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Customer Asset Protection Co.

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Customer Asset Protection Co.

Major Rating Factors

Strengths:

- Strong ability to pay losses under various stress scenarios
- Niche market position as a provider of excess securities account protection to leading broker/dealers
- Liquid and low-risk investment portfolio
- High underwriting standard with zero expected loss ratio

Weaknesses:

- Heavy reliance on capital of its own members and highly rated reinsurers
- Challenging environment for members
- Short operating history

Operating Company Covered By This Report

Financial Strength Rating

Local Currency

A+/Negative/--

Rationale

The insurer financial strength rating on Customer Asset Protection Co. (CAPCO) is based on the company's strong capitalization, niche competitive position serving many of the leading broker/dealers in the U.S. and U.K., high liquidity, low investment risk, and an underwriting standard intended to result in an expected zero loss ratio. Offsetting factors include the company's heavy reliance on its own members and highly rated reinsurers to pay a significant portion of missing or lost assets from remotely possible events, challenging conditions for CAPCO's members, and CAPCO's modest scope of operations.

CAPCO provides excess SIPC (Securities Investors Protection Corp.) coverage for its members, which are broker/dealers. Broker/dealers are regulated entities where customer assets are required to be segregated from the firm's assets and may not be used in the ongoing business of the firm or affected by a broker/dealer's own trading losses or own subprime-related losses. For an excess SIPC claim to occur, all of the following must happen: client assets must be found to be misappropriated, and customer property, SIPC advances, fidelity bond proceeds--if any--and distributions from the general estate of the member--if any--to customers are insufficient to satisfy customer account obligations. Neither SIPC nor excess SIPC cover a decline in the market value of a client's investments.

Standard & Poor's Ratings Services believes CAPCO has the ability to satisfy its policyholder obligations following an extreme event, such as a broker/dealer insolvency coupled with a misappropriation of 20 basis points of aggregate client assets. A broker's loss of capital or lack of liquidity could hurt CAPCO's performance under these tests because a broker/dealer's capital (and sometimes even that of its parents) is a resource to pay claims.

Deterioration in the credit quality and risk-management capabilities of CAPCO's members could affect CAPCO's financial strength. In the past couple of months, Standard & Poor's has revised the outlook on several of CAPCO's members' parents to negative. Also, the ratings on a couple of members are on CreditWatch with negative implications, which means there's the potential for a more imminent downgrade. The capital of CAPCO's members and--in some cases--their parents is an important resource for mitigating CAPCO's potential payments for its excess

SIPC coverage.

CAPCO has an adequate competitive position. Standard & Poor's does not view CAPCO's competitive position as a key ratings factor provided CAPCO is able to maintain a relatively stable membership base that is large enough to make the captive a cost-effective solution for its members. Due to events that affected a member, such as merger or acquisition, three members have withdrawn--or will withdraw--from CAPCO in the past three years. Standard & Poor's believes these departures do not signal a lack of CAPCO's viability.

The investment portfolio is invested almost entirely in U.S. Treasuries with maturities of three years or less. As a result, the risk of material loss to capital because of investment performance is low, and the liquidity of the portfolio is very high.

Outlook

The outlook is negative. Standard & Poor's would lower the ratings on CAPCO if we conclude that deterioration in the financial strength or enterprise risk management of CAPCO's members has had a significant negative impact on its ability to satisfy its potential obligations to policyholders. We would revise CAPCO's outlook to stable if we conclude that CAPCO's claims-paying ability has not been materially weakened. The ratings and outlook on CAPCO will not necessarily move in tandem with those of its members. However, the ratings on the members are an important consideration for those on CAPCO because CAPCO depends on its members' capital as a claims-paying resource.

CAPCO's competitive position and operating performance are less important rating factors than for most insurers because CAPCO is a captive. Consequently, Standard & Poor's would not revise the outlook or change the rating due to moderate changes in these areas. A significant loss of members could lead to a downgrade because the departures would threaten CAPCO's ability to offer excess SIPC coverage on a cost-effective basis. We expect CAPCO to maintain its narrow focus and earn a stable and modest return each year, with a zero loss ratio.

