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Merrill Lynch: Evolution, Revolution and Sale, 1996-2008

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ABSTRACT

Merrill Lynch, one of Wall Street's most heralded "Bulge Bracket" firms, experienced a wide range of changes over its last 12 years until its ultimate sale to Bank of America in 2008. Three successive CEOs – David Komansky, Stan O'Neal and John Thain – each led major changes to strategy, structure, culture, systems and leadership style. Why were all these transformations made? When were they effectively evolutionary and when effectively revolutionary? Were they well managed changes?

CONTENTS

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Introduction

Merrill Lynch was founded in 1914 when Wall Street bond salesman Charles Merrill teamed up with friend Edmund Lynch to open an underwriting firm. By reaching out to investors – ranging from retired shopkeepers to small business owners and widows with nest eggs – Merrill Lynch gained renown for "bringing Wall Street to Main Street." Its growing ranks of brokers – numbering 17,000 by 2008 – were nicknamed "the thundering herd," in a nod to the company's iconic bull logo.[1] Yet, Merrill Lynch itself was long personified as a nurturing, benevolent entity, so-called "Mother Merrill," who spared no expense in taking care of either her clients or her employees. The company became known as a place where loyalty was amply rewarded, where an employee's child was likely to be handed a job.[2] Many say this collegial culture contributed to the company's ability to withstand the Depression, the crash of 1987 and the terrorist attacks of 9/11.

Yet, this organizational culture and its business model and brand, strong as they were, did not enable the company to withstand the fall 2008 financial crisis. Before that time, Merrill Lynch was a multinational corporation with nearly $2 trillion in private, institutional and government client assets. It operated in 40 countries and provided financial services in two segments: the Global Markets and Investment Banking Group and Global Investment Management Units. All of these features made it an important strategic asset for Bank of America, which announced its merger with Merrill Lynch on September 15, 2008. As many company histories might reveal, the journey of Merrill Lynch was marked by evolutions and revolutions, changes by degree and profound transformation. This précis looks at the different routes taken to transform Merrill Lynch by its CEOs in its last decade: David H. Komansky, E. Stanley (Stan) O'Neal, and the last CEO to preside over Merrill Lynch as an independent entity, John Thain.

The Komansky Years (1996-2003)

The appointment of David H. Komansky as Merrill Lynch's CEO in 1996 can be seen as the first significant departure from 80-plus years of company tradition. Like all CEOs before him, Komansky came up through the brokerage side and was a self-admitted "back-slapping, gregarious person." Yet, he was the first Jew to run a company that had been called "the Catholic firm" of Wall Street. This move was hailed as an entrance into a new phase of meritocracy and diversity necessary to tackle the global marketplace. And tackle it, Komansky did. "Five years from today, there will be 6, 8, 10 of the most truly global financial services firms, and we intend to be one of them," he said, and he set a goal of deriving 50% of the company's revenues from abroad, compared to 25% in 1996.[3] With his deal-making prowess, Komansky went on an acquiring spree. In less than a decade Merrill made 19 acquisitions, many of which were in developing Asian economies.[4] Komansky is credited for completing former CEO Daniel Tully's transformation of Merrill from a domestic retail brokerage giant to a global investment banking powerhouse:

> I had the opportunity to see it [Merrill Lynch] metamorphize from pure retail stock and bond operation to a globally integrated financial firm. It was a constant case of evolving, and it had an esprit de corps and familiar feeling valued by a lot of people. It could take on any challenge.[5]

Yet, toward the end of Komansky's tenure, the company was bloated and foundering. While revenues soared at a 15% annualized rate, expenses rose in tandem. By 2000, the best year in investment banking history, Merrill's underwriting and advisory business only managed a $200 million profit.[6] A full three-quarters of the company's bottom line came from low margin-equity related business. According to some, the company was lavishing too much money on the famed thundering herd for too little return.[7] In addition, the company had been slow to get on the Internet bandwagon, leaving firms like Charles Schwab to snag low margin clients at lower cost. With the market crash of 2000, it was revealed just how bad things were, and rumors swirled that Merrill Lynch was ripe for a takeover attempt.[8]

The O'Neal Era (2003-2007)

