UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

GE DANDONG; CHO SIEW KONG DOUGLAS; PAN YUEN DAPHNE; CHU HUI LOO; LOH TUCK WOH PETER; SINGAPORE GOVERNMENT STAFF CREDIT COOPERATIVE SOCIETY, LTD; LI CHAN CHIH ERIC; NI YAN AMY; YEO PENG CHYE; BOEY CHERN YUE; LIM THIAN LOKE; ANG SOO CHENG; NEO SAY HOE; HO YU WAH PETER; CHOH GEK HONG JOHNSON; NG SHOOK PHIN SUSAN; ZHAO YUZHENG and LAM YEEN LENG, Plaintiffs, -vs.- PINNACLE PERFORMANCE LIMITED; MORGAN STANLEY ASIA (SINGAPORE) PTE; MORGAN STANLEY & CO. INTERNATIONAL PLC; MORGAN STANLEY CAPITAL SERVICES INC.; MORGAN STANLEY & CO. INC., Defendants.	Civil Action No. 10 CIV 8086

Expert Declaration of Craig A. Wolson

1. INTRODUCTION AND QUALIFICATIONS

1.01 I have been retained by Ge Dandong, Cho Siew Kong Douglas, Pan Yuen Daphne, Chu Hui Loo, Loh Tuck Woh Peter, Singapore Government Staff Credit Cooperative Society, LTD, Li Chan Chih Eric, Ni Yan Amy, Yeo Peng Chye, Boey Chern Yue, Lim Thian Loke, Ang Soo Cheng, Neo Say Hoe, Ho Yu Wah Peter, Choh Gek Hong Johnson, Ng Shook Phin Susan, Zhao Yuzheng, and Lam Yeen Leng, Plaintiffs in this case, as an expert to support Plaintiffs' motion for class certification. In particular, I have been asked to: (i) examine the transactions that are the subject of this suit--that is, the sale by Pinnacle Performance Limited ("Pinnacle") of the notes (the "Pinnacle Notes") purchased by the plaintiffs in this case; (ii) determine if those transactions deviated in any way from industry custom and practice relating to credit-linked note ("CLN") and collateralized debt obligation ("CDO") structure, and (iii) determine whether the offering materials for these transactions (the

"Offering Materials") omitted information so fundamental to the structuring of the Pinnacle Notes that any reasonable investor would have considered such information material to his or her investment decision. As discussed herein, I conclude that the Pinnacle Notes transaction deviated significantly from standard CLN and CDO structures, that a description of these deviations was omitted from the Offering Materials, and that the omitted information concerned fundamental risk considerations that would have significantly influenced any reasonable investor's decision to purchase the Pinnacle Notes.

1.02 I am Of Counsel to the law firm of Tully Rinckey PLLC in Albany, NY and Washington, DC and the Law Offices of John F. Lang in New York City. In addition, I am on the roster of arbitrators of the American Arbitration Association; I was chosen for this role in particular because of my expertise in structured finance and derivatives.

1.03 A copy of my Curriculum Vitae is attached hereto as Appendix A. As noted in my Curriculum Vitae, I attended the University of Michigan Law School, where I was an Articles Editor of the *Michigan Law Review*. I was admitted to the Bar of the State of New York in 1975. I began my legal career with the New York law firm of Shearman & Sterling, which at the time was the largest law firm in New York. Thereafter, I was employed by Thomson McKinnon Securities Inc. as Vice President and Assistant General Counsel, by J.D.Mattus Company, Inc. as Vice President, Secretary and General Counsel and by Chemical Bank as Vice President and Assistant General Counsel.

