

Credit-Crunch Related Issues Arising with Derivatives

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Overview

- Principal documentary and legal issues highlighted by recent insolvencies
- Events of Default and Termination Events under the ISDA Master Agreement
- Set-off and netting
- Collateral and other risk reduction techniques
- Conflict of laws issues
- Proposed regulation of CDS and establishment of central clearing house
- ISDA credit event auction mechanism and auction hardwiring initiative

Legal and Documentary Risks

In a derivatives context the insolvency of a party is particularly relevant where:

- Insolvent party is a counterparty to derivatives contracts
- Insolvent party is a reference entity under credit default swaps entered into by third parties
- Insolvent party is issuer of shares under an equity derivative transaction entered into by third parties
- Insolvent party is a counterparty to a derivatives contract with a third party (usually the issuer of securities) forming part of the collateral to a structured finance security, e.g. a CDO

Insolvency of Counterparty to a Derivatives Contract

- Has an Event of Default occurred in relation to the counterparty?
- Is termination of the transactions automatic?
- If termination is not automatic, how are the transactions terminated?
- Does it make sense to terminate the transaction?
- If the transaction is terminated, how is the termination amount calculated?
- Can the counterparty raise any defences or rights of set-off?

Possible Risks in connection with a Derivatives Contract

- Are the terms certain?
- In particular, has an ISDA Master Agreement been documented and have all the confirmations thereunder been documented?
- What additional terms have been included in the schedule to the ISDA Master Agreement?
- Have the Master Agreement or confirmations been amended or assigned or novated?
- Certainty of ensuring an Event of Default has occurred before seeking to terminate
- Settlement risk where no transaction netting – section 2(c) of the 1992 and 2002 ISDA Master Agreements only apply to amounts payable in the same currency and under the same transaction unless the parties elect cross transaction netting
- Conflict of laws issues

Issues in relation to CDS Transactions where a Reference Entity is insolvent

- Has a Credit Event occurred in relation to the Reference Entity?
 - “bankruptcy” definition under 2003 ISDA Credit Derivatives Definitions is narrower than the equivalent definitions under the 1992 and 2002 ISDA Master Agreements
- Need to serve Credit Event Notice and Notice of Publicly Available Information?
- Is a Uniform Settlement Agreement entered into by the parties?
- Is there an ISDA protocol in relation to the event and have the parties agreed to be bound by it?
- If the transaction is cash settled, what valuation method and valuation date(s) have been selected under the 2003 Definitions and have the parties varied the ISDA provisions?
- If the transaction is physically settled, what constitutes Deliverable Obligations that can be used to settle the transaction?

Issues in relation to Equity Derivatives Transactions where an Issuer of Shares is insolvent, nationalised or de-listed

- Following definitions under 2002 ISDA Equity Derivatives Definitions could be relevant:
 - “Nationalisation” where all the shares or substantially all the assets of an issuer are nationalised, expropriated or are otherwise required to be transferred to any governmental agency, authority, entity or instrumentality thereof
 - “Insolvency” where by reason of the voluntary or involuntary liquidation, bankruptcy, insolvency, dissolution or winding-up of or any analogous proceedings affecting an issuer, (A) all the shares of that issuer are required to be transferred to a trustee, liquidator or other similar official or (B) holders of the shares of that issuer become legally prohibited from transferring them (this definition is much narrower than the “bankruptcy” definition under the 1992 and 2002 Master Agreements and the 2003 Credit Derivatives Definitions)
 - “De-listing” where the specified exchange announces that pursuant to the rules of such exchange, the shares cease or will cease to be listed, traded or publicly quoted on such exchange for any reason (other than a Merger Event or Tender Offer) and the shares are not immediately re-listed, re-traded or re-quoted on an exchange or quotation system in the same jurisdiction (or where the exchange is within the EU, in any member state of the EU)

Issues in relation to Equity Derivatives Transactions where an Issuer of Shares is insolvent, nationalised or de-listed (cont.)

