

**Deerfield Capital Management LLC**

6250 North River Road  
Rosemont, Illinois 60018 U.S.A.  
Telephone: (773) 380-1600  
SEC File Number: 801-53728

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

July 1, 2010

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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 those 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**

Deerfield is a global fixed-income investment adviser that has provided investment advisory services to clients since 1993. We have been registered with the SEC as an investment adviser 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 the NASDAQ Stock Market under the DFR symbol. We had conducted all of the investing for DFR since its inception in November 2004, as DFR’s external manager, and following the December 2007 acquisition we have continued to conduct all of its investing, as its internal manager.

In June 2010 DFR acquired 100% of Columbus Nova Credit Investments Management, LLC (“CNCIM”), an investment adviser that manages various collateralized debt obligation vehicles (“CDOs”) that focus on leveraged loan credit products. CNCIM operates as a wholly-owned subsidiary of Deerfield and will continue as the investment manager of the CDOs pursuant to the investment management agreements it had entered into with the CDOs before the acquisition. We provide various services to CNCIM and the CNCIM-managed CDOs. Certain of the individuals employed by CNCIM before the acquisition remain CNCIM employees. CNCIM is not registered with the SEC as an investment adviser. Unless otherwise specified or the context otherwise required, the references herein to our investment management and related activities generally apply also to CNCIM.

We encourage you to visit DFR’s website, [www.deerfieldcapital.com](http://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 2009. We engage solely in the investment advisory business. The main advisory service we provide is the management of clients’ investments 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 do not engage in other business activities. We do not provide financial planning or similar services.

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 and consist mainly of management fees based upon a percentage of assets under management and in certain cases performance fees.

We have assumed several management contracts (by assignment, acquisition or otherwise) to manage already established portfolios for structured vehicles and may receive only a portion of the management fees stated in the advisory contract and may have entered into a fee sharing arrangement with the prior manager.

### Clients

We generally provide investment advice to CDOs, private investment funds (“Private Funds”) and individually managed separate accounts (“Managed Accounts”), which are typically maintained by pension and profit sharing plans and other institutional investors. We currently provide investment advice to approximately 30 CDOs, one Private Fund, and six Managed Accounts. We may offer and manage other types of investment programs in the future. We also manage the investing of DFR.

### Education and Business Standards

We generally require our employees who are involved in determining or giving investment advice to clients (“Portfolio Managers,” or “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 our 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 Co-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.

**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**, Co-Chief Investment Officer, Managing Director and Senior Portfolio Manager  
DOB: 1970

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 in 2004.

**Dan Hattori**, Managing Director and Senior Portfolio Manager  
DOB: 1964

Education: B.S. and M.B.A. from DePaul University  
Business background: Mr. Hattori joined Deerfield in 2000.

#### 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.

**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 (but we do not currently operate in such capacity). We are not registered as a securities broker-dealer. As noted above, we have a wholly-owned subsidiary, CNCIM, which is an investment adviser, and we provide various services to CNCIM and the CDOs it manages. Certain of our "Related Persons" (in general, our officers, directors, and non-clerical employees, and any person controlling, controlled by or under common control with us) may be general partners or managers of 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 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 of 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 whether we or our Related Persons may own interests in the vehicles.

#### General Partner/Managing Member Status

A Related Person currently serves as the general partner of the Private Fund we manage, Deerfield Pegasus Loan Capital, L.P., which invests in bank loans and related instruments.

#### 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 or dealer spreads 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.

#### 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 more information about our allocation policies and procedures.



### Non-Public Information

In considering investments in bank 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](http://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 things, 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 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 Ethics (the “Code”) that is a guide to the legal and ethical behavior of our directors, officers and employees (including the employees of CNCIM). 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 of 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; and political activities and contributions.

### 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.

### 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.

### Investor Side Letters

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

## **Section 2. Client Account Information**

### **Advisory Fees**

We do not have a standard fee for our investment advisory services. Our advisory fees are negotiated with each client; the fees generally differ depending on the type of account; and the fees may differ among accounts of the same type, depending on such factors as account size.

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 5-20 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 some CDOs, we may have entered into agreements with specific investors pursuant to which a portion of our management fees are paid to those investors or 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 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 above.

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 Private Funds, we 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 the fees are paid in advance and if 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 basically consists of a reimbursement of certain of our general overhead expenses allocable to our management of DFR's investment portfolio.

## 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 our 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, futures contracts 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.

We may invest in any of the foregoing instruments for DFR.

## Portfolio Review

For CDOs, we generally 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, overcollateralization and other coverage. Our review generally focuses on reconciling the trustee's analysis with our internal records.

For bank loan CDOs, the reviewers are generally the Loan Administrators (there are typically 3-5), supervised by the PM assigned to the CDO. Each bank loan PM (there are typically 4-5) is generally 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 typically 2-3) assigned to the ABS and Bond desks, who report to the ABS/Bond Director or the ABS/Bond Portfolio Manager that they have conducted the review.

The reviewers' instructions are generally 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 typically conduct a monthly review of the Accounts, principally for compliance with their investment guidelines. The reviews are conducted by a Compliance Department employee.

