

ISDA Aims for “Fungible” CDS with Auction Settlement, Big Bang Protocol, and New Standard North American CDS Terms

Overview

Responding to calls for central clearing of credit default swaps (CDS), ISDA will initiate three broad changes in March 2009 that can be applied to new CDS trades as well as outstanding CDS transactions. ISDA will:

1. “hardwire” Auction Settlement for new CDS trades by adding a supplement to the 2003 ISDA Credit Derivatives Definitions that includes terms similar to those used in recent CDS settlement auctions but creates a new industry committee to oversee the auctions and to make certain determinations with respect to CDS transactions;
2. facilitate the amendment of outstanding CDS contracts to include these terms through a “Big Bang Protocol”; and
3. create a new standardized North American corporate CDS contract.

ISDA hopes these changes will simplify CDS contracts, making them more liquid and ready for centralized clearing. The adherence period for the Big Bang Protocol is expected to close on April 7, 2009. Section 5 of this Alert discusses whether a CDS participant should adhere to the Protocol.

Supplement to 2003 ISDA Credit Derivatives Definitions

On March 12, 2009, ISDA is expected to publish the ISDA Credit Derivatives Determinations Committee and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions (March 2009 Supplement), which parties can elect to incorporate into new CDS trades.

Key modifications

- **Auction Settlement:** As an alternative to Physical Settlement or Cash Settlement, the March 2009 Supplement allows parties to select Auction Settlement as the method for calculating payments due following a credit event affecting a CDS reference entity. The Auction Settlement method generally will follow the auction process used in recent CDS settlement protocols, except a Credit Derivatives Determinations Committee will oversee the auction process and have the ability to modify the process for any auction. If no auction is conducted for a particular credit event, CDS contracts will settle under a fallback settlement method (Physical Settlement, unless Cash Settlement is specified in the CDS confirmation). The Auction Settlement terms are expected to include provisions for voluntary compression of loan delivery chains as well as a foreign currency rate conversion mechanism applicable when a Notice of Physical Settlement is amended.
- **Credit Derivatives Determinations Committee:** Under the March 2009 Supplement, a Committee with fifteen voting members will serve as settlement auction coordinator for CDS trades after a credit event affecting the CDS reference entity. This Committee will, among other things, determine whether there has been a Credit Event; whether an auction will be held; and whether a particular obligation is deliverable. This Committee will

also determine whether a Succession Event has occurred and whether there are Substitute Reference Obligations. A Committee will be appointed for each region (Americas, Europe, Japan, Australia-New Zealand, and Asia (other than Japan)). Each Committee will have 10 voting dealer members and 5 voting buy-side members (as well as several non-voting members). Criteria for buy-side membership include at least \$1 billion in assets under management, notional single-name CDS trades of at least \$1 billion, and approval by 1/3 of the current buy-side members. Any Committee decision that fails to win 80% approval will be sent to an external review panel, as nominated by members of the Committee. Any market participant may request that a Committee convene to address a specific CDS question.

- 60/90 Lookback/Backstop Dates: The March 2009 Supplement states that a Credit Event or Succession Event will occur only if the Committee finds that the event took place no earlier than 60 calendar days (for a Credit Event) or 90 calendar days (for a Succession Event) prior to the date on which the Committee received valid notice of such event. Under the March 2009 Supplement, a Credit Event or Succession Event can be effective even if it occurs prior to the Trade Date of a CDS transaction.

Big Bang Protocol

On March 12, 2009, ISDA is expected to open the 2009 Credit Derivatives Determinations Committees and Auction Settlement CDS Protocol, commonly called the “Big Bang Protocol.” The adherence period is expected to close on April 7, 2009, and the Protocol is expected to be effective on April 8, 2009.

Key provisions

- Applies March 2009 Supplement to certain outstanding CDS trades: The purpose of the Big Bang Protocol is to help parties incorporate the terms of the March 2009 Supplement described above into outstanding CDS trades. Outstanding CDS trades excluded from the Big Bang Protocol include loan-only CDS, US municipal CDS, CDS on ABS/MBS/CDO, bespoke portfolio transactions tied to credit-linked notes, and transactions designated by parties as excluded.
- Replaces ISDA CDS Auctions: Parties not adhering to the Big Bang Protocol will settle trades as agreed in the confirmation for the trade, unless otherwise negotiated. The Big Bang Protocol and March 2009 Supplement are meant to replace the ad hoc auction protocols ISDA currently runs. This means that ISDA is unlikely to sponsor ad hoc auction protocols in the future, and that CDS participants may be unable to participate in future auctions with respect to existing CDS transactions unless they have adhered to the Protocol.

New Standards for North American Corporate CDS

Key changes for trades starting March 20, 2009

- 100/500 coupon: A protection buyer will be required to pay a standard coupon (1% for protection against investment grade reference entities and 5% for protection against high yield reference entities).
 - No Restructuring: The standard North American CDS will not have Restructuring as a Credit Event.
 - Fixed payment/accrual period end dates: March 20, June 20, September 20 and December 20 (matching the roll dates for CDX Indices) will be the only available payment/accrual period end dates.
- Fixed Scheduled Termination Date: The Scheduled Termination Date in a standard North American CDS must match one of the four fixed quarterly payment/accrual dates.
- Eliminates short and long stubs: The initial coupon for the standard North American CDS will start to accrue on and including the fixed quarterly payment/accrual date immediately preceding the Effective Date of the transaction.

- Applies March 2009 Supplement: All new North American corporate CDS trades will include the terms of the March 2009 Supplement (which specifies Auction Settlement, establishes the Credit Derivatives Determinations Committee, defines the 60 Day/90 Day Lookback period, etc.)

Should a CDS Participant Adhere to the Big Bang Protocol?

Domestic and foreign regulators are likely to require that at least some CDS products trade on exchanges in the future, and the ISDA CDS initiatives discussed above pave the way for exchange-traded CDS. Something like the new ISDA CDS changes, if not these changes themselves, are necessary to serve as a basis for exchange-traded transactions.

For a CDS participant with existing trades, failure to adhere to the Big Bang Protocol and adopt the March 2009 Supplement entails the risk that the participant may be frozen out of the market—unable to participate in future auctions, holding positions that may have greatly reduced liquidity, potentially hamstrung by physical settlement requirements, and subject to potentially unfavorable calculation agent valuations. A participant's decision will depend to a large extent on the nature of the participant's book of outstanding CDS transactions and its evaluation of the risk of being shut out of future auctions—a risk we believe most participants will find significant.

If history is any guide, the dealer community will likely require that counterparties incorporate the terms of the March 2009 Supplement into every confirmation for future transactions. Meaning that, at least on a going-forward basis, parties wishing to transact in the CDS market will have to live with ISDA's CDS changes. The truly novel element of ISDA's new CDS measures—the inclusion of buy-side members on the Committee—may well present the greatest opportunity, namely, the promise of broad participation by a wider range of market participants in the future development of CDS and other OTC derivative products.

We will be happy to discuss the advantages and disadvantages of adherence with you.

The information in this alert is based on the March 2, 2009 drafts of the 2009 Supplement and Big Bang Protocol, which are subject to change before being finalized on March 12, 2009.

If you would like to learn more about the issues raised in this alert, please contact your Ropes & Gray adviser.

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