill Lynch who had provided financing through reverse repurchase agreements liquidated their collateral. This was widely reported to have been a primary factor in the county's decision to file for bankruptcy. Merrill Lynch stood, virtually alone, in its decision not to liquidate our approximately $2 billion in collateral. Instead, we have cooperated fully with the county and its financial advisor, Salomon Brothers, in their plan for the orderly sale of portfolio assets to stem further losses.

It is typical -- but nonetheless disingenuous -- that some now maintain they were not aware of the potential risks involved in the county's investment strategy. Those risks were publicly aired in a recent political campaign, and the strategy of using leverage to achieve above-average returns was discussed in the annual reports made by the Treasurer's Office to the County Board of Supervisors. It is an immutable fact of investing that higher-than-average returns can never be achieved without incurring an equivalent, higher-than-average risk. As all of the key federal regulators testified before Congress last week, it was a leveraged investment strategy, *not derivatives*, that led to the difficulties encountered by the investment pool.

We hope this information is helpful to you in responding to inquiries. While we regret the county's current financial plight, the Merrill Lynch story is a good one. And it is one that will eventually be reported, as we are called upon to assist various regulators and others in piecing together the true facts surrounding the county's current difficulties. As always, we are committed to keeping you, and through you our clients, fully aware of the true nature of Merrill Lynch's dedication to all of our clients.

In closing, I want to reiterate that all of us in senior management greatly appreciated the opportunity to get together with all of you. From our point of view -- and we hope yours as well -- it was time extremely well spent. We want to again thank you for all of your hard work and loyalty, and your ongoing dedication to the Merrill Lynch Principles of Client Focus, Respect for the Individual, Teamwork, Responsible Citizenship and Integrity. These will continue to be our keys to success as individuals, and as a company.

My best wishes to all of you for a healthy and productive 1995.