- Effect of such event will depend on whether the parties have selected
 - Negotiated Close-out
 - Cancellation and Payment
 - Partial cancellation and Payment

Derivatives in structured finance transactions

- Insolvent party may be a counterparty to a swap with an issuer under a structured finance transaction
- Common examples include interest rate and currency swaps and credit default swaps, particularly in synthetic CDO transactions
- Issuer will often be a SPV without the administrative capability to determine whether to terminate the transaction
- The security trustee as assignee of the rights under the transaction may have the ability to terminate the transaction or be required to do so on the direction of a certain percentage of noteholders but will usually require an indemnity to do so
- There can therefore be significant delays in these transactions in getting derivative transactions terminated

Bankruptcy Event under the ISDA 1992 Master Agreement

The party, any Credit Support Provider of such party or any applicable Specified Entity of such party:

1. is dissolved (other than pursuant to a consolidation, amalgamation or merger);
2. becomes insolvent or is unable to pay its debts or fails or admits in writing its inability generally to pay its debts as they become due;
3. makes a general assignment, arrangement or composition with or for the benefit of its creditors;
4. institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights, or a petition is presented for its winding-up or liquidation, and, in the case of any such proceeding or petition instituted or presented against it, such proceeding or petition (A) results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for its winding-up or liquidation or (B) is not dismissed, discharged, stayed or restrained in each case within 30 days of the institution or presentation thereof;
5. has a resolution passed for its winding-up, official management or liquidation (other than pursuant to a consolidation, amalgamation or merger);
6. seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets;
7. has a secured party take possession of all or substantially all its assets or has a distress, execution, attachment, sequestration or other legal process levied, enforced or sued on or against all or substantially all its assets and such secured party maintains possession, or any such process is not dismissed, discharged, stayed or restrained, in each case within 30 days thereafter;
8. causes or is subject to any event with respect to it which, under the applicable laws of any jurisdiction has an analogous effect to any of the events specified in clauses (1) to (7) (inclusive);
or
9. takes any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts.

Differences between the Bankruptcy Event Definition in 2002 ISDA Master Agreement and 2003 Credit Derivatives Definitions

- **2002 ISDA Master Agreement**
 - if insolvency or bankruptcy proceeding is commenced by a regulator, supervisor or similar official, there is no period allowed for dismissing the order
 - in other cases, the time period for dismissing an order is reduced from 30 days to 15 days
- **2003 Credit Derivatives Definitions**
 - admission of inability to pay debts as they become due must be in writing in a judicial, regulatory or administrative proceeding
 - excluded from the definition is taking any action in furtherance of, or indicating its consent to, approval of, or acquiesce in any of the other sub-paragraphs

Bankruptcy Events of Default – Relevant Issues

- Will often be obvious, e.g., if a company is placed into Chapter 11 proceedings in the U.S. or administration in the UK
- However, if counterparty is a subsidiary of the insolvent entity, it may not itself be subject to a Bankruptcy Event of Default although the insolvent entity may be a Credit Support Provider or Specified Entity
- The relevant event may not, however, be a clear insolvency proceeding, e.g., the Icelandic governmental action in relation to Landsbanki, Glitnir and Kaupthing. The Bankruptcy Event of Default may need more analysis depending on the facts
- Even if the event does not fall within the Bankruptcy Event of Default, the parties may have specified additional termination events, e.g., change of control or ratings downgrading provisions that may have been triggered

Bankruptcy Events of Default – Relevant Issues (cont.)

- Has an Automatic Early Termination been specified?
- Meaning of “unable to pay its debts” – Re Cheyne Finance PLC
- Mechanics for termination – sections 6(a) and 12(a) of the 1992 and 2002 ISDA Master Agreements:
 - non-defaulting party only may serve the notice
 - must specify early termination date by not more than 20 days notice
 - notice not necessary if automatic early termination is provided but will often be provided anyway
 - under 1992 Master Agreement, notice of an event of default cannot be served by fax or electronic messaging system. Under the 2002 Master Agreement such notice may be served by fax but not electronic messaging system or e-mail

Calculation of Close-out Amount Upon Termination

- 1992 ISDA Maser Agreement – section 6(e)
 - non-defaulting party makes the calculation of the Settlement Amount unless otherwise agreed
 - under section 6(d) it must give the defaulting party a statement showing in reasonable detail the calculations, including any relevant quotations
 - second method (two way payment) is usually selected so non-defaulting party may be entitled to payment
 - market quotation – if applicable non-defaulting party must obtain the quotes
 - loss – this can either be selected by the parties in the schedule or is the fallback if a market quotation cannot be obtained. The non-defaulting party calculates in good faith its total losses and costs or gains as a result of the termination including re-establishing any hedge position
 - Once the Settlement Amount is determined, Unpaid Amounts must be added and subtracted from such amount to reach the amount payable by the relevant party
 - ISDA 2009 Close-out Amount Protocol

Calculation of Close-out Amount upon Termination (cont.)

