



## CDO *pinions*

A global biweekly credit derivatives and CDO update

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### In This Issue

#### Credit Derivatives News

Hedge Funds' Influence Loom over Structured Credit Markets ..... 1

Appetite for Structured Credit Grows in Asia-Pac Region..... 1

Total Rate-of-Return CLOs Gain Momentum ..... 2

Synthetic Index Rate of Credit Deterioration Eases ..... 2

ValuSpread ..... 3

Collateral Talk..... 3

CLO Managers Focus on Surveillance ..... 3

Declining Second-Lien RMBS Performance Put Slight Dent on SF CDOs ..... 4

CDOs of Cédulas Hipotecarias Show Stability ..... 4

Innovations ..... 5

Fitch Launches Rating Outlooks for European SF ..... 5

FitchCDx.com – Global Industry Sector Price Movements\* ..... 5

Fitch-Rated CDOs ..... 6-7

Mark Your Calendar ..... 7

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### CREDIT DERIVATIVES NEWS

#### Hedge Funds' Influence Loom over Structured Credit Markets

Hedge funds' influence in both the cash and credit derivatives markets has been accelerating in the past few years. The use of credit strategies is one of the fastest growing areas among hedge funds and is outpacing equity-oriented strategies, according to Fitch's recent survey of prime brokers. Prime brokers offer valuable insight into hedge funds' activities because they provide financing and risk oversight for these investors.

Hedge funds' propensity to trade frequently, employ higher levels of leverage, and willingness to invest in the riskier areas of the credit markets further underscores their importance as a source of liquidity. Nowhere is this trend more evident than in the credit default swap (CDS) arena where hedge funds represent almost 60% of trading volumes. This is a significant spike from 2005 when hedge funds represented less than 30% of trading volumes on a much smaller notional base. Hedge funds also make up one-third of the trading volume in structured credit products including collateralized debt obligations (CDO). Hedge funds have continued to take subordinated and more leveraged risk exposures in exchange for higher returns such as actively investing in second-lien leveraged loans. Additionally, aggressive CDO issuance has been fueled by hedge funds' demand for CDO equity exposures. Recent structured credit innovations reflect hedge funds' appetite for transactions that generate more yield. For example, there have been instances where CDO equity has been structured on the basis of reverse inquiry from hedge funds with few or any triggers at more senior levels of the transaction. There has also been a shift into more speculative and less liquid investments such as subordinated/equity positions, bridge financings and private equity, which reflects hedge funds' high risk tolerance amidst a low return environment.

While the credit market has enjoyed tremendous growth, Fitch also expresses caution and believes that investors should stay vigilant of liquidity risk. The role of hedge funds in the credit markets has no doubt introduced greater liquidity in the near term. However, there is concern that an ill-timed event could lead to a sudden reversal of this liquidity across multiple segments of the credit markets. To view the full results of the study entitled *Hedge Funds: The Credit Market's New Paradigm*, please follow this link [http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=327902](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=327902).

#### Appetite for Structured Credit Grows in Asia-Pac Region

The appetite for structured credit shows no sign of ebbing in the Asia-Pacific region as investors expand and acquire more sophistication in this market. Derivative Fitch recently hosted a conference series in key Asia-Pac markets including Singapore, Taipei, Tokyo and Seoul. Asia-Pac investors are looking into newer types of collateralized debt obligation (CDO) structures such as those that reference Asian assets and commodities-linked credit obligations (CCOs). Synthetic CDOs continue to be a dominant investment vehicle in the region which typically reference global assets. However, market participants are also looking at collateralized loan obligations (CLOs) of Asian assets. Fitch expects a number of such transactions this year.

