

Statement by

Anton R. Valukas

Examiner, Lehman Brothers Bankruptcy

before the

Committee on Financial Services

United States House of Representatives

regarding

**"Public Policy Issues Raised by the Report of the
Lehman Bankruptcy Examiner"**

April 20, 2010

Dear Chairman Frank, Ranking Member Bachus and Members of the Committee:

I appreciate this opportunity to appear before you in connection with my role as the Examiner in the Lehman bankruptcy – the largest bankruptcy proceeding ever filed.

As you know, on February 8, 2010, I filed my Final Report with the Court under seal. On March 11, 2010, a redacted version was publicly released; and on April 14, the entire, unredacted Report was made public. The Report is 2209 pages exclusive of appendices and details my findings – formed from interviews of more than 250 persons and review of approximately 35 million pages of documents.

Your letter dated April 14, 2010, inviting me to appear before the Committee, requests that I address five specific bulleted topics, with a sixth bullet inviting me to comment on other issues I deem relevant to public policy issues raised by my Report. I will address each bullet in the order listed in your letter.

Bullet one: The extent to which corporate governance should be enhanced to appropriately manage firm risk.

We conducted an extensive investigation to learn how Lehman managed, monitored and limited its exposure to risk. Lehman had adequate corporate governance procedures in place. It had quantitative risk models that accurately calculated risk and that accurately warned that Lehman was taking on significant levels of risk in excess of the limits generated by the models. Lehman's procedures included reporting of the limits, and exceedances of the limits, to senior management and the Board.

But we found that Lehman was significantly and persistently in excess of its own risk limits. Lehman management decided to disregard the guidance provided by Lehman's risk management systems. Rather than adjust business decisions to adapt to risk limit excesses, management decided to adjust the risk limits to adapt to business goals.

We found that the SEC was aware of these excesses and simply acquiesced. With no regulator in place that required Lehman to adhere to its risk limits (I will

discuss that issue further in bullet two below), Lehman's risk limits became meaningless.

To be sure, Lehman's corporate governance procedure could have been better. A proper system should have had an independent risk management function that reported directly to senior management, to the Board of Directors, and to the regulators, rather than to a business unit; indeed that is a regulatory requirement (SEC Reg 15c3-4); but in 2006-2007, the Lehman risk function reported to the head of a business line rather than directly to senior management.

Lehman was unique among the investment banks in measuring "risk appetite" – the amount of loss it could expect to incur from market risk, credit risk, and event risk and still return a minimal level of profitability. Lehman had in place a series of risk appetite limits, including a firm-wide limit. Every day, Lehman measured its risk usage and compared the usage to see if it was under or over the risk limit.

Lehman represented to the SEC in writing that its firm-wide risk appetite limit was a "*binding constraint on its risk-taking*" that "*could not be exceeded under any circumstances.*" Lehman repeatedly represented to the SEC that this firm-wide risk appetite limit was a hard limit – a meaningful constraint on Lehman's risk taking. Lehman advised the SEC that the limits were set by senior management and the Board. Excesses of limits were reported to the Board.

So an appropriate governance plan was in place to set risk limits. But management did not observe the limits. For example, Lehman committed to what was its largest single investment – Archstone – in May 2007, with closing to occur later. It was clear prior to the commitment that the Archstone transaction would put Lehman over its then existing risk limits, but the deal was committed anyway. With the inclusion of Archstone, Lehman was clearly in excess of its established risk limits. But in the face of exceeding its risk limits, Lehman did not take steps to reduce risk; rather, it simply raised the risk limits.

Lehman ultimately took writedowns on its investment in Archstone of hundreds of millions of dollars; our retrospective analysis was that the writedowns should have been significantly higher. Archstone was one of the investments that put Lehman on or over the brink; yet it was a transaction that would not have been made had Lehman adhered to its own risk limits.

I ultimately concluded that there were no colorable claims arising from investment decisions such as Archstone. Senior management made the conscious decisions to exceed risk limits and complete the Archstone and other deals because they believed, erroneously, that those deals would be profitable. Likewise the decisions to exceed risk limits were flawed but made in the expectation of profit, not loss.

