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Clients&FriendsMemo

ISDA's Small Bang Protocol: Auction Settlement following a Restructuring Credit Event[1]

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Introduction

On July 14, 2009, the International Swaps and Derivatives Association, Inc. ("**ISDA**") published the 2009 ISDA Credit Determinations Committees, Auction Settlement and Restructuring Supplement (the "**Restructuring Supplement**") to the 2003 ISDA Credit Derivatives Definitions (the "**Definitions**") and on July 18, 2009, it published proposed supporting revisions to the Credit Derivatives Determinations Committees Rules. The Restructuring Supplement expands the ISDA Credit Derivatives Determinations Committees Auction Settlement Supplement published in March (the "**March 2009 Supplement**")[2] to cover hardwired auction settlement following a Restructuring Credit Event. The Restructuring Supplement will be incorporated into the Confirmations of new transactions and can be incorporated into existing transactions through a new ISDA Protocol (the "**Small Bang**"). Adherence to the Small Bang Protocol will also incorporate the terms of the Big Bang Protocol (and therefore incorporate the March 2009 Supplement into existing transactions).

Background

Following a Bankruptcy or Failure to Pay Credit Event (known as "hard" Credit Events), all Deliverable Obligations of the applicable Reference Entity tend to trade at the same price. In contrast, in the event of a Restructuring Credit Event (known as a "soft" Credit Event), bonds with a shorter remaining maturity tend to trade above longer-dated bonds. The protection buyer's ability to deliver such long-dated obligations has become known as the "cheapest to deliver" option. In order to reduce the cheapest to deliver option and better link the underlying credit default swap

[1] Capitalized terms not otherwise defined herein have the meanings assigned to them in the Definitions, the Restructuring Supplement (including its Annexes, Exhibits and Schedules) or the proposed revisions to the Credit Derivatives Determinations Committees Rules, as applicable.

[2] See CWT Clients & Friends memo: ISDA Auction Hardwiring and other Market Initiatives: Strengthening the Infrastructure for CDS Transactions, available at http://www.cadwalader.com/assets/client_friend/040809UPDATE_ISDAAuctionHardwiring.pdf.

("**CDS**") transactions to the credit risk of cash obligations of similar tenor, ISDA has provided for limits on the maturity of Deliverable Obligations in the form of the Modified Restructuring ("**Mod R**") provisions (see "**Restructuring Maturity Limitation**" in Section 2.32 of the Definitions) and the Modified Modified Restructuring ("**Mod Mod R**") provisions (see "**Modified Restructuring Maturity Limitation**" in Section 2.33 of the Definitions).[3] The maturity limitations in the Mod R and Mod Mod R provisions (together, the "**Maturity Limitations**") limit the maturity of Deliverable Obligations based on the maturity of the applicable CDS transaction.

Implementation of the Restructuring Supplement

The Restructuring Supplement establishes a framework for Auction Settlement following a Restructuring Credit Event. In the event of a Restructuring, CDS transactions will be assigned to separate maturity ranges (or "buckets") according to their Scheduled Termination Date. This structure applies the concept of Maturity Limitations in the context of auction procedures by allowing a DC to provide a single list of valid Deliverable Obligations and permitting the determination of a separate final price for the transactions in each maturity bucket.

While the DC can make a determination as to whether or not a Restructuring Credit Event has occurred, unlike a Failure to Pay or Bankruptcy Credit Event, a Restructuring Credit Event must still be triggered under any given CDS transaction by delivery of a Credit Event Notice by a party to the transaction. If the DC makes no determination regarding a Restructuring, applicable parties to the transaction can still trigger by delivering a Credit Event Notice and a Notice of Publicly Available Information. However, if the DC determines that a Restructuring Credit Event has not occurred, the parties will be bound by that determination.

Maturity Limitation Applicable to Mod R and Mod Mod R Transactions where a Credit Event Notice is Delivered by a Buyer

Maturity buckets overlap—they all commence on the Restructuring Date, with maturity buckets for increasingly long-dated groups of CDS transactions ending approximately 2.5 years, 5 years, 7.5 years, 10 years, 12.5 years, 15 years and 20 years, respectively, after the Restructuring Date (each, a "**Limitation Date**" under the Supplement). CDS transactions will fall into the maturity bucket ending soonest following the transaction's Scheduled Termination Date and, in general, Deliverable

[3] Mod R and Mod Mod R are applicable only if the protection buyer triggers the Restructuring Credit Event. The logic behind this asymmetry is that when the protection seller triggers a Restructuring Credit Event, the protection buyer is forced to settle and should have the option to deliver obligations across the credit curve. Therefore, the protection seller is less likely to trigger in the first place.

