Lehman Brothers and Repo 105

A Whistleblower’s Story

In May 2008, Matthew Lee, employed by Lehman Brothers Holdings, Inc. (Lehman) for the past fourteen years, read once again from his employer’s Code of Ethics:

If an individual engages in or becomes aware of any conduct or activity that may violate the Code of Ethics or an applicable law or regulation, it is that individual’s responsibility to promptly report the matter by notifying his or her immediate supervisor or divisional Human Resources Director, or an appropriate representative of Legal, Compliance or Internal Audit. . . . No individual will be subject to retaliation of any kind (or threat of retaliation) for reporting in good faith any ethical concerns, suspected securities law violations or other suspected misconduct. Any individual who believes that he or she has been retaliated against (or threatened or harassed) in violation of this policy should immediately report the matter to his or her immediate supervisor, divisional Human Resources Director, or an appropriate representative of Legal, Compliance or Internal Audit.1

Lee was now a senior vice president in the finance division, overseeing balance sheet accounting across more than one thousand legal entities worldwide that constituted Lehman. He had meant to write this letter for a while, but had not been until then fully convinced that it was the right thing to do. However, a recent meeting with his lawyer persuaded him that it was his duty to report on what he knew. He thus started to type:

I have become aware of certain conduct and practices . . . that I feel compelled to bring to your attention, as required by the Firm’s Code of Ethics, as Amended February 17, 2004 (the “Code”). . . . In the course of performing my duties for the Firm, I have reason to believe that certain conduct on the part of senior management of the Firm may be in violation of the Code. The following is a summary of the conduct I believe may violate the Code and which I feel compelled, by the terms of the Code, to bring to your attention.
1. Senior Firm management manages its balance sheet assets on a daily basis. On the last day of each month, the books and records of the Firm contain approximately five (5) billion dollars of net assets in excess of what is managed on the last day of the month. I believe this pattern indicates that the Firm’s senior management is not in sufficient control of its assets to be able to establish that its financial statements are presented to the public and governmental agencies in a “full, fair accurate and timely manner.” (see Exhibit 1 for the full letter).

Approximately two weeks later, Lee was called into his supervisor’s office and summarily told he was dismissed as part of a broader downsizing program. There was no other reason given. Lee contested his firing, but later accepted a severance package that included a confidentiality clause prohibiting him to further talk about his allegations. Lehman went bankrupt in September 2008 and he never received the full amount of the package.

Commenting on Lee’s letter in 2010, Lehman Brothers’ former auditor Ernst & Young (E&Y) stated:

Lehman conducted an investigation of the allegations in the employee’s May 2008 letter. In July 2008, Lehman’s management reported to the Audit Committee and concluded the allegations were unfounded and there were no material issues identified. We never concluded our review of the matter, because Lehman went into bankruptcy before we completed our audit.

The Rise and Fall of Lehman Brothers

Founded in 1850, Lehman was one of the oldest and most profitable investment banks on Wall Street. Sold to Shearson/American Express in 1984, it was spun off in 1994 through an initial public offering. To lead this new stand-alone public firm, Richard S. Fuld Jr., a Lehman trader since 1969, was named chairman and CEO.

While Lehman’s historical strength was in underwriting and trading fixed income securities, the firm decided to diversify its revenue sources. Lehman was reacting to investors’ worries that the firm was over-exposed to fixed income markets. Consequently, the proportion of Lehman’s revenues derived from its fixed income activities slid from 55% in 1995 to 39% in 2007, with an increasing proportion of revenues coming from its equity and advisory businesses. In mid 2000s, Lehman also made a deliberate decision to pursue a higher growth strategy and switched from the low-risk brokerage model to a higher-risk banking model. Lehman’s balance sheet transformed from merely “transferring” assets to third-parties to “holding” them on their own balance sheet. As a consequence, Lehman started internalizing the various risks it took on the company’s balance sheet.

Lehman took on increasing leverage during the 2000s. While Lehman’s assets increased by about $300 billion between 2004 and 2007, equity rose by a mere $6 billion during the same period. Shawn Tully, senior editor-at-large of Fortune, explained the rationale behind this strategy: “The game Wall Street played relied on leveraging up the cash provided by shareholders to enormous levels and

\[\text{For more information, see “Before the Fall: Lehman Brothers 2008,” HBS Case No. 309-093 (Boston: Harvard Business School Publishing, 2009).}\]
using all the debt to accumulate a giant portfolio of securities. As long as interest rates trend downward, the value of that portfolio swells, yielding gigantic returns on a slim equity base."  