Taiwan remains a strong domestic issuer of collateralized bond obligations (CBOs) in the region. Locally, Fitch has observed that the Taiwanese investor base is becoming less active in buying U.S. synthetic corporate CDOs as interest has shifted to more conservative transactions such as principal-protected notes. More sophisticated Taiwanese investors are also purchasing market value CDOs and new types of credit derivative products, such as synthetic asset backed securities (ABS) CDOs, constant proportion debt obligations (CPDOs) and CCOs. In South Korea, there is increasing interest in synthetic securitizations with



the development of the Korean won (KRW)-denominated credit default swap market. Korea's total CDO issuance volume peaked at KRW29 trillion in 2000, according to Korea Ratings. This growth is fueled by the government's policy of supporting corporate financing, particularly to small-and-medium enterprises (SMEs). In Japan, the commercial real estate (CRE) CDO market looks poised for strong issuance. The number of CRE CDO transactions is currently limited but there are key drivers to its potential growth in Japan, such as diversification of real estate finance, issuance trends in the primary market, development of the secondary market and transparent historical data.

Similar to their counterparts in Europe and North America, Asia-Pac investors are exploring more complicated structures such as repackaging market price risk into credit-like synthetic collateralized securitization vehicles. The convergence of market and credit risks has fueled the demand for more advanced analytical tools.

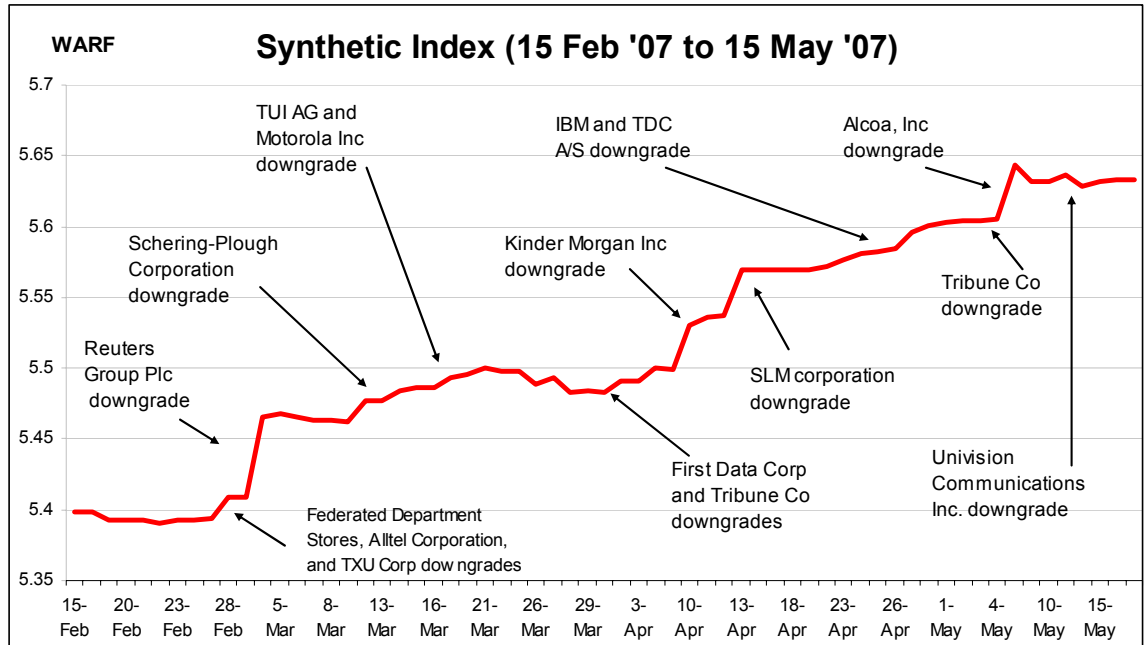
### **Total Rate-of-Return CLOs Gain Momentum**

Alternative collateralized loan obligation (CLO) structures such as those that utilize total return swaps (TRS) or credit default swaps (CDS) are generating more interest among investors as they realize the potential benefits of these transactions vis-à-vis traditional cashflow syndicated CLOs. Fitch has received more inquiries about these structures better known as total rate-of-return (TRR) CLOs, which offer investors leveraged exposure to a portfolio of high yield leveraged loans where the lowest rated notes are typically rated in the 'BBB' rating category. The notes are typically rated to a lower coupon than traditional syndicated cashflow CLOs but noteholders also benefit from an unrated participation in equity-like additional coupon. TRR CLOs are typically actively managed by a third-party and commonly have a seven- to ten-year revolving period and a short amortization period of three years or less. Instead of owning a security with an interest in a cash portfolio, investors typically own a credit-linked note that references the portfolio via a TRS or CDS. Although they remain a small portion of the total CLO universe, TRR CLOs are hitting investors' and asset managers' radars because these deals provide them with more transparent deal economics and the ability to customize their portfolios. For instance, the reinvestment periods for these deals tend to have longer terms and generally provide managers' more flexibility to manage the leverage within the CLO structure. Fitch has been actively rating TRR CLOs since 1996, although issuance did taper in 2002-03, but has since picked up again this year.