There was no takeover, but there was a "revolution" within Merrill Lynch, fomented by the retiring Komansky's successor, E. Stanley O'Neal. Known for his cost-cutting abilities in the brokerage division, where he had fired 2,000 brokers, sending profit margins up by five percentage points, O'Neal became president under Komansky in July of 2001 and CEO in 2003[9]. In just his first three years, he took the company through more cultural change than it had gone through in the previous five decades. Former CEO Daniel Tully, who presided over Merrill from 1992 to 1996, commented:

> [Mr. O'Neal] forgot what Mother Merrill stood for and just disavowed the past. We had a great thing going for us, with the so-called backslapping type of people that we are. We were tough taskmasters but not mean-spirited.[10]

However, according to O'Neal, none of this mattered:

> People say all these things about me. They say I'm a bean counter. I'm not. I spend so little time thinking about numbers, they wouldn't believe it. But if people want to say that I can't do anything about it. I have a job to do, and it has nothing to do with worrying about what people say about me.[11]

O'Neal was the very opposite of Komansky in almost every respect. The first African American to run a major investment bank, he had never been a broker and was described as "aloof," "a loner," and a "bean counter," but also as brilliant and utterly objective. A defining moment in his tenure came right after the 9/11 terrorist attacks, when shaken Merrill employees were forced to evacuate their World Financial Center offices. O'Neal did not wait for the literal dust to subside before announcing his dramatic restructuring plan. For this he was lambasted in the press and reviled by employees.

Yet, his quick cost-cutting actions brought the company back to profitability.[12] Deeming the old Mother Merrill culture passé, O'Neal cut 24,000 jobs and closed 300 field offices. He froze pay, cut bonuses and took away perks to which employees had become accustomed. In the retail business, he began segmenting customers, diverting those with low account balances to impersonal call centers, coddling only the richest clients. As a result, Merrill became the leanest and most profitable of any such firm in the U.S. Profit margins soared to 28%, and the company made more money per broker than either Goldman Sachs or Citigroup.[13]

At the same time that O'Neal was cutting, segmenting and rearranging, he was pushing the company into new and riskier territories. Shortly after he assumed the CEO mantle, he told investors that he wanted to build "a new kind of financial services firm" that provided a greater range of services but with much less people and a constant focus on profitability. He initiated a cutthroat Darwinian ethos that could be described as survival of the riskiest – encouraging managers to take risks, and giving them only six months to a year to show they could succeed. Scuttlebutt was that O'Neal wanted to turn Merrill into another Goldman Sachs.[14] The company continued to increase its exposure in collateralized debt obligations, known as CDOs, complex debt instruments and subprime mortgages. At first, this strategy was a boon, delivering what *The New York Times* called "high-octane, high-risk returns." Then, in July 2007, there was a global credit crunch, spurred by a steep downturn in the value of subprime mortgages, which was, in turn, caused by the high default rate among less creditworthy borrowers. According to Winthrop H. Smith, Jr., former Merrill executive who spent 28 years at the firm and whose father was a founding partner:

> Under Stan's watch, Merrill Lynch has written down $10 billion. This is someone who has tinkered with the culture of a successful firm. Merrill Lynch is in need of a real leader.[15]

When Merrill took an $8.4 billion write-down in the third quarter of 2007 and suffered $2.4 billion in losses, the length of O'Neal's term was the subject of much speculation. Then, when the board learned that O'Neal had made unauthorized merger overtures to Wachovia, his ouster was assured. It didn't help that over the years O'Neal had alienated and pushed out many senior managers, his allies among them, leaving himself quite alone at the top during the crisis. He was forced to resign in October 2007.[16]

The Brief Reign of Thain

O'Neal's forced resignation put Merrill Lynch at a crucial junction. As an analyst at RCM Capital Management said, "The board needs to decide whether the business model was good and the company just needs better execution, or the business model itself needs to be changed."[17] In other words, the company could continue O'Neal's attempt to model the firm after Goldman Sachs and seek out new investment opportunities or go back to the company's retail brokerage roots.[18] The board appointed the first CEO from outside the company, John Thain, a former Goldman Sachs executive of 20 years, but someone with no prior retail brokerage experience. He had most recently been CEO of the New York Stock Exchange (NYSE), with a glowing reputation for having pushed the NYSE into the future. Thain readied the Exchange for the global digital marketplace at a time when morale was at an all-time low. In an interview in 2007 about his view of his new firm Thain said:

> This is a people business, and whether it's on the wealth management side or on the investment banking side or on the trading side, in the end the main asset is people. And so making sure that you're paying attention to people, making sure that you're sensitive to the culture, making sure that the organization is working together as a team is critical to its long-term success.[19]

