LEGAL ISSUES FOR STRUCTURED FINANCE INVESTORS

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The David Doble Solicitors Publication for Institutional Investors

In the aftermath of the credit crisis – further reflections for investors

The problems that have beset the international structured finance market in the wake of the ongoing credit crisis continue to preoccupy investors and regulators. In the previous edition of this newsletter (Legal Issues for Structured Finance Investors, October 2007, which can be found at www.daviddoble.com/issues), we examined some of the important aspects of structured finance transactions that the ratings agencies do not analyse.

In this edition, we highlight a number of additional important considerations for investors in structured finance transactions.

The role of Investment Manager

The role of investment manager in Cash CDOs - to optimise the performance of the collateral portfolio - is well understood by the market and the terms and conditions of its appointment have been to a large extent standardised. The role of investment manager in synthetic CDOs has been subject to much greater evolution in recent years. Managing the portfolio of a Cash CDO will principally involve replacing assets from time to time or, as the case may be, reinvesting the proceeds of redemption of assets within the portfolio, in each case by way of a market sale and purchase.

The structure of synthetic CDOs may provide much greater flexibility and allow the investment manager to increase or decrease (within certain pre-established parameters) the subordination level of the relevant tranche of securities. In theory, any increase in the level of subordination will heighten the risk of loss of principal on the Notes and, conversely, any decrease will lower the risk of such loss. The incentive to effect a synthetic trade within the portfolio that results in an increase in subordination will be the payment of a notional amount (a "trading gain") into the "trading account".
The trading account will reflect the balance from time to time of trading gains and trading losses (which, in turn, result from any synthetic trade within the portfolio that leads to a decrease in the subordination level).

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DAVID DOBLE
SOLICITORS

t. +44 0207 831 1518
www.daviddoble.com

Of key interest, of course, is how a positive balance in this notional account is distributed between the Noteholders and the Investment Manager, and the timing of those distributions. As is explained in a recent report by Moody's Investor Service ("Collateral Manager Incentives, CDS Trading and Value Extraction in Synthetic CDOs"), it is important for investors to consider carefully the risk to principal created by transaction structures that entitle the Investment Manager to receive payment of some or all of the positive balance of the trading account at any point prior to the maturity date of the Notes. Moreover, it will be important in assessing risk to principal in any such transaction, for investors to consider more generally the terms of the Investment Manager's fees and whether fees accrue in all circumstances until the stated maturity, or whether in specified circumstances only, or whether only until redemption date of the Notes, if earlier than the stated maturity. Such considerations, again, may have an effect on the extent to which an Investment Manager is incentivised to make investment decisions based on short-term rather than long-term considerations.

A discussion platform for concerned investors

A number of institutional investors have, in response to the invitation in the previous edition of this newsletter, commented on the difficulties that exist in identifying and liaising with fellow investors in any particular transaction. This constraint is a feature of the way in which fixed income securities are typically held in the European clearing systems, Clearstream and Euroclear. The identities of holders are kept in strict confidence by the clearing systems.

Nevertheless, there is some consensus among those that have responded to us that it would be of great assistance to have access to a facility that would give institutional holders of international capital markets debt the opportunity to convene and participate in meetings with each other (whether "virtually" or face-to-face). This is particularly so in times of market turbulence when the occurrence of defaults and incidence of rating downgrades increases dramatically.

Discussions organised through such a platform might consider investors' concerns in relation to issues of CDOs (or other structured finance securities) which they hold in common.

Future editions of this newsletter will continue this discussion. As previously, if you would like to contribute your ideas or comments, please write to: issues@daviddoble.com.

Read on...

If you would like to:

- register to receive future editions of "Legal Issues for Structured Finance Investors" by email, or;
- suggest topics for discussion in future editions,

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ABOUT DAVID DOBLE SOLICITORS

Legal advisory to institutional investors...

David Doble Solicitors was established in London in 2005 to provide legal advice to institutions, within Europe and beyond, investing in complex structured financial instruments.

DAVID DOBLE
SOLICITORS

t. +44 0207 831 1518
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