LEHMAN BROTHERS

Market Risk Management

Limit Policy

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CONFIDENTIAL

Overview

Fundamental to risk management is the establishment and maintenance of a sound system of integrated market risk limits to control the range of market risks inherent in trading activities. The Firm chooses to use the term "limits" with care because it can be interpreted incorrectly. Trading limits define the level at which intervention is required from more Senior Management with the appropriate authority (see "Management Action Triggers" discussed below). Market risk limits expressed in terms of potential loss associated with the Firm's trading activities have been defined with the following objectives:

- To be within the Firm's risk appetite;
- To protect the Firm's capital base;
- To reduce the volatility of the Firm's trading returns.

The overall risk limit framework is driven by Risk Appetite, which is approved by the Executive Committee on an annual basis and reviewed for possible updates quarterly. Risk Appetite limits are supplemented by VaR limits as well as by other guidelines using additional relevant metrics, as appropriate to the specific business. Limits are set at a Firm-wide level, and cascaded down to the Divisions and Lines of Business within each Division on a global and regional basis. In addition, while the Firm does not manage risk on a legal entity basis, limits are nonetheless applied to the Firm's regulated legal entities as required.

The limits process is administered by MRM in conjunction with the Global/Local Division Heads. Limits are reviewed quarterly, or more frequently as may be required, and changes made as appropriate in the context of changes in markets and the business.

The Cascading Limit Framework

The aggregate Firm-wide limit is set by the Executive Committee, and any changes to, or breaches of, this limit require approval of the Executive Committee. In addition, the Executive Committee approves the allocation of the Firm-wide limit to divisions. Limits set within a Division, both regionally and by Line of Business, are set by MRM in conjunction with the Division Heads. Changes to, and breaches of, intra-Divisional limits require the approval of the Division Head.

The Desk and Business Managers have the authority to set individual trader limits and to reallocate them as they see fit so long as the Line of Business stays within its limit overall.

Approach to Limit Breaches

The Firm has a "zero tolerance" approach to the intentional breaching of limits. Traders who intentionally and flagrantly breach a limit are reprimanded and could be terminated, depending upon the circumstances. The Firm's culture is one where Risk Management, traders and Business Heads work together to examine a trader's request to increase his/her limit. For instance, it may be decided to re-allocate limits within the business on a temporary basis if the other traders are operating below limit.

Management Action Triggers

When a Divisional limit is approached, or seems likely to be exceeded, the issue is escalated both within MRM and the division. The Division head and CRO are then able to decide the action to be taken.

One of three courses may be taken:

- Allow the excess to remain for an agreed period of time in support of the specific trading strategy: this action may occur in cases where the excess was anticipated and discussed with MRM or where the excess is in support of a customer facilitation trade and there is unused risk capacity at the Firm-wide level;
- Agree, in some circumstances, to revise the limits if, for example, there has been a change in the business which warrants such a change; or
- The decision may be taken to reduce the risk profile back within the limit.

Likewise, when an intra-Divisional limit is approached, the Division head determines the appropriate course of action, taking into account the advice of MRM. Market Risk Managers are responsible to report all intra-Divisional excesses and any discussions with the trader or business unit manager regarding them to his/her manager in MRM, who in turn will alert the CRO, and to the Division head. Provided that the limit for the Division has not been breached, the Division head may re-allocate intra-Divisional limits, subject to the advice of MRM. In addition, the CRO is empowered to grant a temporary waiver of an intra-Divisional limit excess. If a temporary waiver is agreed, this becomes the limit used for the duration of the waiver. At the end of the waiver period the limit will revert to the previous level.

In circumstances where excesses are occurring frequently, MRM will bring this to the attention of the CRO. This may result in:

- Action to bring risk below limit;
- An ad-hoc meeting to review the cause of the limit breaches;
- A review of the risk measurement technique;
- An adjustment in the business's allocated risk limits.

Documentation of Limit Excesses

Risk Management has the responsibility to maintain documentation of all current limits and limit changes, and to maintain documentation of all limit breaches and the course of action taken in respect of all breaches.