

Clients & Friends Memo

ISDA Auction Hardwiring and other Market Initiatives: Strengthening the Infrastructure for CDS Transactions¹

March 12, 2009, updated as of April 8, 2009

Overview

The International Swaps and Derivatives Association, Inc. (“ISDA”) is currently facilitating several initiatives that are designed to strengthen the infrastructure for credit default swap (“CDS”) transactions and enhance the liquidity and transparency of the markets for standardized CDS. In particular, on March 12, 2009, ISDA published certain amendments to its standard CDS documentation (i) to provide for several Credit Derivatives Determination Committees (each, a “DC”) to centralize contractual determinations relevant to the credit derivatives market as a whole, including the occurrence, nature and timing of Credit Events, successions and other determinations under various CDS transactions and the initiation of mandatory auction settlement processes, based on a standard auction process template, to aid the cash settlement of CDS transactions and (ii) to institute a rolling 60-day “look-back” on Credit Events and a 90-day “look-back” on Succession Events and to compress the settlement process for loan Deliverable Obligations.

In addition, in connection with ISDA's initiatives, the dealer community has changed trading conventions for North American corporate CDS transactions to provide for a standard Fixed Rate of 1% for single-name investment grade transactions and 5% for single-name high yield transactions and a full 3-month initial Fixed Rate Payer Calculation Period regardless of whether the Trade Date occurs on the start of a Fixed Rate Payer Calculation Period.

These initiatives will be implemented for new transactions executed on or after April 8, 2009 through a combination of operational changes to existing trading conventions and the adoption by counterparties to CDS transactions (each, a “CDS Counterparty”) of the ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (the “Supplement”) to the 2003 ISDA Credit Derivatives Definitions (the “Definitions”). The Supplement will be automatically

¹ All capitalized terms not otherwise defined herein shall have the meanings set forth in the Definitions or the Supplement (including the Annexes, Exhibits and Schedules thereto) or ISDA's Credit Derivatives Physical Settlement Matrix and the related form of Confirmation.

incorporated into any new CDS transaction confirmed by a CDS Counterparty incorporating the most recent version of ISDA's Credit Derivatives Physical Settlement Matrix,² with the exception of transactions referencing U.S. Municipal Entities. CDS Counterparties to CDS transactions executed prior to April 8, 2009 will have the option of amending existing transactions to incorporate the Supplement by executing a special ISDA protocol (the "**Big Bang Protocol**"). Once a CDS Counterparty executes the Big Bang Protocol, such party will be deemed to be an Adhering Party for the purposes of (i) existing CDS transactions and (ii) for all CDS transactions that are entered into from the date of adherence up to January 31, 2011, unless the transaction is an Excluded Transaction.³ If a CDS Counterparty is an Adhering Party, and does not wish to incorporate the terms of the Supplement into a new transaction, it will need to specify in the transaction's documentation that it is not a Protocol Covered Transaction.

After multiple drafts, final versions of the Supplement and the accompanying documents including the form of Credit Derivative Auction Settlement Terms (together with the auction-specific terms to be included as schedules to the form, the "**Auction Settlement Terms**"), DC Rules (the "**Rules**") and the Big Bang Protocol were published on March 12, 2009.⁴ Adherence to the Big Bang Protocol opened on March 12 and closed on April 7. All the provisions of the Supplement will become effective on April 8, with the exception of the provisions relating to the look-back periods, which will go into effect on June 20 (subject to certain exceptions).

Credit Derivatives Committees

A DC will be formed for each of five Regions (the Americas, Asia Ex-Japan, Australia-New Zealand, EMEA (Europe, Middle East and Africa) and Japan). Each DC will be structured to include as its members: 8 Global Dealer Members, 2 Regional Dealer Members, 5 Non-dealer (i.e. buy-side) Members, 2 non-voting Global Dealer Members, 1 non-voting Regional Dealer Member, 1 non-voting Non-dealer Member and ISDA, serving as secretary to each committee (the "**DC Secretary**"). In order to be eligible to serve on a DC, both Global Dealers and Regional Dealers will be required to: (i) participate as a Participating Bidder in auctions; (ii) adhere to Big Bang

² The matrix provides standard trading conventions for the following transaction types: Standard North American Corporate, North American Corporate, European Corporate, Australia Corporate, New Zealand Corporate, Japan Corporate, Singapore Corporate, Asia Corporate, Subordinated European Insurance Corporate, Emerging European Corporate LPN, Emerging European Corporate, Latin America Corporate B, Latin America Corporate BL, Asia Sovereign, Emerging European & Middle Eastern Sovereign, Japan Sovereign, Australia Sovereign, New Zealand Sovereign, Singapore Sovereign, Latin America Sovereign, Western European Sovereign, U.S. Municipal Full Faith And Credit, U.S. Municipal General Fund and U.S. Municipal Revenue.

