

# Disclosure Brochure

March 28, 2019



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Varadero Capital, L.P. is an SEC registered investment adviser. Registration does not imply any level of skill or training.



## Item 2. Material Changes

This Item discusses only the material changes that have occurred since the last annual update of this Disclosure Brochure by Varadero Capital, L.P. (“Varadero” or the “Firm”).

This Disclosure Brochure contains various material changes since the date of the last annual update filed with the Securities and Exchange Commission on March 29, 2018, including:

- Updates made to reflect private fund vehicles currently managed by Varadero (Item 4).

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## Item 4. Advisory Business

Varadero, a Delaware limited partnership, was formed in July 2009. The Firm is principally owned by Fernando Guerrero, the Firm's Managing Partner and Chief Investment Officer.

As of December 31, 2018, Varadero had approximately \$1,676,689,582 in net assets under management, all of which are managed on a discretionary basis. (Note that the method for computing "assets under management" is different than the method for computing "regulatory assets under management" required for Item 5.F. in Form ADV Part 1A).

Varadero provides discretionary investment management services to pooled investment vehicles and, from time to time, provides investment management services to institutions or other investors that have separate accounts. Clients may engage Varadero to manage their assets on a discretionary or non-discretionary basis.

### Private Investment Funds

Varadero serves as the investment manager to several private investment funds, including Varadero Master Fund, L.P. (the "Master Fund"), Varadero Partners, L.P. ("Partners"), Varadero International, Ltd. ("International", and collectively with the Master Fund and Partners, the "VMF Funds"), Varadero Special Opportunities Master Fund, L.P. (the "VSOF Master Fund"), Varadero Special Opportunities International, L.P. ("VSOF International") and Varadero Special Opportunities International (B), L.P. ("VSOF International B", and collectively with the VSOF Master Fund and VSOF International, the "VSOF Funds") (the foregoing private investment funds, collectively, the "Private Funds").

Partners and International serve as feeder funds into the Master Fund and, as such, invest all or substantially all of their investable assets directly or indirectly in the Master Fund. VSOF International B and VSOF International (through its investment in Varadero Special Opportunities Intermediate Fund, L.P., (the "VSOF Intermediate Fund")) invest substantially all of their investable assets through VSOF Master Fund.

The Firm acts as the investment adviser to the VMF Funds and VSOF Funds and is responsible for evaluating and monitoring investments and providing day-to-day managerial services to such Private Funds. An affiliate of Varadero, Varadero General Partner, LLC (the "VMF General Partner"), acts as the general partner to the Master Fund and Partners. Varadero Special Opportunities General Partner, LLC (the "VSOF General Partner"), also an affiliate of Varadero, serves as general partner to the VSOF Master Fund, VSOF Intermediate Fund, VSOF International and VSOF International B.

The VMF Funds seek attractive risk-adjusted total returns for investors primarily by acquiring and actively managing a portfolio of debt instruments. Varadero focuses on investments that it believes to be fundamentally undervalued or to otherwise offer attractive returns with current market prices that are believed to be compelling relative to intrinsic value. In executing its investment program for the VMF Funds, the Firm anticipates investing in a variety of financial instruments with a focus on various forms of asset-backed and other structured credit securities, loans and other investments, including, but not limited to: investment-grade residential mortgage-backed securities ("RMBS"), asset-backed securities ("ABS"), collateralized debt obligations ("CDO"), commercial mortgage-backed securities ("CMBS"), below investment-grade interests (equity tranches and residuals) in RMBS, ABS, CDO and CMBS, performing/non-performing/reperforming mortgage loans, commercial real estate loans, tax liens, consumer loans, small business loans and asset-based investments typically secured by physical,

financial and/or tangible assets, including portfolios of receivables, mezzanine and equity investments in esoteric securitizations and special situation financing. In addition, from time to time, the VMF Funds also may structure and/or acquire participations in and/or assignments of sales of loans and interests therein and may also invest in equity securities of publicly traded companies.

The VSOF Funds seek attractive risk-adjusted total returns by acquiring and actively managing portfolios of loans, leases and other financial assets originated by various types of specialty finance companies or non-bank lenders. In executing its investment program for the VSOF Funds, Varadero may seek to invest in a variety of assets, including small business loans, merchant cash advances, small and medium ticket equipment leases, commercial real estate mortgages, transitional residential real estate loans, residential mortgages, student loans, consumer loans, auto loans and other forms of collateralized and uncollateralized exposures. Varadero may effectuate these investments by, among other things, acquiring whole loans, leases or other financial assets directly. To a lesser degree, Varadero may seek to gain broad exposures to certain asset classes by acquiring securities issued by securitized pools or through other structured finance arrangements.

Participation as an investor in the VMF Funds and VSOF Funds is generally restricted to investors that are “qualified clients” pursuant to the requirements under Rule 205-3 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), “accredited investors” as defined under Rule 501 of the Securities Act of 1933, as amended (the “Securities Act”), and “qualified purchasers” as defined under the Investment Company Act of 1940, as amended (the “Investment Company Act”). Interests in the Private Funds are privately offered pursuant to Regulation D under the Securities Act. The Private Funds currently rely on an exemption from registration under the Investment Company Act.

Varadero advises private investment funds in an attempt to achieve the applicable fund’s investment objectives (consistent with any guidelines and/or restrictions that may be imposed thereon) and does not tailor its advice to the individual needs of any investor in such fund. Private investment fund investors generally may not impose any restrictions on the way in which Varadero provides advice to the applicable fund. Varadero’s management of a private investment fund is subject to, and the terms of any investor’s investment in any such fund and all other terms of a fund are governed by, the terms of the fund’s limited partnership agreement (as applicable), memorandum and articles of association (as applicable), the investment management agreement and subscription agreement, as each may be amended, supplemented or modified from time to time (the “Governing Documents”). Investors and other recipients should be aware that, while this Brochure includes information about private investment funds, including the VMF Funds and VSOF Funds, it is not a complete description of the terms, risks or conflicts associated with an investment in any such fund. More complete information about private investment funds, including the VMF Funds and VSOF Funds, is included in the applicable fund’s offering memorandum and Governing Documents, which may be provided to eligible prospective investors by Varadero or another authorized party.

The information contained in this Brochure is qualified in its entirety by reference to disclosures made in an applicable private investment fund’s offering memorandum and Governing Documents, which should be carefully reviewed prior to making an investment decision. In no event should this Brochure be considered an offer to sell or a solicitation of an offer to buy interests in any VMF Fund or any other private investment fund or relied upon in determining to invest in any such fund. This Brochure is designed solely to provide information about Varadero for purposes of complying with certain obligations under the Advisers Act and, as such, responds to relevant regulatory requirements under the Advisers Act that may differ from the information required to be provided in an offering memorandum

and other related documents. In the event of any inconsistency between a private investment fund's offering memorandum and/or Governing Documents and this Brochure, such offering memorandum and/or Governing Documents, as the case may be, shall control.

## **Separate Accounts**

Varadero's management of separate account assets is based on the individual objectives of each separate account. At the onset of a separate account relationship, Varadero will identify specific investment objectives and/or restrictions of the client and related account. Separate accounts may impose restrictions with respect to specific securities and security type, among other things. All objectives and restrictions shall be contemplated in the investment management agreement relating to such separate account between Varadero and the applicable client.

Similar to the VMF Funds, the separate accounts generally utilize strategies that seek attractive risk-adjusted total returns for investors by acquiring and actively managing a portfolio of debt securities, however, the assets underlying the separate accounts generally have shorter maturity horizons. Furthermore, in executing such investment program, Varadero generally may allocate assets among investment-grade RMBS, ABS, CDO and CMBS, below investment-grade interests (equity-tranches and residuals) in RMBS, ABS, CDO and CMBS, performing/non-performing/reperforming mortgage loans, commercial real estate loans, tax liens, consumer loans, small business loans and asset-based investments typically secured by physical, financial and/or tangible assets, including portfolios of receivables, mezzanine and equity investments in esoteric securitizations and special situation financing. In addition, from time to time, the separate accounts also may invest in other types of investments.

## **Item 5. Fees and Compensation**

Varadero offers its services on a fee basis, which includes fees based upon assets under management and, in certain circumstances, performance-based fees and allocations and incentive-based distributions.

The Firm provides investment management services for an annual fee based upon a percentage of the market value of the assets being managed by Varadero.

### **Private Funds**

For information about the fees charged with respect to investments in private investment fund, please see the applicable fund's offering documents. Varadero, in its sole discretion, may waive all or a portion of the management fee, performance fee and/or incentive allocation due from certain private investment fund investors. Certain investors that are members, partners, affiliates, and employees of Varadero, members of the immediate families of such persons, and trusts or other entities for their benefit may pay reduced management fees, performance fees and incentive allocations.