Archstone was the largest, but not the only instance in which risk management's view was overruled or disregarded. Lehman was in breach of its established risk appetite limits on a persistent basis during the second half of 2007. Lehman ultimately cured the breaches at the end of the year, not by reducing risk, but by raising risk appetite limits again.

To be fair, Lehman made some efforts to reduce some risks during this period, but we found that Lehman did not make a systematic effort to reduce its overall commercial real estate risks, the major factor in the breach, until some time in the spring of 2008.

Lehman also had in place a "single transaction limit" framework to limit the size of individual transactions as a risk control. But in late 2006, Lehman management made the affirmative decision to disregard the single transaction limit because it had cost Lehman significant profit-making opportunities. As a result, Lehman committed to and closed dozens of transactions that were vastly in excess of that business unit's risk limits.

The decision not to enforce these limits had consequences for Lehman in the summer of 2007 when certain Lehman executives became concerned whether Lehman would be able to fund all of its outstanding commitments. At that time, a senior Lehman officer, Ian Lowitt, observed: "In case we ever forget; this is why one has concentration limits and overall portfolio limits. Markets do seize up."

By 2008, Lehman had in place a stress testing program, designed to assess whether Lehman could survive a series of both hypothetical and historical stress scenarios. But Lehman did not include many of its riskiest assets in its stress testing, such as commercial real estate. Without including these investments, the stress testing was – at best – meaningless, because a large proportion – perhaps the majority – of Lehman's risk lay with those business lines. And at worst the stress testing was affirmatively misleading, because it provided false comfort. Because the stress testing was not meaningful, Lehman's management and Board

were deprived of information that would have more accurately described Lehman's true risk picture and that might have led to more decisive action to reduce risk.

Lehman had in place a system for reporting risk issues and breaches of limits to its Board. The reports to the Board were not always timely or in adequate detail. But in sum, Lehman had in place an appropriate set of procedures to track and set limits to control risk, procedures for management review of the limits and compliance with the limits, and procedures for Board reporting and oversight. Lehman had the procedures; it simply chose to ignore them when it reached established limits. And with no effective external regulation, there was no one to require that Lehman stay within limits. Which brings me to the second bullet:

Bullet two: The role of the SEC and other agencies in oversight, examination and enforcement.

By at least 2007, various agencies of the US government were concerned – at the highest levels – with the prospects for Lehman's survival. Former Treasury Secretary Paulson, Fed Chairman Bernanke, then President of the Federal Reserve Bank of New York (FRBNY) Geithner, and Former SEC Chairman Cox each told us that they were concerned about Lehman's future and the effect of Lehman's possible demise on the US economy. That concern intensified after Bear Stearns' near collapse in March 2008. Indeed, on June 13, 2008 - three months before Lehman's bankruptcy - Donald L. Kohn, Vice Chairman of the Federal Reserve, sent an email to Chairman Bernanke stating that "the question is when and how [Lehman] go[es] out of business not whether." The concern at the top was reflected in the personal role each of the individuals assumed in staying abreast of Lehman's situation.

After the near-collapse of Bear Stearns in March 2008, the SEC and FRBNY placed embedded teams at Lehman to gather information and monitor Lehman's condition. Then-FRBNY President Geithner spoke regularly with Lehman's CEO, Richard Fuld and advised him that Lehman needed to raise more capital and / or form a strategic alliance with an entity with a stronger balance sheet.

Secretary Paulson spoke to Mr. Fuld regularly and repeatedly urged that Lehman raise capital, find a strategic partner, or sell Lehman. Beginning in March 2008, Chairman Cox had direct calls with Mr. Fuld every few weeks. Chairman Bernanke spoke infrequently to Mr. Fuld but frequently with Geithner and Paulson about Lehman. Chairman Bernanke observed that Secretary

Paulson was frustrated by Mr. Fuld's "more inertial behavior" to raise capital or find a strategic partner. The Fed was trying to pressure Lehman to be more aggressive, but was conscious of its "appropriate role" as a lender, not a regulator, given that the SEC was the regulator.

