MEMORANDUM FOR THE RECORD

Event: Interview with Robert Upton, former Treasurer of Bear Stearns

Type of Event: Group interview

Date of Event: Tuesday, April 13, 2010 at 1:00 p.m.

Team Leader: Tom Krebs

Location: 1285 Avenue of the Americas, New York, NY at the Paul Weiss conference room

Participants - Non-Commission:

- Robert Upton, former Bear Stearns
- Cathy Redlich, Driscoll & Redlich
- Cori Browne, Driscoll & Redlich
- Eric Goldstein, Paul Weiss
- Jessica Carey, Paul Weiss
- Matt Cipolla, Paul Weiss

Participants - Commission:

- Tom Krebs
- Donna Norman
- Karen Dubas
- Mina Simhai (via phone)
- Desi Duncker (via phone)

MFR Prepared by: Karen Dubas

Date of MFR: April 13, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.

KREBS: Can you tell me your belief about the reasons for the failure of the BSAM hedge funds in June or July 2007?

UPTON: They were extraordinarily leveraged, and you had a parallel decline in the mortgage-related assets that they held and a decline in equity.

KREBS: What sort of assets?

UPTON: I'm working from memory here. There was an overweighting in lower-quality RMBS including subprime mortgages and CDO assets full of subprime securities.

REDLICH: Can Bob explain what interaction he had with these hedge funds?

KREBS: Sure. This is not accusatory. One of our missions is to examine the causes of the failure of Bear Stearns. I want to find out what you believe happened.

So subprime MBS and RMBS were significant holdings in those funds?

UPTON: They had those assets as well as CDOs whose underlying values are related to subprime RMBS, which simply involves buying a bunch of straight subprime RMBS and slicing and dicing them into different tranches and ratings and selling them to investors.

KREBS: Did the hedge funds hold CDOs that had been securitized by Bear Stearns?

UPTON: I'm not sure.

KREBS: Are you familiar with the action by the state of Massachusetts that alleged that the BSAM hedge funds did not follow the conflict of interest procedures?

UPTON: I'm aware of it, but not in detail. It became a high-profile, headline issue that required communication and damage control with rating agencies. Beyond that, I'm not aware of the details of the allegations.

KREBS: Was there a time when Bear Stearns told the hedge funds that they were to have no more dealings with Bear Stearns?

UPTON: I recall that vaguely.

KREBS: Did that action precede the action by the state of Massachusetts?

UPTON: No.

KREBS: In early 2007, Goldman Sachs marked the value of some of the securities that drove down the value of _______.

UPTON: The use of the words "early 2007" implies first quarter. I recall that in second quarter there were pricing procedures for valuing holdings and in one of those iterations Goldman Sachs came in with prices that weren't in the same zip code as other prices. I don't recall the specific month.

KREBS: Was it pursuant to BSAM attempts to obtain marks on the hedge funds?

UPTON: I can explain to the extent that I understand it. I understood it more after the fact. The assets in the funds obtained third-party dealer quotes and took some average of the quotes on a security-by-security basis.

KREBS: Describe for me Bear Stearns's business model.

UPTON: That's a fairly broad question. We had a reasonably diversified business mix. We called it three legs to the stool—Global Clearing Services (prime brokerage), Equity Capital Markets, and Fixed Income (capital markets and sales trading). Within Global Clearing Services (the prime brokerage) we provided, among other things, financing for hedge funds and clearing services for smaller brokerages. Our equities business was a full-service institutional sales and trading business, with risk arbitrage research and the full gamut of what you would usually find in an equities firm. In Fixed Income, we had municipal, credit, high-grade and high-yield, loan, sales and trading, and a significant securitization franchise across a full array of mortgage products.

I deemed those to be the three legs of the stool, but we had five segments. The other two were private client services and the investment bank. They were dwarfed in contribution to net revenues. In terms of net revenue contribution, the largest business segment was Fixed Income.

KREBS: What portion was related to the mortgage business?

UPTON: It was variable depending on the business cycle. I struggle because my memory is imperfect. At peak levels, mortgages might have been 40-45% of Fixed Income, and Fixed Income might have been 50% of the firm. Multiplying that out, mortgages might have been 25% of the firm. That's mortgages broadly defined—it includes residential, commercial, CDOs, etc.

KREBS: There came a point where Bear Stearns began to acquire mortgage originators for the purpose of having that complete integration of that product. What is your recollection of that?

UPTON: There was a movement on Wall Street for a complete vertical integration of that product. Bear Stearns was certainly not the leader in that.

KREBS: When did Bear Stearns begin this vertical integration?

UPTON: It was sometime in the middle of the decade of the 2000s.

KREBS: When were you first aware of possible difficulties in the hedge funds at BSAM?

UPTON: It was early June 2007. My colleague who was the Chief Operating Officer of Fixed Income had mentioned that there may be trouble coming down the pipe with hedge funds in the asset management complex and that I should look at that because it may require dialogue with the rating agencies. Shortly after that it became a headline issue. Jimmy Cayne and Sam Molinaro and I had a meeting with Moody's.

KREBS: [Exhibit 1] This is a document that we've acquired from Merrill Lynch. There is a timeline on this document from June 8 through June 29. Does that generally track with your recollection of the events with BSAM hedge funds?

UPTON: The timeline appears accurate. I haven't studied the positions.

KREBS: At the bottom of this Exhibit 1, there are listed positions with Merrill Lynch with respect to Enhanced Leverage and High Grade Structured Credit. These are the two funds that were in the BSAM hedge funds?

UPTON: Correct.

KREBS: There are repo and collateral positions described in Exhibit 1. Do they look generally to be correct?

UPTON: I have no opinion about the degree to which Merrill Lynch was active in the funds and whether that mark to market is correct.

KREBS: Are you aware that Merrill Lynch attempted to sell those securities into the marketplace?

UPTON: I do recall that.

KREBS: They sold those and received fairly low marks with respect to the valuation of securities.

