

Deerfield Capital Management LLC

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DISCLOSURE BROCHURE
IN LIEU OF FORM ADV PART II
(Pursuant to SEC Rule 204-3(a) under the Investment Advisers Act of 1940)

March 31, 2009

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Introduction

Rule 204-3(a) of the Securities and Exchange Commission (“SEC”) under the Investment Advisers Act of 1940 (the “IAA”) requires registered investment advisers to furnish prospective clients either Part II of the adviser’s SEC Form ADV or a written document (sometimes referred to as the “brochure”) containing at least the information required by Part II. As a registered investment adviser, Deerfield Capital Management LLC (“we” or “Deerfield”) has chosen to furnish the brochure rather than Part II.

This Brochure first summarizes our structure, ownership, operations, and related matters and then summarizes the investment programs we currently offer.

With respect to each of these programs, this Brochure is necessarily general in nature and qualified in its entirety by the offering memorandum, offering circular or other explanatory document specific to the program. For example, the investment strategies, risk factors, and conflicts of interest specific to an investment program are generally discussed in the explanatory document for the program rather than in this Brochure.

You should not invest in any Deerfield program without reviewing the full explanatory document for the program. If there is no such document for the program, which may be the case with respect to Managed Accounts (see below), we will give you any information about the program that you request and that we can reasonably provide. In general, there are various significant risks associated with investing in our programs, such as risks relating to leverage, price volatility, market illiquidity, counterparty and broker credit, currency fluctuation, taxation, execution and settlement, regulatory actions, and systems malfunctions.

The information in this Brochure is current as of the date hereof. The delivery of this Brochure after that date does not imply that the Brochure is current as of that later date.

Section 1. General

We are a global fixed-income investment adviser that has provided investment advisory services to clients since 1993. We have been registered with the SEC since 1997.

Ownership

We are 100% owned, indirectly, by Deerfield Capital Corp. (“DFR”), a public company that acquired us in December 2007 and that is listed on NYSE Alternext U.S. under the DFR symbol. We had conducted all of the investing for DFR since its inception in November 2004, as DFR’s internal manager, and following the December 2007 acquisition we have continued to conduct all of its investing, as its internal manager.

We encourage you to visit DFR’s website, www.deerfieldcapital.com, to obtain significant additional information about Deerfield that is not required to be in this Brochure. The website includes DFR’s filings with the SEC, which contain substantial additional information about Deerfield and DFR. Attachment A hereto includes excerpts from DFR’s most recent annual report filed with the SEC that may supplement certain of the information in this Brochure.

Investment Services

Investment supervisory services accounted for 100% of our total advisory income in 2008. We do not provide financial planning or similar services. We engage solely in the investment advisory business. We do not engage in other business activities. The main advisory service we provide is the management of clients’ investment programs in fixed income securities and related instruments. In almost all cases, we are granted discretionary trading authorization over the account, pursuant to which we purchase and sell securities for the account without the client’s prior consent, pursuant to authority granted to us in the investment management agreement with the client.

We currently provide investment advice to collateralized debt obligation vehicles (“CDOs”), individually managed separate accounts (“Managed Accounts”) and DFR, as well as to another investment adviser—to which we provide recommendations regarding CMO-related securities for the adviser to purchase for its clients (the “Sub-Advisor Program”). We generally have full discretionary trading authorization over the CDOs, Managed Accounts and DFR. We have managed private investment funds (“Private Funds”) in the past and expect to do so in the future, and we may also offer and manage other types of investment programs in the future.

We do not have a standard fee rate. Rather, the fees we charge are negotiated with each client. Our typical fees are described in Section 2.

Clients

Our clients currently consist of CDOs, the owners of the Managed Accounts, and the investment adviser to which we provide advisory services pursuant to the Sub-Advisor Program. In addition, we conduct the investing for our parent company, DFR, as its internal manager.

The owners of the Managed Accounts generally consist of institutional investors, such as employee benefit plans and endowments.

In addition to our clients and DFR, there are underlying investors in the CDOs, DFR and Private Funds. The investors in the CDOs and Private Funds generally consist of institutional investors and high-net worth individuals. The shareholders of DFR include retail investors.

Education and Business Standards

We generally require our portfolio managers (“PMs”) to have one or more forms of relevant advanced degrees or industry certifications or an appropriate number of years of job experience. We determine the education and business standards we require of PMs based on the particular type of position. In some cases, we may require a relevant advanced degree or certification.

Education and Business Background

Set forth below is general background information about the five most senior Deerfield employees who determine the general investment advice we give to our clients, and about our principal executive officers who do not also come within this category of employees. We do not have an investment committee that regularly determines the investment advice we give to clients; we do have an investment committee that periodically reviews the DFR investment portfolio and performs related functions.

Employees Who Determine Investment Advice

Jonathan Trutter, Chief Executive Officer and Chief Investment Officer

DOB: 1957

Education: B.A. from the University of Southern California and M.B.A. from Northwestern University

Business background: Mr. Trutter joined Deerfield in 2000.

Luke Knecht, C.F.A., Chief Operating Officer, Chief Risk Officer and Senior Managing Director

DOB: 1953

Education: B.S. in Business Administration from the University of Colorado

Business background: Mr. Knecht joined Deerfield in 2002.

Dale Burrow, C.F.A., Managing Director and the Director of Research

DOB: 1956

Education: B.B.A. with Special Distinction from the University of Oklahoma and M.B.A. with Special Distinction from DePaul University
Business background: Mr. Burrow joined Deerfield in 2000.

Patrick Maley, Managing Director and Director of Asset-Backed and Corporate Securities

DOB: 1962

Education: B.S.M.E. from the University of Tulsa and M.B.A. from the University of Chicago

Business background: Mr. Maley joined Deerfield in 2004.

Aaron Peck, Managing Director and Senior Portfolio Manager

DOB:

Education: M.B.A. from the University of Chicago and B.S. from McIntire School of Commerce at the University of Virginia

Business background: Mr. Peck joined Deerfield initially in 2002 and then rejoined in 2004.

