

Bond Market 2.0

Powered by Risk-Diffusion Technology

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Background

The declining market for non-cleared single-name credit default swaps (“CDS”), and failure of the Central Clearing (CCP) market for cleared CDS to provide a cost-effective alternative, is concentrating default risk to dangerous levels and choking bond market liquidity with increasing momentum.

CDS contracts have historically been the singular means of directly hedging credit default risk in the bond market. And, until 2007, they efficiently added a degree of certainty that ensured protection and fostered fixed income liquidity.

That market has declined from its high in 2007 of USD 33 trillion to less than USD 4 trillion in outstanding notional value, with most participants anticipating its decline to continue to extinction. There are now less than 200 bond issuers for which a direct default hedge can be purchased, and the cost of that protection has caused most investors to no longer deem it viable.

To provide efficient utility, the structure and operation of a risk-transferring market must mitigate concentrations of risk at every level. The ideal structure would distribute each risk with sufficient breadth to minimize its potential adverse impact upon any single risk holder, and avoid the correlation of such risks. Optimal distribution would thus diffuse each risk among a broad array of holders, so that even a catastrophic event would produce only a modest impact upon any single holder.

Non-cleared CDS transfer risk to a single counterparty, and offer no means for diffusing risk.

Non-Cleared CDS Market: No Risk Diffusion



CDS cleared through a CCP market are cited by some as a preferred alternative to non-cleared CDS, but the CCP structure also concentrates risk – by limiting the distribution of each exposure to a small number of clearing members. For example, the largest 20 members account for roughly 75 per cent of financial resources provided to all CCPs.

Cleared CDS provide moderate diffusion of individual risks.

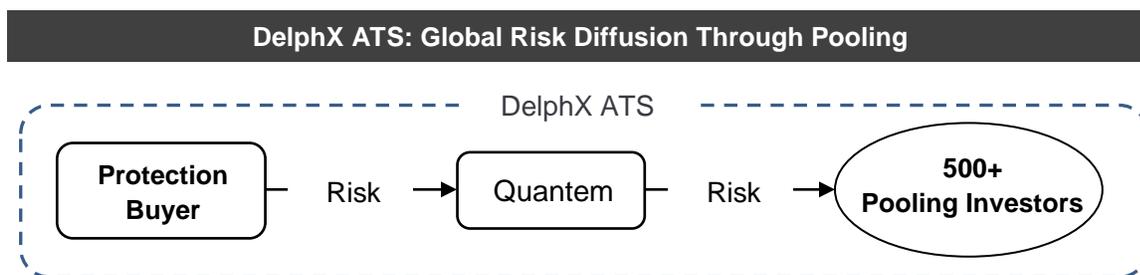
Centrally-Cleared CDS Market: Moderate Risk Diffusion



While centralizing CDS trading into CCPs has reduced the risk of individual holders, it has magnified the systemic importance of CCPs – causing those facilities to become the latest category of “Too Big to Fail” institutions. A recent study of risks in CCP networks found that “...CCP-related losses are likely to be realized precisely under the extreme circumstances where the members are least able to absorb them.” CCPs are thus most likely to fail when they are needed most.

A Securities-Based Solution

To facilitate optimal diffusion of default risk, DelphX designed a securities-based solution through which its wholly-owned subsidiary, DelphX Services Corporation (“DSC”), a securities broker-dealer registered with the U.S. Securities Exchange Commission (“SEC”) (Registration #8-67379) and a member firm of the Financial Industry Regulatory Authority (FINRA) (Member #141368), will operate an Alternative Trading System (“ATS”) pursuant to SEC Regulation ATS. Within that facility, DSC will employ proprietary technology to enable participating securities dealers (“Dealers”) to structure and exclusively purchase tailored new issues of the Rule 144A securities described below for ultimate distribution to Qualified Institutional Buyers (“QIBs”). Those new securities will be transparently administered within a secure distributed ledger and issued by a special-purpose DelphX subsidiary dedicated to the subject Dealer, and in which the Dealer may elect to hold a minority ownership interest (all such entities are collectively referred to herein as “Quantem”). The securities issued by Quantem (“Quantem Securities”) will operate to broadly diffuse default exposures among many risk holders through DelphX’s unique pooling technology.



Quantem Securities are designed to:

- a) globally diffuse credit default risk of the underlying credit securities;
- b) enhance yields of institutional holders willing to assume a share of that risk; and
- c) stimulate the liquidity of Quantem securities and their underlying issues.

