

Clients & Friends Memo

ISDA March 2012 Supplement and Protocol: Updating Muni CDS¹

March 28, 2012

Overview

As of April 3, 2012, the documentation and industry standards for municipal CDS transactions (“**Muni CDS**”) will be brought in line with the corporate and sovereign CDS market through several initiatives led by ISDA and related publications by Markit. Cadwalader represented ISDA and Markit on these initiatives, which include the following features to enhance liquidity and transparency for Muni CDS:

- Determination Committee for the Americas Region will decide on Credit Events and other matters.
- Mandatory auction settlement.
- Rolling “look-backs” for Credit Events and Succession Events.
- Standardized Fixed Rate and full 3-month initial Calculation Periods.
- Recovery assumption of 75%.
- Changes to “Accreting Obligation” and “Accreted Amount” definitions and other Muni CDS-specific provisions.
- Automatic trigger for “Restructuring Credit Event.”
- New or revised templates for many types of Muni CDS transactions.

Background

In 2009, the International Swaps and Derivatives Association, Inc. (“**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, (ii) to initiate mandatory auction settlement processes, based on a standard auction process template, to aid the cash settlement of CDS transactions and (iii) to institute a rolling 60-day “look-back” on Credit Events

¹ All capitalized terms not otherwise defined herein shall have the meanings set forth in the Definitions, the March 2012 Supplement, the March 2012 Protocol or the Matrix and the related form of Confirmation.

and a 90-day “look-back” on Succession Events. In addition, in connection with ISDA’s initiatives, the dealer community simultaneously changed trading conventions for Standard North American Corporate CDS 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.²

ISDA has recently published certain amendments to its standard CDS documentation as it is used for Muni CDS that (i) contemplate incorporation of the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions (the “**July 2009 Supplement**”) to bring in the 2009 updates summarized above, (ii) incorporate the contents of the Additional Provisions for Credit Derivative Transactions – U.S. Municipal Entity as Reference Entity, published by ISDA on September 17, 2004, as such contents may be amended or clarified as set forth by certain amendments to the Definitions as described herein and (iii) make Restructuring Credit Events automatically triggered for Muni CDS. In addition, the dealer community will change trading conventions for Muni CDS to provide for the same standardized coupon (1% or 5%) and full 3-month initial calculation periods as are currently in effect for corporate and sovereign CDS. The recovery assumption for calculating upfront payments will also change to 75%.

Timing and Implementation

These initiatives will be implemented for new transactions in Muni CDS executed on or after April 3, 2012 through a combination of industry standard conventions applied operationally when new standard transaction types under version 18 of ISDA’s Credit Derivatives Physical Settlement Matrix to be published on April 3 (the “**Matrix**”) ³ are elected by counterparties to Muni CDS (each, a “**Muni CDS Counterparty**”) and the adoption by Muni CDS Counterparties of the 2012 ISDA U.S. Municipal Reference Entity Supplement (the “**March 2012 Supplement**”) to the 2003 ISDA Credit Derivatives Definitions (the “**Definitions**”). The March 2012 Supplement will be automatically incorporated into any new Muni CDS transaction confirmed by a Muni CDS

² Cadwalader has previously published the following Clients & Friends Memos discussing the 2009 protocols and the auction processes in detail: http://www.cadwalader.com/assets/client_friend/040809UPDATE_ISDAAuctionHardwiring.pdf; http://www.cadwalader.com/assets/client_friend/072209_ISDAs_Small_Bang_Protocol.pdf; http://www.cadwalader.com/assets/client_friend/111808SummaryCreditDefaultSwap.pdf

³ With the introduction of the new “Standard” Muni CDS Transaction Types (Standard U.S. Municipal Full Faith And Credit, Standard U.S. Municipal General Fund and Standard U.S. Municipal Revenue), all Transaction Types in the Matrix will have both a “Standard” and non-“Standard” version, but, with two exceptions, the “Standard” and non-“Standard” terms in the Matrix are the same. The two exceptions are Japan Corporate and Japan Sovereign Transaction Types, where the “Standard” Transaction Types had an additional note in the previous version of the Matrix. The Matrix has also been revised to be used to document Fixed Recovery and Recovery Lock Muni CDS trades.

Counterparty incorporating the Matrix. Muni CDS Counterparties to Muni CDS transactions executed prior to April 3, 2012 will have the option of amending existing transactions between Adhering Parties to incorporate the March 2012 Supplement by adhering to the 2012 ISDA U.S. Municipal Reference Entity CDS Protocol (the “**March 2012 Protocol**”). Once a Muni CDS Counterparty executes the March 2012 Protocol, such party will be deemed to be an Adhering Party for the purposes of (i) existing Muni CDS transactions and (ii) for all Muni CDS transactions that are entered into from the date of adherence up to July 3, 2012, unless such Muni CDS Counterparty specifies in the transaction’s documentation that it is not a Protocol Covered Transaction.