³ Excluded Transaction is currently defined to include the following: a Loan Only Transactions, a U.S. Muni Transaction, a CDS on ABS Transaction, an Index Excluded Transaction or a Party Agreed Excluded Transaction.

⁴ ISDA has also published a list of answers to frequently asked questions with respect to the changes to certain trading conventions.

Protocol; and (iii) meet notional trade volume criteria based on the Depository Trust and Clearing Corporation (“**DTCC**”) Deriv/SERV Trade Information Warehouse data. Dealers will be chosen in order of highest trading volume of Credit Derivative Transactions (calculated both globally and regionally). Non-dealer Members must meet a \$1 billion threshold both for assets under management and for aggregate notional single-name CDS trade exposure, each as determined in accordance with the Rules, and be approved by one third of the then-current Non-dealer Committee in order to qualify for inclusion in the pool of potential Non-dealer Committee Members and be eligible for participation in a DC. Members of the Non-dealer Committee will be selected randomly for a DC so long as there is at least one “private investment company manager” and at least one “registered investment company manager” among the selected members. The representatives will serve staggered one year terms and all institutions will have a chance to serve before any one institution receives a second term.

To convene a DC a CDS Counterparty shall be required to provide notice and a description of the basis for the request to convene such DC to the DC Secretary. If the information provided is deemed sufficient, the DC Secretary will determine the applicable Reference Entity and Transaction Type and will notify eligible DC Members on the appropriate committee of the potential issues to be addressed (each such issue a “**DC Issue**”). Once a majority of the Convened DC Members have agreed to the DC Issues to be deliberated, the DC Secretary will phrase one or more specific questions (each, a “**DC Question**”) to correspond with each DC Issue and will be expected to phrase questions in language that is as close as possible to language used in the form of standard questions provided in a schedule to the Rules.⁵ The DC may resolve by a majority to rephrase, or by a supermajority to dismiss, a DC Question.

Each convened DC will have full authority to vote to resolve DC Questions and DC resolutions will be binding on all CDS transactions which have incorporated the Supplement. Binding DC Resolutions will include: (i) the existence of Credit Events (and such Credit Event’s type, date, and the date on which the DC secretary effectively received valid Credit Event Notice and Publicly Available Information); (ii) the existence and relevant dates of Succession Events and the determination of any Successor related to such Succession Event; (iii) determinations related to Substitute Reference Obligations; (iv) whether an auction will be held in accordance with the Auction Settlement Terms and other auction-related determinations; (v) Deliverable Obligation Terms and other determinations related to Deliverable Obligations; (vi) the occurrence of a Potential Repudiation/Moratorium; and (vii) the appropriate documentation to be used to determine whether a Loan has been delivered for purposes of physical settlement. There will also be a catchall

⁵ DC questions will not be formulated by the DC Secretary in this manner for issues falling under sections 4.2(b) or 5.2(d) (Nominating Pool Members and Amendments to the Rules, respectively).

provision that will allow for a DC to make determinations related to events that affect the industry as a whole but are not contemplated in the Supplement.

DC Questions related to a Credit Event, Deliverable Obligations, Succession Event or Substitute Reference Obligation must be Resolved by at least an 80% supermajority of the DC and will automatically go to an external review panel if an 80% supermajority is not achieved. If such a DC Question goes to the external review panel, (i) a two-thirds majority will be required to decide any DC Question that was supported by 60% or less of the DC, or (ii) a unanimous decision will be required to decide any DC Question that was supported by more than 60% of the DC. External reviewers are nominated and confirmed by DC members and once a DC Question is referred for external review the reviewers are either selected unanimously by a DC or selected at random by the DC Secretary. Market participants will present arguments to the reviewers to focus their deliberations. External reviewers will be responsible for disclosing potential conflicts of interest.