- 2002 ISDA Master Agreement – section 6(e)
 - non-defaulting party makes the calculation of the Close-out Amount unless otherwise agreed
 - under section 6(d) it must give the defaulting party a statement showing in reasonable detail the calculations
 - Close-out Amount is the amount of the losses or costs or gains of the determining party that are or would be realised under then prevailing circumstances in replacing or providing an economic equivalent of the terminated transactions
 - Close-out Amount must be determined in good faith using commercially reasonable procedures
 - in determining the Close-out Amount, the defaulting party may consider any relevant information including, without limitation, market quotations and relevant market data from external or internal sources and can take into account the actual cost of replicating the transactions
 - once the Close-out Amount is determined in the Termination Currency, Unpaid Amounts must be added and subtracted from such amount, as applicable, to reach the Early Termination Amount

Issues relating to Termination of ISDA Master Agreement

- Is termination prohibited by any relevant insolvency provision
 - termination is not precluded by a UK administration or winding-up and falls within the safe-harbour provisions under the US Bankruptcy Code
- Can the non-defaulting party perpetually seek to rely on section 2(a)(iii) of the 1992 and 2002 ISDA Master Agreements (a condition precedent to any payment by it that no Event of Default has occurred in relation to the other party)
 - Enron v TXU
 - action taken in the US by Lehman to seek to assign open contracts

Set-off and netting under the ISDA Master Agreement

- Distinction between set-off and netting
- Once close-out netting has been effected under Section 6 of the 1992 or 2002 ISDA Master Agreement, rights of set-off may still be capable of being exercised
- The 1992 ISDA Master Agreement expressly provided the Settlement Amount was subject to any rights of set-off. The 2002 ISDA Master Agreement includes an express set-off provision
- Many 1992 ISDA Master Agreements also included a set-off provision in the schedule

Set-off Provision from 2002 ISDA Master Agreement

Any Early Termination Amount payable to one party (the “**Payee**”) by the other party (the “**Payer**”), in circumstances where there is a Defaulting Party will, at the option of the Non-defaulting Party (“**X**”) (and without prior notice to the Defaulting Party), be reduced by its set-off against any other amounts (“**Other Amounts**”) payable by the Payee to the Payer (whether or not arising under this Agreement, matured or contingent and irrespective of the currency, place of payment or place of booking of the obligation). To the extent that any Other Amounts are so set off, those Other Amounts will be discharged promptly and in all respects. X will give notice to the other party of any set-off effected under this Section 6(f).

Issues Relating to Set-off

- In the UK there is mandatory set-off under the Insolvency Rules 1986
- Insolvency Rule 4.90 provides for mandatory set-off in relation to a company subject to a winding-up
- Insolvency Rule 2.85 provides for mandatory set-off in administration where an administrator has provided a notice that a distribution will be made to creditors
- The above rules only apply to mutual credits, debts or other dealings between the relevant parties
- The above rules are mandatory in the UK (National Westminster Bank v Halesowen Pressworks & Assemblies)
- Contractual provisions providing for multi-party set-off are unlikely to be effective in an insolvency (British Eagle International Airlines v Air France)
- UK Banking Act 2009 and the Banking Act 2009 (Restriction on Partial Property Transfers) Order 2009

Counterparty Risk Reduction Techniques for Derivatives

- Guarding against the risk of a counterparty's insolvency or other default
- Guarantees and other instruments
- Collateral is the most common risk reduction method that does not rely on performance by another member of the group
- Parties most commonly use one of the standard form ISDA credit support documents:
 - Credit support annex (English law)
 - Credit support deed (English law)
 - Credit support annex (New York law)
- Also available are other ISDA standard forms/variations, such as Japanese law credit support documents, as well as bespoke collateral solutions, especially on structured finance transactions

ISDA Credit Support Documents

- The credit support documents work on the basis of calculating the net risk or Exposure that a party (X) has to the other party (Y) and comparing that amount to the value of collateral provided (or “posted”) by Y to X
- Each party’s Exposure to the other is calculated (usually on a daily basis) based on the aggregated mark-to-market valuations of the outstanding Transactions supported by the credit support document (which are usually, but not necessarily, all the outstanding derivative Transactions governed by the ISDA Master Agreement between the parties)
- The Exposure will be an amount that roughly approximates to what would be payable by one party to the other pursuant to section 6(e) of the ISDA Master Agreement following an early termination of the relevant Transactions

ISDA Credit Support Documents (cont.)