For DFR, a Senior PM usually conducts a weekly review of DFR's mortgage securities holdings and monitors DFR's other holdings, such as corporate loans, in consultation with the PMs assigned to the holdings.

Our Risk Management Committee generally conducts a monthly review of our Private Funds and the DFR account. This review typically includes an analysis of the account's volatility, risk, leverage and diversification among counterparties, and the creditworthiness of the counterparties. The Committee members include the Chief Risk Officer, a Co-Chief Investment Officer, the Chief Financial Officer, the General Counsel and the 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 clients that are pooled investment vehicles, depends on the type of account and other factors. We may provide additional reports to owners of Managed Accounts upon request.

For CDOs, we generally 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 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, 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, 2009,  
Filed with the Securities and Exchange Commission on March 23, 2010

**PART I.**

**ITEM 1. BUSINESS**

**Overview**

We are a Maryland corporation that commenced operations in December 2004 and completed our initial public offering in July 2005. We have an investment management segment that manages approximately \$9.2 billion of client assets as of January 1, 2010, 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 \$593.6 million as of December 31, 2009, 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 in 2008 when we converted to a C corporation to maximize the use of potential significant tax benefits and provide more flexibility with respect to future capital investment.

From our inception 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 & Company LLC, or 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), Deerfield and Triarc Companies, Inc., or Triarc (as sellers' representative), by which DFR Merger Company, LLC was merged with and into Deerfield, or the Merger. As a result of the Merger, each of Deerfield and DCM, 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.

On March 22, 2010, we entered into an Acquisition and Investment Agreement, or Acquisition Agreement, with Bounty Investments, LLC, or Bounty, an investment vehicle managed by Renova U.S. Management LLC, or Columbus Nova, and Columbus Nova Credit Investments Management, LLC, or CNCIM, pursuant to which we agreed to acquire CNCIM for a total purchase price of \$32.5 million consisting of the issuance of 4,545,455 shares of our common stock (at an implied price of \$5.50 per share), or the Stock Consideration and deferred payments totaling \$7.5 million. Additionally, Bounty has agreed to purchase \$25.0 million in principal amount of senior subordinated convertible notes, or Convertible Notes, issued by us. The proceeds from the Convertible Notes, along with our cash, will be used to repurchase and retire all of the \$73.9 million in principal amount of the outstanding Series A and Series B Senior Secured Notes for a total purchase price of \$55.0 million plus accrued interest. In connection with the Acquisition Agreement, we entered into a Transition Services Agreement with Bounty and CNCIM, pursuant to which we will provide services to CNCIM in connection with CNCIM's management of its CLOs. We also agreed to enter into a Stockholders Agreement upon the consummation of the transactions contemplated by the Acquisition Agreement providing for, among other things, the right of Bounty to nominate up to three directors to the Board based upon specified percentages of ownership of

our outstanding common stock. We refer to the acquisition of CNCIM and our issuance of the Convertible Notes and related agreements as the Transactions.

Please see "*Part II—Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Recent Developments*" for a discussion of the proposed strategic transactions.

## 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 other investment vehicles. Our Principal Investing segment involves maintaining an investment portfolio comprised primarily of bank loans and other corporate debt and Agency RMBS (as defined below). 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."

For disclosure of operating results and total assets by segment see "*Part II—Item 8. Financial Statements and Supplementary Data—Note 27.*"

## Investment Management Segment

Our Investment Management segment is operated through DCM. DCM manages investment accounts for various types of clients, including CDOs, separately managed accounts (separate, non-pooled accounts established by clients) and other investment vehicles. 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 certain discretion to purchase and sell securities and other financial instruments.

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, in some cases, performance fees based on the profits we generate for the account.

### *Assets Under Management*

As of January 1, 2010, DCM's total assets under management, or AUM, was approximately \$9.2 billion, held in 28 CDOs, six separately managed accounts and one other investment vehicle.

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

As of January 1,			
2010		2009	
Number of Accounts	AUM (In thousands)	Number of Accounts	AUM (In thousands)
CDOs(1):			

CLOs	12	\$ 4,041,540	12	\$ 4,286,407
Asset-backed securities	12	4,054,722	12	5,229,331
Corporate bonds	4	754,815	3	775,153
Total CDOs	28	8,851,077	27	10,290,891
Separately managed accounts(2)	6	320,464	5	205,201
Other investment vehicle(3)	1	22,367	—	—
Total AUM(4)		<u>\$ 9,193,908</u>		<u>\$ 10,496,092</u>

- (1) 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, 2010 and 2009, respectively. The AUM for our Euro-denominated CDOs has been converted into U.S. dollars using the spot rate of exchange as of the respective AUM date.
- (2) 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.
- (3) Other investment vehicle AUM represents the AUM of Deerfield Pegasus Loan Capital LP, or DPLC.
- (4) Included in Total AUM for January 1, 2010 is \$288.5 million related to DFR Middle Market CLO Ltd., or DFR MM CLO. Included in Total AUM for January 1, 2009 is \$303.1 million related to DFR MM CLO and \$295.1 million related to Market Square CLO Ltd., or Market Square CLO. DCM manages DFR MM CLO and Market Square CLO 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. As a result of the sale of our preference shares, as of July 1, 2009 we began to receive management fees from Market Square CLO.

