FACT SHEET:

MERRILL LYNCH'S RELATIONSHIP

WITH ORANGE COUNTY

Prepared in Connection with the Hearing of the
Senate Special Committee on Local Government Investments
of the State of California
Sacramento, CA
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The following fact sheet has been prepared to describe the relationship between Merrill Lynch and Orange County, California, and to put that relationship in the proper perspective.

I. Merrill Lynch's Relationship to the Orange County Treasurer's Office.

Merrill Lynch served as one of the Orange County Treasurer's many broker-dealers, selling securities to or purchasing them from the Treasurer and underwriting certain of the securities issued by the County. In both roles, Merrill Lynch was not the only securities firm with which the Treasurer did business. As a full-service broker-dealer, we also provide clients with our research and opinions on market and economic conditions as well as advice and recommendations on transactions that we believe might be appropriate for those clients. The advice and recommendations can be ultimately accepted or rejected by the client.

The terms "investment advisor" and "financial advisor" are industry terms. An "investment advisor" develops investment strategy and controls investment decisions for an account. A "financial advisor" assists an issuer of debt in structuring the debt offering. Merrill Lynch did not perform either function for the Orange County Treasurer or for the County itself.

One important fact is clear: <u>Neither Merrill Lynch nor any of our employees controlled this account, determined its investment strategy or made its investment decisions.</u> These functions were performed by Robert Citron, the Orange County Treasurer. Mr. Citron had extensive experience as an investment manager and sophisticated knowledge of the financial markets, economic trends and the securities he purchased. He was highly regarded in the investment community and had received national and regional recognition for his achievements. Also, he was frequently praised by municipalities, including Orange County, which participated in his investment activities and received above-market returns for many years.

The Orange County Treasurer purchased the majority of his securities through Merrill Lynch because our firm usually offered the most attractive price and/or terms. Mr. Citron used competition to obtain the best price available on any security he bought, and he actively sought competitive bids. More than 25 different securities firms competed for Mr. Citron's business. Because of our dominant position in the capital markets, we were able to offer the best price and/or terms on many transactions, and therefore we were chosen to execute a significant portion -- 65 to 70% -- of the Treasurer's securities purchases. The balance of his securities -- approximately one-third of his purchases (more than $7 billion as of December 1, 1995) -- was purchased from other broker-dealers.

The securities Mr. Citron purchased from Merrill Lynch were well-suited to his investment strategy. A majority of the securities Mr. Citron bought from Merrill Lynch were high quality, traditional fixed-rate bonds issued by U.S. government agencies. While some of the remainder were derivatives, these were not as "exotic" or risky as some have charged. They were primarily U.S. government agency obligations and bank certificates of deposit with relatively simple interest rate formulas. While the interest earnings of these securities varied based on interest rate movements, they were highly rated securities whose principal was very secure. They were entirely appropriate for Mr. Citron's stated strategy, which was "hold to maturity." Had these securities not been liquidated prematurely, the portfolio would not have incurred any loss of principal.

Significantly, top federal regulators have testified to Congress that it was the strategy of leverage achieved through reverse repurchase transactions -- not the derivative securities in the portfolio -- that ultimately created the County's financial problems.

The Orange County Treasurer obtained the vast majority of his reverse repurchase agreements from securities firms other than Merrill Lynch. On December 1, 1994, Merrill Lynch held only approximately 18% of the Treasurer's reverse repurchase agreements. The other 82% was provided by other firms with which the Treasurer executed such agreements.

Many of the transactions Merrill Lynch executed for Mr. Citron were explicitly requested or suggested by him as a result of proposals from our competitors. On numerous occasions, Mr. Citron showed us written proposals from competitors detailing a type of security he wished to buy and asked us to present a counter-proposal. In many cases, the securities he requested were derivatives.

II. Merrill Lynch Apprised the Client of the Risks in His Portfolio

As we did with all our clients, Merrill Lynch apprised the Treasurer's Office of our market and interest rate forecasts. Also, we specifically cautioned Mr. Citron on a number of occasions about the portfolio's volatility and reminded him of its sensitivity to interest-rate changes. At several points, we suggested options for reducing the risk in the portfolio, and in March 1993, we offered to buy back from the Treasurer all of the derivative securities he had purchased from our firm. Had Mr. Citron accepted this offer, it would have locked in substantial profits on those securities and would have significantly reduced the risk profile of the portfolio. He chose not to do so.

Merrill Lynch encouraged additional disclosure to the Orange County Board of Supervisors and pool participants. In late 1992 and early 1993, Merrill Lynch approached Mr. Citron and encouraged him to allow the firm to make a presentation directly to the Board of Supervisors about the risk profile of the portfolio. Mr. Citron rejected this offer, stating that such a presentation would not be appropriate since he was fully authorized to make the investments he was making. Although under no duty to do so, Merrill Lynch then suggested that Mr. Citron provide fuller disclosure of his investment strategy and practices in his Annual Reports to the board 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, 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 the expectation that if interest rates were to increase, the performance of the portfolio would decline and the 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 (see attachments).

Merrill Lynch's decision to continue to do business with Mr. Citron, despite his decision not to adopt all of our investment recommendations, was entirely proper and professional. While Mr. Citron and Merrill Lynch differed in some aspects of their investment outlooks, Mr. Citron's outlook was shared by many other market professionals. We do not refuse to provide our services to clients simply because they disagree with our investment outlook -- particularly when those clients are sophisticated, experienced, institutional investors such as Mr. Citron who had a long and successful track record. Moreover, we were not the sole provider of securities, reverse repurchase agreements or investment information for Mr. Citron, and he would have been able to pursue his investment strategies with or without Merrill Lynch. We believed that the most responsible role we could play was the one we did pursue -- keeping the client apprised of our evolving views on interest rate trends and presenting options that the Orange County Treasurer could use, if he so chose, to modify the portfolio in response to changing market conditions.