- To the extent that a party's Credit Support Amount exceeds the value of its Credit Support Balance, it is obliged to deliver/"post" more collateral
- To the extent that the Value of a party's Credit Support exceeds its Credit Support Amount, it is entitled to request a return of collateral
- Credit Support Amount for a party (Y) means the net Exposure that X has to Y, taking into account any agreed buffers/ Independent Amounts applicable to X and Y (to reflect a general level of risk, irrespective of mark-to-market exposure) and any Threshold (Exposure limit below which Y is not required to post collateral) that X agreed would apply to Y
- Credit Support Balance for Y means the value of all eligible collateral posted to date by Y. In valuing eligible collateral, each type of collateral will have a valuation "haircut" applied, as pre-agreed between the parties

ISDA Credit Support Documents (cont.)

- Outright transfer v security interest
- NY-law credit support annex and English law credit support deed both operate to create security interests in the collateral being posted
- English law credit support annex operates by way of outright transfers of title to the posted collateral
- There are various legal restrictions and operational reasons why parties might select one form over the other
- Equally the choice of credit support document may affect the nature of the parties' rights and obligations and their standing upon an insolvency of the other party

English law Credit Support Annex (“CSA”)

- CSA operates on the basis that the transferor of the relevant collateral (usually cash or treasuries) transfers title outright to the transferee in respect of collateral equal to the Delivery Amount (the amount by which the Credit Support Amount exceeds the adjusted value of the posted Credit Support (subject to any Minimum Transfer Amount set for the posting or return of collateral))– it does not create a security interest
- The transferee has a contractual obligation to re-transfer to the original transferor title to eligible collateral equal to the Return Amount (the amount by which the adjusted value of the posted Credit Support exceeds the Credit Support Amount (subject to any Minimum Transfer Amount set for the posting or return of collateral))
- While the collateral is held by the transferee:
 - it constitutes the asset of the transferee and transferee is free to dispose of or pledge the collateral
 - it forms part of the transferee’s bankruptcy estate in any winding-up
 - any amount payable to the transferor as a “Return Amount” constitutes a separate Transaction under the ISDA Master Agreement
 - therefore the transferor will have only an unsecured claim against the transferee’s bankruptcy estate for the Return Amount
 - the Return Amount is taken into account in the close-out netting arrangements in the ISDA Master Agreement, as it is an Unpaid Amount due under a Transaction

Questions to consider with an English law credit support annex (“CSA”)

- Is there any risk of recharacterisation (as a security interest) in the jurisdictions in which you might want to enforce your rights under the CSA?
- If no material risk, transferee is relying on ISDA Master close-out netting provisions being enforceable, particularly in the transferor’s insolvency – refer to any netting opinion commissioned by ISDA for such jurisdiction
- Would the contractual right to substitute one type of eligible collateral for another type of posted collateral affect the characterisation of the relationships under the CSA?

Questions to consider with an English law credit support annex (“CSA”) (cont.)

- If the posting of collateral is characterised as an absolute transfer in that jurisdiction, is there a risk of an insolvency official of the transfer being able to “claw back” the posted collateral if the transfer took place in a “suspect period” leading up to the date of insolvency?
- Would the choice of English law to govern the transactions under the CSA be upheld?
- Any other requirements/formalities to be fulfilled under the laws of the enforcement jurisdiction in order to create a valid outright ownership transfer?
- Refer to any relevant collateral opinion commissioned by ISDA for that jurisdiction

English law Credit Support Deed (“CSD”)

- CSD creates a security interest in the posted collateral, not an ownership transfer
- The party required to post collateral to meet a Delivery Amount obligation (Chargor) mortgages, charges and pledges all collateral to the Chargee and assigns to the Chargee all related rights in respect of the posted collateral
- When the Chargee returns posted collateral to meet a Return Amount obligation, the security interest over the posted collateral being “returned” is released and a re-assignment of the related rights is effected. This happens automatically, without the need for either party to take action to effect this.