1.04 From 1988 until the present I have worked on hundreds of derivatives transactions. From 1988-92, I served as the main derivatives lawyer for Chemical Bank (now part of JPMorgan Chase), which at the time was the leading interest-rate swaps dealer in the world. During that time, I also served as Chemical's legal representative to The International Swaps Dealers Association (now called The International Swaps and Derivatives Association, but shortened to "ISDA" in all cases), the main trade association for dealers throughout the world involved in derivatives. I was heavily involved in the promulgation of ISDA's Master Agreement forms of 1992, which are still used throughout the industry and which were used by the defendants in this case. Starting in 1994 and continuing until the present, I have also focused on structured finance transactions, including dozens of CDOs (including all the variations thereof--"cash", "synthetic", and "hybrid").

1.05 Beginning in 1995, I worked at several law firms, including Mayer Brown & Platt, Schulte Roth & Zabel, and Cadwalader Wickersham & Taft, LLP, where my practice focused on structured finance and derivatives transactions. I have been a member of The New York City Bar Association's Structured Finance Committee since 2004 and served as the Chairman of the Committee from 2004-2008; the Committee consists, on a revolving basis, of 35 of the leading structured finance attorneys in the United States. Since 2009 I have also been an active member of the American Bar Association's Structured Finance and

Securitization Committee and the New York State Bar Association's Derivatives and Structured Products Committee. I have co-authored and/or edited numerous articles on securitization financing, and I have spoken at or moderated several seminar panels relating to structured finance. Appendix B lists such articles and seminars. As part of my transaction practice, as a member (and, in the case of the New York City Bar, Chairman) of these Committees and as part of my continuing legal education requirements, I have attended dozens (possibly hundreds) of meetings and seminars where CLNs and CDOs were discussed.

1.06 I have acted as an expert witness and/or consultant in numerous cases involving (a) CDOs and other types of securitization financing structures and (b) credit default swaps, interest rate swaps and other types of derivatives. Appendix C lists the cases in which I have been deposed or testified. In 2006 I was chosen by *Law and Politics Magazine,* based on a survey of my peers, as a New York Super Lawyer. I have been included in *Who's Who in the World* since 1993*, Who's Who in America* since 1992*, Who's Who in Finance and Business* since 1993 *and Who's Who in American Law* since 1986.

1.07 This Declaration describes (a) the form and function of CLNs, (b) the form and function of synthetic CDOs, (c) how the transactions that are the subject of this suit deviated significantly from industry customs and practices, and (d) what facts the Offering Materials omitted. In particular, this Declaration supports the argument that the Offering Materials omitted information that would have been material to any reasonable investor.

1.08 In preparing this Declaration, I have relied on my general knowledge, training, experience, and expertise. In addition, I have reviewed in whole or in part the materials listed on Appendix D hereto. Both my analysis and the factual observations I make in this Declaration are, subject to Section 1.09 below, based solely on the foregoing.

1.09 My work on this matter is ongoing. I may review additional materials or conduct further analysis. I reserve the right to update, refine, or revise my opinion as appropriate.

1.10 I am being compensated for my time in this matter at my normal billing rate, currently \$575 per hour (\$675 per hour for depositions and trial testimony). This compensation is not contingent upon the nature of my findings or on the outcome of this litigation.

2. CREDIT- LINKED NOTES

2.01 A CLN is a form of credit derivative. A standard CLN is a security. Like any ordinary bond or note, it has an interest payment and a fixed maturity structure. The performance of the CLN, however, is linked to the performance of a specific asset or specific assets (usually notes or bonds) issued by one or more specific entities (each, a "CLN Reference Entity"). *See, e.g.,* Frank J. Fabozzi, Henry A. Davis and Moorad Choudhry, "Credit-Linked Notes: A Product Primer," *The Journal of Structured Finance* 67, 67 & 71 (Winter 2007) (hereinafter, "Fabozzi, Davis & Choudhry"); *The Handbook of Fixed Income Securities 434* (8th ed. 2012, Frank J. Fabozzi, ed.)(hereinafter, "Fabozzi").

