

# CtW Investment Group

January 16, 2008

Alberto Cribiore  
Member, Finance Committee  
Board of Directors  
c/o Corporate Secretary  
Merrill Lynch & Co., Inc.  
222 Broadway, 17th Floor  
New York, New York 10038

Dear Mr. Cribiore:

Merrill Lynch's failure to manage mortgage-related risk cost its shareholders \$35 billion in 2007, a 43% decline that wiped out all of the shareholder value created since July of 2005. As a diversified financial services company, Merrill Lynch's acute vulnerability to the mortgage meltdown has been an especially unwelcome surprise for shareholders, and tomorrow's fourth quarter earnings release is expected to contain more bad news.

With Merrill Lynch's 2008 director election only three months away, we call on you, as a member of the Finance Committee of the Board of Directors in 2005 and 2006, to describe the actions you took during that period to understand and assess Merrill Lynch's underlying exposure to mortgage risk across its businesses and satisfy yourself that management was taking appropriate steps to control such exposure. Absent a compelling explanation from you or immediate changes to the composition of the Finance Committee, we intend to recommend that shareholders vote against director Armando Codina at the 2008 annual meeting.

Merrill Lynch's classified board prevents shareholders from holding accountable any member of the Finance Committee during the period in question until 2009. Mr. Codina, however, chairs the Nominating and Corporate Governance Committee responsible for both nominating the directors who sit on the Finance Committee and maintaining Merrill Lynch's classified board that insulates those directors from accountability to shareholders. The crux of our concern is as follows:

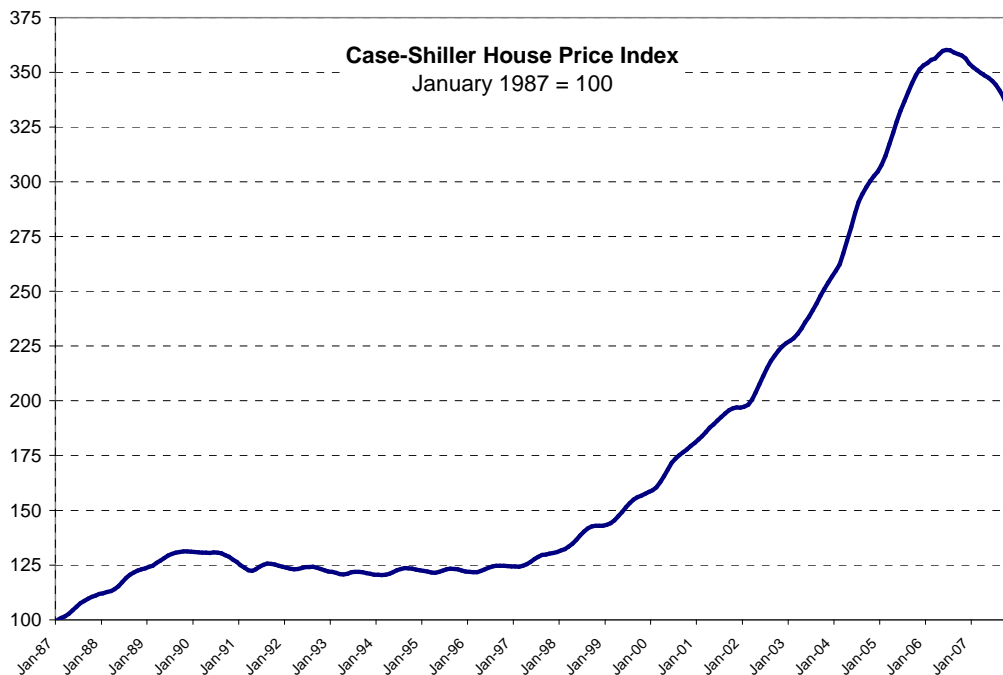
1. By mid-2005 it was apparent that mortgage lenders were loosening lending standards and that an overheated U.S housing market was at risk of collapse. Despite numerous red flags, it appears that management failed to control Merrill Lynch's substantial mortgage risk, especially relating to its investments in collateralized debt obligations (CDOs), until third quarter 2007. By then it was too late to avoid huge losses. In fact Merrill Lynch substantially increased its mortgage-related exposure in 2006.
2. Finance Committee members should have recognized that the risks of such a collapse had risen dramatically by late 2005 and thus taken particular care to satisfy yourselves that management was taking steps to monitor and control Merrill Lynch's exposure. As Mark Adelson, Head of Structured Finance Research at Nomura Securities, warned in September 2005: "Even the possibility of a [housing] bubble burst should lead [investors] to a defensive position." (*Asset Securitization Report*, September 20, 2005)

3. Stanley O’Neal, Merrill Lynch’s former CEO, acknowledged “errors of judgment made within the risk management function” during Merrill Lynch’s October 24, 2007 earnings conference call in which it disclosed a third quarter write-down of \$7.9 billion relating to sub-prime exposure. The board’s acceptance of CEO Stanley O’Neal’s resignation the following week does not absolve Finance Committee members from your responsibility over the prior two years to review Merrill Lynch’s financial risk exposures and satisfy yourselves that its exposure to mortgage-related risk was defensible and its risk management systems robust.

The CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a coalition of unions representing nearly 6 million members, to enhance long-term shareholder value through active ownership. These funds, together with public pension funds in which CtW union members participate, have about \$1.4 trillion in assets and are substantial long-term Merrill Lynch shareholders. We detail our concerns further below.

### The Warning Signs Were There

By mid-2005, it was apparent that a housing bubble had developed and that the risks of a severe mortgage downturn had increased dramatically. Fueled by historically low interest rates, the creation of mortgage products targeting less credit-worthy borrowers and abundant liquidity from a booming secondary market for securitized mortgages, home prices had virtually doubled over the previous five years (see below graph).



Housing starts, which had increased every year since 2000, peaked in second quarter 2005. Mortgage interest rates began rising, with the average rate on a conventional 30-year fixed rate

loan jumping from 5.6% to 6.7% between June 2005 and June 2006. Mortgage lenders were loosening their lending standards and increasingly using novel loan products.

One need have been an economist or the director of financial services firm with access to these data, however, to know that a national housing bubble had developed and could burst. One need only have read the news to see that a growing number of economists, investment professionals and public policy experts were sounding the alarm:

- On May 27, 2005, economist Paul Krugman of the *New York Times* said he saw “signs that America’s housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble.”
- On June 9, 2005, Federal Reserve Chairman Alan Greenspan, while downplaying risk of a national housing bubble, acknowledged in testimony to the Joint Economic Committee that he saw “signs of froth in some local markets where home prices seem to have risen to unsustainable levels.”
- On July 26 2005, *The Wall Street Journal* reported that “Mortgage lenders are continuing to loosen their standards, despite growing fears that relaxed lending practices could increase risks for borrowers and lenders in overheated housing markets.” The article cited increases in novel loan products, including interest-only mortgages, option adjustable-rate mortgages and no documentation loans.
- By December 2005, even some CDO traders warned the bubble could burst. Jason Schechter, then head of CDO trading at Lehman Brothers, echoed other participants at the Opal Financial Group CDO Summit when he said: “What concerns me though is: is this liquidity here to stay, or are we at risk for a sizable downturn?” (*Asset Securitization Report*, December 12, 2005)

While Merrill Lynch and many of its peers failed to heed these warnings, a number of firms did take action to reduce their mortgage risk exposure. Goldman Sachs, for example, began aggressively reducing its mortgage-backed securities exposure in late 2006, both by reducing inventory and hedging. Morningstar recently named PIMCO’s Bill Gross the best fixed-income fund manager in 2007, lauding him for avoiding exposure to subprime securities and for anticipating the effect that the decline in home prices would have on the broader economy and corporate bonds.

### **Despite these Red Flags, Merrill Lynch Failed to Control Its Mortgage-Related Risk**

As a leading underwriter of CDOs in the U.S., Merrill Lynch has substantial exposure to subprime-mortgage-related risk. Despite its concentrated exposure, it appears that Merrill Lynch failed to take adequate steps to manage this risk in response to the warning signs of late 2005. In fact, the company dramatically increased its exposure with its December 30, 2006 acquisition of First Franklin Financial Corporation and affiliated business units, the third largest originator of subprime mortgages in 2006. The stated purpose of the acquisition was to accelerate Merrill Lynch’s vertical integration into mortgages in order to expand its CDO underwriting activity.

The consequences of Merrill Lynch's failure to limit its exposure to a possible mortgage meltdown are increasingly evident. On October 5, 2007 the company—which had been named "Derivatives House of the Year" the previous January by Risk magazine--disclosed an estimated third quarter write-down of \$4.5 billion relating to both its CDOs and subprime mortgages. Less than three weeks later, on October 24<sup>th</sup>, Merrill Lynch disclosed that the actual writedown would be \$7.9 billion and tomorrow's fourth quarter earnings announcement is expected to include an additional subprime-related writedown in the range of \$15 billion.

Merrill Lynch's balance sheet is already showing signs of stress as a result of the third quarter writedown, with tangible adjusted leverage jumping to 17.9x at September 28, 2007, up 30% from 13.8x at December 29, 2006. Another large writedown in the fourth quarter would further weaken the balance sheet and increase the likelihood of further credit rating downgrades.

Yesterday's announced sale of \$6.6 billion in convertible preferred stock, mainly to the Korea Investment Corp., Kuwait Investment Authority and Mizuho Corporate Bank, provides a desperately needed capital infusion. This sale comes on top of the sale of \$6.2 billion of common equity to Temasek Holdings and Davis Selected Advisors and the sale of most of Merrill Lynch Capital' commercial lending business to GE Capital (which frees up another \$1.3 billion in capital), both of which were announced in late December. But these moves may prove insufficient to shore up the company's capital base and satisfy the rating agencies. In response to the two December announcements, Fitch—which downgraded Merrill Lynch's credit ratings in October 2007—said that it was still considering further downgrades.

