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A New Era for Credit Default Swaps:

ISDA Launches the Big Bang Protocol, Determinations Committees and SNAC CDSs

On March 12, 2009, the International Swaps and Derivatives Association, Inc. (“ISDA”) published the much anticipated “Big Bang” credit derivatives protocol (the “BB Protocol”) and supplement (the “March 2009 Supplement”) to the 2003 ISDA Credit Derivatives Definitions (the “2003 Definitions”).

By adhering to the BB Protocol, adhering parties will incorporate the March 2009 Supplement into their existing credit default swap (“CDS”) documentation. The principal effect of this will be threefold:

- i. Existing settlement options will be replaced by an “auction” settlement – a system developed by ISDA in recent years that now will effectively be hardwired into CDS documentation. The choice made in current CDS documentation between settlement in “cash” or by “physical delivery” will be converted to an auction methodology;
- ii. Regional “Determinations Committees” established by ISDA will be authorized to make binding determinations with respect to key matters, including whether a “Credit Event” has taken place and which securities may be used to satisfy any physical delivery settlement requirements; and
- iii. Standardized “lookback” limits or “Backstop Dates” will be established, effectively limiting the time that may elapse from the occurrence of certain Credit Events until the time that they are asserted by a party.

For parties adhering to the BB Protocol, the “hardwiring” of auction settlements and the establishment of the Determinations Committees will become effective on April 8, 2009; the lookback limits will become effective as of June 20, 2009. However, ISDA intends for the March 2009 Supplement to be separately incorporated into new CDS confirmations going forward until January 1, 2011, at which point the provisions of the March 2009 Supplement will be standardized in boilerplate CDS documentation.

Market participants may adhere to the BB Protocol from *March 12, 2009, to April 7, 2009*, using the form of adherence letter that has been published on ISDA’s website. Parties to CDSs will still be able to select cash or physical delivery for settlement, but it is expected that the auction methodology will become the prevailing means to settle CDSs going forward.

In addition to and separate from the BB Protocol, ISDA is rolling out a new CDS contract that will standardize single-name CDS trading, the Standard North American CDS Contract (“SNAC”). SNACs are intended to become industry-standard trades and thus represent a significant step to centralized processing of CDSs. The key distinguishing feature of SNACs is their fixed premium or “coupon”

of 100 or 500 basis points, depending on whether the debt of the referenced name of the CDS is considered investment grade or high yield.

This Alert brings into sharper focus these developments, each of which is viewed as a critical step toward central clearing CDSs, the implementation of operational improvements for CDSs and the overall reduction of systemic risk in the over-the-counter (“OTC”) credit derivatives market.

Credit Default Swaps

Generally

To introduce the CDS amendments included in the BB Protocol and March 2009 Supplement, the following provides a brief overview of existing CDS terms and procedures. CDSs are among the most frequently-traded OTC credit derivatives. The terms of a CDS are generally governed by the 2003 Definitions with applicable supplements. In a CDS, one party, the “Protection Seller,” undertakes to provide credit protection with reference to a reference entity (or its successor) to the other party, the “Protection Buyer.” The Protection Buyer pays a premium, or “coupon,” to the Protection Seller in exchange for the Protection Seller making a payment upon the occurrence of a specified Credit Event.

CDS Documentation

As OTC derivatives, CDSs are typically documented by means of a trade confirmation that accompanies a boilerplate ISDA Master Agreement, a Schedule that varies the terms of that Master Agreement and a Credit Support Annex. Parties to a CDS incorporate the terms of the 2003 Definitions in the CDS confirmation. CDSs are also documented in accordance with Master Confirmation Agreements that incorporate the 2003 Definitions. The form of confirmations for index CDSs have become quite standardized, with accepted universes of credit events, obligations and deliverable obligations.

CDS Settlement

If a Credit Event occurs prior to midnight GMT on the Scheduled Termination Date for the transaction and notice of the Credit Event and of publicly available information are issued within the Event Determination Date, then settlement of the CDS

takes place. Currently, a CDS may be settled by cash or by physical delivery as specified in the confirmation. However, due to potential uncertainties relating to the amount properly payable in cash settled transactions, most confirmations opt for physical settlement.