Executive Officers

Peter Rothschild, Interim Chairman of the Board of Directors of DFR and Director of Deerfield

DOB: 1955

Education: B.S.M.E. from Tufts University and MBA from Harvard Business School

Business background: Mr. Rothschild joined DFR's Board of Directors in 2004, and has been the Managing Member of Daroth Capital LLC, a holding company, since its founding in 2001, and the President and CEO of its wholly owned subsidiary, Daroth Capital Advisors LLC, a securities broker-dealer, since 2002.

Francis Straub, Chief Financial Officer and Managing Director

DOB: 1972

Education: B.B.A. from Ohio University

Business background: Before joining Deerfield in 2005, Mr. Straub was the Manager of Financial Reporting for Archipelago Exchange LLC from August 2004 to August 2005 and Vice-President of Finance and Accounting for Z-Tel Technologies, Inc. from May 2003 to July 2004.

Robert Contreras, General Counsel and Managing Director

DOB: 1969

Education: B.S. from Indiana University and J.D. from Loyola University of Chicago School of Law

Business background: Mr. Contreras joined Deerfield in 2000

Frederick White, Chief Compliance Officer and Managing Director

DOB: 1944

Education: B.A. from Cornell University and J.D. from University of Michigan Law School

Business background: Mr. White joined Deerfield in 2002.

Other Financial Industry Activities or Affiliations

We are registered with the Commodity Futures Trading Commission as a commodity trading advisor, and our U.K. affiliate, Deerfield Capital Management (Europe) Limited, is a member of the U.K. Financial Services Authority, although we expect to cancel this membership in 2009. We are not registered as a securities broker-dealer. Certain of our Related Persons¹ may be general partners or managers of

¹ In general, our officers, directors, and non-clerical employees, and any person controlling, controlled by or under common control with us

investment-related entities, but our clients are not solicited to invest in those entities, although we might solicit such investment in the future.

Participation or Interest in Client Transactions

We and our Related Persons may, as principal, buy securities from or sell securities to a client account, in that we may cause an account in which we or such persons have a material ownership or other financial interest to engage in such principal trades with a client account. We would effectuate such trades only if we consider them to be in the best interests of the client account, principally because we considered the trade desirable for the client account and the trade price to be better than we could have obtained for the client account in an open market transaction. We will generally disclose in the disclosure document for the client account that we may engage in such principal trades with the account.

We have various policies and procedures setting forth the terms under which we may engage in principal trades, including that they be approved in advance by our Chief Compliance Officer. Our principal trades could create a conflict of interest for us, in that we might have an incentive to favor (for example, with regard to transaction price) an account in which we or our Related Persons have a financial interest over the client account that we arrange to buy securities from or sell securities to such proprietary account.

Neither we nor our Related Persons, as broker or agent, effect securities transactions for compensation for any client, or effect securities transactions for non-clients.

We and our Related Persons may recommend to clients that they buy securities or investment products in which we or a Related Person has some financial interest, in that we or such Related Persons may recommend to clients that they invest in Private Funds or other investment vehicles that we manage and in which we or such Related Persons have an ownership interest (through personal investments in those vehicles). We believe the investment by us or our Related Persons in these vehicles helps to align our interests with those of our clients, but we recognize that conflicts of interests could result from these recommendations, and we have policies and procedures to address such conflicts. Specifically, we will not cause any of our Managed Accounts to invest in the investment vehicles we manage, or purchase the interest of an investor in such vehicle who wishes to sell his interest, unless we obtain the client's prior specific authorization.

We and our Related Persons may buy securities that we recommend to clients, in that, as noted above, we and such Related Persons may personally invest in Private Funds or other investment vehicles that we manage and that we have recommended to clients that they invest in. As also noted above, we believe the investment by us and our Related Persons in these vehicles helps to align our interests with those of our clients, but we recognize that conflicts of interests could result from these investments and we have policies and procedures to address such conflicts. These include prohibitions in our Code

of Business Conduct and Ethics (see below) on our employees (i) engaging in transactions that would conflict with our clients' interests, (ii) "front running" of clients' transactions (purchasing securities in advance, causing client accounts to purchase the same securities), (iii) buying securities on the basis of material non-public information, and (iv) personal trading of securities without reporting those transactions to us, and in the case of certain investment vehicles we manage obtaining our prior approval of the transaction. Also, we generally disclose in the disclosure documents for the investment vehicles we sponsor that we or our Related Persons may own interests in the vehicles.

General Partner/Managing Member Status

We do not currently serve as the general partner or managing member of an investment fund but we expect that we or a Related Person will do so in the future.

Conditions for Managing Accounts

We establish conditions for managing accounts on a case-by-case basis. For CDOs these conditions may include collateral eligibility criteria, asset quality tests, and coverage tests and related ratios. For Managed Accounts and Private Funds, these conditions may include minimum account size.

Investment or Brokerage Discretion

We generally have the authority to determine, without obtaining specific client consent, the securities to be bought or sold for the client, the amount of the securities to be bought or sold, the broker or dealer to be used, and the commission rates to be paid. Typically, the only limitations on our authority as to the types or amount of securities to be purchased for an account are the investment guidelines established for the account. Currently, the only client for which we do not have discretion is the Sub-Advisor Program client.

Allocation of Investment Opportunities to Client Accounts

We have various policies and procedures for allocating investment opportunities among similar client accounts. In general, when we cannot obtain execution of the overall desired amount of an investment opportunity, we allocate the amount executed proportionally based on the relative net asset values of the accounts, but we may allocate on some other basis if we determine that such allocation is in the overall best interests of our clients. In such situations, we will follow a policy of overall allocations to the accounts that we believe is fair and equitable to the accounts. We can provide you with our allocation policies and procedures.

Non-Public Information

In considering investments in bank or mezzanine loans for some of our client accounts, we may obtain non-public information about a borrower, such as financial

projections, and such information may be material. Our possession of such information may restrict us in our ability to buy or sell other securities of the borrower for other client accounts. In addition, our affiliates might acquire non-public information about particular companies, which could restrict us from investing in the securities of those companies for client accounts, or restrict our ability to liquidate positions when we would otherwise do so.

