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U.S. DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

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OMB APPROVAL  
OMB = 1505-0100  
Expires: September  
1998

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ANNUAL AUDITED REPORT  
FORM G-405  
PART III

Information Required of Government Securities  
Brokers and Dealers  
Pursuant to Section 15C of the Securities  
Exchange Act of 1934, SEC Rule 17a-5 and 17 CFR 405.2

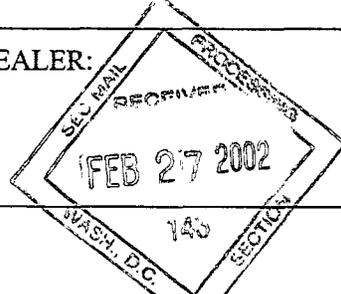
SEC FILE NO.  
8-38051

REPORT FOR THE PERIOD BEGINNING 12/30/2000 AND ENDING 12/28/2001  
MM/DD/YY MM/DD/YY

A. REGISTRANT IDENTIFICATION

NAME OF GOVERNMENT SECURITIES BROKER OR DEALER:

MERRILL LYNCH GOVERNMENT SECURITIES INC.



Official Use Only  
FIRM ID. NO.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS:  
(Do not use P.O. Box No.)

Merrill Lynch World Headquarters - World Financial Center - North Tower - 250 Vesey Street  
(No. and Street)

New York New York 10281-1308  
(City) (State) (Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Donald C. Han (201) 671-0347  
(Area Code - Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report\*  
(Name - if individual, state last, first, middle name)

Deloitte & Touche LLP

Two World Financial Center New York NY 10281  
(Address) (City) (State) (Zip Code)

CHECK ONE:

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

PROCESSED  
MAR 22 2002  
THOMSON FINANCIAL

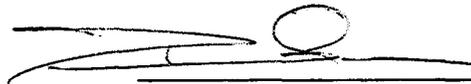
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\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis of the exemption. See 17 CFR 240.17a-5(e)(2), 17 CFR 405.2.

Handwritten initials and date: 4/3/02

AFFIRMATION

I, Donald C. Han, affirm that, to the best of my knowledge and belief, the accompanying consolidated financial statements and supplemental schedules pertaining to Merrill Lynch Government Securities Inc. and subsidiary (the "Company"), for the year ended December 28, 2001, are true and correct. I further affirm that neither the Company nor any officer or director has any proprietary interest in any account classified solely as that of a customer.

  
Signature February 25, 2002  
Date

Vice President - Controller  
Title

Subscribed and Sworn to before me  
on this 25<sup>th</sup> day of February, 2002

  
Notary Public

**GERARD M. HAUGH**  
NOTARY PUBLIC, State of New York  
No. 01HA5020017  
Qualified in Orange County  
Commission Expires Nov. 8, 2005

Deloitte & Touche LLP  
Two World Financial Center  
New York, New York 10281-1414

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**Deloitte  
& Touche**

## INDEPENDENT AUDITORS' REPORT

Merrill Lynch Government Securities Inc.:

We have audited the accompanying consolidated balance sheet of Merrill Lynch Government Securities Inc. and subsidiary (the "Company") for the year ended December 28, 2001, that you are filing pursuant to Section 405.2 of the Regulations under Section 15C of the Securities Exchange Act of 1934. This consolidated financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this consolidated financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated balance sheet presents fairly, in all material respects, the financial position of Merrill Lynch Government Securities Inc. and subsidiary at December 28, 2001, in conformity with accounting principles generally accepted in the United States of America.

*Deloitte & Touche LLP*

February 25, 2002

**Deloitte  
Touche  
Tohmatsu**

# MERRILL LYNCH GOVERNMENT SECURITIES INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEET AS OF DECEMBER 28, 2001

(Dollars in Thousands, Except Per Share Amount)

