MEMORANDUM FOR THE RECORD ("MFR")

Event: Interview with Jamie Mai and Ben Hockett of Cornwall Capital, Inc.

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Team Leader: Dixie Noonan

Location: Offices of Cornwall Capital, 745 Fifth Avenue, 7th Floor, New York, NY 10151

Participants - Non-Commission: Jamie Mai and Ben Hockett of Cornwall Capital, Inc.; William H. Gussman, Jr. of Schulte Roth & Zabel LLP

Participants - Commission: Dixie Noonan

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Note: This is a summary of the interview and the dialogue is paraphrased. It is not a transcript and should not be quoted as such.

Summary of the Interview or Submission:

*Jamie recommended the book, "How I Caused the Credit Crisis," written by a former Goldman trader, which is currently available only in the Kindle edition.

The October 6, 2006 *Grant's Interest Rate Observer* was what gave Cornwall the idea for their trades shorting subprime MBS through credit default swaps. The article includes a chart from Paul Singer, general partner of Elliott Associates, showing that if home prices stay flat to appreciating by 4%, the entire double-A tranche of a subprime CDO would fail. It shows that the triple-A tranche of a subprime CDO would be partially wiped out if home prices depreciated by 0 to -4%, and that the entire triple-A tranches of subprime CDOs would be wiped out if home prices depreciated by -4% to -7%. Cornwall's strategy was to buy credit default swap protection on the double-A tranche of subprime CDOs.

Ben and Charlie Ledley[1] had also seen a September 8, 2006 issue of *Grant's Interest Rate Observer* with another article about subprime MBS and CDOs, which stated: "For institutional investors equipped to deal in credit default swaps, there's an opportunity to lay down a low-cost bearish bet."

House prices had already started to fall in 2006. They peaked in the fall of 2005 (Shiller index would show for sure).

Cornwall has been told that most hedge funds involved at the ABS level were buying protection on the triple-B tranche of subprime RMBS.

It wasn't until sometime in 2006 that the market came out with CDS (credit default swaps) on CDOs. The only way to get short exposure was through CDS.

Pay-As-You-Go ("PAUG") – allows the security to reference assets with unknown cash flows and where the notional can change over time depending on underlying.

The ISDA Master Agreement ("MA") outlines the relationship between the fund and the dealer. The "Confirmation," for example, a PAUG Confirmation, wasn't in the MA. It was a confirm issued upon the time of the trade concerning how the trade could work.

The ISDA MA is a contract you enter into once with each dealer; not for individual deals.

Ever since Long Term Capital Management, dealers required an ISDA MA to transact in derivatives even if no credit risk is involved.

The Credit Support Annex ("CSA") specifies how the collateral is to be calculated/posted. The Confirmation specifies the details for each individual transaction.

The PAUG Confirmation for CDO trades had language not incorporated into the ISDA MA, and Ben believes that the Confirmation trumps the ISDA MA where there is conflict.

In theory, you are able to negotiate the CSA. In practice, it was like pulling teeth just to get Cornwall Capital to be able to trade in CDS.

Cornwall was able to pull collateral if they made money on their trades, but the contract (not sure whether MA, CSA or Confirmation) allowed the dealer, usually Bear Stearns, to determine an independent amount of collateral that Cornwall was required to post, at Bear's discretion. In Cornwall's experience, the independent amount tracked the collateral that should have been posted to Cornwall when they made money on their trades. Meaning, if Cornwall's trades moved in their favor, Cornwall should have been able to require Bear to post collateral, but instead, Bear would up the independent amount it required Cornwall to post to offset.

[1] Charlie Ledley was with Cornwall Capital until Spring 2010.

*In a fractional reserve banking system, anything can cause a liquidity problem. CDOs made this far more likely because they increased leverage a lot. There did come a point when derivatives weren't just transferring risk, but creating it.

Synthetic CDOs were originally called balance sheet loans (because they were used to offset credit risk from assets held on balance sheet). They were also originally conceived to diversify risk, and included all sorts of different assets with cash flows.

The tipping point – Securitizations are probably a good thing. Securitizations of securitizations, maybe. The point when the CDO became used to aggregate the same type of assets, it fundamentally ceased to serve the purpose of diversification. Correlation assumptions make sense if the CDO assets are diverse, but the correlation assumptions don't make sense in subprime CDOs. At some point in 2004-2005 going forward, the tail started wagging the dog.

You could create an infinite number of CDOs on a finite number of assets. This was driven by ratings-based buyers (and there was a regulatory component; European banks don't have to hold capital against triple-A rated assets, meaning that their triple-A liabilities weren't on their balance sheets).

For example, IKB bank (in Europe) could buy a bond with borrowed cash (and could borrow/fund below LIBOR for many years). Ben's suspicion is that you needed the German bank to buy CDOs and pay cash for it (because they can borrow for free). It's not held on the German bank's balance sheet. Once the bond is created, there is a CUSIP that is created for that tranche and you can find it on Bloomberg. This allowed AIG to do unfunded positions on that pool, and trade CDS on it.