Balance Sheet

We are not required to provide a balance sheet with this Brochure and none is provided. However, our financial results are consolidated with DFR's, and DFR's financial statements are filed with the SEC and available on www.deerfieldcapital.com.

Additional Compensation

We and our Related Persons do not have any arrangements, whether oral or in writing, where we or they receive an economic benefit from non-clients. We do not currently have any arrangements for compensating any person for client referrals but we might have such arrangements in the future. Any such arrangement would comply with applicable IAA requirements.

General Methods of Analysis, Sources of Information and Investment Strategies

Our securities analysis methods may include fundamental, technical, charting and cyclical methodologies, as well as methods specific to investing in fixed income instruments and their derivatives.

The sources of information we may use in our securities analysis include financial newspapers and magazines; inspections of corporate activities; research materials prepared by others; market commentary of brokers and dealers; corporate rating services, annual reports; prospectuses; filings with the SEC; company press releases; information obtained directly from securities issuers; and publicly available pricing and interest rate information.

The investment strategies we may use include long and short term purchases, trading, short sales, margin transactions, option writing, spread and relative value strategies, hedging, and strategies specific to investing in fixed income instruments.

Leverage

Some of our investment strategies may involve the borrowing of substantial amounts of funds, which are then used to increase the amount of the security held in the portfolio. As a result, the gross value of the positions in these accounts may exceed by substantial amounts the net asset values of the accounts. In evaluating the performance of these accounts, you should consider, among other factors, the amount and type of leverage used by the account.

In addition to using borrowing to achieve leverage, we may also leverage some of our accounts by using instruments, such as futures contracts, with embedded leverage. There are various ways to quantify the amount of leverage used by a particular account, particularly where the leverage is used to increase the position size of related long and short positions. Please contact us if you would like specific information about the amount and type of leverage used by a particular strategy in which you are an existing or potential investor.

Past Performance

In evaluating the past performance of our investment programs, you should consider, among other factors, that past profits are not necessarily indicative of future results, the results generally reflect the reinvestment of earnings, the portfolio management team that produced the results may have experienced changes of personnel, specific strategies or techniques that produced past profits may no longer be feasible, the results may have been generated with the use of substantial leverage, the indices that may be used as a general basis of comparison might not be the most appropriate benchmarks for the particular strategy, and the fees charged to the accounts may have been lower in prior periods than those currently charged.

Forward-Looking Statements

In evaluating our promotional materials and the statements herein, you should consider that statements that are not historical facts are based on our current expectations, speak only as of the date of the presentation and are susceptible to a number of risks, uncertainties and other factors. The actual results of our investment programs may differ materially from any future results that might be inferred from such forward-looking statements.

Many factors could cause such differences, including the current dislocations in the credit markets where we trade; liquidity and volatility in those markets; changes in interest rates or the general economy; changes in governmental regulations or taxation rates; the availability of investment opportunities; the degree and nature of our competition; and other risks and uncertainties all of which are difficult or impossible to predict accurately and many of which are beyond our control. New risks and uncertainties are expected to arise from time to time, and we cannot predict these events or how they may affect our investment programs. We assume no obligation to update any forward-looking statements after the date of the presentation as a result of new information, future events or developments, except as required by federal securities laws.

Compensation of Our Portfolio Managers

Our PMs may derive a substantial part of their compensation from the fees we earn from the accounts they manage. Where we are entitled to a performance fee for managing an account, the compensation of the PMs who manage the account may be

based, all or in part, on the amount of the performance fees we receive from the account. This may give the PMs an incentive to invest more aggressively for the account than in the absence of such arrangement.

Code of Ethics

We have a Code of Business Conduct and Ethics (the “Code”) that is a guide to the legal and ethical behavior of our directors and employees. The Code expresses our commitment to the highest standards of integrity and fair dealing in all of our activities, and compliance with both the letter and the spirit of the law. We will provide a copy of the Code to clients and prospective clients upon request.

The Code addresses the general responsibilities of our directors and employees; the reporting of violations of the Code, or any other Deerfield policy or applicable law; equal opportunity for Deerfield employees; workplace harassment; professional conduct of employees; compliance with securities and other laws; reporting of personal securities transactions; issuance of promotional materials; relationships with vendors; treatment of other Deerfield employees, Deerfield clients and other business relationships; avoidance of conflicts of interest; use of Deerfield property; maintenance of the confidentiality of non-public information; computer security; communications with the media; recordkeeping; effectuation and enforcement of the Code, and the responsibilities of the Chief Compliance Officer relating to the Code; community involvement; political activities and contributions; and workplace safety and health.

Conflicts of Interest

We have various actual and potential conflicts of interest that arise in the course of managing client accounts. For example, our performance fee arrangements with client accounts might give us an incentive to trade more aggressively for the client account than we would in the absence of such arrangements; our arranging for client accounts to engage in cross trades with each other might give us an incentive to favor one account over another in such cross trades, because we may earn higher fees from one account than the other, or we may have a larger financial interest in one account than the other; and our engagement in principal trades with client accounts may give us an incentive to favor our proprietary account over the client account with respect to the price or other term of the trade.

Also, our discretion in allocating investment opportunities among client accounts might give us an incentive to favor one client account over another in allocating a scarce investment opportunity, because we may earn higher fees from or have a greater financial interest in one of the accounts; we might have an incentive to favor the account of our parent company, DFR, over the account of a client with which we are not affiliated; and our Related Persons may trade for their personal accounts the same instruments we trade for client accounts.

DFR Affiliation

DFR's affiliation with us may create certain risks for our clients, such as potential conflicts of interest in our trading of the same instruments for client accounts as we trade for DFR.

SEC Inquiry

In connection with an investigation by the SEC into Real Estate Mortgage Investment Conduits, the SEC has directed Deerfield and DFR, by information requests and various subpoenas, to provide the SEC with a substantial amount of information and documents relating to certain mortgage securities transactions effected by Deerfield for DFR in 2005 and 2006, and the SEC has deposed various individuals who were Deerfield employees at the time of the transactions regarding the transactions. It is possible Deerfield or DFR, or its employees, could become subject to an SEC enforcement or other proceeding relating to the transactions.