So the agencies were concerned. They gathered information. They monitored. *But no agency regulated.*

The Fed and Treasury took pains to tell us that the SEC was Lehman's regulator, and that they therefore deferred to the SEC. For its part, the FRBNY viewed its role as a potential lender, not as a regulator. Secretary Geithner viewed the SEC, not the FRBNY, as Lehman's primary regulator; he told us that the FRBNY had "no knowledge, reach or capacity to affect [Lehman's] behavior." Secretary Geithner stated that the FRBNY had authority to obtain information from Lehman solely from the FRBNY's status as a "rather late, reluctant creditor" to Lehman through the Fed's discount window.

But former SEC Chairman Cox took equal pains to say, during our interview with him on January 8, 2010, that the SEC's statutory jurisdiction was limited to Lehman's broker-dealer subsidiary and that it was not the regulator of Lehman itself.

Despite Chairman Cox's statement, we believe it is clear that the SEC was Lehman's primary regulator. In 2005, the European Union ("EU") announced that it would regulate global financial institutions unless they were regulated by an equivalent domestic agency. In response, all of the major investment banks – Lehman, Bear Stearns, Goldman Sachs, Morgan Stanley and Merrill Lynch – voluntarily submitted to regulation under the SEC's Consolidated Supervised Entity ("CSE") program. Lehman was free to withdraw, but if it had done so, it would have become subject to EU supervision; so the SEC thus had *de facto* supervisory authority; the SEC's General Counsel's office has acknowledged that it had that authority, stating that "CSE staff thus had broad authority in its supervision of Lehman Brothers."

The SEC Rule governing the CSE program, 69 Fed. Reg. 34.428, mandates that, in order to participate in the CSE program, the broker-dealer must submit a written undertaking by the ultimate holding company - LBHI - that "[a]cknowledge[s] that the [SEC] may implement *additional supervisory conditions* if the ultimate holding company fails to comply in a material manner with any provision of its undertaking" which requires the holding company to provide the SEC with information about the company's capital and other specified financial,

operational and risk management information on a monthly, quarterly and annual basis, as well as to “implement and maintain a consolidated internal risk management control system . . .” The SEC rule expressly contemplates SEC regulatory authority over the holding company.

Perhaps most significant, in February 2008 testimony to the Senate Banking Committee, Chairman Cox acknowledged that, through the CSE Program, the SEC had authority to “monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities . . . or the broader financial system, at risk.”

We believe it clear, then, that the SEC was in fact Lehman’s primary regulator. The SEC told us that were constantly monitoring Lehman’s risk and liquidity. But there was little if any actual regulation; we observed no instance in which the SEC did anything, in Chairman Cox’s words, to “act quickly in response to financial or operational weaknesses” at Lehman.

The SEC made a few recommendations or directions here and there, but in general it simply collected data; it did not direct action, it did not regulate.

It is one thing for Lehman to have exercised the business judgment, although in retrospect clearly bad judgment, to forge ahead and take on excessive risk. But it was quite another for the supposed regulator – a regulator who had been told by Lehman that its risk controls were binding and not meant to be exceeded under any circumstances – to stand by idly and simply acquiesce to management’s decision. The SEC’s mission – clearly stated on its own website – is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” The SEC’s role was not to simply absorb and acquiesce to Lehman’s decisions; the SEC’s role was to supervise and regulate to protect investors and the markets.

I will briefly address three critical areas, which are described in complete detail in my Report, in which the SEC had actual knowledge – or could have, with minimal effort, obtained that knowledge – of significant issues that, if they had been the subject of regulation, might have altered the outcome.

The SEC *knew* that Lehman was reporting sums in its reported liquidity pool that the SEC did not believe were in fact liquid; the SEC *knew* that Lehman was exceeding its risk control limits; and the SEC *should have known* that Lehman was manipulating its balance sheet to make its leverage appear better than it was. Yet even in the face of actual knowledge of critical shortcomings, and after Bear

Stearns' near collapse in March 2008 following a liquidity crisis, the SEC did not take decisive action.

