MEMORANDUM

TO: File
FROM: Aaron Foxman
RE: Meeting with the representatives of the Credit Derivatives Product Companies
DATE: November 4, 2010

On November 4, 2010, Ling Yu, Thomas McGowan, Sheila Swartz, Jeffrey Dinwoodie, Richard Grant, and Leah Drennan of the Securities and Exchange Commission met with representatives from the Credit Derivatives Product Companies (collectively, the "CDPC representatives") at the SEC's headquarters in Washington, DC.

The CDPC representatives included Richard Claiden (CEO, Primus Guaranty Ltd.), Gene Park (CEO, Quadrant Structured Investment Advisers, LLC), Steven Kahn (President and CEO, Invicta Financial Group), and Brant Imperatore (Partner, The Cypress Group).

The CDPC representatives discussed the implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including issues relating to definitions (including "security-based swap," and "major swap participant") and margin requirements for swaps and security-based swaps.

Agenda

The representatives from Primus Guaranty Ltd., Quadrant Structured Investment Advisers, LLC and Invicta Financial Group ("Companies") would like to meet with the relevant SEC personnel to discuss the following three issues:

1. The treatment of existing swaps, specifically in regards to the potential imposition of margin requirements on pre-enactment swaps;
2. The definition of Security-Based Swap; and
3. The definition of Major Swap Participant

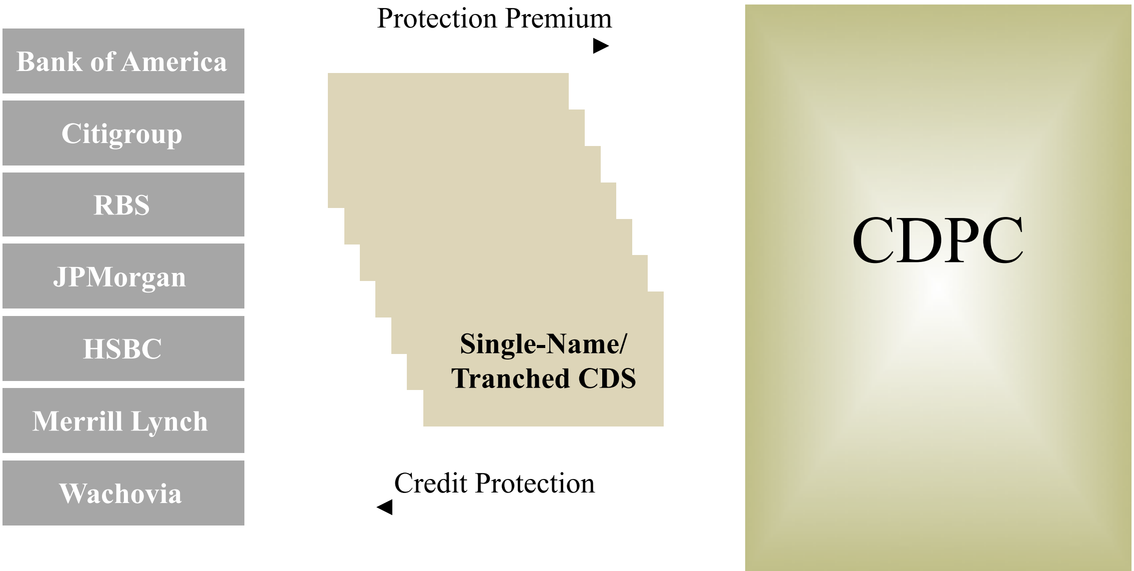
The Companies to attend the meeting all represent credit derivative product companies ("CDPCs"). CDPCs specialize in selling credit risk protection in the form of credit default swap contracts that offer protections against the risk of default on single name reference entities and on pools of credit consisting of multiple reference entities. While CDPCs do continue to function, as a result of the change in counterparty requirements with regards to collateralization, CDPCs have stopped writing new business and are in a state of wind down.

Credit Derivative Product Companies (“CDPCs”)

A Presentation to the CFTC and SEC Regarding the Applicability of the Dodd-Frank Bill to CDPCs

Overview of CDPCs

- CDPCs are limited purpose companies that sold credit default protection in the form of credit default swaps (“CDS”) referencing primarily investment-grade corporate obligations. There are two main types of CDS written by CDPCs:
    - Protection written on an individual corporate credit obligation (“Single-Name CDS”) - see Appendix I for a description of a Single-Name CDS); and
    - Protection written on a specific risk layer against a diversified portfolio of corporate credit obligations (“Tranched CDS”) - also referred to as corporate synthetic CDO tranches (see Appendix II for a description of a Tranched CDS).
- Credit protection provided by CDPCs was in the form of long-dated CDS contracts with no collateral posting requirement
- CDPCs earn quarterly premiums in return for providing credit default protection to its customers or “counterparties” (mainly large international banks). A CDPC is obligated to pay claims to the extent certain credit events (i.e. a default by a corporate entity covered in the CDS contract) occur and cumulative losses exceed pre-specified deductibles (in Tranched CDS).