In addition to Varadero and/or the relevant affiliate's fees and allocations, investors in private investment funds, including the VMF Funds and VSOFF Funds, bear indirectly certain fees and expenses as more fully described in the applicable offering documents. Such fees and expenses vary, but typically include (but are not limited to) the following: legal and compliance fees and expenses; audit, tax and accounting fees; insurance costs and expenses; administrative, custodial and transaction fees; costs and commissions paid to custodians, broker-dealers and other third parties; and investment and research-related expenses. Varadero has sole discretion to choose the prime broker(s) and custodians for the

VMF Funds and VSOF Funds. For the VMF Funds, the Firm utilizes the prime brokerage, clearing and custodial services of J.P. Morgan Clearing Corp., J.P. Morgan Securities LLC and certain affiliates thereof and The Northern Trust Company, Millennium Trust Company, LLC, Wilmington Trust, National Association and U.S. Bank National Association for additional custodial services. For the VSOF Funds, the Firm utilizes the custodial services of The Northern Trust Company, Wilmington Trust, National Association and U.S. Bank National Association.

Assets invested in the VMF Funds are subject to lock-up periods and other restrictions and will not be readily available for withdrawals or redemptions. For additional information about investments in the VMF Funds, please see the VMF Fund's offering documents.

## **Separate Accounts**

In general, the Firm's annual fee for separate accounts is (i) calculated monthly in arrears, based on the actual days elapsed over a 365-day year and the market value of the assets being managed by on the last day of each month, and (ii) is payable quarterly in arrears. In any partial calendar quarter, such fee is prorated based on the number of days in which the investment account was open during such calendar quarter. The annual fee may be negotiated and will vary depending upon a number of factors, including the market value of the assets under management, the type of investment management services to be rendered, account composition, anticipated amount of resources utilized in the relationship and the existence of related accounts. Further, in certain circumstances, as may be agreed between Varadero and a separate account client, Varadero also may receive certain performance-based compensation. In general, the Agreement between Varadero and a separate account client will continue in effect until terminated by either party pursuant to the terms of the Agreement. Varadero's fees are prorated through the date of termination and any remaining balance will be charged or refunded to the client, as appropriate. Separate account clients generally may make additions to and withdrawals from their account at any time, subject to Varadero right to terminate an account and usual and customary securities settlement procedures.

In addition to the advisory fees assessed by Varadero, separate account clients will bear and be charged with costs and expenses relating to the activities and operations of the account. Such costs and expenses incurred in connection with transactions effected on behalf of the account may include, without limitation, trading expenses, custodial fees, brokerage commissions, spreads and other mark-ups and mark-downs, and legal fees and expenses and fees and expenses of other service providers related to or incurred connection with due diligence and negotiation of applicable transaction documentation. Certain types of expenses, such as research and data subscription services, may be charged to private investment funds and may or may not be charged to separate accounts. To the extent a product or service is attributable to multiple clients, Varadero maintains policies and procedures that are intended to facilitate the fair and equitable allocation of such expenses. Varadero may have a conflict of interest in determining whether such costs and expenses should be charged such private investment fund or separate account client or otherwise absorbed by Varadero in respect of any client.

## **Item 6. Performance-Based Fees, Performance-Based Allocations, Incentive-Based Distributions and Side-by-Side Management**

As discussed in response to Item 5, above, in certain instances, the VMF and VSOF General Partners may receive performance allocations based on the performance of their respective Private Fund investments. Varadero also may be entitled to performance-based compensation in connection with separate

accounts and certain Private Funds. These arrangements raise certain conflicts of interest. Such performance-based compensation arrangements may create an incentive for Varadero to make investments that are riskier or more speculative than would be the case absent any such arrangement. In addition, performance-based compensation arrangements may create an incentive to favor accounts subject to performance-based arrangements over those that do not and to favor higher fee paying clients in the allocation of investment opportunities. Varadero believes that it has reasonable controls in place to mitigate such potential conflicts of interest.

## **Item 7. Types of Clients**

Varadero provides investment management services on a discretionary basis to the private investment funds and separate accounts. Investors in private investment funds, and separate account clients, may include pension plans, foundations, funds of funds, charitable organizations, trusts, estates, corporations, sovereign wealth funds, other institutional investors, and high net worth individuals.

Investors in the VMF Funds and VSOF Funds generally must be “accredited investors” as determined under Regulation D under the Securities Act, “qualified clients” as defined for purposes of Rule 205-3 under the Advisers Act, and “qualified purchasers” or “knowledgeable employees” as defined and interpreted for purposes of Section 3(c)(7) of the Investment Company Act, as and to the extent required thereunder.

The minimum capital commitment for investing in private investment funds managed by Varadero is generally \$1 million, generally subject to reduction by the VMF General Partner. The minimum capital commitment for investing in a separate account, if applicable, shall be described in the written investment management agreement entered into by and between Varadero and the separate account client.

The Firm, in its sole discretion, may accept clients with smaller investments based upon certain criteria including additional investments, related accounts, account composition, pre-existing client relationships and account retention.

## **Item 8. Methods of Analysis, Investment Strategies and Risk of Loss**

### **Methods of Analysis Used in connection with Structured and Specialty Credit Strategies**

In connection with the VMF Funds and separate accounts seeking principally to invest in specialty finance and structured credit investments, Varadero generally seeks long term stability and consistent portfolio returns utilizing a fundamental credit framework to identify target investments with a strong orientation towards protecting invested capital across a variety of potential macroeconomic scenarios.

Varadero attempts to reduce complex instruments to their base components before testing the effect of multiple macroeconomic scenarios on cash flows and across the deal waterfall/liability structure (to the extent applicable, mostly in securities). The Firm's investment process is intended to identify and trigger the sale of “rich” positions and the acquisition of “cheap” sectors and/or positions. The Firm generally expects to draw upon quantitative and qualitative research capabilities, generally including external research, internal research, analysis, modeling and scenario analysis, internal knowledge and extensive experience with respect to asset class performance as well as security-specific structural analysis.



Allocations between asset classes are based upon relative value. The Firm monitors and compares the risk/return characteristics of various segments in the specialized credit markets. The relative value of such segments will depend upon the absolute level of expected returns and the variation in expected returns between various economic scenarios used by Varadero in connection with such analysis. If certain asset classes are believed to be trading rich to others, the Firm will work to re-allocate capital to asset classes believed to be cheaper. Factors that may be taken into account include the size of the opportunity, the liquidity of the position and the complexity of the investment.

Varadero may use long and/or short positions in various liquid indices, public equities and options, corporate and municipal debt (both cash and synthetic) and engage in the use of fixed income derivatives, such as credit default swaps, total return swaps, forward contracts, futures and other similar instruments. Further, the Firm may from time to time originate certain investments, including, without limitation, participation in and/or assignments of sales of loans or interests therein.

For additional information about the investment strategies or methods of analysis of the VMF Funds, please see the applicable VMF Fund's offering documents.

## **Investment Risks**

An investment in the structured and specialty credit strategies managed by Varadero, through separate accounts or via investment in the Private Funds, entail a certain degree of risk, including risks arising with respect to price movements, volatility, lack of liquidity, and other risks relating to or arising out of business, legal, financial or economic conditions that could affect the payment of interest and principal on the underlying securities. Although Varadero seeks to manage and/or mitigate such risks through its active monitoring of such assets, the strength and direction of markets and its monitoring of portfolio-level liquidity, among other things, such strategies are designed for sophisticated investors who fully understand and are capable of bearing the risks of such investments, including the partial or total loss of capital. There can be no assurance that a client's investment objectives will be achieved, and actual investment results may vary substantially.

Set forth below is a non-exhaustive summary of such risks/risk factors and the risk/risk factors may not be applicable to all investment management clients and mandates; however, prospective investors in the Private Funds are advised to review the applicable Private Fund offering materials for a more extensive description of the risks of investing in such Private Fund. Prospective separate accounts may request additional details relating to such risks from Varadero.

## **Business and Market Risks**

Investments made by Varadero may involve a high degree of business and financial risk that can result in substantial losses. These risks could arise from changes in the financial condition or prospects of an investment, changes in national or international economic and market conditions and changes in laws, regulations, fiscal policies, or political conditions of countries in which investments are made, including the risks of war and the effects of terrorist attacks and security operations. A negative impact on economic fundamentals and consumer and business confidence would likely increase market volatility and reduce liquidity, both of which could have a material adverse effect on investment performance and these or similar events may affect the ability of Varadero to structure and execute its investment strategies.

## **Investment and Trading Risks**

All investments in securities risk the loss of capital. Certain investment programs may utilize such investment techniques as leverage, margin transactions, short sales, swaps, options on securities and forward contracts, which practices may, in certain circumstances, increase the adverse impact to which a client may be subject. Varadero may invest in bonds or other fixed income securities, including, without limitation, public and private non-investment grade bonds, secured loans, second lien debt, convertible securities, options, swaps and other securities with fixed-income characteristics. Such securities may primarily be below “investment grade” and may face ongoing uncertainties and exposure to adverse business, financial or economic conditions which could lead to the issuer’s inability to meet timely interest and principal payments. The market prices of such securities are also subject to abrupt and erratic market movements and changes in liquidity and above-average price volatility, and the spread between the bid and asked prices of such securities may be greater than those prevailing in other securities markets.

