ORAL STATEMENT OF RICHARD M. FUSCONE, MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED BEFORE THE CALIFORNIA SENATE SPECIAL COMMITTEE ON LOCAL GOVERNMENT INVESTMENTS

FEBRUARY 16, 1994

Senators Craven and Killea, and Members of the Special Committee:

Introduction

I am Richard Fuscone, Director of the Fixed Income Securities Group of Merrill Lynch. With me, at the Committee's request, are Elke Chenevey and Tim Romer, of our Western Regional Public Finance office in Los Angeles. Also with me is Cody Press, who heads that office. We are pleased to assist the Committee today in its effort to gather facts about the fund managed by the Orange County Treasurer, Robert Citron.

Since I appeared here on January 17, Merrill Lynch has provided the Committee with information it has requested, and we met with your staff about a week ago, to help them prepare for these hearings. This morning, I would like to address two points in particular: the relationship between Merrill Lynch and the Orange County Treasurer's Office, and the securities purchased and sold by the Treasurer through Merrill Lynch.

Relationship Between Orange County Treasurer's Office and Merrill Lynch

For twenty years, Merrill Lynch was one of the many broker-dealers that purchased and sold securities for our client — the Orange County Treasurer's Office. We also underwrote certain securities issued by the County. We understand that today's hearings will focus on both of those roles. Because we focused primarily on our role as broker-dealer during last month's hearings, I will begin today by describing our role as underwriter.

Merrill Lynch as Underwriter

In July 1994, the County issued $600 million in taxable notes. We understand that this was a continuation of an investment strategy fashioned by the County Budget Director and the County Treasurer, working with their financial adviser, Leifer Capital. The strategy, called an "arbitrage note," was initiated in 1993 with a $400 million one-year offering. Merrill Lynch was not involved in the 1993 offering and did not devise the strategy. That note was due to mature in 1994, and the County decided that the note would be "rolled over," and the amount increased to $600 million. Merrill Lynch did not have any involvement in that decision.

The underwriting contract was initially awarded to PaineWebber. Shortly before that offering closed, we became aware of the pricing of the offering, and we realized that we could give a better price to the County. We contacted the County and pointed out that we could save the County approximately $300,000 in interest costs. Ultimately, we were awarded the contract when our proposal was not matched.

The Official Statement for the July 1994 note offering was prepared by prominent legal counsel — hired by the County and Leifer Capital —and contained all appropriate disclosures. In particular, the Official Statement noted:

- **that the investment pool's portfolio was not marked to market;**
- **that the portfolio included derivatives;**

- that the portfolio utilized leverage in the form of reverse repurchase agreements;
- that loss of principal was possible in certain market environments; and
- that the price and income volatility of the securities held in the portfolio was greater than standard fixed income securities and could serve to increase the volatility of the pool's return and market value in various interest rate environments.

The securities issued in this offering was purchased exclusively by a small number of large, sophisticated, institutional investors.

We have been asked why Merrill Lynch repeatedly notified the Treasurer's Office of the risks in Mr. Citron's investment strategy, but did not notify investors of those risks when we underwrote County securities. The critical question for an investor considering the purchase of Orange County notes was whether the County had the ability to meet its obligations when they came due. The issues Merrill Lynch raised with Mr. Citron regarding the performance of the Orange County portfolio did not involve any concern that the County would be unable to meet its debt obligations. In fact, in the summer of 1994, neither the rating agencies — which gave their highest ratings to these notes — nor the County's officials, nor Merrill Lynch had any concern with the County's ability to meet its obligations under the notes. The County repeatedly confirmed that it had sufficient liquidity to meet these obligations, and Merrill Lynch was unaware of any information to the contrary.