The ATS will be initially deployed in the U.S. to facilitate default protection for underlying corporate, municipal and sovereign debt securities denominated in USD. Its primary-market element will facilitate

Dealer structuring and origination of new Rule 144A securities known as Covered Put Options™ (CPOs) and Covered Reference Notes™ (CRNs), which will be continuously administered within a transparent distributed ledger maintained by DelphX (“DelphX Ledger”). The secondary-market element of the ATS will facilitate multi-Dealer market-making and trading of all outstanding CPOs, CRNs and their underlying cash bonds.

Each CPO will be pre-funded through the sale of a new CRN and the securities will collectively operate to provide a cost-effective security-based alternative to CDS contracts. That operation and DelphX’s diffusion of risk through transparent pooling will provide both secured default protection to CPO holders and enhanced investment yields to CRN holders.

Upon the occurrence of a default or other qualifying credit event involving the third-party bond underlying a CPO, the CPO holder can immediately exercise its contractual right (but not obligation) to put (sell) the underlying security to Quantem at its full par value (CPO Strike Price).

Through Quantem Securities:

Protection Buyers can:

- a) Receive guaranteed par-value CPO proceeds upon the default of an underlying credit issue they selected from the more than 6 million issues available for CPO protection;
- b) Eliminate the need for variation and other collateral margins for credit protection; and
- c) Generate competitive risk-free returns through basis-trading.

Credit Investors can:

- a) Secure enhanced yields on investment grade notes in which referenced default risk has been embedded; and
- b) Definitively manage or eliminate credit exposures by pairing investments in offsetting Quantem Securities.

All ATS Participants can:

- a) Competitively speculate on the future movement of CPO pricing for any underlying security;
- b) Negotiate the purchase of new CPOs and CRNs and trade all outstanding CPOs, CRNs and underlying cash bonds in the Secondary-Market of the ATS; and
- c) Access continually updating and validating MAV_{en}[®] benchmark pricing forecasts for all Quantem Securities and underlying issues.

NRSRO Credit Rating

All CPOs and CRNs will be issued and collateralized at origination by Quantem, a subsidiary of DelphX Corporation. Quantem will limit the assets collateralizing CPOs and CRNs to cash, cash equivalent securities, corporate debt securities rated A or higher and guaranteed investment contracts (GICs) issued by highly-rated insurers, with all such assets being held in custody by Quantem's independent custodian.

Quantem has commenced the process of becoming rated by a Nationally Recognized Securities Rating Service Organization ("NRSRO"), and such rating would also apply to its CPO and CRN securities. It is also intended that rating of the Quantem Risk Pool will be sought from one or more NRSROs as soon as the facility has developed sufficient size, diversity and experience to clearly demonstrate its stochastic model, sustainability and risk-diffusing utility. It is anticipated that the risk-mitigating/stabilizing characteristics of the utility, and the predictable claim experience resulting, will qualify the Pool for high credit ratings. Discussions with several NRSROs indicate that, upon the issuance of a superior credit rating of the Pool, the rating of Pooled-Risk CRN securities will also be commensurately enhanced.

On the matter of credit ratings, it should be noted that the current pricing of default protection for a given credit security is both a primary determinant of the current market value of that security, and a superior metric for determining the current credit worthiness of its issuer. Given their post-crisis concerns regarding the accuracy and conflicts of interest of credit ratings issued by NRSRO agencies, it is anticipated that regulators will favor the market-based alternative to traditional credit ratings offered by the ATS and CPO securities -which continually determine in real-time the market's current assessment of the credit-worthiness of a fixed income securities issuer.

Primary-Market Interaction

ATS participants can negotiate their purchase of a new CPO or CRN by:

- a) Selecting the underlying security from the ATS Security Reference Database (which includes more than 6 million corporate, municipal and sovereign bonds, asset-backed securities, mortgage-backed securities and other credit securities);
- b) Specifying the desired Face Amount, Expiration/Maturity Date and proposed Premium/Coupon; and
- c) Negotiating their purchase of the pending new CPO/CRN with one or more Dealers.

Participation in the DelphX ATS will be available to Dealers and all financially-sound institutional investors acceptable as a customer to the custodian. The custodian will maintain customer accounts for each ATS participant as may be required to efficiently provide all custody, investment and cash management services required by DelphX, Quantem and that participant.