## **Use of Models**

Varadero uses quantitative models and algorithms to assist in evaluating certain investment opportunities and for risk management insights. Use of models and quantitative risk management tools may seek to be predictive, but there is no guarantee of investment success. These models are dynamic and, as a result, variables, factors, assumptions and methodologies change over time. Models, algorithms and data may prove incorrect or incomplete and market dynamics change over time, which may diminish the effectiveness of or extinguish correlations that existed in the past. Most statistical formulae cannot fully match the complexity of the financial markets and a model may be flawed or may not work as anticipated. While Varadero seeks to assure that its proprietary models are sound in their development and appropriately adapted, calibrated and configured, analytical error, software development errors, implementation, input and data errors pose inherent risks to the use of models and investment management processes. Other models or tools may produce substantially different outcomes.

## **Cybersecurity**

Varadero is susceptible to operational, financial, and information security risks resulting from cyber-attacks. Such attacks can include, among other things, the attempted theft, misuse, improper release, corruption or destruction of, or unauthorized access to, confidential data relating to Varadero, any private investment funds, private investment fund investors and separate account clients; disruptions or failures to systems, networks, devices and applications relating to the operations of Varadero, private investment funds and their service providers; and extortion, and other fraudulent attempts to negatively influence employee behavior. As part of its business, Varadero processes, stores and transmits large amounts of electronic information, including information relating to the transactions of its clients and personally identifiable information of private investment fund investors. Additionally, service providers are subject to the same electronic information security threats, and the failure to adopt or adhere to adequate data security policies or a breach of a service provider’s systems may cause information related to transactions or personally identifiable information to be lost or improperly accessed, used or disclosed. Although Varadero has procedures and systems in place to protect against cybersecurity threats, such measures cannot provide absolute security. Successful cyber-attacks may cause Varadero and its advisory clients to suffer, among other things, financial loss, the disruption of its business, liability to third parties, regulatory intervention or reputational loss.

## **Financial Market and Interest Rate Fluctuations**

General fluctuations in the market prices of securities and interest rates may affect the value of investments. Volatility and instability in the securities markets may also increase the risks inherent in such investments. The ability of companies or businesses to refinance debt securities may depend on their ability to sell new securities in the high yield debt or bank financing markets which may, at certain times, be difficult to access at favorable rates. Interest rate changes may affect the value of a debt instrument indirectly (especially in the case of fixed rate securities) and directly (especially in the case of instruments whose rates are adjustable). In general, rising interest rates will negatively impact the price of a fixed rate debt instrument and falling interest rates will have a positive effect on price. Adjustable rate instruments also react to interest rate changes in a similar manner although generally to a lesser degree (depending on the characteristics of the reset terms, among other factors). Interest rate sensitivity is generally more pronounced and less predictable in instruments with uncertain payment or prepayment schedules. Factors that may affect market interest rates include, without limitation, inflation, slow or stagnant economic growth or recession, unemployment, money supply, monetary policies, international disorders and instability in domestic and foreign financial markets.

## **Expedited Transactions**

Investment analyses and decisions by Varadero may be undertaken on an expedited basis in order to take advantage of investment opportunities. In such cases, the information available at the time of an investment decision may be limited, and Varadero may not have access to the detailed information necessary for a full evaluation of the investment opportunity. In addition, Varadero may rely upon independent consultants in connection with its evaluation of proposed investments. There can be no assurance that these consultants will accurately evaluate such investments.

## **Credit Risk; Investment in Debt Instruments**

One of the fundamental risks associated with debt investments is credit risk (that is, risk of non-payment where a borrower may be unable or unwilling to make principal and interest payments on outstanding debt obligations when due). Bonds or other debt securities subject the holder of such securities to credit risk to the issuers of those investments, which may be evidenced by such issuers' credit rating (if any). Securities which are subordinated and/or have a lower credit rating are generally considered to have a higher credit risk and a greater possibility of default than more highly rated securities. In the event that any issuer of bonds or other debt securities experiences financial or economic difficulties, this may affect the value of the relevant securities (which may be zero) and any amounts paid on such securities (which may be zero). Debt securities are also subject to market risk and interest rate risk (as discussed above under "Financial Market and Interest Rate Fluctuations"). Market risk relates to the changes in risk or perceived risk of an issuer, country or region. The values of debt securities may be affected by changes in the credit rating or financial condition of the issuing entities.

## **Structured Finance Securities**

Varadero will invest in structured products, including asset-backed and other structured credit securities, and may do so in both original and restructured issuances, and in cash or synthetic form. Structured finance securities may be issued by special purpose vehicles that own a pool of underlying assets, such as loan contracts, corporate bonds, or asset-backed securities. Structured finance securities are designed to expose the holders of these securities to the credit risk of the underlying assets and to entitle such holders to payments based on the payment stream from the underlying assets owned by

the structured finance security issuer. The payment stream on the underlying assets may be apportioned among the structured products to create securities with different investment characteristics such as varying maturities, payment priorities and interest rate provisions, and the extent of the payments made with respect to the structured products is dependent on the extent of the cash flow on the underlying assets. Issuers often issue several distinct tranches of securities as part of the same offering, which may have varying maturities, income streams, priorities and ratings depending on their respective position within the offering structure. Tranches can vary from investment grade to high-yield. If there are any defaults in the underlying assets, investment grade and senior tranches are usually (but not always) entitled to repayment prior to the subordinated tranches. Client accounts may invest in any tranche, from the riskiest, most leveraged residual or “equity” tranche (which generally bears the first-loss risk of defaults from the assets held by the issuer) to more senior debt tranches. Subordinated structured products typically have higher yields and present greater risks than unsubordinated structured products. In addition to the credit risk of the underlying assets, structured finance securities may expose investors to interest rate, market and other credit risks. Moreover, investing in structured finance securities may entail a variety of unique risks including, among other risks, prepayment risk. In addition, the performance of a structured finance security will be affected by a variety of factors, including its priority in the capital structure of the issuer thereof, the availability of any credit enhancement, the level and timing of payments and recoveries on and the characteristics of the underlying receivables, loans or other assets that are being securitized, remoteness of those assets from the insolvency of the originator or transferor, the adequacy of and ability to realize upon any related collateral and the capability of the servicer of the securitized assets.

Structured finance securities investments involve certain market risks as they may be illiquid in nature and no readily available secondary market may be available. Further, investments in structured products may be subject to greater volatility than an investment directly in the underlying market or security. Total return on a structured product is derived by linking the return to one or more characteristics of the underlying asset.

## **Lower Credit Quality Securities**

Varadero may invest in securities deemed by rating companies to have substantial vulnerability to default in payment of interest and/or principal. Other securities may be unrated. Lower-rated and unrated securities may be subject to large uncertainties or major risk exposures to adverse conditions, and may be considered to be predominantly speculative. In such cases, such securities generally will offer a higher return potential than higher-rated securities, but likely involve greater volatility of price and risk of loss of income and principal. The market values of certain of these securities (such as subordinated securities) also tend to be more sensitive to changes in economic conditions than higher-rated securities.

## **Investments in Asset-Backed Securities**

Investment characteristics of asset-backed securities (“ABS”) differ from traditional debt securities. Among the major differences, interest and principal payments are made more frequently, usually monthly, and principal may be prepaid at any time because the underlying loans or other assets generally may be prepaid at any time. ABS are not secured by an interest in the related collateral. Credit card receivables, for example, are generally unsecured and debtors are entitled to the protection of a number of state and federal consumer loan laws, many of which give such debtors the right to set off certain amounts owed on the credit cards, thereby reducing the balance due. Most issuers of ABS

backed by automobile receivables permit the servicers to retain possession of the underlying obligations. If the servicer were to sell these obligations to another party, there is a risk that the purchaser would acquire an interest superior to that of the holders of the related ABS. In addition, because of the large number of vehicles involved in a typical issuance and technical requirements under state laws, the trustee for the holders of an ABS may not have a proper security interest in all of the obligations backing such ABS. Therefore, recoveries on repossessed collateral may not, in some cases, be available to support payments on these securities. The risk of investing in ABS is ultimately dependent upon payment of consumer loans by the debtor.

ABS are often backed by pools of any variety of assets, including, for example, leases, mobile home loans and aircraft leases, which represent the obligations of a number of different parties and use credit enhancement techniques such as letters of credit, guarantees or preference rights. The value of an ABS is affected by changes in the market's perception of the asset backing the security and the creditworthiness of the servicing agent for the loan pool, the originator of the loans or the financial institution providing any credit enhancement, as well as by the expiration or removal of any credit enhancement.