### **Synthetic Index Rate of Credit Deterioration Eases**

Although the Fitch synthetic index shows that corporate credit quality has continued to deteriorate, the rate of deterioration has slowed down for two consecutive months for the first time in 2007. The weighted average rating factor (WARF) deteriorated by 4.33% during the quarter (February 15 to May 15). The month from February 15th to March 15th was the most volatile (1.62% WARF deterioration), while the following two months showed a slower rate of deterioration of 1.52% (March 15 to April 15) and 1.13% (April 15 to May 15).

Downgrades outweighed upgrades by a ratio of 1.31 downgrades for every upgrade. Furthermore, the ratio of 1.46 negative net notch movements for every positive net notch movement suggests that the magnitude of downgrades were also larger this quarter. Downgrades were more than twice the size of upgrades as a percentage of total notional (8.9% downgrades compared to 4.12% upgrades). A large number of names representing the top 100 names (top 6% of the index) were downgraded this quarter including Federated Department Stores (0.51% of index), Alltel Corporation (0.32%), Kinder Morgan, Inc. (0.24%), SLM Corporation (0.24%), Motorola Inc. (0.23%), and Reuters Group Plc. (0.21%). However, most of these names were downgraded in the first month of this quarter (Feb. 15 to March 15). The United States once again experienced the largest negative net notch movement four times that of the United Kingdom, which experienced the second largest negative net notch movement in the index. The US auto industry currently represents approximately 2.39% of the index and has remained stable this quarter, neither experiencing upgrades nor downgrades. More details on the index methodology and the latest index report are available at [www.derivativefitch.com](http://www.derivativefitch.com).



Source: Derivative Fitch.

## VALUSPREAD

This table illustrates the two-week spread movement of the Dow Jones CDX & iTraxx Europe indices.

Index Name	2007-05-25 Mean*	2007-06-08 Mean*	Percentage Change
CDX NA IG 5y High Volatility Series 8 (ex 06/2012)	84.75	88.5278	4.2674
CDX NA HY 5y High Yield Overall Series 8 (ex 06/2012)	253.736	259.692	2.29368
CDX NA IG 5y Investment Grade Series 8 (ex 06/2012)	34.1074	35.5572	4.07737
CDX NA IG 5y Crossover Series 8 (ex 06/2012)	143.893	149.522	3.76494
iTRAXX Europe — 125 Series 7 (ex 06/2012)	20.7138	21.676	4.43924
iTRAXX Europe — Crossover Price Index Series 7 (ex 06/2012)	192.1	207.437	7.39375
iTRAXX Europe — Senior Financials Price Index Series 7 (ex 06/2012)	8.048	7.96025	(1.10235)
iTRAXX Europe — HiVol Price Index Series 7 (ex 06/2012)	39.972	42.0783	5.00556

\*Data is calculated by Derivative Fitch based on actual contributions received from market participants. For more data analysis contact the Valuspread team at [www.valuspread.com](http://www.valuspread.com).

## COLLATERAL TALK

### CLO Managers Focus on Surveillance

CLO asset managers have been riding the wave of historically low default rates but many agree that this favorable credit environment could potentially head south. At Derivative Fitch’s and Reuter’s Loan Pricing Corp.’s joint *Second Annual Loan & CLO Conference* in New York City last month, asset managers noted that they are putting more focus on their surveillance procedures to ensure that they have the ability to weather a bear market. One manager said that his firm is conscious about how many credits each analyst covered and stressed the importance of differentiating between “real” versus “perceived” value, explaining that managers may be lured to purchase assets outside their comfort zones or core competencies. Another asset manager said that it is important for analytical staff to go beyond asset



accumulation but also have the necessary portfolio management skills. Asset managers' roles have been put in the spotlight as CLOs continue to enjoy aggressive issuance and as more covenant-lite loans hit the market.

