

Non-Traditional Capital Structure Arbitrage Transactions

SFC Associates, LLC

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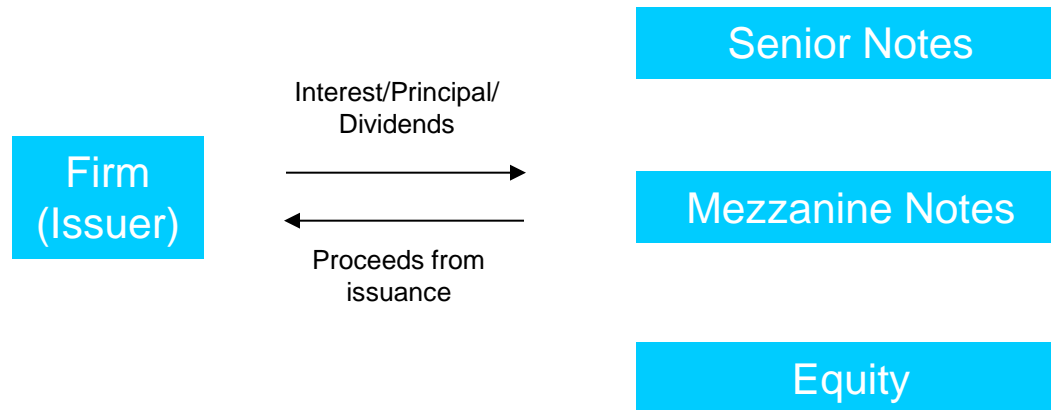
Jean-Batiste Carelus, Senior Principal

Defining Capital Structure Arbitrage

Capital-structure arbitrage is a strategy in which a firm's under-valued security is bought and the same firm's over-valued security is sold.

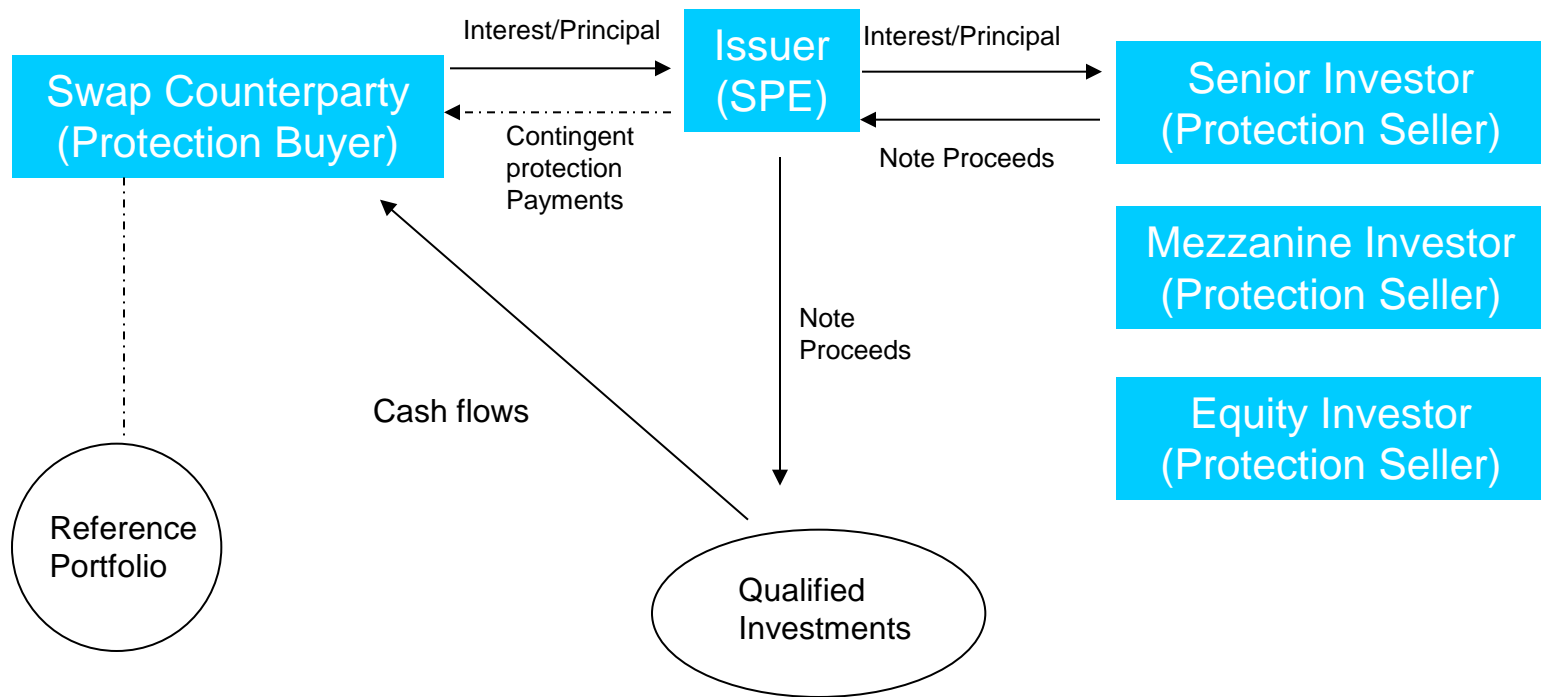
This presentation clarifies the difference between traditional and certain non-traditional CDO capital structure arbitrage transactions transacted prior to the Credit Crisis.

