MEMORANDUM FOR THE RECORD

Event: Interview with Bill Schlich of Ernst & Young

Type of Event: Interview

Date of Event: April 13, 2010

Team Leader: Tom Krebs

Location: Wilmer Hale

Participants – Non-FCIC: Bill Schlich (Partner, Ernst &Young), Miles Ruthberg (Latham & Watkins), Ronald Hauben (Deputy General Counsel, Ernst & Young), Reginald Brown (Wilmer Hale)

Participants – FCIC: Jay Lerner, Troy Burrus, Hilary Allen

Memorandum prepared by: Hilary Allen

Date of Memorandum: April 13, 2010

Summary of the Interview:

Biography

- Bill Schlich is the leader of E&Y's global Banking Capital Markets group (it is E&Y's largest sector with $3 billion in annual revenues).
- Schlich graduated from SUNY Binghamton in 1987, joined E&Y upon graduation and became a partner in 1999.
- Schlich started working with Lehman in 1999. Prior to that, he was involved with Bankers Trust (during the 90s), Morgan Stanley (in connection with its amalgamation with Dean Witter in the mid to late 90s) and Mizuho (went up to and overlapped with the start of his work on Lehman).
- From 2004 until September 2008, Schlich was the coordinating partner for Lehman
- Schlich has spent the majority of his career dealing with investment banks, derivatives, complex products and reporting.

Background of relationship between E&Y and Lehman

- In 1984 Lehman went public, E&Y was Lehman's auditor from that time until Lehman's bankruptcy. This was a big audit for E&Y. E&Y also audits UBS, ING, SocGen, CIBC.
- Lehman had three hubs: Tokyo, NY and London. There was a partner in each E&Y office in those jurisdictions (incl NY) that ran the audit and reported back to Schlich.
- Europe was becoming a bigger piece of Lehman, and there is speculation that it would have grown larger than Lehman's US operations if Lehman hadn't failed.

- E&Y had separate teams looking after Lehman's capital markets (divided into fixed income and equities, which was further divided into cash equities and derivatives), investment banking, asset management and corporate. Each area had an E&Y partner in control.
- The role of each audit was to provide reasonable assurance that the financial statements, when taken as a whole, materially represented Lehman's condition and the state of its operations.
- The last audit of Lehman performed by E&Y was for the financial year ending Nov 30, 2007. E&Y also did quarterly reviews for Q1 and Q2 2008. A quarterly review does not provide an assurance that there is no material misstatement in the financials, instead it states that nothing has come to the attention of auditor that indicates that the financials need to be changed.
- In NY, 70-100 people would work on the Lehman audit (about 70,000 hours a year worth of work would be done in NY, and 120,000 hours globally). Quarterly reviews involved about 300-400 hours of work.
- There would be work on the audit year-round. The audit would ramp up from August to November. Planning would be April – June, with the testing of models. Schlich would be involved in Lehman every day or every few days.
- Lehman's 10K was filed 60 days after its November 30 year end (at the end of January 2008).
- E&Y would issue an unqualified opinion on the date the 10K was filed.
- Schlich spent a lot of time in Lehman in June 08, regarding Q2 numbers and Lehman's first ever quarterly loss.
- Schlich had very little contact with the SEC and the Fed in connection with his work for Lehman.
- Schlich met with Fuld in quarterly meetings to review internal controls and financial statements, together with Lehman's business heads. Fuld would ask questions in those meetings (he had to verify financial statements, and wanted to satisfy himself that these were correct). Repo 105 never came up in those meetings because, in E&Y's view, these transactions were appropriate and accurately accounted for. Generally, Schlich would give a presentation and that was it. E&Y did occasionally raise issues in these meetings (e.g. documentation deficiency).
- Fuld was present, focused and engaged in these meetings.
- Schlich met with Gregory twice a year to give updates. He also met with Russo, Calzado on a quarterly basis. Repo 105 never came up during any of these meetings.
- The main day-to-day contacts for Schlich were Riley (head product controller), Rudofker, Ed Grieb/Martin Kelly (Controllers), O'Meara, Callan, Lowitt (CFOs), Paul Tucci (treasury). Schlich thinks, but is not sure, that Riley, the Controller and Treasury reported to the CFO.
- Front office/traders price the book. Product control's job is to check these prices.
- Valuation is the responsibility of management. Audit's job is to test valuation controls to ensure that financial statements taken as a whole are free of material misstatement. Lehman had a large valuation group independent from the traders. Each product is broken down for separate valuation. E&Y would sometimes run their own independent tests on valuations. Where assets were illiquid and valuations were model driven, E&Y would get Lehman's work product for 2 months of valuations then E&Y would work through these papers and do tests.
- E&Y didn't find any material weaknesses in these valuation procedures, although processes can always be improved. For valuing illiquid assets, you need to see if the process is reasonable, and make sure the process is applied consistently. It is likely, however, that different people would all value these in different ways.
- As of 11/30/2007, there was no issue with the valuation of Archstone. The subsequent quarterly reviews were limited in scope, and did not review the pricing or inputs of Archstone.