2.02 The issuer (the "Issuer") of a CLN is typically a trust set up by a sponsoring commercial bank or investment bank. *See, e.g.,* Fabozzi at 329. The Issuer is typically a bankruptcy-remote special purpose vehicle (an "SPV") that is controlled indirectly by the sponsoring bank; the sole purpose of such vehicle is to issue CLNs to investors. A CLN investor typically is a financial institution or other institutional investor; in my experience, with one exception of which I am aware, CLNs have not been sold to retail investors.

2.03 The primary agreement underlying a CLN is known as a credit default swap (a “CDS”). The CDS functions as a form of insurance that transfers the credit risk of the CLN Reference Entities from a protection buyer to a protection seller. In other words, the protection buyer pays the protection seller to bear the loss should a CLN Reference Entity suffer one or more defined “Credit Events” (such as default or bankruptcy). Conversely, the protection seller stands ready to compensate the protection buyer with respect to a decline in value of the relevant security of the CLN Reference Entity should a Credit Event occur (*e.g.*, a decline in value of $100 million of Microsoft bonds). *See, e.g.*, Fabozzi at 1546-51.

2.04 Traditionally, the sponsor of the SPV that issues the CLNs is the buyer of credit protection, while the SPV is the seller of credit protection. In order to effect this transaction, the sponsoring bank and the SPV enter into the CDS as counterparties. In exchange for assuming the credit risk associated with the CLN Reference Entities, the SPV receives periodic credit protection payments from the sponsoring bank. Because the SPV is an empty shell created by the sponsoring bank, the SPV funds its credit protection obligations by selling CLNs to investors and passing along the sponsoring bank's periodic credit protection payments. In this manner, it is the CLN investors who ultimately assume the credit risk associated with the CLN Reference Entities.

2.05 The credit protection payments are expressed as a fraction of the notional amount of the credit protection the sponsoring bank purchased (*e.g.*, quarterly payments of 0.5% of the notional amount). The size of the credit protection payment depends on the creditworthiness (*i.e.*, the riskiness) of the CLN Reference Entities. The riskier the CLN Reference Entities, the greater the chance a Credit Event will occur and that the SPV will have to make payments to the sponsoring bank under the CDS and, therefore, the greater the periodic credit protection payments the sponsoring bank will have to make in order to entice investors to fund the SPV's contingent payment obligations through the purchase of CLNs.

2.06 Customarily, the Issuer will reinvest the proceeds from the sale of the CLNs (*i.e.*, the investors' principal) into interest-generating assets commonly referred to as "Underlying Assets." The Underlying Assets serve as collateral for the SPV's payment obligations to the sponsoring bank. If the CLN Reference Entities suffer a Credit Event, the Underlying Assets are liquidated to fund the SPV's payments to the sponsoring bank under the CDS. If the CLN Reference Entities do not experience a Credit Event, the Underlying Assets are liquidated upon the maturity of the CLNs and the investors' principal is returned to them. The interest generated from the Underlying Assets during the life of the CLNs is paid to the investors along with the protection buyer's periodic credit protection payments.

2.07 As a result, under standard CLN structure both the protection-buying sponsoring bank and the protection-selling SPV (and implicitly the investors in the SPV) have a significant interest in safeguarding the investors' principal during the life of the CLN. The Underlying Assets are the source of any funds paid to the sponsoring bank for a Credit Event and are returned to the CLN investors if no such event occurs. For this reason, it is customary for the Underlying Assets to consist of a conservative investment that is both safe and liquid, such as Treasury bills. *See, e.g.*, Fabozzi at 330-32; Fabozzi, Davis & Choudry at 71; Arvind Rajan, Glen McDermott and Ratul Roy, *The Structured Credit Handbook* 152 (2007) (hereinafter "Rajan, McDermott & Roy").

2.08 Against this backdrop, it is not surprising that, to my knowledge, based on my experience and activities as described in Sections 1.04 and 1.05 above, CLN investors are primarily concerned with the riskiness of the CLN Reference Entities and not the Underlying Assets. This is not only because the Underlying Assets are traditionally safe, conservative investments but also because the return on the CLN is driven primarily by the credit risk associated with the CLN Reference Entities and not the Underlying Assets.