If the parties agreed to physically settle the CDS, the Protection Buyer delivers obligations that it selects at its option from among a pre-agreed list of deliverable obligations of the reference entity against payment by the Protection Seller of the notional amount of the CDS price. Under cash settlement, the Protection Seller pays the difference between the notional amount of the CDS and the current value of deliverable obligations selected by the Protection Buyer having a par amount equal to the notional amount of the CDS. In both cases, the Protection Buyer has the option to select any deliverable obligation that satisfies the deliverable obligation definition, subject only to some restrictions in the case of the Credit Event for restructuring (if applicable), provided that certain requirements are met and the parties have agreed to “modified restructuring” or “modified modified restructuring.”

The physical settlement procedures set out in the 2003 Definitions are based on the implicit assumption that there is a large supply of fungible securities within the applicable deliverable obligations categories such that debt obligations of a given entity within certain parameters ought to trade at a similar discount or premium to par regardless of the original coupon, tenor or other economic terms. The sufficiency of this supply of deliverable securities supports physical settlement based on the credit protection buyer’s selection of the “cheapest to deliver” deliverable obligation of the reference entity for purposes of valuation or delivery. This assumption, however, has not proven to be accurate. Efforts to settle CDS transactions referencing obligations of some entities that have become insolvent have revealed that the notional amount of exposure to the credit risk of such entities in the CDS market was far greater than the actual amount

of securities issued by them that would satisfy the criteria for deliverable obligations.¹

Because the Protection Buyer does not need to own Reference Obligations before entering into a CDS or during its term, upon the bankruptcy of the name or default of the Reference Obligation, Protection Buyers in a physically-settled CDS must often source the obligations in the open market and obtain the bonds. The notional amount of CDSs referencing names with significant short interest has often been greater than the float of bonds available for delivery as deliverable obligations. This has resulted in the anomaly of “bond squeezes” as Protection Buyers compete to acquire the deliverable obligations and often drive up prices in the process, resulting in a distortion of the economics of the credit protection transaction.

To facilitate settlement of CDSs and minimize the opportunity for bond squeezes to develop, ISDA began implementing an auction methodology as a way of making cash settlements more practicable and as a way of encouraging market participants that had opted for physical settlement to instead agree to settle on a cash basis. To date this auction methodology has been applied on a case-by-case basis. Participants could adhere to an auction protocol that imposed cash settlement and imposed a procedure to govern settlement of a CDS in connection with a particular defaulting entity. The protocols allowed parties to settle a CDS by means of a cash payment in an amount based on the auction-produced value for a specified deliverable obligation rather than having to compete directly with an outsized number of purchasers to purchase the deliverable obligations.

¹ For example, when automotive supplier Delphi Corporation filed for bankruptcy in 2005, an imbalance between the notional amount of CDSs referencing Delphi and the aggregate principal amount of Delphi deliverable obligations helped to create a “bond squeeze” that affected the economics of Delphi CDS trades. This ultimately contributed to the creation by ISDA of the cash settlement protocol for settlement of index trades referencing Delphi. See Nomura Securities CDO/CDS Update for October 31, 2005 (noting that Delphi bonds traded up to nearly 70 cents on the dollar, owing to short squeeze following its bankruptcy credit event).

Hardwiring Auction Settlement

Because the auction procedures have not previously been part of the standard ISDA documentation for CDS contracts, CDS participants have had to consider whether to adhere to an auction process for settling a CDS on a case-by-case basis and, after determining to adhere to a particular auction process, completed paperwork each time to evidence adherence. The BB Protocol and the March 2009 Supplement “hardwire” these auction procedures into standard CDS documentation, alleviating the need for adherence to individual auction protocols.

CDSs that become subject to the March 2009 Supplement will be settled by “Auction Settlement,” unless the parties have affirmatively chosen an alternative method. Auction Settlement, which is described in a new Article XII of the 2003 Definitions and an annex to the March 2009 Supplement (“Article XII”), thus becomes a third, but also the preferred, method of settling a CDS. If Auction Settlement applies, then the auction rules of Article XII operate to bring about settlement of the CDS.

