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## Merrill's Other Issue

### *Firm May Have to Answer to SEC for Hedge Fund Actions*

By Yael Bizouati

Following reports alleging that Merrill Lynch off loaded some of its subprime assets into hedge funds to scrub its balance sheet, and on the heels of the ousting of the firm's CEO, Stan O'Neal, the Securities and Exchange Commission has launched an investigation into the firm, industry sources say.

The SEC declined to either confirm or deny such an investigation.

Merrill released a statement last week saying it had no reason to believe that any such inappropriate transactions had occurred. "Such transactions would clearly violate Merrill Lynch's policy," the statement read.

Merrill's marks reflect all of the firm's exposure to CDOs regardless of how they are financed, on or off balance sheet, a spokeswoman says. Although she declined to say whether the SEC was investigating the firm, she says Merrill would cooperate with any investigations.

At the heart of the issue is whether Merrill placed CDO and RMBS tranches with some hedge funds to put off reporting big losses.

"They didn't permanently place CDOs with hedge funds, they parked them there; it was a temporary arrangement," says Mark Adelson, a consultant with Adelson & Jacob Consulting. "There is nothing wrong with selling risky securities, but there is almost always something wrong with parking them. You are misleading your shareholders about the real condition and prospects of your business."

For Adelson, what is even more startling is how a firm such as Merrill ended up holding \$30 billion of mortgage-backed securities in the first place. "There is nothing strange with bulge-bracket firms having a big inventory, but let's remember that CDOs are strange, exotic fringe instruments at the edges of capital markets, so to be holding that much is amazing," he says.

Janet Tavakoli, founder and president of Tavakoli Structured Finance, a Chicago-based consulting firm, says she has close knowledge of Merrill "making the rounds asking hedge funds to engage in one-year off-balance-sheet credit facilities." She adds, however, that the funds she knows of all refused to participate in such arrangements, declining to name the firms.

Tavakoli says transferring risk using total return swaps is acceptable if it's priced correctly, but only if it is properly accounted for. The problem, she says, is that Merrill is not coming clean with any clear explanations as to what they did with the assets.

Given Merrill's direct investment in mortgage lenders and servicers, Tavakoli finds it difficult to understand why the bank did not report losses - and put on massive hedges - nearly one year ago, she says. "Blaming models or rating agencies is like blaming mathematics because you miscalculated."

In its public announcement of third-quarter earnings, Merrill seemed unprepared to discuss the excess exposure reduction

unaccounted for by write-downs, a reticence Tavakoli calls "disconcerting."

"One would think that after having made such huge write-offs, they would be willing to put people's minds at rest, say here's our exposure, here's how we manage to reduce it and here's our forecast in terms of remaining exposure.' How hard was it for O'Neal to say that?"

She adds that during the meeting, O'Neal asserted Merrill had provided significant transparency, but "having taken such a whopping write-down, and significantly revising it, that was the wrong thing to say."

In a note to clients dated Oct. 8 - prior to O' Neal's departure - Tavakoli said Merrill "must have been praying for a six sigma miracle when it issued its first-quarter and second-quarter numbers and accepted its managers' excuses for not marking down its CDO positions."

She also notes that the firm was one of the credit providers to Bear Stearns Asset

Management's ill-fated structured credit funds. "In April of 2007, credit line providers challenged the funds' marks. Yet, it seems, Merrill was not so finicky when it came to marking its own books."

The situation with both firms is oddly similar to some industry insiders. New York-based lawyer Jacob Zamansky of Zamansky & Associates, who is representing several investors in the Bear Stearns hedge fund case, says that in both cases the firms were trying to pawn off their poor performing assets. He says the Merrill case is in some ways reminiscent of Enron and that the firm might be opening itself to potential liability for shareholders that claim to have been defrauded.

"The SEC is probably looking at conflicts of interest between Merrill and the hedge funds and their prime brokerage relationship," Zamansky says.