#### ***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, 2010, we managed 28 CDOs. Twelve of the CDOs, commonly referred to as collateralized loan obligations, or CLOs, invest mainly in bank loans, twelve mainly in ABS and four mainly in corporate bonds.

#### ***Other Investment Vehicle***

Our other investment vehicle represents Deerfield Pegasus Loan Capital LP, or DPLC, our investment venture with Pegasus Capital Advisors L.P., or Pegasus. Pegasus and DFR committed to invest \$74.0 million and \$15.0 million, respectively, in DPLC. We initially expected such amounts to be invested primarily in corporate bank loans and other senior secured corporate loans. However, as a result of the

rapid recovery of corporate loan prices, the return thresholds we initially expected for DPLC are no longer attainable, and we are currently evaluating other investment strategies. The commitments of each of Pegasus and DFR are subject to numerous conditions, any or all of which may not be satisfied. As of December 31, 2009, Pegasus and DFR had funded \$20.0 million and \$4.0 million, respectively, of such commitments. DPLC is managed by DCM. For further disclosure concerning Pegasus see "*Part II—Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Recent Developments.*"

### ***Separately Managed Accounts***

Our six 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 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 20 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 DPLC. We did not have any performance fees in the current year related to DPLC and do not expect to have performance fees in the next year related to DPLC.

### **Principal Investing Segment**

Income from our Principal Investing segment is influenced by four factors: (i) the nominal amount of interest income we earn on our investment portfolio and the net spread, or difference, between the interest income we earn on our investment portfolio and the cost of our borrowings net of hedging derivatives, if any, (ii) the net recognized gains and losses, if any, on our investment portfolio, (iii) provision for loan losses, if any, and (iv) the volume or aggregate amount of such 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 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 investment in the equity of DFR Middle Market CLO Ltd, or DFR MM CLO, and our investment in DPLC.

### *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, CLO debt, CLO equity and equity securities, either as direct investments, for hedging purposes or in connection with other strategies.

\* \* \*

### **Employees**

As of both December 31, 2009 and 2008, we had approximately 67 employees.

\* \* \*

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

\* \* \*

### **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, 2009			
	Investment Management	Principal Investing	Eliminations	Consolidated
	(In thousands)			
Net revenues	\$ 18,990	\$ 13,693	\$ (6,027)(1)	\$ 26,656
Expenses	(27,681)	(17,566)	6,027(1)	(39,220)
Other income and (loss) gain	(56)	76,953	—	76,897
Income tax expense	(29)	—	—	(29)

Net (loss) income	\$	(8,776)	\$	73,080	\$	—	\$	64,304
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	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	\$ (149,496)	\$ (607,914)	\$ —	\$ (757,410)

	Year ended December 31, 2007			
	Investment Management	Principal Investing	Eliminations	Consolidated
	(In thousands)			
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	\$ (60)	\$ (96,176)	\$ —	\$ (96,236)

(1)

Primarily represents internal fees charged to the Principal Investing segment by the Investment Management segment on a cost plus basis for investment advisory, management and operational services. In addition, for the year ended December 31, 2009 this includes \$0.2 million of management fees which were earned on our investment in DPLC and eliminated upon consolidation.

Our Principal Investing segment results of operations include the financial results of DFR MM CLO for the years ended December 31, 2009 and 2008 and the financial results of DPLC for the year ended December 31, 2009. The Principal Investing segment results of operations also includes the financial results of Market Square CLO for the year ended December 31, 2008. On June 30, 2009, we sold all of our preference shares in Market Square CLO to an unrelated third party in exchange for an upfront payment and a delayed purchase price in the form of a right to receive a portion of the future distributions, if any, on the preference shares. As a result of the sale, we determined we were no longer the primary beneficiary of Market Square CLO and therefore deconsolidated Market Square CLO. As of December 31, 2009, none of the Market Square CLO assets, liabilities or equity are included in our consolidated balance sheet; however, all of the financial impacts to the consolidated statements of operations from the previous consolidation of Market Square CLO were recognized through June 30, 2009. The Principal Investing segment results of operations also includes the financial results of Pinetree CDO for the year ended December 31, 2007. On December 31, 2007 we sold all of our preference shares in Pinetree CDO. As a result of the sale, we

determined we were no longer the primary beneficiary of Pinetree CDO and therefore deconsolidated Pinetree CDO. As of December 31, 2007, none of the Pinetree CDO assets, liabilities or equity were included in our consolidated balance sheet; however, all of the financial impacts to the consolidated statements of operations from the previous consolidation of Pinetree CDO were recognized through December 31, 2007.

## Investment Management Segment

### Revenues

Our Investment Management segment revenues primarily represent the fee income earned for the management of investment accounts for various types of clients. The Investment Management segment was created as a result of the Merger. As such, data presented for the year ended December 31, 2007 represents the period from December 22, 2007 to December 31, 2007. The following table summarizes the Investment Management segment revenues:

	Year ended December 31,			Variance	
	2009	2008	2007	2009 vs. 2008	2008 vs. 2007
	(In thousands)				
<b>Investment Management Segment Revenues</b>					
Interest income	\$ 82	\$ 723	\$ 43	\$ (641)	\$ 680
Interest expense	4,999	7,108	242	(2,109)	6,866
Net interest expense	(4,917)	(6,385)	(199)	1,468	(6,186)
Investment advisory fees(1)	23,907	52,225	1,893	(28,318)	50,332
Total Investment Management segment revenues	<u>\$ 18,990</u>	<u>\$ 45,840</u>	<u>\$ 1,694</u>	<u>\$ (26,850)</u>	<u>\$ 44,146</u>

(1)

Investment advisory fees include intercompany investment advisory fees of \$6.0 million, \$12.1 million and \$0.4 million for the years ended December 31, 2009, 2008, and 2007, respectively, which are eliminated upon consolidation.

