



Capital Markets in Flux Unprecedented Events During the Week of September 14, 2008

In a series of unprecedented events during the week of September 14, 2008, a number of private and public sector actions occurred that will have broad ranging and long-term implications for the capital markets. These actions include:

- (1) The Chapter 11 bankruptcy filing by Lehman Brothers Holdings Inc. and the subsequent purchase announcement by Barclay's Capital;
- (2) The announced acquisition of Merrill Lynch by Bank of America;
- (3) The creation of the Consortium of Global Commercial and Investment Banks;
- (4) The regulatory actions taken by the Board of Governors of the Federal Reserve to increase liquidity;
- (5) The Board of Governors of the Federal Reserve authorization of an \$85 billion credit facility to American International Group ("AIG");
- (6) The Securities and Exchange Commission ("SEC") actions regarding the Lehman Brothers Holdings, Inc. Chapter 11 filing;
- (7) The SEC's revised "naked" short selling rules;
- (8) Congressional Activity;
- (9) The Federal Open Markets Committee action; and,
- (10) Central Banks Take Coordinated Action to Address U.S. Liquidity Shortage.

These actions represent a coordinated private and public sector response to the pervasive uncertainty regarding the capital markets. In addition, these efforts are also intended to increase market liquidity and to address investor concerns. Detailed below is a summary of each of these activities, as we know them to be right now:

(1) Lehman Brothers Holdings Inc. Files for Chapter 11 Bankruptcy Protection

On September 15, 2008, Lehman Brothers Holdings Inc. ("LBHI") filed a petition under Chapter 11 of the U.S. Bankruptcy Code with the United States Bankruptcy Court for the Southern District of New York. This filing does not include the broker-dealer subsidiaries or other subsidiaries of LBHI. All of the Lehman Brothers broker-dealers will continue to operate.

At the time of the filing, published reports indicated that Lehman had \$613 billion in debt and \$639 billion in assets, making it the largest Chapter 11 case in history, surpassing the 1992 WorldCom, Inc. \$41 billion bankruptcy case. The Lehman Chapter 11 filing includes \$138 billion in senior bond debt and \$17 billion in subordinated and junior bond debt.

Customers of LBHI, including customers of its wholly-owned subsidiary, Neuberger Berman Holdings, LLC, could continue to trade or take other actions with respect to their accounts. Neuberger Berman, LLC and Lehman Brothers Asset Management will be allowed to conduct business as usual and were not be subject to the bankruptcy case of its parent. Additionally, its portfolio management, research and operating functions remain intact. Fully paid securities of customers of Neuberger Berman were also segregated from the assets of Lehman Brothers and thus are not subject to the claims of Lehman Brothers Holdings' creditors.

In a subsequent development on September 16, 2008, LBHI announced that Barclay's Capital, the investment banking division of Barclays Bank PLC, signed an agreement to acquire substantially all of the North American businesses and operating assets of Lehman Brothers Inc., a wholly-owned subsidiary of LBHI and certain related assets of LBHI and its affiliates for \$250 million in cash and certain contingent considerations and assumed liabilities. In addition, Barclay's Capital agreed to purchase the Lehman Brothers headquarters building located at 745 Seventh Avenue in New York City and two of its data centers located in New Jersey for approximately \$1.45 billion. The final purchase price is subject to appraised value. The transactions have been approved by the Boards of Directors of Barclays Bank PLC and LBHI and Lehman Brothers Inc., and does not require shareholder approval. However, the transaction is subject to the approval by the Bankruptcy Court for the Southern District of New York.

The businesses being acquired will include Lehman Brothers' Investment Banking, and Fixed Income and Equities Sales, Trading and Research Operations and certain supporting functions. Approximately 10,000 employees from Lehman Brothers Inc. and LBHI will become Barclay's Capital employees at the completion of the purchase. Barclay's Capital has also agreed to provide LBHI with \$500 million in debtor-in-position financing and a substantial interim credit facility to Lehman Brothers Inc. to fund its ongoing operations. Barclay's Capital plans to begin immediate discussions with the relevant regulatory authorities regarding the purchase of Lehman Brothers Inc.'s similar operations outside of North America.