Lehman, following other Wall Street peers, had expanded increasingly in riskier activities, such as the packaging and trading of exotic types of mortgage-backed securities. These high-margin products helped Lehman to post record profits ($4.2 billion) and revenues ($19.3 billion) in 2007. Fuld emphasized that Lehman had a core competence in dealing with these risky products: “Smart risk management is never putting yourself in a position where you can’t live to fight another day.”

As Lehman had no access to a stable base of retail deposits, it relied instead on constantly refinanced short-term loans. It was therefore vital for the company to maintain investor confidence: bad news alarming Lehman creditors could jeopardize the short-term financing of the firm. Lehman knew how dangerous such a financing model could be: in 1998, the company suffered greatly following rumors about Lehman’s insolvency in the wake of the near-collapse of the hedge fund Long Term Capital Management. Fuld’s successful management of the investors’ confidence crisis at that time was seen by many as the defining moment in his career at Lehman.

However, investor confidence was shaken immensely in March 2008 when another highly-leveraged firm, Bear Stearns, collapsed. While analysts and rating agencies had been increasingly worried about investment banks’ leverage positions since mid-2007, it then became urgent for most Wall Street firms, Lehman included, to calm the markets by conveying reassuring news about their leverage ratios.

Erin Callan, then Lehman CFO, said at that time that Lehman was fighting “hand-to-hand combat” to fend off rumors and concerns about its liquidity. She had reassured investors about Lehman’s leverage on March 18, 2008, during the first quarter earnings call:

We did, very deliberately, take leverage down for the quarter. We ended with a net leverage ratio of 15.4 times down from 16.1 at year end [see Exhibit 2]. And we will continue to allocate capital on the balance sheet in the market in a way that we consider prudent, and that reflects the liquidity profile of the balance sheet.

Citing market conditions and possible forthcoming losses, on June 2, 2008, Standard & Poor’s downgraded Lehman’s credit ratings from A+ to A, however, on a positive note, it praised Lehman’s “strong funding/liquidity profile.”

Less than a week later, Lehman pre-announced its first ever quarterly loss as a public company, $2.8 billion. The firm appointed a new CFO and announced that it would issue $6 billion in stock, its third capital raise since the beginning of the year. New CFO Ian Lowitt reiterated the focus on reducing leverage in the subsequent earnings call, on June 16, 2008: “As a result, we reduced our gross leverage from 31.7 times to 24.3 times at May 31, and we reduced net leverage from 15.4 times to 12 times. ... I think we feel the appropriate leverage for us to operate is in the low double digits at the moment. ... We’re going to operate conservatively.”

However, this strategy did not reassure everyone. David Einhorn, a hedge fund manager, had started to short Lehman’s shares in July 2007, and encouraged investors to do the same. He was particularly critical of Lehman’s leverage, and mistrusted its publicly stated ratios: “The problem is the overall leverage and loan portfolio ... they are 40 times levered on tangible equity, and they own
things that don’t strike me as being the kinds of things that should be levered at all.”

While some analysts downplayed Einhorn’s claims, the fact remained: by June 2008, Lehman was the Wall Street investment bank with the highest level of shares sold short.

Over the summer, Moody’s lowered its outlook for the firm to negative, citing additional mark-to-market losses, mortgage exposures and potential franchise erosion. On the plus side, it noted that “Lehman had been proactive in its efforts at bolstering capital and de-leveraging its balance sheet” and that “Lehman’s liquidity management and stand-alone liquidity position remain[ed] sound.”

In August, Lehman laid off 1,500 employees, 6% of its workforce, as analysts anticipated another quarterly loss. Wall Street was anxious: in the first eight months of 2008, Lehman’s shares had lost 73% of their value.

On September 10, 2008, Lehman announced a second quarterly loss of $3.9 billion, along with its intent to sell off most of its investment-management business. Fitch Ratings placed Lehman’s ratings on Rating Watch Negative, citing heightened pressures that had adversely impacted Lehman’s financial flexibility and its ability to raise capital.

Three days later, then President of the Federal Reserve Bank of New York Timothy F. Geithner, convened Wall Street bankers for a meeting on the future of Lehman, in which he made it clear that the government would not bail out the firm. Many plans were drawn up during that weekend as to which (or whether any) financial firm would accept to buy Lehman without government backing.

There was no taker. Lehman filed for bankruptcy under Chapter 11 of the Bankruptcy Code on September 15, 2008, citing “significant liquidity problems.” With over $600 billion in assets, Lehman’s was the largest bankruptcy filing in American history.

**Repo 105 Transactions and Balance Sheet Management**

*Accounting for Repo Transactions*

Lehman, like its Wall Street peers, frequently used repurchase agreements (“Repos”) as a vehicle to provide liquidity, and to finance its short-term borrowings. Repos were a fast growing source of financing and commonly used by many banks and financial institutions. In 2007, the repo market had doubled its size since 2002, with gross amounts outstanding of roughly $11 trillion in the US and Europe.

