Message From Sandie O’Connor

STAYING THE COURSE AMID TURBULENT MARKETS

During the final weeks of the third quarter we all witnessed a series of financial events that once seemed unimaginable and which permanently altered the global financial landscape. Throughout this period, investors’ confidence in the financial markets has been routinely tested as uncertainty increased, volatility spiked to once unthinkable highs and performance across a variety of asset classes suffered.

In September, the securities lending industry faced its toughest challenge as a major securities borrower, Lehman Brothers, filed for bankruptcy. Fortunately our clients were insulated by the combination of J.P. Morgan’s indemnification against borrower default along with the firm’s world-wide global resources. During this period of unprecedented market volatility and lack of liquidity, it is notable that we were able to return to our clients over 99% of the specific securities that were on-loan to Lehman. Our clients received the cash equivalent for the remaining securities that we were not able to purchase in the market. Furthermore, September saw the commencement of various short selling restrictions world-wide that had a profound effect on the securities lending industry (additional information is available in this issue of the Quarterly). In our capacity as a leading financial institution, we remained in constant communication with global central banks and market regulators to discuss the unintended consequences of these restrictions. Moreover, these short selling restrictions also impacted hedge fund strategies which, when coupled with the deleveraging trend, reduced demand to borrow securities.

Throughout this historic period, we have continued to adhere to a disciplined risk management framework in all aspects of lending and reinvestment activities with the goal of maintaining liquidity and preserving capital. As market conditions grew more challenging, we strived for complete transparency by increasing our level of communication with clients to address concerns and questions related to their securities lending program. These unsettling times serve to underscore the importance of relying on a strong lending agent backed by the capital strength of J.P. Morgan’s global franchise.

Even during this volatile period, J.P. Morgan Securities Lending continues to maintain its role as an industry leader. We were recently recognized as the “Best Securities Lending Provider” by AsianInvestor in its Annual Service Provider Awards. The award is given to the firm demonstrating performance, presence and innovation in securities lending in Asia, where J.P. Morgan has had a significant presence for some time. We currently have clients in nine countries across the Asia Pacific region, and are actively pursuing arrangements with potential clients in India, Malaysia, Thailand and Indonesia to source new businesses.

We also recently served as a sponsor of the European Beneficial Owners’ Securities Lending Summit in Edinburgh, Scotland. David Lewis, EMEA Head of Securities Lending Client Management, was a panel speaker on the global credit crunch and Richard Steele, Head of Discretionary Securities Lending Product Development, participated in a panel discussion on the securities lending global market outlook. We view these opportunities as ideal ways to strengthen both our partnership with our clients and J.P. Morgan’s stature as a respected industry leader.

As you’ll read in this issue of Securities Lending Quarterly, our Investment team’s decisions focused on maintaining liquidity and preserving capital as the financial and liquidity crisis intensified. Meanwhile, our Fixed Income Trading team navigated a difficult environment marked by volatile spreads, headwinds in lending agencies and mortgage-backed securities, and a wide range of issues trading at near-zero rebate rates. Our Equity Lending team coped with extreme volatility in global stocks, driven by high commodity prices, rising inflation, short selling restrictions and drastic changes in the global financial system. Despite an unprecedented level of change among our borrowers, including fewer counterparts with whom to trade, reductions in risk appetite and heightened regulatory oversight, our Lending and Investment teams continued to actively manage balances and risk in the best interest of our clients.

It is during these challenging times that we are reminded of the role securities lending plays as a vital component and major source of liquidity for domestic and international finance markets. It is an integral part of the investment management business supporting a variety of trading strategies, as well as a necessary tool for delivering alpha and reducing portfolio expenses for asset managers.

We hope you found our recent communication, covering various aspects of the securities lending industry from the history of lending to the value of participating in a lending program, to be both helpful and educational. We endeavor to consistently provide our clients with informative and useful materials. Finally, as we embark on the final quarter of the year, we remain committed to delivering excellence in every aspect of lending, and to partnering with clients to weather these challenging conditions together. We thank you for your business, support and trust.

