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### FCIC memo of staff interview with Ronald Hauben, Ernst and Young

Ronald Hauben

Miles Ruthberg

Reginald J. Brown

Jay Lerner

Troy Burrus

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**Author/Creator**

Ronald Hauben, Miles Ruthberg, Reginald J. Brown, Jay Lerner, Troy Burrus, and Hilary Allen

**MEMORANDUM FOR THE RECORD**

Event: Meeting with Ronald Hauben of Ernst & Young, Miles Ruthberg of Latham & Watkins and Reginald Brown of Wilmer Hale

Type of Event:

Date of Event: April 9, 2010

Participants - Non-Commission:

Ronald Hauben, Deputy General Counsel at Ernst & Young, Miles Ruthber of Latham & Watkins and Reginald Brown of Wilmer Hale. The purpose of the meeting was to discuss Lehman Brothers' use of Repo 105.

Participants - Commission:

Jay Lerner, Troy Burrus and Hilary Allen

MFR Prepared by: Hilary Allen

Date of MFR: April 9, 2010

Summary of the Interview or Submission:

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

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On Thursday, April 8, 2010, I, together with Jay Lerner and Troy Burrus, participated in a meeting with Ronald Hauben, Deputy General Counsel at Ernst & Young, Miles Ruthber of Latham & Watkins and Reginald Brown of Wilmer Hale. The purpose of the meeting was to discuss Lehman Brothers' use of Repo 105.

- E&Y was Lehman's financial statement auditor from 1994 until Lehman's bankruptcy.
- Bill Schlich was the E&Y partner from 2004-2008. Kevin Riley was his predecessor.
- E&Y conducted an audit once a year (just after Nov 30 year end) and gave an opinion as to whether financials taken as a whole are correct in all material respects.
- In addition to the annual audits, E&Y would do a limited quarterly review of financials. These were high level inquiries about changes in numbers, intended to see if financials match what management is saying.

- For every hour of work done on quarterly reviews, E&Y did 10 hours of audit work (100,000 hours per year on audit. \$30-\$40 million in fees).
- Lehman had \$1 trillion of off-balance sheet assets.
- The Lehman Examiner focused on Repo 105 – this was a very small piece of what was going on.
- Repo 105 wasn't used for toxic assets – the perception in the public is that it was. In fact, the repo collateral was very high quality.
- E&Y thinks an important conclusion of the Valukas report is that there are no colorable claims about asset valuation. Thinks the absence of claims is quite telling – Valukas didn't disagree with the good faith nature of the valuations of assets.
- Valukas focused on Repo 105 with E&Y.
- Hauben's view is that the failure of the repo market is what drove the failure of the investment banks, because of short-term funding business model.
- Valukas doesn't challenge the accounting for Repo 105 transactions – doesn't find any colorable claim here (the accounting satisfies FAS 140). Valukas found no issues with the accounting at all.
- Repo 105 accounting policy was looked at by Bill Schlich and his predecessor multiple times and evaluated for compliance with GAAP. E&Y reviewed the Repo 105 accounting policy and concluded it complied with FAS 140. The examiner didn't look at what auditing work was done to ensure compliance with the policy (this was done by E&Y in the UK – they found compliance).
- The understanding is that Repo 105 was started in 2001.
- The Examiner didn't look at accounting prior to 2007. E&Y is now looking back at working papers from before then. E&Y has located documentation of a review of the updated Repo 105 policy in 2006. E&Y will provide us with these type of documents.
- Repo 105 was not considered one of the more significant audit issues.
- Valukas claims arise not out of accounting, but out of disclosure (he claims that the disclosure re the leverage ratio is misleading).