## **Declining Second-Lien RMBS Performance Put Slight Dent on SF CDOs**

Subprime closed-end second lien mortgage loan securitizations are in the spotlight as the performance of the 2006 vintage continues to deteriorate. These transactions represent a small niche in the overall subprime residential mortgage backed securities (RMBS) market but they are also among the worst performers through the first four months of 2007.

Subprime closed-end second lien RMBS differ from other types of subprime RMBS in both the performance of the underlying mortgage portfolios and the structure of the deals. For instance, the majority of the loans in these pools are junior liens that typically represent the remaining 20% of the home value after an 80% loan-to-value (LTV) first lien mortgage is securitized in a separate RMBS transaction. Recovery prospects on the second lien loans are poor due to the junior nature of the lien, especially in housing markets that have negative home price growth such as certain parts of California.

Both high grade and mezzanine structured finance (SF) CDOs have some exposure to closed-end second lien RMBS. Fitch has rated a total of 116 U.S. CDOs with exposure to these transactions, 35 of which are exposed to the 2006 vintage. These U.S. CDOs include 16 cashflow mezzanine and 11 cashflow high grade SF CDOs, four synthetic SF CDOs, three commercial real estate (CRE) CDOs and one market value SF CDO. European CDOs have a relatively lower degree of exposure to closed-end second lien RMBS which is isolated to eight transactions. The highest total exposure for European CDOs is approximately 2.20% of the reference portfolio. Fitch has not placed any tranche on Rating Watch Negative to date. However, Fitch also expects this negative performance trend to continue. The potential for negative rating actions on both high grade and mezzanine SF CDOs increases dramatically in cases where there are significant exposures to subprime closed-end second lien RMBS and limited asset manager flexibility to sell problem assets. High grade SF CDOs with vintage exposure, in particular, merit a closer inspection, as they apply higher levels of leverage than mezzanine SF CDOs, which makes the former more vulnerable to negative rating migrations that are triggered by just one or two assets. In some instances, 2006 vintage second-lien RMBS bonds have been downgraded from single-A to below investment grade territory within a year of issuance. Fitch's RMBS and CDO surveillance groups are keeping a close eye on these transactions and are jointly releasing a more detailed analysis in the next few days.

## **CDOs of Cédulas Hipotecarias Show Stability**

If the first quarter of 2007 is any indication of positive things to come, then CDOs of cédulas hipotecarias (CH) should continue to enjoy healthy issuance for the rest of the year. Since experiencing a reversal in the previous trend of falling collateralization ratios (CRs) from the second and third quarters of 2006, the CRs of the individual issuers have varied, but the overall trend points towards stability.

CDOs of CH are covered bonds that are issued by Spanish financial institutions and collateralized by mortgage loans. They have mandatory overcollateralization of the eligible pool and they enjoy further security cover, in the event of the liquidation of the issuer, from the issuer's total pool of mortgage loans. Each pool has a corresponding CR, which is the ratio of the outstanding balance of CHs to the relevant pool. The CR of the eligible mortgages is the eligible collateral ratio (EC) and that of the total mortgages is the total collateral ratio (TC). The EC levels of 57% of the individual issuers fell in the fourth quarter. However, the TC levels of 57% of the issuers increased in the same period. In the first quarter of 2007, the majority of issuers showed an increase in both their EC (64%) and TC (62%) ratio.

Fitch is keeping an eye on two significant developments that loom in the horizon such as the potential for a downturn in the Spanish housing market and changes to the legislative environment under which these CDOs operate. However, even with the uncertainty surrounding these two developments, there is some reassurance from the overall trend towards a more stable level of CRs, even if the values of individual

CRs are demonstrating some volatility. The EC ratios of some institutions remain close to the current limit established by Spanish law. However, Fitch has verified that these CRs remain in line with a 'AAA' stress scenario and are still above the legally required limits. For more information about CDOs of CH, please check out the latest *OC Tracker* performance report at [www.derivativefitch.com](http://www.derivativefitch.com).