Mark-to-market collateralization of each CPO will consistently exceed the collateralization requirements specified in Securities Exchange Act Rule 15c3-1e(c)(4), and automatically increase to 100% collateralization on the CPO's Exercise Date.

DelphX Ledger

Once the sale of a new CPO or CRN is confirmed, Quantem will immediately notify the custodian of all pertinent information regarding each transaction through redundant encrypted messages transmitted: i) within the secure DelphX Ledger; and ii) via a Virtual Private Network maintained between Quantem and the custodian. All elements of, and subsequent actions relating to, the CPO/CRN will then be continually recorded and updated in real-time within the transparent DelphX Ledger for all participants to monitor, though the identities of the holders will never be discernable.

It is important to note that:

- a) The proprietary version of distributed ledger technology developed and employed by the management of DelphX in the operation of the DelphX Ledger is a closed system in which a limited number of nodes (operated by the custodian and selected major participants) will be authorized to enter information into the Ledger;
- b) The Ledger is exclusively an accounting, reporting and verification mechanism, and has no facility for accommodating the transfer of assets or funds within the Ledger. All transfers of assets and funds will be solely performed by the custodian(s) appointed by Quantem and the clearing principal(s) appointed by DSC;
- c) All transfers of assets and funds performed by the custodian(s) and clearing principal(s) will be at the specific direction of Quantem or DSC, each of which must also be confirmed by Quantem or DSC via an external communication protocol established with each such custodian and clearing principal; and
- d) Quantem will employ its proprietary technology to issue and administer within the Ledger only smart securities that are originated and traded within the regulated ATS and will not offer or facilitate trading of any form of digital coins, tokens or other cryptocurrencies.

Utility of Risk Pooling

The Law of Large Numbers holds that the average results obtained from a large number of risks will move closer to the expected result as more and more risks are Pooled-Risk. As the number of risks of an event increase, the number of occurrences of that event get closer and closer to the average chance of the event taking place.

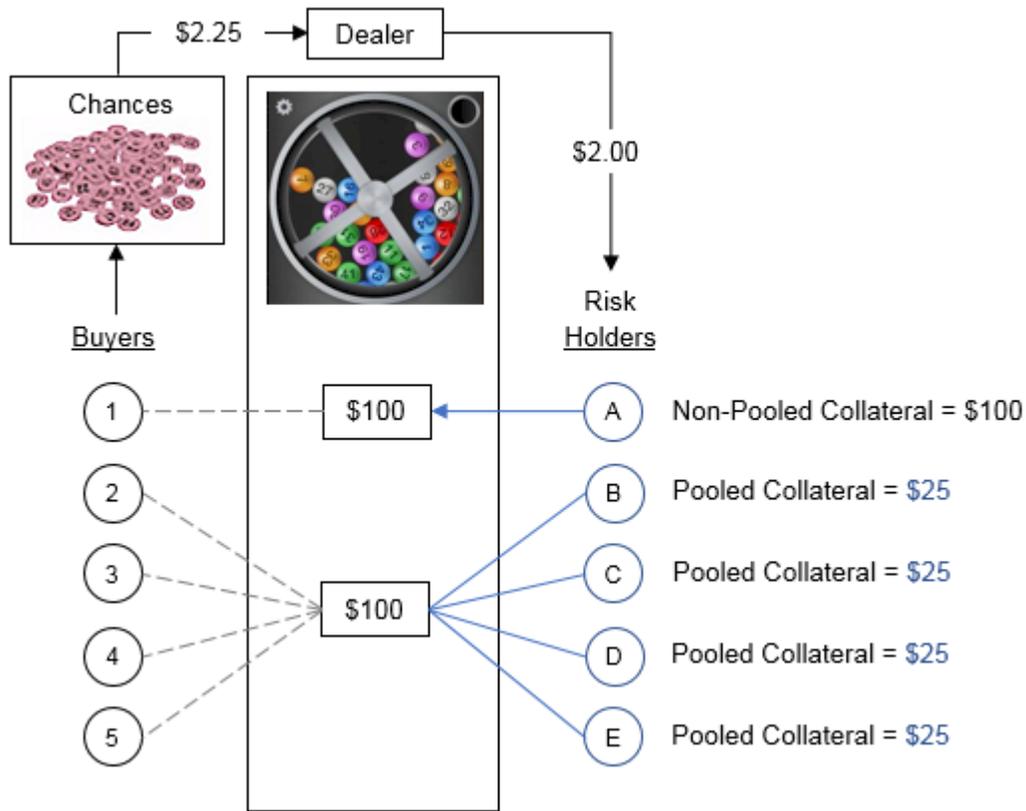
This result can be used to demonstrate that the entry of additional risks to a pool of risks tends to reduce the variation of the mean loss per risk around the expected value. When each contribution of a risk to the pool is accompanied by a contribution to the pool's collateral resources that exceeds the expected loss payment relating to that new risk, the entry of additional risks enhances the accuracy with which the pool's future claim experience can be forecast.

