TEIGLAND-HUNT LLP

CLIENT ALERT
July 17, 2009

ISDA's "Small Bang" in a Nutshell: CDS Auctions Will Now Cover Restructuring Credit Events

– Deadline for Adherence: Friday, July 24th

As described in our alert of April 3, 2009, the International Swaps and Derivatives Association, Inc. (ISDA) published documentation in March that requires adhering market participants to settle certain credit default swap (CDS) transactions via market auctions. Parties that adhered to the "Big Bang" protocol at that time effectively agreed to settle existing CDS trades through the auction process whenever auctions are held in respect of certain credit events. Mandating the auction settlement method in this way has been perceived by regulators as critical to the proper functioning and integrity of the CDS market as a whole.

Because of the complexities involved in settling a "Restructuring" credit event[1] by auction, ISDA deliberately excluded Restructuring events from the auction hardwiring process that took place in March. ISDA has since developed the necessary methodology for settling Restructuring events via auctions. As further summarized below, ISDA's new "Small Bang" protocol will now hardwire the auction settlement method so that it can apply to existing CDS trades that are to be settled following the occurrence of Restructuring credit events.[2]

Summary of Restructuring and the CDS "Small Bang" Protocol

In March 2009 ISDA published its 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (the "March 2009 Supplement") in order to implement an "auction settlement method" for most CDS trades.[3] Although the March 2009 Supplement effectively

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[1] Under the 2003 ISDA Credit Derivatives Definitions (the "Definitions"), a "Restructuring" credit event generally captures events involving the restructuring of an entity's debt, such as a reduction in the amount of interest or principal payable; postponement of a date for payment of interest or principal; or a change in the ranking in priority of payment of debt.
[2] Note that this client alert is intended merely to summarize some of the key terms relevant to the Small Bang protocol only and is not a detailed examination of its provisions, which are very complex. Please refer to the complete documentation implementing the Small Bang and accompanying materials for a more detailed understanding of its terms. Capitalized terms used in this alert but not otherwise defined have the meanings given to them in the Definitions and supplements thereto as applicable.
[3] See Article XII of the March Supplement for terms related to auction settlement.

hardwired auction terms for most CDS trades, it did not include auction terms for Restructuring credit events as noted above. The “Big Bang” protocol issued by ISDA at that time served to incorporate the March 2009 Supplement’s new auction terms into most existing CDS trades. Over 2,000 market participants adhered to the Big Bang protocol prior to the close of the adherence period on April 7, 2009.

Since then ISDA has developed an auction methodology that can be applied following the occurrence of a Restructuring credit event. Consequently, ISDA has now published a new supplement to the Definitions (dated July 14, 2009) (the “July 2009 Supplement”) that expands the scope of the auction settlement method to include Restructuring credit events based on this methodology. Similar to the Big Bang protocol, the Small Bang protocol will allow market participants to incorporate the terms of the new July 2009 Supplement into their existing CDS trades.

In developing an auction methodology for Restructuring credit events, ISDA had to address a variety of complex issues, a few of which are summarized below.

1. ***Mod R vs. Mod Mod R[4]:*** If parties wish to include Restructuring as a credit event in a CDS trade, the Definitions permit them to apply either the “Mod R” or “Mod Mod R” standard in order to restrict the types of obligations that a CDS buyer can deliver (in circumstances where the buyer has elected to settle (or trigger) the CDS trade) following a Restructuring credit event.[5] The restrictions relate not only to the transferability of obligations, but also to their maturity dates. In summary:

    - Under ***Mod R***, deliverable obligations must be (1) fully transferable; and (2) mature prior to the earlier of (a) 2.5 years following the date of restructuring; and (b) the latest final maturity date of any restructured bond or loan (*provided* that such maturity limitation will not fall earlier than the termination date of the relevant CDS).

    - Under ***Mod Mod R***, deliverable obligations must be (1) conditionally transferable; and (2) mature prior to the later of (a) either (i) 5 years following the date of restructuring for any restructured bond or loan or (ii) 2.5 years following the date of restructuring for other deliverable obligations; and (b) the termination date of the relevant CDS.