A former Goldman colleague said, "John loves to take things apart and fix them. He understands risk."[20] In fact, Thain's nickname was "Mr. Fix-it." Yet, in an interview with a *BusinessWeek* reporter shortly after he was named CEO of Merrill, Thain implied he would neither rush to dismantle nor to acquire, but said simply, "The company will focus on developing the business it has."[21] In terms of the retail brokerage business, so tied to Merrill's roots and old culture, Thain left Bob McCann in place to rule over the thundering herd.[22] McCann was a longtime Merrill veteran, known for his Irish-Catholic glad-handing, of whom a colleague said "[he] connects with people."[23]

From the start, Thain had to resolve many questions. Would it be best to instill a Goldman-like business model and a Goldman-like culture in troubled Merrill? But hadn't O'Neal himself tried to push Merrill to be more than an investment banking and retail brokerage firm, similar to Goldman? Hadn't this led to much of its troubles? And what about the Mother Merrill which had once existed? Ex-Merrill executives such as Win Smith, who was removed by O'Neal, predicted that Thain would "…take time to understand the old culture and what made it so good…because he understands the power of culture, which Stan did not."[24] And former Merrill chairman Dan Tully said of Thain, "Let's give him a chance," even as he said, in the same breath, "Charlie Merrill would turn over in his grave if he knew we hired someone from Goldman Sachs."[25]

In that early interview with CNBC's Maria Bartiromo in the November 2007 *BusinessWeek*, the cautious, measured Thain emerged, making comments such as:

> I'm not at all sure that I want to change it (the wealth management business). I first have to learn about it. It is the leading wealth management franchise in the world.
>
> I think that phrase (Mother Merrill) had a negative connotation in the past, and I don't think about it that way. I don't know if they think about it that way.
>
> The Board is looking for leadership. The Board is looking for strategy and direction. The Board is looking to unify the company. And it's also looking to focus on some specific concerns – risk management, and of course, the fixed income area. And also to further develop the senior management team.[26]

All eyes were on Thain. The next chapter of Merrill Lynch's story had begun to be written. Would it be a further evolution or another revolution?

Thain's Bumpy Ride

At the outset, Thain set clear goals for himself and the organization. He vowed to establish a new leadership team, repair the firm's failed risk function, and raise capital to replace huge losses on mortgage securities. Within weeks of his appointment, Thain lured a cadre of former colleagues from Goldman Sachs and the NYSE to run various parts of the business. Nelson Chai of NYSE was appointed CFO. Margaret Tutwiler, also of the NYSE, was appointed Head of Communications. High-profile recruits from Goldman Sachs included Peter Krause to run Strategy, Tom Montag as Head of Sales and Trading and Noel Donohoe as Co-Chief Risk Officer, all reporting directly to the CEO.[27] In particular, regarding the newly formed risk function, Thain said:

> Noel's appointment and the new reporting structure of risk management emphasize the importance of this area to me and to Merrill Lynch. Noel's many years of market risk and product control experience will make an important addition to our risk management function and is complementary to the firm's existing team.[28]

Having made significant structural and personnel changes, the firm focused on repairing its balance sheet. At the close of 2007, additional losses forced Thain to raise equity from a group of sovereign wealth and private equity funds. But the new fiscal year brought an even more challenging environment. In March 2008, Wall Street woke up to news that Bear Stearns, a firm with a storied history, was being sold to JPMorgan Chase for $2 per share – with government assistance – essentially wiping out shareholders. As markets tumbled, Merrill Lynch employees and shareholders found themselves facing a similarly dire situation. After three consecutive quarters of staggering writedowns, seeking to end the cycle of losses and dilutions, Thain arranged a fire sale of nearly $30 billion of CDOs, at the price of 0.22 cents on the dollar, to the Lone Star fund. Merrill booked the transaction as a sale, which some said was optimistic if Lone Star decided to send the CDOs back, leaving Merrill holding only the down payment.[29]

Thain explained the reasoning behind the transaction this way:

> If you look at our business in the second quarter, the work of 60,000 employees generated $7.5 billion in revenues and almost $2 billion in pre-tax income, but all of the efforts of all those people were wiped out by the declines in asset values … These assets that we sold accounted for about 70% of all the losses we've taken over the last twelve months. So when we had the opportunity to sell them … and to raise capital at the same time, we took advantage of that opportunity because it's a great risk reduction trade, it puts us in a much better position to manage our business going forward and with the new capital, we are very well capitalized.[30]

Many criticized this move. Since Merrill financed 75% of the transaction with its own balance sheet, many analysts believed the firm had not reduced much of its exposure at all. Moreover, other investment banks, such as Lehman Brothers, who were holding similar assets on their balance sheets at significantly higher market values, were forced to mark them to down to Thain's 0.22 cent valuation.