Workforce Reductions

Because of adverse financial market conditions, we have substantially reduced our workforce—in each department—since March 2008, and we may reduce the workforce further in 2009. Such reductions could significantly impair our investment advisory capabilities and related administrative operations.

Investor Side Letters

The investment vehicles that we manage may enter into agreements with particular investors in the vehicles waiving specified provisions of the vehicle's governing documents without disclosing the fact or substance of such waivers to other investors in the vehicles.

Section 2. Client Account Information

We currently provide investment advice to 27 CDOs, 5 Managed Accounts, DFR, and another investment adviser (pursuant to the Sub-Advisor Program), and we expect to manage the investing for one or more Private Funds.

Advisory Fees

We do not have a standard fee for advising clients. Our advisory fees are individually negotiated with each client, and generally differ depending on the type of account.

For CDOs, we generally charge a senior management fee and a subordinated management fee, and in some cases a performance fee. In general, the management fees are based on the par value of the underlying collateral and range between 5-25 basis points for the senior management fee and 5-45 basis points for the subordinated management fee, and the performance fees are based on the cash flows to certain classes of investors and range from 10% to 20% of such flows above a specified rate of return.

For Managed Accounts, we generally charge a management fee ranging from 10-35 basis points per year of the average net value (or in some cases the gross asset value) of the account for the year, the specific amount depending on the size and strategy of the portfolio.

For the Sub-Advisor Program, we charge a management fee based on the value of the securities purchased by the investment adviser for its clients pursuant to our recommendations to the adviser.

For Private Funds, we would generally charge a management fee and performance fee, in amounts to be determined on a fund-by-fund basis.

Our management fees are paid in advance or arrears depending on the relevant management agreement. If paid in advance, and we do not provide investment management services to the account for the full period of the advance, we will promptly refund a pro-rata portion of the fees.

Our fee for managing DFR is generally our costs for the portfolio management and other services we provide to DFR plus, in the case of services that contribute significantly to DFR's key competitive advantages, core capabilities, or fundamental risks of success or failure, an additional 37% of such costs.

Types of Investments

The instruments we invest in for the CDOs may include investment grade corporate bonds, syndicated bank loans, asset-backed securities, U.S. government securities, and derivatives of such instruments.

The instruments we invest in for DFR and Private Funds may include residential mortgage-backed securities that are either non-agency or guaranteed by a U.S. government agency, interest rate swaps, securities repurchase contracts and re-repurchase contracts, commercial mortgage-backed securities, collateralized debt obligations, consumer asset-backed securities, senior secured and unsecured corporate loans, credit default swaps and total return swaps on senior secured loans, corporate mezzanine loans, U.S. government securities, distressed and stressed debt securities, equity securities that are private equity investments or interests in partnerships, preferred stock, non-control common equity investments, warrants and derivatives of such instruments.

The instruments we invest in for our Managed Accounts may include obligations of the U.S. Treasury and its agencies, securities collateralized by U.S. government guaranteed obligations or by obligations of agencies implicitly or explicitly guaranteed by the U.S. government, and U.S. denominated money market instruments.

Portfolio Review

For CDOs, we review each monthly report of the CDO's trustee, which analyzes the CDO's compliance with its indenture tests relating to collateral eligibility, asset quality, and overcollateralization and other coverage. Our review focuses on reconciling the trustee's analysis with our internal records.

For bank loan CDOs, the reviewers are Loan Administrators (there are currently 3) assigned to our bank loan desk, supervised by the PM assigned to the CDO. Each bank loan PM (there are currently 7) is assigned to 2-4 bank loan CDOs.

For asset-backed ("ABS") and investment grade corporate bond ("Bond") CDOs, the reviewers are the Credit Analysts and Fund Accountants (there are currently 2) assigned to the ABS and Bond desks, who report to the ABS/Bond Director that they have conducted the review.

In each case, the reviewers' instructions are to determine if there is any discrepancy between the trustee's tests results and our internal records, to seek to resolve any such discrepancies, and to discuss any unresolved discrepancies with their supervisors.

For Managed Accounts, we conduct a daily review of the Account, principally for compliance with its investment guidelines and other relevant requirements. The reviews are conducted by PMs assigned to the day-to-day management of the Accounts. A Senior

PM generally conducts a weekly or monthly review of the Accounts, for overall investment guideline compliance and performance.

For DFR, a Senior PM conducts a weekly review of DFR's mortgage securities holdings and generally monitors DFR's other holdings, such as corporate loans, in consultation with the PMs who are assigned to the holdings. The Valuation Committee of Deerfield conducts a quarterly valuation of DFR's less liquid portfolio securities.

Our Risk Management Committee conducts a monthly review of all accounts managed by Deerfield. The review includes an analysis of the account's volatility, risk, leverage and diversification among counterparties, and the creditworthiness of the counterparties. The Committee members include our Chief Risk Officer, Chief Investment Officer, Chief Financial Officer, General Counsel and Chief Compliance Officer.

Brokerage Discretion

We typically have authority to determine the broker or dealer to be used for the accounts we manage, and the commission rate to be paid to brokers. The only limitations on our authority in this regard would be those agreed to with the client.

The factors we consider in determining the broker or dealer to be used and the reasonableness of the commission rate paid are mainly the quality of execution, the financial condition of the broker or dealer, and the overall quality of the broker or dealer's services, which may include services other than execution of a specific trade, such as general market or company research the broker or dealer provides to us or specific trading ideas. The research generated by a client's trading may be used for the benefit of other clients and not all clients will benefit from all research obtained, but we do not have any "soft dollar" arrangements.

Certain brokers and dealers may introduce prospective clients to us or prospective investors to the Private Funds we advise. This might give us an incentive to cause client accounts to use those firms as brokers and trade counterparties, whether or not they provide best execution, the lowest commission rate, or the best transaction prices or terms.

Reports to Clients

The nature and frequency of the reports we provide to clients, or to the underlying investors in the case of CDOs and Private Funds, depends on the type of account we manage or advise for the client.