<b>ASSETS</b>		<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>
CASH	\$ 1,025	LIABILITIES:
CASH SEGREGATED AND SECURITIES ON DEPOSIT FOR REGULATORY PURPOSES OR DEPOSITED WITH CLEARING ORGANIZATIONS	<u>218,039</u>	PAYABLES UNDER REPURCHASE AGREEMENTS
RECEIVABLES UNDER RESALE AGREEMENTS	<u>37,788,954</u>	
RECEIVABLES UNDER SECURITIES BORROWED TRANSACTIONS	<u>16,987,018</u>	TRADING LIABILITIES, AT FAIR VALUE:
TRADING ASSETS, AT FAIR VALUE:		U.S. Government and agencies
U.S. Government and agencies	5,631,241	Contractual agreements
Mortgage-backed	3,209,791	
Bankers acceptances, certificates of deposit, and commercial paper	1,364,553	SHORT-TERM PAYABLES TO AFFILIATED COMPANIES
Contractual agreements	<u>422,098</u>	
	<u>10,627,683</u>	OTHER LIABILITIES:
SECURITIES PLEDGED AS COLLATERAL	<u>3,734,974</u>	Securities failed to receive Interest
		Accrued liabilities and other expenses, primarily to brokers and dealers
OTHER RECEIVABLES:		
Securities failed to deliver	3,830,651	Total liabilities
Interest	134,835	
Other	<u>1,943,848</u>	SUBORDINATED BORROWING
	<u>5,909,334</u>	
OTHER ASSETS:		STOCKHOLDER'S EQUITY:
Equipment and facilities (net of accumulated depreciation and amortization of \$31,086)	1,212	Common stock, \$100 par value - 1,000 shares authorized; issued and outstanding
Other	<u>65,080</u>	Paid-in capital
	<u>66,292</u>	Retained earnings
TOTAL ASSETS	<u>\$75,333,319</u>	Total stockholder's equity
		TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY
		<u>\$75,333,319</u>

See Notes to the Consolidated Balance Sheet.

# MERRILL LYNCH GOVERNMENT SECURITIES INC. AND SUBSIDIARY

## NOTES TO CONSOLIDATED BALANCE SHEET YEAR ENDED DECEMBER 28, 2001 (Dollars in Thousands)

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Description of Business** - Merrill Lynch Government Securities Inc. is a wholly-owned subsidiary of Merrill Lynch & Co., Inc. ("ML&Co.") and is primarily engaged in business as a dealer in U.S. Government, agency and mortgage-backed securities. Through its wholly-owned subsidiary, Merrill Lynch Money Markets Inc., the Company provides a full range of origination, trading, and marketing services for money market instruments, such as commercial paper, bankers acceptances, and certificates of deposit.

**Basis of Presentation** - The Consolidated Financial Statements include the accounts of Merrill Lynch Government Securities Inc. and its subsidiary (collectively, the "Company") and are presented in accordance with accounting principles generally accepted in the United States of America and prevailing industry practices. All material intercompany balances and transactions have been eliminated.

**Use of Estimates** - In presenting the Consolidated Financial Statements, management makes estimates regarding certain trading inventory valuations, the outcome of litigation, the realization of deferred tax assets, and other matters that affect the reported amounts and disclosure of contingencies in the financial statements. Estimates, by their nature, are based on judgment and available information. Therefore, actual results could differ materially from those estimates.

**Trading Assets and Liabilities** - Fair values of liquid trading securities and derivative contracts are based on quoted mid-market prices and pricing models that utilize inputs based on quoted market factors and indicators of general market conditions. Obtaining the fair value for certain securities and for derivatives contracts requires the use of management judgment and estimates. In general, derivatives are 'marked to market', with prices for trades calculated, and independently verified, using observed information about the costs of hedging out the risk and other trades in the market. Directly observed prices may come from exchange traded derivatives, over-the-counter trades, or external pricing services. Where necessary, extrapolation methods are applied to observed market data in order to estimate prices that are not directly observable. This enables the firm to mark all positions consistently when only a subset of prices are directly observable.

Valuation adjustments are taken for individual positions where either the sheer size of the trade or other specific features of the trade or particular market requires greater attention than simple application of the pricing models. Changes in the assumptions used to calculate the fair value of these positions could have a material effect on the financial condition of the Company.

**Fair Value** - Substantially all of the Company's financial instruments are carried at fair value or at amounts that approximate fair value. Assets carried at amounts that approximate fair value consist predominantly of short-term financial instruments, which include cash, cash segregated and securities on deposit for regulatory purposes or deposited with clearing organizations, most

receivables under resale agreements and securities borrowed transactions, and other receivables. Similarly, most payables under repurchase agreements, short-term payables to affiliated companies, subordinated borrowing from ML&Co., and other liabilities are carried at amounts that approximate fair value.