Thain had taken bold steps in his first year at the helm – raising over $27 billion in capital in five separate offerings. He integrated and elevated the firm's risk functions and tied business unit compensation to the profitability of the firm as a whole. With risky exposures (at least seemingly) down significantly, the firm was thought to be "well-capitalized", and with new leadership in place, Merrill Lynch seemed poised to withstand tough markets.

The Sale, and End, of Merrill Lynch

On Friday, September 12, 2008 Thain was invited to secret weekend meetings at the New York Federal Reserve where it was revealed that if no buyers emerged, Lehman Brothers, the 138-year-old investment firm, would face bankruptcy when the markets opened Monday morning. It was widely believed that Bank of America (BofA) and Barclay's were the only serious bidders. When the U.S. Treasury refused to provide any backstop similar to that provided in the Bear Stearns transaction, both Barclay's and Bank of America declined the Lehman acquisition. As the Lehman bankruptcy became imminent, Thain, fearing a systemic lack of confidence and the onslaught of short-sellers, picked up the phone, called Ken Lewis of Bank of America and asked if he would be interested in a transaction. Lewis flew up from Charlotte, North Carolina immediately.[31] As Lewis recalled, "It didn't take but about two seconds to see the strategic implications - the positive implications … [Merrill Lynch] has created the best wealth management company in the world and we acknowledge that."[32] This was the same Ken Lewis who had said almost a year before the deal, "I've had all the fun I can stand in investment banking at the moment. To get bigger is not something I want to do."[33] Yet, at the time of the deal, Lewis seemed to be the only one who wasn't questioning its viability. Business columnist Jack Flack parsed the Bank of American press release announcing the deal as meaning one thing for the company: adding Merrill Lynch would finally get us the respect we deserve. By merging Merrill's investment bank with Bank of America's existing operations, the huge Charlotte-based bank would be instantly catapulted into the "league tables" for both debt and equity underwriting.[34]

On Monday morning, September 15, concurrently with the announcement of Lehman's demise, Thain and Lewis appeared in a press conference announcing the sale of Merrill Lynch to Bank of America in an all-stock transaction, valuing the firm at nearly $50 billion on the date of the announcement. The two executives stressed the strategic rationale behind the deal, with Merrill gaining access to a massive balance sheet and Bank of America attaining Merrill's prized wealth-management franchise, lucrative clients and international footprint. Soon after the deal was announced, Bank of America issued a press release confirming that John Thain would join the combined company as Head of Investment Banking, Commercial Banking and Wealth Management, reporting directly to Ken Lewis. In announcing the deal, Thain said:

> The deal that we have with Bank of America is a strategic one that makes a huge amount of strategic sense – the combination of their strength in the US on the commercial banking side and on the retail banking side combined with our strength in wealth management and global investment banking makes a tremendous amount of sense…The combined entity is probably the world's strongest financial institution. We will have great financial strength. We will have a global reach. If you look across the different businesses we are number one or number two across almost every business that we will be in. Whether it's commercial banking, retail banking, investment banking, wealth management, we will be the leading financial institution in the world.
>
> There really won't be any cuts necessarily in fixed income or commodities because there's a commitment to continue to expand both…but there will be redundancies in the combined companies. Most of those redundancies really come on the infrastructure side. In places like IT, operations, finance, where there is an overlap of corporate functions…Between the two companies, it will be thousands of jobs. [35]

As the next months unfolded, Merrill Lynch's past and present executives either fled the merged company or dug their heels in, resisting changes. Year-end bonuses awarded to Merrill Lynch executives by John Thain were publicly exposed and challenged by the media and U.S. congressional committees overseeing financial bailouts to firms such as the Bank of America. And Bank of America began to institute changes to many sacred Merrill Lynch traditions including ending Broker Sales Award Incentives such as elaborate travel and entertainment events. Among Merrill employees, there was fear, uncertainty and anger about the future. Some of it was attributed to John Thain's actions and some to Bank of America. Whatever emotions emerged, one fact would not change. Merrill Lynch's 93-year history as an independent company and iconic American brand was coming to a close.

