

## **Basis Yield Alpha Fund** (the "Fund")

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Dear Shareholder,

As shareholders will be aware, the Basis Yield Alpha Fund (Master) (Master Fund) purchased Timberwolf securities from Goldman in June 2007 and is presently suing Goldman over that transaction in the United States District Court in New York. The directors of the Master Fund maintain their resolve to continue to pursue the claim against Goldman.

As many of you will also be aware, on 13 April 2011, the United States Senate's Permanent Subcommittee on Investigations (**Investigations Subcommittee**), chaired by Senator Carl Levin, released a report entitled *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (**Senate Report**) which included, among other things, a case study on Goldman Sachs and its creation and sale of the Timberwolf securities to Basis and other investors. When releasing the Senate Report, Senator Levin said: "*Our investigation found a financial snake pit rife with greed, conflicts of interest, and wrongdoing*".

Basis is pleased that the U.S. Senate's thorough investigation of Goldman and Timberwolf has placed a spotlight on Goldman's conduct and placed in the public record Goldman's own internal communications that make clear what Basis has said all along: Goldman deliberately lied in selling the Timberwolf security to Basis.

The Senate Report is the culmination of an investigation, commenced by the Investigations Subcommittee in November 2008, into some of the key causes of the financial crisis. In conducting the investigation, the Investigations Subcommittee "*...has engaged in a wide-ranging inquiry, issuing subpoenas, conducting over 150 interviews and depositions, and consulting with dozens of government, academic, and private sector experts.*" The Master Fund's directors and Basis Capital Funds Management Limited are pleased to have been able to assist the Investigations Subcommittee with its inquiry. A copy of the Investigation Subcommittee's press releases of 13 April 2011 is attached with this letter. If shareholders wish to view a copy of the Senate Report and its exhibits, they may do so by using this link <http://levin.senate.gov/newsroom/release.cfm?id=332491> and scrolling to the bottom of the document. Alternatively, further detail from the Senate Report is set out in the annexure to this letter.

The Senate Report details that with respect to Timberwolf:

- Goldman was the single largest source of assets, providing 36% of the assets by value, including US\$15 million in single name CDS contracts naming Abacus securities; the Pitch Book, however, stated that “All assets will be purchased from the market”;
- By the time Greywolf (collateral manager) and Goldman were nearing completion of the acquisition of the Timberwolf assets in March 2007, Goldman was becoming increasingly concerned about the deteriorating subprime mortgage market and the falling value of the assets in its CDO warehouse accounts, including assets that went into Timberwolf, and that as a result, bringing Timberwolf securities to market and selling them quickly became a high priority for Goldmans;
- By 20 May 2007, Goldman’s own internal staff considered that “the risks of the RMBS underliers are frequently not fully reflected in the marks on the CDOs [referenced in the Timberwolf portfolio]” and that “based on the [underlying] RMBS marks” the price for the A2 [junior AAA] Timberwolf securities (which Goldmans would sell to the Fund in mid June 2007 for a price of 84.33 cents in the dollar) was only 24 cents in the dollar;
- Following a presentation on Sunday 20 May 2007 during which the Goldman’s Mortgage Department expressed its concern to CFO David Viniar about the synthetic CDO positions held by Goldman, including Timberwolf, Goldman decided to target four fund managers, including Basis Capital as potential buyers of those synthetic CDO securities and to incentivise its salespeople by offering “ginormous sales credits”;
- Goldman aggressively pursued Basis Capital to buy highly rated Timberwolf securities with a face value of US\$100 million, including setting up a call with the head of its New York trading desk to “clarify any and all questions you have on the marking policy of Goldman...and the overall trading that has been seen by the [Goldman] desk in the last 1-6 weeks.”
- During the sales process Goldman failed to disclose the fact that it did not consider the value of the securities to be anywhere near the prices they were marketing them at and that they had a substantial short position with respect to the deal. The Pitch Book stated that Goldman expected to invest in 50% of the Equity of the deal, creating the impression of an alignment of interests between Goldman and prospective long investors, when, in fact, the size of its short position dwarfed any interest Goldman might have had in the long position.

We will continue to inform shareholders of any new developments with respect to the claim as and when they occur.