    Because the maturity limitations that result under Mod R and Mod Mod R can vary depending on the termination date of a particular trade, what may be deliverable under one CDS trade may not be deliverable under a comparable

[4] The provisions describing Mod R and Mod Mod R are set forth in Sections 2.32 and 2.33, respectively, of the Definitions.

[5] Mod R is generally applied to North American trades, and Mod Mod R is generally applied to European trades. If the parties choose not to apply either of these options to the Restructuring credit event, the “Old R” standard will apply – meaning that deliverable obligations will be subject only to a 30-year maturity limitation. Old-R CDS trades are now relatively rare.

CDS trade with a different termination date. This complication created a challenge for auction hardwiring because CDS auction methodology requires a single list of deliverable obligations for any given auction. To address this issue, the July 2009 Supplement establishes the ability to hold multiple auctions in order to settle Restructuring events, with each auction being based on a different maturity limitation or "bucket" as described below.

2. ***Maturity Buckets:*** Following the occurrence of a Restructuring credit event, the July 2009 Supplement provides for the establishment of various maturity buckets (e.g., 2.5 year, 5 year, 7.5 year, 10 year, 12.5 year, 15 year, 20 year and 30 year buckets). A single list of deliverable obligations will be created for each bucket based on the applicable maturity limitation of the bucket. Transactions referencing the relevant Restructuring credit event will then be allocated among the maturity buckets based on their respective scheduled termination dates.[6]

3. ***Determining How Many Auctions to Hold – The 500/5 Criteria:*** In contrast to other credit events, the July 2009 Supplement provides that, upon the occurrence of a Restructuring credit event, parties retain the right to decide whether or not to call for (or "trigger") settlement of the trade. In order to settle a trade based upon an auction, a credit event notice must be effectively delivered prior to the "Exercise Deadline", which is close of business on the fifth business day following publication of the final list of deliverable obligations for the relevant bucket. The Credit Derivatives Determination Committee will then decide whether to hold an auction for one or more maturity buckets based upon available trade data for transactions that were triggered. If 500 or more transactions assigned to a maturity bucket are triggered, and 5 or more major dealers are party to such trades, then an auction will automatically be held for that maturity bucket.[7] If no auction is held for a particular maturity bucket, a party to a CDS trade in that bucket will have the option to move the trade to another bucket for which an auction is to be held.[8]

Last Chance to Adhere to Big Bang. Adherents to the Small Bang protocol will automatically be adhered to the Big Bang protocol to the extent they did not previously adhere prior to the closing of the adherence period in April. A future adherence period for the Big Bang protocol is not contemplated by its terms, so the Small Bang may present a final opportunity to adhere to the Big Bang protocol.

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[6] A CDS trade will generally be assigned to the maturity bucket with an end date that is on or immediately after the scheduled termination date for the CDS trade. Note, however, that a technical rounding *down* convention will apply in certain cases. It provides that, if there are no deliverable obligations with a maturity date falling between the next earliest maturity bucket and the scheduled termination date of a trade, then the CDS trade will be assigned to the next earliest maturity bucket. For example, if the scheduled termination date is 6 years out and there are no deliverable obligations with maturities from 5 to 6 years, then the CDS trade will be assigned to the 5 year maturity bucket.

[7] The relevant Determinations Committee may decide to hold auctions for other maturity buckets if it so chooses.

[8] See new Section 12.17 of the Definitions, which is included in Section X of the July Supplement, for details. Note that the bucket to which a party may move its trade will depend on whether a party is buyer or seller.

Deadline. All market participants wishing to adhere to the Small Bang protocol must send an adherence letter to ISDA in accordance with specified procedures ***by Friday, July 24, 2009***. Please note that ISDA is encouraging firms to adhere as soon as possible as submissions are expected to be high close to the deadline, which may result in delays in the posting of adherence letters.

Effective Date. For adhering parties, the terms of the Small Bang protocol will become effective as of July 27, 2009.

More Information. For further information about the Small Bang protocol and the relevant documentation published by ISDA, please see the Small Bang protocol section of the ISDA Website: www.isda.org/smallbang/index.html.

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

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