Competitive Position: Value Of Excess SIPC To Broker/Dealers Gives CAPCO Secure Position In The Market

CAPCO has an adequate competitive position. Standard & Poor's primary concern is the financial strength and enterprise risk management (ERM) of CAPCO's members. We do not view CAPCO's competitive position as a key ratings factor provided CAPCO is able to maintain a relatively stable membership base that is large enough to make the captive a cost-effective solution for its members. Due to events that affected a member, such as merger or acquisition, three members have withdrawn--or will withdraw--from CAPCO in the past three years. Standard & Poor's does not believe these departures signal a lack of CAPCO's viability.

CAPCO exists to provide excess SIPC and similar forms of excess securities account protection to its owners, which is coverage in excess of amounts covered by the SIPC in the U.S. and in excess of similar coverage provided by the Financial Services Compensation Scheme (FSCS) in the U.K. In addition, CAPCO might provide "sweep account" coverage for customer cash deposited in bank affiliates of member companies (in cases where both bank and broker/dealer become insolvent and losses occur), although this product has not yet been offered.

SIPC is a form of insurance that protects the customers of broker/dealers if there are losses to their accounts, which

would be triggered by the broker/dealer's insolvency and by missing assets in customer accounts. Because of the regulatory oversight of the SEC and the self-regulatory organization (SRO) to which it delegates some oversight (the NYSE), and because of the risk management practices and segregation of customer assets, the risk of loss is remote. If customer account losses occur, SIPC coverage is structured so that SIPC will cover all customer losses except when the aggregate loss of customer assets is extremely large. Coverage under the FSCS is similar. Such large losses could conceivably happen due to massive fraud or operational failure at the broker/dealer.

The challenging macroeconomic environment and the disruption in the financial markets could negatively impact CAPCO's financial strength. The parents of many of CAPCO's insureds recently sustained significant losses due to a sharp decline in the market value of residential mortgage-backed securities and other structured finance products. The broker/dealers' financial strength is relevant to CAPCO because the capital of its members and in some cases its parents can be used to mitigate CAPCO's exposure from the loss or misappropriation of clients' funds.

For the most recent quarter, most members either reported a net loss or a significant decline in earnings. Also, Bear Stearns Companies, a member of CAPCO, encountered a severe lack of liquidity that led to its being acquired by JPMorgan Chase & Co. Standard & Poor's does not expect broker/dealers' revenue and earnings to improve in the near term. Neither operating losses by brokers or investment losses by their clients would qualify as an excess SIPC claim.

Despite these difficulties, most of the brokers' parents still have counterparty credit ratings in the 'A' category or better. CAPCO requires a broker to purchase additional reinsurance if its probable maximum loss from either of Standard & Poor's two stress tests exceeds \$100 million.

CAPCO faces modest competition from insurers such as Lloyd's and XL Capital Ltd., who sell coverage to broker/dealers other than CAPCO's owners. Standard & Poor's believes CAPCO, as a captive, is well suited to serving its customers' needs because its interests are aligned with those of its customers and it has management and a board of directors from the broker/dealer industry who have a strong understanding of the underlying risk.

The value of CAPCO to its insured broker/dealers is significant, based on its value to the broker/dealers' marketing efforts, and to a lesser extent on risk transfer. By having an excess SIPC insurer, a broker/dealer can provide assurance to customers and prospects that their accounts have protection at more than the \$500,000 SIPC limit and \$100,000 cash sublimit. Not limiting its liability is one of CAPCO's advantages. Most alternatives to CAPCO have limits; therefore, withdrawing from CAPCO and opting for the alternative coverage would require the broker to notify its clients that it had reduced its excess SIPC coverage.

Standard & Poor's does not view the withdrawals by a few members as a concern, but maintaining a stable and sizable membership base is important to the rating on CAPCO. CAPCO's membership base is now 22 compared with 25 in 2005. Some membership turnover is inevitable due to consolidation and other events in the broker/dealer industry.

Historical

CAPCO is a captive insurer owned by the broker/dealers it insures, which are leading U.S. broker/dealers and a few of their U.K. affiliates. Before CAPCO's formation in 2003, its members purchased excess SIPC insurance from various property & casualty insurers. Many of these carriers stopped offering the coverage.

Prospective

CAPCO is expected to maintain a strong competitive position as an excess SIPC insurer within the realm of its market-leading broker/dealer owners. The value of excess SIPC to broker/dealers gives this product a secure position in the market. Substitute products are not expected, because insurance protection is well understood and easy to explain to broker/dealer customers, whereas the security and ease of explaining other products is likely to be lower. The risk of losing business to competitors is low because CAPCO is sponsored by its customers, is meeting its customer needs, and has the competitive advantage of a captive, as noted previously.