UPTON: My recollection is that the prices that they saw in the marketplace were not as high as people had expected.

KREBS: What was the effect on the Bear Stearns hedge funds?

UPTON: I did not sit in BSAM. I guess that other lenders would have marked capital, lenders would have called more capital, and there would have been heightened pressure on BSAM.

KREBS: Was BSAM holding some of the same securities that were held in Bear Stearns?

UPTON: Is it possible there might have been a couple of small positions in Bear Stearns inventory that were the same as BSAM? Possibly. Were there significant concentrations? My recollection is absolutely no.

KREBS: What impact did the difficulties in the BSAM hedge funds have with respect to Bear Stearns?

UPTON: Over time the impact was severe. At the outset it was clear that Bear Stearns was very big in mortgages. In these landscapes, Bear Stearns had the smallest and weakest credit of the

five investment banks. There was increased scrutiny over governance and risk management issues.

Historically, Bear Stearns was deemed to be one of the most savvy and best risk managers on Wall Street. How could that still be the case if we could that to happen in our hedge funds? At a time with obvious deteriorations in the mortgage market and asset quality, there was a significantly larger cloud over Bear Stearns as a result of all of the events around BSAM hedge funds. It resulted in rating scrutiny and funding and liquidity pressures.

Events unfolded over nine months that called into question the wholesale-funding investment banking model. Over eighteen months, this model came under significant stress with obvious impact on all five firms.

KREBS: Who was in charge of BSAM?

UPTON: Rich Marin.

DUNCKER: Can we follow up on the previous answer? The funding and liquidity pressures—can you talk about the impact of the failure of the hedge funds on Bear Stearns's borrowing in the repo market? Did Bear Stearns and BSAM have the same lenders?

UPTON: That was not the case. The hedge fund was a buy-side account that borrowed from dealers. Bear Stearns was a dealer and borrowed money in the repo market from lenders who had significant size. The lenders to Bear Stearns and other dealers were Fidelity and Dreyfus and other firms. Did the events of the BSAM funds in the summer and fall of 2007 affect our ability to fund ourselves? Not terribly. The effect was more in the unsecured markets. We had attempted to convert more of our funding to repo previously.

The other overriding event that in mortgage- and asset-backed land, the transparency of market values started to evaporate the comfort of lenders. The impact was that the availability and tenure was reduced, probably to a greater degree in Bear Stearns than elsewhere. The seminal event was the August 9 event when BNP Paribas suspended funding on 3 ___.

DUNCKER: was Bear Stearns active in the asset-backed commercial paper market (ABCP)?

UPTON: No.

DUNCKER: So Bear Stearns was unaffected by drop-off in the ABCP market?

UPTON: Correct.

KREBS: Were the institutions who had provided repo lending to BSAM those same companies or firms who sold BSAM the product that they purchased for ownership in those funds?

UPTON: I don't know the answer, but the traditional business model involves providing financing to those who you sold products to. The business model would suggest that your statement would be correct.

KREBS: Is it reasonable to assume that Merrill Lynch sold CDOs and other investments to the hedge funds?

UPTON: Yes.

KREBS: What did Bear Stearns do when it first learned of problems relating to the hedge funds?

UPTON: I was not on Executive Committee or the Management and Compensation Committee—those are the two senior management committees. I believe there was a lot of dialogue to which I was not privy.

KREBS: Do you know whether Mike Alex was sent down to look at the hedge funds?

UPTON: Yes.

KREBS: Did Rich Marin have risk management folks independent of Mike?

UPTON: Yes.

KREBS: Who else was sent from Bear Stearns to review activities related to BSAM?

REDLICH: During what time period?

KREBS: When Bear Stearns became aware of the difficulties at the hedge funds.

UPTON: Between May 2007 and late 2007, both Paul Friedman and Tommy Marano spent time at the funds.

KREBS: Tommy Marano was a trader?

UPTON: Years ago, but at the time he ran the Mortgage Department. Friedman was COO of the Mortgage Business.

KREBS: Did they have recommendations?

UPTON: That wouldn't have come to me. I assume their findings were shared at a senior management level.

KREBS: Are you aware that Bear Stearns committed $1.6 billion to become a repo lender to High Grade?

UPTON: I was aware. We committed $3.2 billion, but only ended up needing to fund $1.6 billion. I did not make that decision, but I was aware of it after the fact to communicate it to investors or rating agencies. I was aware of both the original commitment and what we ultimately provided.

KREBS: What happened after commitment of $1.6 billion?

UPTON: We gave them cash, and they gave us collateral. We managed the collateral as best we could and marked it, it deteriorated rapidly, and there was an ultimate bankruptcy declaration at the end of July.

KREBS: How did the market receive that?

UPTON: It's not clear to me that there was a perceptible incremental negative change as a result of the bankruptcy. Everyone was aware that was going to be the outcome. Exposures on Bear Stearns did not get larger as a result of that announcement.

The trend toward bankruptcy and the announcement got rating agencies focused on whether they had to take action on Bear Stearns. Ultimately, S&P took action on August 3 and changed the A+ long-term debt rating the outlook from stable to negative.

KREBS: What did you do before it was announced?

UPTON: That last week I was fielding a lot of calls from vacation. It was clear that I needed to come back from Nantucket and had intensive dialogue from with Fitch, Moody's, S&P, and ____—this was the July 31 and August 1 time period. I think we allayed concerns of three of the four.

The analysts and committee of S&P was on the verge of making a decision around August 1 and 2. I kept providing a lot of information and requested some forbearance from them to no avail. Ultimately, they decided to change the outlook early on August 3. I marshaled the troops. Once they made the decision for the negative outlook, there's no more dialogue. You have to respect their independence. There was then a focus on massaging the language on the press release to make it seem less negative.

KREBS: What did you say to the rating agencies to allay their concerns to about changing the outlook for Bear Stearns?