### **Collateralized Debt Obligations**

Collateralized debt obligations ("CDOs") generally are limited recourse obligations of a special purpose issuer created solely for the issuance of securities, linked to the performance of an underlying pool of assets held by the issuer. Client accounts may acquire CDO securities backed by various types of assets and combinations of assets, including high-yield and other types of corporate debt securities, loans, trust preferred shares, asset-backed securities, mortgage-backed securities and other types of structured finance securities (including those described in these risk factors and including interests in other CDOs), and other debt instruments, and credit default swaps, credit-linked notes and other derivative instruments referencing asset-backed securities or other debt instruments. Client accounts may also invest in multi-sector CDOs, which are backed by structured finance securities secured by a variety of different types of underlying assets. A multi-sector CDO can have a large portion of its portfolio consist of a single asset class, such as subprime residential mortgage-backed securities and in commercial real estate CDOs backed by commercial mortgage-backed securities, and whole loans. The holders of CDOs rely on distributions or proceeds from the collateral for payment. If distributions or proceeds from the collateral are insufficient to make payment, no other assets will be available for payment. Collateral is subject to various risks, including credit, liquidity, currency and interest rate risks. For example, high-yield debt securities and loans may be unsecured and, as described below, may be subordinated to other obligations of the issuer. Collateral that is rated below investment grade indicates a greater possibility that adverse changes in the financial condition of the relevant issuer and/or economic conditions in general may impair the ability of that issuer to make payments of principal and/or interest.

A CDO collateralized by a pool of loans is often called a collateralized loan obligation ("CLO"). CLOs may consist of, among other things, senior secured loans, senior unsecured loans, and subordinate corporate loans, including loans rated below investment grade or equivalent unrated loans. Issuers of CLOs may acquire interests in loans by way of sale, assumption, transfer or participation. In the case of a transfer, a transferee typically succeeds to all the rights and, in some cases, the obligations of the transferring institution. However, a CLO that becomes a lender under the credit agreement with respect to the relevant debt obligation may have rights more restricted than those of the transferring institution. If a

CLO issuer acquires loans by way of participations, it will not be able to enforce directly any of the related borrower's obligations under such loans or control the exercise of any of the remedies available upon borrower default, and the CLO issuer will be exposed to the credit risk of the participation seller, in addition to that of the borrower. The CLO issuer will have to depend on the lenders who are contractual parties to the related credit agreement to enforce borrower obligations and exercise remedies even though the CLO issuer's interests may differ from such lenders. In addition, loans are not as easily traded as securities for a variety of reasons, nor is there any assurance that supply and demand in loan trading will provide an adequate degree of liquidity for the CLO.

CDOs are also subject to the possibility that the quality of the collateral may decline in value due to interest rate and currency fluctuations. Such interest rate or currency risks may be mitigated by interest rate or currency swaps but such swaps may not provide full protection and the costs of such swaps may be significant. Such costs may adversely affect the ability of the issuer to make payments to holders of the CDOs. The collateral also may bear interest at a fixed rate while CDOs may bear interest at a floating rate (or vice versa) with a resultant mismatch in payment obligations of the collateral and the relevant CDOs. As a result of such mismatches, fluctuations in floating rate indices may adversely impact the ability of the issuer of the relevant CDOs to make payments.

In addition to the risks associated with the types of collateral used for CDOs, CDOs may be subject to more acute credit, liquidity, leverage and interest rate risks than the underlying component debt and/or derivative instruments. CDO investors are also exposed to market risk, because the default triggers in CDOs may, at times, be more sensitive than those in the underlying collateral, and because the ability to accelerate and liquidate is generally controlled by the most senior class of holders. As a result, a CDO can go into default earlier, and, on liquidation, suffer losses more severe, than those experienced by the underlying pool of collateral. These credit, liquidity, market value, and other risks are compounded, and further multipliers of leverage and correlation risk (the factors that may make multiple credits default simultaneously) introduced, when a CDO invests significantly in other CDOs or in other complex structured products (such as RMBS or CMBS), creating a layering of structured products that makes the CDO security even harder to value and more unpredictable. Further, although any financial product can be exposed to conflicts of interest among its structurers, underwriters, participants, or different classes of investors, this risk is particularly acute in CDO structures. Finally, CDOs are normally privately placed and offer less liquidity than many other classes of investments; there may, at times, be protracted periods where there may be a substantially contracted market for certain types of CDO securities.

## **Residential Mortgage Backed Securities**

Varadero may invest certain assets in residential mortgage backed securities ("RMBS") and become holders of RMBS. Holders of RMBS bear various risks, including credit, market, interest rate, structural and legal risks. RMBS represent interests in pools of residential mortgage loans secured by residential property. Such loans may be prepaid at any time. Residential mortgage loans are obligations of the borrowers thereunder only and are not typically insured or guaranteed by any other person or entity, although such loans may be securitized and the securities issued in such securitization may be guaranteed or credit enhanced. The rate of defaults and losses on residential mortgage loans will be affected by a number of factors, including general economic conditions and those in the area where the related mortgaged property is located, the borrower's equity in the mortgaged property and the financial circumstances of the borrower. If a residential mortgage loan is in default, foreclosure of the related mortgaged property may be a lengthy and difficult process, and may involve significant



expenses. Further, the market for defaulted residential mortgage loans or foreclosed properties may be very limited.

At any one time, a portfolio of RMBS may be backed by residential mortgage loans with disproportionately large aggregate principal amounts secured by properties in only a few states or regions. As a result, the residential mortgage loans may be more susceptible to geographic risks relating to such areas, such as adverse economic conditions, adverse events affecting industries located in such areas and natural hazards affecting such areas, than would be the case for a pool of mortgage loans having more diverse property locations. In addition, the residential mortgage loans may include so-called “Jumbo” mortgage loans, having original principal balances that are higher than is generally the case for residential mortgage loans. As a result, such portfolio of RMBS may experience increased losses.

Each underlying residential mortgage loan in an issue of RMBS may have a balloon payment due on its maturity date. Balloon residential mortgage loans involve a greater risk to a lender than self-amortizing loans, because the ability of a borrower to pay such amount will normally depend on its ability to obtain refinancing of the related mortgage loan or sell the related mortgaged property at a price sufficient to permit the borrower to make the balloon payment, which will depend on a number of factors prevailing at the time such refinancing or sale is required, including, without limitation, the strength of the residential real estate markets, tax laws, the financial situation and operating history of the underlying property, interest rates and general economic conditions. If the borrower is unable to make such balloon payment, the related issue of RMBS may experience losses.

Prepayments on the underlying residential mortgage loans in an issue of RMBS will be influenced by the prepayment provisions of the related mortgage notes and may also be affected by a variety of economic, geographic and other factors, including the difference between the interest rates on the underlying residential mortgage loans (giving consideration to the cost of refinancing) and prevailing mortgage rates and the availability of refinancing. In general, if prevailing interest rates fall significantly below the interest rates on the related residential mortgage loans, the rate of prepayment on the underlying residential mortgage loans would be expected to increase. Conversely, if prevailing interest rates rise to a level significantly above the interest rates on the related mortgages, the rate of prepayment would be expected to decrease. Prepayments could reduce the yield received on the related issue of RMBS.

## **Commercial Mortgage Backed Securities**

Commercial mortgage backed securities (“CMBS”) are subject to particular risks, including lack of standardized terms, dependence on cash flows from underlying loans, refinancing risk of the underlying loans, the payment of all or substantially all of the principal of the underlying loans only at maturity, the complexity and inflexibility of CMBS structures, reliance upon servicers, and control by other holders and servicers who may have conflicting positions. The repayment of loans secured by income-producing properties typically is dependent upon the successful operation of the related real estate project and the cash flow generated by that project rather than the liquidation value of the underlying real estate. Net operating income from an income-producing property can be affected by, among other things, tenant mix, success of tenant businesses, property management decisions, property location and condition, competition from comparable types of properties, the solvency of the related tenant, any need to address environmental contamination at the property, the occurrence of any uninsured casualty

at the property, changes in national, regional or local economic conditions and/or in specific industry segments, declines in regional or local real estate values, declines in regional or local rental or occupancy rates, increases in interest rates, real estate tax rates and other operating expenses, changes in applicable laws, rules, regulations and governmental fiscal policies, acts of God, terrorism, social unrest and civil disturbances. Consequently, adverse changes in economic conditions and circumstances generally are more likely to have an adverse impact on mortgage backed securities secured by loans on commercial properties than on those secured by loans on residential properties. The exercise of remedies and successful realization of liquidation proceeds relating to CMBS may be highly dependent on the performance of the servicer or special servicer. There may be a limited number of special servicers available, particularly those that do not have conflicts of interest. Additional risks may be presented by the type and use of a particular commercial property. Special risks are presented by hospitals, nursing homes, hospitality properties, hotels and certain other property types. Commercial property values and net operating income are subject to volatility, which may result in net operating income becoming insufficient to cover debt service on the related mortgage loan. Declining real estate values and diminished availability of leverage and/or refinancings for commercial real estate generally would be expected to result in increased delinquencies and defaults on commercial mortgage loans. In addition, economic downturns may affect the financial strength of real estate tenants and result in increased rent delinquencies and increased vacancies, particularly in the retail sector. Ongoing and extensive downturns may lead to increased vacancies, decreased rents or other declines in income from, or the value of, commercial real estate, which would likely have an adverse effect on CMBS that are backed by loans secured by such commercial real estate. Such downturns likely may adversely affect the financial resources of borrowers under the underlying loans and likely adversely their ability make principal and interest payments on, or refinance, the outstanding debt when due or to sell the related properties for an aggregate amount sufficient to pay the outstanding debt when due.