For CDOs, we make available to the investors in the CDO, on our website, the monthly report of the CDO's trustee, which shows the CDO's holdings and recent transactions, the CDO's compliance with its various asset quality and coverage tests, the CDO's cash balances, and certain other financial information. For the Sub-Advisor

Program we provide market commentary as requested by the client. For DFR, we make available to the investors in DFR, on DFR's website, the quarterly and annual financial reports that DFR files with the SEC, and we provide DFR's directors with updates on DFR's portfolio on an approximately quarterly basis, and more frequently depending on such factors as significant adverse changes in price volatility, margin requirements, market liquidity and position financing availability.

For Private Funds, we expect to provide to the investors in the Fund, on our website, a monthly or quarterly report of the investment performance of the Fund and of the investor's interest in the Fund, along with general market commentary.

Attachment A

Excerpts from Report on Form 10-K of Deerfield Capital Corp.
For the Fiscal Year Ended December 31, 2008,
Filed with the Securities and Exchange Commission on March 16, 2009

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PART I.

ITEM 1. BUSINESS

Overview

We are a Maryland corporation with an Investment Management segment that manages approximately \$10.5 billion of client assets (\$598.2 million of which is also included in our Principal Investing portfolio), as of January 1, 2009, including bank loans and other corporate debt, residential mortgage-backed securities, or RMBS, government securities, and asset-backed securities, or ABS. In addition, our Principal Investing segment has an investment portfolio of approximately \$808.4 million, as of December 31, 2008, comprised of fixed income investments, including bank loans and other corporate debt and RMBS. Historically, we had elected to be taxed as a real estate investment trust, or REIT. However, our status as a REIT terminated (retroactive to January 1, 2008) during the third quarter of 2008 when, in an effort to increase stockholder value, we converted to a C corporation to maximize use of potential significant tax benefits and provide more flexibility with respect to future capital investment.

From our inception in December 2004 through December 21, 2007, we were externally managed by our indirect, wholly-owned subsidiary, Deerfield Capital Management LLC, or DCM. As an externally-managed company, we had no employees of our own and relied on DCM to conduct our business and operations. All of our investment management services were provided by DCM under the supervision of our board of directors, or our Board.

On December 21, 2007, we completed our acquisition of Deerfield pursuant to a merger agreement, dated as of December 17, 2007, among us, DFR Merger Company, LLC (our wholly-owned subsidiary that was merged into Deerfield & Company LLC, or Deerfield), Deerfield and Triarc Companies, Inc., or Triarc (as sellers' representative), by which DFR Merger Company, LLC was merged with and into Deerfield on December 21, 2007, or the Merger. As a result of the Merger, each of Deerfield, DCM and Deerfield Capital Management (Europe) Limited, or DCM Europe, became our indirect, wholly-owned subsidiaries, and we became internally managed. DCM is a Chicago-based, SEC-registered investment adviser dedicated to serving the needs of investors by providing a variety of investment opportunities including structured vehicles, separately managed accounts and investment funds. The Deerfield organization commenced investment management operations in 1993. As of December 31, 2008, we had approximately 67 employees.

Our Business

Our business is managed in two operating segments: Investment Management and Principal Investing. Our Investment Management segment involves earning investment advisory fees for managing a variety of investment products including collateralized debt obligations, or CDOs, separately managed accounts and investment funds. Our Principal Investing segment involves maintaining an investment portfolio comprised primarily of bank loans and other corporate debt, Agency RMBS and non-Agency RMBS. Agency RMBS are backed by mortgage loans and are guaranteed as to principal and interest by federally chartered entities such as the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage

Corporation, or Freddie Mac, and, in the case of the Government National Mortgage Association, or Ginnie Mae, the U.S. government. We refer to these entities as “Agencies” and to RMBS guaranteed or issued by the Agencies as “Agency RMBS.” Our Agency RMBS portfolio consists of Fannie Mae and Freddie Mac securities. We refer to our investments in senior secured loans (first lien and second lien term loans), senior subordinated debt facilities and other junior securities, typically in middle market companies across a range of industries, as “Corporate Loans.”

Investment Management Segment

Our Investment Management segment is operated through DCM. DCM manages investment accounts for various types of clients, including CDOs and separately managed accounts (separate, non-pooled accounts established by clients). DCM has also previously managed private investment funds and a structured loan fund. Except for the separately managed accounts, these clients are collective investment vehicles that pool the capital contributions of multiple investors, which are typically financial institutions, such as insurance companies and banks, employee benefits plans and “funds of funds” (investment funds that in turn allocate their assets to a variety of other investment funds). Our teams that manage these accounts are supported by various other groups within DCM, such as risk management, systems, accounting, operations and legal. DCM enters into an investment management agreement with each client, pursuant to which the client grants DCM discretion to purchase and sell securities and other financial instruments without the client’s prior authorization.

Our primary source of revenue from our Investment Management segment is the investment advisory fees paid by the accounts we manage. These fees typically consist of management fees based on the account’s assets and performance fees based on the profits we generate for the account.

Assets Under Management

As of January 1, 2009, DCM’s total assets under management, or AUM, was approximately \$10.5 billion, held in 27 CDOs and five separately managed accounts.

The following table summarizes the AUM for each of our product categories:

	As of January 1,			
	2009		2008	
	Number of Accounts	AUM(1) (In thousands)	Number of Accounts	AUM(1) (In thousands)
CDOs(2) :				
CLOs(3)	12	\$ 4,286,407	16	\$ 5,844,241
Asset-backed securities	12	5,229,331	13	6,868,959
Corporate bonds	3	775,153	2	668,527
Total CDOs	27	10,290,891	31	13,381,727
Investment funds(4):				
Fixed income arbitrage	0	—	2	674,647
Separately managed accounts(5)	5	205,201	6	435,577
Total AUM(6)		\$ 10,496,092		\$ 14,491,951

(1)

AUM numbers are reported as of January 1, 2009 and 2008, rather than December 31, 2008 and 2007 to be inclusive of contributions, which for the investment funds were effective the first of every month.

(2) CDO AUM numbers generally reflect the aggregate principal or notional balance of the collateral and, in some cases, the cash balance held by the CDOs and are as of the date of the last trustee report received for each CDO prior to January 1, 2009 and 2008, respectively. For January 1, 2008, our CDOs/CLOs AUM included AUM related to a structured loan fund.