English law Credit Support Deed (“CSD”) (cont.)

- While the collateral is held by the Chargee:
 - it remains an asset owned by the Chargor (subject to the security interest created)
 - it does not form part of the Chargee’s bankruptcy estate in any winding-up
 - the Chargee is not permitted to use, dispose of or pledge such collateral and owes a duty of reasonable care to the Chargor in respect of the posted collateral and is liable for the acts of any custodian with whom it holds the posted collateral
 - the Chargee is obliged to keep the posted collateral segregated from the assets of the Chargee, or its custodian
 - The Chargor remains entitled to exercise the votes on any shares or bonds constituting the posted collateral
 - once a Relevant Event occurs (such as an Early Termination Date or Event of Default under the ISDA Master Agreement) the Chargee is permitted to enforce its security rights and sell the posted collateral and apply the proceeds towards any section 6(e) payment owed to it under the ISDA Master Agreement

Questions to consider with an English law credit support deed (“CSD”)

- Under the laws of the jurisdiction in which enforcement of the security interests would take place
 - what law governs the creation of the security interests?
 - what law governs the perfection of the security interests?
 - would the security interests, created at the time of the ISDA Master Agreement, constitute valid security for obligations under future Transactions?
 - if so, would further “perfection” be required, other than delivery of the asset?
 - is there any problem with the amount secured not being a fixed amount or subject to a maximum?
 - is any “perfection” action needed in that jurisdiction such as filing or registration?
 - any other formalities in that jurisdiction, such as a local business licence?
 - does the right of the Chargor to substitute collateral affect the validity or priority of the security interests?

New York law credit support annex (“NY CSA”)

- Similar to the English law credit support deed, in that it creates a security interest over the posted collateral (this time under Article 9 of the New York Uniform Commercial Code) and does not transfer title to the collateral
- BUT similar to the English law credit support annex, in that the Chargee is expressly permitted to sell, transfer, pledge or rehypothecate the collateral, so long as the Chargee is not in default under any Transaction
- As such, if the Chargee disposes of the posted collateral, the Chargor has no right to reclaim such collateral from the purchaser, nor any proprietary interest in the disposal proceeds

New York law credit support annex (“NY CSA”) (cont.)

- The Chargor will be owed an obligation by the Chargee to return collateral equivalent to the posted collateral but this is only an unsecured obligation, with the remedy for breach being damages
- If at the time of the Chargee’s insolvency, the Chargee has not disposed of or encumbered the posted collateral, then the collateral remains the property of the Chargor. However, the Chargee will generally not be obliged to keep the posted collateral segregated from its own assets and therefore identification and recovery could prove problematic
- Once an Event of Default occurs, the security interest can be enforced by sale of the posted collateral, with the proceeds being applied to pay any section 6(e) amounts due to the Chargee

Questions to consider with a NY law credit support annex (“NY CSA”)

- Under the laws of the jurisdiction in which enforcement of the security interests would take place
 - all the questions to be considered in respect of an English law credit support deed
 - would the Chargee’s right to sell, transfer, pledge or rehypothecate the posted collateral be recognised?
 - is there a risk of such right giving rise to a recharacterisation of the NY CSA or invalidating the security interests created?

Considerations as to which Credit Support Document to Use

- Poster or recipient of collateral? Or potentially both?
- English law CSA provides most certainty of enforceability from recipient's standpoint and provides the fewest conflict of laws issues to be investigated
- Some entities (such as entities governed by the US Investment Company Act of 1940) may be unable to post collateral under an English law CSA
- Depending on where collateral poster/collateral are located, may be advantages in having documents governed by English/NY law in terms of recognition of foreign judgements or application of foreign laws
- English law CSA gives least protection to collateral poster in event of collateral holder's insolvency. NY CSA at least allows parties to restrict rehypothecation rights of collateral holder

Considerations as to which Credit Support Document to Use (cont.)

