

ISDA Auction Hardwiring: ISDA Streamlines CDS Settlement Auction Process

The International Swaps and Derivatives Association ("ISDA")¹ has published a new framework to facilitate settlement of credit default swaps. This framework includes a new Credit Derivatives Determinations Committee, Auction Settlement Supplement (the "Supplement") to the 2003 Credit Derivative Definitions ("CDS Definitions"), and a new Protocol (the "Big Bang Protocol") specifying auction settlement procedures applicable to credit default swap ("CDS") transactions. The Supplement introduces important changes into the CDS market that will be applied to new CDS transactions commencing April 8, 2009. CDS counterparties can also apply these changes to existing CDS contracts via adherence to the Big Bang Protocol.

The Supplement

CDS can be settled through physical delivery of specified obligations or by cash settlement. With rapid growth in the CDS market, the amount of CDS entered into with respect to a particular obligation has come, in many cases, to exceed the size of the market in the relevant physical bonds, potentially calling into question orderly settlement of such transactions. As a result, following Credit Events during the past year, ISDA has on an ad hoc basis created auction protocols to facilitate streamlined settlement of CDS written on large reference

entities, allowing the parties the option to cash settle or to physically settle their CDS even where available physical obligations are insufficient to settle all CDS calling for physical settlement.

To date, the ISDA auction settlement process for CDS transactions has relied on adherence by counterparties to ad hoc ISDA protocols created for particular reference entities such as Lehman, Fannie Mae, and Freddie Mac. The new Supplement "hardwires" the existing CDS auction settlement mechanics as the uniform CDS settlement method, standardizing the auction settlement process across CDS transactions so that auction procedures remain consistent from one CDS settlement auction to the next. ISDA will no longer need to publish auction protocols for each Credit Event, while protection buyers and sellers will not have to adhere to multiple specific-purpose CDS settlement protocols. Counterparties entering into an agreement subject to the CDS Definitions on or after April 8, 2009 will be able to select "Auction Settlement" as the settlement method for their trades and will no longer have to monitor ISDA announcements or submit adherence letters in order to have trades covered by the ISDA auctions. If no auction is conducted for a particular Credit Event, CDS contracts will settle under a fallback settlement method agreed to by the parties in the relevant Confirmation.

The Supplement also includes provisions establishing the ISDA Determination Committees (the "Determination Committees"), which will make binding determinations for issues pertaining to CDS transactions. Currently, most determinations required under CDS

¹ Capitalized terms used and not otherwise defined in this *DechertOnPoint* shall have the meaning set forth in the ISDA 2003 Credit Derivative Definitions or the Credit Derivatives Determinations Committee and Auction Settlement Supplement (including any related Annexes, Exhibits and Schedules thereto).

contracts are made by the named calculation agent, including determinations as to whether or not a Credit Event or Succession Event has occurred. The Supplement provides that these determinations will be made by the newly-formed Determination Committees. In addition, the Determination Committees will: establish the timing of CDS settlement auctions; determine any amendments required to the procedures for any particular CDS settlement auction; and decide upon the list of deliverable obligations for any settlement auction. The Determination Committees is an entirely new element in the hardwired structure; there will be one Committee for each region, each composed of ten dealer members and five non-dealer members (representing the buy-side). Each Committee will consider and decide issues involving reference entities traded under transaction types for their relevant region.

The Supplement also creates the concept of a “look-back period” of 60 days applicable to Credit Events and 90 days for Succession Events. Under current CDS contracts, a Credit Event or Succession Event for a specific CDS transaction can be declared only if the event occurs between a transaction’s Effective Date and its Termination Date. The Supplement implements a time limitation on when such events can be declared, and allows a Credit Event or Succession Event occurring prior to the Effective Date of a CDS transaction to be a triggering event for such CDS transaction. This single look-back period is intended to achieve consistency across hedging transactions, where an investor enters into offsetting trades with identical terms that have different Effective Dates, in which case the investor runs the risk of a Credit Event or Succession Event occurring between the two Effective Dates for the offsetting CDS transactions.

The amendments made by the Supplement will apply to all future CDS transactions referencing the amended CDS Definitions on or after April 8, 2009. Parties who do not agree to include the Supplement’s settlement terms in future Confirmations, or who fail to adhere to the Big Bang Protocol, will need to settle their trades in accordance with the terms of the relevant Confirmation (absent an agreement between the parties to an alternative approach).

The Big Bang Protocol

CDS counterparties who wish to have the Supplement govern all their existing CDS transactions can amend their existing trades on a multilateral basis with all other

adhering counterparties by agreeing to the Big Bang Protocol. Upon adherence to the Big Bang Protocol, covered existing transactions will be subject to the Determination Committee provisions on or after April 8, 2009. In addition, parties adhering to the Big Bang Protocol also ensure that the Supplement will apply to new covered CDS trades entered into between April 8, 2008 and January 11, 2001, and trades novated between adhering parties on or after April 8, 2008 but before January 31, 2011.

The Big Bang Protocol will apply to trades typically covered by past auction protocols, including: (i) certain index trades (e.g., CDX and iTraxx tranching and untranching); (ii) certain swaptions² (single name and portfolio); and (iii) certain non-swaption trades. These transactions constitute the majority of the CDS market. Covered Non-Auction Transactions include reference-obligation only, fixed recovery, preferred CDS and party-specific non-auction trades. While the Big Bang Protocol will not apply to loan-only, municipal, ABS, MBS, CDO and certain custom-made portfolio CDO transactions, CDS counterparties will have the option of amending one or more of their transactions on a bilateral basis to customize those contracts as the counterparties deem appropriate.

Deadline for Adherence to the Big Bang Protocol

The Big Bang Protocol will facilitate the amendment of existing CDS transactions to reflect the new terms of the Supplement. The Big Bang Protocol is open for adherence until 5:00 PM New York time on April 7, 2009. A failure to adhere means that, absent affirmative measures to amend existing agreements, existing CDS will not be subject to future settlement auctions and related terms. It is important to note, however, that CDS counterparties may also bilaterally amend their ISDA Master Agreements, individual Confirmations, or CDS Master Confirmation Agreements to incorporate any or all of the provisions of the Supplement.

To adhere to the Big Bang Protocol, market participants must submit an adherence letter, in the form available on the ISDA website (www.isda.org), to ISDA via e-mail

² A swaption is an option granting its owner the right but not the obligation to enter into an underlying swap. Although options can be traded on a variety of swaps, the term “swaption” typically refers to options on interest rate swaps.

at hardwiring@isda.org on or before 5:00 PM New York time on April 7, 2009. The adhering party's e-mail to ISDA must include: (i) a signed copy of the adherence letter stating the name and information of the contact person at the adhering party; and (ii) a conformed copy of the adherence letter (hard copies are not required and there is no adherence fee). Protocol adherence will not be effective until both the signed and conformed versions of the adherence letters are submitted by email in accordance with the foregoing procedures.

parties are free to incorporate these terms into existing transactions by specific agreement, and future agreements would incorporate the Supplement by incorporating the amended CDS Definitions. The dealer community can be expected to favor incorporation of the Supplement into their future transactions, and end users will wish to consider the potential impact of these provisions on their CDS transactions.



Conclusion

As noted above, parties who do not adhere to the Big Bang Protocol by April 7, 2009 will not have the benefit of automatic incorporation of the Supplement into existing CDS with other adhering parties. However,

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