2.09 Accordingly, a CLN that reinvested its investors' principal into risky Underlying Assets would deviate significantly from customary CLN structure, would run counter to investor expectations, and would be a significant factor in any reasonable CLN investor's decision process.

3. SYNTHETIC CDOs

3.01 A collateralized debt obligation ("CDO") is an arrangement under which a portfolio of debt or debt-linked assets owned by an SPV can serve as the collateral for one or more classes of notes to be issued by the SPV. (In actuality, these notes are the "collateralized debt obligations". However, throughout the industry the issuer of these notes and/or the arrangement under which the issuer issues such notes are often referred to as the "CDO". I will use this term in this Declaration to refer to the transaction and not the issuer (which, for tax and certain historical reasons not relevant to this discussion, is usually a Cayman Islands company with limited liability), which I will refer to as the "CDO Issuer", or the notes, which I will refer to as the "CDO Notes".) The portfolio may consist of actual assets that the CDO

Issuer purchases and holds (a "cash CDO") or a collection of CDS that merely reference assets synthetically (a "synthetic CDO").

3.02 For example, a $200 million cash CDO could be based on 20 bonds of $10 million each issued by 20 different investment- grade corporations. To purchase these assets, the CDO Issuer issues CDO Notes backed by those assets to investors. The end result is that the purchasers of the CDO Notes gain "exposure" to the CDO Issuer's asset portfolio. In this manner, while the income generated by those assets is passed through the CDO structure to CDO noteholders, any impairment of those assets will create corresponding impairment to the CDO Notes and result in losses to the noteholders.

3.03 Under a synthetic CDO, exposure to a portfolio of corporate or other debt is achieved "synthetically" via CDS rather than by cash purchase of the actual assets. For example, whereas a $200 million cash CDO can raise $200 million from investors to purchase 20 bonds of $10 million each, a $200 million synthetic CDO can achieve exposure to the same portfolio by entering into CDS referencing a $200 million notional amount of the same 20 bonds.

3.04 Synthetic CDOs thus offer almost unlimited flexibility in the portfolio of credit risk on which they are based. The synthetic CDO can easily enter into CDS referencing any notional amount (*e.g.,* $100 million, $200 million*, etc.)* of any credits (one Microsoft bond, the bonds issued by several emerging market countries, the bonds issued by every company in France, *etc*.), whether or not any such bonds are available for purchase.

3.05 Because synthetic CDOs are based on CDS, the synthetic CDOs feature counterparties that take opposing "long" and "short" positions on the CDO's risks. In each case, the synthetic CDO Issuer is "long" the risk; it contracts with one or more counterparties through one or more CDS to provide credit protection with respect to the CDO's referenced portfolio. In exchange for credit protection payments provided to the CDO Issuer by its counterparty, the CDO Issuer (and implicitly its investors) agrees to "assume" the credit risks referenced by the CDS and compensate the counterparty to the extent that such risk materializes.

3.06 The CDO Issuer "funds" its potential counterparty obligations by raising principal through the sale of notes to investors. By this means, the CDO Issuer essentially transfers its "long" risk position to the investors that purchase the notes issued by the CDO Issuer. The principal paid by investors to purchase the CDO Notes is at risk of impairment should the reference entities ("CDO Reference Entities") included in the CDO Issuer's portfolio default, triggering the CDO Issuer's obligations to pay its CDS counterparty with the investors' principal.

3.07 Customarily, CDOs (particularly synthetic, which are in essence a form of credit derivative, transforming the CDO investors into sellers of CDS/credit protection) were not sold to retail investors. On the contrary, CDOs customarily were sold to financial institutions or institutional investors. *See, e.g.*, Fabozzi at 1544; Rajan, McDermott & Roy at 20-21.