There were conversations about Archstone, but not at the level there would be for a year-end audit.
- Management and E&Y did have conversations regarding how product control would view the Archstone portfolio in Q1 and Q2 08. This was common practice, because Archstone was a big position.

Lehman's business model
- Lehman maintained significant portfolios of assets for client purposes, proprietary trading and hedging purposes.
- Footnote 3 on Page 104 of Lehman's 2007 10K shows growth in mortgage backed securities (includes origination and securitization). The footnote generally breaks down the asset classes and shows the growth from 2006.
- In the period 2005-2006, interest rates were low and funding was cheap, which led to large growth. This was consistent across the investment banking industry. Lehman was looking to balance their holdings outside of the US (with holdings in Asia and Europe) and to grow their asset management business.
- Lehman has always been big in the mortgage business.
- Lehman and Bear Stearns were involved more in fixed income than the other investment banks.
- Lehman was a market maker in equities and corporate debt, and involved in government issues. It was also a big derivatives dealer, and involved in underwriting.
- Neuberger Berman was Lehman's asset management business, which they were looking to grow.
- Mid-07 there starts to be pressure in the subprime space and any related assets (such as MBSs). March 08 is where Bear crashed. Some of Lehman's growth in 2007/2008 was due to there being less liquidity in the markets after the subprime crisis, which meant that Lehman had to hold assets. After Bear, Lehman (and others) started to actively try to shrink their assets.
- At the end of 2007, across the industry, people started to concentrate on their valuations. Liquidity also was an issue in late 2007/early 2008, but the demise of Bear really put pressure on liquidity in every asset class (i.e. there was a general lack of desire to purchase assets). It is difficult to price liquidity problems into the marketplace.
- Lehman was equally involved in residential mortgages and commercial property. There was some pressure on commercial property in late 2007, but the problems with that asset class really built up in 2008.
- Lehman was a highly leveraged institution (as disclosed in the MD&A). Lehman's funding took the form of equity and short and long term debt (see Lehman's 2007 10K FN 8 p116). Secured funding is an important part of the funding – typically the funding was secured by highly liquid assets (easily sold, repoed, pledged to a federal agency). This was a common funding model for investment banks (Schlich doesn't know if funding model proportions are similar for other investment banks).
- Part of Lehman's business is making sure it has a large pool of securities available for customers. The vast majority of repos were secured borrowings, and accounted for as such. The assets supporting these were highly liquid and the financings were done short term (a few days, weeks, a month).
- At the end of Nov 2007, Lehman had $230 billion of repos on its balance sheet. This represents positions that have been netted out – the gross number of repos is much higher than

this, and because these were rolling over on a daily basis, the volumes of trading repos were huge.
- A gross balance sheet shows every transaction. Every investment bank goes through processes to net out liabilities and assets (there are accounting requirements for netting under e.g. FIN 41 which deals with repos and reverse repos). All investment banks net (Schlich is not sure if this is strictly required, thought).
- E&Y had no concerns re Lehman's normal repo business. The vast majority of repos are accounted for as loans - $230 billion of repos (that is a net number – could be double or even higher).
- A small amount of repos were accounted for as sales because they satisfied FAS 140 (this standard is based on the control model: if you don't have the ability to buy back the securities you have relinquished control, and there has been a sale). If you have retained 98% - 102% of the interest, you are presumed to have control and you need to show on a facts and circumstances basis that control was relinquished. The securities need to be highly liquid for this accounting treatment. At 95%, the presumption is that there is no control, and you can rely on FAS 140 if there is a true sale under the law in the jurisdiction in which the transaction is done.