- The MD&A (only place where net leverage is discussed) and footnotes are the relevant parts of Lehman's reporting for disclosure purposes.
- Net leverage is not part of GAAP or financial statements (it is a non-GAAP financial measure). It is only discussed in the MD&A.
- Net leverage is smaller than gross leverage, so Ruthberg thinks that this is why companies prefer to disclose net leverage. Not sure how meaningful this number is (doesn't take asset quality into account, or off-balance sheet assets). Need to look at the relationship of assets to equity.
- Every institution calculates leverage differently – you can't compare the numbers between different institutions. The regulators didn't pay much attention to these numbers.
- Lehman calculation of net leverage excludes from assets in the numerator a number of asset categories that they consider risk free, but don't exclude cash.
- Repo 105 doesn't reduce net leverage – it just swaps treasuries for cash. The use of the cash to pay down liabilities is how net leverage is reduced. Lehman could have sold the treasuries to the same effect, but thought it was cheaper this way (they retain the interest on the securities, notwithstanding that there is a sale resulting a legal transfer of control).
- The obligation to repurchase is an off-balance sheet commitment (part of the \$1 trillion).
- E&Y doesn't audit the MD&A. It is require to read it, and make sure there is nothing inconsistent with the financials, and no material misstatements of fact. E&Y doesn't consider that there are any material misstatements, although in hindsight more details about off-balance sheet assets would be nice to have (although these were not required).
- The numbers used for calculating net leverage come from audited financials (no one is challenging these).
- Repo agreements have a reset provision which maintains the value of the derivative (i.e. the 5% haircut) at a stable value. The collateral changes constantly so the value of the collateral remains constant.
- To the extent of E&Y's knowledge, it has no reason to believe that the MD&A disclosure was wrong. E&Y doesn't know what management knows (especially what emails are out there).

- E&Y never saw McDade's "Drug we r on" email or the other emails cited in the Valukas report. E&Y was not aware that there were discussions at a senior level questioning Repo 105. Had they been aware, they would have looked more closely at Repo 105.
- E&Y was not aware of any inconsistencies in the audited financials.
- E&Y had specific dialogue about Repo 105 in connection with the Nov 2007 audit, and everyone indicated compliance. Management (CFO, Controller) wrote representation letters saying that financial statements were correct (didn't specifically reference Repo 105, though).
- No one E&Y dealt with raised concerns about Repo 105.
- Matthew Lee had nothing to do with financial reporting. His job was to ensure that subsidiary entities had policies in place to ensure that their financials were correct, then that reporting was rolled into the full Lehman reports.
- It is correct that no true sale opinion would have been given in the US (the US law is different from English law). Most of the repo transactions were done out of Europe (LBIE) usually with European counterparties, so it didn't strike E&Y as unusual that the opinion was under English law.
- E&Y has asked other London law firms about the Linklaters opinion, and they all agree with it.
- FAS 140 focuses on transfer of control – it requires a true sale under the law of the jurisdiction where the transaction occurs.
- Accounting has to be under US GAAP for consolidated entities based in the US, notwithstanding that the underlying transactions that have been done under foreign law.
- Most, but not all, of the Repo 105 transactions were done out of LBIE in London. If there was a Repo 105 transaction was done in the US, then you might not be able to get sale accounting for that transaction.
- E&Y London audited LBIE. Bill Schlich's understanding is that internal audit at E&Y London audited compliance with the Repo 105 policy. E&Y London had to satisfy that LBIE's accounts complied with GAAP to pass that information up to E&Y in the US. There is an internal annual report from E&Y UK to US about whether LBIE's accounts comply with US GAAP.