Merrill Lynch as Broker-Dealer

We also understand that the Committee wants to explore today Merrill Lynch's efforts to bring the risk profile of the portfolio to the attention of the Board of Supervisors. In the fall of 1992, bond prices deteriorated and non-dollar interest rates became more volatile. As I testified last month, I spoke with Mr. Citron in November, 1992, and encouraged him to allow us to make a direct presentation to his Board of Supervisors. He rejected that offer, stating that such a communication would not be appropriate, since he was fully authorized to make the investments he was making. Merrill Lynch then suggested that Mr. Citron provide fuller disclosure of his investment strategy and practices in his Annual Reports to the Board of Supervisors and other pool participants. Specifically, on April 1, 1993, and again on September 2, 1993, Merrill Lynch sent Mr. Citron draft language that enhanced the Treasurer's disclosure of his strategy of leverage through the use of reverse repurchase agreements, the purchase of derivatives, the fact that the portfolio was leveraged by a ratio of 2 to 1 and that, if interest rates were to increase, the performance of the portfolio would decline and principal might be eroded. Mr. Citron, with some modifications, included this enhanced disclosure in his September 10, 1993, Annual Report to the Board of Supervisors which, as Mr. Citron told the Senate on January 17, 1995, he also sent to the approximately 180 individual pool participants.

The Securities Purchased and Sold by The Orange County Treasurer's Office

Questions also have been raised regarding the quality of the securities in the portfolio. The securities purchased by Mr. Citron through Merrill Lynch and contained in the portfolio at the time of bankruptcy were of the highest quality — mainly U.S. government agency obligations and bank certificates of deposit. He repeatedly stressed his "hold-to-maturity" investment strategy, and these investments were appropriate for that strategy. They were not illiquid, as illustrated by the ease with which the County's Advisers have liquidated the securities in recent weeks. These securities had high intrinsic value and a guaranteed principal return at maturity.

Mr. Citron used the competitive process to get the best deal for the portfolio, and Merrill Lynch was one of many broker-dealers competing for the Treasurer's business. Because of our performance and our ability to offer the best price and terms on many transactions, we were chosen to execute a significant portion — approximately 65 - 70% — of the Treasurer's securities purchases. He purchased the balance of the securities from other broker-dealers. Indeed, in December of 1994, more than $7 billion of the securities in the portfolio had been purchased from other firms.

While the County Treasurer's Office also entered into reverse repurchase agreements in order to increase the portfolio's yield, on December 1, 1994, Merrill Lynch held only approximately 18% of the Treasurer's reverse repurchase agreements: 82% of the Treasurer's reverse repurchase agreements were with other firms.

Attention also has been focused on the fact that the Treasurer purchased derivatives. While some derivatives have been derided publicly, knowledgeable investors and, indeed, top regulatory officials, uniformly stress that the term also encompasses many valuable securities that have been instrumental in maximizing investment results and hedging risks for even the most conservative of investors.

The derivatives in the portfolio did not cause the County's losses. The unprecedented increase in interest rates throughout 1994 impacted all fixed income portfolios, whether or not they held derivatives. The London InterBank Offered Rate, or "Libor," a commonly used measure of interest rates, rose from 3-1/8% in January 1994 to 6-3/16% by December 1, 1994. As interest rates rose, the market value of existing bonds went down. This was not a problem for bondholders who planned to hold the bond until maturity, as the Treasurer planned to do, because at that time, the bond could be redeemed at full value.

Unfortunately, despite the County Treasurer's plans to hold until maturity, the portfolio was liquidated before the securities matured. Merrill Lynch stood by the County and worked with the County's advisors to sell, in an orderly fashion, the securities which were subject to reverse repurchase agreements. We were virtually alone in doing so. Others liquidated immediately upon learning of the Treasurer's resignation and upon observing the County's failure to retain an immediate, credible replacement. The County's plans for bankruptcy made the problem worse. Most financial institutions sold out at distressed prices, exacerbating the County's losses. In fact, had the County managed to avoid abrupt liquidation, the mark-to-market loss in the portfolio today would have been far less than it was just two months ago.

Conclusion

In conclusion, Merrill Lynch is in the business of helping its clients make money, and we were extremely disappointed that the County was unable to work through its problems without taking the extraordinary step of filing for bankruptcy. Even though the County has sued us, we would like to continue to be constructive in the process of helping legislators and regulators understand what happened and how to prevent a recurrence in the future. In that regard, Merrill Lynch believes that the changes in state law recommended by the State Treasurer, for example, are reasonable and appropriate. Changing the rules may eliminate some of the discretion afforded to municipal money managers. While new rules might limit the yield treasurers can earn for their constituents, they also might ensure that treasurers can establish *and carry through* investment strategies in which the people have confidence.

Thank you for this opportunity to address the Committee. We are pleased to respond to the Committee's questions.