### Net Interest Income

Interest income for the year ended December 31, 2009 is primarily comprised of interest earned from our cash balances. Interest income for the year ended December 31, 2008 is primarily comprised of interest earned on preferred shares of CDOs of \$0.5 million and interest earned on cash balances of \$0.2 million. We owned preferred shares issued by two and one of the CDOs that we managed as of December 31, 2009 and 2008, respectively. The primary driver of the reduction in interest income during the year ended December 31, 2009, as compared to the year ended December 31, 2008, was the termination of equity distributions from our investments in preferred shares of CDOs during the first quarter of 2009. Interest expense for all periods presented is primarily comprised of interest expense on the Series A and Series B Notes. The reduction in interest expense during the year ended December 31, 2009, as compared to the year ended December 31, 2008, was the result of a reduced interest rate environment.

### Investment Advisory Fees

For the years ended December 31, 2009, 2008 and 2007, investment advisory fees were \$23.9 million, \$52.2 million and \$1.9 million, respectively, on a segment basis, and \$17.9 million, \$40.2 million, and \$1.5 million, respectively, on a consolidated basis due to the \$6.0 million, \$12.1 million and \$0.4 million, respectively, of fees earned by the Investment Management segment from the Principal Investing segment, which are eliminated upon consolidation. Our investment advisory fee revenue during the periods presented was generated by our CDOs, our investment funds, which were liquidated in 2008, our separately managed accounts and DPLC. The following discussions further analyze and explain changes in our investment advisory fees by type and product.

### ***CDOs***

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

	Year ended December 31,		Variance
	2009	2008	2009 vs. 2008
	(In thousands)		
Senior Management Fees:			
CLOs	\$ 6,693	\$ 8,620	\$ (1,927)
ABS	3,330	5,304	(1,974)
Corporate Bonds	1,833	1,027	806
Total Senior Mangement Fees	11,856	14,951	(3,095)
Subordinated Management Fees:			
CLOs	2,774	12,654	(9,880)
ABS	152	352	(200)
Corporate Bonds	564	310	254
Total Subordinate Mangement Fees	3,490	13,316	(9,826)
Performance Fees(1):			
CLOs	1,026(2)	—	1,026
ABS	—	2,774(3)	(2,774)
Corporate Bonds	225(4)	—	225
Total Performance Fees	1,251	2,774	(1,523)
Total CDO Advisory Fees:			
CLOs	10,493	21,274	(10,781)
ABS	3,482	8,430	(4,948)
Corporate Bonds	2,622	1,337	1,285



**Total CDO Advisory Fees**

\$ 16,597    \$ 31,041    \$ (14,444)

- (1) Performance fees are generally earned after certain investors' returns exceed a specified internal rate of return, or 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 on CLOs for the year ended December 31, 2009 represent previously deferred subordinate management fees.
- (3) Performance fees on ABS CDOs for the year ended December 31, 2008 included a non-recurring performance fee of \$2.7 million received from one of our ABS CDOs.
- (4) Performance fees on Corporate Bonds CDOs for the year ended December 31, 2009 include \$0.2 million in fees related to a previously liquidated corporate bond CDO as a result of a settlement received in connection with certain litigation relating to one of the assets previously held in the CDO.

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 20 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.

Under the investment management agreements between DCM and the CDOs it manages, the payment of DCM's management fees is generally subject to a "waterfall" structure. Pursuant to these "waterfalls," all or a portion of DCM's subordinated management fees may be deferred if the CDOs do not generate sufficient cash flows to pay the required interest on the notes that the CDOs have issued to investors and certain expenses they have incurred. This could occur if, for example, the issuers of the collateral underlying the CDOs default on or defer payments of principal or interest relating to such collateral or the ratings assigned to such collateral are downgraded below a specified threshold. In addition, all or a portion of DCM's subordinated management fees may be deferred if, among other things, overcollateralization tests and other structural provisions built into the CDOs divert cashflows to the prepayment of the debt securities issued by the CDOs.

