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CLIENT
MEMORANDUM

CREDIT DEFAULT SWAPS IN THE HEADLINES: WHAT SENIOR MANAGEMENT NEEDS TO KNOW ABOUT HOW CDSs WORK, AND RECENT EFFORTS TO REGULATE CDSs

All Eyes on Credit Default Swaps

In recent months, credit default swaps ("CDSs") have been the subject of growing public scrutiny. As defaults by sellers of these unregulated instruments have risen, there has been a call for regulation at the state and federal levels, increased disclosure and transparency, and investigation into possible fraud and manipulation.

Those not intimately familiar with these popular and controversial financial instruments may be wondering how exactly CDSs work and why they are suddenly of such great concern to so many.

The following is a brief introduction to CDSs, outlining the basic mechanics of a CDS, and some recent developments in, and proposed future regulation of, the CDS market.

How Credit Default Swaps Work

A CDS is an over-the-counter negotiated contractual agreement between two counterparties designed to transfer credit risk. CDSs are most often documented using standard forms and definitions prepared by the International Swaps and Derivatives Association ("ISDA"). The protection "Buyer" makes a fixed payment (either up-front or periodically) to the protection "Seller", and the Seller agrees to pay a "Settlement Amount" to the Buyer under certain circumstances. The Settlement Amount is paid if a specified event or events (each a "Credit Event")[1] occur with respect to a specified company (the "Reference Entity") that is unrelated to the Buyer or the Seller.

The fixed payment that the Buyer pays for a CDS is based on the market's perceived likelihood, at the time the CDS is purchased, that a Credit Event will occur. The cost of purchasing protection on a Reference Entity will fluctuate as, among other market factors, public opinion of the Reference Entity improves or worsens.

The Settlement Amount that is ultimately paid by the Seller is a function of a hypothetical principal amount ("Notional Amount"), and the current market value, of a specified asset (the "Reference Obligation")[2] issued or guaranteed by Reference Entity at the time the Credit Event occurs. ISDA estimates that as of mid-2008, the aggregate Notional Amount of outstanding CDSs was approximately 55 trillion dollars.

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[1] Common examples of Credit Events include bankruptcy and payment default, but the parties to a CDS can contractually agree to name any Credit Events they wish.

[2] Common examples of Reference Obligations include municipal or corporate bonds, collateralized debt obligations, mortgage-backed securities, and various indices based on such debt obligations.

Many CDSs are purchased by a Buyer with an interest in the underlying Reference Obligation (or, if the Reference Obligation is an index, securities similar to those such index comprises) as a hedge against the Buyer's risk of loss on such Reference Obligation; for example, if the underlying Reference Obligation suffers a payment default, or the Reference Entity goes into bankruptcy, the Buyer would receive a Settlement Amount. Such a CDS is referred to as a "Covered Swap."

Additionally, a Buyer may purchase a CDS on a Reference Entity in which the Buyer does not hold any interest, in order to speculate (rather than hedge risk of loss) on the future creditworthiness of the Reference Entity (e.g., buying a CDS on a security issued by an entity in financial distress). Such a speculative CDS is referred to as a "Naked Swap," and is distinguished from a traditional insurance policy, which is usually only purchased on an "insurable interest" (i.e., an asset in which the Buyer holds an interest). As the price of a CDS increases or decreases with the Reference Entity's condition, the CDS can be traded (via assignment) by the Buyer.

In some cases, the Buyer of a CDS will require that the Seller post collateral in an amount sufficient to secure the Seller's obligation to pay the Settlement Amount. The amount of collateral that a Seller will be required to post under such a CDS will be related, in part, to the likelihood of a Credit Event, occurring (i.e., as a Credit Event becomes more likely, the Seller will have to post more collateral). However, the obligation to post collateral is a negotiated provision, and not a standard requirement of entering into CDS. As a result, Buyers that did not negotiate collateral provisions have unsecured claims against their protection Sellers. Even when CDSs are drafted so as to grant Buyers the right to request collateral from Sellers, some Buyers fail to exercise that right.