3.08 There are three primary risk factors that CDO investors consider in determining whether to invest in and/or how to structure CDO Notes: (i) the tranche characteristics; (ii) the composition of the portfolio of CDO Reference Entities (the "CDO Reference Entity Portfolio"); and (iii) the management and substitution of CDO Reference Entities during the life of the CDO. Typically, these terms are heavily negotiated and have a direct impact on the riskiness of the CDO.

Tranche Characteristics. CDOs issue multiple levels ("tranches") of unequal notes representing senior, intermediate, and subordinate interests and payment priorities. The most junior of the tranches (often called an "equity" or "first loss" tranche) stands first in line for any and all collateral portfolio losses. Senior tranches in turn are protected from collateral portfolio losses by the sum total of the more junior tranches below them. To compensate the investors in junior tranches for assuming greater risk, such investors receive higher yields than investors in more senior tranches.

The risk embodied in each CDO tranche is defined by three structural factors: (i) the tranche's "Attachment Point," which is the level of aggregate portfolio losses at which the tranche in question begins to suffer principal impairment (*e.g.*, 5%); (ii) the tranche's "Detachment Point," which is the level of aggregate portfolio losses at which the tranche in question suffers total principal impairment (*e.g.*, 7%); and (iii) the tranche's "Thickness," which is the difference between the tranche's Detachment Point and Attachment Point (*e.g.*, 7% minus 5%, or 2%).

Composition. The composition of the CDO Reference Entity Portfolio also directly impacts the risk to the investor. The riskier the CDO Reference Entities, the greater the likelihood that: (i) a Credit Event will occur and (ii) losses will surpass the tranche's Attachment Point, resulting in the diminution of the investor's principal. In addition, if default risk for the various CDO Reference Entities is closely correlated--that is, if a Credit Event occurred with respect to a company in a specific sector, other companies in that sector are also likely to suffer credit events--the risk of principal impairment is generally greater than if the credit risk for the various Reference Entities were not closely correlated.

CDO Management. How the CDO is managed also impacts investor risk. In order to avoid conflicts of interest between the arranging bank and the investors in the CDO Notes, by 2006-07 it was industry custom for the sponsor to retain an independent collateral manager to select the CDO Reference Entities and, depending on the collateral manager's mandate, to make permitted substitutions during a specified period of time in the life of the CDO in order to meet an investor's expected rate of return. Accordingly, a CDO arrangement under which the sponsor--*i.e.*, the party taking the "short" position with respect to the CDO Reference Entity risk--selected the CDO Reference Entities would deviate from customary practice, would foster conflicts of interest, and would be a significant consideration for any reasonable investor in CDO Notes.

4. THE PINNACLE TRANSACTIONS DEVIATED SIGNIFICANTLY FROM INDUSTRY CUSTOM AND PRACTICE AND THE OFFERING MATERIALS OMITTED INFORMATION MATERIAL TO ANY REASONABLE INVESTOR.

4.01 Before I address the specific information that was omitted from the Offering Materials and that so fundamentally deviated from standard CLN and CDO structuring that any reasonable investor would have considered that information highly material to his or her investment decision, there are several general observations (which I have set out in Sections 4.02-4.05 below) that merit discussion.

4.02 First, as indicated above, the Pinnacle Notes transactions deviated from customary industry practice by reinvesting the proceeds of the CLNs into atypical Underlying Assets--*i.e.,* the single-tranche, "bespoke" (that is, unique, specifically-designed) ACES CDO Notes referred to in Section 4.03 below--as opposed to Treasury bills or other similarly secure investments. In so doing, the Pinnacle Notes introduced risk into a part of a CLN transaction--the Underlying Assets--that is customarily extremely low-risk and a place where a reasonable CLN investor would typically not expect to find risk.