UPTON: I said that the risk management for the dealer firm was as strong as ever. The oversight of risk management in BSAM would be taken over by Mike Alex in the dealer firm. We had learned our lesson with governance and risk oversight. The other franchises continued to perform well. While it was a generally stressful environment, ratings were meant to look through the cycle. Based on what I described, an adjustment to the rating was not merited.

[Short break. Resume at 1:50]

NORMAN: When you were involved in the conversations with the rating agencies regarding whether the outlook change was merited, where there specific conversations about Bear Stearns's liquidity and short-term funding?

UPTON: Liquidity and short-term funding are very interrelated. On an ongoing basis, funding liquidity and capital and liquidity risk management were regularly disclosed and discussed.

Acknowledging and understanding that wholesale funding institutions needed to manage these issues, every time I spoke to the rating agencies I updated them on liquidity risk management. The multiple times that I spoke to them between June 7 and the press release, there was always an update about what's happening in the markets.

NORMAN: Over time, particularly with the High Grade fund and the Expanded Leverage fund, there was almost a wholesale dependence on very short-term funding. One of the lessons learned from the BSAM collapse is that redemption calls can come quickly. Did the rating agencies want to hear about changes in your liquidity short-term structure and processes and in your reliance on the repo market? Were there conversations about that?

UPTON: We had articulated very clearly to the rating agencies and other investor constituents that we had reduced our reliance on short-term funding and had begun to use more of the equity repo market. In that process we were careful about insisting on a certain degree of tenure—90 days, 60 days, or evergreen tenure. They were all aware that we were (1) cognizant of the risk and (2) on the corporate and equity side implemented a funding philosophy.

Separately, in the mortgage equity trading area, the philosophy as we moved into early- and mid-2007 was to put more marginal collateral out into term repo. We were not as successful as we would have liked to have been. There was a general tendency of providers to shorten tenure because of concerns about price transparency.

So I undoubtedly made all of those points to the rating agencies. For the more marginal quality assets in the Fixed Income space, we were adding more tenure.

SIMHAI: What was the average maturity for commercial paper?

UPTON: Thirty to forty days.

SIMHAI: When you pushed to repo, what was the average term?

UPTON: When we converted $30 billion, it was equal to or greater. Creditors in general are more comforted if they have collateral. It was equal or greater maturity and they had collateral.

We charged that expense to the desks that we were funding the position for. I was not the most popular person at the firm.

NORMAN: To the best of your recollection in the summer of 2007, what percentage of repo collateral could be characterized as subprime mortgage related?

UPTON: Purely subprime was a very small piece. These numbers are very "ish," if you understand what I mean. If we had $105 billion, probably under $10 billion was subprime, and I can't imagine that more than $20-25 was a combination of subprime and Alt-A.
NORMAN: What percentage was RMBS?

UPTON: Probably about 45%, so that would be $60 billion of the $105 billion of collateral.

KREBS: The S&P press release is issued on August 3. What happened in Bear Stearns then?

UPTON: After it was released, there was general concern that as a result of it, the market would infer that S&P had some knowledge or information that everyone would interpret as being materially more negative and that we were about to blow a hole in our balance and that we were about to implode. Rating agencies did not generally take action without material knowledge.

We were worried about a significant market overreaction. With credit default swap (CDS) spreads and stock prices, that was the case. We decided to put out a press release and in addition hosted an investor call that afternoon to discuss the outlook and quarter-to-date performance and our risk management practices.

KREBS: How did it work out?

UPTON: It was a well-intended call. The press release worked reasonably well, and everything stabilized afterward. Then we had the investor call, and it didn't work out as well as we had hoped.

Jimmy Cayne made an introduction, followed by Sam Molinaro, then Mike Alex, and then myself. That was the extent of the prepared commentary, and I thought that went pretty well. Then there was a Q&A that did not go as well as hoped.

An analyst—it was Mike Mayo—had asked Sam how he characterized the markets. Sam said that in his 20 plus years in the industry, it was the worst Fixed Income market that he had seen, and that spooked some of the participants. That had an adverse impact on the price of the stock.

KREBS: After that, BNP Paribas ceased withdrawals. Did that exacerbate difficulties?

UPTON: That resulted in tighter conditions globally, but it didn't necessarily impact our stock or CDS directly. That was the start of a trend of more constrained funding ability.

KREBS: Was the impact of BNP limited to Europe or did it include PIMCO as well?

UPTON: I don't recall any specific dialogue with PIMCO around August 9. The constraint and adverse effect on short-term funding markets was not limited to Europe.

KREBS: What did you do to reassure folks in Europe? Did you visit them?

UPTON: I was there in May of 2007. I did not visit it at all in the summer or fall. I was there in February 2008 to allay creditors.

KREBS: After the fall of 2007, what actions did you take to shore up the books at Bear Stearns?

UPTON: The situation was not untenable. We were open for business and fully funded. We did issue some long-term debt in September or early October, which is good, long-term, stable liquidity capital. We continued to push for one-off arrangements and put a number of those on the books. We tried to control the balance sheet. From a funding and liquidity standpoint, we tried to maintain the availability that we had.

KREBS: Was your prime brokerage business principally located in Europe?

UPTON: No. It was principally located in the United States.

KREBS: What impact did the press release and BNP have with your relationship with prime brokers?

UPTON: In the August 2007 time period, we saw a marginal pull back from some large prime brokerage clients for their entire account. They would typically run debits and shorts. Because of their concern, they tended to shrink the size of their activities with us in all of those areas.

KREBS: What did you do?

UPTON: The heads and salespeople in the prime brokerage area were out in force explaining why we didn't have a problem and offered myself and Molinero to explain why were okay.

SIMHAI: Who were the prime brokers?

UPTON: I don't remember.

KREBS: Did they take the securities of the hedge funds onto their balance sheets? What happened?

UPTON: Bear Stearns loaned $1.6 billion to BSAM, we got about $1.6 billion in collateral. We managed as best we could. Upon bankruptcy, we seized the collateral, took it on the balance sheet, and worked it into sales flow. In the third quarter when we took sizable write downs, a lot of it was related to that collateral.

