



CLIENT ALERT
APRIL 3, 2009

The New Face of Credit Default Swaps: CDS Auction Hardwiring and the Determinations Committee

- ***Note: Deadline to adhere to “Big Bang” Protocol is Tuesday, April 7th***

On March 12, 2009, the International Swaps and Derivatives Association, Inc. (ISDA) published documentation to allow the incorporation of an auction settlement mechanism into standard credit default swap (CDS) transactions. The auction settlement method has been perceived by regulators as critical to the proper functioning of the CDS market as a whole. Hardwiring the auction settlement method into standard CDS documentation presented a number of challenges for the industry, including ensuring that the new rules-based approach is fair to all market participants. A significant part of this process has been the creation of a “Determinations Committee” that will decide certain key issues relevant to the settlement of CDS transactions and related matters. Furthermore, market participants should note that certain changes necessary to effectuate auction hardwiring have resulted in amendments to several CDS standard terms. Lastly, for existing CDS trades (and certain future CDS trades on a going forward basis for a limited time period), market participants have until Tuesday, April 7, 2009 to adhere to an ISDA “Big Bang” Protocol in order to multilaterally amend such trades to incorporate the auction settlement methodology.

CDS Auction Hardwiring Background

Most CDS transactions provide that, upon the occurrence of a “Credit Event” with respect to the entity referenced in the CDS (the “Reference Entity”), the CDS (or credit protection) buyer must physically deliver a debt obligation of the Reference Entity in order to receive payment from the CDS seller. In other words, when a Reference Entity goes bankrupt, for example, the credit protection buyer typically is required to deliver certain bonds or loans of the Reference Entity to the other party in return for payment of the par value of the bond or loan. If the buyer does not already own a deliverable bond or loan, then the buyer must purchase a deliverable bond or loan on the market and deliver it to the seller. However, if a large number of CDS protection buyers were to seek to purchase particular bonds or loans of a Reference Entity following a credit event in order to settle their CDS transactions, this purchasing could artificially drive up the price of the bonds and loans of the Reference Entity and result in market distortions. As



the CDS market grew over time, it became clear that this situation could happen with greater frequency and often times there simply would not be enough bonds or loans available to settle the CDS trades of certain Reference Entities that were heavily traded.

Over the years the industry recognized and addressed this issue by voluntarily arranging auctions, under the auspices of ISDA, whereby certain parties were able to buy and sell the relevant obligations of a failed Reference Entity. Market participants were then able to use the resulting auction price in order to cash settle their obligations under their respective CDS trades rather than engage in physical settlement by delivery of bonds or loans of the Reference Entity.

The voluntary auction process worked fairly well for numerous large-scale credit events and most of the market chose to participate in these auctions. In fact, a March 2009 report of the Senior Supervisors Group (comprised of key financial market regulators from around the world) entitled *Observations on Management of Recent Credit Default Swap Credit Events* included the following assessment:

"Overall, [our] review confirmed the effectiveness of the existing auction-based settlement mechanism. Surveyed participants reported that the recent credit events were managed in an orderly fashion, with no major operational disruptions or liquidity problems."

However, given the voluntary nature of the CDS auction process to date, regulators were nonetheless concerned about the risk that a large market participant could refuse to participate in an auction and potentially cause a breakdown in this ad hoc settlement mechanism. For example, on March 18, 2008, Treasury Secretary Henry Paulson stated, on behalf of the President's Working Group, that there was a need to hardwire the ISDA auction settlement mechanism as a standard part of the CDS transaction documentation. Specifically Secretary Paulson stated, "The industry ... should incorporate, without delay, cash settlement protocol into standard documentation. We don't need good ideas sitting on the shelf; we need good ideas put into practice. All market participants, not just the dealer community, need to participate in the solution."¹

Since that time, market participants, including both dealers and buy-side participants, have been steadily working toward hardwiring the auction process into standard CDS documentation and creating a mechanism to address the determination of whether a credit event has occurred, whether to hold an auction and the terms of such auction, among other determinations. This new determinations and auction process will be a standard part of most CDS transaction documentation going forward as set forth in the relevant documentation published by ISDA on March 12, 2009 (the ISDA Auction Documentation).

¹ Remarks by Secretary Henry M. Paulson, Jr. on Recommendations from the President's Working Group on Financial Markets <http://www.treas.gov/press/releases/hp872.htm>

Structure of ISDA Auction Hardwiring Documentation

The ISDA Auction Documentation accomplishes auction hardwiring through a suite of documents:

- the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (the “Supplement”);
- the Credit Derivatives Auction Settlement Terms (Annex A to the Supplement) (the “Auction Settlement Terms”);
- the Credit Derivatives Determinations Committees Rules (Annex B to the Supplement) (the “DC Rules”);
- the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol (the “Big Bang Protocol”).

- ***DC Rules***

The DC Rules set forth the composition of, and the rules governing, the Determination Committee. The DC is comprised of ten dealer voting members² and five non-dealer voting members³. The DC may undertake to determine various CDS issues as and when they arise, including (1) whether a Credit Event or Succession Event has occurred with respect to a Reference Entity, (2) whether to hold an auction in order to settle a Credit Event with respect to a Reference Entity, (3) the relevant terms for an auction and (4) whether a certain obligation will be deliverable in respect of a Credit Event. Determinations by the DC in accordance with the DC Rules are generally binding on market participants that incorporate the new Supplement into their CDS transactions, and a DC determination that a Credit Event has occurred satisfies such market participants’ obligations to deliver Credit Event Notices.⁴ In certain circumstances (e.g., if less than 80% of the DC determines that a Credit Event has occurred), the determinations by the DC are subject to review by an external review panel.