At the final shareholder's meeting approving the transaction, on December 5, 2008, Winthrop H. Smith, Jr., delivered an emotional speech to shareholders and employees. Here is a brief excerpt:

> At this point I want to make it very clear that I support the merger with Bank of America, and I am thankful for John Thain's clear and decisive leadership at that moment of crisis this fall. I am encouraged by the respect that Ken Lewis says he has for our great franchise and for the many thousands of fine professionals who are still part of the Merrill Lynch team. I do hope Ken and his colleagues at Bank of America will allow the firm that they bought to thrive under its new ownership, and that they will appreciate the strong culture that made Merrill what it was by 2001 and will also appreciate the many fine people who hung in and are still with Merrill Lynch, including members of my own family.

> All of us want this new organization to succeed and become preeminent. We all know that what has occurred is the given reality and it is time to move forward. However, before we do. Some things need to be said for the record.
>
> …
>
> Today is not the result of the sub-prime mess or synthetic CDOs. They are the symptoms. This is the story of failed leadership and the failure of the Board of Directors to understand what was happening to this great company, and its failure to take action soon enough. I stand here today and say shame to both the current as well as the former Directors who allowed this former CEO [O'Neal] to wreak havoc on this great company. … Shame, shame, shame for allowing one man to consciously unwind a culture and rip out the soul of this great firm. Shame on them for allowing this former CEO to retire with a $160 million retirement package and shame on them for not resigning themselves. …
>
> But I must give the Devil his due. I applaud the Board for selecting John Thain. John inherited a mess, but he did so many of the right things. He reached out to the past; he reached out to the people of Merrill Lynch around the world and showed them his humanity as well as his intelligence. John had the intellect, the experience, the humility, the common sense and the integrity to pull it off had not the markets melted down this past fall. Then he had the wisdom, as Kenny Rogers sang, to know when to fold them so that Merrill did not go the way of Lehman.
>
> We thank you John not only for what you tried to do and what you did do. We thank you because we know you knew what Mother Merrill really stood for. As a competitor at Goldman Sachs you respected our past and our present and you were serious about restoring our valued principles once you became our leader.

Having led the battle to save Merrill Lynch, Thain's next task would be to manage the aftermath of the deal. The months after the consummation of the transaction were marked by public relations disasters that called both the viability of the deal and Thain's credibility into question. Shortly after the deal closed, Bank of America announced severe cutbacks in the brokerage unit, cutting back training and monitoring expenses. This enraged the highly independent brokerage force.[36] By December 2008 a formidable clash of cultures had developed leading to the high-level defections of Greg Fleming, the Merrill Lynch president and deal architect slated to run Global Commercial and Investment Banking for the combined firm, and Bob McCann, long time veteran and head of Merrill's prized brokerage unit.[37] With his leadership in question, Thain reported dramatic losses to close the fourth quarter of 2008. Reeling from losses, Bank of America's board was forced to seek a bailout from the US Treasury. With the media swirling, Lewis claimed to know nothing of the mounting losses at Merrill as tensions between Thain and Lewis escalated.

During the first weeks of 2009, Thain was plagued by allegations, not denied by Bank of America, that he had accelerated bonus payments to Merrill executives to skirt Bank of America approval, squandered $1.2 million on lavish renovations of his executive suite, and misled Bank of America about the financial outlook of Merrill Lynch's business. Headlines across the financial and mainstream press reviled the ex-Mr. Fix-it as the new face of Wall Street excess.

The tension culminated on January 22, 2009, in a meeting with Lewis that reportedly lasted less than 15 minutes, in which in no uncertain terms, John Thain was ousted from the combined company. Thain's departure was perhaps the final symbol that Merrill Lynch would no longer exist. Just as it had brokered many deals of companies that would become absorbed in others, Merrill Lynch would now become absorbed into Bank of America.

Assignment Questions

1. How and why did Komansky change Merrill Lynch? Was he successful and effective overall?
2. How and why did O'Neal change Merrill Lynch? Was he successful and effective overall?
3. How and why did Thain change Merrill Lynch? How well did he handle the sale and its aftermath?
4. What lessons do you take from the Merrill Lynch story of the last decade?

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