### **Residential Whole Loan Mortgages**

Varadero may invest in residential whole loan mortgages (including related structured transactions in which the underlying credit risk is based on such whole loans). Such whole loan mortgages may include subprime, non-performing and sub-performing mortgage loans which are subject to increased risks as opposed to prime whole loan mortgages. A whole loan mortgage is directly exposed to losses resulting from default and foreclosure. Therefore, the value of the underlying property, the creditworthiness and financial position of the borrower, and the priority and enforceability of the lien are each of great importance. To the extent that the value of the property underlying these mortgage loans decreases and an investor must foreclose on such property following a borrower default, the proceeds of such property may be insufficient to cover the outstanding balance on such loan. There can be no assurance as to the adequacy of the protection of the terms of the loan, including the validity or enforceability of the loan and the maintenance of the anticipated priority and perfection of the applicable security interests. Furthermore, claims may be asserted that might interfere with enforcement of an investor's rights. If foreclosure on the real estate securing a mortgage loan is required because of a default by the borrower under such mortgage loan, an investor may assume direct ownership of the underlying real estate. In the event of a foreclosure, an investor would bear the risk of being unable to dispose of its collateral at advantageous times and prices or in a timely manner, because real estate assets generally experience periods of illiquidity. The lack of liquidity might result from general economic conditions impacting the real estate and credit markets, low occupancy rates, high operating expenses, the early stage of development, the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. The liquidation proceeds upon sale of such real estate may



not be sufficient to the cost basis in the loan, resulting in a loss to the investor. Any costs or delays involved in the effectuation of a foreclosure of the loan or a liquidation of the underlying property will further reduce the proceeds and thus increase the loss.

Whole loan mortgages hold additional risks related to the foreclosure, ownership and operation or management of the underlying real property. For example, whole loan mortgages are subject to “special hazard” risk (property damage caused by earthquakes or environmental hazards, which are not covered by standard property insurance policies), and to bankruptcy risk (reduction in a borrower's mortgage debt due to a borrower's bankruptcy). In addition, claims may be asserted against the investor on account of its position as the mortgage holder or property owner, including responsibility for tax payments, environmental hazards and other liabilities, including lending liability claims. Further, as whole loans are not securities, they may be harder to dispose of than interests in structured finance vehicles.

## **Commercial Real Estate Loans**

Commercial real estate loans are secured by income-producing commercial and multifamily real properties. Commercial real estate loans generally may entail risks of delinquency and foreclosure, and risks of loss in the event thereof, that may be greater than similar risks associated with loans secured by other types of property. Commercial real estate loans generally are non-recourse loans and in the event of a default generally there will be recourse only against the specific properties and other assets that have been pledged to secure such loans. Also, even if a commercial real estate loan provides for recourse to a borrower or its affiliates, an investor in such loan is unlikely to ultimately recover any amounts not covered by the commercial property. Therefore, the ability of a borrower to repay a loan secured by an income producing real property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the real property is reduced (for example, if rental or occupancy rates decline or real estate tax rates or other operating expenses increase), the borrower's ability to repay the loan may be impaired. The value of an income producing real property is directly related to the net operating income derived from such real property. Net operating income of an income producing real property can be affected by, among other things, tenant mix, success of tenant businesses (for those multifamily properties that have a retail or office component), property management decisions (including responding to changing market conditions, planning and implementing rental or pricing structures and causing maintenance and capital improvements to be carried out in a timely fashion), property location and condition, competition from comparable types of properties, changes in laws that increase operating expense or limit rents that may be charged, any need to address environmental contamination at the property and the occurrence of any uninsured casualty at the property. Furthermore, the value of any commercial real property and the net operating income may be adversely affected by risks generally incident to interests in real property, including various events which the related borrower, property manager, servicer or investor, may be unable to predict or control, such as changes in general or local economic conditions and/or specific industry segments, declines in real estate values, declines in rental or occupancy rates, increases in interest rates, real estate tax rates and other operating expenses, changes in governmental rules, regulations and fiscal policies, including environmental legislation, acts of God, environmental hazards, and social unrest and civil disturbances.

## Real Estate Loans and Participations

Real estate loans may be at the time of their acquisition, or may become after acquisition, non-performing for a wide variety of reasons. Such non-performing real estate loans may require a substantial amount of workout negotiations and/or restructuring, which may entail, among other things, a substantial reduction in the interest rate and a substantial write down of the principal of such loans. However, even if a restructuring were successfully accomplished, a risk exists that upon maturity of such real estate loan, replacement “takeout” financing will not be available. Purchases of participations in real estate loans raise many of the same risks as investments in real estate loans and also carry risks of illiquidity and lack of control. It is possible that Varadero may find it necessary or desirable to foreclose on collateral securing one or more real estate loans purchased for a client account. The foreclosure process can be lengthy and expensive. Borrowers often resist foreclosure actions by asserting numerous claims, counterclaims and defenses against the holder of a real estate loan including, without limitation, lender liability claims and defenses, even when such assertions may have no basis in fact, in an effort to prolong the foreclosure action. In some jurisdictions, foreclosure actions can take up to several years or more to conclude. At any time during the foreclosure proceedings, the borrower may file for bankruptcy, staying the foreclosure action and further delaying the foreclosure process. Foreclosure litigation tends to create a negative public image of the collateral property and may result in disrupting ongoing leasing and management of the property.

## Small Business Loans and Merchant Cash Advances

Loans to and merchant cash advance (“MCA”) arrangements with smaller-sized companies of a less seasoned nature involve significantly greater risks than larger, better-known companies. Such companies often are not well-known to the investing public, may not have significant institutional ownership and may have cyclical, static or only moderate growth prospects. The financial results of such companies may be more volatile than larger capitalization companies and smaller companies may have greater difficulty in covering borrowing costs. A deterioration in economic conditions in the United States and other general economic conditions beyond a merchant’s control could adversely affect the ability of merchants under a loan agreement to meet its payment obligations and the ability of the merchants under a MCA agreement to generate an adequate volume of future sales to remit the purchased future receivables. Losses on merchant loan agreements may increase due to factors such as prevailing interest rates, the rate of unemployment, the level of consumer and business confidence, commercial real estate values, the value of the U.S. dollar, energy prices, changes in consumer and business spending, the number of personal bankruptcies, disruptions in the credit markets and other factors. Small- and medium-sized businesses have historically been, and may in the future remain, more likely to be affected or more severely affected than large enterprises by adverse economic conditions. Economic conditions could deteriorate in connection with an economic recession or due to events such as rising oil prices, increased unemployment levels, terrorist events and extreme weather conditions. If economic conditions worsen, delinquencies on small business loans and lower than anticipated amounts of remitted purchased receivables under MCA arrangements could be higher than otherwise anticipated. In addition, an improvement in economic conditions could result in prepayments of the small business loans and higher than anticipated amounts of remitted purchased receivables on MCA agreements. Geographic concentration of merchant loans and MCA exposures could expose an investor to an increased risk of loss due to risks associated with certain regions. For example, certain regions of the United States from time to time will experience weaker economic conditions and, consequently, loans and MCA exposures to merchants in such regions will experience higher rates of losses than on

similar assets nationally. In addition, natural disasters in specific geographic regions may result in higher rates of losses in those areas. Furthermore, substantial concentrations to merchants within a particular industry can increase the risk of loss when adverse events or economic conditions (whether as a result of industry-specific events or general economic events) have a disproportionate negative impact on certain such industries) and the ability of merchants within such industries to make timely payment on their small business loans or to generate future receivables in the case of MCA agreements.

The collateral supporting small business loans and MCA agreements primarily consists of receivables under such loans and agreements. The collectability of loan payments generally depends upon several factors, including, but not limited to, the continued profitability of a merchant's business, the level of work-outs, settlements and charge-offs. The collectability of purchased receivables under MCA agreements will depend on several factors, including, but not limited to, the amount and timing of a merchant's future sales volumes, whether merchants go out of business or file for bankruptcy protection before remitting the purchased receivables, whether merchants breach any contractual covenants that may give rise to recourse against such merchants, and the resulting level of work-outs, settlements and charge-offs. Difficult economic conditions could adversely affect a merchant's ability to make loan payments and transferred purchased receivables and may result in shortfalls in payments.