- ***Supplement***

The Supplement amends the relevant sections of the 2003 ISDA Credit Derivative Definitions (the “Credit Derivative Definitions”) to incorporate the auction settlement method, incorporate the DC Rules and to make certain other changes necessary to effectuate the auction process. For instance, under the standard 2003 ISDA Credit Derivative Definitions, a pre-condition to settlement of a CDS transaction is the delivery of a “Credit Event Notice” from one party to the other. Under the new auction settlement methodology, the DC determination that a credit event has occurred would, in essence, satisfy this pre-condition.

² The ten dealer voting members are comprised of eight dealers that have the highest credit derivatives notional trading volume globally and two dealers that have the highest credit derivatives notional trading volume for a particular region, in each case as determined by DTCC.

³ The non-dealer voting members are selected randomly by ISDA from a committee of buy-side members who satisfy certain requirements (e.g., assets under management; volume of single name credit derivative transactions) and such buy-side voting members serve staggered one year terms on a rotating basis.

⁴ A Credit Event Notice is still required (i) in the event of a Restructuring Credit Event or (ii) if the CDS transaction provides that only the Buyer or only the Seller may deliver a Credit Event Notice.

- ***Auction Settlement Terms***

The Auction Settlement Terms set out certain generally applicable terms for all auctions. For instance, the Auction Settlement terms provide a method for determining participating bidders in the auction.

- ***Big Bang Protocol***

The Big Bang Protocol is a form of multi-lateral amendment that amends certain existing CDS trades to incorporate the auction mechanism and revised CDS terms published as part of the Supplement. The Big Bang Protocol also amends certain CDS trades for a limited time period going forward in order to give parties an opportunity to bilaterally amend their master confirmation agreements and make any other necessary conforming changes to their transaction documentation. The Big Bang Protocol provides that the Supplement and the Auction Settlement method apply to all Protocol Covered Transactions (as defined in detail in the Big Bang Protocol). Adherence to the protocol means that the auction settlement method will apply to all Protocol Covered Transactions effective April 8, 2009.

Key Issues

- ***60-Day Look-back Period for Credit Events (90-Day Look-back for Succession Events):*** The Supplement provides that the protection period for a CDS transaction begins 60 days prior to the date of determination of a Credit Event (in the case of a DC determination⁵, the date that ISDA received a request from a market participant to consider whether a Credit Event has occurred, otherwise, the date that a Credit Event Notice is effective). Therefore, even if a Credit Event occurred 60 days prior to the trade date for a CDS transaction, that event is still relevant so long as a request is submitted to ISDA to consider whether such event is a Credit Event within 60 days of the occurrence of such event. The purpose of this provision is to ensure that all CDS trades on a particular underlier are fungible and, thus, all such trades can be treated the same for purposes of an auction.⁶ A similar concept is included for Succession Events; however, the look-back period is 90 days.
- ***External Reviewers:*** Any ISDA Member may nominate a person to be a part of the pool of external reviewers, and such nominee must be approved by more than 50% of the DC.⁷ Such external reviewer can also be removed from the pool of reviewers by majority vote of the DC. When an external review panel is needed to review a DC determination (i.e., because the necessary supermajority vote was not achieved with respect to an issue), the DC Rules provide that the

⁵ Other than a Restructuring.

⁶ Portfolio compression capability is an additional benefit of the fungibility that results from the look-back period concept.

⁷ A current employee of a DC member or an Affiliate of a DC Member may not be part of the pool of external reviewers.

DC will attempt to unanimously select five external reviewers⁸ from the pool of external reviewers to consider the issue in question; if the DC cannot agree on five names unanimously, ISDA will fill the remaining slots with names selected at random from the reviewer pool. Once chosen, the reviewers must disclose conflicts of interest and may recuse themselves or be removed by majority vote of the DC based on such conflicts. If fewer than three external reviewers remain after this process, the question under review will be deemed to be determined in accordance with the original determination of the DC.

- **Excluded CDS Transactions:** Certain CDS transactions are excluded from the scope of the Big Bang Protocol. These excluded transactions include loan only CDS transactions, CDS transactions on U.S. municipal entities, CDS transactions on asset-backed securities, and CDS transactions with respect to which the parties have agreed in a side letter that the transactions will not be Protocol Covered Transactions for the purposes of the Big Bang Protocol.
- **Deadline:** All market participants wishing to adhere to the Big Bang Protocol must send an adherence letter to ISDA by April 7, 2009. For adhering parties the auction hardwiring terms will be effective as of April 8, 2009.
- **ISDA Website:** For further information about the auction hardwiring provisions and to access the relevant documentation published by ISDA, please see the CDS Auction Hardwiring section of the ISDA Website: www.isda.org

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If you have any questions regarding CDS auction hardwiring or the Big Bang Protocol, please contact one of the following:

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⁸ Three of the five external reviewers will vote, the remaining two external reviewers are alternates.



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