Assuming a stable and independent probability distribution for loss exposure, an insurance company is better served by issuing 500 rather than 150 insurance policies. In turn, that increased accuracy in forecasting aggregate claims enables the insurer to reduce its premiums and aggregate reserves.

To demonstrate the lower collateral requirements produced by pooling, let's assume that a charity event offers a continually-recurring lottery in which participants can buy chances to win \$100. The lottery is operated by a neutral dealer which offers in each lottery a total of 100 Chances, numbered 1 through 100, at a price of \$2.25 each. The number of each Chance corresponds to the number of a ball rotating in a tumbler containing balls numbered 1 through 100.

Of the \$2.25 collected for each Chance sold, the dealer retains 5 cents, remits 20 cents to the charity, and offers the remaining \$2.00 to other participants willing to hold the risk that a Chance they fund will win. To assure Chance buyers that the \$100 prize will be immediately available to them if their number is released from the tumbler, each Risk Holder is required to post collateral.

Example of Risk Pooling: Lottery Prize = \$100 Chance Price = \$2.25



If Holder A elects to not pool their risk with the other Holders, he or she will be required to post \$100 as collateral for the Chance held by Buyer 1 and will fully fund the prize paid if Buyer 1 wins. Holder A thus has a 1% risk of losing \$100 in return for its receipt of the \$2.00 payment.

If Holders B, C, D and E elect to pool their risks, each will post \$25 in collateral and will lose that sum if Buyer 2, 3, 4 or 5 wins. Each thus has a 4% risk of losing \$25 in return for the \$2.00 payment.

If all Chances in the lottery were sold and all Risk Holders elected to pool, each would post only \$1.00 in collateral for each Chance they funded and have a 100% chance of losing the collateral they posted in return for their receipt of the \$2.00 payment per funded chance. Each Holder would thus earn a 100% profit on their collateral investment.