KREBS: What was the cause of the rest of the write downs?

UPTON: The write downs were a function of (1) subprime-related assets from BSAM, and (2) CDO warehouses. A CDO warehouse is where a dealer obtains collateral with the ultimate intention of putting it into a CDO. Bear Stearns made the decision to partner with someone and bring in a bunch of CDO warehouse collateral with the thought that stress in markets had hit the bottom. In the fall that wasn't the case, and we wrote the CDO assets down.

SIMHAI: With the collateral from the hedge funds, can you describe how it was marked to market?

UPTON: I was not involved in the valuation of that collateral. Where third-party quotes were available, we would use them. Where models were available and there were verifiable inputs, that was second best. Where it was more of a guess with a models, that was last.

KREBS: In connection with the securitization of mortgages, Bear Stearns was not able to sell every tranche of every CDO and would take them on its books. Is that correct?

UPTON: The intent would be to distribute fully. There may have been times when that wasn't accomplished.

KREBS: How did Bear Stearns acquire mortgages for securitization?

UPTON: There were two channels: purchase and origination. We built an origination capability so we could originate mortgages into our securitization pipeline. We also provided warehouse financing to some originators.

KREBS: If mortgages could not be securitized and sold, would Bear Stearns take them on their books?

UPTON: Correct.

KREBS: And Bear Stearns revalued them as the market depreciated?

UPTON: Yes, they were marked to market.

KREBS: Was that part of the write downs?

UPTON: Yes, there were probably whole loans that were part of the big fourth quarter write down.

KREBS: **[Exhibit 2.]** This is a Fixed Income overview. Are you familiar with this document?

UPTON: Is this from Equity Investor Day or Fixed Income Investor Day? Equity would be hosted by Molinero, and Fixed Income would be hosted by me.

I do recall this presentation; I think it might have been for Fixed Income day.

KREBS: Please look at page 10. It says that Bear Stearns "originated $4.8 billion in loans in 2006, up from $400 million in 2005." Is that correct?

UPTON: That follows my understanding and is consistent with the vertical integration endeavor that I described earlier.

KREBS: On page 11, it says that Encore Credit Corporation is a subprime wholesale platform. Is that what you remember?

UPTON: My recollection is that Encore was acquired in late 2006. It would not have been part of Bear Stearns's business model in the period that's described in the bar chart. We were expanding our origination to include subprime, and the chart shows what they had originated to this date.

KREBS: On page 12, what was EMC Mortgage Corporation?

UPTON: It was a wholly-owned subsidiary with a predominant activity of servicing lower quality mortgages. They potentially had some origination capabilities. They had relationships with originators of Alt-A and subprime products and were able to capture that flow and put that into securitization pools.

KREBS: Look at page 16. For how many years was Bear Stearns ranked number one with respect to RMBS securitization?

UPTON: I'm not sure.

KREBS: What about this quote that it was for "ranked #1 in U.S. MBS in 2006 for the third year in a row"?

UPTON: That's certainly what it says.

KREBS: Can we talk about the development of a business model to focus on an activity at Bear Stearns? How was the decision made to focus on this segment of securitization?

UPTON: The Financial Analytics and Structured Transactions (FAST) team was a Fixed Income team that was filled with quants and real pocket protector experts in mortgage analytics and securitization. It gave us a competitive advantage when it comes to the technology and capabiltiy to securitize any type of product. That group was designed in the early 90s and was why senior management thought we had a competitive advantage in securitization activities.

The management made a conscious decision to expand our securitization footprint to all applicable asset classes because of the expertise in the FAST group.

SIMHAI: Did other investment banks have similar groups?

UPTON: I can't speak to other investment banks. My current employer does not have a group like that.

NORMAN: Were there internal discussions of bankruptcies of originators during that period?

UPTON: Certainly by late February 2006 with the announcements by New Century and HSBC, there was a lot of stress in subprime origination market. We had finalized a price in September 2006. That was why we felt so good about paying almost nothing for that platform. Bear Stearns's M.O. was that we liked to buy assets cheap. We made money, "buying into distressed markets" and waiting for them to turn around.

KREBS: What happened in December 2007 at Bear Stearns?

UPTON: The disclosure was made at a Merrill Lynch conference in November. What happened in December is that we scrubbed the numbers, put together the annual report, got everyone paid, had some Christmas parties, and closed out the year.

KREBS: **Exhibit 3** is a Merrill Lynch document.

UPTON: I don't recall the particular numbers, but I recall the document.

KREBS: What is the "obligation to return securities received as collateral"?

UPTON: I'm not an accountant, I'm a CFA. I believe it's a balance sheet asset, but I can't give you more details.

KREBS: Does it refer to reverse repos?

UPTON: Reverse repos is an asset. I'm out of my realm. I believe it has to do with pledging one type of collateral for another.

KREBS: What about "securities sold for repurchase"?

UPTON: That's repo financing.

KREBS: What about "securities loaned"?

UPTON: You put equity collateral out in the stock loan market.

KREBS: Does that mean you would put it out as collateral for loans as cash?

UPTON: No. There's a clear distinction between fixed income financing and corporate/equity stock borrow/loan markets. Securities Loaned is assets or liabilities that relate to prime brokerage markets. Reverse repo and repo are related to the financing of fixed income markets and financing that income as well as fixed income inventory.

KREBS: When prime brokerage firms have accounts at Bear Stearns, could Bear Stearns use that cash for lending activities, particularly repo?

UPTON: It depends on the balance in their account. If they only have fully-paid-for securities, no. If they have margin debit, you can use a certain percentage. If they have ____, you can or

cannot use it. In any event, that's the traditional prime brokerage activity that we do for clients, and not much of that would affect the repo that we do for Fixed Income clients.

KREBS: Did you ever become concerned about financing?

UPTON: I was concerned about the way we financed loans to prime brokerage clients. Prime brokerage clients have margin debt, shorts, and free credits. Margin debt is where we've loaned the money. Shorts are where they've shorted a security and we take the cash that's generated and borrow the security and deliver it off. Free credits are cash that they leave with us pending reinvestment.

