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A legal update from Dechert's Financial Services and Finance and Real Estate Groups

ISDA Credit Default Swap Auction Protocols

Following recent credit events including the placement of Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac") under conservatorship by the Federal Housing Finance Agency, the Chapter 11 bankruptcy filing of Lehman Brothers Holdings Inc. ("Lehman"), and the placement of Washington Mutual Inc. ("Wamu") into receivership by the Federal Deposit Insurance Corporation, the International Swaps and Derivatives Association ("ISDA") recently announced its intention to hold auctions in relation to credit default swaps in which Fannie Mae, Freddie Mac, Lehman or Wamu, respectively, were named as reference entities. ISDA has subsequently issued the 2008 Fannie Mae and Freddie Mac CDS Protocol (the "Protocol").

ISDA's website is available at www.isda.org. A draft timeline for the Fannie Mae, Freddie Mac, and Lehman auction processes is available at www.isda.org/companies/ISDAProtocolTimeline.pdf. The proposed timing of the auction processes is below.

Fannie Mae and Freddie Mac Credit Default Swap Auction

The Protocol is available at www.isda.org/companies/ff/pdf/Draft-Fannie-Freddie-CDS-Protocol.pdf. A draft of the adherence letter for parties wishing to participate in the Protocol is attached as an exhibit in the Protocol.

September 29 – commencement of adherence process and publication of the Protocol and list of deliverable obligations.

October 2 – closing date for submission of letters of adherence to the Protocol.

October 6 – auction date.

October 8 – deadline for receipt of notice of physical settlement of trades under the Protocol.

October 15 – cash settlement date for transactions governed by the Protocol.

The Protocol applies to a credit default swap only if both counterparties become adhering parties to the Protocol and is deemed effective on receipt by ISDA of an adherence letter from the later of the two adhering parties.

Lehman Credit Default Swap Auction

October 1 – deadline for submission of deliverable obligations.

October 3 – commencement of adherence process.

October 7 – closing date for submission of letters of adherence for the Lehman credit default swap auction.

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Wamu Credit Default Swap Auction

At the time of writing, no dates have been set for the submission of deliverable obligations, the adherence process or the auction for Wamu credit default swaps, however these will also become available on ISDA's website.

This update is intended to highlight key terms of the Protocol and to provide background to the credit default swap market and the development of the credit default swap auction process.

Background

The credit default swap market has undergone rapid expansion in recent years. The credit default swap market initially developed to allow hedging of debt instruments held by a counterparty. A holder of a debt instrument (e.g., a bond) who was concerned about the creditworthiness of the issuer (the "Reference Entity") of the bond could purchase credit protection with respect to the Reference Entity from a counterparty in the form of a credit default swap. In return for a premium paid by the purchaser of credit protection (the "Protection Buyer"), if a credit event occurred with respect to the Reference Entity (typically the bankruptcy or failure to pay debt of the Reference Entity) and certain conditions were met, the counterparty (the "Protection Seller") would pay the Protection Buyer the notional amount of the credit default swap, in exchange for the delivery by the Protection Buyer to the Protection Seller of the bond or other debt instrument of the Reference Entity, as described in the credit default swap. This method of settling a credit default swap is referred to as "physical settlement." Alternatively, the counterparties could agree to cash settle the credit default swap by marking to market a reference obligation specified in the credit default swap, with the Protection Seller then (i) paying the Protection Buyer an amount equal to the notional amount of the credit default swap, multiplied by (ii) the reference price specified in the credit default swap (usually 100%) minus the mark to market price of the reference obligation established by the cash settlement valuation procedures.

As the market in credit default swaps developed, participants began to use credit default swaps as a mechanism to take a position or "view" on the creditworthiness of a Reference Entity. A Protection Buyer merely had to find a counterparty in the market willing to take the opposite view for a premium; there is no requirement for either counterparty to a credit default swap to own any physical security of the Reference Entity with respect to whom they are taking a credit position. Eventually, the market in credit default swaps began to overtake the market in physical bonds with a greater notional amount of credit default swaps entered into with respect to a Reference Entity than there were debt instruments issued by the Reference Entity.