Sandie O’Connor
Global Head Financing & Markets Products

J.P. Morgan
Short selling restrictions and their impact on securities lending

Richard Steele, head of discretionary securities lending product development, explains what factors lay behind the recent short selling measures introduced by financial market regulators around the world, and how the measures impact securities lending.

During September and October 2008, regulatory authorities of many of the world’s leading securities markets introduced a range of temporary measures designed to curb short selling. The introduction of the measures came after a period in which the shares of leading financial institutions had come under intense pressure as a result of turmoil in the financial markets.

The U.K. Financial Services Authority (FSA) led the charge by introducing a temporary ban on the short selling of financial stocks from midnight on September 18. On the following day, the U.S. Securities and Exchange Commission (SEC) announced that in concert with the FSA it was taking “temporary emergency action to prohibit short selling in financial companies to protect the integrity and quality of the securities market and strengthen investor confidence”.

During the following fortnight, many other financial regulators followed the lead taken by the U.S. and the U.K. so that, by the first week of October, more than 20 of the world’s major securities markets had either implemented or announced plans to curb short selling. The additional markets impacted included Australia, France, Germany, Netherlands, Singapore, South Korea, Spain and Switzerland.

What is short selling?

Short selling or “shorting” is the practice of selling a financial instrument that the seller borrows first (does not own), and then purchasing it later to “cover the short”. In general, regulators continue to regard short selling as a legitimate investment technique that contributes to price efficiency and adds liquidity to the markets in ‘normal market conditions’.

What led to the imposition of restrictions on short selling?

Most regulators cited the exceptional market conditions and the need to take action to protect the integrity and quality of the securities markets while strengthening investor confidence as the main drivers.

Hector Sants, FSA chief executive, said in his statement announcing the U.K. measures: “We have taken this decisive action, after careful consideration, to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector.”

What types of restrictions were imposed by regulators?

Although the nature of the restrictions varied from market to market, certain themes were readily distinguishable. Approximately half of the securities market regulators restricted short selling of financials only, while the remainder implemented broader restrictions up to and including prohibiting the shorting of all equity securities. Also, there was a focus on ‘naked’ short selling where the short seller has not arranged for securities to cover the short sale, e.g., borrowed them. Additional measures adopted in some markets included daily disclosure of net short positions and tightening of settlement rules, including buy-in provisions to further discourage naked shorts.

How do regulators view short selling in light of recent events?

In general, regulators have made it clear in recent pronouncements that they continue to regard short selling as a legitimate investment technique which, under normal market conditions, contributes to price efficiency and adds liquidity to the markets.

Speaking on September 18, SEC Chairman Christopher Cox said, “The emergency order temporarily banning short selling of financial stocks … would not be necessary in a well-functioning market, is temporary in nature and part of the comprehensive set of steps being taken by the Federal Reserve, the U.S. Treasury, and the U.S. Congress.”

Similarly, the FSA’s Hector Sants said “While we still regard short-selling as a legitimate investment technique in normal market conditions, the current extreme circumstances have given rise to disorderly markets.”

This position is backed up by the temporary nature of the bans announced to date. In the U.S., the short selling restriction on financials was lifted on October 8 and other markets are set to follow suit over the next month. However, the U.K. ban does not lift until January 16, 2009.

How have the short selling restrictions impacted securities lending?

Regulators have made it abundantly clear that the restrictions target short sellers rather than securities lenders. Broadly speaking, none of the regulations published to date impose additional restrictions on securities lending activity, although some make it clear that borrowing of securities should only be carried out for ‘legitimate’ purposes, i.e., not to facilitate prohibited short selling.

How is J.P. Morgan monitoring ongoing program compliance?

J.P. Morgan performs a daily review of data from all sources to identify any changes in the short selling restrictions that require communication or action, including incorporation into operating procedures. Information is sourced from our local agent banks, regulator communications, compliance reports and trade association distributions.

What is the outlook for fourth quarter 2008 and beyond?