The firm typically had a significant amount of free credit balance that was allowed to fund the margin loans that we made to hedge fund clients, and that's the piece that concerned me. Bear Stearns was using confident sensitive overnight brokerage funding to fund margin loans to clients.

KREBS: What was the injury in that?

UPTON: The free credits were subject to overnight redemption. If that funding source disappeared, we had to fund that debt through another mechanism or tell clients to shrink the amount that they funded with us. Cash reserves would be putting more margin collateral out to raise money.

KREBS: What was the reaction of Bear Stearns management when you expressed your concerns?

UPTON: I was part of Bear Stearns management. There was healthy dialogue. There was a need to balance profitability with a perceived potential risk that had not proven to be very onerous in the past. We were balancing those two points of dynamic tension: profitability versus safety.

KREBS: Did you discuss this with Mike Alex?

UPTON: Possibly, but I don't recall specifically.

KREBS: When did you raise theses issues?

UPTON: I raised these issues at various points from mid-2007 to early2008.

SIMHAI: Was it the decision made by the majority of senior management to continue this practice despite your concerns?

UPTON: Yes.

KREBS: What was Bear Stearns's condition as of December 31, 2007?

UPTON: There was concern about year-end funding pressures, so we did everything to make sure we had access to cash. In general it was the same as it had been for the past few months.

KREBS: In January, Schwartz replaces Cayne.

UPTON: Yes.

KREBS: Throughout this process—say from July 31, 2007 to December 31, 2007—how often were you meeting with SEC?

UPTON: Starting on August 5—on a Sunday—a number of us spent a long time in a meeting with the SEC. From August 5 through the mid to end of October, I had a nightly call with the SEC.

KREBS: Who was at the Aug 5 meeting?

UPTON: Mike Macchioroli, Matt Eichner, and some of Eichner's underlings. I think Gin Giles. I don't think Eric Sirri was there. Immediately after the August 3 conference call, the SEC wanted first-hand information about risk, funding, and liquidity.

KREBS: Who at Bear Stearns had the most contact with the SEC's CSE program?

UPTON: It was probably myself. Maybe Mike Alix too.

There's a daily process to fund a securities firm. It's a $400 billion balance sheet that's fairly complex, and every day at the end of the day I did my best to take a snapshot and let them know. The calls were daily until some point in October, and then they were weekly for a few weeks, and by December there was some decision not to do them anymore.

KREBS: Was the SEC on site during that time?

UPTON: Not on a daily basis. My belief is at some point during those six months, there were on-site visits, some of which I attended

KREBS: By December 31, the SEC meetings were less frequent than they had been?

UPTON: Their daily calls with me had subsided. I don't have insight about their dealings with the rest of the firm.

[Break at 2:45pm]

KREBS: In the meetings that you had with the SEC, did they make any specific requests of you or Bear Stearns?

UPTON: In the fall 2007 conference calls? There was a standard set of information that I gave them every day. From time to time, they wanted additional information, and I would give that to

them the next night. They wanted to know details like how much commercial paper we had and how much we rolled? Were there one-off specific repo transactions? What was the pricing? They were interested in the vast array of everything that related to our funding and liquidity profile.

NORMAN: Was that information easy to get day to day?

UPTON: I don't know that it was easy, but it was important.

NORMAN: So it existed?

UPTON: I collected it from the various parts of the firm.

SIMHAI: Do you recall Mike Macchioroli asking Sam how you plan to be around next year?

UPTON: No, I don't recall that question

DUNCKER: Do you recall what Macchioroli wanted in the August 5 meeting?

UPTON: I don't have specific recollection about specific questions.

SIMHAI: Do you recall questions about how Bear Stearns could continue as a business?

UPTON: No.

NORMAN: Eric, could you assist us in finding this data as quickly as possible? The data that you provided in the nightly calls. From August 5

CAREY: Was this in hard copy or in emails?

UPTON: This would have been in a folder with handwritten notes. I don't know if it would have been retained.

GOLDSTEIN: We'll make a diligent search.

UPTON: In February 2008, we sent the SEC a daily email about our liquidity reserve condition. We had a soft target of $5 billion for our liquidity reserve. We breached that one day, and we immediately notified them of that breach pursuant to CSE requirements, and they requested daily updates. I think it might have been Jeff Farber (controller) or Mike Alex that notified them.

NORMAN: Did the SEC request that you decrease your overnight repos or increase your liquidity reserves?

UPTON: No. I don't recall any specific requests. Every day the specific request was that we would talk tomorrow.

KREBS: Tell us a little about yourself.

UPTON: I'm a humble dirt farmer from New Mexico. I have an undergraduate degree in business and economics and a graduate degree in finance, both from Temple. I eventually got a CFA and worked in commercial banking. I followed securities industry as analyst starting around 1988 and continuing for the next 12-13 years. When I was working for a rating agency in New York, I decided that I wanted to manage the industry instead of observe it, and I reached out to Sam Molinero and joined the firm in December 1999.

KREBS: What changes did you experience from 1999 to 2008 in terms of the business model or funding?

UPTON: The head count, revenue, profit, and credit ratings of the firm throughout the golden era of mortgage securitization did nothing but blossom. The balance sheet, funding, and liquidity process management—when I first joined there was an emerging set of best practices among the investment banks, and that didn't really exist at Bear Stearns. Over the course of the next nine years, I worked within the CFO organization and drove the finance department toward best practices.

That involved one key assumption that if I had sufficient high quality collateral, I would always be able to obtain sufficient funding. That assumption was violated in February 2008 and led to the failure of the five investment banks.

I instilled a process to vigorously charge people for the cash that they used. They didn't like that, but it was something that was prudent and had to be done. Securitization, whether mortgage, credit, etc, was a driver of very solid performance of the firm from after tech bubble burst until 2007. We consistently generated record earnings and profitability.

KREBS: How would you characterize the communication between the divisions at Bear Stearns?