Management And Corporate Strategy

Standard & Poor's views CAPCO's lack of dedicated employees as a modest weakness. However, its organizational structure is typical for a captive, and the lack of managers dedicated solely to CAPCO has not been an issue in the past. CAPCO benefits from its managers' experience in risk management and knowledge of the broker/dealer industry. CAPCO's board of directors consists of representatives from its members. Most representatives are from the members' risk management areas.

CAPCO outsources some functions from its lead reinsurer and from leading professional services firms in the actuarial, accounting, and legal areas. The lead reinsurer underwrites the business based on its own underwriting criteria, which are in addition to CAPCO's strict requirements for new members. The lead reinsurer has expertise in financial guaranty and is well versed in the reinsurance needs of financial institutions. Alignment of interests with the underwriters is achieved by having a substantial portion of risk born by the underwriter via excess of loss reinsurance.

Accounting

There are no accounting issues that are a significant consideration in Standard & Poor's analysis of CAPCO. CAPCO's financial statements are relatively simple. Its assets are easy to value (e.g. U.S. Treasuries). CAPCO has only a modest amount of liabilities, and they require few assumptions.

CAPCO prepares U.S. GAAP (generally accepted accounting principles) financial statements, which are audited by Saslow Lufkin & Buggy LLP (Saslow). Management selected Saslow because the firm specializes in captives and is an affordable alternative to the Big Four. Although CAPCO's management maintains the confidentiality of its financial statements, Standard & Poor's has access to the financial statements and reviews them as part of the rating process.

Operating Performance: Premiums Sufficient To Cover Reinsurance And Other Expenses

Since CAPCO is a captive, Standard & Poor's does not consider its operating performance as a key ratings factor unless significant losses threaten its capitalization and ability to pay claims. Nevertheless, CAPCO has generated consistent profits due to a zero loss ratio since its formation in late 2003, including net income of \$4 million in 2007.

Despite CAPCO's short history, there is a long record of more than 30 years of excess SIPC coverage being written

with no claims by other market participants with comparable underwriting standards. While one excess SIPC insurer did experience one small loss, this loss came from a much smaller broker/dealer that does not fit the CAPCO profile. There has never been a SIPC proceeding involving a major broker/dealer.

CAPCO is expected to operate with a zero loss ratio and to earn a stable and modest profit every year, as premiums should be sufficient to cover reinsurance and other expenses. Standard & Poor's views the potential for claims as very remote but possible. Other than claims, the only significant uncertainty to CAPCO's expense structure is the cost of reinsurance, but it is expected that CAPCO would have the ability to raise its insurance premiums commensurately if necessary. Although CAPCO's ROE is expected to be modest in the low single digits, the real value of CAPCO to its owners is strategic and not tied to earnings.

Enterprise Risk Management

CAPCO's enterprise risk management (ERM) is considered to be adequate, reflecting the limited scope of CAPCO's operations and the risk management experience of its employees and external consultants. Operational risk of the insured broker/dealers is the biggest risk to CAPCO. However, CAPCO does not control its members' risk management programs and operating process. Regulatory oversight by the NYSE and SEC enhances broker/dealers own risk management practices and operating controls.

The ERM practices and operational processes of CAPCO's members are extremely important to its rating. If members have effective controls, they will be more likely to thwart an attempted theft of clients' funds. Therefore, deterioration in members' ERM practices could negatively impact the rating on CAPCO. Societe Generale, which is not a member of CAPCO, recently reported a loss of over \$7 billion due to unauthorized trading. The loss demonstrates that brokers' systems are not impregnable, but there are significantly more restrictions on access to clients' accounts than a broker's own trading accounts.

Investments And Liquidity: Risks Are Taken In Underwriting, Not Investment Portfolio

CAPCO's liquid and low risk investment portfolio is a strength to its rating. CAPCO invests in highly rated short-term paper, mostly obligations of the U.S. government. The risk of material loss to the portfolio is very low. The low investment yield that can be expected from such a portfolio is not viewed negatively because operating performance is not a major ratings factor.