The restrictions announced to date have been temporary in nature and, in most cases, are likely to be lifted by year end. South Korea and Taiwan plan to keep their restrictions in place until December 31, 2008, while the U.K. ban remains in force until January 16, 2009. The restoration of more normal market conditions may lead regulators to relax their current stance further; however, this is unlikely to bring a full reversion to the short selling regimes that preceded the 2008 market turmoil. A number of jurisdictions have promised further regulatory reviews and, although making the short selling bans more permanent appears unlikely, the reviews are likely to lead to more stringent short sale disclosure regimes and possibly some other measures to curb naked shorting and improve transparency as well.

J.P. Morgan Securities Lending will continue to monitor and advise clients of these developments. For more information, please contact your securities lending relationship manager.
Product and New Markets Update

We continue to invest in systems, innovation and service to benefit our clients, as evidenced by the expansion of our non-custody offering, particularly in Europe, and the recent announcement regarding our pooling product, where J.P. Morgan will provide securities lending in a tax transparent pool for the global pension funds of Shell Asset Management Company (SAMCo).

In parallel, and equally important, is the continued expansion of new markets, where we continue to make progress.

Specifically, following our new markets update last quarter, where we reported that J.P. Morgan became the first agent lender for Greek equities, we are pleased to announce that in September 2008, J.P. Morgan also became the first major agent lender for Polish equities. With the opening of these two markets, J.P. Morgan is now actively lending in over 30 international markets. Investing in the opening of new markets allows us to keep our clients at the forefront of opportunities in the context of appropriate risk management.

Poland – J.P. Morgan became the first agent-lender to lend Polish equities. Historically, inconsistent opinions regarding the applicability of stamp duty restricted securities lending in this market. Shortly after the Polish Minister of Finance issued a note on the non-applicability of stamp duty and J.P. Morgan conducted due diligence, the market became operational. All Polish equity lending trades are conducted over the counter (OTC), typically with T+2 settlements and no buy-ins or penalties. With limited supply from other major lending agents, high fees represent an attractive revenue potential for participating clients.

Brazil – This complex lending market is a top priority for due diligence given the significant demand. We are in the final stages of developing a model to support clients and expect to be able to lend early in 2009, subject to agreements with borrowers.

We are also assessing Israel, Malaysia and Indonesia as possible market expansions in 2009.

Finally, in an interesting development, China recently announced a pilot securities lending program. The program is limited to qualified local broker-dealers lending from their proprietary books, and the initial pool of eligible stock will be limited to the most liquid blue-chips. We will monitor this closely and will work with the local regulators to develop the market more broadly.

For more information on new lending opportunities for clients in the global arena, please contact your securities lending relationship manager.
From the Investment Desk

Highlights

• Maintaining liquidity and preserving capital drove our investment decisions during third quarter 2008 amidst unprecedented market volatility.
• Client communication remains a top priority, as clients seek guidance from us on both market conditions and the impact recent events have had on our lending capability and their reinvestment programs.
• Repurchase agreements against high-quality securities continue to dominate the portfolio, as market events continue to strain the supply of U.S. fixed-income securities.

Market Recap

Third quarter 2008 brought an unprecedented level of interest-rate volatility, due largely to the fact that the marketplace struggled to digest the effects of major unexpected events. These included the bankruptcy filing of Lehman Brothers, AIG’s federally-assisted bailout, Freddie Mac’s and Fannie Mae’s shift from implicit to explicit guarantees and J.P. Morgan’s decision to buy the bulk of Washington Mutual’s operations after the bank was seized by federal regulators. In addition, after its mid-September Federal Open Market Committee meeting, the Federal Reserve (the Fed) cut the fed funds rate by 50 basis points to 1.5%. Meanwhile, as lawmakers and policy experts collaborated to formulate a $700 billion plan to purchase hard-to-value securities, this effort evolved into a significant infusion of capital into the U.S. banking system at large. As the quarter ended, the major stock markets buckled under unforeseen volatility, with the Dow Industrial Index falling—and subsequently, rising—by unprecedented levels.

Strategies and Opportunities

For most of the quarter, our investment activity was highly concentrated inside of six months, with the majority of activity in three months and under. As the quarter came to a close, we restricted most activity to one week, as the market struggled to absorb the news on AIG and Lehman Brothers in a very short window of time. The events of September pushed investors into the overnight-to-7-day markets, as we then began to digest the decisions of the Fed and the Treasury.