- CSD provides most protection to collateral poster against collateral holder's insolvency
- CSD is less commonly used than the others because of lack of ability of collateral holder to use the posted collateral in its day to day business, and increased legal requirements and due diligence needed to ensure enforceable security interest, duty of reasonable care regarding posted collateral and possible need to perfect security by registration (although if financial collateral, then under English law certain formalities now waived (in favour of recipient) under UK's Financial Collateral Arrangements (No. 2) Regulations 2003)

Other Cross-Border Conflicts Issues

- Set-off. Where parties rely not on security interests or proprietary rights to reduce their risk, but instead on the ability to set off unsecured claims against unsecured liabilities, many questions need to be considered from the point of view of the laws of the jurisdiction in which enforcement action is most likely to be taken against the counterparty, such as:
 - what set-off and netting rights are recognised in such jurisdiction?
 - is there a need for mutuality of claims for set-off to apply?
 - are there any restrictions on the right to set-off?
 - can parties contractually agree to exclude set-off rights?
 - are there any restrictions on the types of claims that can be subject to set-off rights?

Other Cross-Border Conflicts Issues (cont.)

- will an assignment of rights destroy rights of set-off (and is there any difference where such assignment is legal or equitable, where relevant?)
- can parties acquire debts of a third party to achieve set-off rights against such party and can such rights be acquired for such purpose after such party's insolvency (or any relevant suspect period)?
- is set-off permitted after the insolvency of the counterparty?
- do any mandatory set-off rights apply in relation to the insolvency of a party?
- can contingent liabilities be set-off?
- can unliquidated and/or unmatured debts be set-off?
- what is the effect of set-off on subordinated or preferential debts?
- can multi-party set-off arrangements be effective?
- in relation to netting, does the jurisdiction permit both settlement netting and close-out netting?

Other Cross-Border Conflicts Issues (cont.)

- Can a party's rights, enforceable under the chosen governing law of the contract, potentially be overridden by the order of a foreign court?
- Consider the current motion scheduled for hearing in New York in relation to the Chapter 11 bankruptcies of various Lehman Brothers entities in the US
- Lehman's bankruptcy trustees are applying for court order in NY to allow the assumption and assignment of various derivatives contracts which are in-the-money for Lehman's, but which have not matured and not been terminated by the counterparty
- Assuming the counterparty is not in default, Lehman's entity has no right to early termination

Other Cross-Border Conflicts Issues (cont.)

- Counterparty has the right, but not the obligation, to effect an early termination of the Transactions under the ISDA Master Agreement
- If counterparty elects not to terminate, under an English law ISDA Master Agreement it has no obligation to make payments/deliveries while the Lehmans entity remains in default (section 2(a)(iii) of the ISDA Master Agreement and Enron v TXU)
- Lehmans company generally may not assign its rights under ISDA Master Agreement without the other party's consent, except for the purposes of a corporate merger/amalgamation or where the ISDA Master Agreement has been terminated and it is assigning the right to receive a section 6(e) payment (neither of which would apply where the counterparty to the Lehmans entity has not terminated the Transactions) (section 7 of ISDA Master Agreement)

Other Cross-Border Conflicts Issues (cont.)

- Therefore, seemingly under English law, a Lehmans entity which has an in-the-money ISDA Master Agreement has no legal ability to extract the value from that contract unless the court orders some remedy, such as permission to assign its rights to a third party
- Based on current English law, no obvious remedy to be granted to Lehmans entities, so we await with interest the results of the NY court hearing – especially in respect of Lehmans ISDA Master Agreements governed by English law

Credit Derivatives Big Bang Protocol

- The ISDA CDS Protocol incorporates 2009 Credit Derivatives Determinations Committees and Auction Settlement Supplement into transactions which apply the 2003 ISDA Credit Derivatives Definitions
- Principal aims to promote certainty, stability and speed of resolution as regards Succession Events, Credit Events and subsequent valuations of obligations underlying credit default swaps by:
 - standardising determinations of Credit Events and Succession Events
 - adopting an auction settlement method based on previous credit derivative auction protocols
- Specifically, it establishes Determinations Committees and incorporates their resolutions into Covered Transactions. This supersedes the role of Calculation Agent for the purposes of determining Credit Events, Auction Terms and Succession Events
- Applies Auction Settlement Method for many (but not all) Covered Transactions
- Creates Credit Event and Succession Event Backstop Dates

Credit Derivatives Big Bang Protocol (cont.)

