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

MEMORANDUM FOR THE RECORD

Event: Teleconference with a Reserve Primary Fund team about the Short-term funding markets

Type of Event: Conference Call

Date of Event: March 25, 2010

Participants - Non-Commission:

Reserve Primary Fund (RPF):
Mike Luciano – Portfolio Manager; Kathy Birch – General Counsel; Dan Bruch – CFO; Ryan Perry

Dewey & LeBoeuf, RPF Counsel:
Stephen Best - Attorney; Ryan Perry – Associate

Participants - Commission:

Tom Krebs, Mina Simhai, and Desi Duncker

MFR Prepared by: Desi Duncker

Date of MFR: March 25, 2010

Summary of the Interview or Submission:

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

---

On Thursday, March 25, 2010 Tom Krebs, Mina Simhai, and I had a conference call with the Reserve Primary Fund (RPF), with their counsel on the line as well, to discuss their perspective of the commercial paper (CP) market. *Note that the following is merely a synopsis of the comments of the RPF team and is not necessarily a statement of fact or of the opinions of the FCIC team.*

Background of Commercial Paper and Repo Markets

Commercial paper (CP) is a short-term, unsecured loan that is traded at a discount. There are several types of CP, including General Obligation, which is considered safer, and asset-backed commercial paper (ABCP), which is written against assets. For ABCP, it is generally assumed in the market that these are the assets that the sponsor just wants to remove from its balance sheet. Repurchase agreements (repo) are loans made to dealers. This is typically an overnight trade, and collateral is negotiable. This is safer, and collateral is held with a third party.

The spread between general obligation CP and ABCP has increased, as ABCP is typically backed by mortgages, banks wrote loans that people couldn't afford, and housing prices stopped rising. Note that some ABCP conduits have a "rich uncle"—an example is Wamco, whose shareholders were made whole by its sponsor, Legg Mason.

Money market funds have to be short-term and have to invest in rated paper. Prior to a recent rules change, they were permitted to hold 5% of their fund in Tier 2 (A2/P-2) paper. When Mr. Luciano arrived at RPF in July '07, they didn't buy Tier 2 paper because everyone else was doing so.

For ABCP, the banks owned mortgages and lumped them together. December '06 was the first month in which housing prices didn't rise. As summertime approached, the housing market started to lose value.

Reserve Primary Fund tried to find ABCP programs that had no subprime. They didn't buy SIVs, as they considered them to be losers.

The salesperson would approach me with a new ABCP program. They would set up a meeting with the credit analyst. They would discuss the terms: collateral, guarantee, etc. Every CP program is an individual program, with different terms. For instance, State Street would guarantee 100%. Others had no guarantee. Some were somewhere in the middle, *i.e.*, they would guarantee it against something specific. They are bells & whistles that make them attractive. They wouldn't give the loan detail, but RPF could drill in deeper (*i.e.*, x% of loans are car loans, etc.) Mr. Luciano didn't know how much disclosure was required for ABCP programs.

In summer '07, Columbia's Enhanced Cash Fund broke the buck, but they weren't bailed out, as Bank of America said it wasn't a true 2a-7 money market fund.

ABCP became popular in '04 – '05.

Countrywide: They were shocked to see a triple-A rated investment dropped so much. People were shying away, trying to find banks that didn't have much exposure.

Bear Stearns hedge funds lost money, were closed down, and then the Columbia situation occurred. People were shying away from Alt-A and subprime.

Reserve Primary Fund never liked Countrywide, as they didn't think highly of their business model. (Mr. Luciano felt the same way when he was at Citi.) They weren't sure who was buying their paper, but it seemed to be for risk-takers.

As a money market fund manager, RPF was interested in collateral and counterparties (as less sophisticated investors in the fund may redeem when they see a bad name).

Mr. Luciano noted that, in July '07, when he moved from Citi, they were shifting away from ABCP. He felt that there was value in non-subprime ABCP, as it was over-collateralized. RPF was trying to find that value. Mr. Luciano felt that, since he's been at RPF, they made the right call, as performance was very strong prior to Lehman.

When Mr. Luciano joined RPF, they had too much repo (25%). They decreased repo, and wanted to get more yield, so they "barbelled" to stay in compliance with 2a-7 average maturity rules. On one end were

overnight ABCP instruments that were 20 bps higher than repo. On the other were longer-term instruments.

Bear Stearns

At the desk, they were getting calls from investors wandering why they were in BSC. This is an example of headline risk. In that case, there is nothing they can do, as their number one priority is their shareholders. However, at the end of the day, BSC debtholders were made whole, as it just became JPM debt.

Bear Stearns was 2nd tier, wasn't that big. When the Fed backstopped the deal, RPF felt that they would backstop bigger rivals such as Goldman and Lehman.

They were comfortable with repo, given that the collateral was held by BNYM, but were forced to pull because of their investors. On Tuesday, the CEO appeared on CNBC. On Wednesday, RPF pulled their repo lines, two days prior to Bear Stearns collapsing.

After BSC, RPF reviewed the business models of other dealers (viewed quarterly financials, releases, etc.)

Lehman

In June '08, there was a story in the *Wall Street Journal* that Lehman had to borrow at the discount window. RPF called Lehman and in July met with the treasurer, Paulo Tanucci. Mr. Tanucci, Bill Lista joined Mr. Luciano, Damon Chan, RPF's credit analyst, and their salesperson. The Lehman team said the story wasn't true, that liquidity was improved, and that Level 3 assets had improved. Lehman said everything was fine, and the meeting was a roundtable discussion.

Lehman claimed that people were selling them short, and guys like Gasparino were trying to justify their salary. Reserve Primary Fund added $185 million in Lehman paper in April and $200 million in May. They thought that the government would save the day, or at least find a buyer.

In order to sell commercial paper holdings, you need to find a buyer. During the week of September 12th, with CNBC running stories on them, they released 3rd-quarter financials early. Reserve Primary Fund thought that the Fed would backstop them. And also, there was nobody to sell the Lehman CP to.

For a company to go from single-A to default is unprecedented, and people didn't know how to handle it. RPF was holding $785 million in Lehman paper at the time, with $250 million in floating rate notes, which were going to mature in 13 months. (The rest was commercial paper.) (Back in March '08, other dealers were similar and Lehman paper was a little cheaper.)

After Lehman there was a lot of collateral damage, with money being pulled out of money market funds and securities lenders. All the good names were expensive. People bought U.S. government paper (*i.e.*, UST, Fannie/Freddie).

Repo

RPF only does tri-party repo, through both JPM and BNYM, depending on how the dealer sets it up. The trade is agreed to over the phone, the dealer gives instructions, and SS (RPF's custodian) proceeds.

The #1 yielding money market mutual fund is a Fidelity fund. Mr. Luciano checked the fund holdings and he saw that they have several repo agreements for equities, mortgages, etc.

Causes of the Crisis

Everybody was induced to thinking they could own a house, and it was assumed that house prices would keep rising. Rating agencies became sloppy, and everyone relied on them. This is where everything went wrong. "What was going on at Moody's and S&P?", exclaimed Mr. Luciano.

4814-6153-6774, v. 1