## INNOVATIONS

### Fitch Launches Rating Outlooks for European SF

Fitch's rating outlooks for European structured finance (SF) has made its debut this month. Rating outlooks are being introduced to European SF tranches to provide more forward-looking information to market participants. The rating agency currently publishes rating outlooks for corporate, financial institutions, sovereign and municipal issuers. An outlook indicates the likely direction of any rating change over a one to two year period. Outlooks may be Positive, Negative, Stable or in some cases Evolving. These outlooks will be reviewed along with the rating review of a particular transaction and will be supplemented with a commentary describing Fitch's rationale for the outlook. For more information on this latest offering, please go to [http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=327624](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=327624).

### FITCHCDX.COM – GLOBAL INDUSTRY SECTOR PRICE MOVEMENTS\*

Fitch Industry	Week of 07-June-2007	Week of 31-May-2007	Spread Change	% Change ▼	# Assets
Gaming, Lodging and Restaurant	108	102	6	6.2	5
Miscellaneous	89	86	4	4.4	26
Metals and Mining	31	30	1	4.0	7
Utilities	21	21	1	2.4	23
Automotive	138	136	2	1.7	23
Retail	103	102	1	1.2	9
Transportation	50	49	1	1.2	9
Building and Materials	82	82	1	1.1	20
Sovereign	89	88	1	1.0	13
Food, Beverage and Tobacco	35	35	0	0.8	18
Paper and Forest Products	94	93	0	0.3	11
Banking and Finance	28	28	0	0.1	133
Industrial/Manufacturing	82	82	0	0.1	12
Real Estate	66	66	0	0.1	5
Broadcasting and Media	111	111	0	0.0	31
Healthcare and Pharmaceutical	50	50	0	0.0	5
Consumer Products	56	56	0	(0.5)	8
Telecommunication	83	84	(1)	(1.0)	30
Chemical	43	43	(1)	(1.2)	14
Computers and Electronics	37	37	(1)	(1.6)	9
Supermarkets and Drug Stores	62	63	(1)	(1.9)	10
Insurance	11	11	0	(3.4)	16
Textiles and Furniture	98	102	(3)	(3.4)	5
Energy	15	15	(1)	(4.0)	4

\*Weekly credit default prices sourced from GFI Group Inc. ([www.GFIgroup.com](http://www.GFIgroup.com)). Visit [www.fitchcdx.com](http://www.fitchcdx.com) for advanced analysis and data for the credit derivatives market.

## FITCH-RATED CDOs (AS OF APRIL 2007)

This is a sample list of the variety of deals that Fitch has rated in the U.S., Europe and Asia.

### USA

Deal Name	Deal Type
ACAS CLO 2007-1	Middle Market CLO
Alesco Preferred Funding XV	Trust Preferred CDO
Canal Point II	Total Rate of Return CLO
Capital Source CLO 2007-1	Middle Market CLO
C-BASS CBO XVIII	Structured Finance CDO
CBRE Realty Finance CDO 2007-1	Commercial Real Estate CDO
CoLTS 2007-1	Middle Market CLO
Dutch Hill Funding II	Structured Finance CDO
Emporia Preferred Funding III	Middle Market CLO
Glacier CDO V	Structured Finance CDO
LNR CDO V	Commercial Real Estate CDO
Maxim High Grade CDO II	Structured Finance CDO
Nautilus RMBS CDO IV	Structured Finance CDO
Newcastle CDO IX	Commercial Real Estate CDO
Nomura CRE CDO 2007-1	Commercial Real Estate CDO
Norma CDO I	Structured Finance CDO
NorthStar Real Estate CDO IX	Commercial Real Estate CDO
Novastar ABS CDO I	Structured Finance CDO
OCI Enhanced Loan Income Fund	Total Rate of Return CLO
Preferred Term Securities XXV	Trust Preferred CDO
Sandelman Realty CRE CDO I	Commercial Real Estate CDO
Silver Marlin ABS CDO I	Structured Finance CDO
Taberna Preferred Funding VIII	Trust Preferred CDO
Trapeza CDO XII	Trust Preferred CDO
Volans Funding 2007-1	Structured Finance CDO