Cornwall participated at the CDO level, and wasn't able to be too choosy. Cornwall knew from reading research that they wanted to buy CDS on double-A tranches of CDOs. They went to banks and said they wanted to buy CDS on double-A tranches. Banks would come back with a list of 1-10 tranches on which Cornwall could buy CDS protection. Cornwall used Lehman Live to get information on the tranches on the list. (This showed what % the CDO's assets were made up of, and also attachment and detachment points for liability on the tranches. Some would have larger equity tranches at the bottom, and the attachment point would show this.) Intex, a more robust data source on underlying loan pools, would not even return Cornwall's phone calls.

Cornwall didn't know how to distinguish between cash and synthetic CDOs. They didn't know if the underlying collateral was synthetic. Jamie said this may not have mattered, though. Cornwall did mostly old deals – 2005 and 2006.

CDO managers manage pools that are either static or dynamic. The deals were all dynamic until a certain point when the static pool was introduced, which was relatively later. Cornwall believes that all of its trades were dynamic.

To know whether a pool is dynamic or static, look in the CDO prospectus under "Reinvestment Period."

CDO trustees issue quarterly trustee reports regarding the assets in the pools. Cornwall did not receive these reports (presumably they went to the long investors).

In 2005, Ben started the process of getting Cornwall's ISDA.

Cornwall counterparties – Bear Stearns – sales – Andrew Javorsky in structured credit sales (not a trader). It was unclear how much the sales guys knew. Brett Perlmutter worked with Cornwall on the first round of CDO trades Cornwall did. Cornwall met the Bear traders once in Las Vegas.

Stacy Strauss at Morgan Stanley.

Greg Donohue, salesperson at Deutsche Bank. (Per Lewis's book, he had never had his own client before.) Ben had a relationship with Deutsche because he worked there for 8 years.

Cornwall had seen Greg Lippmann's deck about shorting subprime securities. They also had a couple of conversations with a trader to help them understand how it worked and the structure of the trades – Rich Rizzo. Cornwall went to Deutsche Bank – Deutsche didn't pitch them.

[Cornwall thought it was important to pay attention to the fixed or variable cap, which is what implied a write-down on the securities or not. This is important for mark to market of the CDO vs. waiting for underlying cash flows of underlying bonds.]

It wasn't standard for Cornwall to get to see deal prospectuses. They may have seen one or two.

The spread on Cornwall's trades is not necessarily comparable to other trades because they may have been buying protection on a different tranche (or a tranche rated differently). They were paying 65 basis points getting in on the CDS trades on double-A tranches. Burry was paying more because he was buying CDS on a different tranche.

Cornwall never had to post variation margin, which you post when you're losing money. They did post initial margin – premium payments – maybe 1-1.5% of notional. Looking at their marks might be more interesting. These would be shown on the monthly broker statements. Documents underlying one trade, e.g., collateral and marks – it's easy to give us the marks that are in the Cornwall system (rather than dig up emails that show what the dealers marks were on a given deal).

All of Cornwall's profit was made when they sold their positions. Their marks were never moved before then.

If Cornwall was paying 50 basis points, that's 0.5% per year running the life of the trade (assuming a 5 year trade, this means Cornwall would pay 2.5% over the life of the deal).

Cornwall believes that dealers were offering protection on the same tranches for which Cornwall held protection at a price of 30-40% of notional (i.e., 3000-4000 basis points). In other words, it was selling for 80 times what Cornwall had bought at, or 80 times what the dealers were marking Cornwall's positions at.

The source for this was Ben talking to people in the market. Banks weren't marking positions. Someone (either at Deutsche or Morgan Stanley he thinks) told Ben that one position Cornwall owned was traded at a much higher level (price). This made Cornwall believe that their dealers weren't marking the Cornwall positions appropriately (and in a way that would be favorable to Cornwall). By the time banks were trading in price up front, information from Bear shut down.

Banks were still publishing research showing a minor widening – only 60 to 70 basis points. I.e., investment banking research was understating the size of sell off in the market. Deals were continuing to get issued at 50 basis points.

Possible source of information at the banks –

BWICS or OWICS – bid with intent to close or offer with intent to close.[2] This is where a list is sent to all banks, and there is an auction the next day. Dealers participate by bidding, and if they don't win the bid, they are still usually given feedback on where the bonds are trading. This may not be a meaningful source of information; it may be done for price discovery purposes. In any event, this is where Ben believes some of the information came from that he got from banks about Cornwall's positions trading significantly higher than dealers were currently marking Cornwall's positions.

Looking at the list of Cornwall trades that Ben Hockett emailed in advance, re: ACABS 2006-1A A2l – This was one of the bonds that Cornwall was getting market information on. This bond was leading the market down in Cornwall's portfolio. Ben thinks the information he got on this bond came from Deutsche or Morgan Stanley. They would probably be less likely to tell Cornwall if they'd actually won the BWIC or OWIC auction; probably they bid, lost, and then got soft information from the buyer.

Another deal listed – TOURM 2005-1A III – (Tourmaline) – Jamie said this was another interesting deal. It was managed by Blackrock. There was chatter that Blackrock, the CDO manager, might be creative in the way it was trading. (Perhaps managing CDOs and shorting?)