UPTON: There was an element of silo mentality and "this is my P&L." Over time that was encouraged to be watered down, but it never got to the extent that you had one firm with solid communications across all of the divisions.

The division leaders and senior managers were concerned with the entire firm. The business unit heads were concerned with their own P&L. It was silo-centric or silo mentality.

KREBS: Jump to Monday, March 10, 2008. What happened? Did you have any indication that what was about to happen was going to happen?

UPTON: None. I went home on Friday feeling good. There was the Moody's erroneous ratings decline. It was first thing in the morning around 9am that Moody's was downgrading Bear Stearns. We never recovered.

KREBS: Wasn't that a press release about downgrades of certain securities as opposed to the firm itself?

UPTON: Correct, that's why I said erroneous. There were a few announcements that "Moody's downgrades Bear Stearns" and the tickers forgot to add MBS or RMBS, and then all of the sudden the CDS is blowing out and the stock is dropping. With the crash of Thornburg Mortgage and Peloton Partners in late February, there was concern about strength in the MBS market. That headline went across and the wheels never came back on the bus.

During the course of Monday, there wasn't a significant outflow by the broker dealers.

KREBS: Were there any other clues on Monday other than CDS spreads or the stock price?

UPTON: I kept hearing that there were a lot of rumors in the marketplace. I'm sure I got extra calls from the rating agencies or concerned investors. I told them that there was no material change in the liquidity position and that I felt as good about the numbers as ever.

KREBS: You had $18.1 billion in cash reserves?

UPTON: I think it was $18.3 billion.

KREBS: When did the reserves start to be depleted?

UPTON: Marginally on Tuesday. More significantly on Wednesday. On Thursday it was a bloodbath. It was much more accelerated.

KREBS: Was Bear Stearns during this period of time (March 10-14) aware of a number of novations that were attempted to be made with respect to transactions by Bear Stearns?

UPTON: I was not in derivatives ops. I learned that there was an increasing trend of derivatives counterparties going to other dealers to novate transactions with Bear Stearns.

KREBS: Someone at Goldman Sachs said that they wouldn't do business with Bear Stearns anymore?

UPTON: I read that in the newspaper like you did. I have no other knowledge of it.

KREBS: How did $18 billion get to $2 billion by Thursday?

UPTON: The composition of outflow was dominated by free credit. Then some significant margin call collateral, and then some other smaller things.

The collateral dispute number was $1.5 billion. The natural process for collateral disputes is that a dealer's back office would look at a pool of derivative trades and mark them to market and figure out their exposure and decide what the margin would be. My hindsight supposition is that with all of the derivatives trades getting novated to dealers, the dealers' back offices were working with a bigger pool of trades than we were looking at.

In a normal market, at the end of the day if they ask for margin and we disagree, we would not post the margin, and we would both relook at each other's data and in a day or two would agree to an amount. In the stressed market, if we didn't meet their margin calls, the rumors go around Wall Street that Bear Stearns is not meeting margin calls, so the other dealers are marking up their margin calls more. Then the margin dispute calls widen even more. We still aren't meeting them because we want to go back to the normal market dispute process. It mushrooms and becomes part of the overall problem, and I think that's how it became $1.5 billion.

KREBS: Why was this normal resolution process not followed?

UPTON: There was a general sense of urgency on the Street to more aggressively manage their exposure to Bear Stearns.

KREBS: Fear?

UPTON: Also known as fear.

KREBS: Did anyone at Bear Stearns make a decision not to communicate that to others?

UPTON: I don't know with certainty, but I'd imagine that communication would be made. It would have been somebody in derivatives ops, maybe Mike Alex.

My opinion was sought on Wednesday, and I recommended making the margin calls. At the meeting there was a group decision to make the margin calls, and I think the majority were made that evening.

KREBS: On Thursday, what's happening with prime brokerages?

UPTON: There's an acceleration of redeeming free credits. In August 2007, there was a general pull back. In March 2008, it didn't feel like there was a general pull back. It was a complete free credit withdrawal; there was not aggregate account shrinkage.

That resulted in calls on our liquidity reserves.

KREBS: Had you warned Bear Stearns about the free credits earlier?

UPTON: Yes, it was a point of debate that reasonable people could disagree on. I had expressed concern, and other people had expressed concern about not doing them. This involved senior guys in the equity and prime brokerage franchise, my colleague who helped run Treasury, and Sam Molinero. Sam thought that we shouldn't increase or decrease usage of free credits; he wanted to draw a line in the sand about where we were in February and stay there. I wouldn't call it a policy; it was a decision.

KREBS: Between Monday, March 10 and Thursday, what communications did you have with the SEC?

UPTON: They weren't as frequent as one would assume. I'm sure I spoke with them—by then we were sending them daily liquidity information—on Monday, Tuesday, and Wednesday evenings once a day, late in the day, and then several times on Thursday. It wasn't initially much more than the information that I had been sharing with them in the fall.

KREBS: Did you discuss the condition of the firm's repo market?

UPTON: There's a distinction between equity repo versus fixed income repo. One involved collateral that was highly transparent. That piece of repo was quite stable. The other piece of repo was managed more by the fixed income group and Paul Friedman, and in that market you saw more marginal collateral calls, difficulties with mark to market, volatility in marks, and concern among lenders.

In that market, at the beginning of the week, we didn't experience much angst. The same fifty lenders who had leant to us for twenty years let us know, starting on Wednesday and picking up in the later part of the week, especially Thursday, that they were not going to roll the next day.

KREBS: Were you given a reason?

UPTON: I was not. I don't know if the contact at the repo desk asked for a reason. I'm going to speculate that the reason was fairly obvious to all at that point.

KREBS: In October 2007, State Street informed Bear Stearns that they would only lend on an overnight basis and would not lend on term repo.

UPTON: State Street was probably a pimple. I can't imagine that was a material issue at that point.

Because of general angst about mortgage collateral and a general shrinkage in the market—yeah, there was a shortening of tenure and a reduction of availability. With the collateral that the counterparties disappeared on, the firm's general approach was to not fund a lot of that in term.