4.03 Second, CDOs customarily are sold to highly sophisticated investors, such as financial institutions, hedge funds, insurance companies, *etc.* In fact, despite having worked on numerous CDO transactions and having discussed innumerable additional transactions with colleagues, I am aware of only one other transaction in which retail investors invested (indirectly) in CDOs, and that transaction is the subject of litigation. Here, contrary to industry custom and practice, the Pinnacle Notes investors essentially invested in CDO Notes (the "ACES CDO Notes") issued by Morgan Stanley ACES SPC ("ACES") because the money such investors invested in the Pinnacle Notes was, in turn, reinvested by Pinnacle into ACES CDO Notes.

4.04 Third, as discussed above, under standard CLN structure both counterparties have an interest in ensuring that the money raised by the issuance of the CLNs remains safe and available during the life of the CLN. This is because such money serves as the source of payments to the protection-buying sponsoring bank if the CLN Reference Entities experience a Credit Event and, if not, is returned to the CLN investors when the CLNs have matured. The Pinnacle Notes deviated materially from this customary arrangement because the protection buyer, Morgan Stanley Capital Services Inc. ("MS Capital"), still stood to gain if the Underlying Assets became valueless inasmuch as it was the "short" counterparty (and creator) of the ACES CDO Notes selected for the Underlying Assets.

4.05 Fourth, a CDO’s terms are typically heavily negotiated by the opposing counterparties, and an independent collateral manager is customarily employed to select the CDO Reference Entities comprising the CDO portfolio and to make permitted substitutions during the CDO’s term. Here, in contrast, the ACES CDO Notes were not the product of arms-length negotiations. Instead, such Notes were created by interested parties--ACES is a special purpose entity affiliated with Defendants, MS Capital, one of Pinnacle's counterparties, selected the CDO Reference Portfolio, and Morgan Stanley & Co. International plc ("MS International"), a corporate entity related to MS Capital, selected the ACES CDO Notes on Pinnacle's behalf--and did not utilize a disinterested third-party collateral manager.

4.06 The Offering Materials omitted crucial information with respect to these deviations which any reasonable investor would have factored into his or her investment decision:

• Although documents that the Defendants issued to distributors indicated that the Defendants had determined as early as May 2006 (approximately three months before the first series of Pinnacle Notes was offered) that: (i) the Underlying Assets would consist of single-tranche synthetic CDO Notes; (ii) the CDO Reference Portfolio for each such CDO would consist of approximately 100 Reference Entities (as compared to the 7 Reference Entities for the Pinnacle Notes); and (iii) the tranche at issue would begin to suffer principal impairment upon even modest defaults, the Offering Materials did not provide any information regarding points (ii) and (iii) to investors. In fact, other than mentioning the synthetic CDOs' credit ratings, the Offering Materials omitted key information relating to the riskiness of the Underlying Assets.

• The Offering Materials also did not inform investors that: (i) the same entity that stood as the "short" counterparty to the Pinnacle Notes--MS Capital--would also be the "short" counterparty to the Underlying Assets for the Pinnacle Notes and (ii) because of this arrangement, MS Capital stood to gain if the Underlying Assets decreased in value. As noted, this scenario was the opposite of the typical CLN structure under which both counterparties customarily stand to lose if the Underlying Assets lose their value.

• The Offering Materials also did not inform investors of MS Capital's role in structuring ACES and the ACES CDO Notes and that there would be no independent collateral manager. This information related directly to obvious conflicts of interest because the ACES CDO Notes were structured by related, interested entities--most notably, MS Capital--and were selected by another related entity, MS International.

4.07 Finally, if, in fact, the Defendants selected CDO Reference Entities in order to intensify the risk of loss – and thereby increase the odds that the Defendants would benefit at the investors' expense – as alleged in the Complaint, any reasonable investor would have found that information material to such investor's investment decision.

5. SUMMARY

I have been a securities and finance attorney for close to 40 years. I have specialized in derivatives transactions for close to 25 years and structured finance/securitization transactions for over 15 years. During the course of this time I have come to know what the standards and practices of disclosure in these industries are. Based on these years of experience, it is my conclusion that some very significant information that would have been material to any investor in the CLNs that are the subject of this litigation was omitted.

Craig A. Wolson