***Securities Financing Transactions*** - The Company enters into repurchase and resale agreements and securities borrowed transactions to accommodate customers (i.e., matched-book), finance firm inventory positions, and obtain securities for settlement.

Resale and repurchase agreements are accounted for as collateralized financing transactions and are recorded at their contractual amounts, plus accrued interest. The Company's policy is to obtain possession of collateral with a market value equal to or in excess of the principal amount loaned under resale agreements. To ensure that the market value of the underlying collateral remains sufficient, collateral is valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged, when appropriate. Substantially all repurchase and resale activities are transacted under master netting agreements that give the Company the right, in the event of default, to liquidate collateral held and to offset receivables and payables with the same counterparty. The Company offsets certain repurchase and resale agreement balances with the same counterparty on the Consolidated Balance Sheet.

Securities borrowed are recorded at the amount of cash collateral advanced. Securities borrowed transactions require the Company to provide the counterparty with collateral in the form of cash, letters of credit, or other securities. On a daily basis, the Company monitors the market value of securities borrowed against the collateral value.

On the Consolidated Balance Sheet as of December 28, 2001, all firm-owned securities pledged to counterparties where the counterparty has the right, by contract or custom, to sell or repledge the securities are classified as securities pledged as collateral as required by Statement of Financial Accounting Standards ("SFAS") No. 140, *Accounting for Transfers and Servicing Financial Assets and Extinguishment of Liabilities*.

Interest rate swaps may be used to modify the interest rate characteristics of long-term resale and repurchase agreements. These swaps are accounted for at fair value, with amounts to be paid or received recognized as adjustments to interest expense or revenue. (see the Derivatives section for additional information on accounting policy for derivatives).

***Trading Assets and Liabilities*** - The Company's trading activities consist primarily of securities trading, derivatives dealing and securities financing transactions. Trading assets and trading liabilities consist of cash instruments (such as securities) and derivative instruments used for trading purposes or for managing risk exposures in other trading inventory. (See the Derivatives section for additional information on accounting policy for derivatives).

Trading securities are recorded on a trade date basis at fair value. Included in trading liabilities are securities that the Company has sold but did not own and will therefore be obligated to purchase at a future date ("short sales").

Fair values of trading securities are based on quoted market prices, pricing models (utilizing indicators of general market conditions or other economic measurements), or management's estimates of amounts to be realized on settlement, assuming current market conditions and an orderly disposition over a reasonable period of time.

*Derivatives* - A derivative is an instrument whose value is "derived" from an underlying instrument or index, such as a future, forward, swap, or option contract, or other financial instrument with similar characteristics. Derivative contracts often involve future commitments to exchange interest payment streams based on a notional or contractual amount (e.g., interest rate swaps) or to purchase or sell other financial instruments at specified terms on a specified date (e.g., options to buy or sell securities).

Derivatives are often referred to as off-balance-sheet instruments since neither their notional amounts nor the underlying instruments are reflected on the balance sheet; however, the fair value of all derivatives are recorded on the Consolidated Balance Sheet. Derivative instruments are reported on a net-by-counterparty basis on the Consolidated Balance Sheet where management believes a legal right of setoff exists under an enforceable netting agreement.

*Valuation of Derivatives* - Fair values for certain exchange-traded derivatives, principally futures and certain options, are based on quoted market prices. Fair values for over-the-counter ("OTC") derivative financial instruments, principally forwards, options, and swaps, represent amounts that would be received from or paid to a third party in settlement of these instruments. These amounts are determined using pricing models based on the present value of estimated future cash flows employing mid-market valuations with appropriate adjustments. These adjustments are integral components of the mark-to-market process and relate to credit quality and concentration, market liquidity, and exposure close-out costs associated with unmatched positions. Adjustments are also made for administrative costs incurred to service periodic cash flows and to maintain hedges over the life of the contract. A portion of income related to long-term contracts is recognized as the related administrative costs are incurred.