### **Where was the Finance Committee?**

While it is the CEO's job to manage overall exposure to risk, the NYSE listing requirements mandate that it is the responsibility of the Audit Committee or other designated committee to review the firm's major financial risk and assess the steps management has taken to control such exposure. At Merrill Lynch, the board has designated the Finance Committee to be responsible for overseeing financial risk, while the Audit Committee retains oversight responsibility for operational, legal and reputational risks. Moreover, while directors cannot be expected to understand every technical aspect of an underlying business, they still must acquire and maintain sufficient knowledge and understanding of the company's business to properly discharge their duty of care.

We believe that Merrill Lynch's Finance Committee failed in these duties as they relate to the company's exposure to mortgage-related risk in general and its investments in complex, mortgage-backed derivatives in particular. As *The New York Times* reported on December 21, 2007: "This year the leaders of some of the world's most respected financial institutions — leaders who are paid first and foremost to manage risk — have been caught either unaware or uninformed about giant risks their companies took. Their financial engineers concocted securities so complex that even the brainiacs cannot figure out what those investments are worth."

One factor may be the composition of the Finance Committee and its overlapping responsibilities with the Audit Committee. In particular, we question whether Finance Committee director John

D. Finnegan's long personal and business relationship with former CEO Stanley O'Neal, which dates to the time they worked together in the General Motors treasury department, compromised his willingness to reign in Mr. O'Neal's aggressive risk and outsized compensation (Mr. Finnegan also sits on the board's compensation committee).

Moreover, given the tremendous time demands of Mr. Finnegan's job as the CEO of Chubb, we further question whether he had the time to effectively monitor Merrill Lynch's exposure to mortgage risk and fully understand its investments in complex derivatives. For this very reason, many institutional investors have proxy voting policies that dictate that CEOs should restrict their service on outside boards.

Finally, we question the board's decision to split responsibility for risk oversight between two separate committees. While there is overlapping membership on the committees, this structure may have had the effect of diffusing responsibility to the detriment of the corporation and its shareholders.

### **Merrill Lynch Shareholders Require a Detailed Explanation**

Last November, the Merrill Lynch issued a statement to the New York Times that said "The board asked the right questions, exercised diligence, and acted aggressively on the basis of the information that was presented to it. No board, however, can be expected to act on the basis of information not known to it, and even the most responsible and diligent board cannot prevent every serious problem that a company may face."

In preparation for Merrill Lynch's 2008 director election, we believe shareholders are entitled to a detailed explanation as to what steps Finance Committee members took, individually and collectively, to: (1) understand Merrill Lynch's exposure to mortgage risk through both its lending and structuring business and its investments in CDOs, SIVs and other exotic debt instruments; and (2) satisfy themselves that management was taking appropriate steps to control such exposure. Among the issues we would like directors to address:

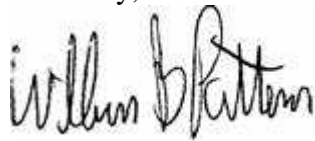
- *Internal flow of information.* What information was routinely provided to you by management? How frequently was the information provided? Did you request additional information from management in response to mounting concerns with mortgage-related risk? What additional information did you request and when was it requested? Did the Committee meet regularly with the senior executives at the company with direct responsibility for measuring, analyzing and managing risk? How often did these meetings take place? Who was present at these meetings?
- *Independent assessment of information.* What independent steps did you take to evaluate the information provided by management? Third-party advisors can serve as an important tool for directors to assess the quality of information they are receiving in the boardroom. Which, if any, outside firms were used by the Committee? When were they hired and what role did they play?

- *Committee deliberations and actions.* What additional actions, if any, did the Committee require management to take to control Merrill Lynch's significant mortgage-related exposure? We are particularly interested in deliberations and actions with respect to risk assessment, internal valuation models and hedging strategies. When did these actions occur?

We are not seeking an exhaustive set of documentation, but rather a cogent description of specific steps that you, as an incumbent director on the committee responsible for risk oversight, took to independently and pro-actively protect the interests of Merrill Lynch shareholders from excessive exposure to mortgage risk. We have made similar requests to Mr. Finnegan, Ann N. Reese and Charles O. Rossotti.

We look forward to a timely response so that shareholders can properly assess your performance and Mr. Codina's candidacy.

Sincerely,

A handwritten signature in black ink, appearing to read "William Patterson". The signature is written in a cursive, somewhat stylized font.

William Patterson  
Executive Director

cc: John A. Thain, Chairman and CEO  
Armando M. Codina, Chair of the Nominating and Corporate Governance Committee