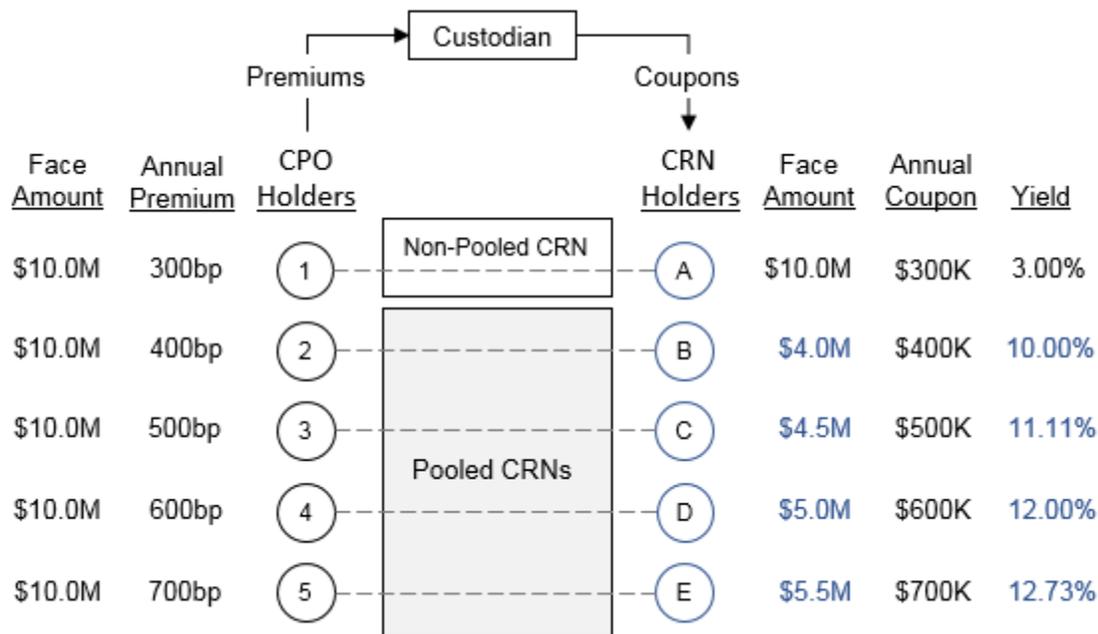
Pooling CPO/CRN Risks

When bidding for a new CRN, the prospective buyer elects to purchase either a Retained-Risk or Pooled-Risk version of the CRN. If a Retained-Risk CRN is purchased, the CRN holder will fully retain the embedded risk of the underlying security defaulting in the future and the loss arising from the

exercise of the CPO related to the Retained-Risk CRN. As the lower risk and collateral requirement produced by pooling will not be available to holders of Retained-Risk CRNs, Quantem cannot offer such CRNs at a lower face amount (purchase price) than the face amount of its related CPO.

If pooling of the risk is chosen, the premium of the related CPO being negotiated will determine the coupon and the discounted face amount of the CRN being offered. As indicated below, as the premium of the offered CPO is increased (reflecting the market's higher assessment of the default risk of the underlying security), the face amount of the related CRN correspondingly increases. That increase in CRN face amount is the result Quantem's need for an increased level of collateral to fund the increased concentration of risk of the underlying security defaulting.

Utility of CRN Risk Pooling: Assuming Common CPO Face Amount of \$10M



In the example above;

- 1) CRN (Risk) Holder A has elected to not pool its risk of loss resulting from a default of the security underlying the related CPO held by Holder 1, and thus Holder A must fund 100% of the collateral required by Quantem to guarantee the potential settlement proceeds payable to Holder 1 if the related CPO becomes exercisable.
- 2) CPO Holder 2 and CRN Holder B have respectively negotiated an annual CPO premium of 400bp (payable by Holder 2 to the Custodian in quarterly installments) and a \$400K CRN coupon payment (payable by the Custodian to Holder B in quarterly installments). As Holder

B has elected to purchase a Pooled-Risk CRN, the 400bp premium (risk concentration) of the related-CPO enabled Quantem to sell the CRN held by Holder B at a lower purchase price/face amount of \$4.0M, thus enhancing Holder B's coupon-yield to 10.00%.

- 3) The negotiated annual premium of a CPO determines the coupon and face amount offered by Quantem for the Pooled-Risk version of its related-CRN. For example, the 700bp premium of the CPO held by Holder 5 caused Quantem to offer and sell the related-CRN held by Holder E with a \$700K coupon and a face amount (purchase price) of \$5.5M. That higher face amount reflects Quantem's increased collateral requirement resulting from the higher premium (risk-concentration) of the CPO held by Holder 5 relative to the concentration of the other Pooled-Risk CPOs in the example (held by Holders 2,3 and 4).

Resulting Enhanced Yields

Transferring the risk embedded within a CRN to the Quantem Risk Pool enables the holder to reduce its exposure from 100% of that risk to a small and continually-reducing share of the cost of funding CPO exercise proceeds payable under all CPOs related to the hundreds (and eventually thousands) of CRNs included in the Risk Pool.

Through Normal Distribution and operation of the Law of Large Numbers, pooling of risks will facilitate:

- 1) Predictions of aggregate default probability with greater accuracy and stability;
- 2) Lower collateral requirements for any single CRN holder (as all pool participants will only nominally share in each Pooled-Risk CRN); and
- 3) Sales of Pooled-Risk CRNs at Face Amounts significantly lower than retained-risk CRNs referencing the same underlying security.

That lower collateral requirement for Pooled-Risk CRNs then:

- 1) Lowers the amount of cash Quantem must collect from its sale of each Pooled-Risk CRN – enabling it to sell the new CRN at a Face Amount that is lower (e.g. 3.5M) than the Face Amount of the related CPO (e.g. 10.0M);
- 2) Causes the total annual premium paid by the CPO holder (e.g. 300bp per 1,000 Face Amount times 10.0M Face Amount for a total annual premium of \$300,000);
- 3) Causes the Coupon the CRN holder receives (assuming the full \$300,000 premium for ease of calculation) to be paid directly to the CRN holder by the custodian (not part of the pool mechanics);