*Risk Management of Derivatives* - The derivatives activity of the Company is subject to the overall risk management policy and procedures of ML&Co. In the course of conducting its business operations, the Company is exposed to a variety of risks. These risks include market, credit, liquidity, process, and other risks that are material and require comprehensive controls and management. (See Note 3. Market Risk and Credit Risk sections). The responsibility and accountability for these risks remain primarily with the Company. The ML&Co. risk management group ensures that these risks are properly identified, monitored, and managed. The Company has clearly defined risk tolerance levels that are regularly reviewed by the ML&Co risk management group to ensure consistency with the Company's business strategy, capital structure, and current and anticipated market conditions.

*Accounting for Derivatives and Hedging Activities* - On the first day of fiscal year 2001, the Company adopted the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No.133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts ("embedded derivatives") and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the Consolidated Balance Sheet and measure those instruments at fair value. The accounting for changes in fair value of a derivative instrument depends on its intended use and the resulting designation. Upon adoption of SFAS No. 133, all existing hedge relationships were designated anew. The adoption of SFAS No. 133 did not materially impact the consolidated financial statements.

Derivatives entered into in a dealing capacity are recognized at fair value on the Consolidated Balance Sheet as trading assets and liabilities in contractual agreements. Derivatives entered into

in a non-dealing capacity are designated, on the date they are entered into, as either a hedge of the fair value of a recognized asset or liability ("fair value" hedge).

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The risk management objectives and strategies are monitored and managed by the Company in accordance with established ML&Co risk management policies and procedures that include risk tolerance levels. The Company also formally assesses, both at the inception of the hedge and on an ongoing basis, whether the hedging derivatives are highly effective in offsetting changes in fair value or cash flows of hedged items. When it is determined that a derivative is not highly effective as a hedge the Company discontinues hedge accounting.

The Company enters into when-issued and delayed delivery transactions. Unrealized gains and losses from these transactions are reflected in the related cash instrument caption.

***Brokers and Dealers Receivables and Payables*** - Receivables from brokers and dealers include amounts receivable for securities not delivered by a seller to the Company by the settlement date ("failed to deliver"), deposits for securities borrowed, margin deposits, commissions, and net receivables arising from unsettled trades. Payables to brokers and dealers include amounts payable for securities not received by a purchaser from the Company by the settlement date ("failed to receive"), deposits received for securities loaned, and net payables arising from unsettled trades.

***Interest and Other Receivables and Payables*** - Interest and other receivables include interest receivable on governmental obligations, customer receivables, collateralized financing transactions, interest rate swap transactions and receivables from commissions and fees and income taxes. Interest and other payables include interest payable for securities financing transactions, and amounts payable for employee compensation and benefits, restructuring reserves and income taxes.

***Income Taxes*** - The results of operations of the Company are included in the consolidated U.S. federal income tax return of ML&Co. ML&Co. allocates income taxes to its subsidiaries in a manner that approximates the separate company method.

The Company uses the asset and liability method in providing income taxes on all transactions that have been recognized in the Consolidated Financial Statements. The asset and liability method requires that deferred taxes be adjusted to reflect the tax rates at which future taxable amounts will be settled or realized. The effects of tax rate changes on future deferred tax liabilities and deferred tax assets, as well as other changes in income tax laws, are recognized in net earnings in the period such changes are enacted. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company provides for deferred income taxes resulting from temporary differences that arise from recording certain transactions (principally asset and liability reserves) in different years for income tax reporting purposes than for financial reporting purposes.

***Equipment and Facilities*** - Equipment and facilities primarily consist of technology hardware and software and leasehold improvements. Equipment and facilities are reported at historical cost, net of accumulated depreciation and amortization.

## 2. RELATED PARTY TRANSACTIONS

The Company participates with affiliated companies in the sales of certain securities to third parties. The Company earns revenue from such sales through a service fee. In addition, the Company makes payments to affiliated companies for certain services provided in the execution and settlement of securities transactions, pursuant to various service fee agreements. The charge for these services is based primarily on the volume of transactions processed. The Company also reimburses affiliated companies for various operating expenses paid by such affiliated companies on its behalf.

The Company also borrows funds from and lends funds to affiliated companies for financing purposes.

