



★ ★ US SECURITIES & EXCHANGE COMMISSION ★ ★
DIVISION OF TRADING AND MARKETS

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MEMORANDUM

T0: Erik Sirri, Director
Robert Colby, Deputy Director
Michael Macchiaroli, Associate Director
Matthew Eichner, Assistant Director

From: Phillip Minnick, Branch Chief
Marta Chaffee, Securities Compliance Examiner
Radley Macalintal, Staff Accountant

Subject: Parent Company Liquidity Inspections Scope Memorandum for the Consolidated Supervised Entities (“CSE”)

This memorandum defines the scope for the parent company liquidity inspections that will be conducted at the five CSEs beginning with Merrill Lynch and Bear Stearns. In determining the scope of these inspections, the staff held discussions with the Division of Trading and Markets’ CSE Risk Monitors, as well as firm personnel.

The inspections are designed to enhance the CSE program staff’s collective understanding of how liquidity held at the parent company is integrated into the overall liquidity risk management process. Specifically, the staff will verify (1) the composition of assets that comprise liquidity held by the parent company, (2) the mechanism for immediate monetization of non-cash assets, and (3) the use of management information systems to manage parent company liquidity. Ultimately, the staff will compare and contrast the different strategies for managing and controlling the assets that comprise parent company liquidity across all five CSEs, as well as test the implementation of the relevant policies and procedures at each firm.

1. Liquidity Composition

To verify the composition of assets that comprise parent company liquidity, the staff will identify all components of liquidity held by, or available to, the parent company without any restrictions. These assets generally will include a mixture of cash and highly liquid securities (e.g., Treasuries, Agencies, short dated commercial paper, etc.), as well as related repurchase (“repo”) or reverse repo agreements.

Once the pool of assets is defined, the staff will sample the pool to confirm, among others things, the existence of the assets, the legal entity with rights to the assets, that the assets are liquid, and that the assets are available to the parent without restriction. The staff also will verify that firms

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are complying with existing policies and procedures relating to investment guidelines and the legal entities in which assets are held.

Furthermore, for parent company liquidity assets that are pledged to the parent as collateral for intercompany receivables, the staff will review and verify these arrangements. Specifically, the staff will review the legal agreements to confirm that these relationships are documented properly. In addition, the staff also will test a sample of outstanding repos and reverse repos to confirm the nature of the collateral and its availability to the parent company without restriction.

2. Monetization of the Liquidity Pool

To the extent that firms rely on securities or non-cash assets (*e.g.*, Treasuries, Agencies, short dated commercial paper, etc.) as part of parent company liquidity, the staff will analyze how the firms monetize these assets. The primary focus will be to verify that these assets may be monetized quickly and that the cash proceeds are available to the parent company immediately, usually within twenty-four hours. Accordingly, the staff will review the firms' monetization policies and procedures and review transactions where parent company liquidity non-cash assets were monetized. The staff also will review the priority or hierarchy of accessing non-cash assets as well as identify any regulatory or cross-border barriers to monetization.

3. Management Information Systems

The objective of the staff's review will be to gain an understanding of the technological infrastructure used to monitor, access, and manage parent company liquidity. The staff will identify the key systems used to manage liquidity and will test the operations and functions of these systems in real-time context. For testing purposes, the staff will select a sample of key reports and determine if the reports are accurate and adhere to established policies and procedures. Lastly, the staff will review system auditability.

cc: Raymond Doherty