The assumption was that if you had great collateral, you could get funding. That was the presumption that the investment banks operated around. By the end of the week, when the noise around a specific counterparty got loud enough, a lot of traditional lenders in that market all of the sudden decided not to lend to them, even against Treasury collateral.

KREBS: Who were your principal repo lenders in that week of March?

UPTON: About twenty-five guys in fixed income repo lending. Mostly 2A7 money funds.

KREBS: When did you know that Bear was going to fail?

UPTON: It was Thursday afternoon, March 13, shortly after a meeting Sam and I had with the Bank of New York between 2pm and 4pm. We were in the process of trying to roll our facility

and they were concerned about all of the rumors. We were trying to get more funding from them on a secured basis.

KREBS: Was repo tri-party or bilateral?

UPTON: It was a mix of both.

KREBS: Who would be the bilateral counterparties?

UPTON: You're stretching my knowledge now. Virtually all of the equity and corporate space was done as a tri-party space using the JP Morgan platform.

KREBS: How did the Bank of New York meeting end?

UPTON: We agreed to love to love each other. Everyone was happy, we had a clearing of the air, let's be the best of friends, love the love.

KREBS: How could Bear Stearns have been saved?

UPTON: My views have changed. Before Lehman Brothers went down and the wholesale investment banking model was done—in mid-summer 2008—I thought some things could have changed the outcome.

I am re-educated now. In hindsight, it was a tsunami. There was nothing that could have been done. The entirety of the model of the wholesale funding investment bank structure was predicated on this assumption. It was the canary in the coal mine.

Lehman was gone. Merrill was never good at this—they never had a real Treasurer. Morgan Stanley had free credit issues too. If Morgan Stanley had been done, I have no doubt that Lloyd and Goldman Sachs would have been done in five days. Then the Fed comes in. If the last two big broker-dealers had gone down, who knows what would have happened. So the Fed come in and saves them and said, "These guys are okay. Don't F with them."

It was a tsunami. We couldn't have done anything.

KREBS: At the end of each quarter, did Bear Stearns manage its balance sheet?

UPTON: Yes. I think we disclosed it appropriately in the 10-Qs and annual report both about why and how we did it. I crafted that in 2002 because we didn't want to deceive anyone. It said something like: "To verify the inherent liquidity of the securities sitting on the balance sheet and consistency of credit considerations of…."

KREBS: Did that management of the balance sheet and quarter end have an impact on your rating?

UPTON: It was a fancy way of saying "to window dress and manage our balance sheet."

KREBS: Why?

UPTON: Higher credit ratings are better. Higher leverage is inconsistent with higher credit ratings. The general goal was to make sure that creditors and rating agencies were happy, and one of the things they focused on was leverage, and that's one of the things that Bear Stearns could manage.

KREBS: What would typical leverage be in mid-quarter?

UPTON: Embedded into the Q's and K's, there was disclosure that if you took the average of the month ends for the previous 12 months, the quarter end would usually be x% higher. The gross leverage (average of month ends) was maybe 35.

SIMHAI: How did the leverage change between the middle and the end of the month?

UPTON: There was no real intra-quarter window dressing. We brought the balance sheet way down by the end of the quarter. I would set a target for the balance sheet and we would decide what we could do to bring it down, but that would happen August 31st, and we wouldn't do much until November 30th. The peak was about 35, and our target was usually around 28.

NORMAN: Is that a topic you ever discussed with the rating agencies?

UPTON: Sure.

NORMAN: Can you discuss that. You said that it kept everyone happy.

UPTON: Creditors in general looked at leverage in assessing the credit quality of the firm. Did we go into great detail about how big the balance sheet might have gotten? They were aware of the shrinking.

NORMAN: How did you know that they were aware?

UPTON: We had discussions with S&P, Fitch, and Moody's. Moody's in particular did not like leverage ratios because of the phenomenon we've just described. What is meant to be captured in the leverage ratio is my capacity to absorb loss. Moody's started to completely discount any leverage ratio and think more about risk measures. All of the firms and rating agencies knew that we managed the balance sheet down and made disclosures about what we did, why we did it, and what it would have been if we didn't

NORMAN: From your experience working at a rating agency, would it bother you that they did this process?

UPTON: The quarterly window dressing? I don't know that it affected the rating. Various agencies would request information about what the leverage had been intra-quarter. I understand the line of inquiry, and I think I've answered the question.

NORMAN: It sounds like you're saying that if you didn't manage it down, you could be subject to a downgrade.

UPTON: Rating agencies look at a number of factors for a rating. There are so many factors. At the margin, double leverage at the holding company was not a factor. At the margin, if you were maybe on the cusp of another rating and your leverage was 40 instead of 28, that could affect your rating.

NORMAN: You say with confidence that it was discussed and known?

UPTON: Absolutely. With confidence.

NORMAN: Was this discussed with anyone at the SEC?

UPTON: The disclosure in the Q and K that started in 2002 was a direct result of SEC inquiry.

NORMAN: Did they have other concerns prior to March 2008 after the disclosure?

UPTON: I don't know

NORMAN: Did the CSE program have any concerns?

UPTON: I don't think so

KREBS: In the fourth quarter of 2007, Bear Stearns lost $84 million. To what do you attribute the loss? Is it simply the markdowns on the mortgage-related securities?

UPTON: I think the markdown was about $1.7 billion. If that had not been there, I would guess that we would have been profitable. The other businesses slowed somewhat because securities is a cyclical business, but that markdown was the driver of why we lost all of that money. We wouldn't have been as profitable as in the fourth quarter of 2006 when we had record earnings.

KREBS: What was your compensation?

UPTON: There was base and bonus. The base was [36CFR1256.56: P] It was changed from [36CFR1256.56:] around 2005 or so.

KREBS: The bonus compensation was half in stock, right?