Repo 105
- Schlich did not review Lehman's Repo 105 policy when it was put in place in 2001. Sometime between 2004-2008, Schlich did review the policy (probably 2006-2007). Schlich doesn't know if Lehman tried to get a true sale opinion in the US.
- UK law regarding transfer of control is different from US law, and US choice of law provisions would indicate that for these UK transactions, you should look to English law on the true sale issue.
- The audit of the Repo 105 policy was done in the UK (Andrew Woosey was the Partner in London). E&Y NY did not specifically review the procedures for compliance with the Repo 105 Policy. Schlich reviewed the policy itself.
- Valukas raised issues re disclosures in the footnotes and the MD&A. There was no literature at that time requiring Repo 105 transactions be disclosed (FAS 166, effective 2010, would require such disclosure).
- In Lehman's 10K for 2007, FN1 is a Summary of Significant Accounting Policies. This states that if control is surrendered, then it is a sale for FAS 140 – the statement is located under subheading "Securitization Policies". Valukas feels that this disclosure has not been restated with regard to repo. Schlich's view is that if you made the same disclosure regarding every sale of every asset class, the 10K would be huge.
- The Valukas report focuses on one ratio (i.e. the leverage ratio), but Schlich's view is that the point of disclosures is to give a picture of the financial state of the firm as a whole.
- MD&A makes it clear that the institution is highly leveraged. However, an investor can't just look at the leverage ratio, because different types of assets create different types of risk. Schlich's view is that the disclosure should show where the risks lie (i.e. whether risky assets are held).
- Schlich believes that if the reader looks at the disclosure as a whole, the reader understands what the leverage is, and what is off-balance sheet.
- FN9 to Lehman's 2007 10K lays out Lehman's off-balance sheet commitments, totaling almost $1 trillion. The Repo 105 off-balance sheet amounts are part of this total.

- Whether a $38 billion disclosure re repo 105 was made in FN9 it would not have affected the understanding of the off-balance sheet amount of $1 trillion. If Lehman had wanted to make a specific disclosure re the $38 billion as a business decision that wouldn't be a problem, but it was not required under FAS 140. FAS 166 would now require this.
- There is no fixed way to calculate balance sheet materiality: it is done on a facts and circumstances basis.
- There is no rule of thumb for materiality for footnotes – have to look at what message the reader gets overall.
- If there was a $38 billion error on the balance sheet prior to publication, E&Y would advise that Lehman adjust the numbers. If Lehman hypothetically refused, it would be a facts and circumstances specific determination for E&Y about whether it was material (the test for materiality here would be, was the error at such a level that, if it had been included in published financials, the company would need to restate its financial statements, and rebalance) and needed to be disclosed to the audit committee. However, E&Ys view is that there was no error re Repo 105 disclosure.
- With respect to mistakes in the footnotes, E&Y's view is that there was no error here, but hypothetically, they would suggest that any errors be fixed prior to publication. E&Y would not tell Lehman that they needed to restate their published financials if the footnotes included a $38 billion error in a pool of $1trillion of off-balance sheet liabilities (the amounts in the footnotes don't need to balance).
- If there had been an error in the balance sheet that would have changed the leverage ratio by 0.1, that would not necessarily be material (there was no threshold or $ amount), although E&Y would have considered correcting the error if the financial statements had not yet been released. Lehman's internal rules re calculation of leverage (i.e. that prior to publication, 0.1 is material with respect to errors/adjustments on the balance sheet, but not necessarily with respect to the footnotes) has nothing to do with E&Y's vision of materiality.
- Once financial statements have been published, the degree of materiality required to restate financials must be high (0.1 would not be sufficient). Before the statements are filed, the thresholds for materiality are lower, but sometimes it is not operationally worthwhile to revise the statements for immaterial matters. This is especially the case for late journal entries.
- Examiner's issue is not that there is an error, but whether $38 billion has to be broken out from the $1 trillion as a separate disclosure in FN9.
- Jay Lerner present Schlich with a document: Schlich had not previously seen the document presented. The first bullet on the last page mentions E&Y – Schlich does not recall any specific concerns raised by Lehman during the specified time period. E&Y did review the Repo 105/108 policy in 2006-07.
- The Repo 105 policy follows the accounting rules so it doesn't change much, but it was refreshed (reevaluated, redated) occasionally. This was done for many of Lehman's accounting policies when a new head of accounting was appointed. Not all policies are run past E&Y – especially when (like FAS 140) the underlying accounting standard hadn't changed.
- E&Y suggested, and Lehman's Controller was of the same mind, that Lehman's accounting of adjustments/netting should be reviewed (this process commenced in 2007). Sometime in late 2007, there was a draft policy. This covered Repo 105, amongst other things - like TBAs (i.e. unannounced securities).