In a normal environment, in which there are no claims, liquidity is expected to be strong. Operating cash inflows should be predictable and more than sufficient to cover the company's minimal operating expenses.

In the rare event of a claim, liquidity needs will be high. The liquid investment portfolio coupled with proceeds from its reinsurers should be sufficient to facilitate the payment of a claim, even in severe scenarios. The most important liquidity consideration is the ability to convert the entire investment portfolio to cash in a period of roughly three years without material realized losses, which is about how long a SIPC liquidation with losses to client assets takes. CAPCO could liquidate its portfolio sooner than three years, but there could be some realized losses.

Capitalization: Capital and Reinsurance Sufficient To Cover Low Probability Large Loss Events

CAPCO's capital adequacy is very strong and in excess of what is needed if no loss occurs, which is highly likely. The key drivers of CAPCO's capitalization are its members' resource and its reinsurance program. The most significant need for capital is to cover extremely remote large losses. Capital available to cover losses consists of the following:

- Broker/dealer's intrinsic capital and in some cases resources of the parent.
- Broker/dealer's insurance coverage for theft and other events that would cause a loss.
- CAPCO's equity.
- Excess of loss reinsurance coverage purchased by CAPCO.

Three events (listed below) must occur in order for CAPCO to pay a claim. The extremely remote joint probability of these events occurring support CAPCO's 'A+' insurer financial strength rating.

- The broker/dealer must lose a portion its clients' funds. The loss would most likely be due to theft.
- The broker/dealer must exhaust its intrinsic capital, insurance coverage.
- After SIPC mutualizes the total loss amount over all the accounts of the broker/dealer, the loss to an individual account must be greater than \$500,000 (\$100,000 cash). Otherwise, SIPC will indemnify the investor.

The insurer financial strength rating on CAPCO depends on its ability to pass two tests used by Standard & Poor's to assess its claims-paying ability. Both tests (below) involve analyzing individual accounts, determining amounts covered by SIPC and applying the terms of CAPCO's reinsurance treaty.

- One broker's loss or misappropriation of \$3 billion of client's funds. This test considers a broker/dealer's capital to be a claims-paying resource. As a condition of membership, each broker/dealer agrees to indemnify CAPCO for any losses. Some of the parents guaranteed their broker/dealers' obligations to CAPCO. If a guarantee exists, Standard & Poor's assumes the parent's capital is also available as a claims-paying resource.
- One broker's loss of 20 basis points of all clients' assets. This test assumes the broker/dealer is insolvent; therefore, its capital is not considered a claims-paying resource. However, if a guarantee exists from the broker/dealer's parent, the parent's capital would be a claims-paying resource.

Standard & Poor's believes CAPCO might not be able to pay multiple large claims. The correlation between two broker/dealers incurring a claim should not be high, but difficult times in the industry could increase the probability of an attempted theft by employees. Since historical data and robust security procedures suggest a very low probability of a single claim, the potential for a default in the extremely remote multi-claim scenario should not be a concern at the current rating level.

Reinsurance plays a key role in CAPCO's ability to satisfy its policyholder obligations under the two scenarios Standard & Poor's uses to test CAPCO's capitalization. Standard & Poor's reviewed the strength of CAPCO's reinsurers, and the issues affecting the financial guaranty sector have not affected CAPCO's ability to satisfy its policyholder obligations. Standard & Poor's believes the reinsurers' claims-paying ability will remain excellent during the timeframe in which a claim would come due. Both reinsurers are currently rated 'AAA'.

Financial Flexibility: Minimal Need For Additional Capital

CAPCO's need for additional capital is minimal because its initial capital and retained earnings should be sufficient. If additional capital were needed for some reason, its owners are expected to have the ability to put in additional capital. CAPCO also has directors and officers coverage that would mitigate capital requirements if it were to somehow have losses from lawsuits tied to mismanagement. In addition, reinsurance is an important part of CAPCO's structure. The attractiveness of this kind of reinsurance is high, as demonstrated by the strong interest of highly rated reinsurers in providing this coverage. Thus, CAPCO should have the ability to obtain the reinsurance coverage it needs going forward.

Ratings Detail (As Of June 5, 2008)*

Operating Company Covered By This Report

Customer Asset Protection Co.

Financial Strength Rating

Local Currency

A+/Negative/--

Counterparty Credit Rating

Local Currency

A+/Negative/--

Domicile

Vermont

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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