UPTON: The percentage was variable based on the size of the bonus. In 2006 my compensation was about [36CFR1256.56: Privac] and in 2007 it was about [36CFR1256.56: P]. That was my biggest year. I think that of the [36CFR1256.56: Pri] bonus, it was about 50/50 equity and cash.

KREBS: Could Bear Stearns have prevented the liquidity crunch in March?

UPTON: No. It was a tsunami.

NORMAN: What was the critical assumption that led to the tsunami?

UPTON: It was the critical assumption that underpinned all of the liquidity risk management practices for the investment banks—that if I had adequate quality collateral, I could always obtain financing. When the noise became so loud that they wouldn't lend against Bear Stearns for Treasuries, that assumption was void.

It wasn't a matter of selling the collateral, it was a matter of obtaining funding to sell the next day.

SIMHAI: Are you familiar with the Repo 105 transactions of Lehman Brothers? Did Bear Stearns do anything similar to that?

UPTON: No.

NORMAN: The SEC asked questions related to liquidity and the repo market from August to October 2007, and then February through March 2008. Between the genesis of the CSE program in 2004 through August of 2007, did the SEC have any concerns about your funding mechanisms or liquidity?

UPTON: We spent a lot of time with the SEC related to CSE program. As we changed our funding mechanisms we shared that with them on a regular basis, and they were generally enthusiastic about our transition.

NORMAN: Did Bear Stearns support the CSE program?

UPTON: Mike Alex or Sam Molinero would know better.

KREBS: **Exhibit #4** Bates number BSC-FCIC-e00138668.

UPTON: This is a talking points document developed to allow people who were getting concerns from constituents to respond by highlighting solid points around our profile.

NORMAN: Four lines from the bottom it says:

> Existing funding structure & liquidity risk framework ensures funding of balance sheet for 12 months without the need to issue additional unsecured funding or liquidate assets.

What were the assumptions behind that?

UPTON: This is referring to the one critical assumption that I've already talked about. That was the way that we tried to manage liquidity risk at the firm.

Investment banks knew that liquidity risk was key. As the industry matured, best practices arose around how to manage that. They depended on one key assumption that was ultimately violated.

NORMAN: Did you have conversations with the Fed about repo exposure?

UPTON: Others at the firm were in dialogue with the Fed to talk about repo and actions that the Fed might take with the investment banks, including Bear Stearns. It would probably be Mike Alex, who was friendly with Geithner, who would have spoken to that. Schwartz might of as well.

NORMAN: What were these conversations about?

UPTON: I wasn't a part of those conversations. That was probably the first quarter of 2008.

KREBS: **Exhibit #5.** Bates number BSC-FCIC-e00151617

UPTON: These are minutes from the regular operations committee.

KREBS: Is anyone missing?

UPTON: I don't see Molinero there, so some people might be missing.

NORMAN: What procedures would the SEC be investigating?

UPTON: I think this was just an audit check-the-box process. My recollection is wholly imperfect. They were doing some minutia check-the-box auditing procedure and we were doing things that provided integrity to the notion of a liquidity reserve. There were a couple of SEC guys that had been in there the week before and would be coming in next week. I'm not sure who they would have been.

The audit of the procedures that we undertook was new. This audit was still in the introductory stages. I don't know that any conclusions were reached at that point.

KREBS: **Exhibit #6.** Bates number BSC-FCIC-e00145922

UPTON: It appears to be a series of emails.

NORMAN: This was an email chain that you were on. There's a comment from Sam Molinero:

> FYI. HSBC advised yesterday they were cutting our bank credit lines. Their decision is a function of both risk and reward.
>
> (insufficient business). This call has no impact on counterparty trading lines.

Why would this have no impact on counterparty trading lines?

UPTON: I think that's what they told with us the day before. They would stop their corporate banking activity with us but they would continue their counterparty trading lines.

NORMAN: Was this an early warning sign?

UPTON: There were so many early warning signs starting around August 3. Did this stand out among a sea of hundreds? No.

NORMAN: **Exhibit #7.** Bates BSC-FCIC e00140463.

Look at the second page. These are minutes of an operations committee meeting. About midway through the page, Mike Alex reported on our fixed income repo activity…

> We've received from the NYSE a final revision to the risk disclosure statement that we have sought to obtain for many months. As a result, we hope to move several accounts from non trading book loans in BSIL to more efficient funding in BSSC.

UPTON: This is about a margin loan that we booked offshore—because of a portfolio margin that was being affected by the NYSE—and we could bring them onshore and they could still get the margin requirements that they wanted.

It's not clear that Mike is talking about funding versus financing of less liquid. I think Mike would be worried about lending to someone and they gave us poor assets as collateral. It wouldn't be so much about how we funded the collateral.

NORMAN: On the next page it says:

> The committee was informed of our plans to place substantial additional capital in BSIL as a result of new Basle II requirements and our not having received full "model relief" for certain transactions. E&Y has been retained to help us obtain such relief which could result in substantial reductions in capital requirements.

UPTON: As you transition from old capital rules to Basel requirements, we were working with external people to make sure that we met the robustness tests to approach the FSA and get lower capital requirements.

NORMAN: Would that be to take full advantage of the CSE program?

UPTON: CSE allowed us to move from traditional net capital to Basel requirements. I think we had a lot of those models in the U.S. and we were trying to move those to Europe. That would be a question to pose to Mike Alex.

NORMAN: Did your auditors ever raise questions about your models?

UPTON: Not that I recall.

KREBS: Have you ever given testimony in a case or before a grand jury?

GOLDSTEIN: Not beyond the SEC short selling investigation that we've already talked about.

KREBS: There came a point in time after you had been interviewed for several books that you changed your position with respect to statements that you may have made?

UPTON: Yes.

KREBS: Who else did you speak to other than *House of Cards*?

UPTON: A *Wall Street Journal* reporter named Kate Kelly published in May 2009 a book called *Street Fighters*.

NORMAN: Are you or have you been involved in any litigation in connection with your time at Bear Stearns?

UPTON: No.

KREBS: Thank you for your time.

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