Standard repo transactions were completed in two steps. Lehman would first borrow cash using assets on its own balance sheet as collateral. The value of the collateralized asset equals the original borrowed amount plus the haircut (i.e., 2% for repo 102 transactions). Subsequently, as Lehman repaid the cash it would then repossess the collateralized asset and pay the lender the originally borrowed amount plus the interest.

Accounting for a typical repurchase agreement was straightforward. At the inception of the loan, the borrowing bank recorded a short-term liability for the cash received. When the loan was repaid, the liability would disappear and an interest expense recorded for the amount paid in excess of the initial borrowed amount. The collateralized assets remained on the bank’s balance sheet often with footnote disclosures noting the collateralized amount. Such an accounting treatment effectively
considered the repo transaction as a financing activity, thereby recognizing both the increase in cash as well as the liabilities from entering a repurchase agreement.

SFAS 140 governed the accounting for “transfers and servicing of financial assets,” such as the repurchase transactions and similar financing transactions and asset transfers. In certain circumstances, the transfer would qualify as a sale, as opposed to a financing activity. The “control” criterion determined a transfer of an asset as a sale, or not. SFAS 140 indicated that when the collateralization was between 98% and 102%, a repo borrower maintained effective control over the collateralized assets and consequently the transaction could not be considered as a sale. SFAS 140, however, stated three conditions under which a sale could be recorded, which amounted to surrender of control, but also noted that it was very rare that repurchase commitments were considered as such (see Exhibit 3).

**Lehman’s Interpretation of SFAS 140 and Repo 105 Transactions**

Lehman had created a new type of repo transaction which allowed the firm to consider the transaction as a sale. Lehman, by taking higher haircuts of 5 or 8% (the haircut of a typical repo transaction was 2%), justified the transaction as a sale in accordance with its interpretation of SFAS 140. Lehman’s rationale was that a higher haircut established a surrender of control over the asset.

Considering the transfers as sales implied that at the inception of borrowing, Lehman, would record (apart from an increase in cash) a reduction in the collateralized assets, equivalent to the borrowed amount plus the haircut. The difference between the cash received and the transferred asset value (the haircut) was recorded as an option to repurchase (an asset account). Since the total assets remained unchanged, the transfer of assets by itself did not have a large effect on Lehman’s leverage ratio.

Lehman would then use the cash proceeds from the Repo transaction to pay down other liabilities, thereby reducing the total liabilities on its balance sheet. Equity remained unchanged which implied lower leverage ratios (see Exhibit 4). Lehman was able to reduce its net balance sheet through its Repo 105 practice by more than $138 billion between the fourth quarter of 2007 and the end of the second quarter of 2008. Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods which reduced its net leverage (see Exhibit 5).

Lehman never publicly disclosed its use of Repo 105 transactions, and its accounting treatment for these transactions. In its financial statements, Lehman accounted for the Repo 105 transactions as derivatives but added them to the larger group of more “traditional” derivatives, presented in a footnote. Faced only with the total value of Lehman’s derivatives, readers were thus unable to know that Lehman had engaged in Repo 105 transactions. Moreover, there was no indication in the

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b Lehman’s definition of net leverage was net assets over tangible equity. Net assets were defined as total assets excluding (1) cash and securities segregated and on deposit for regulatory and other purposes; (2) securities received as collateral; (3) securities purchased under agreement to resell; (4) securities borrowed; and (5) identifiable intangible assets and goodwill. Lehman calculated tangible equity capital as stockholder’s equity and junior subordinated notes less identifiable intangible asset and goodwill. (Report of Anton R. Valukas, Examiner on Lehman Brothers Holdings Inc. Chapter 11 Proceedings, p. 805).
financial statements that Lehman had the obligation to repurchase securities worth tens of billions of dollars on a short-term basis.

“An Important Ratio”

Starting mid-2007, market participants began to scrutinize more carefully the leverage of investment banks, and their focus moved from revenue to balance sheets. In fact, according to a Lehman insider, Lehman’s chief risk officer Madelyn Antoncic, who was responsible for setting trading limits did, in late 2006, advise “caution, pullback, and extra study” at meetings of the executive committee during the discussion of deal proposals. However, in 2007, she was sidelined: “whenever there were tense issues involving risk being aired in front of the executive committee”, CEO Fuld asked her to leave the room together with the deal team. All the while, top Lehman executives pressured the firm’s businesses to reduce the net leverage ratio of the firm by selling assets in order to meet market expectations and avoid a ratings downgrade. It is against this backdrop that Lehman’s traders significantly increased the quarter-end use of Repo 105 transactions.