Auction Settlement Process

The risk of procedural difficulties and market disruptions related to the “short squeeze” condition where protection buyers simultaneously seek to buy the same debt obligations for use in physical settlement of transactions has grown along with the CDS market. Since cash settlement presents drawbacks related to pricing, market participants, together with ISDA, have moved toward a hybrid form of settlement, in which the parties cash settle their transactions using a market value that is generated by a carefully choreographed set of market transactions.⁶ Over the past few years, ISDA has periodically published settlement protocols with respect to Credit Events for certain Reference Entities, but parties to an affected transaction had to agree to follow the settlement protocol in order for it to be binding. If parties enter into a CDS transaction incorporating the Supplement (or adhere to the Big Bang Protocol and enter into a transaction that is not an Excluded Transaction before January 31, 2011 with another Adhering Party and do not bilaterally opt out of Auction Settlement) the parties to the transaction will be automatically bound to the auction procedures set by the DC.⁷

Upon a determination by a DC that an auction will be held to settle relevant transactions in accordance with the Auction Settlement Terms, the DC will then determine the date of such auction, the timing of publication of bidding information and the other auction-specific terms including the inside market quotation amount, the maximum inside market bid-offer spread and

⁶ For a more detailed description of the auction settlement process, please See CWT Clients and Friends Memo, *A Plain English Summary of Credit Default Swap Settlement Protocol*, Nov. 18, 2008, available at http://www.cadwalader.com/assets/client_friend/111808SummaryCreditDefaultSwap.pdf

⁷ Transactions that are eligible for the standard pricing initiatives that will be implemented on an operational basis will be subject to Auction Settlement if booked on DTCC.

minimum number of valid inside market submissions. Determinations with respect to Deliverable Obligations will also be made by the DC and included as a schedule to the Auction Settlement Terms.

Rolling “Look-Back” Period

In order to make the credit profile of transactions that are otherwise identical more fungible, implementation of the Supplement will create rolling look-back periods with respect to Credit Events and Succession Events. Therefore, all transactions will have some retroactive exposure regardless of Trade Date. The Credit Event Backstop Date will be 60 days prior to the date of the request for the DC to convene to determine the existence of the Credit Event. Since information surrounding Succession Events typically takes longer to reach the market than does information related to Credit Events, the Succession Event Backstop Date will be 90 days prior to the date of the request for the DC to convene for purposes of such DC determination. In order to apply to a given transaction, a Credit Event or Succession Event would have to take place no more than 60 or 90 days, respectively, before the request to convene; otherwise the event will be considered stale and will not affect that transaction.

Loan Settlement

For the purposes of physical settlement with respect to which loans are delivered, the Supplement will also simplify the loan settlement process through elimination of steps in a settlement chain by voluntary compression. If a loan is to be settled through multiple customers and dealers, physical settlement will take place between the first and last links (if the parties consent) and cash settlement will apply to the links in between.

Changes to CDS Trading Conventions for North American Corporate Transactions

In order to standardize the trading conventions applicable to North American corporate Transactions, ISDA has updated its Credit Derivatives Physical Settlement Matrix (the “**Matrix**”), and the related form of Confirmation, to introduce the new “Standard North American Corporate” Transaction Type. Going forward, market participants will have the option to elect either this new Standard North American Corporate Transaction Type or the pre-existing North American Corporate Transaction Type. Electing the new Standard North American Corporate Transaction Type will require CDS Counterparties to implement the new standardized trading conventions detailed below. The updated Matrix introducing the Standard North American Corporate Transaction Type and the related form of Confirmation were published on April 8, 2009.

Standard Pricing

The new Standard North American Corporate Transaction Type will require standardized Fixed Amounts of 1% for investment grade Reference Entities and 5% for high yield Reference Entities. In most cases, upfront payments will be required to address the rigidity of the standardized Fixed Amounts. The concept of “Initial Payments” has been added to the related form of Confirmation to incorporate an upfront payment.

Standardized Accruals

The new Standard North American Corporate Transaction Type will also require standardized accrual periods. Regardless of the Effective Date of a Transaction, accruals would begin on the March 20, June 20, September 20 or December 20 (each, a “**Quarterly Date**”) that is on or before the Trade Date plus one calendar day and the Scheduled Termination Date for a transaction will also always be a Quarterly Date. Therefore, stub periods will be eliminated and all settlements will be full coupons. The Initial Payments will take into account any accruals occurring prior to the Trade Date.

Conclusion

These initiatives should strengthen the infrastructure of the CDS market and enhance the liquidity and transparency of the markets for standardized CDS. The standardization of these elements will also expedite achievement of the industry’s goal of clearing CDS through a central counterparty.

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

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