Liquidity. The SEC and the FRBNY each told us that Lehman's liquidity was of critical importance. But Lehman included in its reported liquidity pool assets that both the SEC and the FRBNY concluded, when they were advised of the facts, were not proper components of liquidity because they were not readily monetizable.

Lehman publicly disclosed its liquidity pool – the amount supposedly available to Lehman to satisfy its short-term obligations – because liquidity was essential to maintain the confidence of Lehman's trading partners. On June 9, 2008 - just three months before declaring bankruptcy - Lehman announced its liquidity pool was at \$45 billion, its "largest ever."

On September 10, 2008 - five days before it filed for bankruptcy - Lehman publicly announced that its liquidity pool was holding steady at approximately \$41 billion. By Friday, September 12, however, Lehman had less than \$2 billion of assets that could readily be turned into cash; it literally did not have sufficient cash to open for business on Monday, and it filed for bankruptcy protection on September 15.

We know in retrospect that Lehman's report of a \$41 billion liquidity pool on September 10 was off by tens of billions of dollars. In the course of my investigation, we discovered an internal Lehman document that lists Lehman's actual liquidity during Lehman's final week, categorizing the assets as "High," "Mid" and "Low" "Ability to Monetize." On September 9, the day before the announcement of the \$41 billion pool, Lehman had \$40.6 billion of assets in its supposed pool. But the internal document shows that only \$24.7 billion of that amount was in the "High" category; there was \$0.9 billion in "Mid" category; and \$15 billion of the \$41 billion liquidity pool was in fact not liquid at all, because those amounts were pledged to the clearing banks. On September 10, after the announcement of a \$41 billion pool, the "High" ability to monetize assets plummeted from \$24.7 to 9.4 billion; on September 11 the amount fell further to \$7 billion; and by September 12 it was a mere \$1.4 billion.

The SEC did not learn all of these precise facts until September 12 or later. But months earlier, it *had* learned critical information that put it on notice

that Lehman's liquidity was not as was portrayed to the investing public. But the SEC did not act on its knowledge, it simply acquiesced.

In June 2008, one of Lehman's clearing banks, Citibank, required that Lehman post \$2 billion as a "comfort deposit" as a condition for Citi's continued willingness to clear Lehman's trades. Lehman was technically free to withdraw the deposit, but it could not do so as a practical matter without shutting down or disrupting the business it ran through Citi. Later in June, Lehman posted \$5 billion of collateral to JPMorgan, Lehman's main clearing bank, in response to an earlier demand by JPMorgan. Lehman continued to count virtually all of these deposits in its reported liquidity pool – nearly \$7 billion of a reported \$40 billion, 17.5% of the total.

The SEC had actual knowledge, in June 2008, of the Citi deposit. The SEC believed that it was not proper to include such deposits in a reported liquidity pool. The FRBNY, when it ultimately learned about the deposit months later, likewise agreed that it was improper to include such deposits in a liquidity pool. But while the SEC disapproved of Lehman's inclusion of that amount in its liquidity pool, it took no action to require that Lehman not do so. The SEC did not direct that Lehman publicly disclose the facts so that no one was misled about Lehman's liquidity. And, remarkably, the SEC did not ask the logical question "Are there other deposits like this one?" so they did not learn – until September 12 – that virtually all of the \$5 billion JPMorgan deposit was also included in the reported liquidity pool, as well as more than \$9 billion Lehman posted to JPMorgan after September 8.

On September 12, 2008, the significance of Lehman's collateral postings became clear to the SEC's Michael Hsu. Mr. Hsu connected the dots in an email that day that "lehman's liquidity pool is almost totally locked up with clearing banks to cover intraday [sic] credit []. This is a really big problem." But even then, with Lehman shares being actively traded, the SEC did not require Lehman to make any announcements about its severely depleted liquidity.

Risk. The SEC knew that Lehman was in repeated and persistent breach of its own risk limits, yet the SEC simply acquiesced; it took no action either to get Lehman back into control or to require that Lehman publicly disclose the full extent of its risk-taking.