In March 2008, Fuld appointed Bart McDade, a Lehman veteran, as “balance sheet czar” to further emphasize the importance of de-leveraging. McDade wanted Lehman’s traders to exercise more discipline with respect to Repo 105 transactions, and in an email declared Repo 105 as “another drug we [are] on.” From his perspective, Lehman’s traders should have sold inventory to reduce the balance sheet.

However, when traders found it hard to sell sticky assets or wanted to avoid selling them at a discount, they knew they could “rent the balance sheet,” by removing certain inventory temporarily through Repo 105 and still reach Lehman’s net leverage ratio targets. Increased pressure from Lehman senior executives to meet balance sheet reduction targets intensified in the time leading up to each of the firm’s quarter ends. Mitchell King, a senior trader at Lehman, reflected that there was always balance sheet pressure at quarter ends, but starting sometime in mid-2007, there was a definite increase in the level of pressure as the firm tried desperately to reduce its balance sheet. The goal was to stay profitable but reduce the size of the balance sheet. To the powers that be, Repo 105 counted as a balance sheet reduction.

Lehman’s auditor, E&Y, understood the pressure faced by Lehman. The auditors’ “walk-through” paper related to Lehman’s audit for the period ended on November 30, 2007 commented: “Net leverage is an important ratio analyzed by the rating agencies and included in Lehman’s earnings release.”

In its earnings calls with securities analysts, monitored by several E&Y auditors, Lehman consistently emphasized its aggressive efforts to deleverage. However, Lehman did not disclose that its net leverage ratio, which it cited as evidence of its discipline and financial health, depended, to some extent, upon its Repo 105 practice.

During May and June of 2008, Lehman met with all three rating agencies that rated its debt (Fitch Rating, Moody’s and Standard & Poor’s) and argued that no negative ratings actions against Lehman were justified due to achieved and expected asset reductions, deleveraging, and improvements in gross and net leverage ratios. Nowhere in the presentations given to the ratings agencies was it
disclosed that Lehman used Repo 105 transactions or the impact of Repo 105 transactions on Lehman’s balance sheet and leverage ratios.28

Officials at the Federal Reserve of New York and the Securities and Exchange Commission were also unaware of Lehman’s use of Repo 105 transactions to reduce assets and lower leverage ratios.

Auditing at Lehman

E&Y began to work for Lehman in 1994, when the latter was spun-off from American Express.29 E&Y not only audited Lehman’s books, but also performed other accounting, advisory, and tax services, for which E&Y received more than $150 million from 2001 through Lehman’s bankruptcy in September 2008.30 Lehman was a big client for E&Y and many of its accountants worked every year only on this account. In fact, Lehman was among E&Y’s top 15 clients for each of the past seven years preceding Lehman’s downfall. In 2007, it was its eighth most important American client by audit fees.31

Some of Lehman’s finance executives were E&Y-alumni. Christopher O’Meara, Lehman’s CFO from 2004 to 2007, was previously a senior manager in E&Y’s Financial Services division. In 1994, while E&Y was auditing Lehman, he made the switch. David Goldfarb, who preceded O’Meara as Lehman’s CFO from 2000 to 2004, was also employed by E&Y from 1979 to 1993 as a senior partner in the Financial Services practice.32 Goldfarb was alleged to be the person inside Lehman to have created the Repo 105 transactions.33

In compliance with the Sarbanes-Oxley Act of 2002, Lehman made sure that E&Y reported directly to its Audit Committee. All members of the Lehman Audit Committee were independent, and the committee’s chair was a financial expert. The Audit Committee met privately with the engagement partner of the audit firm without Lehman management present. E&Y supplied the audit committee with a list of Lehman’s significant accounting policies and also reported any significant disagreement with management on financial reporting.34

An excerpt from E&Y’s engagement letter with Lehman, referring to the detection of potentially fraudulent acts, confirmed the audit firm’s commitment to communicate with the Audit Committee:

If we become aware of fraud involving senior management or fraud (whether by senior management or other employees) that causes a material misstatement of the consolidated financial statements, we will report this matter directly to the Audit Committee. We will ensure that the Audit Committee is adequately informed of illegal acts that come to our attention unless they are clearly inconsequential.34

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Ernst & Young and Repo 105

In 2001, Lehman discussed its internal Accounting Policy Statement (“the Policy”) with E&Y’s then engagement partner Kevin Reilly and E&Y auditors Matthew Kurzweil and William Schlich. This Policy stated Lehman’s wish to use Repo 105 transactions. E&Y approved the Policy, although it did not help Lehman to draft it, and it played no advisory role regarding the Repo 105 transactions. The E&Y audit partners were also aware that Lehman used the Repo 105 transactions to manage its balance sheet. A memo sent by a senior Lehman auditor, Kristine Smith, on August 19, 2001 to Reilly, Schlich, and Kurzweil described Repo 105 as an accounting treatment giving Lehman the ability to characterize repo and repo trades as inventory trades and will allow for an increased ability to net down Lehman’s balance sheet.