#### **Certain Equipment Leasing Risks**

Certain investments may consist of direct or indirect exposure to equipment leasing transactions. Leasing transactions generally rely primarily on the underlying equipment sub-leases or structured transactions as well as the residual value of the equipment to generate returns. Such returns may be negatively impacted by defaults by sub-lessees/end-users or a failure to realize residual value with respect to equipment. Investment performance attributable to such assets may be affected by the credit risks of the sub-lessees/end-users and the market risks of residual values, among other factors. A leasing transaction may result in a loss in the event a lease counterparty defaults. Such losses, which may not be recoverable, may include, but are not limited to, rental or other revenue; legal and other costs associated with taking enforcement action against the counterparty and storing and transporting the leased equipment; costs related to breaking financing arrangements associated with the lease, including costs associated with the early termination of financing arrangements and losses when selling equipment earlier than originally anticipated. Leasing contracts may require counterparties to maintain, service and insure the leased equipment. If a counterparty fails to maintain equipment in accordance with the terms of its lease, unanticipated expenditures may be required to repair the equipment. To the extent an investor purchases used equipment, there is no assurance that an inspection of such equipment prior to acquisition will reveal any or all defects and problems with the equipment. An investor may incur losses associated with the investment, including legal costs, costs of repair and lost revenue from the delay in being able to sell or re-lease the equipment due to undetected problems or issues. In addition, the market value of the equipment may be lower than anticipated, resulting in a loss on any such investment. Furthermore, certain types of equipment are subject to registration or other regulatory requirements, and an investor or its counterparty may lose the ability to own or operate that equipment should it fail to comply with such requirements. In addition to impairing the ability to earn rentals from that equipment, an investor (directly or indirectly) may be subject to penalties or be forced into a sale of that equipment on unfavorable terms. Governmental agencies may require changes or improvements to equipment resulting in increased costs and loss of rental revenue while the changes are made, potentially adversely affecting an investor's anticipated returns from that investment.

### Investments in Consumer Loans through Platform Services

Certain investments may consist of loans or loan exposures offered through lending platforms. These loans and loan exposures may be risky and speculative investments and will represent unsecured obligations of a variety of borrowers, the identities of whom may not be made available to any investor. In deciding whether to purchase a loan, investors will not have access to financial statements or other detailed financial information of the borrowers and therefore will not be able to verify the identity of any borrower. As a result, an investor must rely on the efforts of the platform sponsor or a servicer for such information.

An investor will receive payments on such loans or loan exposures only if the third-party platform originating the loans receives the borrower's payments on such loans and passes such payments through to the investor. If a borrower is unable or fails to make payments on a loan for any reason, the ability to recover any outstanding principal or interest due may be greatly limited, as (among other reasons) an investor may not have direct recourse against the borrower or may otherwise be limited in its ability to directly enforce its rights under the loan, whether through the borrower or the platform through which such loan was originated, the loan may be unsecured or under-collateralized and/or it may be impracticable to commence a legal proceeding against the defaulting borrower.

Varadero may have limited knowledge about the underlying loans and will be dependent upon the platform through which the loan was originated for information regarding underlying loans. Although Varadero conducts diligence on the platforms, it may not have the ability to independently verify the information provided by a platform, other than payment information regarding loans and loan exposures owned, which will be observed directly as payments are received. In certain situations, particular loan characteristics may not be reviewed at the time of investment and general criteria may be negotiated in advance with platform sponsors. As a result, investors may be dependent upon a platform's ability to collect, verify and provide information to the investor about each loan and borrower.

Varadero will rely on the borrower's credit information, which may or may not be provided by the platforms. Such information may be out of date, incomplete or inaccurate and may, therefore, not accurately reflect the borrower's actual creditworthiness. Platforms may not have an obligation or an ability to update borrower information, and, therefore, Varadero may not be aware of any impairment in a borrower's creditworthiness subsequent to the making of a particular loan. Varadero typically will not have access to all data utilized by a platform to assign credit scores to particular loans purchased directly or indirectly by an investor, and will not independently diligence or confirm the truthfulness of such information or otherwise evaluate the basis for the platform's credit score of those loans. As a result, investments may be made based on outdated, inaccurate or incomplete information. In addition, the platforms' credit decisions and scoring models are based on algorithms that could potentially contain programming or other errors or prove to be ineffective or otherwise flawed. This could adversely affect loan pricing data and approval processes and could cause loans to be mispriced or misclassified, which could ultimately have a negative impact on investment performance.

In addition, the underlying loans, in some cases, may be affected by the success of the platforms through which they are facilitated. Therefore, disruptions in the businesses of such platforms may also negatively impact the value of investments. Disruption in the business of a platform could limit or eliminate the ability to invest in loans originated by that platform, and therefore an investor could lose

some or all of the benefit of its diligence effort with respect to that platform. Investments could be adversely impacted if a platform that services the investments becomes unable or unwilling to fulfill its obligations to do so. In order to mitigate this risk, Varadero generally would seek to rely on a backup servicer provided through the platform or through an unaffiliated third-party backup servicer. To the extent that it is not possible to collect on defaulted loans or to the extent borrowers prepay loans, a platform that services loans may no longer be able to collect a servicing fee, which would negatively impact its business operations. These or other similar negative events could adversely affect the platforms' businesses and/or investor participation in a platform's marketplace and, in turn, the business of the platforms, which creates a risk of loss for investments in securities issued by a platform or derivatives thereon.

Many investments in consumer loans and related exposures will be unsecured obligations of borrowers. This means that they are not secured by any collateral, not insured by any third party, not backed by any governmental authority in any way and (except generally in the case of certain loans to businesses) not guaranteed by any third party. When a borrower defaults on an unsecured loan, the holder's only recourse is generally to accelerate the loan and enter into litigation to recover the outstanding principal and interest. There is no assurance that such litigation would result in full repayment of the loan and the costs of such measures may frequently exceed the outstanding unpaid amount of the borrowing. Varadero generally will need to rely on the efforts of the platforms, servicers or their designated collection agencies to collect on defaulted loans and there is no guarantee that such parties will be successful in their efforts to collect on loans. Varadero typically will not know the identity of borrowers and will contract with the platforms or third-party loan servicers to service the loans and, therefore, does not expect to (and in many cases will have no way to) pursue borrowers that fail to repay principal or interest. In addition, investments in shares, certificates, notes or other securities representing an interest in a special purpose entity organized by an alternative lending platform and the right to receive principal and interest payments due on whole loans or fractions of whole loans owned by such entity are typically unsecured obligations of the issuer. As a result, investors generally may not look to the underlying loans to satisfy delinquent payments on such interests.

### **Bank Loans and Participations**

There are special risks associated with bank loans and participations including: (i) the possible invalidation of an investment transaction as a fraudulent conveyance under relevant creditors' rights laws; (ii) environmental liabilities that may arise with respect to collateral securing the obligations; (iii) adverse consequences resulting from participating in such instruments with other institutions with lower credit quality; and (iv) limitations on the ability to directly enforce rights with respect to participations. Successful claims by third parties arising from these and other risks, absent customary exceptions, may be borne by an investor. Further, in general, the secondary trading market for senior secured loans and subordinated loans is not well developed. No active trading market may exist for certain such loans, which may make it difficult to value them. Illiquidity and adverse market conditions may mean that an investor may not be able to sell senior secured loans and subordinated loans quickly or at a fair price. To the extent that a secondary market does exist for such loans, the market for them may be subject to irregular trading activity, wide bid/ask spreads and extended trade settlement periods.

## **Lender Liability and Equitable Subordination**

A number of judicial decisions in the United States have upheld the right of borrowers to sue lending institutions on the basis of various evolving legal theories (collectively termed “lender liability”). Generally, lender liability is founded upon the premise that an institutional lender has violated a duty (whether implied or contractual) of good faith and fair dealing owed to a borrower or has assumed a degree of control over the borrower resulting in a creation of a fiduciary duty owed to the borrower or its other creditors or shareholders. Because of the nature of certain underlying investments, an investor could be subject to allegations of lender liability. In addition, under common law principles that in some cases form the basis for lender liability claims, if a lender or bondholder (i) intentionally takes an action that results in the undercapitalization of a borrower to the detriment of other creditors of such borrower, (ii) engages in other inequitable conduct to the detriment of such other creditors, (iii) engages in fraud with respect to, or makes misrepresentations to, such other creditors or (iv) uses its influence as a stockholder to dominate or control a borrower to the detriment of other creditors of such borrower, a court may elect to subordinate the claim of the offending lender or bondholder to the claims of the disadvantaged creditor or creditors, a remedy called “equitable subordination.”