The Seller of a given CDS may in turn hedge its risk by purchasing a back-to-back CDS from another Seller on the same Reference Entity, subject to the same Credit Events; the second Seller may buy a third CDS from another Seller, and so on, in a continuing chain of risk reallocation.

Unregulated CDS Market and Increasing Defaults

CDSs are generally unregulated today. CDSs have been excluded from the definition of "securities" under the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "1934 Act") (other than antifraud and anti-manipulation provisions of the 1934 Act) and as such are not regulated by the SEC,[3] and the Commodity Futures Modernization Act of 2000 (the "CMFA") expanded the list of the derivative products, such as CDSs, that are exempt from regulation. Although not regulated by the state, disputes arising under CDS contracts are most often governed by New York State law. In September of this year, the New York State Insurance Department (the "NYSID") issued Circular Letter No. 19, which stated that the NYSID planned to begin regulating certain CDS contracts as insurance in January of 2009. However, the First Supplement to Circular Letter No. 19 issued on November 20 indicated that the NYSID would delay indefinitely its regulation of such CDS contracts and defer to the progress made toward comprehensive federal regulation of CDSs as discussed below.

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[3] CDSs are subject to the Investment Company Act of 1940.

In recent months, rising rates of payment defaults and bankruptcies among Reference Entities have led to increasing numbers of Credit Events under the CDSs that name such Reference Entities and increased demands for the payment of Settlement Amounts. However, the Sellers of such CDSs have also been experiencing financial difficulties, and some Sellers that did not collateralize their obligations under their CDSs may lack sufficient cash to pay such Settlement Amounts. In those cases where the Buyer of one CDS is the Seller in another back-to-back CDS, such party may default on the CDS for which it is a Seller if it does not receive payment on the CDS for which it is the protection Buyer, triggering a string of domino-effect defaults.

Additionally, as the creditworthiness of many Reference Entities has declined, and the likelihood that Credit Events will occur has increased, Buyers of CDSs that require collateral postings have made more frequent collateral calls on protection Sellers. Many of these Sellers have had difficulties meeting these collateral calls.

Furthermore, there have been recent allegations of market manipulation via purchase of naked CDSs. Because the price of a CDS is regarded as an accurate reflection of the creditworthiness of its corresponding Reference Entity, any steps taken to artificially change the price of a CDS may inappropriately affect the value of the related Reference Entity. In recent months, suspicions and allegations of short selling (purchasing Naked Swaps) of certain financial institutions have been increasing.

Recent Calls for Increased Regulation, Disclosure and Investigation

Without federal or state authorization to regulate CDSs, governmental agencies have been unable to take significant action to address what is perceived by many (whether justified or not) as an escalating chain reaction of default, economic loss, and possible fraud and manipulation. As a result, there have been a number of proposals for federal regulation of CDSs, and the institution of guidelines for increased disclosure and oversight.

The SEC - Request for Authorization and a Central Clearinghouse: The SEC has requested that Congress grant the SEC authority to regulate the CDS market.[4] Further, the SEC has called for the establishment of a central, unified clearinghouse for the sale of CDSs. Such a system would, the SEC argues, discourage fraud, alleviate the risk of individual Sellers being exposed to one another's credit risks, and allow the central counterparty to net individual CDSs against one another, reducing the liquidity issues now posed by an increasing number of defaults and requests for settlement in the intricate "web" of the current CDS market.[5]

[4] Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing, and Urban Affairs, United States Senate, September 23, 2008.

[5] In late September 2008, New York Governor David Patterson announced that the New York State Insurance Department was considering taking steps to (i) define covered CDSs as insurance policies, (ii) require protection Sellers to register with New York as insurance companies, and (iii) allow the New York State Insurance Department to regulate the covered CDS market. Gov. Patterson has since decided to postpone this plan following increased steps to regulate CDSs at the federal level.

The Senate and the CFTC - Bills Proposing a Central Clearinghouse: During the 110th Congress, which is now concluding, a substantial number of bills that would have provided for some increased regulation of derivatives were introduced. Although none of those bills were enacted into law, late in the Congress two influential Senators introduced bills in direct response to the concerns over the credit risks created by CDSs. S.3714, the "Derivatives Trading Integrity Act of 2008" (the "DTIA"), introduced by Senate Agriculture Committee Chairman Harkin (D-Iowa) and S.3691, the "Financial Regulation Reform Act of 2008" (the "FRRA"), introduced by Senator Collins (R-Maine), echo the SEC's call for a central clearinghouse and increased disclosure. However, the two bills reflect the continuing dispute in Congress and the private sector over what government agency is best suited to regulate CDSs.