Lehman also informed E&Y that although US law firms would not qualify Repo 105 transactions as “sales”, the UK law firm Linklaters gave its assurance that these transactions could qualify as such under some strict conditions: the transactions had to involve securities “sited” in the UK, and they had to be executed in the UK, under the English law. Lehman however later started to include in its Repo 105 transactions billions of dollars of American fixed income government securities. A US-based Lehman entity wishing to engage in a Repo 105 transaction would first transfer its securities to LBIE, an affiliate of Lehman in the UK, which would then make the transaction. E&Y’s then engagement partner William Schlich maintained that he was not aware that such transactions took place. However, Lehman’s Kristine Smith and Martin Kelly insisted in their testimonies following Lehman’s downfall that they had specifically told Schlich that Repo 105 transactions also included American securities.

In 2006, after reviewing the Lehman Policy and the Repo 105 transactions, a member of the E&Y audit team, Bharat Jain, became worried that these could represent a reputational risk for Lehman. On September 7, 2006, Jain wrote an e-mail to his senior manager, Jennifer Jackson, mentioning that he wanted “to know what is our thought process behind how much of these Lehman should do from reputational risk, etc. perspective. Are we comparing to other competitors, are we referring to any industry publications, any regulatory guidance, etc.?”

Jackson later testified that she had perceived Jain’s e-mail as being serious: “[t]he raising of the concern around reputational risk . . . didn’t happen every day. . . . I can’t think of an[other] example off the top of my head where Lehman entered into transactions, and we had a concern around reputational risk.” Nonetheless, she could not remember if she had actually raised this “reputational risk issue” related to Repo 105 with her direct superior, Schlich.

Initially, Lehman had informed E&Y via e-mail that it was planning to limit Repo 105 transactions to about $20 billion or $30 billion. However, in 2007, Lehman started to exceed this limit, and, at the end of the second quarter of 2008, Repo 105 transactions amounted to $50.38 billion. E&Y was aware of the increasing size of these transactions: the audit firm received many internal documents produced by Lehman that stated the volume of its Repo 105 transactions.

E&Y was also told of Lehman’s increased reliance on Repo 105 by Martin Kelly, soon after he became Lehman’s financial controller in December 2007. Kelly informed Schlich of the sudden increase in Repo 105 transactions happening at the end of every quarter. He pointed out that the
accounting justification to treat them as sales was “legalistic” and “form-driven” and that Lehman had to rely on Linklaters’ opinion.\footnote{Kelly later testified that E&Y remained “comfortable with the treatment under GAAP [Generally Accepted Accounting Principles] for the same reason that Lehman was comfortable.”\footnote{Moreover, the auditors’ walk-through papers also included materiality calculations of net leverage ratios. In particular, E&Y’s working documents in relation with Lehman’s 2007 audit stated: “Materiality is usually defined as any item individually, or in the aggregate, that moves net leverage by 0.1 or more (typically $1.8 billion).”\footnote{However, this definition reflected Lehman’s determination of a materiality threshold, while E&Y did not opine on the materiality of Lehman’s Repo 105 usage.\footnote{In 2009, interviewed by the bankruptcy examiner, Schlich admitted that E&Y did not have a “hard and fast rule” to define materiality and that, in the balance sheet context, materiality depended “upon the facts and circumstances.”\footnote{Accordingly, E&Y CEO Jim Turley explained his firm’s judgment on the lack of materiality of Lehman’s repo transactions with reference to companies’ widespread efforts to manage their balance sheet:}}}}

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Accordingly, E&Y CEO Jim Turley explained his firm’s judgment on the lack of materiality of Lehman’s repo transactions with reference to companies’ widespread efforts to manage their balance sheet:

All organizations - financial firms and others - manage their balance sheets. I don’t think managing the balance sheet by itself is window-dressing. What’s important is to make sure investors have a proper view of the leverage of an organization. The repo transactions at Lehman - and again, the accounting for them wasn’t challenged - would have changed the leverage from something like 31 times to 32 times. Lehman would have remained the third-highest-leveraged bank.\footnote{“Dealing With a Whistleblower”}