Capital Structure of Hypothetical Firm



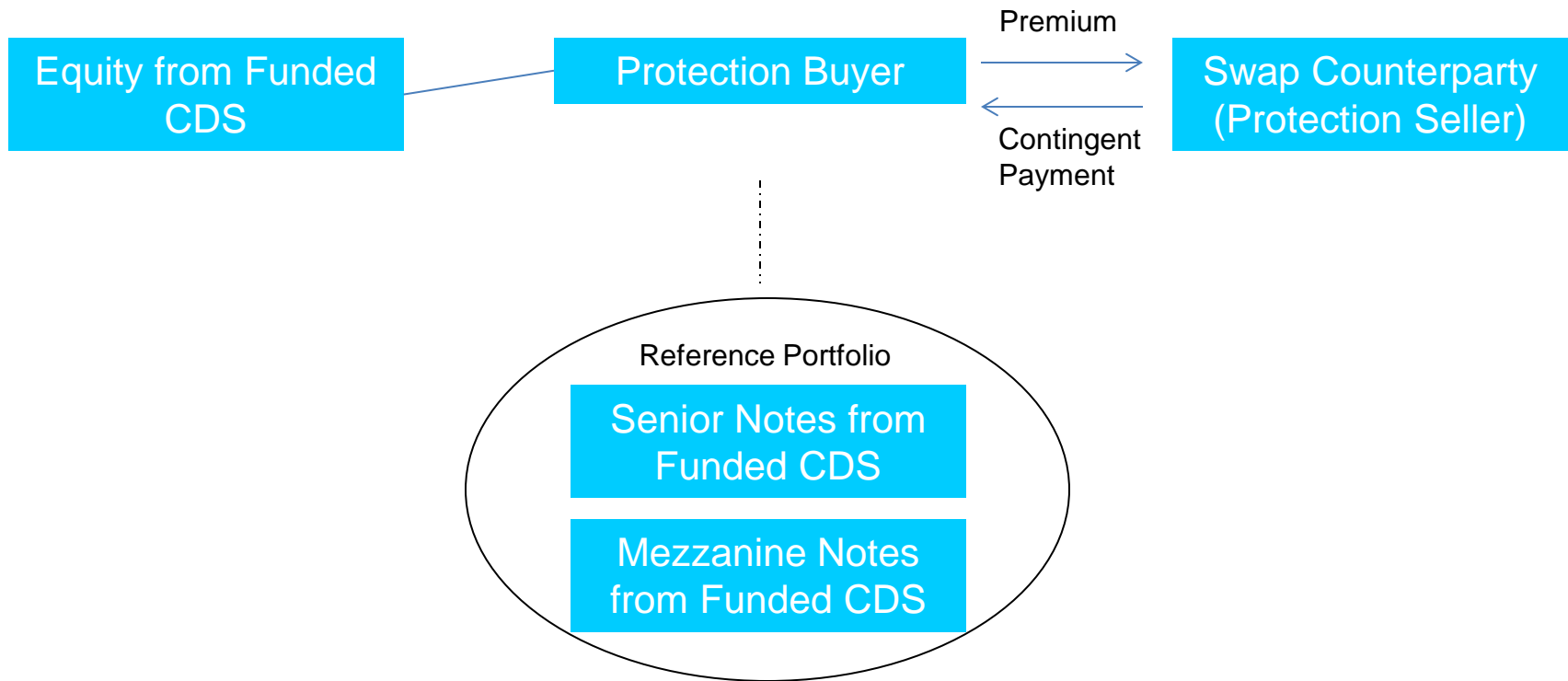
- An investor can arbitrage this Firm's capital structure by going long (buying now) the equity and shorting (selling now to repurchase later) the notes issued by the Firm.
- This is typically done through an arms-length transaction in an open market.
- The investor typically does not control investment decisions at the Firm.

Typical Funded Credit Default Swap



- Counterparty/Protection Buyer is unknown by the Investor/Protection Seller. Motivation of the Protection Buyer is easily concealed from the Investor/Protection Seller.

Typical Arbitrage of CDO Structure

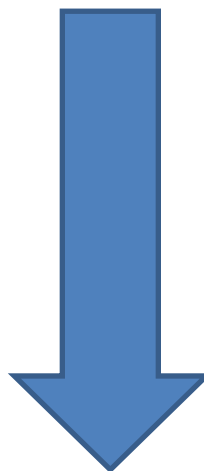


* Buying protection achieves the same result as shorting a security.