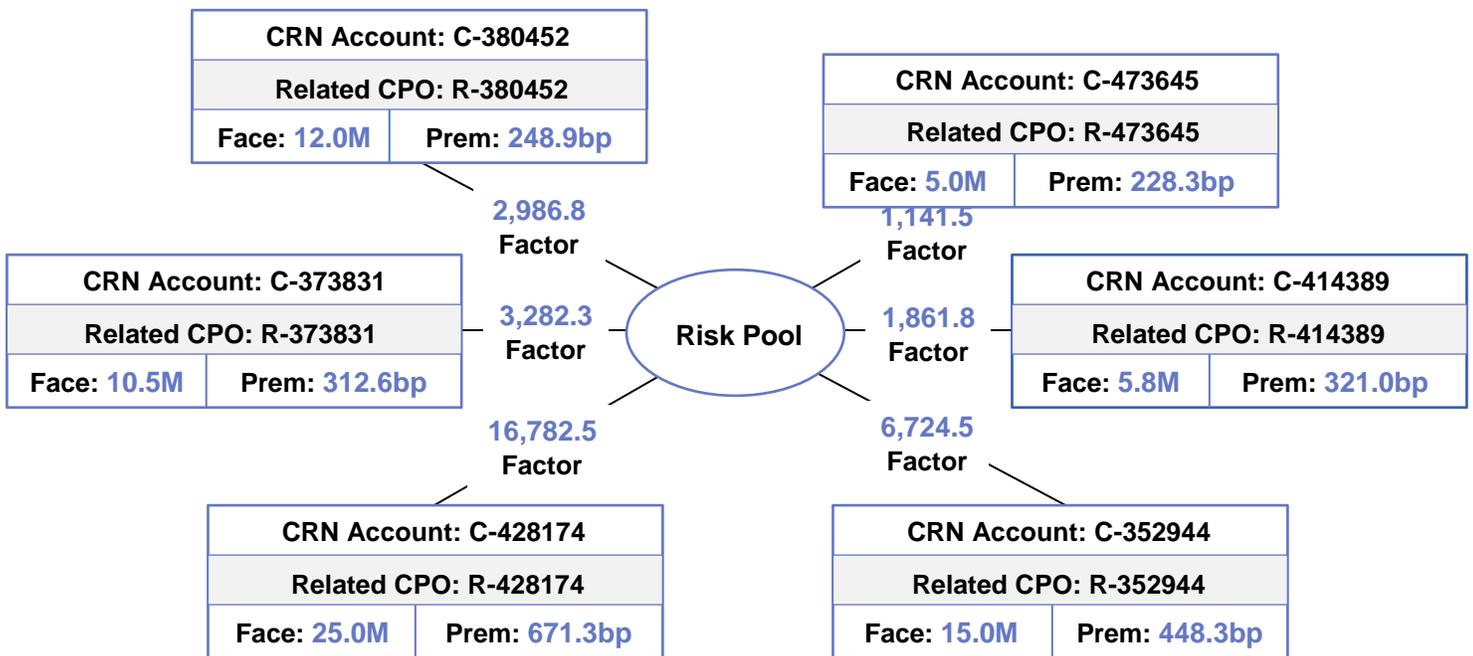
- 4) Causes a CRN holder not electing to pool its risk to receive a 3.0% yield (300,000/10M), as the full risk of the related CPO defaulting and 10M becoming payable is held by the retained-risk CRN holder); and
- 5) Causes the Pooled-Risk CRN holder to receive an 8.57% yield (300,000/3.5M) due to the lower Face Amount of its Pooled-Risk CRN.

The lower risk and collateral requirement produced by pooling is thus conveyed by Quantem to CRN holders through the lower risk-based face amounts. Indicated below are the face amounts resulting from each displayed CPO premium, and the higher post-claim total returns rendered by pooling risks.