- (3) The AUM for our Euro-denominated CLO has been converted into U.S. dollars using the spot rate of exchange on December 31, 2008 and 2007, respectively.
- (4) For January 1, 2008, the number of accounts for the investment funds does not include feeder funds, which are funds that invest all or substantially all of their assets into a trading fund which we managed, although some of our management fees were paid pursuant to contracts with those feeder funds. The investment funds were liquidated during 2008.
- (5) AUM for certain of the separately managed accounts is a multiple of the capital actually invested in such account. Management fees for these accounts are paid on this higher AUM amount.
- (6) Included in Total AUM are \$295.1 million and \$294.6 million related to Market Square CLO Ltd., or Market Square CLO, and \$303.1 and \$300.0 million related to DFR Middle Market CLO Ltd., or DFR MM CLO, for January 1, 2009 and 2008, respectively, which amounts are also included in the total AUM reported for the Principal Investing portfolio as of December 31, 2008 and 2007. DCM manages these CDOs but is not contractually entitled to receive any management fees so long as 100% of the equity is held by Deerfield Capital LLC, or DC LLC, or an affiliate thereof. All other amounts included in the Principal Investing portfolio are excluded from Total AUM.

Collateralized Debt Obligations

The term CDO generally refers to a special purpose vehicle that owns a portfolio of investments and issues various tranches of debt and equity securities to fund the purchase of those investments. The debt tranches issued by the CDO are typically rated by one or more of the principal rating agencies based on portfolio quality, diversification and structural subordination. The equity securities issued by the CDO vehicle represent the first loss piece of the capital structure and are generally entitled to all residual amounts available for distribution after the CDO's obligations to the debt holders and certain other parties have been satisfied. As of January 1, 2009, we managed 27 CDOs. Twelve of the CDOs, commonly referred to as collateralized loan obligations, or CLOs, invest mainly in bank loans, twelve mainly in ABS and three mainly in corporate bonds.

Separately Managed Accounts

Our five separately managed accounts are managed pursuant to our proprietary Return Profile Management program, or RPM. RPM is a quantitative strategy for managing the duration profile of bond portfolios designed to add value in relation to a chosen benchmark by dynamically varying the portfolio's mix of cash (a low duration asset) and U.S. Treasury securities or Agency RMBS (an asset with duration risk). Duration essentially measures the market price volatility of financial instruments as a function of interest rate changes. The portfolio begins with a mix of cash and bonds, resulting in a duration equal to the starting target designated for each account. The RPM model is designed to then either lengthen (as rates move up) or shorten (as rates move down), the portfolio's duration in response to changes in interest rates. RPM does not involve forecasting of interest rates. Instead, decision-making is based on rate volatility and trends. RPM generally is implemented with U.S. Treasury securities or Agency RMBS to maximize liquidity and reduce transaction costs.

Investment Funds

We previously managed two investment funds. The funds invested generally in government securities of developed countries and related instruments, such as interest rate swaps and options.

Investment Advisory Fees

Our primary source of revenue from our Investment Management segment is the investment advisory fees paid by the accounts we manage. These fees typically consist of management fees based on

the account's assets and performance fees based on the profits we generate for the account. Almost all of our investing for these accounts is in fixed income securities and related financial instruments. We have certain discretionary trading authority over all of the accounts we manage. Our fees differ from account to account, but in general our fees from CDOs consist of a senior management fee (payable before the interest payable on the debt securities issued by the CDO) that ranges from 5 basis points to 25 basis points annually of the principal balance of the underlying collateral of the CDO, a subordinate management fee (payable after the interest payable on the debt securities issued by the CDO and certain other expenses) that ranges from 5 basis points to 45 basis points annually of the principal balance of the underlying collateral of the CDO, and, in certain CDOs, performance fees that are paid after certain investors' returns exceed an internal rate of return, or IRR, hurdle. The performance fees generally range from 10% to 20% of residual cash flows above the IRR hurdle and vary by transaction.

Seasonality

While our Investment Management segment is not directly affected by seasonality, our investment advisory fees may be higher in the fourth quarter of our fiscal year as a result of our revenue recognition accounting policy for performance fees related to investment funds we managed or may manage in the future. Performance fees on certain accounts may be based upon calendar year performance and are recognized when the amounts become fixed and determinable upon the close of the performance fee measurement period. We did not have performance fees in the fourth quarter of 2008 as a result of the liquidation of our investment funds during 2008. However, should we resume management of investment funds in the future, we may again be affected by seasonality.

Principal Investing Segment

Income from our Principal Investing segment is influenced by three factors: (i) the net spread, or difference, between the interest income we earn on our investment portfolio and the cost of our borrowings net of hedging activities, (ii) the recognized gains and losses on our investment portfolio and (iii) provision for loan losses, if any. Our net interest income will vary based upon, among other things, the difference between the interest rates earned on our interest-earning investments and the borrowing costs of the liabilities used to finance those investments. We use leverage to seek to enhance our returns, which can also magnify losses. The cost of borrowings to finance our investments comprises a significant portion of our operating expenses.

Our Principal Investing Portfolio

RMBS

We invest in pass-through RMBS, which are securities representing interests in mortgage loans secured by residential real property. Payments of both principal and interest on RMBS, or only principal or interest in the case of principal-only or interest-only securities, are generally made monthly, net of any fees paid to the issuer, servicer or guarantor of the securities. The Agency hybrid adjustable-rate RMBS represent the entire ownership interest in pools of residential mortgage loans made by lenders such as savings and loan institutions, mortgage bankers and commercial banks.

The investment characteristics of pass-through RMBS differ from those of traditional fixed-income securities. The major differences include the monthly payment of interest and principal, as described above, and the possibility that unscheduled principal payments may be received at any time due to prepayments on the underlying mortgage loans. These differences can result in significantly greater price and yield volatility than is the case with traditional fixed-income securities.