Obligations for the transactions assigned to each maturity bucket will be those with a final maturity date not exceeding that bucket's end date.[4]

Auction Procedures and Contingencies

After the DC has made a determination that a Restructuring Credit Event has occurred, it will, over a period of approximately two weeks, compile a Final List of Deliverable Obligations and, for each maturity bucket, the range of Scheduled Termination Dates of the CDS transactions assigned to that bucket. Following the publication of this Final List, a Buyer will have a prescribed number of days within which to trigger the Restructuring Credit Event in a particular transaction by delivering a Credit Event Notice (the last day to trigger, the "**Exercise Cut-off Date**").[5]

ISDA has provided for the circumstances in which there will be no auctions for certain maturity buckets, either (a) because there are no Deliverable Obligations that such buckets do no share with a shorter-dated bucket or (b) because a DC has determined that an auction for such bucket is not warranted for other reasons, such as, for example, a limited notional volume of transactions falling within such bucket. In the case of contingency (a), the transaction will then "round down" to the next earlier maturity bucket that does not suffer from the same lack of Deliverable Obligations.

In contingency (b), a DC may determine that even though a Restructuring Credit Event has occurred, there will be no auction with respect to one or more of the maturity buckets. If at least 300 transactions are triggered after a Restructuring Credit Event determination with respect to a given maturity bucket and five or more dealers are parties to such transactions, an Auction will be required to be held for such maturity bucket. The relevant DC may also determine that an auction will be held for a maturity bucket that does not satisfy this "300/5 Criteria".

Parties to CDS transactions assigned to a maturity bucket for which no auction will be held will still have the opportunity to participate in an auction by exercising the "**Movement Option**". A buyer can always exercise the Movement Option and can move a transaction into the next earlier maturity bucket for which an auction is being held. The seller (if the buyer delivered the Credit Event Notice) can move a transaction into the longest-dated maturity bucket. If buyer and seller both deliver a Notice to Exercise Movement Option prior to the Movement Option Cut-off Date, the buyer's notice will prevail. The auction will take place no earlier than six Business Days following the Buyer's

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4 There are some exceptions to these Maturity Limitation Dates with respect to Restructured Bonds or Loans with a final maturity date occurring after the 2.5-year Limitation Date where the transaction's Scheduled Termination Date occurs prior to such final maturity date (for transactions specifying Mod R) and with respect to the 5-year maturity bucket (for transactions specifying Mod Mod R).

5 For the applicable trigger periods, which in certain circumstances differ as between the Buyer and the Seller, see Section 11 of the Restructuring Supplement.

Exercise Cut-off Date. If neither party exercises the Movement Option, the transaction will be settled in accordance with the Fallback Settlement Method, which is Physical Settlement unless the parties have specified Cash Settlement as the Fallback Settlement Method in their transaction's Confirmation. If Physical Settlement is applicable as the Fallback Settlement Method, the transaction's applicable maturity bucket and the Final List of Deliverable Obligations will still apply for settlement of the transaction.

Index Transactions

Following a Restructuring Credit Event under an index transaction covered by the Restructuring Supplement,[6] the relevant Reference Entity will be removed from the index for an untranched transaction and will be split off into a single-name transaction. For a tranched transaction, the Reference Entity will remain in the reference portfolio. Currently, if the entirety of the notional amount of the relevant Reference Entity is not triggered, after settlement of the Restructuring Credit Event, such tranched transaction will be treated as a bespoke portfolio transaction, rather than being treated as a fungible index transaction as would be the case for an untranched transaction. ISDA's working group is endeavoring to develop a mechanism for treating such tranched transactions similarly to the untranched transactions in this regard, but such a mechanism is not yet reflected in the Supplement.

Conclusion

Making auction settlement possible following a Restructuring Event is intended to create certainty and reduce operational risk. The implementation of the Restructuring Supplement is also intended to increase the standardization that is a prerequisite to the central clearing of CDS transactions that trade with Restructuring. Adherence is now open and will close on July 24, 2009. The changes go into effect on Monday, July 27, 2009.

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6 Currently, these include iTraxx transactions for which Mod Mod R is applicable and CDX EM and CDX EM diversified transactions for which Restructuring without any maturity limitations is applicable.

Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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