When Lehman applied for and was granted CSE status, it advised the SEC that it had a robust procedure to calculate and set risk limits as a “*binding constraint on its risk-taking*” that “*could not be exceeded under any circumstances.*”

The SEC received monthly information about Lehman’s risk limits and risk usage from Lehman. In October 2007, the CSE staff learned that Lehman was more than 20% over its recently increased risk appetite limit amount. But the SEC simply acquiesced; it did nothing with that information other than to ask whether the limit breaches had been properly escalated within Lehman. It did not direct compliance with risk limits. It did not direct public disclosure that Lehman failed to stay within its limits.

Lehman’s CSE application also advised the SEC that Lehman was “in the process of developing single transaction limits,” but that the businesses were “currently operating as if the limits [were] in place.” But by July 2007, Lehman had committed to approximately 30 deals that exceeded its then existing limit. The SEC simply acquiesced; it did nothing to require adherence to single transaction limits; it did not require public disclosure of management’s decision not to apply those limits.

Under the CSE Program, Lehman was required to develop and maintain a market-based stress testing program, under which the firm’s portfolio would be tested against a series of both hypothetical and historical stress scenarios. Lehman did test, but it did not include many of its riskiest assets – such as commercial real estate – in the testing models. For example, the SEC knew that Lehman’s internal stress test excluded untraded positions, including commercial real estate. The SEC simply acquiesced; it did nothing to require adjustment to the tests. When Lehman did experimental testing in 2008 with those excluded assets added into the tests, the results were stunning: The tests that were shared with the SEC showed potential losses in all cases of less than \$4 billion; but with the excluded assets factored in, the losses soared to \$9.4 billion in one instance, \$13.4 billion in another.

Balance Sheet Manipulation. I will address this point in a bit more detail below as an independent bullet point, but it is pertinent here. My Report details Lehman’s use of an accounting device known as Repo 105 – a device which was described in contemporaneous e-mails from Lehman executives as a “gimmick” and a “drug we r on” whose only purpose was

to “manage” the balance sheet – to temporarily move \$50 billion of assets of balance sheet at quarter end reporting periods. The effect of these transactions was to allow Lehman to report significantly lower leverage numbers at a time when the rating agencies and business parties viewed leverage as a critical metric.

The SEC did not know about the practice. But it is difficult to understand why not. In the post-Enron world, it would be logical, if not obvious, to ask public companies to explain their off-balance sheet transactions. I saw nothing in my investigation to suggest that the SEC asked even the most fundamental questions that might have uncovered this practice early on, before Lehman escalated it to a \$50 billion issue.

I must emphasize, as I attempted to set out in my Report, that Lehman’s failure was the result of many factors; there is no single cause or actor. I do not view my appearance today as an occasion to assign blame but rather as an opportunity to offer insights that might enhance the government’s ability to protect the nation’s financial infrastructure from another Lehman.

But it is my conclusion that the SEC did not effectively regulate. The SEC even had the benefit of its own Inspector General’s draft report regarding Bear Stearns during the summer before Lehman failed – a report that highlighted, in the context of Bear, the SEC’s failures to effectively regulate Bear’s risk, leverage, capital and liquidity. And still the SEC failed to act with respect to Lehman.

Recently, current SEC Chairman Mary Schapiro came to Chicago with her senior staff to meet with me and my partners to discuss the Report. We sincerely appreciate the SEC’s efforts to follow up on issues raised by the Report. I did not suggest to her, and I am not here today to suggest, any specifics for what regulations there should be or what agency should enforce those regulations. But as someone who has spent considerable time investigating the facts which preceded Lehman’s failure, I have views on what was *not* done – there was a void that I believe merits additional attention and action, by this Committee or by others.

Bullet three: The relationship and means of communication between the SEC, FRBNY and other agencies.

Like most Americans, I was disturbed to learn after 9/11 that various intelligence agencies did not always share information with one another. I thought we learned something from that, but apparently not.

Lehman's collapse was not unanticipated. After Bear Stearns -- a firm whose business model was nearly identical to Lehman's -- almost collapsed, the SEC and the FRBNY assigned dedicated teams to Lehman to monitor its affairs in real time. One would expect that both agencies would work together to avert Lehman's failure. And for the most part, they did. But there were serious lapses.