### EUROPE

Deal Name	Deal Type
Aeolus CDO Limited Colonnade II	Structured Finance CDO
Aphex Capital Plc Series 2006- 31-33	Structured Finance CDO
Aphex Capital Plc Series 34-36 "Dent Blanche"	Structured Finance CDO
Ashwell Rated S.A. Series 8-12 (Constellations Synthetic CDO 2007-1)	Synthetic Investment Grade Corporate CDO
Avoca CLO VII Plc	High Yield Loans
AyT Cedulas Cajas Global FTA Series XII and Tap IX	Structured Finance CDO
Builder IV Series 320 Class E	Structured Finance CDO
Clock Finance No. 1	Small-Medium Enterprise CDO
E.L.A.N. Limited Series 2007-2 and ELVA Funding Plc Series 2007-1	Synthetic Investment Grade Corporate CDO
Elva Funding Plc Series 2007-2 and 3	Synthetic Investment Grade Corporate CDO
Eolo Investments B.V. Series 2007-1 Plc	Structured Finance CDO
Euromax VI ABS Limited	Structured Finance CDO
Glastonbury Finance 2007-1 Plc	Structured Finance CDO
Harvest CLO V Plc	High Yield Loan CDO
HEAT Mezzanine S.A. Compartment 3	Small-Medium Enterprise CDO
ICO Meditation I Ayt, FTA	Structured Finance CDO
IM Cedulas 10, FTA	Structured Finance CDO
Magnolia Finance V plc Series 2007-6	Synthetic Investment Grade Corporate CDO

**EUROPE (CONTINUED)****Deal Name**

Omega Capital Investments plc Series 43 (Waypoint CDO)  
Pangaea ABS 2007-1 Plc  
PREPS 2007-1 Plc  
Programa Cedulas TdA Series A4 Tap April 2007  
Programa Cedulas TdA Series A5 and Tap A4 and A6  
Proventus European ABS CDO Plc  
SCUTE I B.V.  
SMART PFI 2007 GmbH  
Smile Securitization Company 2007 B.V.  
Taberna Europe CDO I Plc  
Zoo ABS 4 Plc  
Zoo HF 3 Plc

**Deal Type**

Synthetic Investment Grade Corporate CDO  
Structured Finance CDO  
Small-Medium Enterprise CDO  
Structured Finance CDO  
Structured Finance CDO  
Structured Finance CDO  
Structured Finance CDO  
Small-Medium Enterprise CDO  
Small-Medium Enterprise CDO  
Trust Preferred CDOs  
Structured Finance CDO  
Market Value CDO

**ASIA-PACIFIC****Deal Name**

Corsair (Jersey) Limited Series 304  
Corsair (Jersey) Limited Series 324  
Corsair (Jersey) Limited Series 326  
Corsair (Jersey) Limited Series 327  
Corsair (Jersey) Limited Series 328  
Eirles Two Limited Series 323 (Picasso)  
Morgan Stanley ACES 2007-3, 2007-4, 2007-5  
Morgan Stanley ACES 2007-15  
Morgan Stanley ACES Series 2007-16  
Omega Series 44 to 45  
Queenstown CDO I Trust Series 2007-2  
  
Queenstown CDO Limited Series 2007-3  
  
Zenesis 2007 – 1/11, 1/13, 2/11,2/14, 3/12 and 3/14  
Zircon Finance 2007-1  
Zircon 2007-3

**Deal Type**

Single-Tranche Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
Single-Tranche (Funded) Corporate CDO  
Single-Tranche (Funded) Corporate CDO  
Single-Tranche (Funded) Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO  
(Investment Grade Bonds)  
Single-Tranche Synthetic Corporate CDO  
(Investment Grade Bonds)  
Synthetic CDOs of CDOs (CDO Squared)  
Synthetic Corporate CDO  
Single-Tranche Synthetic Corporate CDO

**MARK YOUR CALENDAR****June 18–19****CDOs and Structured Credit 101 and 102**

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