Post-Claim Total Returns of Pooled-Risk CRNs									
CPO Face	CPO Premium	CRN Face	CRN Coupon	Assumed Annual Rates of CPO Settlements Paid From Pool					
				1%	2%	3%	4%	5%	6%
\$1,000	15 bp	\$200	\$7.5	3.80%	3.80%	3.80%	3.80%	3.80%	3.79%
\$1,000	30 bp	\$225	\$9.8	4.40%	4.40%	4.40%	4.40%	4.28%	4.02%
\$1,000	60 bp	\$250	\$13.5	5.51%	5.51%	5.46%	5.27%	5.06%	4.80%
\$1,000	100 bp	\$275	\$16.6	6.17%	6.17%	6.13%	5.85%	5.52%	5.13%
\$1,000	200 bp	\$300	\$24.5	8.42%	8.42%	8.20%	7.72%	7.14%	6.43%
\$1,000	300 bp	\$350	\$33.2	9.81%	9.81%	9.51%	8.91%	8.19%	7.29%
\$1,000	400 bp	\$400	\$40.0	10.38%	10.38%	10.18%	9.49%	8.66%	7.61%
\$1,000	500 bp	\$450	\$50.0	11.58%	11.58%	11.22%	10.48%	9.58%	8.44%
\$1,000	600 bp	\$500	\$60.0	12.55%	12.55%	12.07%	11.30%	10.35%	9.14%
\$1,000	700 bp	\$550	\$70.0	13.35%	13.35%	12.78%	11.98%	11.00%	9.74%
\$1,000	800 bp	\$575	\$80.0	14.66%	14.62%	13.95%	13.12%	12.09%	10.75%
\$1,000	900 bp	\$600	\$90.0	15.87%	15.77%	15.06%	14.20%	13.13%	11.73%
\$1,000	1,000 bp	\$625	\$100.0	16.99%	16.82%	16.09%	15.21%	14.11%	12.67%
\$1,000	1,100 bp	\$650	\$110.0	18.03%	17.80%	17.07%	16.17%	15.05%	13.58%
\$1,000	1,200 bp	\$675	\$120.0	19.00%	18.72%	17.98%	17.08%	15.94%	14.45%
\$1,000	1,300 bp	\$700	\$130.0	19.91%	19.59%	18.84%	17.93%	16.79%	15.27%
\$1,000	1,400 bp	\$725	\$140.0	20.75%	20.40%	19.65%	18.74%	17.59%	16.07%
\$1,000	1,500 bp	\$750	\$150.0	21.55%	21.17%	20.42%	19.50%	18.35%	16.82%
\$1,000	1,600 bp	\$775	\$160.0	22.30%	21.89%	21.14%	20.23%	19.07%	17.64%
\$1,000	1,700 bp	\$800	\$170.0	23.00%	22.57%	21.82%	20.91%	19.76%	18.53%

Pooled-Risk CRN at the time of each collection by dividing the Risk-Factor of that CRN by the total sum of all Risk-Factors of Pooled-Risk CRNs currently outstanding to determine the current Risk-Share of each CRN. Thus, as the size of the Risk Pool continually increases, the pro rata exposure represented by the Pool Share of any given CRN will continue to decrease. This continually-reducing exposure to any single risk demonstrates a primary benefit of pooling risk within the transparent DelphX Ledger.