Repo against high-quality securities dominated our investment decisions, due to a combination of a flight-to-quality into U.S. fixed-income securities, coupled with the unwinding of transactions related to Lehman Brothers. This convergence of events put further strain on the supply of U.S. fixed-income securities, with Treasury bills trading at below zero percent—a further reminder of the intensity of the markets’ concerns.

We continue to buy asset-backed commercial paper (CP), but only in very short-term maturities out to one month. The Fed has recently provided support to the CP market, as investors clearly remain more concerned about the health of banks than they are about the health of CP issuers. Why? Because banks dominate the financial landscape so powerfully, and they extract so much money out of the markets on a regular basis, rumors around the banking industry typically turn into reality. As such, this quarter the Fed announced a program to deal with the outflows in money-market funds by buying up large amounts of existing commercial paper from registered 2a7 funds. This alleviated some pressure in the CP market by improving the trading levels.

In general, the overall interest-rate sensitivity of the portfolio, as measured by the weighted average maturity (WAM), of nine days continues to represent our conservative approach given recent events, as we continue to focus on building liquidity as a defensive measure against further unforeseen events.

Outlook

With conditions changing so rapidly and dramatically, it is challenging to provide clients with any sense of expectations, even on a short-term basis. That said, we do believe that overnight interest rates could likely go lower in reaction to a slowdown in global growth, which seems probable. The credit crunch in the U.S. is now a decidedly global problem, evidenced by the speedy collaboration we saw among world leaders this quarter as they worked in tandem to support global financial sectors.

Amidst the uncertainty of these times, we have confidence that the programs policymakers and legislators have initiated should have a significant impact—a thawing-out effect, if you will—in helping to alleviate frozen credit markets. While our investment strategy will be dominated by very short-term instruments, we will remain on watch for signs of market stability to dictate when a shift in strategy is warranted.

Along with liquidity management and capital preservation, communication with our clients continues to be among our highest priorities. Clients understandably want to know not only what is happening in the markets, but how those events currently and potentially impact their lending programs. We believe thorough, meaningful and frequent communication can help clients understand the bigger picture during this turbulent time, and shed light on the importance of staying the course. These are indeed unprecedented times, but they serve to illustrate why a conservative, prudent approach is so important at all times, in all market cycles. We encourage you to look to us as a partner during this difficult time, and as always, we welcome your inquiries and comments on our reinvestment activities and strategies.
The third quarter was an extremely volatile period for equities, with indexes repeatedly surging and crashing. The turbulence began with concerns over sky-high commodity prices and rising inflation, and then quickly switched to concerns over the health of the global economy. From there, it moved on to the failure of Lehman Brothers and the end of the investment bank as an independent entity. Short-selling restrictions were imposed across global equity markets, and the quarter closed amidst a liquidity crisis and the risk of a global financial system meltdown.

Lending balances and revenues held up well until the last week of September, going into a steep decline after the Lehman bankruptcy and once short-selling restrictions were imposed. We enter the fourth quarter with the equity securities lending landscape changed forever. The newer realities include fewer counterparts with whom to trade, lower risk appetite from virtually all market participants and greater regulatory oversight of the business.

The key events that occurred this quarter and which are likely to shape the securities lending business going forward include:

**Short-selling restrictions** – Closer scrutiny and restrictions on short selling initially started in the U.S. in July, with the Securities Exchange Commission (SEC) imposing such restrictions on stocks of 19 financial firms. The SEC’s target was naked short sells, and required a short seller to have a contractual agreement to borrow the shares. This rule expired on the 12th of August. However, by the end of September, with the Lehman collapse and markets in freefall, restrictions were back in place and became global as the U.K. Financial Services Authority (FSA) temporarily banned shorting of financial stocks. The U.S., Australia and a host of other countries followed suit, with restrictions ranging from a complete short-selling ban across an entire market, as in Australia, or a ban on naked shorts of financial companies, as in Germany. As with the initial ban in the U.S., the markets’ immediate reaction was positive but short-lived, as investors went back to fundamentals, thinking about the health of the financial system and the looming threat of recession. Short sellers and lenders attracted a lot of negative press and the securities lending business was slow to defend itself. Regulators had a need to have some controls during periods of extreme volatility, due to concerns about abusive short selling, i.e., naked shorts. However, borrowing and shorting stocks add liquidity to the market and are used for a variety of trading strategies including hedging risk, aiding price discovery and to prevent fails, all of which were negatively impacted by the bans. Hedge Funds are generally net long equities and hedge their risk by shorting a smaller number of shares. As their ability to hedge was removed, many funds found it necessary to unwind long positions, further negatively impacting the market. Analysis of the amount of stock on loan in some of the hardest hit companies, such as financials, showed levels to be low relative to the issued share capital, e.g., 3%-7%. Of course, as we all saw, after a temporary rally, the bans did not stop shares in financial companies, or the wider markets, from falling.

**End to the era of independent investment banks** – In early- to mid-September, news reports centered on Lehman’s struggle for survival. On September 10, Lehman brought forward its third quarter results and gave details of a survival plan. However, the plan was a work-in-progress with nothing definitive on the table, and as such, failed to halt its share price’s slide. On September 14, the holding company went into bankruptcy, causing a massive unwinding of loans. J.P. Morgan reacted extremely quickly to protect its clients’ interests, and had over 90% of positions closed out within 24 hours. In addition, Merrill Lynch agreed to be taken over by Bank of America and Morgan Stanley and Goldman Sachs also became bank holding companies. During this time of volatility amongst our borrowing counterparts, J.P. Morgan continued to actively manage balances and risk in the interests of our clients.

**Decreased demand from hedge funds for loans** – Short-selling restrictions, reduced leverage, poor performance and large cash holdings to cover client redemptions all led to decreased borrowing demand from hedge funds.

Balances held up well until the end of the quarter, when all these drivers started to have a significant impact on balances. The collapse of Lehman cruelly exposed the risks to hedge funds that materialize when their prime broker goes out of business, as their assets were frozen or lost. This caused a massive reassessment of prime-broker risk amongst funds and has probably signalled the demise of the sole prime broker, as funds rushed to open accounts with alternative service providers and/or to switch business to prime brokers perceived as being more stable, such as those owned by a bank. This impacted the lending book as balances shifted between borrowers.

**Emerging markets** – In general emerging market indices fell sharply, due to investment fund outflows based on concerns about future growth and declines in commodity prices. This has been reflected in lending balances and revenues in those markets.

Although the quarter was extremely challenging and we expect the fourth quarter to be at least as tough, the securities lending business has in the past proved to be very resilient and we’re confident that after a period of retraction business will improve. During these times, the view of J.P. Morgan is that our business will emerge stronger as consolidation, focus on risk management and scale become ever more important and play to our strengths.
From the Lending Desks
Fixed Income

Highlights
- The government takeover of the Government Sponsored Enterprise (GSE) did not significantly change the spread dynamics between Treasuries and Agencies or Agency Mortgages.
- Narrow spreads between Treasuries and Agencies as well as Agency Mortgages prevailed for the majority of the quarter.
- Spreads increased to over 200 basis points by quarter-end as market events exacerbated the flight-to-quality.
- We commenced lending U.K. gilts versus sterling cash.

U.S. Update
Market Recap
The Treasury market had its share of records this quarter as issuance for many types of Treasuries achieved new highs. Two- and five-year notes increased to new highs of $34 billion and $24 billion respectively, a direct result of a bulging budget deficit that is nearly $455 billion, an increase of $162 billion from fiscal year 2007. Budget deficit estimates for fiscal year 2009 could be as high as $750 billion, given the potential impacts from a possible recession and the financial market’s challenges.

On August 8, the Fed announced the Term Securities Lending Facility Options Program (“TSLF Options Program” or “TOP”). As part of this program, the New York Fed offered options on $50 billion in TSLF loans that spanned the third quarter-end in two separate auctions held August 27 and September 10. (There will also be a TOP that covers year-end; details to be announced November 3.)