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

	Average AUM(1) (In thousands)	Year ended December 31, 2009		Weighted Average Contractual Rate(3)	
		Effective Rate(2)		Senior	Subordinated
		Senior Management Fee	Subordinated Management Fee(4)	Management Fee	Management Fee
CLOs(5)	\$ 3,779,403	0.18%	0.10%	0.18%	0.33%

ABS:

High-grade ABS	3,202,580	0.05%	0.00%	0.05%	0.06%
Other ABS	1,389,986	0.12%	0.01%	0.15%	0.22%
Total ABS	4,592,566	0.07%	0.00%	0.08%	0.11%
Corporate bonds(6)	837,972	0.22%	0.09%	0.21%	0.23%
Total CDOs	<u>\$ 9,209,941</u>	0.13%	0.05%	0.13%	0.21%

Year ended December 31, 2008					
	Average AUM(1) (In thousands)	Effective Rate(2)		Weighted Average Contractual Rate(3)	
		Senior Management Fee	Subordinated Management Fee	Senior Management Fee	Subordinated Management Fee
CLOs(5)	\$ 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	6,266,305	0.08%	0.01%	0.09%	0.11%
Corporate bonds(6)	703,239	0.15%	0.04%	0.20%	0.18%
Total CDOs	<u>\$ 11,632,185</u>	0.13%	0.11%	0.14%	0.19%

(1)

Average AUM is calculated as the average of the AUM on the first day of each month in 2009 and 2008, respectively. 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. The AUM for our Euro-denominated CDOs has been converted to U.S. dollars using the spot rate of exchange as of the respective AUM date.

(2)

The effective rate for the years ended December 31, 2009 and 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 or 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, 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, 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 subordinated management fee effective rates include previously deferred subordinated management fees received during the year and categorized as performance fees.
- (5) DFR MM CLO has been excluded from all categories in this table as DCM manages this CLO, but is not contractually entitled to receive any management fees for DFR MM CLO so long as 100% of the equity is held by DC LLC or an affiliate thereof. In addition, Market Square CLO has been excluded from all categories in this table through July 1, 2009, when we became entitled to receive management fees from Market Square CLO as a result of the sale of all of our preference shares of Market Square CLO on June 30, 2009.
- (6) 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 rates set forth in the management agreement.

The following table summarizes select details of the structure of each of our CDOs:

	Closing Date Month/Year	January 1, 2010 AUM(1) (In thousands)	First Optional Call Date(2)	Auction Call Date(3) Month/Year	Termination of Reinvestment Period(4)	Maturity Year
<b>CLOs:</b>						
Rosemont CLO, Ltd.	01/02	\$ 141,027	10/05	n/a	01/07	2013
Forest Creek CLO Ltd.	05/03	264,993	07/07	n/a	07/08	2015
Long Grove CLO Ltd.	06/04	353,518	08/08	n/a	05/10	2016
Market Square CLO Ltd.	05/05	273,709	07/07	n/a	04/11	2017
Cumberland II CLO Ltd.	09/05	376,207	02/10	n/a	11/11	2019
Marquette Park CLO Ltd.	12/05	291,902	04/10	n/a	01/12	2020

Bridgeport CLO Ltd.	06/06	490,773	10/09	n/a	07/13	2020
Burr Ridge CLO Plus Ltd.	12/06	288,667	06/12	n/a	03/13	2023
Schiller Park CLO Ltd.	05/07	400,369	07/11	n/a	04/13	2021
Bridgeport CLO II Ltd.	06/07	496,983	12/10	n/a	09/14	2021
DFR Middle Market CLO Ltd.( 5)	07/07	288,477	07/10	n/a	07/10	2019
Gillespie CLO PLC (6)	08/07	374,915	02/13	n/a	08/13	2023
<b>Total CLOs</b>		4,041,540				
<b>ABS CDOs:</b>						
Mid Ocean CBO 2000- 1 Ltd.	01/01	110,453	04/06	n/a	01/06	2036
Mid Ocean CBO 2001- 1 Ltd.	10/01	126,048	02/06	n/a	01/06	2036
Oceanview CBO I, Ltd.	06/02	157,168	06/06	06/12	06/06	2032, 2037(7)
Northlake CDO I, Limited	02/03	112,105	03/06	03/13	03/07	2033
Knollwood CDO Ltd.	03/04	118,323	04/07	04/12	04/08	2039
River North CDO Ltd.	01/05	210,452	02/09	02/13	02/09	2040
Buckingham CDO Ltd.	07/05	794,798	08/10	08/13	08/10	2040
Pinetree CDO Ltd.	11/05	182,072	01/10	01/14	01/10	2045

Buckingham CDO II Ltd.	12/05	1,116,306	03/11	03/14	03/11	2041
Knollwood CDO II Ltd.	07/06	66,474	07/09	07/13	n/a	2046
Buckingham CDO III Ltd.	08/06	1,056,493	09/11	09/14	09/11	2051
Aramis CDO	03/07	4,030	03/12	n/a	n/a	2047
<b>Total ABS CDOs</b>		4,054,722				
<b>Corporate Bond CDOs:</b>						
Valeo Investmen t Grade CDO Ltd.	01/01	280,589	01/05	n/a	01/06	2013
Valeo Investmen t Grade CDO II Ltd.	05/01	255,578	06/05	n/a	06/06	2013
Robeco CDO II Limited	08/01	110,718	08/05	n/a	02/06	2013
Mayfair Euro CDO I B.V.(6)	06/01	107,930	05/06	n/a	05/06	2013
<b>Total Corporat e Bond CDOs</b>		754,815				
<b>Total CDO AUM</b>		\$ 8,851,077				

(1)

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, 2010.