Final versions of the March 2012 Supplement and the March 2012 Protocol were published on March 5, 2012. The related amendments to the DC Rules as described below (the “**Rules**”) were posted on ISDA’s website on March 12, 2012. Adherence to the March 2012 Protocol opened on March 5 and closes on April 2. All the provisions of the March 2012 Supplement will become effective on April 3, with the exception of the provisions relating to the look-back periods, which will go into effect on June 20.

Muni CDS-Specific Amendments to the Definitions

By contemplating incorporation of the July 2009 Supplement, the March 2012 Supplement brings Muni CDS up to date with current corporate and sovereign CDS by making Muni CDS subject to resolutions of the DC, mandatory auction settlement processes and “look-backs” on Credit Events and Succession Events. The March 2012 Supplement also incorporates the contents of the Additional Provisions for Credit Derivative Transactions – U.S. Municipal Entity as Reference Entity, published by ISDA on September 17, 2004, as modified by certain amendments to clarify provisions that have previously been discussed in the Muni CDS market.

The definitions of “Accreting Obligation” and “Accreted Amount” have been amended to pick up bonds issued with an original issue price of less than 95%, which will not accrete in accordance with their terms without an accretion table. Like the existing 2003 Accreted Amount definition, a straight-line accretion table will be ignored, any other accretion table will be used and any bond with no accretion table will accrete on a bond-equivalent yield basis. The March 2012 Supplement introduces a definition for “Double-Barrel Obligation Liability” and amends the definition of “Not Subordinated”. These amendments were intended to clarify the status of certain double-barrel bonds (i.e., bonds supported by both a general obligation and a revenue source). If a double-barrel bond is specified as a Reference Obligation with respect to a Reference Entity, any Full Faith and Credit Obligation Liability of such Reference Entity (including any double-barrel bond with a different revenue source) would constitute a Deliverable Obligation, unless the parties elect otherwise in the applicable confirmation. The Electronic Municipal Market Access (EMMA) system of the Municipal Securities Rulemaking Board has been added as a source of Publicly Available

Information in lieu of any Nationally Recognized Municipal Securities Information Repository in order to take into account recent changes to the continuing disclosure requirements under SEC Rule 15c2-12. In addition, unlike the Credit Event scheme for corporate CDS, "Restructuring" Credit Events will be automatically triggered for Muni CDS.

Amendments to the DC Rules

ISDA has published a rider that will amend the existing DC Rules to incorporate coverage of Muni CDS and the existing DC for the Americas region will now make determinations in respect of Muni CDS. A new defined term, "**Muni Dealer Institutions**" is included in the amendments and defined as the top 6 dealer ISDA Members by trading volume in single-name Muni CDS and MCDX over a one-year period. Pursuant to the same essential framework that applies to corporate CDS in the current DC Rules, Muni Dealer Institutions who fail to participate in Muni CDS Auctions will become ineligible for, and will be removed from, the DC for the Americas region *solely* for purposes of Muni CDS DC Determinations and not for any other purposes. Those dealers that are not designated Muni Dealer Institutions will not face any consequences if they do not participate in Muni CDS Auctions.

Section 3.2(a)(i) of the DC Rules currently provides that if DTCC determines that there exist, outstanding and confirmed through DTCC, 300 or more transactions for which Auction Settlement is specified in the related Confirmations to which 5 or more dealer members of the DC for the Americas region are parties, holding an auction will be mandatory. This section has been amended, solely for purposes of Muni CDS, to provide that if 3 or more dealer members are parties to 300 or more transactions, holding an auction will be mandatory. This variation stems from the lesser number of Muni CDS dealers as compared to corporate CDS dealers in the market. In addition, the Trading Volume Data Guidelines have been amended to enable monitoring of the necessary Muni CDS data.

New Templates

The March 2012 Protocol provides line by line amendments for certain existing templates used for Muni CDS, globally and specifically with respect to the following standard templates: (i) Confirmation for use with the Credit Derivatives Physical Settlement Matrix (Version 17 – March 16, 2011), (ii) Exhibit F to the Definitions (Novation Confirmation), (iii) Confirmation for Credit Derivative Transactions – U.S. Municipal Entity As Reference Entity (2004), (iv) Confirmation for Single Name Swaption Credit Derivative Transactions and (v) Confirmation for use with MCDX Untranchored Terms.

The following additional updated or new templates will be published on April 3, 2012 to use for new trades after April 3: (i) Confirmation for use with the ISDA single name CDS Swaption

Standard Terms Supplement incorporating the new Standard Muni Transaction Types (ii) the MCDX Untranchured Transactions Standard Terms Supplement and related short form confirmation, (iii) the MCDX Tranche Transactions Standard Terms Supplement and related short form confirmation, (iv) Loss at Maturity Provisions for use with tranche MCDX, tranche CDX and tranche iTraxx and (v) form of Untranchured Swaption Confirmation for MCDX and Untranchured Swaption Standard Terms for MCDX. With the exception of the Confirmation for use with the ISDA single name CDS Swaption Standard Terms Supplement (which will be published by ISDA), each of these updated or new templates will be published by Markit.

Conclusion

These initiatives should strengthen the infrastructure of the Muni CDS market and enhance the liquidity and transparency of the markets for standardized Muni CDS.

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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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