Initial Structure of Non-Traditional Trade

- No overcollateralization trigger allows payments to equity regardless of quality test status
- Early payment to equity erodes credit enhancement

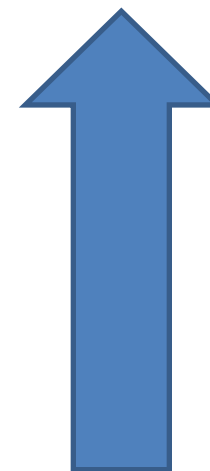
Payment of
interest and
principal



Senior Investor
(Protection Seller)

Mezzanine Investor
(Protection Seller)

Equity Investor
(Protection Seller)



Assignment
of losses

Non-Traditional Trade vs. Traditional Arbitrage

CDO Arbitrage Trade

- Requested creation of the CDO structure
- CDS is transacted between two parties – no transparency
- Trading on non-public information
- Significant control over investment decision

Traditional Arbitrage

- Firm is a publically traded company
- Short positions are transparent and monitored
- Trading on non-public information is prohibited
- No control over firm investment decision

Analysis of Non-Traditional Trade Requires...

- Experience reviewing and negotiating ISDA documents
- Experience performing collateral and cash flow analysis with industry standard models
- Access to industry standard data for peer analysis
- A team with experience across asset management, RMBS trading and securitization, rating agency analysis, and testifying experience

Team Biographies

Team Biographies

Ezra Zask, Founder and Managing Principal, has been actively managing, consulting, teaching and testifying about fixed income, structured products, investment management and hedge funds for over two decades. He has taught at the graduate schools of Yale, Princeton, Fordham and Carnegie Mellon. He founded a hedge fund focused on currency and fixed income arbitrage; managed large scale trading operations; worked extensively with hedge funds focused on structured products. He has served as a consultant and testifying expert in numerous cases involving structured products, including mortgage products, investment suitability, damages and hedge funds. He has testified in FINRA, ICC, AAA and JAMS arbitration; U.S. District Court; New York State Supreme Court; Delaware Court of Chancery and SEC administrative proceedings. He holds a B.A. Princeton and an M.A. and M.Phil. From Columbia Universities.

Jean-Baptiste Carelus is Senior Principal at SFC and President of JBC Economic Consulting Inc. Mr. Carelus has experience in the analysis of structured products, including residential mortgage backed securities (RMBS); cash, market value, and synthetic collateralized debt obligations (CDOs); credit default swaps (CDS); Closed-end Funds (ARPs); and Structured Investment Vehicles (SIV). He has more than 13-years of rating agency experience with over 7-years directly analyzing structured products as a member of the Standard & Poor's Structured Finance Ratings Group. He has consulted to hedge funds, mutual funds, financial guaranty insurers, and the staff of the Government Oversight Committee of the House of Representatives. He holds a B.A. in Politics and Economics from SUNY College at Old Westbury and an M.A. in Economics from CUNY Brooklyn College.

Team Biographies

Jack Chen provides advisory and consultancy services in litigation support (e.g., expert witness testimony), real estate investments and restructuring, financial analysis, business and organization management and capital structures. He is a recognized expert in structured finance where he has over 15 years' of experience and his product expertise includes cash and synthetic CDOs, CLOs, DPCs and SIVs. Mr. Chen began his career as an associate at Willkie Farr & Gallagher and then joined Sullivan & Cromwell with a practice in corporate law, securities and a concentration in structured finance. He left law to rate derivatives and structured products at Moody's Investors Service and then served as the Chief Operating Officer of HillMark Capital and then of Centerline Financial before founding Pronetik. Mr. Chen has been quoted or cited in the Wall Street Journal, Market Watch News Hub, Risk, Creditflux, Asset-Backed Alert and Structured Credit Investor.

Jeane Leschak is a former Mortgage Banker/Transaction Manager that has extensive experience in all facets of residential-mortgage-backed securitization (RMBS), RMBS ratings, risk management, compliance and origination. As Director at Nomura Securities International, Inc. she was responsible for building a multi-billion dollar RMBS business (i.e., fixed-rate, ARM, home equity and subprime transactions). She managed approximately 100 deal closings totaling over \$35 billion. Prior to joining Nomura, she served as Analyst at Moody's Investors Service where she analyzed and rated approximately \$9 billion in RMBS transactions. Ms. Leschak managed the mortgage origination operations at Atlantic Bank and Emigrant Bank, and as Vice President managed the mortgage due diligence operation at Salomon Smith Barney. Ms. Leschak is a Summa-cum-Laude graduate of St. Francis College and has extensive training in real estate finance.

Team Biographies

Thomas A. Fritz is a former Managing Director at S&P with the ABCP Ratings Group. He led the development, publication, and administration of ratings criteria for commercial paper conduits and synthetic securities criteria for single name and small pool derivatives. Mr. Fritz chaired criteria and rating committees analyzing over more than one trillion dollars of complex ABCP and bond structures. He holds a B.S. in Psychology from Missouri Valley College and an MBA from New York University.

Robert Maroney is a mortgage finance professional and credit analyst with 20 years experience including coordinating the loan level credit, regulatory compliance and property due diligence reviews for bulk whole loan purchases. He has provided instructions for underwriting review; reviewed underwriting exceptions; accepted/rejected loans for purchase; and managed the exception review process for seller repurchase demands.

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