Consequently, physical settlement became a less attractive option, as Protection Buyers who did not hold the physical debt instruments of a Reference Entity that were permitted deliverable obligations under the credit default swap would have to go into the market to purchase them after the occurrence of a credit event. This would artificially drive up the price of the Reference Entity's debt instruments and, under circumstances where the aggregate notional amount of credit default swaps in the market exceeded the aggregate outstanding principal amount of debt instruments issued by the Reference Entity, physical settlement could become impossible. The alternative was to cash settle the credit default swap in accordance with the credit default swap documentation.

The ISDA auction protocol process was developed to permit counterparties who opt to adhere to the relevant protocol to streamline settlement of credit default swaps written on large Reference Entities, to create a transparent price that the whole market can use, and to allow counterparties the option to cash settle or to effectively physically settle their credit default swaps.

Overview of the Credit Default Swap Auction Process

In the event that a large Reference Entity is the subject of the credit event, ISDA in conjunction with Markit Group Limited ("Markit") and Creditex Securities Corp. ("Creditex") will generally administer an auction to determine a market price by which the types of credit default swaps specified in the protocol written on the Reference Entity ("Covered Transactions") can be settled.

The auction is a voluntary process by which market participants agree to be governed by a protocol issued by ISDA. A separate protocol is issued with respect to each Reference Entity that will be the subject of an auction. Adherents to the protocol agree that certain amendments will be deemed made to the documentation governing each Covered Transaction between it and any other party adhering to the protocol in accordance with certain terms specified in the protocol. In order to become an adhering party to the protocol, such party must enter into an adherence letter (the form of which is attached as an exhibit to the protocol) during the adherence period prior to the cut-off date specified in the protocol. For example, the adherence period for the Protocol is from September 29, 2008 to October 2, 2008.

In order to be a participating bidder in the auction, participants must be credit default swap dealers listed on ISDA's website www.isda.org, and must enter a bidding agreement letter, the form of which is attached as an exhibit to the Protocol.

If a participating bidder desires on its own behalf or that of its customers to physically settle deliverable obligations specified on the ISDA website as acceptable under the protocol ("Deliverable Obligations"), such bidder must deliver a notice of physical settlement, the form of which is attached as an exhibit to the protocol.

While all of the credit default swaps under a protocol are cash settled, the two stages of the protocol permit participants to both cash settle their credit default swaps and trade Deliverable Obligations, resulting in an effective physical settlement for those who elect physical settlement as part of the auction process.

Below is a general description of the credit default swap auction process, as described in the Protocol.

Credit Default Swap Auction Process under the Protocol – Stage 1

The Protocol splits the credit default swap auction process into two stages, each occurring on the same day.

The first stage of the auction has two aims: (i) to create an "inside market midpoint" price for the Deliverable Obligations, and (ii) to establish the amount of physical settlement requests.

The inside market is established by participating bidders submitting firm buy and sell quotations for the Deliverable Obligations creating a two-way market, subject to certain requirements specified in the Protocol. The inside market is then used to create an "inside market midpoint" price which is used in determining the final price of the auction.

The inside market midpoint price is determined by sorting the various bids and offers into "matched markets," with the bids being sorted in descending order and the offers being sorted in ascending order (so the highest bid is tallied with the lowest offer). Where bids and offers cross (i.e., the bid is higher than the offer) or match, these are termed "tradeable markets" and are thrown out for the purposes of determining the inside market midpoint. The inside market midpoint price is then determined by taking the mean of all of the bids and offers included in the matched markets that fall within the "best half" of the remaining bids and offers.

These steps are set out in the following example (prices are provided for illustration only and are not intended to be indicative).

Step 1 – Sort bids from highest to lowest and offers from lowest to highest.

Contributed	
IM Bids	IM Offers
39.500%	41.000%
40.000%	42.000%
41.000%	43.000%
45.000%	47.000%
32.000%	34.000%
38.750%	40.000%
38.000%	39.500%
41.000%	42.750%

Matched Markets

Sorted		
IM Bids	IM Offers	
45.000%	34.000%	Tradeable Markets
41.000%	39.500%	
41.000%	40.000%	
40.000%	**41.000%**	Best Half
39.500%	**42.000%**	
38.750%	**42.750%**	
38.000%	42.000%	
32.000%	47.000%	

Step 2 – Ignore all Tradeable Markets

Step 3 – The inside market midpoint is the mean of the Best Half of the remaining Matched Markets. If there is an odd number of Matched Markets, round up.