In May 2008, Lehman management passed Lee’s May 16, 2008 letter to the E&Y audit team. Schlich immediately alerted the Audit Committee: "When we learned of the letter, our lead partner promptly called the Audit Committee Chair; we also insisted that Lehman’s management inform the Securities and Exchange Commission and the Federal Reserve Bank of the letter. EY’s lead partner discussed the whistleblower letter with the Lehman Audit Committee on at least three occasions during June and July 2008.\footnote{While this letter failed to mention Repo 105 transactions, it raised a series of potential accounting irregularities. Alarmed, the Audit Committee directed E&Y to assist Lehman’s own Corporate Audit group in an inquiry on this matter. The Audit Committee’s chairman, Thomas Cruikshank, instructed E&Y to meet Lee, to look into his allegations, and to report the results of this investigation to the Audit Committee. Cruikshank told E&Y to inform the Audit Committee of every possible assertion made by Lee, whether included in his letter or other facts surfacing during the investigation process.\footnote{Schlich then wrote the following to his E&Y colleagues:}"

Schlich then wrote the following to his E&Y colleagues:

[W]e are also dealing with a whistleblower letter, that is on its face pretty ugly and will take us a significant amount of time to get through. I am confident from what I have seen it shouldn’t result in any significant issues around financial reporting, but again there is a lot of work to do yet. This combined with some
very difficult accounting issues around off-balance sheet items is adding stress to everyone.\textsuperscript{49}

On June 12, 2008, Schlich and Hillary Hansen, another E\&Y partner, interviewed Lee. During this interview, Lee made additional allegations not mentioned in his letter. Specifically, he told the E\&Y partners that, at the end of the second quarter of 2008, Lehman removed fixed income securities valued at $50 billion from its balance sheet using Repo 105 transactions, putting them back on the balance sheet a few days later.

The Audit Committee met with Schlich on June 13, 2008, exactly one day after his interview with Lee, for an update on E\&Y’s investigations on that matter. Schlich did not report on the Repo 105 allegations. In addition, Schlich remained silent on these Repo 105 allegations at another Audit Committee meeting held on July 8, 2008 and also when Lehman’s Corporate Audit Group presented the results of the investigation into Lee’s claims to the Audit Committee on July 22, 2008.\textsuperscript{50} Corporate Audit concluded: “[n]o material issues have been identified.”\textsuperscript{51}

Overall, Lehman’s Audit Committee remained unaware of the Repo 105 transactions, and the fact that these transactions were not disclosed in Lehman’s filings. The Audit Committee was also unaware that Lehman transferred American-based securities to its UK affiliate LBIE so that Repo 105 transactions could be executed in the UK. At no time was the size and growth of these transactions, and their recurrent quarter-end timing, raised as an issue.

In the meantime, E\&Y had issued an unqualified audit review report for Lehman’s Form 10-Q on July 10, 2008, less than a month after the interview with Lee.\textsuperscript{52}

\textbf{Postscript}

In an interview given in the summer of 2010, E\&Y CEO Turley commented on his firm’s work at Lehman: “At the end of the day we feel very good about the work we did at Lehman.”\textsuperscript{53} He contended that E\&Y partners “actually were at some level comforted that the issues were disclosure issues around Repo 105,”\textsuperscript{54} because the accounting treatment was aligned with the US rules.

In a subsequent TV interview he concluded: “I think it's important to put Lehman's failure into context. I think it was a result of a global financial meltdown, huge mortgage defaults, asset values falling, liquidity crisis… And it wasn't just Lehman. There would have been numbers of financial institutions filing Chapter 11, if not for the actions of governments, both in U.S. and globally. I think it's clear, though, that reform of the system was needed.”\textsuperscript{55}
Exhibit 1 Matthew Lee’s Letter
May 16, 2008

PERSONAL AND CONFIDENTIAL

BY HAND

Mr. Martin Kelly, Controller
Mr. Gerard Reilly, Head of Capital Markets Product Control
Ms. Erin Callan, Chief Financial Officer
Mr. Christopher O’Meara, Chief Risk Officer
Lehman Brothers Holdings, Inc. and subsidiaries
745 7th Avenue
New York, N.Y. 10019

Gentlemen and Madam:

I have been employed by Lehman Brothers Holdings, Inc. and subsidiaries (the “Firm”) since May 1994, currently in the position of Senior Vice President in charge of the Firm’s consolidated and unconsolidated balance sheets of over one thousand legal entities worldwide. During my tenure with the Firm I have been a loyal and dedicated employee and always have acted in the Firm’s best interests.