- Once both parties to a credit derivative transaction have adhered to the CDS Protocol, auction settlement will apply automatically to a wide range of credit derivative transactions between those parties and will also apply to other credit derivatives transactions between those parties if the CDS confirmation specifies “Auction Settlement”. It will apply to all outstanding transactions at the time of adherence to the CDS Protocol, but not retrospectively to those transactions that have already settled
- The auction methodology prescribed in the CDS Protocol will then apply in relation to an applicable Credit Event, with the auction terms (date, time, market quotation amount, Deliverable Obligations, etc.) specific to that Credit Event being set by the relevant Determinations Committee

Credit Derivatives Big Bang Protocol (cont.)

- This will result in consistency of settlement of CDS transactions (because the same auction valuation will apply to an underlying obligation, across all CDS of parties adhering to the CDS Protocol) and certainty in advance as to the methodologies to be used for determining the settlement terms that will apply
- Each region (Americas, Asia excl. Japan, Japan, Australia – New Zealand and EMEA) will have its own Determinations Committee
- Each Determinations Committee will consist of a certain number of credit derivatives dealers (8 global dealers, 2 regional dealers, 3 non-dealer ISDA members, 1/2 non-voting dealers, 1 non-voting regional dealer per region and 1 non-voting, non-dealer member)

Credit Derivatives Big Bang Protocol (cont.)

- The effect of the Credit Event and Succession Event Backstop Dates is to provide that a Credit Event or Succession Event, which occurs more than 60 days or 90 days, respectively, before delivery to a party of a Credit Event Notice/Notice of Publicly Available Information/Succession Event Notice, or before the date of a request to the Determinations Committee, will have no impact on a CDS transaction of that party
- This creates a single “look-back” period applicable to all trades incorporating the 2009 supplement, irrespective of the Effective Date of the trades, which encourages fungibility of trades
- If a party believes that a Credit Event has occurred, it can request the Determinations Committee to make a determination, which will then be posted on the ISDA website
- The provisions of the Supplement will take effect as from April 8, 2009 (except for the Backstop Dates, which for transactions existing as at April 8, 2009 will not take full effect until June 20, 2009)

Credit Derivatives Big Bang Protocol (cont.)

- Covered Transactions include those which have previously been the subject of the ISDA Protocols, such as those referencing CDS indices (including CDX and iTraxx Tranching and Untranching), swaptions (single name and portfolio), non-swaptions (such as single name, nth to default, recovery lock and bespoke portfolio transactions). It also includes those which have not previously been included in ISDA Protocols, such as Reference Obligation only, fixed recovery and preferred CDS. For these latter types, the Supplement applies the Determinations Committee provisions, but not the Auction Settlement Provisions
- Non-covered transactions include Loan only CDS, US Municipal type CDS and CDS on ABS
- The Determinations Committee will not hold an auction for restructuring Credit Events
- The CDS Protocol is open for adherence now, and up until April 7, 2009

Other Credit Derivatives Developments

- Proposals to regulate credit default swaps
- Difference between credit default swaps and insurance
- In U.S., New York State Insurance Superintendent, in his testimony to the U.S. House of Representatives Committee on Agriculture in November 2008, decried the “total lack of regulation of credit default swaps”, stating “some swaps are insurance” and proposing to assume responsibility for the regulation of the credit derivatives industry
- He stated the need, in his opinion, for
 - sellers of protection to maintain adequate capital to minimise counterparty risk
 - a guarantee fund
 - clear dispute resolution mechanisms
 - comprehensive market data to be available
 - comprehensive regulatory oversight

Other Credit Derivatives Developments (cont.)

- New York State Insurance Superintendent's Proposal now shelved, but in January 2009, a draft bill was proposed by the Chairman of House of Representatives Agriculture Committee proposing to ban the entry by U.S. parties into credit default swaps, unless the underlying bond or loan is held by the protection buyer. It also proposed that U.S. trading would have to be cleared through a central clearing counterparty, to reduce counterparty risk
- In Europe, no proposals to ban trading of CDS without holding the underlying, but EU commissioner McCreevy has pushed for the establishment of a European CCP and obtained "in principle" commitments from major CDS dealers to clear "standard" CDS contracts through a CCP by the middle of 2009 – this following the clear threat of new EU regulations for credit derivatives if industry participants did not commit
- Different exchanges now competing to set up and run CCP's in US and Europe (Intercontinental Exchange, CME Group, Eurex, NYSE Euronext LIFFE and LCH Clearnet)
- Threat of EU CDS regulation has now diminished but not disappeared

Any Questions?

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