(2) Bank of America to Acquire Merrill Lynch

On September 14, 2008, Bank of America Corporation announced an agreement to acquire Merrill Lynch & Co., Inc. in a \$50 billion all-stock transaction. Under terms of the transaction, Bank of America will exchange .8595 shares of Bank of America common stock for each Merrill Lynch common share. The price is 1.8 times stated tangible book value. The deal reportedly values Merrill Lynch at \$29 per share, 70 percent higher than its close the Friday prior to the deal's announcement.

The transaction is expected to close in the first quarter of 2009. It has been approved by directors of both companies and is subject to shareholder votes at both companies and standard regulatory approvals. Bank of America expects to achieve \$7 billion in pre-tax expense savings, fully realized by 2012. The acquisition is expected to be accretive to earnings by 2010.

(3) Creation of the Consortium of Global Commercial and Investment Banks

On September 14, 2008, a group of global commercial and investment banks formed the Consortium of Global Commercial and Investments Banks ("Consortium") for the purpose of

mitigating the unprecedented volatility in the capital markets.¹ The Consortium initiated a series of actions to help enhance liquidity and mitigate volatility and other challenges affecting global equity and debt markets.

Consortium members plan on utilizing the expanded classes of collateral under the Primary Dealers Credit Facility (see the next section for additional information), including equities that were made possible by the September 14, 2008 announcement by the Federal Reserve Board. Consortium members plan to continue working closely with one another as well as with the U.S. Treasury Department, the Federal Reserve, the Securities and Exchange Commission, governments and regulators around the world, and other market participants, to provide additional liquidity and assurances to capital markets and the banking system.

Specifically, Consortium members are working together on the following:

- **Collateralized Borrowing Facility** - Establish a collateralized borrowing facility, to which ten banks (Bank of America, Barclays, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Merrill Lynch, Morgan Stanley, and UBS) have committed to fund \$7 billion each (\$70 billion in total). The Facility will be available to these participating institutions for liquidity up to a maximum of one third of the facility for any one bank. The size of the Facility may increase as other banks are permitted to join the facility.
- **Market Liquidity** - Assist in maximizing market liquidity through their mutual commitment to their ongoing trading relationships, dealer credit terms and capital committed to markets.
- **OTC Derivatives** -Help facilitate an orderly resolution of OTC derivative exposures between Lehman Brothers and its counterparties. This effort included opening the OTC derivatives market for trading this Sunday afternoon.

(4) Actions by the Board of Governors of the Federal Reserve to Increase Liquidity

The Board of Governors of the Federal Reserve (“Federal Reserve”) undertook the following actions regarding Primary Dealer Credit and Term Securities Lending Facilities:

- **Primary Dealer Credit Facility** - One of the first significant actions the Federal Reserve took in reaction to the housing finance crisis was on March 16, 2008, when it authorized the Federal Reserve Bank of New York to create a new lending facility. Called the Primary Dealer Credit Facility (“PDCF”), the PDCF is intended to improve the ability of primary dealers to provide financing to participants in securitization markets. The PDCF is an overnight loan facility that provides funding to primary dealers in exchange for a specified range of eligible collateral and is intended to foster the functioning of financial markets more generally.

¹ The Consortium is comprised of the following members: Bank of America, Barclays, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Merrill Lynch, Morgan Stanley, and UBS. MBA notes that the composition of this Consortium may evolve in light of the announced Bank of America and Merrill Lynch merger as well as other pending industry consolidation efforts.

- On September 14, 2008, the Federal Reserve expanded the type of collateral eligible to be pledged at the PDCF. Eligible collateral now includes equities and other types of collateral that can be pledged in the tri-party repurchase systems of the two major clearing banks. Banks use tri-party repurchases for short-term financing amongst each other. Previously, PDCF collateral had been limited to investment-grade debt securities.

This action provides assurance that if investors pull away from brokers, they will be able to access cash through the PDCF by posting an expanded range of collateral.