I have become aware of certain conduct and practices, however, that I feel compelled to bring to your attention, as required by the Firm’s Code of Ethics, as Amended February 17, 2004 (the “Code”) and which requires me, as a Firm employee, to bring to the attention of management conduct and actions on the part of the Firm that I consider to possibly constitute unethical or unlawful conduct. I therefore bring the following to your attention, as required by the Code, “to help maintain a culture of honesty and accountability”. (Code, first paragraph).

The second to last section of the Code is captioned “FULL, FAIR, ACCURATE, TIMELY AND UNDERSTANDABLE DISCLOSURE”. That section provides, in relevant part, as follows:

“It is crucial that all books of account, financial statements and records of the Firm reflect the underlying transactions and any disposition of assets in a full, fair, accurate and timely manner. All employees...must endeavor to ensure that information in documents that Lehman Brothers files with or submits to the SEC, or otherwise disclosed to the public, is presented in a full, fair, accurate, timely and understandable manner. Additionally, each individual involved in the preparation of the Firm’s financial statements must prepare those statements in accordance with Generally Accepted Accounting Principles, consistently applied, and any other applicable accounting standards and rules so that the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the Firm.

Furthermore, it is critically important that financial statements and related disclosures be free of material errors. Employees and directors are prohibited from knowingly making or causing others to make a materially misleading, incomplete or false statement to an accountant or an attorney in connection with an audit or any filing with any governmental or regulatory entity. In that connection, no individual, or any person acting under his or her direction, shall directly or indirectly take any action to coerce, manipulate, mislead or fraudulently influence any of the Firm’s internal auditors or
independent auditors if he or she knows (or should know) that his or her actions, if successful, could result in rendering the Firm’s financial statements materially misleading.”

In the course of performing my duties for the Firm, I have reason to believe that certain conduct on the part of senior management of the Firm may be in violation of the Code. The following is a summary of the conduct I believe may violate the Code and which I feel compelled, by the terms of the Code, to bring to your attention.

1. Senior Firm management manages its balance sheet assets on a daily basis. On the last day of each month, the books and records of the Firm contain approximately five (5) billion dollars of net assets in excess of what is managed on the last day of the month. I believe this pattern indicates that the Firm’s senior management is not in sufficient control of its assets to be able to establish that its financial statements are presented to the public and governmental agencies in a “full, fair accurate and timely manner”. In my opinion, respectfully submitted, I believe the result is that at the end of each month, there could be approximately five (5) billion dollars of assets subject to a potential write-off. I believe it will take a significant investment of personnel and better control systems to adequately identify and quantify these discrepancies but, at the minimum, I believe the manner in which the Firm is reporting these assets is potentially misleading to the public and various governmental agencies. If so, I believe the Firm may be in violation of the Code.

2. The Firm has an established practice of substantiating each balance sheet account for each of its worldwide legal entities on a quarterly basis. While substantiation is somewhat subjective, it appears to me that the Code as well as Generally Accepted Accounting Principles require the Firm to support the net dollar amount in an account balance in a meaningful way supporting the Firm’s stated policy of “full, fair, accurate and timely manner” valuation. The Firm has tens of billions of dollars of unsubstantiated balances, which may or may not be “bad” or non-performing assets or real liabilities. In any event, the Firm’s senior management may not be in a position to know whether all of these accounts are, in fact, described in a “full, fair, accurate and timely” manner, as required by the Code. I believe the Firm needs to make an additional investment in personnel and systems to adequately address this fundamental flaw.

3. The Firm has tens of billions of dollar of inventory that it probably cannot buy or sell in any recognized market, at the currently recorded current market values, particularly when dealing in assets of this nature in the volume and size as the positions the Firm holds. I do not believe the manner in which the Firm values that inventory is fully realistic or reasonable, and ignores the concentration in these assets and their volume size given the current state of the market’s overall liquidity.

4. I do not believe the Firm has invested sufficiently in the required and reasonably necessary financial systems and personnel to cope with this increased balance sheet, specifically in light of the increased number of accounts, dollar equivalent balances and global entities, which have been created by or absorbed within the Firm as a result of the Firm’s rapid growth since the Firm became a publicly traded company in 1994.

5. Based upon my experience and the years I have worked for the Firm, I do not believe there is sufficient knowledgeable management in place in the Mumbai, India Finance functions and department. There is a very real possibility of a potential misstatement of material facts being efficiently distributed by that office.
6. Finally, based upon my personal observations over the past years, certain senior level internal audit personnel do not have the professional expertise to properly exercise the audit functions they are entrusted to manage, all of which have become increasingly complex as the Firm has undergone rapid growth in the international marketplace.