Corporate Loans

We invest in Corporate Loans. From time to time we also participate in revolving credit facilities and bridge loan commitments, under which the lender is obligated to advance funds to the borrower upon request, pursuant to the terms of the credit facility. We invest in middle market and more broadly syndicated Corporate Loans both directly and also through our investments in the equity of DFR Middle Market CLO Ltd., or DFR MM CLO, and Market Square CLO Ltd., or Market Square CLO. During the year ended December 31, 2008, we began to opportunistically sell Corporate Loans not held within DFR MM CLO or Market Square CLO in connection with our strategy of increasing liquidity in the Principal Investing segment and focusing on growing the Investment Management segment.

Other Investments

In addition to Agency RMBS and Corporate Loans, we may invest in other asset classes and securities, including commercial real estate, credit default swaps, or CDS, high yield bonds and equity securities, either as direct investments, for hedging purposes or in connection with other strategies.

* * *

Employees

As of December 31, 2008 and 2007, we had approximately 67 and 130 employees, respectively. As of March 16, 2009, we had approximately 64 employees. On March 1, 2008, in response to the adverse credit markets, we implemented a cost savings initiative, or the March 2008 Plan. The March 2008 Plan reduced our headcount by 13 employees, or 10% of the then current workforce, across a broad range of functions. Following the March 2008 Plan, in response to concerns about employee retention, we provided guaranteed payments to employees related to their 2008 compensation. In November 2008, in response to the continued deterioration in market conditions, our Board approved a second cost saving initiative, or the November 2008 Plan. The November 2008 Plan involved reducing headcount by 24 employees, or approximately 26% of the then current workforce, reducing bonus compensation and instituting a salary freeze. The November 2008 Plan headcount reductions were largely related to the fixed income arbitrage trading business and the associated back-office infrastructure. We believe these cost savings initiatives will improve our financial results without adversely impacting our ability to operate our business in a sound manner.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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Results of Operations by Segment

Management evaluates the performance of each business unit based on segment results. The following table presents the results of operations by segment:

	Year Ended December 31, 2008			
	Investment Management	Principal Investing	Eliminations	Consolidated
	(In thousands)			
Net revenues	\$ 45,840	\$ (32,074)	\$ (12,064)(1)	\$ 1,702
Expenses	(191,570)	(23,142)	12,064(1)	(202,648)
Other income and loss	(3,639)	(552,474)	—	(556,113)
Income tax expense	(127)	(224)	—	(351)
Net loss	<u>\$ (149,496)</u>	<u>\$ (607,914)</u>	<u>\$ —</u>	<u>\$ (757,410)</u>
	Year Ended December 31, 2007			

	<u>Investment Management</u>	<u>Principal Investing</u>	<u>Eliminations</u>	<u>Consolidated</u>
	<u>(In thousands)</u>			
Net revenues	\$ 1,694	\$ 91,280	\$ (438)(1)	\$ 92,536
Expenses	(1,779)	(22,472)	438(1)	(23,813)
Other income and loss	—	(163,979)	—	(163,979)
Income tax benefit (expense)	25	(1,005)	—	(980)
Net loss	<u>\$ (60)</u>	<u>\$ (96,176)</u>	<u>\$ —</u>	<u>\$ (96,236)</u>

(1) Represents the fees charged to the Principal Investing segment by the Investment Management segment on a cost plus basis for investment advisory, management and operational services.

Investment Management Segment

The Investment Management segment was created as a result of the Merger. As such, prior period data represents the period from December 22, 2007 to December 31, 2007.

Revenues

Our Investment Management segment revenues primarily represent the fee income earned for the management of investment accounts for various types of clients. The following table summarizes the Investment Management segment revenues:

	<u>Year Ended December 31,</u>	
	<u>2008</u>	<u>2007</u>
	<u>(In thousands)</u>	
Investment Management Segment Revenues		
Interest income	\$ 723	\$ 43
Interest expense	<u>7,108</u>	<u>242</u>
Net interest expense	(6,385)	(199)
Investment advisory fees(1)	<u>52,225</u>	<u>1,893</u>
Total Investment Management segment revenues	\$ 45,840	\$ 1,694

(1) Investment advisory fees include intercompany investment advisory fees of \$12.1 million and \$0.4 million for the years ended December 31, 2008 and 2007, respectively, calculated in conjunction with our management agreement, which are eliminated upon consolidation.

Net Interest Income

Interest income is primarily composed of interest earned on preferred shares of CDOs of \$0.5 million and \$36,000 and interest earned on cash balances of \$0.2 million and \$7,000 for the years ended December 31, 2008 and 2007, respectively. Interest expense is primarily composed of \$7.1 million and \$0.2 million on the Series A and Series B Notes for the years ended December 31, 2008 and 2007, respectively.

Investment Advisory Fees

For the years ended December 31, 2008 and 2007, investment advisory fees were \$52.2 million and \$1.9 million, respectively, on a segment basis, and \$40.2 million and \$1.5 million, respectively, on a consolidated basis due to the \$12.1 million and \$0.4 million, respectively, of fees earned by the Investment Management segment from the Principal Investing segment, which are eliminated in consolidation. During the year ended December 31, 2008, we earned non-recurring performance fees of \$2.7 million related to one of our ABS CDOs that exceeded a net interest spread hurdle during its initial asset ramp-up period and

\$1.2 million related to an investment fund which liquidated on April 30, 2008. Our significant investment advisory fee revenue streams during the period presented were generated by our CDOs, our investment fund, which has subsequently liquidated, and our separately managed accounts.

CDOs

The following table summarizes the investment advisory fee revenues from CDOs:

	Year Ended December 31, 2008			
	Senior	Subordinated	Performance	Total CDO
	Management Fees	Management Fees	Fees(1)	Advisory Fees
	(In thousands)			
CLOs	\$ 8,620	\$ 12,654	\$ —	\$ 21,274
ABS	5,304	352	2,774(2)	8,430
Corporate bonds	1,027	310	—	1,337
Total CDOs	<u>\$ 14,951</u>	<u>\$ 13,316</u>	<u>\$ 2,774</u>	<u>\$ 31,041</u>

- (1) Performance fees are generally earned after certain investors' returns exceed a specified IRR. For purposes of this and the following table, and in accordance with our accounting policies, we also classify any previously deferred senior or subordinated management fees that are subsequently paid as performance fees.
- (2) Performance fees for the year ended December 31, 2008 included a non-recurring performance fee of \$2.7 million received from one of our ABS CDOs.