Overview of CDPCs - Continued

- CDPCs are separately capitalized with equity and long-term debt.
- Each CDPC has different risk/return tolerances with respect to the type of credit protection it wrote. A vast majority (~90%) of the CDS notional written by the CDPC industry is very remote risk (i.e. high deductible or "attachment point") Tranched CDS.
- CDPCs operate under strict Operating Guidelines that were approved by rating agencies and counterparties, mandating daily minimum capital adequacy requirements, leverage restrictions, liquidity requirements, portfolio diversity and pre-specified risk limits.
- As per its organizational and swap documents (negotiated, bilateral contracts), CDPCs were and are expressly prohibited from posting daily margin or collateral due to the potential volatility risk to the business. Instead, CDPCs capital is segregated to satisfy potential claims and was sized to meet actual default risk, based on a capital adequacy model ("Capital Model").
- The Capital Model (governed by the Operating Guidelines) is a prospective default simulator which calculates the minimum required capital to maintain sufficient claims-paying ability to its counterparties.
- Capital adequacy as determined by the Capital Model is a function of the underlying credit quality of the corporate reference obligations, the diversity of the portfolio, and tenor – and not a function of mark-to-market valuations of the CDS portfolio. Since a CDPC hold its contracts to maturity, interim market fluctuations do not have an economic impact on the company.
- Because CDPCs were expressly prohibited from posting collateral, negotiated premiums were lower than those paid to collateral posting credit protection providers and debt investors were willing to provide financing on more attractive terms.

Impact of the 2008 Credit Crisis and its Aftermath

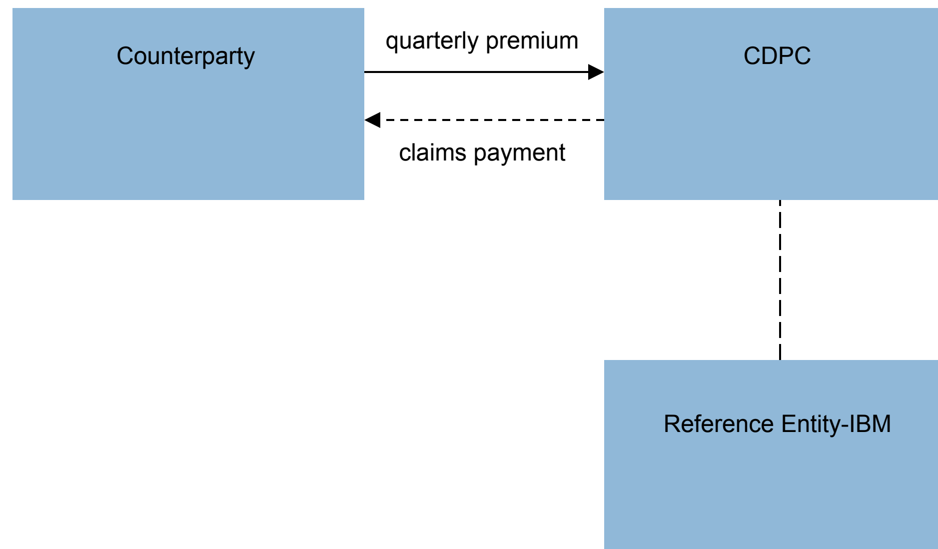
- Throughout the 2008 credit crisis and thereafter, CDPC's counterparties were unwilling to transact new business without collateral.
- Since CDPCs are not permitted to post collateral, the entire industry stopped transacting new business with CDPCs and, as a result, the industry is in run-off with no new swaps having been written since 2008.
- While most CDPCs have experienced credit events on their CDS portfolios, they have paid all claims when due.
- CDPCs continue to operate normally in run-off which includes collecting premiums, paying claims, and maintaining proper levels of capital on a prospective basis.

Applicability of the Dodd-Frank Bill

- The aggregate outstanding CDS notional for the entire CDPC industry is less than one half of one percent of the CDS market. Due to the fact that CDPCs are a tiny fraction of the market, the failure of any CDPC would not cause any systemic risk to the derivatives market or the financial system.
- CDPCs have not been active participants in the CDS market since 2008 and therefore should not be categorized either as Swap Dealers or as Major Swap Participants as defined in the Dodd-Frank Bill.
- CDPCs have strict Operating Guidelines that include daily capital adequacy requirements, which was the original trade-off behind not posting collateral to counterparties.
- CDPCs are expressly prohibited in their organizational and ISDA documents from posting collateral. A new collateral posting requirement could cause a liquidity squeeze for many CDPCs, would explicitly break existing contracts and would expose CDPCs to risks that their structure was explicitly designed to avoid.

Appendix I: Single-Name CDS Description

- In a single-name CDS transaction, in return for receiving a quarterly premium, CDPCs provide protection associated with credit events on a specified reference entity – typically an investment grade corporation such as IBM.
- Credit events which would lead to a claim being presented to the CDPC by a counterparty generally include bankruptcy and failure-to-pay.
- Claims are cash settled though an ISDA protocol which determines a recovery value for the securities associated with the bankrupt entity.



Appendix II: Tranched CDS Description

- In a Tranched CDS transaction, in return for receiving a quarterly premium, CDPCs provide protection on losses exceeding a pre-specified threshold on an underlying portfolio.
- A Tranched CDS generally references a diverse portfolio of 100 or more equally weighted investment-grade corporate credit obligations ("Reference Entities")
- Claims start to be paid by the CDPC only if losses on the underlying portfolio exceed at pre-specified threshold, the "Attachment Point"
- The aggregate amount of claims that can be made on a Tranched CDS is equal to the Notional Amount (e.g. $500mm) of the contract which begins to be paid out only if underlying losses exceed the "Attachment Point" (e.g. 15%, below)