Yours faithfully,

Peter Dobson

on behalf of **Basis Yield Alpha Fund**

## Annexure 1

### Goldman's conflict of interest

At page 377 of the Senate Report, the Subcommittee reaffirms its findings of fact of April 2010 with respect to Goldman's conduct, including that:

*"In 2007, Goldman went beyond its role as market maker for clients seeking to buy or sell mortgage related securities, traded billions of dollars in mortgage related assets for the benefit of the firm without disclosing its proprietary positions to clients, and instructed its sales force to sell mortgage related assets, including high risk RMBS and CDO securities that Goldman Sachs wanted to get off its books, and utilising key roles in CDO transactions to promote its own interests at the expense of investors, creating a conflict between the firms proprietary interests and the interests of its clients."*

The Senate Report concludes that its Goldman Sachs case study identifies a number of practices that raise conflicts of interest concerns, including:

- Goldman shorting securities it had created;
- Goldman failing to disclose key information to investors e.g. that Goldman's interests were not aligned with investors interests as represented in the Pitch Books;
- Goldman misrepresenting the source of the assets of its CDOs;
- Goldman taking immediate post sale markdowns causing their clients to suffer immediate losses and requiring them to post additional cash collateral;
- Goldman using poor quality loans from lenders with a history of issuing high risk, poor quality loans to which Goldman had supplied securitisation services and warehouse accounts;
- Goldman concealing its net short position from late 2006 through 2007.

### Disclosure obligations

The Senate Report notes that whether acting as underwriter or placement agent [as Goldman was with respect to the Timberwolf transaction], a major part of the investment bank's responsibility is to solicit customers to buy the new securities being offered. Under the securities laws, an issuer selling new securities to potential investors has an affirmative duty to disclose material information that a reasonable investor would want to know. The Senate Report continues to say that Goldman's marketing and solicitation efforts to sell certain RMBS and CDO securities, including Timberwolf, to clients raises multiple questions about whether Goldman met its obligation to disclose material adverse information to potential investors and whether it fulfilled its obligation to avoid material misrepresentations and omissions of material facts (such as its net short position or adverse view of the quality of the underlying assets) when recommending the purchase of those securities.

## Timberwolf

The Senate Report (at pages 623-624) contains this assessment of Goldman with respect to the sale of the Timberwolf CDO:

*With respect to Timberwolf, Goldman personnel knew that the CDO's assets had begun losing value almost from the time they were acquired. Timberwolf was a CDO<sup>2</sup> transaction comprised of 56 different CDO assets with over 4,500 unique underlying securities. In February 2007, Mr. Sparks told a senior Goldman executive that it was a deal "to worry about," and that its assets had already incurred such significant losses that they had exhausted the share of the warehouse risk held by Goldman's partner in the transaction. Despite that loss in value, Goldman continued with the issuance of the Timberwolf securities in March 2007. By May, a special CDO valuation project undertaken by the Mortgage Department found that the Timberwolf's assets had lost still more value. Despite its lower internal valuation, Mr. Sparks advised Goldman senior executives that his CDO pricing strategy was to "take the writedown, but market at much higher levels" to avoid "leaving some money on the table."*

*During the spring and summer of 2007, Goldman aggressively marketed Timberwolf securities to investors around the world, eventually selling about \$853 million in Timberwolf securities to 12 investors. Goldman sold the securities at prices substantially above its internal book values for the Timberwolf securities. After making a sale, Goldman then, sometimes only days or weeks later, marked down the value of the securities it had sold, resulting in investors realizing losses and sometimes requiring the investor to post additional cash margin or collateral. In September 2007, an internal Goldman analysis found that, in just six months, Timberwolf's AAA rated securities had lost 80% of their value. One of Goldman's senior executives monitoring Timberwolf pronounced it "one shitty deal." The CDO was liquidated in October 2008, and the investors who purchased Timberwolf securities lost virtually their entire investments.*

*Goldman CEO Lloyd Blankfein said publicly about the firm's securities: "If we believed it would fail ... the security wouldn't work, we would not sell it." But Goldman marketed the Anderson and Timberwolf securities to clients knowing that each CDO had poor quality assets that were continually losing value. It marketed them at the same time it was investing on the short side of the CDOs and the subprime mortgage market as a whole, and its Mortgage Department head was telling his staff that it was "Game Over" and time to "get out of everything." Within a year, the Anderson and Timberwolf securities were virtually worthless. Given what Goldman knew when marketing Anderson and Timberwolf, Goldman was recommending investments that were most likely not suitable for any investor.*

M I C H I G A N

**Carl Levin**  
UNITED STATES SENATOR

FOR IMMEDIATE RELEASE  
April 13, 2011

Contact: Senator Levin's Office  
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## **Senate Investigations Subcommittee Releases Levin-Coburn Report On the Financial Crisis**

WASHINGTON – Concluding a two-year bipartisan investigation, Senator Carl Levin, D-Mich., and Senator Tom Coburn M.D., R-Okla., Chairman and Ranking Republican on the Senate Permanent Subcommittee on Investigations, today released a **635-page final report** (PDF, 6MB) on their inquiry into key causes of the financial crisis. The report catalogs conflicts of interest, heedless risk-taking and failures of federal oversight that helped push the country into the deepest recession since the Great Depression.