The DTIA provides for the Commodity Futures Trading Commission (the "CFTC"), not the SEC, to establish and regulate the clearinghouse, based on Chairman Harkin's position that the CFTC is more qualified for such a task. The DTIA would also revise certain modifications to the Commodity Exchange Act (the "CEA") adopted under the CFMA (e.g., removing exemptions for CDSs from the ban on OTC trading, eliminating assumptions that CDSs do not qualify as illegal futures/gaming contracts, etc.).

The FRRA, on the other hand, provides for a joint effort by the SEC, the CFTC and the Board of Governors of the Federal Reserve System (the "Board") to establish and run the clearinghouse. The SEC would establish the initial rules regarding fraud and manipulation prevention, the Board would establish rules regarding examination of risk and information-reporting requirements, and the CFTC would be responsible for rules on position reporting and would handle ongoing regulation of the clearinghouse. The FRRA would revise the definition of CDSs to include all risk-transferring contracts (potentially encompassing within CDSs a variety of commercial contracts, i.e. letters of credit, guarantees, insurance, etc.). In addition, the FRRA would provide for the establishment of a Blue Ribbon Independent Commission to review the financial regulatory structure in the United States through hearings and investigation.

Since both President-elect Obama and Democratic and Republican leaders in Congress have indicated that financial market reform will be a priority in the early months of 2009, we expect that versions of the DTIA and the FRRA will be reintroduced in the new Congress, along with what will probably be a large number of other bills that propose other approaches to regulating CDSs. The primary goals of all of these bills will be increased transparency and disclosure in the CDS market and the prevention of market manipulation. We anticipate that Congress will pass, and President Obama will sign, a CDS regulation bill, either as stand-alone legislation or as part of a larger financial markets reform package.

Private Industry - Improved Public Information, Central Clearinghouse: On the private industry side, steps toward increased disclosure have already been taken by the Depository Trust and Clearing Corporation, which announced on October 31, 2008 that it would make weekly website postings of the gross and net values of CDSs for the top 1,000 Reference Entities. Industry participants have also made public statements supporting the central clearinghouse concept. In addition, there is growing interest among many CDS dealers and end-users in establishing a central clearinghouse on which parties could trade CDSs and that would eliminate counterparty credit risk. This idea is still evolving and further developments are expected.

Increased Accounting Disclosure Requirements: For public companies that are protection Sellers, increased accounting disclosure is already required pursuant to FASB Statement No. 133 and FASB Interpretation No. 45, in which the Financial Accounting Standards Board established broader disclosure requirements for reporting periods ending November 15, 2008 and beyond, including disclosure of the maximum settlement amount potentially payable under a provider's CDSs and the status of payment and performance risk thereunder.

SEC and NY Investigations into Fraud and Manipulation: Both the SEC's Division of Enforcement and a joint New York State and New York City taskforce have initiated investigations into possible market manipulation with respect to the CDS market. The investigations are continuing, so that it is unclear whether they will produce any significant enforcement actions or regulatory or other reform of the CDS market.

The Future of Credit Default Swaps

The spotlight that has been turned on the CDS market in recent months has yielded a multitude of demands and proposals for government and private responses. Given the size and economic impact of the CDS market, in the current uncertain economic climate it is important that investors and market participants develop a better understanding of how CDSs work, what benefits and risks they involve, and how they may be regulated in the future.

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This memorandum was prepared by Thomas French and Jack Habert. If you have any questions about this memorandum, please contact any of the members of the Willkie Farr & Gallagher Credit Crisis Task Force attached, or the attorney with whom you regularly work. The Task Force (which includes UK insolvency professionals from our strategic ally, Dickson Minto W.S., and attorneys from our European offices) was formed to respond to client questions and provide targeted advice in connection with the credit crisis.

December 17, 2008

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