- (2) CDOs are generally callable by equity holders once per quarter beginning on the "first option call date" and subject to satisfaction of certain conditions.
- (3) ABS CDOs generally contain a provision requiring the manager thereof to attempt to liquidate the collateral held therein on the "auction call date," subject to certain conditions, generally including that the proceeds from any such liquidation be sufficient to redeem the notes and pay certain additional expenses.
- (4) Termination of reinvestment period refers to the date after which we can no longer use certain principal collections to purchase additional collateral, and such collections are instead used to repay the outstanding amounts of certain debt securities issued by the CDO.
- (5) We are not contractually entitled to receive any management fees from this CLO so long as 100% of the equity is held by DC LLC or an affiliate thereof.
- (6) The AUM for our Euro-denominated CDOs has been converted into U.S. dollars using the spot rate of exchange on December 31, 2009.
- (7) Maturity date varies by tranche of notes.

The CDOs that we manage generally contain certain structural provisions, including but not limited to overcollateralization requirements, that are meant to protect investors from deterioration in the credit quality of the underlying collateral pool. Recent increased defaults and downgrades of the collateral underlying our CDOs have put downward pressure on overcollateralization ratios and increased the likelihood that the CDOs we manage will experience events of default or trigger other structural provisions. Noncompliance with overcollateralization tests and other structural provisions may cause cash flows from the CDOs to be diverted to prepay the debt securities issued by the CDOs, which may decrease the asset base on which our future management fees are calculated and typically results in the deferral of the payment of our subordinated management fees. In addition, in certain cases, noncompliance with these overcollateralization tests or other structural provisions can lead to events of default under the indentures governing the CDOs and, ultimately, acceleration of the notes issued by the CDO and the liquidation of the underlying collateral. Certain of our CDOs contain provisions prohibiting the liquidation of the CDO following an event of default unless either the proceeds from the liquidation will be sufficient to pay off all of the notes issued by the CDO along with certain specified expenses or a majority or supermajority of certain specified classes of notes vote to liquidate the CDO. We believe that CDOs that contain these provisions are less likely to liquidate upon the occurrence of an event of default. In addition, certain CDOs we manage contain provisions where noncompliance with overcollateralization tests causes us to become subject to removal as investment manager at the discretion of certain classes of investors.

CLO investment advisory fee revenue declined by \$10.8 million for the year ended December 31, 2009, as compared to the year ended December 31, 2008. We managed four market value CLOs during 2008, all of which contained liquidation triggers and events of default based on the market value of the CLO's assets. The significant decline in liquidity in the credit markets during the year ended December 31, 2008 had a negative impact on the market values of the assets held in our CLOs. All four of our market value CLOs breached their market value triggers during the year ended December 31, 2008 and were subsequently liquidated. For the year ended December 31, 2008, we earned senior management fees of \$1.8 million and subordinated management fees of \$0.8 million on these market value CLOs. The remainder of our CLOs are cash flow CLOs. Triggers and events of default in these deals are not based on the market value of the underlying asset portfolio.

Subordinated management fees on CLOs declined by \$9.9 million during the year ended December 31, 2009 as compared to the year ended December 31, 2008. This was primarily due to the failure of the overcollateralization tests for substantially all of our cash flow CLOs during the year ended December 31, 2009, resulting in the deferral of subordinated management fees on those CLOs. We earned subordinated management fees on our cash flow CLOs of \$2.8 million and \$11.8 million for the years ended December 31, 2009 and 2008, respectively. During 2009, all \$1.3 million of performance fees represent previously deferred subordinated management fees.

We expect a portion of our CLO subordinated management fees to continue to be deferred in the near term. However, over time and with continued improvement in market conditions and effective portfolio management, we expect our CLOs to return to compliance with their overcollateralization tests, and, subject to the satisfaction of certain other conditions, we would expect to recoup at least a portion and potentially substantially all of the deferred subordinated management fees and to receive future subordinated management fees on a current basis. We have recently begun to receive a portion of our previously deferred subordinated management fees and, as of December 31, 2009, our CLOs have unrecognized deferred subordinated management fees totaling approximately \$6.9 million.

ABS CDO revenue declined by \$5.0 million for the year ended December 31, 2009 as compared to the year ended December 31, 2008 as a result of a decline in senior management fees of \$2.0 million, subordinated management fees of \$0.2 million and performance fees of \$2.8 million. These declines were primarily the result of one of our ABS CDOs liquidating and the reduction in AUM for the remainder of our ABS CDOs, as compared to the year ended December 31, 2008. In addition, during the year ended December 31, 2008 a non-recurring performance fee of \$2.7 million was received from one of our ABS CDOs. We expect our ABS CDO AUM and management fees to continue to decline as a result of both the diversion of cash flows to prepay the debt securities issued by those CDOs based on continued noncompliance with overcollateralization tests and other structural provisions and additional defaults and ratings downgrades with respect to the underlying collateral in those CDOs.

We are continuing to focus on our previously announced strategy of acquiring existing CDO management contracts. On July 17, 2008, we acquired the management contract for Robeco CDO, and, on February 11, 2009, we assumed the management contract for Mayfair Euro CDO.