Risk-Based Sharing of Aggregate Pooled Risk

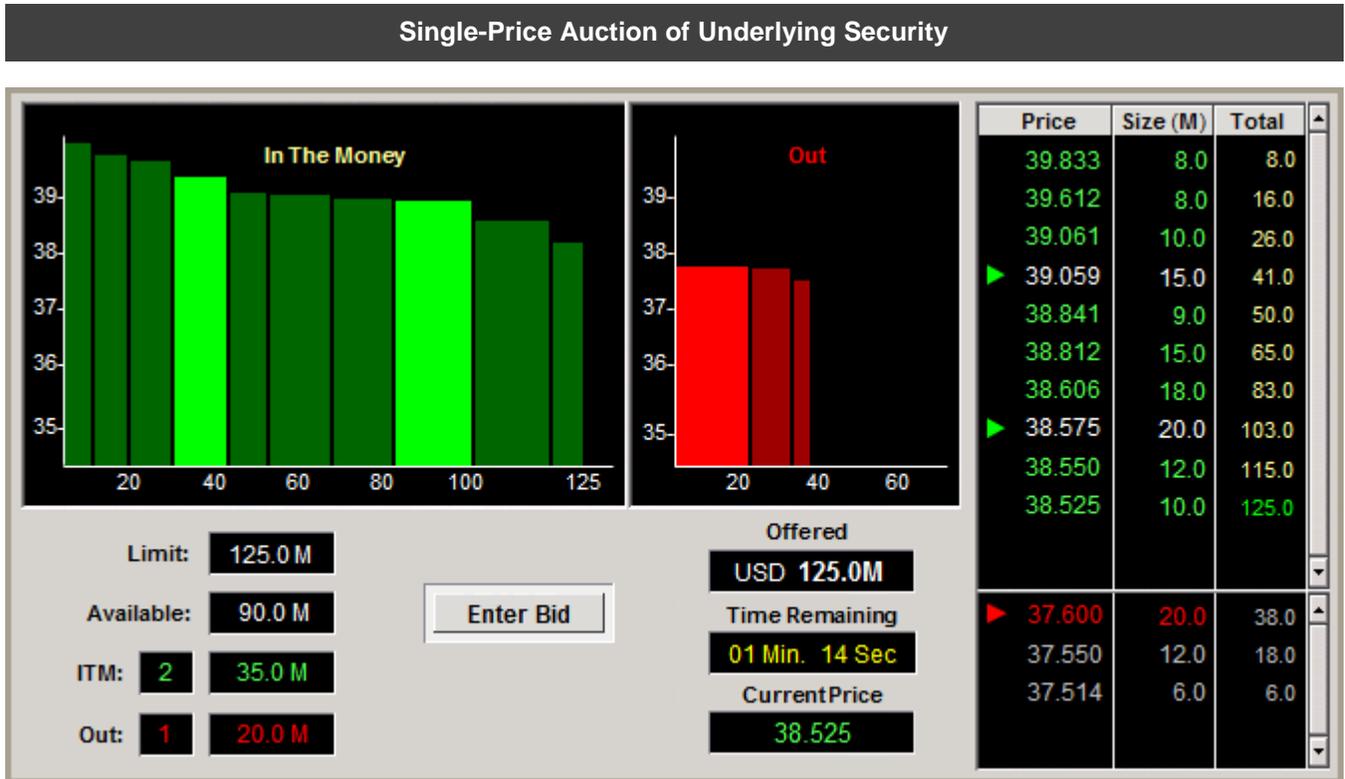


Market-Based Determination of Underlying Security Value

The definition and requirements of a qualifying Credit Event are specified in the CPO and CRN documentation. Upon the reporting of a qualifying Credit Event (Exercise Date of the CPO), Quantem will promptly schedule a Single-Price Auction to be conducted on the ATS (occurring no less than 15 business days nor more than 20 business days following the Exercise Date of the CPO), to which all ATS participants will be invited to participate. Prior to the Auction, all participants intending to sell some or all of their holding of the underlying security may post their anonymous Sell order(s) at the single Clearing Price determined in the Auction.

Following the Auction Close, CPO holders electing to Physically Settle will then receive proceeds equal to the Face Amount of the CPO (100% of par value of the underlying security). For CPO holders

electing to Cash Settle, the current market value (Auction Clearing Price) of the underlying security will be subtracted from its \$1,000 par value to calculate the cash CPO Sale Proceeds then due. Based on historical CDS trading activity, it is likely that the rate of origination of new and trading of existing CPOs referencing the subject underlying security will materially increase during the period leading up to the scheduled auction.



Secondary-Market Interaction

Immediately upon their issuance, all CPO and CRN securities are eligible for trading in the ATS, wherein all participants can transmit limit-orders to one or more Dealers to sell CPOs and CRNs they hold, and limit-orders to buy such securities. The price, size and terms of all secondary CPO and CRN trades are reported in real-time within the ATS, recorded in the DelphX Ledger and cleared by Quantem.

It is important to note that, at no time, are any participant funds or assets conveyed or held within the ATS or by Quantem or DSC. All processing of collections, remittances and transfers of currency or assets will be exclusively performed by the ATS custodian, and/or the designated registrar/transfer agent pursuant to the instructions of DSC and Quantem.

CPO and CRN Exemptions

- a) All CPOs and CRNs are securities, as defined under the U.S. Securities Act of 1933 (the “1933 Act”) and not security-based swaps or other derivative instruments;
- b) Quantem’s offering, issuance and sale of new CPO and CRN securities will rely on a valid exemption from registration under the 1933 Act; and
- c) New CPO and CRN securities will be offered and sold by Dealers to ATS participants that meet all of the following criteria:
 - i) Accredited Investors, as defined in SEC Rule 501;
 - ii) Qualified Purchasers, as defined in the Investment Company Act of 1934 (the “1934 Act”);
and
 - iii) Currently accepted as a trading counterparty by the Clearing Principal.
- d) Subsequent transfers of CPO and CRN securities resulting from secondary-market trading with Dealers on the ATS will also be limited to participants that meet all of the above requirements.

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