- Footnotes are part of the financial statements, and are within the purview of the audit.
- Valukas takes the view that the footnotes should have disclosed Repo 105 (i.e. the commitment to repurchase).
- E&Y doesn't see anything in applicable GAAP at the time that required that type of disclosure. The rules have changed (effective 2010) and now this type of disclosure might be required (the accounting rule change was prospective only). (i.e. FAS 166 was issued in June 2009, and it requires more disclosure for sales transactions that result in ongoing commitments.)
- The value of the derivative part of a Repo 105 transaction is disclosed in the financials (the \$5). Only the sold assets (the \$100) are not).
- Footnote 9 deals with off-balance sheet assets. Lehman had off balance-sheet assets of around \$1 trillion (including derivatives \$700 bil, secured lending commitments of \$100 bil).
- Valukas took the view that footnotes to the financial statements, taken as a whole, must include everything that is relevant. Focused on the wording of footnote 1 of the financials. Took the view that Lehman should have disclosed repos that are sales, because it disclosed repos that are financings.
- E&Y did not think the MD&A was misleading – thought it was consistent with financials.
- All of the investment banks had comparable gross leverage levels (throughout 07, Lehman were middle of the pack, and would have been even if they had added \$50 billion in assets). If E&Y thought the accounting was wrong on \$50 billion of transactions, E&Y would have considered it material.
- The focus on leverage came with Bear Stearns collapse. The banks measured their leverage by assets to equity.
- The repo 105 was not a significant factor in the reduction of leverage at Lehman between Q1 and Q2 of 2008. The levels of repo 105 were consistent in Q1 and Q2.
- Sometime in May, E&Y believes that Matthew Lee learns he is likely to be fired.

- On May 16, Lee writes a letter (goes to a number of senior executives). E&Y gets the letter 27/28 May – E&Y understands that Lee wrote the letter after he found out that he was likely to be fired. The letter did not refer to Repo 105.
- E&Y first reaction was to tell Rudofker to alert the audit committee, SEC and Fed about Lee's letter. E&Y understands that this was done (Rudofker said it had been). This was all verbal – there is no email evidence.
- Rudofker does an internal review, and Schlich talks to the audit committee multiple times.
- On July 22 – Rudofker makes a report to the audit committee that there are no material misstatements in the financials. E&Y told the audit committee that Lee's issues would be considered in their audit (they said it would change the auditing for 2008, but in the end no audit was done in 2008).
- The plan at E&Y for the 2008 audit was to evaluate controls, enhance testing re substantiation of assets and asset valuation. This never happened because the audit was never done.
- E&Y said that they wanted to meet with Lee before the Q2 financials were released. Lehman pre-released these on June 9.
- E&Y met with Lee on June 12. A lawyer from Lehman (Joe Palizado) was also present. Rudofker was not present. E&Y felt that Lee couldn't substantiate his accusations. During the meeting, he made a reference to Repo 105 which was noted by Hillary Hansen (she didn't have responsibility for Repo 105, so she was not familiar with it) in her handwritten notes. Because there were no inaccuracies in financials, E&Y did not tell the audit committee about Repo 105.
- Hansen asked Schlich about Repo 105 for clarification after the meeting.
- Matthew Lee's lawyer wrote an email to the company's lawyers before E&Y met with him, which may mention Repo 105. E&Y never saw those emails.
- In June of 08, the use of repo 105 by Lehman was tapering off. On June 12, McDade made the decision to halve repo 105 from 50 to 25 billion.
- Schlich was more focused on valuation issues than repo 105. Schlich was satisfied that Lee didn't see any issues with valuations.



- Hauben's view is that the real cause of Lehman's failure was that its financing collapsed – a run on the bank. The run was caused because of a loss of confidence, because of uncertainty about valuations and declines in value. Acceleration happened within a few weeks (late August).
- Everyone knew that Lehman was under stress, but people didn't realize that it was in a dire state until Summer of 2008 (management turnover, trying to raise capital and not being able to, all were signs)
- Problems of the value of Lehman's asset pool really started to be clear in the summer of 2008. However, there were conversations about using capital raised to buy more real estate, even in the summer of 2008.
- The different investment banks had different exposures. ML took huge write-downs in 07/08, and Lehman didn't. This was because Lehman didn't have residential real estate holdings (other than in the form of securitized bonds). It had commercial real estate holdings, which held their value until later.