#### *Other Investment Advisory Fees*

The following table summarizes the respective investment advisory fee revenues for our investment management contracts related to our separately managed accounts, fixed income arbitrage investment funds and other investment vehicles for the years ended December 31, 2009 and 2008:

	<u>Average AUM(1)</u>	<u>Management Fees (In thousands)</u>	<u>Performance Fees</u>
<b>Year ended December 31, 2009:</b>			
Separately managed accounts	\$ 313,471	\$ 858	n/a
Other investment vehicle(2)	\$ 13,656	\$ 425	\$ —
<b>Year ended December 31, 2008:</b>			
Fixed income arbitrage investment funds	\$ 455,427	\$ 7,064	\$ 1,186(3)
Separately managed accounts	\$ 363,666	\$ 870	n/a

(1)

Average AUM is calculated as the average of the AUM on the first day of each month in 2009 and 2008.

(2) Represents management fee revenues earned on DPLC. We recognized management fee revenues on the portion of the AUM which is not related to our investment in DPLC. As of January 1, 2010, Deerfield and Pegasus agreed to temporarily suspend management fees related to DPLC.

(3) Performance fees were related to our smaller investment fund, which liquidated on April 30, 2008.

n/a—not applicable

The reduction in other investment advisory fees during the year ended December 31, 2009 as compared to the year December 31, 2008, was primarily driven by the liquidation of our fixed income arbitrage investment funds during 2008. For the year ended December 31, 2008, we earned management fees of \$7.1 million and incentive fees of \$1.2 million related to these liquidated investment funds.

On April 14, 2009, we announced the formation of DPLC, our investment venture with Pegasus. Pegasus is a U.S.-based private equity firm. Pegasus and DFR are currently committed to invest \$74.0 million and \$15.0 million, respectively, in DPLC. We initially expected such amounts to be invested primarily in corporate bank loans and other senior secured corporate loans. However, as a result of the rapid recovery of corporate loan prices, the return thresholds we initially expected for DPLC are no longer attainable, and we are currently evaluating other investment strategies. As a result of the formation of DPLC, we earned management fees on the portion of the assets under management which is not related to our investment in DPLC. As of January 1, 2010 DFR and Pegasus agreed to temporarily suspend management fees related to DPLC. The commitments of each of Pegasus and DFR are subject to numerous conditions, any or all of which may not be satisfied. As of December 31, 2009, Pegasus and DFR had funded \$20.0 million and \$4.0 million, respectively, of such commitments. See "*Recent Developments*" later in this section for further information.

#### *Intercompany investment advisory fees*

As a result of the Merger, we entered into a new management agreement with DCM. Management fees paid pursuant to this agreement are eliminated upon consolidation in accordance with GAAP. Fees are paid on a cost plus margin basis for investment advisory, management and operational services. All ancillary services, including back office support and certain operating expenses, are charged at cost. For the years ended December 31, 2009, 2008 and 2007, the intercompany investment advisory fees earned in accordance with the new management agreement with DCM were \$5.8 million, \$12.1 million and \$0.4 million, respectively. In addition, intercompany investment advisory fees for the year ended December 31, 2009 include \$0.2 million of management fees which were earned on our investment in DPLC and eliminated upon consolidation.

#### *Expenses*

The following table summarizes our Investment Management segment expenses for the periods presented:

	<u>Year ended December 31,</u>		<u>Variance</u>
	<u>2009</u>	<u>2008</u>	<u>2009 vs. 2008</u>
	<u>(In millions)</u>		
Salaries	\$ 7.9	\$ 13.7	\$ (5.8)
Incentive compensation	3.3	11.3	(8.0)



Employee benefits	0.9	1.9	(1.0)
Total compensation and benefits	12.1	26.9	(14.8)
Audit and audit-related fees	0.6	0.7	(0.1)
Legal fees	0.1	0.6	(0.5)
Other professional fees	0.2	0.2	—
Total professional services	0.9	1.5	(0.6)
Insurance expense	0.4	0.5	(0.1)
Software and data feeds	1.1	1.9	(0.8)
Other general and administrative fees	0.9	1.1	(0.2)
Total general and administrative expense	2.0	3.0	(1.0)
Fixed asset depreciation	2.7	1.3	1.4
Intangible asset amortization	5.2	8.1	(2.9)
Total depreciation and amortization	7.9	9.4	(1.5)
Occupancy	2.4	2.5	(0.1)
Cost savings initiative	0.2	1.8	(1.6)
Impairment of intangible assets	1.8	47.3	(45.5)
Impairment of goodwill	—	98.7	(98.7)
Total impairment of intangible assets and goodwill	1.8	146.0	(144.2)
Total Investment Management segment expenses	\$ 27.7	\$ 191.6	\$ (163.9)

The decrease in expenses of \$163.9 million for the year ended December 31, 2009, compared to the year ended December 31, 2008, was primarily attributable to decreases in impairment charges on intangible assets and goodwill of \$144.2 million and decreases in compensation and benefits of \$14.8 million.