III. Merrill Lynch's Earnings on the Orange County Treasurer's Account.

Merrill Lynch's earnings in connection with this account were at all times reasonable, appropriate and competitive. Merrill Lynch has disclosed to the Senate Special Committee that our total net income related to our activities with the Orange County Treasurer's Office was $10.2 million in 1993 and $2.0 million in 1994 based on net revenues for those two years of $62.4 million. These sums are far less than have been reported in news accounts, some of which reported claims by County representatives that Merrill Lynch had earned more than $100 million in fees.

The revenue from which this net income was derived came both from the Treasurer's Office directly, in transactions such as secondary market sales of securities and reverse repurchase agreements, as well as from other sources, such as underwriting fees paid to us by Fannie Mae and other issuers of securities purchased by the Treasurer. In fact, of the $62.4 million in total net revenues we received over this two-year period, $12.1 million -- less than 20% -- came directly from the County Treasurer's Office. It is not the case, as some newspaper accounts have reported, that Merrill Lynch received earnings both from an issuer such as Fannie Mae and from the County Treasurer in the same transaction.

Some have incorrectly claimed that our proceeds exceeded $100 million on a series of "reverse-to-maturity" transactions from March 1993 through January 1994 and that our profits exceeded $40 million. In fact, our net revenues on these transactions were approximately $10.8 million (included in the $62.4 million figure noted above), slightly more than one percent of the principal amount of the securities in question, and our net income (or profit) was $2.3 million. It is important to understand that reverse-to-maturity transactions are a type of reverse repurchase agreement in which the "buyback" date matches the maturity date of the securities. The broker-dealer buys the securities at their "par" or face value, resells them in the marketplace at their current price, and commits to make a series of semi-annual payments to the client based on an agreed-upon formula that is tied to future interest rates. Because Merrill Lynch cannot predict what these future payments will be, we use the net proceeds from the initial purchase and resale to "hedge" our future cost. As a result of the "hedge," we adopt a neutral position: that is, Merrill Lynch has no vested interest in whether interest rates move up or down.

IV. The July 1994 $600 Million Note Offering.

In July 1994 Orange County issued $600 million in taxable notes. It has been reported that this was a continuation of an investment strategy fashioned in 1993 by the County Budget Director and the County Treasurer, working with their financial advisor, Leifer Capital. Merrill Lynch had no involvement whatsoever in the creation or direction of this strategy. The strategy, called an "arbitrage note," began with a 1993 $400 million one-year offering in which Merrill Lynch was not involved. When that note offering was due to mature in mid-1994, the County decided that the note would be "rolled over" and the amount increased to $600 million. The Assistant

County Treasurer has testified that the strategy of increasing the note offering to $600 million was suggested by the County's Budget Director as a means of increasing the portfolio's income.

In May 1994, Leifer Capital solicited various broker-dealers to submit proposals to underwrite the notes. Merrill Lynch submitted a proposal but was not selected. Several weeks later, when word began to circulate among investors and bond traders of the price the underwriter was planning to charge for the deal, Merrill Lynch realized that, based upon its pricing of a similar transaction, we could offer a better price to the County, and we did so. In response to our offer, the County contacted the firm that had been previously selected. When that firm refused to match our offer, the County switched underwriters. Our offer saved the County $300,000 and had the additional benefit to the County of reducing the interest it subsequently paid on other floating-rate notes.

The County's Official Statement for the $600 million note offering contained appropriate disclosures of the risk profile of the portfolio. The Official Statement, prepared by prominent legal counsel, disclosed that the pool's portfolio was not marked-to-market but was in fact carried at cost, that it was interest rate sensitive, that it included derivatives, that it utilized leverage in the form of reverse repurchase agreements, and that loss of principal was possible in certain market environments. Further, repayment of the notes was backed by the general funds of the County as well as by pledged funds in the investment pool, facts important to the rating agencies (which gave their highest rating to the notes) and to potential investors. Indeed, this note offering was purchased exclusively by a small number of large, institutional investors.

V. Conclusion

It is clear that Orange County officials relied on interest income from the investment pool to fund County operations and avoid either cutting services or raising taxes and that their reliance on this interest income grew over time. Indeed, Mr. Citron testified before the Senate Special Committee investigating the Orange County matter that he was "pressured" by officials to increase the income on his portfolio, and his assistant noted the particular pressure to increase earnings for the 1994-95 fiscal year. Moreover, County officials and other investors repeatedly praised Mr. Citron for his high interest income and expressed their appreciation for the programs that were made possible by his results. It seems less than candid for such officials now to claim that they were unaware of the higher risks that always accompany higher returns in any investment program.

Such claims are simply not credible. In fact, Mr. Citron disclosed his use of leverage and his purchase of derivatives in his Annual Reports, and his investment strategy was the focus of Mr. Citron's 1994 reelection campaign and was reported in the press. In that campaign, Mr. Citron's opponent repeatedly charged that the investment strategy carried risks, and in May he sent a lengthy letter to the Board of Supervisors detailing his concerns. The Treasurer's investment practices were also the subject of audit reports from the County's Auditor-Controller, who on several occasions warned of the need for more oversight of the Treasurer's activities.

While Merrill Lynch regrets very much the concern and anxiety imposed on County residents by the current financial difficulties, we must make clear that Merrill Lynch has served its client faithfully and that our dealings with the County and the Treasurer have been professional and proper at all times.