## **Investments in Senior Loans**

Senior secured loans are usually rated below investment grade or may also be unrated. As a result, the risks associated with senior secured loans are similar to the risks of below investment grade fixed income instruments, although senior secured loans are senior and secured in contrast to other below investment grade fixed income instruments, which are often subordinated or unsecured. Investment in senior secured loans rated below investment grade is considered speculative because of the credit risk of their issuers. Such companies are more likely than investment grade issuers to default on their payments of interest and principal. An economic downturn would generally lead to a higher non-payment rate, and a senior secured loan may lose significant market value before a default occurs. Moreover, any specific collateral used to secure a senior secured loan may decline in value or become illiquid, which would adversely affect the senior secured loan’s value. Senior secured loans are subject to a number of risks, including liquidity risk and the risk of investing in below investment grade fixed income instruments.

There may be less readily available and reliable information about most senior secured loans than is the case for many other types of securities. As a result, Varadero will rely primarily on its own evaluation of a borrower’s credit quality rather than on any available independent sources. Therefore, a client will be particularly dependent on the analytical abilities of Varadero.

## **Investments in Subordinated Loans or Securities**

Certain investments may consist of loans or securities, or interests in pools of securities, that are subordinated or may be subordinated in right of payment and ranked junior to other securities issued by, or loans made to obligors. If an obligor experiences financial difficulty, holders of its more senior securities will be entitled to priority of payment. Some asset-backed investments may also have structural features that divert payments of interest and/or principal to more senior classes of loans or securities backed by the same assets when loss rates or delinquency exceeds certain levels. This may interrupt the income received from investments.



## **Non-Performing Nature of Loans**

There are varying and sometimes limited sources of statistical default and recovery rate data for loans and other debt securities and numerous methods for measuring default and recovery rates. The historical performance of the credit market or the leveraged loan market is not indicative of future results. Certain loans purchased by Varadero may be non-performing and possibly in default. Furthermore, the obligor and/or relevant guarantor may also be in bankruptcy or liquidation. There can be no assurance as to the amount and timing of payments with respect to the loans.

## **Servicer Risk**

Loan servicing may entail the assessment and/or collection of payments and fees from borrowers, the allocation and payment of such amounts to investors and the execution of collections processes upon nonpayment of borrower loans, which may include referral of overdue loans to collections personnel or outside collection agencies. Fees charged by a loan servicer reduce the returns on investments. In the event that a servicer is unable to service the loan, there can be no guarantee that a backup servicer will be able to assume responsibility for servicing the loans in a timely or cost effective manner; any resulting disruption or delay could jeopardize payments due to an investor in respect of its investments or increase the costs associated with an investor's investments.

## **Investments in High Yield Securities**

High yield securities that are below investment grade or unrated face ongoing uncertainties and exposure to adverse business, financial or economic conditions which could lead to the issuer's inability to meet timely interest and principal payments. The market values of certain of these lower-rated and unrated debt securities tend to reflect individual corporate developments to a greater extent than do higher-rated securities, which react primarily to fluctuations in the general level of interest rates, and tend to be more sensitive to economic conditions than are higher-rated securities. Companies that issue such securities are often highly leveraged and may not have available to them more traditional methods of financing. A major economic recession could severely disrupt the market for such securities and may have an adverse impact on the value of such securities. In addition, any such economic downturn could adversely affect the ability of the issuers of such securities to repay principal and pay interest thereon and increase the incidence of default of such securities.

## **Use of Leverage**

The use of leverage increases both the possibilities for profit and the risk of loss. Investment returns may also be leveraged with options, short sales, swaps, forwards and other derivative instruments. In the futures markets, margin deposits are typically low relative to the value of the futures contracts purchased or sold. Such low margin deposits are indicative of the fact that any futures contract trading is typically accompanied by a high degree of leverage. Low margin deposits mean that a relatively small price movement in a futures contract may result in immediate and substantial losses to the investor. For example, if at the time of purchase, 10% of the price of a futures contract is deposited as margin, a 10% decrease in the price of the futures contract would, if the contract is then closed out, result in a total loss of the margin deposit before any deduction for brokerage commissions. Thus, like other leveraged investments, any purchase or sale of a futures contract may result in losses in excess of the amount invested. Borrowings also may be provided through repurchase agreements. Under a repurchase agreement, the owner sells securities and agrees to repurchase them at a specified date and price. Repurchase agreements may involve the risk that the market value of the securities purchased

with the proceeds of the repurchase agreement may decline below the price of the securities the owner had sold but is obligated to repurchase. In the event the buyer of securities under a repurchase agreement files for bankruptcy or becomes insolvent, such buyer or its trustee or receiver may receive an extension of time to determine whether to enforce the obligation of seller to repurchase the securities and a seller's use of the proceeds of the repurchase agreement may effectively be restricted pending such decision.

## **Investments in Equity Securities**

Although Varadero generally does not intend to invest a large portion of its assets in equity securities, it may invest in preferred or common stocks and without limitation on the type, size or operating experience of companies. Investments in equity securities of small or medium-sized market capitalization companies will have more limited marketability than those of larger companies. Securities issued by smaller companies may have greater price volatility. Investments in equity securities will be subject to normal market risks. Because equity securities rank lower in the capital structure of an issuer, such investments may subject investors to additional risks not applicable to debt securities

## **Item 9. Disciplinary Information**

Registered investment advisers are required to disclose all facts regarding any legal or disciplinary events that would be material to a client's evaluation of Varadero's advisory business or the integrity of management. Varadero does not have any items to disclose in respect of this Item.

## **Item 10. Other Financial Industry Activities and Affiliations**

Varadero and its management persons are not registered as broker-dealers and do not have any application pending to register with the Securities and Exchange Commission as a broker-dealer or registered representative of a broker-dealer, nor is Varadero or any of its management persons registered or have any application to register, as a futures commission merchant, commodity pool operator, a commodity trading adviser, or an associated person of any of the foregoing.

Each of Varadero, the VMF General Partner and the VSOF General Partner are exempt from registration as a commodity pool operator and commodity trading adviser with the Commodity Futures Trading Commission ("CFTC"). Varadero, the VMF General Partner and the VSOF General Partner have claimed an exemption in respect of each Private Fund, as applicable, from registration as a commodity pool operator under applicable requirements of the CFTC.

As previously indicated, Varadero acts as an adviser to private investment funds where a related party may be the general partner or management persons may serve as a directors, officers or other authorized person. Except for the foregoing, and as otherwise disclosed in this Brochure, neither Varadero nor any of its management persons has a relationship or an arrangement that is material to its advisory business or to its clients. In addition, Varadero has implemented policies and procedures to minimize potential or actual conflicts of interest which may have an impact on its advisory business or relationship with its clients.



## **Item 11. Code of Ethics**

Varadero maintains a Code of Ethics (the “Code”) which establishes our policy that all personnel of the Firm must put the interests of advisory clients before their own personal interests and must act honestly and fairly in all respects in dealings with clients. In recognition of the Firm’s fiduciary duty to its clients and the Firm’s desire to maintain its high ethical standards, the Code contains provisions designed to prevent improper personal trading, to identify conflicts of interest and to provide a means to resolve any actual and potential conflicts of interest in favor of the Firm’s clients.

The Code applies to all personal accounts of all covered persons. For these purposes, a “covered person” includes any director, manager, officer, supervised person or access person of the Firm and personal accounts include, among other things, any account in which a covered person has a beneficial ownership, accounts maintained by or for a covered person’s spouse and minor children, and accounts maintained by or for immediate family members who live in the covered person’s household.

Subject to certain limited exceptions, the Code requires pre-clearance of transactions in reportable securities, prior approval to participate in securities issued in an initial public offering and private placement/limited opportunity investments and prohibitions on trading in securities listed on the Firm’s restricted securities list. The Code also discourages short-term and excessive personal trading and includes prohibitions on managing third party accounts of non-Firm clients. Covered persons are also subject to certain reporting requirements relating to their securities holdings which reports are periodically reviewed by the Firm’s Chief Compliance Officer to ensure compliance with the Code’s personal trading requirements. Access Persons may, in certain instances, invest in securities that overlap with those of an advisory client managed by Varadero. Such investments will only be permitted if Varadero believes that it is able to manage any potential conflict of interest between the Access Person’s interest and the interest of its advisory clients.

The Firm’s Chief Compliance Officer distributes the Code to all covered persons annually. All covered persons are required to sign a form acknowledging their receipt of the Code.

Clients and prospective clients may contact Varadero to request a copy of its Code of Ethics.

## **Material Non-Public Information**

Varadero has implemented policies and procedures that are reasonably designed to prevent the misuse by the Firm and its personnel of material information regarding issuers of securities that has not been publicly disseminated. Such policies are designed to be in accordance with the requirements of the Advisers Act and other federal securities laws. In general, when the Firm is in possession of material non-public information related to a publicly-traded security or the issuer of such security, whether acquired unintentionally or otherwise, neither the Firm nor its personnel are permitted to render investment advice as to, or otherwise trade or recommend a trade in, the securities of such issuer until such time as the information that the Firm has is no longer deemed to be material non-public information.