Our fees differ from account to account, but in general, our fees from CDOs consist of a senior management fee (payable before the interest payable on the debt securities issued by the CDO) that ranges from 5 basis points to 25 basis points annually of the principal balance of the underlying collateral of the CDO, a subordinate management fee (payable after the interest payable on the debt securities issued by the CDO and certain other expenses) that ranges from 5 basis points to 45 basis points annually of the principal balance of the underlying collateral of the CDO, and, in certain CDOs, performance fees that are paid after certain investors' returns exceed an IRR hurdle. The performance fees generally range from 10% to 20% of residual cash flows above the IRR hurdle and vary by transaction.

The following table summarizes the average AUM and effective and contractual fee rates of our CDOs:

	Year Ended December 31, 2008				
	Average AUM(1) (In thousands)	Effective Rate(2)		Weighted Average Contractual Rate(3)	
		Senior	Subordinated	Senior	Subordinated
		Management Fee	Management Fee	Management Fee	Management Fee
CLOs(4)	\$ 4,662,641	0.18%	0.27%	0.20%	0.30%
ABS:					
High-grade ABS	3,624,939	0.05%	0.00%	0.05%	0.06%
Other ABS	2,641,366	0.13%	0.01%	0.14%	0.19%
Total ABS	<u>6,266,305</u>	<u>0.08%</u>	<u>0.01%</u>	<u>0.09%</u>	<u>0.11%</u>
Corporate bonds(5)	703,239	0.15%	0.04%	0.20%	0.18%
Total CDOs	<u>\$ 11,632,185</u>	<u>0.13%</u>	<u>0.11%</u>	<u>0.14%</u>	<u>0.19%</u>

- (1) Average AUM is calculated as the average of the AUM on the first day of each month in 2008. CDO AUM numbers generally reflect the aggregate principal or notional balance of the collateral and, in some cases, the cash balance held by the CDO and are as of the date of the last trustee report received for each CDO prior to the AUM date, as appropriate. Our CLO AUM includes AUM related to our structured loan fund, which is currently in the process of being liquidated.

- (2) The effective rate for the year ended December 31, 2008 is calculated by taking management fees earned during the period divided by the average AUM. The senior and subordinated management fee effective rates may differ from the contractual fee rates for various reasons, including the following: (a) we may have entered into agreements with specific investors pursuant to which a portion of our management fees are paid to those investors and (b) our senior and subordinated management fees may be deferred as a result of certain structural provisions built into the documents governing the CDO. In certain circumstances, we may at a later date and subject to certain performance triggers, be entitled to repayment of the fees paid to investors described in (a) above. In addition, we may at a later date and subject to the satisfaction of certain structural provisions, be entitled to payment of the deferred fees described in (b) above.
- (3) The weighted average contractual senior and subordinated management fee rates are obtained by multiplying the contractual fee rates for each CDO by that CDO's average AUM and dividing that number by the total average AUM for the relevant asset class.
- (4) The AUM for our Euro-denominated CLOs has been converted to U.S. dollars using the spot rate of exchange as of the respective AUM date. Market Square CLO and DFR MM CLO have been excluded from all categories in this table as DCM manages these CLOs, but is not contractually entitled to receive any third party fees so long as 100% of the equity is held by DC LLC or an affiliate thereof.
- (5) The effective and contractual rates for Robeco CDO are calculated based on the fees that we are entitled to receive pursuant to the asset purchase agreement between DCM and Robeco Investment Management, Inc. and are not the total fees paid by the CDO or the contractual fee rate set forth in the management agreement.

* * *

Expenses

The following table summarizes our Investment Management segment expenses for the year ended December 31, 2008 (In millions):

Salaries	\$ 13.7
Incentive compensation	11.3
Employee benefits	1.9
Total compensation and benefits	26.9
Audit and audit-related fees	0.7
Legal fees	0.6
Other professional fees	0.2
Total professional services	1.5
Insurance expense	0.5
Software and data feeds	1.9
Other general and administrative fees	1.1
Total general and administrative expense	3.0
Fixed asset depreciation	1.3
Intangible asset amortization	8.1
Total depreciation and amortization	9.4
Occupancy	2.5
Cost savings initiatives	1.8
Impairment of intangible assets	47.3
Impairment of goodwill	98.7
Total impairment of intangible assets and goodwill	146.0
Total Investment Management segment expenses	\$ 191.6

The most significant recurring expenses for the Investment Management segment are compensation and benefits costs. On March 1, 2008, in response to the adverse credit markets, we implemented the March 2008 Plan and reduced our headcount by 13 employees, or 10% of the then current workforce, across a broad range of functions. This resulted in severance expense of \$0.3 million during the year ended December 31, 2008. Following the March 2008 Plan, in response to concerns about employee retention, we provided guaranteed payments to employees related to their 2008 compensation.

As of December 31, 2008, we had approximately 67 employees, a reduction of approximately 63 employees since December 31, 2007. In addition, during the year ended December 31, 2008, we revised our incentive compensation plan as a result of the decline in our performance during the year. Although we have adjusted our current accrual to reflect our decision not to utilize share-based compensation for a portion of our incentive compensation during 2008, we may change our decision in future years.

During the year ended December 31, 2008, we recorded \$47.3 million of impairment charges on intangible assets which were initially recorded as a result of the Merger. We recorded impairment charges of \$35.4 million associated with the management contracts related to our investment funds, which performed poorly and were liquidated during the year, and \$4.0 million of impairment charges related to the “Deerfield” trade name.

Other Income and Gain (Loss)

Other income and gain (loss) for the Investment Management segment primarily consisted of the realized and unrealized losses related to our investments in preferred shares of CDOs that are managed by DCM. We sold eight of these investments in December 2008. During the year ended December 31, 2008, we recognized realized and unrealized losses of \$1.3 million and \$2.6 million, respectively, in net loss (gain) on trading securities in the consolidated statements of operations related to these investments.

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