*Links to the full report and the exhibits are available at the bottom of this page.*

"Using emails, memos and other internal documents, this report tells the inside story of an economic assault that cost millions of Americans their jobs and homes, while wiping out investors, good businesses, and markets," said Levin. "High risk lending, regulatory failures, inflated credit ratings, and Wall Street firms engaging in massive conflicts of interest, contaminated the U.S. financial system with toxic mortgages and undermined public trust in U.S. markets. Using their own words in documents subpoenaed by the Subcommittee, the report discloses how financial firms deliberately took advantage of their clients and investors, how credit rating agencies assigned AAA ratings to high risk securities, and how regulators sat on their hands instead of reining in the unsafe and unsound practices all around them. Rampant conflicts of interest are the threads that run through every chapter of this sordid story."

"The free market has helped make America great, but it only functions when people deal with each other honestly and transparently. At the heart of the financial crisis were unresolved, and often undisclosed, conflicts of interest," said Dr. Coburn. "Blame for this mess lies everywhere from federal regulators who cast a blind eye, Wall Street bankers who let greed run wild, and members of Congress who failed to provide oversight."

The Levin-Coburn report expands on evidence gathered at four Subcommittee hearings in April 2010, examining four aspects of the crisis through detailed case studies: high-risk mortgage lending, using the case of Washington Mutual Bank, a \$300 billion thrift that became the largest bank failure in U.S. history; regulatory inaction, focusing on the Office of Thrift Supervision's failed oversight of Washington Mutual; inflated credit ratings that misled investors, examining the actions of the nation's two largest credit rating agencies, Moody's and Standard & Poor's; and the role played by investment banks, focusing primarily on Goldman Sachs, creating and selling structured finance products that foisted billions of dollars of losses on investors, while the bank itself profited from betting against the mortgage market.

**New Evidence.** Today's report presents new facts, new findings and recommendations, with more than 700 new documents totaling over 5,800 pages. It recounts how Washington Mutual aggressively issued and sold high-risk mortgages to Wall Street, Fannie Mae, and Freddie Mac, even as its executives predicted a housing bubble that would burst, and offers new detail about how its regulator deferred to the bank's management. New documents show how Goldman used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold CDOs in ways that created conflicts of interest with the firm's clients and at times led to the bank's profiting from the same products that caused substantial losses for its clients. Other new information provides additional detail about how credit rating agencies rushed to rate new mortgage-backed securities and collect lucrative rating fees before issuing mass ratings downgrades that shocked the financial markets and triggered a collapse in the value of mortgage related securities. Over 120 new documents provide insights into how Deutsche Bank contributed to the mortgage mess.

"Our investigation found a financial snake pit rife with greed, conflicts of interest, and wrongdoing," said Levin. Among the report's highlights are the following.

- **High Risk Lending.** With an eye on short term profits, Washington Mutual launched a strategy of high-risk mortgage lending in early 2005, even as the bank's own top executives stated that the condition of the housing market "signifies a bubble" with risks that "will come back to haunt us." Executives forged ahead despite repeated warnings from inside and outside the bank that the risks were excessive, its lending standards and risk management systems were deficient, and many of its loans were tainted by fraud or prone to early default. WaMu's chief credit officer complained at one point that "[a]ny attempts to enforce [a] more disciplined underwriting approach were continuously thwarted by an aggressive, and often times abusive group of Sales employees within the organization." From 2003 to 2006, WaMu shifted its loan originations from low risk, fixed rate mortgages, which fell from 64% to 25% of its loan originations, to high risk loans, which jumped from 19% to 55% of its originations. WaMu and its subprime lender, Long Beach Mortgage, securitized hundreds of billions of dollars in high risk, poor quality, sometimes fraudulent mortgages, at times without full disclosure to investors, weakening U.S. financial markets. New analysis shows how WaMu sold some of its high risk loans to Fannie Mae and Freddie Mac, and played one off the other to make more money.
- **Regulatory Failures.** The Office of Thrift Supervision (OTS), Washington Mutual's primary regulator, repeatedly failed to correct WaMu's unsafe and unsound lending practices, despite logging nearly 500 serious deficiencies at the bank over five years, from 2003 to 2008. New information details the regulator's deference to bank management and how it used the bank's short term profits to excuse high risk activities. Although WaMu recorded increasing problems from its high risk loans, including delinquencies that doubled year after year in its risky Option Adjustable Rate Mortgage (ARM) portfolio, OTS examiners failed to clamp down on WaMu's high risk lending. OTS did not even consider bringing an enforcement action against the bank until it began losing substantial sums in 2008. OTS also failed until 2008, to lower the bank's overall high rating or the rating awarded to WaMu's management, despite the bank's ongoing failure to correct serious deficiencies. When the Federal Deposit Insurance Corporation (FDIC) advocated taking tougher action, OTS officials

not only refused, but impeded FDIC oversight of the bank. When the New York State Attorney General sued two appraisal firms for colluding with WaMu to inflate property values, OTS took nearly a year to conduct its own investigation and finally recommended taking action -- a week after the bank had failed. The OTS Director treated WaMu, which was its largest thrift and supplied 15% of the agency's budget, as a "constituent" and struck an apologetic tone when informing WaMu's CEO of its decision to take an enforcement action. When diligent oversight conflicted with OTS officials' desire to protect their "constituent" and the agency's own turf, they ignored their oversight responsibilities.