## **Item 12. Brokerage Practices**

Varadero has a fiduciary duty to use its reasonable efforts to obtain best execution of securities transactions engaged in for client accounts. This means that in selecting broker-dealers and other counterparties to execute transactions, Varadero must attempt to obtain prompt and reliable execution,

while seeking to ensure that the total cost or proceeds of any transaction is the most favorable attainable under prevailing market conditions. The determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the client. Varadero need not necessarily solicit competitive bids on each transaction. In arranging for the purchase and sale of a client's portfolio securities (including those held by VMF Funds and other private investment funds), Varadero may consider many factors, which may include, without limitation: the execution capabilities required by the transaction; listed bids and asks and opportunities for price improvement; the difficulty of execution and the ability to handle difficult trades; the ability and willingness of the broker-dealer to facilitate the portfolio transactions by participating therein for its own account; the importance to the account of speed, efficiency, and confidentiality; the apparent familiarity of the broker-dealer with sources from or to whom particular securities might be purchased or sold and expertise with difficult securities trading style and strategy and size and type of the transaction; the reputation, perceived financial stability and soundness of the broker-dealer and frequency of errors; the ability to source assets, provide financing and provide structuring services; the ability to handle a block order for securities and distribution capabilities; and other matters relevant to the selection of a broker-dealer or other counterparty for portfolio transactions for any account.

Varadero periodically reviews its relationships with broker-dealers and other counterparties and the effectiveness of its efforts to obtain best price and execution.

## **Soft Dollars**

Varadero currently does not maintain any soft dollar arrangements, but it may use full-service broker-dealers and may on occasion receive and use research provided by these full service broker-dealers.

## **Allocation of Investment Opportunities**

Transactions for each client generally will be effected independently, unless Varadero decides to purchase or sell the same securities for several clients at approximately the same time. Varadero may (but is not obligated to) combine or "batch" such orders to obtain best execution, to negotiate more favorable prices, or to allocate equitably among Varadero's clients differences in prices and other transaction costs that might have been obtained had such orders been placed independently. Under this procedure, transactions will generally be averaged as to price and allocated among Varadero's clients pro rata to the purchase and sale orders placed for each client on any given day. To the extent that Varadero determines to aggregate client orders for the purchase or sale of securities, Varadero generally does so in accordance with applicable rules promulgated under the Advisers Act.

Varadero and its affiliates and their respective members, directors, officers and employees may have conflicts of interest in allocating investments among, and in effecting transactions and taking actions for, VMF Funds and other investment management clients as a result of having differing economic interests and as a result of allocation limitations. In order to mitigate these conflicts, Varadero has adopted policies and procedures pursuant to which it will seek to allocate investment opportunities on a fair and equitable basis among advisory clients for which participation in the respective opportunity is considered appropriate, taking into account, among other considerations, whether the risk-return or liquidity profile or other characteristics of the proposed investment is consistent with the client's objectives and guidelines, which objectives and guidelines may be considered (i) solely in light of the specific investment under consideration or (ii) in the context of the portfolio's overall holdings and available capital; the potential for the proposed investment to create concentration or other imbalances in a client's portfolio; potential tax consequences; there being sufficient investable cash or there exists

other considerations or needs with respect to the liquidity of a client's portfolio; and whether such allocation would create a meaningful or de minimis exposure with respect to the client. Such considerations may result in allocations among advisory clients on an other than pro-rata basis.

## **Directed Brokerage**

The client may direct Varadero in writing to use a particular broker-dealer or other counterparty to execute some or all transactions for the client. In that case, the client will negotiate terms and arrangements for the account with that financial institution, and Varadero will not seek better execution services or prices from other financial institutions or be able to "batch" client transactions for execution through other financial institutions with orders for other accounts managed by Varadero. As a result, the client may pay higher prices or other transaction costs or greater spreads, or receive less favorable net prices, on transactions for the account than would otherwise be the case. Subject to its duty of best execution, Varadero may decline a client's request to direct brokerage if, in Varadero's sole discretion, such directed brokerage arrangements would result in additional operational difficulties.

## **Cross Transactions**

Varadero may cause its existing clients to engage in trades ("cross trades") with one or more other accounts if it is determined that the transaction is in the interests of both client accounts (and consistent with the investment program, risk management and other relevant considerations) and conducted on a fair and equitable basis. Cross trading can reduce the transaction costs for both the buying and selling accounts and may allow for other beneficial efficiencies to clients. However, cross trading presents a potential conflict of interest and may be appropriate only if the Firm meets its fiduciary obligations to clients on both sides of the transaction and where best execution requirements are met. The vast majority of trades made for client accounts will be executed through the open market or with reference to an independently established market price. Varadero may not charge any fees to effect a cross trade. Expenses incurred in a cross trade are allocated equitably between the transferee and the transferor by Varadero.

## **Item 13. Review of Accounts**

Varadero monitors client portfolios on an ongoing basis to determine whether investments should be maintained in light of market conditions and opportunities. Such reviews are conducted by Varadero analysts with respect to securities and other instruments within their areas of expertise, the Firm's Chief Risk Officer and, from time to time, other members of the Firm's investment committee. In conducting such reviews, Varadero may consider account performance, holdings and portfolio characteristics as well as client objectives and the investment thesis relating to the portfolio and investment strategy used.

Unless otherwise agreed upon, clients (other than investors in the Private Funds) are provided with transaction confirmation notices and regular summary account statements directly from the broker-dealer or custodian for the client accounts. Clients should compare the account statements they receive from their custodian with those they receive from Varadero.

Investors in each Private Fund receive periodic written reports on the Private Fund's operations that contain information about the value of the Private Fund's assets and net asset value, and the Private Fund's annual financial statements, audited by an independent public accounting firm. Investors also

receive periodic written communications from Varadero discussing its investment views and strategies and the performance of the Private Funds.

## **Item 14. Client Referrals and Other Compensation**

Varadero is required to disclose any relationship or arrangement where it receives an economic benefit from a third party (non-client) for providing advisory services. In addition, Varadero is required to disclose any direct or indirect compensation that it provides for client referrals. Varadero does not have any required disclosures to this item.

## **Item 15. Custody**

Varadero does not have custody over the assets of any separate account clients as investment management fees assessed currently are invoiced to such clients and account assets are held by an unaffiliated qualified custodian selected by the client. Varadero's client agreement with respect to the separate accounts and/or the underlying agreement between a separate account client and its custodian or broker-dealer may in the future authorize Varadero through such financial institution to debit the client's account for the amount of Varadero's fee and to directly remit that management fee to Varadero in accordance with applicable custody rules. In any such case, the relevant financial institutions will be required to send the client a statement, at least quarterly, indicating all amounts disbursed from the account including the amount of management fees paid directly to Varadero. Clients should carefully review any such statements and compare them to those received from Varadero.

Varadero is deemed to have custody over the assets of the Private Funds because of the authority of Varadero and its affiliates over the accounts and assets of such Private Funds. In such cases, Varadero complies with the Rule 206-4(2) (the "Custody Rule") under the Advisers Act either by, among other items required by the Custody Rule (i) distributing audited financial statements in accordance with the Custody Rule or (ii) subjecting the vehicle to a surprise inspection and providing for the delivery of custodial statements to the Private Fund's underlying investors. When audited financial statements are provided by an independent public accounting firm, investors in the applicable Private Fund do not receive statements directly from the Private Fund's custodian. Such audited financial statements are prepared in accordance with generally accepted accounting principles and distributed within 120 days of the applicable Fund's fiscal year end. Investors in such Private Funds are urged to carefully review such statements.

## **Item 16. Investment Discretion**

Varadero is given the authority to exercise discretion on behalf of its clients generally through a power-of-attorney granted through the applicable investment management agreement. The Firm may take discretion over the following activities: the securities or other financial instruments to be purchased or sold; the amount of securities or other financial instruments to be purchased or sold; when transactions are made; and the broker-dealer or other counterparty to be utilized in connection with the execution of client transactions. Varadero may implement its investment management recommendations only after the client has arranged for and furnished Varadero with all information and authorization regarding accounts with appropriate financial institutions.

### **Item 17. Voting Client Securities**

To date, Varadero has not recommended equity securities to its clients and does not anticipate that it will do so in the future. As a result, the securities that Varadero has recommended to its clients have not issued proxies and the Firm does not anticipate that the securities it recommends will issue proxies in the future. In the event this changes, the Firm will implement policies and procedures to ensure it casts proxy votes in a manner consistent with the best interests of the clients to which such securities were recommended.

### **Item 18. Financial Information**

Varadero is required to disclose any financial condition that is reasonably likely to impair its ability to meet contractual commitments to clients. Varadero has no disclosures pursuant to this Item.