Affiliate-related balances included in the Consolidated Balance Sheet follow:

Assets:	
Trading assets	\$ 96,412
Receivables under resale agreements	5,225,787
Other receivables	<u>103,015</u>
	<u>\$ 5,425,214</u>
Liabilities:	
Trading liabilities	\$ 192,458
Payables under repurchase agreements	23,916,547
Short-term payables	1,350,062
Subordinated borrowing from ML&Co.	1,300,000
Other payables	<u>178,057</u>
	<u>\$ 26,937,124</u>

## 3. TRADING AND RELATED ACTIVITIES

The Company's trading activities primarily consist of providing securities brokerage, derivatives dealing and financing to clients. While trading activities are primarily generated by client order flow, the Company also takes proprietary positions based on expectations of future market movements and conditions. The Company's trading strategies rely on the integrated management of its client-driven and proprietary transactions, along with the hedging and financing of these positions.

Certain trading activities expose the Company to market and credit risks. These risks are managed in accordance with established risk management policies and procedures.

**Market Risk** - Market risk is the potential change in a financial instrument's value caused by fluctuations in interest rates or market prices. The level of market risk is influenced by the volatility and the liquidity in the markets in which financial instruments are traded.

The Company seeks to mitigate market risk associated with trading inventories by employing hedging strategies that correlate price movements of trading inventories and related financing and hedging activities. The Company uses a combination of cash instruments and derivatives to hedge its market exposures. The principal market risks affecting the Company's financial instruments are

interest rate risk and, with respect to mortgage-backed securities, prepayment risk. The following discussion describes these types of risks.

*Interest Rate Risk* - Interest rate risk arises from the possibility that changes in interest rates will affect the value of the Company's financial instruments. Interest rate swap agreements, futures, and U.S. Treasury securities and options are common interest rate risk management tools. The decision to manage interest rate risk using futures, swap contracts or options, as opposed to buying or selling short U.S. Treasury or other securities, depends on current market conditions and funding considerations.

Interest rate swap agreements used by the Company include caps and basis swaps. Interest rate caps provide the purchaser with protection against rising interest rates. Basis swaps are a type of interest rate swap agreement where variable rates are received and paid, but are based on different index rates.

*Prepayment Risk* - Prepayment risk, which is related to interest rate risk, arises from the possibility that the rate of principal repayment on mortgages will fluctuate, affecting the value of mortgage-backed securities.

*Credit Risk* - The Company is exposed to risk of loss if a counterparty fails to perform its obligations under contractual terms and the collateral held, if any, is deemed worthless ("default risk"). Both cash instruments and derivatives expose the Company to default risk. The Company has established policies and procedures for mitigating credit risk on principal transactions, including reviewing and establishing limits for credit exposure, maintaining collateral, and continually assessing the creditworthiness of counterparties.

Liabilities to other brokers and dealers related to unsettled transactions (i.e., securities failed to receive) are recorded at the amount for which the securities were acquired and are paid upon receipt of the securities from other brokers or dealers. In the case of aged securities failed to receive, the Company may purchase the underlying security in the market and seek reimbursement for losses from the counterparty.

The Company uses resale and repurchase agreements to finance securities and bonds borrowed transactions, to facilitate settlement processes, and to meet customer needs. Under these agreements and transactions, the Company either receives or provides collateral, including U.S. Government and agencies securities, mortgage-backed securities, or money market instruments. When providing collateral for these transactions, the Company delivers its own securities and securities owned by counterparties collateralizing resale agreements and other obligations.

*Concentrations of Credit Risk* - The Company's exposure to credit risk, associated with its trading and other activities, is measured on an individual counterparty basis, as well as by groups of counterparties that share similar attributes. Concentrations of credit risk can be affected by changes in political, industry, or economic factors. To reduce the potential for risk concentration, credit limits are established and monitored in light of changing counterparty and market conditions.

At December 28, 2001, the Company's most significant concentration of credit risk was with the U.S. Government and its agencies. This concentration consists of both direct and indirect exposures. Direct exposure, which primarily results from taking trading asset positions in instruments issued by the U.S. Government and its agencies, amounted to \$5,702,266. The Company's indirect exposure results from maintaining U.S. Government and agencies securities as collateral, primarily for resale agreements and bonds borrowed transactions. The Company's

direct credit exposure on these transactions is with the counterparty; thus the Company has credit exposure to the U.S. Government and its agencies in the event of the counterparty's default. Securities issued by the U.S. Government or its agencies held as collateral at December 28, 2001 totaled \$107,214,770.