- **Inflated Credit Ratings.** The Report concludes that the most immediate cause of the financial crisis was the July 2007 mass ratings downgrades by Moody's and Standard & Poor's that exposed the risky nature of mortgage-related investments that, just months before, the same firms had deemed to be as safe as Treasury bills. The result was a collapse in the value of mortgage related securities that devastated investors. Internal emails show that credit rating agency personnel knew their ratings would not "hold" and delayed imposing tougher ratings criteria to "massage the ... numbers to preserve market share." Even after they finally adjusted their risk models to reflect the higher risk mortgages being issued, the firms often failed to apply the revised models to existing securities, and helped investment banks rush risky investments to market before tougher rating criteria took effect. They also continued to pull in lucrative fees of up to \$135,000 to rate a mortgage backed security and up to \$750,000 to rate a collateralized debt obligation (CDO) – fees that might have been lost if they angered issuers by providing lower ratings. The mass rating downgrades they finally initiated were not an effort to come clean, but were necessitated by skyrocketing mortgage delinquencies and securities plummeting in value. In the end, over 90% of the AAA ratings given to mortgage-backed securities in 2006 and 2007 were downgraded to junk status, including 75 out of 75 AAA-rated Long Beach securities issued in 2006. When sound credit ratings conflicted with collecting profitable fees, credit rating agencies chose the fees.
- **Investment Banks and Structured Finance.** Investment banks reviewed by the Subcommittee assembled and sold billions of dollars in mortgage-related investments that flooded financial markets with high-risk assets. They charged \$1 to \$8 million in fees to construct, underwrite, and market a mortgage-backed security, and \$5 to \$10 million per CDO. New documents detail how Deutsche Bank helped assemble a \$1.1 billion CDO known as Gemstone 7, stood by as it was filled with low-quality assets that its top CDO trader referred to as "crap" and "pigs," and rushed to sell it "before the market falls off a cliff." Deutsche Bank lost \$4.5 billion when the mortgage market collapsed, but would have lost even more if it had not cut its losses by selling CDOs like Gemstone. When Goldman Sachs realized the mortgage market was in decline, it took actions to profit from that decline at the expense of its clients. New documents detail how, in 2007, Goldman's Structured Products Group twice amassed and profited from large net short positions in mortgage related securities. At the same time the firm was betting against the mortgage market as a whole, Goldman assembled and aggressively marketed to its clients poor quality CDOs that it actively bet against by taking large short positions in those transactions. New documents and information detail how Goldman recommended four CDOs, Hudson, Anderson, Timberwolf, and Abacus, to its clients

without fully disclosing key information about those products, Goldman's own market views, or its adverse economic interests. For example, in Hudson, Goldman told investors that its interests were "aligned" with theirs when, in fact, Goldman held 100% of the short side of the CDO and had adverse interests to the investors, and described Hudson's assets were "sourced from the Street," when in fact, Goldman had selected and priced the assets without any third party involvement. New documents also reveal that, at one point in May 2007, Goldman Sachs unsuccessfully tried to execute a "short squeeze" in the mortgage market so that Goldman could scoop up short positions at artificially depressed prices and profit as the mortgage market declined.

**Recommendations.** The Report offers 19 recommendations to address the conflicts of interest and abuses exposed in the Report. The recommendations advocate, for example, strong implementation of the new restrictions on proprietary trading and conflicts of interest; and action by the SEC to rank credit rating agencies according to the accuracy of their ratings. Other recommendations seek to advance low risk mortgages, greater transparency in the marketplace, and more protective capital, liquidity, and loss reserves.

For the full report and relevant exhibits, use the links below:

- **REPORT - Wall Street & the Financial Crisis - Anatomy of a Financial Collapse**
- **FOOTNOTE EXHIBIT LOCATOR (by FN and Bates)**
- **FN 107 - 1342 (pgs 1-1037)**
- **FN 1343 - 1459 (pgs 1038-2164)**
- **FN 1462 - 1576 (pgs 2165-3003)**
- **FN 1584 - 1622 (pgs 3004-3448)**
- **FN 1623 - 2406 (pgs 3449-4484)**
- **FN 2409 - 2706 (pgs 4485-5459)**
- **FN 2724 - 2831 (pgs 5460-5901)**