Both the SEC and the FRBNY focused much of their attention on Lehman's liquidity, but neither agency directed Lehman to take any action. Both agencies had access to daily liquidity reports from Lehman soon after Bear Stearns' near collapse in March 2008. And both agencies monitored Lehman on site beginning in March 2008. On occasion, the SEC deferred to the FRBNY to develop stress test parameters to determine Lehman's vulnerability to a bank run. But we found little evidence that the two agencies pooled their resources as a team to maximize their ability to regulate Lehman. For example, after Lehman failed several stress tests in May and June 2008, neither the SEC nor the FRBNY directed Lehman to take corrective action to strengthen its liquidity position.

Significantly, the SEC and the FRBNY failed to share information about Lehman's liquidity and Lehman's inclusion of encumbered collateral in its liquidity pool. The SEC knew in June 2008 about the \$2 billion Citi deposit and that it was included by Lehman in its reported liquidity pool. It did not share that information with the FRBNY, which did not learn those facts until late August 2008. Additionally, the SEC prepared liquidity analyses of the CSE firms, including Lehman, but the SEC affirmatively declined to share these with the FRBNY because, they explained to us, the analyses were in draft form and never finalized.

The FRBNY knew by at least July 2008 about the \$5 billion JPMorgan collateral pledge which had been made in June 2008. The FRBNY did not pass on that information to the SEC. By August 20, 2008, the FRBNY realized that Lehman was including virtually all of the \$5 billion collateral pledge to JPMorgan in Lehman's reported liquidity pool, but - again - the FRBNY did not share this with the SEC.

So as of August 20, the combined knowledge of the government was that at least \$7 billion of Lehman's supposed liquidity -- a significant portion of the total -- was not liquid because it was pledged. But there was no combined knowledge because the SEC and FRBNY had not shared their individual knowledge.

The FRBNY knew about agreements that Lehman executed with its clearing banks on August 26 and September 9, 2008 that significantly increased the

clearing banks' rights with respect to Lehman collateral. It did not share that information with the SEC. In sum, the FRBNY did not *volunteer* information regarding the CSEs. Instead, the FRBNY only shared information specifically *requested* by the SEC.

The failure to share was not a top down decision. At the top, Chairman Bernanke and Chairman Cox were personally involved in the negotiation and execution of a Memorandum of Understanding between the Fed and the SEC that provided for the exchange of information. The failure was at a staff level, but it was a genuine failure.

The FRBNY and Fed witnesses we spoke to, from Chairman Bernanke and Secretary Geithner down to their staffs, indicated to us that they had some question with the competence of the SEC personnel who were supposedly regulating Lehman. These comments were not a reflection on the competence of particular individuals, but rather on the culture of the SEC. As Chairman Bernanke put it, with due deference to the lawyers he was speaking to, the SEC has a lawyer, enforcement mentality rather than a banker, regulator point of view. The SEC is competent to enforce rules, but it may lack the experience and skill sets possessed by bank regulators to evaluate financial risks of particular loans and other investments.

The agency with the skill sets to regulate a financial institution like Lehman – the Fed – did not have the authority; and the agency with the authority – the SEC – may not have had the skills. And the two agencies were unable to smooth out the gaps because they failed to have full and open sharing of information.

Bullet four: The appropriateness of accounting practices such as Repo 105.

I devote 320 pages of my Report to Lehman's Repo 105 practices, detailing Lehman's use of an accounting technicality to temporarily remove significant amounts of assets off balance sheet for no apparent reason other than to artificially and deceptively reduce Lehman's reported net leverage and, therefore, the market perception of Lehman's viability.

I express no view on whether, as a technical matter of GAAP accounting, it is permissible to treat transactions as sales which are by all other measures financings. But I have a definite view that it is *not* appropriate to engage in significant amounts of such transactions without disclosure.

Lehman did not disclose that it used \$50 billion of these transactions. To the contrary, it affirmatively and erroneously stated in its public filings that it used repo transactions solely as financings. The effect of these transaction was to reduce its net leverage by nearly two full points – when Lehman itself defined a material transaction as one which affected net leverage by one tenth of one point. The failure to disclose the facts was not appropriate.