The Company's most significant industry concentrations are financial institutions and municipalities. Financial institutions include other brokers and dealers, commercial banks, finance companies, investment companies, and insurance companies. This concentration arises in the normal course of the Company's trading and financing activities.

**Trading Derivatives** - The Company's trading derivatives consist of derivatives provided to customers and derivatives entered into for proprietary trading strategies or risk management purposes.

Default risk is limited to the current cost of replacing derivative contracts in a gain position. Default risk exposure varies by type of derivative. Swap agreements and forward contracts are generally OTC-transacted and thus are exposed to default risk to the extent of their replacement cost. Since futures contracts are exchange-traded and usually require daily cash settlement, the related risk of accounting loss is generally limited to a one-day net positive change in market value. Option contracts can be exchange-traded or OTC-transacted. Purchased options have default risk to the extent of their replacement cost. Written options represent a potential obligation to counterparties and, accordingly, do not subject the Company to default risk.

The Company generally enters into International Swaps and Derivatives Association, Inc. master agreements or their equivalent ("master netting agreements") with each of its counterparties, as soon as possible. Master netting agreements provide protection in bankruptcy in certain circumstances and, in some cases, enable receivables and payables with the same counterparty to be offset on the Consolidated Balance Sheet, providing for a more meaningful balance sheet presentation of credit exposure.

To reduce default risk, the Company requires collateral, principally U.S. Government and agencies securities, on certain derivative transactions. From an economic standpoint, the Company evaluates default risk exposures net of related collateral. In addition to obtaining collateral. The Company attempts to mitigate default risk on derivatives by entering into transactions with provisions that enable the Company to terminate or reset the terms of the derivative contract.

The Company attempts to mitigate default risk on derivatives by entering into transactions with provisions that enable the Company to terminate or reset the terms of the derivative.

**Securities Financing Transactions** - The Company enters into secured borrowing transactions to finance trading inventory positions, obtain securities for settlement, and meet customer needs.

Under these agreements and transactions, the Company receives collateral in connection with resale agreements and securities borrowed transactions. Under many agreements, the Company is permitted to sell or repledge these securities held as collateral and uses the securities to secure repurchase agreements or deliver to counterparties to cover short positions. At December 28, 2001, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was \$114,385,182 and the fair value of the portion that has been sold or repledged was \$108,361,482.

The Company pledges firm-owned assets to collateralize repurchase agreements and other secured financing. Pledged securities that can be sold or repledged by the secured party are classified as securities pledged as collateral on the Consolidated Balance Sheet. The carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge are as follows:

Classification	Carrying value at December 28, 2001
U.S. Government and agencies	\$12,619,628
Mortgage-backed	2,085,637
Bankers acceptances, certificates of deposit, and commercial paper	<u>993,180</u>
Total	<u>\$15,698,445</u>

#### 4. NON-TRADING ASSETS AND LIABILITIES

The Company holds a minority interest in a company which provides a co-mingled platform for execution of U.S. government instruments and corporate debt products. The Company's investment amounted to \$3,750 which is held at cost and in the opinion of management approximates the net realizable value. It is included in Other Investments on the Consolidated Balance Sheet at December 28, 2001.

#### 5. COMMITMENTS AND CONTINGENCIES

**Litigation** - As of December 28, 2001, the Parent and/or certain of its subsidiaries, including the Company, have been named as parties in various actions, some of which involve claims for substantial amounts. Although the results of legal actions cannot be predicted with certainty, it is the opinion of management that the resolution of these actions will not have a material adverse effect on the financial condition of the Company.

**Other Commitments** - In the normal course of business, the Company enters into when-issued and delayed delivery transactions. Settlement of these transactions as of December 28, 2001, would not have a material effect on the consolidated financial position of the Company.

In connection with its financing activities, the Company had commitments to enter into resale and repurchase agreements at December 28, 2001. The amounts at December 28, 2001 were \$7,045,782 and \$4,142,156, respectively.

The Company obtains standby letters of credit from issuing banks to satisfy various collateral requirements in lieu of the Company depositing collateral of securities or cash. Letters of credit aggregated \$33,300 at December 28, 2001.

#### 6. EMPLOYEE BENEFIT PLANS

The Company participates in various benefit and incentive plans sponsored by ML&Co.