The purpose of these options is to bring relief during periods of “elevated stress in the financial markets, such as quarter-ends,” according to the Fed’s statement. Since the credit crunch began, each month-end and quarter-end has become more volatile as borrowers are focused on balance-sheet usage and typically unwind positions, causing upward pressure in financing rates. Additionally, the Fed announced an extension of its liquidity measures through January 30, 2009, “in light of continued fragile circumstances in the financial markets.”

Market events also led to an unprecedented “Flight-to-Quality” into Treasury securities, as virtually all market participants sought the safety and liquidity of Treasuries. Spreads increased to over 200 basis points for Treasuries, levels not seen since last March with the collapse of Bear Stearns. To help alleviate the situation, the Treasury Department issued $300 billion in Treasury Bills in a so-called Supplementary Financing Program. Nonetheless, the extra supply did not ease the demand.

The scarcity of some issues, combined with diminished holdings in the Fed’s System Open Market Account (SOMA), caused a plethora of issues to trade at a near-zero rebate rate. Large trading volumes, combined with less liquidity due to quarter-end and balance-sheet constraints by dealers, caused systemic clearance problems.

In addition, the TSLF continues to have a negative impact on the utilization of the agency debenture (agencies) and mortgage-backed (MBS) assets. The spread between agencies versus MBS was five basis points for most of the quarter. The market events which transpired this quarter have also led to diminished capacity by dealers for accepting agencies and MBS, since both asset classes trade as general collateral. The increased spread between overnight LIBOR and the Fed-Funds rate, as well as the issuance of Fannie Mae and Freddie Mac Discount Notes, has significantly increased the challenge of lending agencies and MBS. The capital charges imposed on dealers for transacting loans with collateral margins led to a significant increase of the intrinsic spread over the Fed-Funds rate. Prevailing market conditions will continue to inhibit trading in these asset classes, setting the stage for a challenging fourth quarter.

Corporate Bonds
The third quarter began with nervousness dissipating in the wake of the bailout of Bear Stearns. Although sentiment had improved, and some traders were reentering the market, hedge fund deleveraging remained in full swing. Liquidity concerns forced many hedge funds to hold cash rather than trade, and a spike in credit-default swaps coincided with weak demand in the cash markets to short corporate bonds. As summer came to an end, interest in the financial sector heated up with all banks and broker/dealers in play. As interest in shorting financials picked up, demand for gaming and consumer bonds waned.

With the turmoil in the markets due to Lehman Brothers’ bankruptcy filing, Bank of America’s purchase of Merrill Lynch and the U.S.-government bailout of AIG, deleveraging only accelerated while brokers looked to unwind trades with their clients. While balances began to drop, we did see spreads widen for many specials. Locate lists from brokers picked up dramatically late during the third quarter, and borrowers were often willing...
to take positions regardless of size or spread. Above average recalls were a main driver of the increase in spreads as some lending participants began to evaluate their investment strategies.

As we are seeing in fourth quarter, we anticipate deleveraging to continue as brokers seek to unwind trades prior to year-end. Balances will likely continue to drop before stabilizing while demand for certain issues could keep spreads wider than summer levels.

International Update
As expected, July and August were quiet holiday months with little activity and virtually no specials. However, with the freeze in the credit markets following the aftermath of the Lehman collapse, a number of lenders pulled out of the market, thereby reducing the bond supply. Therefore, September saw a return of specials, increased spreads and bonds trading with intrinsic value, particularly in France, Germany and Italy, where certain specific issues traded as high as 100 basis points.

Meanwhile, increased illiquidity in the corporate bond market meant more borrowers searching for supply to cover recalls.

Also during this quarter, lending gilts versus sterling cash was approved, and the first trades booked to those eligible clients were at levels of up to 40 basis points (GC vs. non cash typically generates 6 basis points). Not only were short-dated gilts fully lent, but there was also increased demand for long-dated and linkers, albeit at GC levels. However, 4Q 09 (GB0032785924) and 4Q 11 (GB00B0LNX641) yielded 175 basis points due to short supply in the repo market.

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