I provide these observations to you with the knowledge that all of us at the Firm are entrusted to observe and respect the Code. I would be happy to discuss any details regarding the foregoing with senior management but I felt compelled, both morally and legally, to bring these issues to your attention. These are, indeed, turbulent times in the economic world and demand, more than ever, our adherence and respect of the Code so that the Firm may continue to enjoy the investing public’s trust and confidence in us.

Very truly yours,

MATTHEW LEE

cc: Erwin J. Shustak, Esq.

Exhibit 2  Net Leverage Ratios

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage ratio</td>
<td>24.3</td>
<td>31.7</td>
<td>30.7</td>
<td>30.3</td>
<td>28.7</td>
<td>28.1</td>
<td>26.2</td>
</tr>
<tr>
<td>Net leverage ratio</td>
<td>12.1</td>
<td>15.4</td>
<td>16.1</td>
<td>16.1</td>
<td>15.4</td>
<td>15.4</td>
<td>14.5</td>
</tr>
<tr>
<td>Repo 105 usage (billion)</td>
<td>$50.4</td>
<td>$49.1</td>
<td>$38.6</td>
<td>$36.4</td>
<td>$31.9</td>
<td>$27.3</td>
<td>$24.5</td>
</tr>
</tbody>
</table>

Leverage ratio (a simplified definition) = total assets/stockholders’ equity.
Net leverage ratio (a simplified definition) = net assets/ tangible equity.


Exhibit 3  Accounting for Transfers and Servicing of Financial Assets: SFAS 140

A transfer of assets qualifies as a surrender of control if and only if the following three criteria are met:
- The transferred assets have been isolated from the transferor
- Each transferee has the right to pledge or exchange the assets it received and no condition both constrains the transferee from taking advantage of its right to pledge or exchange and provide more than a trivial benefit to the transferor.
- The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

Paragraph 218:
“[P]articipants in the very large markets for repurchase agreements and securities lending transactions are, for the most part, unaccustomed to treating those transactions as sales, and a change to sale treatment would have a substantial impact on their reported financial position. … Judgment is needed to interpret the term substantially all and other aspects of the criterion that the terms of a repurchase agreement do not maintain effective control over the transferred asset. However, arrangements to repurchase or lend readily obtainable securities, typically with as much as 98 percent collateralization (for entities agreeing to repurchase) or as little as 102 percent overcollateralization (for securities lenders), valued daily and adjusted up or down frequently for changes in the market price of the securities transferred and with clear powers to use that collateral quickly in the event of default, typically fall clearly within that guideline.”

Exhibit 4  Impact of Repo 105 on Lehman’s Balance Sheet: A Simplified Illustration

<table>
<thead>
<tr>
<th>Illustrative Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets (in millions)</strong></td>
</tr>
<tr>
<td>Cash &amp; equivalents</td>
</tr>
<tr>
<td>Collateralized agreements</td>
</tr>
<tr>
<td>Financial instruments</td>
</tr>
<tr>
<td>Others assets</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

**Net Leverage ratio** 17.6 (≈440/25)

Net leverage ratio (a simplified definition) = net assets/ tangible equity.
Net asset (for illustrative purpose in this example), is defined as total assets excluding collateralized assets.

**Impact on Net leverage ratio from usage of Repo 105**

<table>
<thead>
<tr>
<th>Transaction\Accounting Treatment</th>
<th>As Financing</th>
<th>As Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1: Execute a $50 bio repo transaction</td>
<td>19.6</td>
<td>17.6</td>
</tr>
<tr>
<td>Step 2: Use cash to pay down liability</td>
<td>17.6</td>
<td>15.6</td>
</tr>
</tbody>
</table>

Source: Casewriters’ calculation.

Exhibit 5  Lehman’s Use of Repo 105

Endnotes


11 The People of the State of New York complaint against Ernst & Young LLP (NY Supreme Court 2010), p.22.

12 The People of the State of New York complaint against Ernst & Young LLP, p.22.


17 The People of the State of New York complaint against Ernst & Young LLP, p.24.


22 Ibid.


27 The People of the State of New York complaint against Ernst & Young LLP, p.22.


35 The People of the State of New York complaint against Ernst & Young LLP, p.8 (emphasis added in original). Note: CUSIP stands for “Committee on Uniform Securities Identification Procedures,” founded in 1964 for the purposes of facilitating clearing and settlement of trades.

36 The People of the State of New York complaint against Ernst & Young LLP, p.10.

37 The People of the State of New York complaint against Ernst & Young LLP, p.19.

38 The People of the State of New York complaint against Ernst & Young LLP, p.20.

39 The People of the State of New York complaint against Ernst & Young LLP, p. 20.

40 The People of the State of New York complaint against Ernst & Young LLP, p.11.

41 The People of the State of New York complaint against Ernst & Young LLP, p.13.