- **Term Securities Lending Facility** - The Federal Reserve Bank of New York also operates a Term Securities Lending Facility (“TSLF”) that offers Treasury general collateral (“GC”) to the Bank’s primary dealers in exchange for other program-eligible collateral. It is intended to promote liquidity in the financing markets for Treasury and other collateral and thus foster the functioning of financial markets more generally.

On September 14, 2008, the Federal Reserve also expanded the type of collateral eligible for TSLF transactions. TSLF-eligible collateral for Schedule 2 auctions will now include all investment-grade debt securities. Previously, only Treasury securities, agency securities, and AAA-rated mortgage-backed and asset-backed securities could be pledged.

Also, Schedule 2 TSLF auctions will be conducted each week; previously, Schedule 2 auctions had been conducted every two weeks. In addition, the amounts offered under Schedule 2 auctions will be increased from a total of \$125 billion to a total of \$150 billion. Amounts offered in Schedule 1 auctions will remain at a total of \$50 billion. Thus, the total amount offered in the TSLF program will rise to \$200 billion from \$175 billion.

These changes represent a significant broadening in the type of collateral accepted under both programs and should enhance the effectiveness of these facilities in supporting the liquidity of primary dealers and financial markets more generally.

The Federal Reserve also adopted an interim final rule that provides a temporary exception to the limitations in section 23A of the Federal Reserve Act (“Regulation W”). The exemption allows insured depository institutions to finance transactions of a subsidiary broker dealer for securities or other assets that the affiliate ordinarily would have financed through the U.S. tri-party repurchase agreement market. This will provide securities dealers with another source of funding for market making. The exemption expires on January 30, 2009, and is subject to various conditions to promote safety and soundness. Comments on the interim rule must be submitted to the Federal Reserve by October 31.

(5) AIG Credit Facility Authorized by Board of Governors of the Federal Reserve

On September 16, 2008, the Federal Reserve, with the full support of the Treasury Department, authorized the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (“AIG”) under section 13(3) of the Federal Reserve Act. The Federal Reserve determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance. The purpose of this liquidity facility is to assist AIG in meeting its obligations as they come due. This loan will

facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy.

The Federal Reserve indicated that the secured loan has terms and conditions designed to protect the interests of the U.S. government and taxpayers. The loan is collateralized by all the assets of AIG, and of its primary non-regulated subsidiaries. These assets include the stock of substantially all of the regulated subsidiaries. The loan is expected to be repaid from the proceeds of the sale of the firm's assets. The U.S. government will receive a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders. The AIG facility has a 24-month term. Interest will accrue on the outstanding balance at a rate of three-month Libor plus 850 basis points. AIG will be permitted to draw up to \$85 billion under the facility.

(6) SEC Lehman Brother Holdings Inc. Actions

In response to the Lehman Brothers Holdings Inc. Chapter 11 bankruptcy filing, the Securities and Exchange Commission ("SEC") announced that staff would remain on-site at Lehman Brothers to oversee the orderly transfer of customer assets to other brokerage firms. In the announcement the SEC offered assurances that Securities Investor Protection Coverage still applies to the firm's customers.

(7) SEC Modifies "Naked" Short Selling Rules

On September 17, 2008, the SEC took several coordinated actions to strengthen investor protections against "naked" short selling. The SEC's actions will apply to the securities of all public companies, including all companies in the financial sector. The actions are effective at 12:01 a.m. ET on Thursday, September 18, 2008. This action goes beyond the SEC's previously issued emergency order, which was limited to the securities of financial firms with access to the Federal Reserve's Primary Dealer Credit Facility. In an ordinary short sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price). An abusive naked short transaction is the practice of selling a stock short without first borrowing the shares or ensuring that the shares can be borrowed as is done in a conventional short sale. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.