The FCIC could subpoena bid-asks on a couple of Cornwall's positions from February to June 2007 and compare the marks given to Cornwall on their positions vs. the price at which the dealers were selling the same protection at that time. Cornwall will send FCIC underlying information and monthly marks on a couple of positions that the FCIC can use to gather this information from dealers.

[2] According to Investopedia, BWIC stands for "Bid Wanted in Competition."

Cornwall also suggested – Find CDOs that had a settle date (the date brought to life) after the TABX was invented, on Feb. 21, 2007 – This is when the market was clearly going down. Find out who bought, at what level, and what trades were going on on the other side, or week after. I.e., 2 weeks later trading at 50 cents on the dollar. Certainly 6 months later.

The TABX – referenced a nasty pool of late 2006 mortgage (2007 CDOs).

Bear & Deutsche didn't believe the TABX decline impacted the marks on Cornwall's trades. (In other words, the TABX lost 50% in value, but Cornwall's marks didn't move. Since both were re: subprime securities, Cornwall thought their marks should have moved in their favor after TABX.) Even as late as May 2007, Bear didn't think the TABX had anything to do with Cornwall's 2004 and 2005 vintages.

Counter-arguments – the TABX is not really reflective, it references the ABX, which is only 18 securities. [Ben forwarded me an email that he received from an investment banker with the counterarguments the banks were making.]

Feb. 26, 2007 – ACA – Roadshow presentation – 5 days after the TABX when they were marketing the deal. It didn't close until March.

Cornwall never picked the bonds that went into the securities it shorted.

*The causes of the financial crisis were set largely before February 2007. If looking at suspicious behavior, look at February 2007-forward.

Cornwall met with the SEC in the spring of 2007. Jamie will separately email the names of the people they met with. The meeting related to what Cornwall saw as the root of the mess in structured finance – ratings agencies – abrogating the need for traditional price discovery and due diligence. Also, ratings are baked into legislation and mandates of registered advisory firms. There was a massive amount of gaming going on to meet mandates. Rating agencies' processes lacked integrity. SEC shouldn't let rating agencies masquerade as though they had imprimatur of a government agency. The SEC's response – they listened, were cordial, and Cornwall never heard back from them.

Ben – regarding derivatives: Energy markets post-Enron – did a great thing in getting everything on an exchange. (There's a difference between <u>trading</u> on an exchange and <u>clearing</u> on an exchange. Clearing shows what trades are happening and at what prices, but does not show who the counterparties to the trades are.) It's still an OTC market, but trades are posted on an exchange and don't depend on liquidity on exchange. People have told Ben this is a great blueprint, that the energy market is now much more transparent.

If all CDS had been posted to an exchange (limits customization), the counterparty becomes the exchange, and there is no "too big to fail" unless the exchange fails. The exchange could still fail, it's funded by its members, but you would see it coming. The aim is getting rid of the

counterparty credit issue and TBTF risk. (You may not need to go so far as to post the names of the parties on the trades.)

Depository Trust and Clearing Corporation (DTCC) – undertook an aggregation process, different from an exchange or clearinghouse.

Beyond this, the concept of trading derivatives on stuff that doesn't exist – e.g., $1 trillion CDOs on $1 billion in assets – this is massive, hidden leverage. Ben doesn't know how to get at this – maybe to limit synthetic beyond notional.

Jamie – The whole construct of CDS – there is some social utility – but need to take a hard look, especially regarding the collateral aspect. Without CDS, there would be no "too big to fail" – it's 100% a function of CDS. Not all CDS are bad, but eliminating them would eliminate the "too big to fail" problem.

Cornwall has no interest in CDS going forward. They lost faith in the integrity of the CDS market.

They were also becoming an unsecured creditor of Bear Stearns, and closed out of most all of their trades in August 2007; the last in September 2007. Cornwall had already made half the money they ever would have made on the positions.

If the Fed or a government agency had stepped in during 2006-2007, and guaranteed all mortgages and disallowed prepayments, Cornwall would have lost a lot of money. But there never would have been a credit crisis (other than a sovereign credit crisis). This meant that there was some tail risk for Cornwall here; they thought the government might do this.

Jamie was surprised by the paucity of private rights of action, particularly to sue the rating agencies. (They thought about forming a nonprofit to sue the rating agencies.) You don't solve the problem without fixing the credit rating agencies. This is needed to restore integrity in the markets. It's unclear why you need them in the first place. Or you could make the buyer of the bond pay for them (rather than the seller, which is the current set up). Probably can't get rid of them entirely, given that ratings are built into so many statutes and mandates. Ben wonders if it would be possible to marry the rating agencies with the bond insurance companies, to make the rating agencies have skin in the game.

You have to have interests aligned, whether in transactions where the agent is actually the counterparty and not disclosing, or getting CDO bonuses on year one. There is an incentive for a rational person to take risk they're ultimately not going to bear.

Same for risk capital being aligned with losses as well as gains – equity and bondholders – longer term the moral hazard is significant.