The defined contribution plans consist of the Retirement Accumulation Plan, the 401(k) Savings and Investment Plan and the incentive plan consists of the Employee Stock Ownership Plan. These plans are available to substantially all U.S. employees who have met service requirements.

ML&Co. has purchased a group annuity contract that guarantees the payment of benefits vested under a U.S. defined benefit plan that was terminated in accordance with the applicable provisions of the Employee Retirement Income Security Act of 1974.

#### **7. SUBORDINATED BORROWING**

At December 28, 2001, the Company's subordinated borrowing amounts outstanding and available with ML&Co. totaled \$1,300,000 and \$1,500,000, respectively. The subordinated borrowing agreement matures on October 15, 2003.

This borrowing is approved for regulatory capital purposes and accrues interest based on the 30-day commercial paper rate.

#### **8. INCOME TAXES**

At December 28, 2001, the Company had a current net tax receivable of \$8,702 from ML&Co. and deferred tax assets of \$15,432 and deferred tax liabilities of \$1,684. No valuation allowance is required.

#### **9. REGULATORY REQUIREMENTS**

As a primary U.S. Government securities dealer, the Company is subject to the financial responsibility requirements of Section 402.2 of the regulations under Section 15C of the Securities Exchange Act of 1934 (the "Rule"). The Rule provides that the ratio of liquid capital to total haircuts (as defined) shall be maintained in excess of 1.2 to 1. At December 28, 2001, the Company's liquid capital, total haircuts, and ratio of liquid capital to total haircuts were \$1,317,716, \$519,169, and 2.5 to 1, respectively.

\* \* \* \* \*

Deloitte & Touche LLP  
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**Deloitte  
& Touche**

February 25, 2002

Merrill Lynch Government Securities Inc.  
Merrill Lynch World Headquarters - North Tower  
World Financial Center  
New York, New York 10281 - 1308

Dear Sirs:

In planning and performing our audit of the consolidated financial statements of Merrill Lynch Government Securities Inc. and subsidiary (the "Company") for the year ended December 28, 2001 (on which we issued our report dated February 25, 2002), we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurance on the Company's internal control.

Also, as required by Section 405.2 of the Regulations under Section 15C of the Securities Exchange Act of 1934, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by the Company that we considered relevant to the objectives stated in Section 405.2: (1) in making the periodic computations of total haircuts and liquid capital under Section 402.2; (2) in making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by Section 404.5; and (3) in determining compliance with the exemptive provisions of Section 403.4.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control and of the practices and procedures, and to assess whether those practices and procedures can be expected to achieve the Department of Treasury's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized acquisition, use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. Section 405.2 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Merrill Lynch Government Securities Inc.  
February 25, 2002  
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Because of inherent limitations in any internal control or the practices and procedures referred to above, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control or of such practices and procedures to future periods are subject to the risk that they may become inadequate because of changes in conditions or that the degree of compliance with the practices or procedures may deteriorate.

Our consideration of the Company's internal control would not necessarily disclose all matters in the Company's internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the Company's internal control and its operations, including control activities for safeguarding securities, that we consider to be material weaknesses as defined above.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Department of Treasury to be adequate for its purposes in accordance with the regulations under Section 15C of the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 28, 2001, to meet the Department of Treasury's objectives.

This report is intended solely for the information and use of the board of directors, management, the Department of Treasury, the National Association of Securities Dealers, Inc., the Federal Reserve Bank of New York, the Securities and Exchange Commission and other regulatory agencies that rely on Section 405.2 of the Regulations under Section 15C of the Securities Exchange Act of 1934 in their regulation of government securities brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Yours truly,

*Deloitte & Touche LLP*

MERRILL LYNCH GOVERNMENT SECURITIES INC.  
AND SUBSIDIARY  
(S.E.C. I.D. No. 8-38051)

CONSOLIDATED BALANCE SHEET  
AS OF DECEMBER 28, 2001  
AND  
INDEPENDENT AUDITORS' REPORT  
AND  
SUPPLEMENTAL REPORT ON INTERNAL CONTROL

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Filed in accordance with  
Section 405.2 of the regulations under Section 15C  
of the Securities Exchange Act of 1934 a PUBLIC DOCUMENT.