The SEC's actions were as follows:

- **Hard T+3 Close-Out Requirement; Penalties for Violation Include Prohibition of Further Short Sales, Mandatory Pre-Borrow** - The SEC adopted, on an interim final basis, a new rule requiring that short sellers and their broker-dealers deliver securities by the close of business on the settlement date (three days after the sale transaction date, or T+3) and imposing penalties for failure to do so. If a short sale violates this close-out requirement, then any broker-dealer acting on the short seller's behalf will be prohibited from further short sales in the same security unless the shares are not only located but also pre-borrowed. The prohibition on the broker-dealer's activity applies not only to short sales for the particular naked short seller, but to all short sales for any customer. Although the rule will be effective immediately, the SEC is seeking comment during a period of 30 days on all aspects of the rule. The SEC expects to follow further rulemaking procedures at the expiration of the comment period.

- **Exception for Options Market Makers from Short Selling Close-Out Provisions in Reg SHO Repealed** - The SEC approved a final rule to eliminate the options market maker exception from the close-out requirement of Rule 203(b)(3) in Regulation SHO. This rule change also becomes effective at 12:01 a.m. ET on Thursday, September 18, 2008. As a result, options market makers will be treated in the same way as all other market participants, and required to abide by the hard T+3 closeout requirements that effectively ban naked short selling.

(8) Congressional Activity

Congress has planned multiple hearings to explore these recent developments in further detail. A Senate Banking Committee hearing regarding regulatory actions related to recent bank failures is scheduled for September 18th; followed by a September 23rd hearing on the actions summarized above.

(9) Federal Open Market Committee Action

On September 16, 2008, the Federal Open Market Committee unanimously voted to keep its target for the federal funds rate at two percent. The committee cited a significant increase in financial market strain and the ongoing housing contraction as reasons for keeping the federal funds rate unchanged. The committee believes that the ongoing measures to foster market liquidity should help to promote moderate economic growth.

(10) Central Banks Take Coordinated Action to Address U.S. Liquidity Shortage

On September 18, 2008, the Bank of Canada, the Bank of England, the European Central Bank (“ECB”), the Board of Governors of the Federal Reserve (“Federal Reserve”), the Bank of Japan and the Swiss National Bank announced coordinated measures designed to address the continued elevated pressures in short-term US dollar funding markets. These measures, together with other actions taken in the last few days by individual central banks, are designed to improve the liquidity conditions in global financial markets. Overall, the dollar funding operations conducted by the Eurosystem could reach an outstanding amount of \$110 billion, compared to the current \$50 billion.² The following measures were adopted:

- **Overnight Maturity for US Dollar Funding** - The Governing Council of the ECB has added an overnight maturity to its operations providing US dollar funding to Eurosystem counterparties. The Eurosystem shall conduct US dollar liquidity-providing operations with its counterparties against Eurosystem-eligible collateral. This activity will be performed as long as needed based upon prevailing market conditions. The US dollars will be provided by the Federal Reserve to the ECB, up to \$40 billion by means of a temporary reciprocal currency arrangement (swap line).

² The Eurosystem is the monetary authority of the Eurozone, the collective of European Union member states that have adopted the euro as their sole official currency. The Eurosystem consists of the ECB (it decides the monetary policy) and the central banks of the member states that belong to the Eurozone (their function is to apply the monetary policy decided by the ECB). The primary objective of the Eurosystem is price stability. Secondary objectives are financial stability and financial integration. The mission statement of the Eurosystem says that the ECB and the national central banks jointly contribute to achieving the objectives.

- **Term Auction Facility Increases** - The Governing Council of the ECB has decided, in conjunction with the Federal Reserve, to increase the amount of US dollar liquidity provided to the counterparties of the Eurosystem to \$25 billion for the 28-days maturity operations, and to \$15 billion for the 84-days maturity operations.

MBA will continue to closely monitor these and other activities and work with the regulatory agencies and Congress to aggressively pursue regulations and legislation that will bring greater liquidity, transparency, and stability to the capital markets, thereby positively influencing the return of investor confidence to these markets.

In addition, as further details emerge regarding Lehman Brothers Holdings Inc. Chapter 11 filing and other capital market events, we will share that information with MBA members.