Best Half	
IM Bids	IM Offers
40.000%	41.000%
39.500%	42.000%
38.750%	42.750%

Inside Market Midpoint = Average (40,41,39.5, 42, 38.75, 42.75)

40.667%, rounded to 40.625%[1]

The final part of the first stage of the auction is to determine the amount of physical settlement requests. Participating bidders can submit physical settlement requests either on their own behalf or on behalf of their customers. The buy and sell physical settlement requests are then separately aggregated to determine the "open interest" (i.e., the difference between the aggregate buy and sell requests). This is then carried over to the second stage of the auction.

At this stage an adjustment amount is determined for bids and offers that are off-market (i.e., the wrong side of the inside market midpoint) with respect to crossing bids and offers, i.e., "tradeable markets." For example, if the open interest is to sell Deliverable Obligations and a bid is higher than the inside market midpoint price, then the participating bidder will be required to pay an adjustment amount equal to the inside market quotation amount specified in the Protocol, multiplied by the greater of (i) zero and (ii) amount by which their bid price exceeded the inside market midpoint. The adjustment amounts are paid to ISDA and applied first to cover costs associated with the auction process with any remaining amounts distributed *pro-rata* to participating bidders.

Following this process, by 11:00 AM New York time on the auction date, Markit and Creditex, the administrators of the auction, will then publish:

- the size and direction of the open interest;
- the inside market midpoint; and
- details of any adjustment amounts.

1 Example taken from Draft 2008 Fannie Mae and Freddie Mac CDS Protocol, Exhibit 3, Section 3(c).

Credit Default Swap Auction Process under the Protocol – Stage 2

The second stage of the auction process is to match the open interest and create a final price. This is achieved by participating bidders submitting "limit orders" with respect to the open interest on behalf of themselves or their customers and the matching of limit orders or inside bids/offers against the open interest.

If the open interest is to sell, then participating bidders have an opportunity to submit limit orders that are offers. Conversely, if the open interest is to buy, then participating bidders have the opportunity to submit limit orders that are bids. The limit orders differ from the physical settlement requests in that they have a firm price associated with the order, in addition to specifying a quotation amount and a buy/sell direction. The limit orders are then aggregated with the inside market bids or inside offers (as applicable depending on the open interest) and treated as unmatched limit orders which are then matched against the open interest starting with the lowest offer or the highest bid (as applicable depending on the direction of the open interest). These are matched to the open interest until (i) all of the open interest has been matched against unmatched limit orders totalling the same size as the open interest, or (ii) all of the unmatched limit orders of the relevant type have been matched to the open interest.

The final price is then determined in the case of clause (i) in the preceding paragraph by reference to the matched limit order with the highest offer or lowest bid, as applicable, provided that if the open interest is an offer to sell and the price of the lowest matched limit order exceeds the inside market midpoint price by more than the cap amount specified in the Protocol (1%), then the final price will be the inside market midpoint price plus the cap amount, and if the open interest is to purchase and the inside market midpoint price exceeds the price of the highest matched limit order by more than the cap amount, then the final price will be the inside market midpoint price minus the cap amount. If the open interest is zero, the final price will be the inside market midpoint price. If the final price is determined in the case of clause (ii) of the preceding paragraph where there open interest is to buy, the final price will be the highest limit offer or inside market offer received or where the open interest is to sell, the final price will be zero. In such cases all physical settlement requests of the same type as the open interest (e.g., bids to purchase or offers to sell) will be matched pro rata against the limit orders and physical settlement requests on the opposite side of the market to form trades.

Fannie Mae and Freddie Mac Auction

The Protocol is comprised of the following items:

- general terms and conditions;
- form of adherence letter;
- form of revocation notice from an adhering party;
- auction methodology;
- form of bidding agreement letter (for those entities wishing to actively participate in the auction);
- form of notice of physical settlement; and
- amendments to Covered Transactions.

The timeline for the Fannie Mae and Freddie Mac auction is set out above. Separate auctions will be conducted for each of Fannie Mae and Freddie Mac. There will be two separate auctions held for each depending on the nature of the credit default swap that was entered into, one in respect of certain covered subordinate non-index transactions and one in respect of covered senior transactions as specified in the Protocol.

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