ISDA intends for the March 2009 Supplement to standardize the manner in which auctions are conducted. ISDA indicates that Auction Settlement Terms will be published for each auction that the relevant Determinations Committee (discussed below) deems necessary by majority vote. ISDA will publish two schedules to the March 2009 Supplement to further clarify standard deliverable obligations and other auction specific terms. These schedules, Article XII and Determinations Committee resolutions relating to auctions will collectively constitute the standard method of auction settlement going forward.

The Five Determinations Committees

Efforts to amend CDS documentation have arisen from systemic and market conditions as well as from documentation disputes. For example, parties have litigated issues such as whether a Credit Event has taken place and whether securities delivered by the Protection Buyer, under the cheapest to deliver option, satisfy the requirements for deliverable obligations that may be tendered to the Protection Seller in connection with settlement of a CDS.

Accordingly, a purpose of the Determinations Committees created through the March 2009 Supplement will be to resolve key issues such as whether a Credit Event has taken place and which securities are within the realm of permissible assets to be delivered for settlement of the CDS. ISDA has made some determinations regarding such issues on a case-by-case basis in connection with auctions, most recently in respect of whether stripped securities issued by Fannie Mae and Freddie Mac were deliverable obligations for purposes of settling CDSs referencing those entities. The Determinations Committee may also determine whether a Succession Event has occurred with respect to a reference entity and who the Successor of that Reference Entity is in cases where that is not clearly apparent by application of the procedures in the 2003 Definitions.

Accordingly, Annex A to the March 2009 Supplement (Credit Derivatives Determinations Committees Rules) introduces five Determinations Committees. A principal purpose of the Determinations Committees is to resolve key issues regarding settlement of CDSs, including those described above. One Determinations Committee is assigned to each of the following regions: the Americas; Europe/the Middle East and Africa; Asia ex-Japan; Japan and Australia and New Zealand. Each of the five Determinations Committees has fifteen voting members comprised of eight representatives from “global” dealers, two additional regional dealers and five “buy-side” firms. ISDA is to serve as the secretary of each Determinations Committee.

The Determinations Committees will make binding determinations for issues such as (i) whether events in the market rise to the level of a Credit Event or Succession Event in a CDS; (ii) whether an auction will be held to facilitate settlement of CDSs; and (iii) whether certain securities are Deliverable Obligations that may be deliverable in physical settlement or used as the basis for valuation in cash settlement.

In order to convene a Determinations Committee, a market participant must submit a request to ISDA in accordance with Section 2.1 of Annex A of the March 2009 Supplement. The request must describe the issue or issues that it believes should be

deliberated. For example, the request may seek a determination that a Credit Event exists or existed at some point in the past. The Determinations Committee Secretary then forwards that request to the Determinations Committee for the region in which the market participant operates and calls a meeting of convened Determinations Committee members. Rules for the establishment of a quorum and other procedures of the Determinations Committee are set forth in the March 2009 Supplement. Each request for Determinations Committee resolution will be published on ISDA’s website.

A convened Determinations Committee may resolve by supermajority vote issues such as whether a Credit Event (or Succession Event) has occurred, whether an auction is necessary for settlement and if so, whether (by majority vote) an obligation may be delivered (and the level of subordination of that obligation) in CDS settlement. Certain decisions by the Determinations Committee may be subject to external review of ISDA members through a process described in Section 4 of the March 2009 Supplement. ISDA intends the Determinations Committee structure to bring transparency and more structured review to CDS settlement and activities within the CDS market.

The Lookback Concept

Under traditional CDS practice, a Credit Event Notice must be given no later than the 14th calendar day after the “Scheduled Termination Date,” “Grace Period Extension Date” (if applicable) or “Repudiation/Moratorium Evaluation Date” (if applicable). When a Credit Event occurs at or near the beginning of the term of the CDS transaction, this provision gives the notifying party – normally the Protection Buyer – significant latitude to choose the time to give the Credit Event Notice that is most advantageous to it based on the prices of the deliverable obligations that can be selected using the cheapest to deliver option.

