IN RECENT YEARS, our investment bank clients have been increasingly focused on structures that use an embedded credit default swap or credit exposure as a central or ancillary element of a transaction. We have been closely involved in developing these structures and executing transactions using these features. For example, we have worked on variable rate funding notes linked to hedge fund performance where the transactions were based on a sharing of credit risk between two or more financial institutions. We have designed credit default swaps for these and other structures involving the transfer of credit exposure through fixed income products. Where liquidation of the underlying collateral may affect capital treatment of a transaction (which often is the case for international clients), we have structured products that meet the requirements of a number of different regulatory schemes.

In 2006, we closed 15 transactions incorporating credit default swaps the reference assets of which were notes linked to hedge fund interests. In some cases, these transactions employed special purpose vehicles, such as when an existing issuer transferred its hedge fund interests into a newly-formed segregated portfolio company in order to be afforded the benefits of a recently-adopted British Virgin Islands statute that recognizes ring-fencing of a company’s assets. Working with our financial services and bank regulatory colleagues, we structured and documented these transactions in a manner that resulted in the desired segregation of the financed assets while protecting priority and perfection of security interests relative to other potential creditors of both the former issuer and the newly-formed segregated portfolio company.

We also have been called upon by our clients who are major issuers or distributors of structured notes under medium-term note programs to customize privately placed or other exempt note issuances that use a reference credit default swap to determine principal or interest payment amounts. These embedded CDS have referenced traded credit default indices, large customized baskets of reference entities, narrower customized baskets and even a single reference entity. The loss exposures in
these notes have covered various credit rating levels, with lower rated instruments posing different tax and ERISA issues than higher rated instruments. We have worked closely with our clients to develop several novel structures where the credit risk is tested over multiple periods, with the cumulative or formulaic results of those tests affecting principal or periodic interest payments.