Lehman post-Bear

- After Bear, Schlich had conversations with Lehman regarding whether their leveraged funding model was appropriate.
- In 2008 (ramping up post-Bear), the SEC and the Fed were talking to Lehman very regularly about their funding model. Schlich would review Lehman's presentations about funding sources. This was a very constant communication – more than in the period before Bear, about the structure and term of Lehman's funding, repo counterparties and maturities, what has changed.
- Mid 08, the regulators were asking Lehman, has anyone pulled away, are there any major concerns. From mid-2008 Lehman was trying to increase the term of funding (asking for weekly, monthly terms for repos rather than a couple of days).
- June, July, August: limited reviews/conversations by E&Y did not indicate that Lehman had any issues with their funding.
- Post-Bear, all the investment banks started looking closely at liquidity and leverage, shrinking and de-risking balance sheets. Lehman continued to be concerned by valuations, how to price liquidity into the asset classes, but was fine in terms of capital, liquidity and balance sheet.
- Counterparties started to pull away in September.

Matthew Lee
- Lee had worked at E&Y before Lehman, but Schlich and Hansen had not dealt with him before.
- Schlich thinks that Lee reported to Lehman's Controller, but is not sure.
- In late May ($27^{th}/28^{th}$), Schlich was informed of the Matthew Lee letter, and got a copy several days later. Schlich spoke with head of internal audit (Beth Rudofker) and controller (Martin Kelly), and told both of them to inform the audit committee, the SEC and the Fed.
- Regulation by the Fed and CSE supervision by the SEC, plus increased activity by regulators post-Bear, were things that Lehman did not have much experience with, so Schlich was trying to assist with his prior experience with regulators.
- Rudofker and Kelly agreed that this made sense, and Rudofker told Schlich that Lehman had spoken to the regulators (but didn't mention any specific names, and didn't specify whether she had spoken to both the SEC and the Fed). None of this is documented by email.
- June 12: Schlich met with Lee together with Hillary Hansen (she had been on the Lehman account for a while, but E&Y will verify the length of her involvement). Joe Polizado (GC Lehman) was also there, but he left to give E&Y time alone with Lee (this was prearranged by E&Y).
- Hansen had a deep capital markets background and understood valuation, so Schlich wanted to include her in the meeting.
- Two of Lee's allegations worried Schlich the most: the first allegation was that Lehman had $30-35 billion of unsubstantiated assets (the number was provided in the meeting, the letter was silent on this point). This concerned Schlich very much, as substantiation of assets was a large part of Lee's job. The second allegation was that there were $10s of billions of assets that were not appropriately priced and couldn't be sold at the prices that were attributed to them. If these allegations were true, Schlich considered that the balance sheets would need to be restated. Also, with a $35 billion unsubstantiated balance sheet, Lehman couldn't issue a Q which would be a disaster.
- The other points raised in Lee's letter were non-issues. The controls over the Mumbai operations were also done out of NY. Management balance sheet (used to manage operations on an ongoing business) never matches books and records (the former is not done in accordance with GAAP).