Bullet five: The quality of Lehman's Management Discussion and Analysis Disclosures.

I found that there are colorable claims that the Management Discussion and Analysis (“MD&A”) sections of Lehman’s Form 10-K for 2007 and Form 10-Q filings in 2008 were misleading.

Lehman emphasized to the investing public that it had worked to lower its net leverage ratio, and stated in its MD&A that net leverage is “more meaningful” than a simple leverage ratio. But Lehman did not disclose that it had only temporarily reduced its net leverage ratio through Repo 105 transactions. Consequently, Lehman’s statement that the net leverage ratio was a “more meaningful” measurement of leverage was rendered misleading because that ratio – as reported by Lehman – was not an accurate indicator of Lehman’s actual leverage, and in fact, understated Lehman’s leverage significantly. In light of the market’s focus on the leverage of investment banks in late 2007 and 2008, I found that sufficient evidence exists for a judge or jury to find that Lehman’s reported net leverage ratio was materially misleading during that period.

An MD&A should include an “analysis” of known material trends, events, demands, commitments, and uncertainties – not simply a restatement of financial statement information. For example, an MD&A should provide information about the *quality* of, and potential variability of, a company’s earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. Regulation S-K requires a registrant to discuss known trends involving its capital resources, *specifically including off-balance sheet financing arrangements*. The same regulation specifies that a registrant should discuss, among other things, the “nature and business purpose to the registrant of such off-balance sheet arrangements” and “[t]he importance to the registrant of such off - balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits.” My report details statements, in both interviews and in contemporaneous e-mails, by senior

Lehman employees that the Repo 105 transactions had no business purpose at all, but did have a marked effect on Lehman's reported net leverage ratio.

SEC guidance also states that an MD&A should describe "unusual events and transactions" to help identify apparent trends. Lehman did not disclose the unusual nature of the Repo 105 transactions or the trend of the temporary reduction of Lehman's reported net leverage ratio at the end of reporting periods.

Lehman's obligation to repurchase \$50 billion of Repo 105 transactions should have been disclosed in its MD&A. That obligation was a known event that was reasonably likely to occur and would have had a material effect on the company's financial condition or results of operations. In addition, in the Liquidity and Capital Resources section of Lehman's MD&A's, Lehman should have included a discussion of the timing and/or amounts of the cash flow created by the repayment of the Repo 105 cash borrowing in the first seven to ten days after the end of the reporting period.

Bullet six: Other relevant issues.

Because neither the SEC nor any other agency directed Lehman to correct its misleading and incomplete public statements, the public did not know there were holes in the reported liquidity pool, nor did it know that Lehman's risk controls were being ignored, or that reported leverage numbers were artificially deflated. Billions of Lehman shares traded on misinformation.

Lehman officers emphasized to us that they freely and fully provided information to various government agencies. I found no evidence to suggest that Lehman withheld any information requested by any agency. But it is my conclusion that the government simply acquiesced to the information it was given; it took no regulatory action, it did not ask hard questions.

It is difficult to speculate on what might have happened in the past had the SEC or the Fed or the Treasury taken more decisive action. We cannot say with certainty what might have worked, but we do know what did not work. If Lehman had been directed to follow its risk controls, it presumably would have taken on less risk. If Lehman had been required to disclose its true liquidity when its pool was first depleted with the \$2 billion Citi deposit in June 2008, when the depletion was not terribly material, it presumably could not have

continued to count increasingly large amounts of encumbered assets as liquidity as it was required over the summer to pledge more assets with its clearing banks.

I have to state the obvious. There is no bright line action that can be said in retrospect "had the government done this, Lehman would not have failed." It is far from clear that the most engaged regulator could have saved Lehman from its fate. But what is clear is that had the government acted sooner on what it did or should have known, there would have been more opportunities for a soft landing. The markets might have been spared the turmoil of Lehman's abrupt failure.

What is clear is that the regulators were not fully engaged and did not direct Lehman to alter the conduct we know in retrospect led Lehman to ruin. Someone must be in charge. And the agency in charge must have the will to act.