The lookback concept in the March 2009 Supplement changes this practice by establishing a convention for preventing a CDS from being triggered by Credit Events that occur too far in the past. It also contains a parallel convention for determining the Successor for a reference entity. The earliest that this exposure-limiting concept

becomes effective in CDS documentation is June 20, 2009.

Under the March 2009 Supplement, to be effective, a Credit Event must have occurred no more than sixty days prior to the date on which the Determinations Committee receives a request to determine whether the Credit Event occurred. For a Succession Event in a CDS governed by the March 2009 Supplement to be effective, that event must have occurred ninety days before a request is lodged for the Determinations Committee to determine whether a Succession Event has taken place.

This new concept seeks to rid the market of “stale” requests for determinations that a Credit Event or Succession Event has taken place. If an event that arguably could be a Credit Event is not brought to the attention of a Determinations Committee within sixty days (in the case of a Credit Event) or ninety days (in the case of a Succession Event), the event cannot trigger a CDS that is governed by the March 2009 Supplement. Once the Determinations Committee receives a request to determine whether a Credit Event has taken place, the sixty and ninety day lookback periods are tolled.

SNACs

The SNAC is a new CDS contract that ISDA is introducing to the market for purposes of standardizing this swap. SNAC is a single-name CDS trade. The distinguishing feature of a SNAC CDS is its fixed coupon of 100 or 500 basis points, depending on whether the debt of the referenced name of the CDS is considered investment grade (for which the fixed coupon, or premium payable by the Protection Buyer, is 100 basis points) or high yield (for which the coupon is 500 basis points). Documentation for SNAC CDSs is currently being finalized by ISDA. ISDA will also further update its matrix for CDS trades to include this product and transaction type. SNACs will be warehoused in the DTCC Trade Information Warehouse. DTCC has indicated that it will overwrite several fields (including the Effective Date, payment frequency, First Fixed Payer Payment Date, Single Payment Date and Restructuring, which will not be a permitted Credit Event for SNAC CDSs) if the parties seeking to enter into a SNAC do not conform the details of their trade to the standard SNAC terms.

It is important to note that adhering to the BB Protocol does not convert an existing CDS to a SNAC; these are separate initiatives.

Application of the Big Bang Protocol

Adhering to the BB Protocol will result in the March 2009 Supplement becoming applicable to most, but not all, types of CDS transactions (“Protocol Covered Transactions”)² that have already been entered into by adhering parties or that adhering parties enter into on or before January 31, 2011. As noted above, ISDA expects to have incorporated the terms of the March 2009 Supplement into its standard documentation by that date. Moreover, for certain types of Protocol Covered Transactions (*e.g.*, Fixed Recovery, Reference Obligation Only Transactions, Preferred CDS or Party Specified Non-Auction Transactions), adherence will result only in the application of the provisions of the March 2009 Supplement relating to the Determinations Committees; Auction Settlements will not be applicable to these covered but “non-auction” transactions. The BB Protocol will cover novations so long as the transferee and remaining party to the novations have previously adhered to the BB Protocol and the underlying transactions that are the subject of the novations are Protocol Covered Transactions.

Adherence to the Big Bang Protocol

The final day of submission to ISDA of the BB Protocol adherence letter is April 7, 2009. A form of BB Protocol adherence letter has been published on the ISDA website, www.isda.org, on the page entitled “CDS Auction Hardwiring.” The letter must be properly completed by each entity that desires to incorporate the March 2009 Supplement terms into transactions that exist as of the date of protocol adherence. One letter is to be submitted for each entity that desires to adhere to the BB Protocol. Managers advising funds may list in the adherence letter those funds covered by an ISDA

² CDS transactions that would not be Protocol Covered Transactions, and that thus would not be affected by adherence to the BB Protocol, include Loan Only transactions and transactions covering underlyings that are U.S. municipal securities, asset-backed securities or CDOs.

Master Agreement and, once submitted, such funds become subject to the Protocol.

Please contact the authors for more information about the BB Protocol, the March 2009 Supplement and SNAC. These rules and developments are

designed to address current risks and provide greater certainty in the settlement of this important derivative. These are significant developments affecting the CDS market and its participants, warranting careful review and consideration.

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