The \$14.8 million, or 54.9%, decrease in compensation and benefits for the year ended December 31, 2009, as compared to the year ended December 31, 2008, was primarily the result of the implementation of two cost savings initiatives and to a lesser extent a reduction in our projected 2009 incentive compensation for existing employees. On March 1, 2008, in response to the adverse credit markets, we implemented a cost savings initiative and reduced our headcount by 13 employees, or 10% of our then current workforce, across a broad range of functions. In November 2008, in response to the continued deterioration in market conditions, we implemented a second cost savings initiative and reduced our headcount by 24 employees, or approximately 26% of our then current workforce, and reduced bonus compensation. The compensation payable to those 24 employees accounted for approximately 37% of our annual compensation expense in 2008. The 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 continue to improve our

financial results without adversely impacting our ability to operate our business in a prudent manner. As of December 31, 2009 and 2008 we had approximately 67 employees.

We also focused on cost savings resulting from the reduction of our other operating expenses (excludes depreciation and amortization, cost savings initiatives and impairment of intangible assets and goodwill) which resulted in an aggregate savings of \$1.8 million or 24.0% decrease in operating expenses which consisted of savings of \$0.6 million, \$0.1 million, \$1.0 million and \$0.1 million in professional fees, insurance expense, general and administrative expense and occupancy expense, respectively.

During the year ended December 31, 2009, we recorded \$1.8 million of impairment charges on intangible assets. We recorded impairment charges of \$0.8 million associated with the management contract for Knollwood CDO II and \$0.2 million associated with the management contract for Valeo CDO as a result of the decline in expected future management fee cash flows from these CDOs. In addition, we recorded \$0.8 million of impairment charges related to the "Deerfield" trade name.

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

In addition, we recorded impairment charges of \$7.9 million associated with the management contracts related to our CDOs. This is comprised of \$3.3 million, \$1.5 million, \$1.3 million, \$1.0 million, \$0.4 million, \$0.3 million and \$0.1 million related to the intangible assets associated with the management contracts for Coltrane CLO PLC, or Coltrane CLO, Bryn Mawr CLO II Ltd., or Bryn Mawr CLO II, Castle Harbor II CLO Ltd., or Castle Harbor II CLO, Western Springs CDO Ltd., or Western Springs CDO, Aramis CDO, Knollwood CDO II and Access Institutional Loan Fund, or Access Fund, respectively. Coltrane CLO triggered a market value-based event of default during the first quarter of 2008 and was liquidated by an administrative receiver. Western Springs CDO triggered an event of default during the first quarter of 2008 resulting primarily from downgrades of its underlying collateral and was subsequently liquidated. Castle Harbor II CLO triggered a market value-based event of default and was subsequently liquidated. Access Fund triggered a market-value based event of default in the third quarter of 2008 and was subsequently liquidated. During the fourth quarter of 2008, Bryn Mawr CLO II triggered a market value-based event of default and was subsequently liquidated. As of December 31, 2008, we also recognized partial and full impairment charges associated with the management contracts related to Knollwood CDO II and Aramis CDO, respectively, as a result of impairment analysis based on future cash flows.

For the year ended December 31, 2008, we recorded full impairment of the \$98.7 million in goodwill recorded in conjunction with the Merger. Although a significant amount of time had not passed since the Merger, the continued deterioration of global credit markets and significant decline in our overall market capitalization during the first quarter of 2008 was a triggering event for an analysis of possible goodwill impairment. For the first quarter of 2008, the estimated cash flows generated by the Investment Management segment were generally consistent with the cash flows estimated at the time of the Merger. However, the market multiple for the companies that we considered comparable had decreased. This decline in market multiples largely contributed to the \$20.0 million of goodwill impairment recorded during the first quarter of 2008. As a result of the further decline in our overall market capitalization experienced during the third quarter of 2008, we performed another analysis for possible goodwill impairment as of September 30, 2008 and determined that impairment on the remaining goodwill balance (after Merger purchase price adjustments) of \$78.1 million was necessary. This was a result of the combined effect of lower market multiples, continued decline in our overall market capitalization and reduced estimated cash flows from the Investment Management segment compared to those estimated at the time of the Merger due to declines in AUM.

In connection with the Lease Amendment signed on November 27, 2009, we expect our annual rent expense to be reduced by approximately \$1.3 million annually to reflect the reduced square footage of the New Premises. We will recognize a non-cash acceleration of depreciation and amortization expense related

to certain leasehold improvements and fixed assets on the Original Premises as a result of a shorter estimated life for the use of those assets. The total impact of the acceleration of the depreciation and amortization expense is approximately \$6.9 million, which we will expense ratably from the date the Lease Amendment was signed to the date on which we vacate the Original Premises (expected to be April 30, 2010). The impact of the accelerated depreciation during the year ended December 31, 2009 was approximately \$1.4 million.

***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 and beneficial interest in CDOs. During the year ended December 31, 2009, we recognized unrealized losses of \$0.1 million in net gain (loss) on investments at fair value in the consolidated statements of operations related to these investments. During the year ended December 31, 2008, we recognized realized and unrealized losses of \$1.3 million and \$2.6 million, respectively, in net gains (loss) on investments at fair value in the consolidated statements of operations related to these investments.

***Income Tax Expense***

For the year ended December 31, 2009, the Investment Management segment recorded income tax expense of \$29,000 due to our subsidiary in London. There is a full valuation allowance on all of our deferred tax assets except for those associated with our subsidiary in London. See "*Income Taxes*" within the "Critical Accounting Policies" section for a full discussion of our accounting for income taxes.