- Schlich doesn't know why these issues (other than the unsubstantiated assets) were of importance to Lee.
- Lee didn't explain why he wrote the letter, and his demeanor was very calm during his meeting with Schlich.
- Schlich asked Lee about material misstatement, fraud, manipulation but he didn't know if any of this occurred. He said he didn't know because he couldn't substantiate $35 of assets.
- Lee had a listing of all the assets he needed to substantiate – the cumulative total of all the items he couldn't substantiate was $30-$35 million.
- E&Y's view is that Lee meant by unsubstantiated that he didn't have the necessary documents to substantiate, not that there was malfeasance.
- Lee thought there were lists of assets that couldn't be valued (this was not Lee's area – his allegations here were vague). E&Y couldn't comment definitively on this until E&Y had done their audit.
- Schlich has no memory of Lee bringing up Repo 105. He was concerned with the two issues referred to above (and didn't think there was anything wrong with Repo 105), although Schlich concedes that Hansen made a note re $50 billion of Repo 105 in her meeting notes. Schlich said that there were a lot of other things going on with Lehman that needed to be considered from an accounting perspective.
- Hansen was not familiar with Repo 105. She worked on equity derivatives, and the detailed audit of Repo 105 was done out of the UK. Hansen was taking notes of the meeting. After the meeting, Hansen recalls speaking with Schlich which put her mind at ease that Repo 105 was a non-issue. Schlich doesn't remember this conversation.
- Repo 105 was also brought up in a meeting with Schlick, Hansen and Riley. Gerry Riley is the head product controller in charge of valuation. Schlich and Hansen had conversations with him regularly, but the focus was on high level issues. Schlich was being pulled in and out of meetings all the time. Schlich was primarily concerned with valuation when talking with Riley.
- E&Y's lawyers are not sure how firm Hansen's recollection is of a mention of Repo 105 during the meeting with Gerry Riley.
- Audit committee's preliminary results were that Lee's allegations were not true. E&Y agreed with the preliminary conclusion, but couldn't comment definitively until they completed their year-end audit.
- Schlich met with the audit committee, and they agreed that there were valuation procedures that need to be changed. This process was never completed because Lehman went bankrupt.

Schlich's view of the demise of Lehman
- In Q2 of 2008: Lehman does a $6 billion capital raise, and (around the same time, or even simultaneously) announces their first ever loss.
- In June/July, Lehman was looking for potential partners, deals (including KDB).
- To Schlich's knowledge, Lehman had no liquidity issues even into August, no withdrawals of counterparties. Then in September, there was a run on the bank (precipitated by a complete lack of faith in the investment bank business model that relies on short term financing and has investments in fixed assets).
- There was a complete lack of liquidity, which had the effect that the quality of assets became somewhat irrelevant.

- Schlich was at Lehman when potential suitors were going through the books – Schlich thought there was going to be a forced deal, and when that didn't happen Lehman tried to accumulate cash to open on Monday, and that's when counterparts started pulling away from them.
- Each investment bank is different – Merrill had large exposure to CDOs, Citi had exposure to SIVs, Lehman had commercial real estate. Liquidity dried up in respect of all of these asset classes.
- Schlich suggested that Morgan Stanley would be in the same position as Lehman if they hadn't received a capital injection from Treasury and become a Financial Holding Company.
- If FHC status and a capital infusion had been given to Lehman and Bear, Schlich's view is that they would have survived.
- Schlich thinks that Russo (on behalf of Lehman) had requested to be converted to an FHC, but he isn't sure.

Affiliated funds
- Schlich has heard of Hudson Castle and Fenway. He recalls that they were conduit deals, but needs to refresh his memory. A conduit vehicle would be funded by the selling of notes.
- In Schlich's experience, Lehman would not use a conduit vehicle to get assets off its books.
- At this point, Schlich is not aware of anything improper being done with Hudson Castle.
- No one at E&Y was looking into Hudson Castle before the NYT article was released last night.
- When successful traders wanted to go make their own book of business, Lehman would sometimes help them set up funds. Accounting rules would not require consolidation of these funds if there was separate capital.
- Sometime in 2008, [Reader] wanted to leave Lehman and set up a firm with outside funding. Lehman was never audited after the formation of R3 (because of its bankruptcy), but prior to September 2008, there were conversations about R3's external funding model to determine whether consolidation would be required – to avoid this, any funding from Lehman would have to be done on arm's-length terms. After Lehman's bankruptcy, R3 got sold to BlackRock (or BlackStone).
- The first step in determining whether consolidation is required is to look at who owns the significant equity in the entity. If that is not determinative, you look at who gets the majority of the variable interest.
- Email from Schlich to Carmine DeScipio (head of Fin Services in NY) and Steve How (head of the Americas) is regarding R3 and the latest update Schlich had got on that valuation. E&Y were working through the valuation of R3. Valukas thought this reference was to Repo 105.

<u>Interesting Quotes from Schlich</u>:

N.B. that these are paraphrased:
- My emphasis on the valuation issues raised by Lee's letter, and not on Repo 105, was appropriate.
- There is no reason why I wouldn't have brought up Repo 105 if I thought it was an issue. I am comfortable that we got the main issues right.
- Examiner had the incentive to find a colorable claim, not defenses for E&Y.