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THE BIG BANG: MAJOR CHANGES IN THE GOVERNANCE PROVISIONS FOR CDS TRANSACTIONS

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THE NEW CDS GOVERNANCE PROVISIONS REPRESENT A SYSTEMIC CHANGE TO THE GOVERNANCE OF CDS TRANSACTIONS AND A MAJOR STEP TOWARD ACHIEVING THE TRANSPARENCY AND LIQUIDITY DEMANDED BY REGULATORS AND THE GENERAL PUBLIC.

Credit default swap (CDS) dealers and end-users, under the auspices of the International Swaps and Derivatives Association, Inc. (ISDA), have developed and implemented significant new provisions to govern most CDS transactions ("New CDS Governance Provisions"). The New CDS Governance Provisions for existing CDS transactions were implemented by CDS market participants using the "Big Bang" CDS implementation protocol ("Big Bang Protocol"). The adherence period for the Big Bang Protocol ended on April 7, 2009, with more than 2,000 market participants adhering. As a result, existing CDS transactions of the type covered by the Protocol that are between any two of those approximately 2,000 adhering parties are now governed by the New CDS Governance Provisions. CDS counterparties that did not adhere to the Big Bang Protocol can still have their current and prospective CDS transactions governed by the New CDS Governance Provisions by following specific procedures discussed below.

The New CDS Governance Provisions include (1) adopting an auction methodology to settle CDS transactions following a credit event; (2) establishing Determinations Committees and procedures (including an appeal process to review decisions of the Determinations Committees) that will determine, among other things, whether a credit event has occurred; (3) adding the concepts of a credit event backstop date and a succession event backstop date; (4) eliminating the perceived inequity relating to foreign exchange provisions with respect to the Notice of Physical Settlement (NOPS); and (5) adding a voluntary compression mechanism to facilitate the settlement of loans following a CDS settlement auction.

ADDITION OF CDS AUCTION SETTLEMENT PROTOCOL

Historically, almost all single reference entity CDS transactions provided that a protection buyer must physically settle CDS transactions following a credit event by delivering to the protection seller one or more debt instruments of the relevant reference entity. As demonstrated by prior CDS settlements following a credit event, however, the value of CDS transactions written on a particular reference entity substantially exceeded the value of the reference entity's outstanding debt. This imbalance, if not addressed, would have prevented the orderly settlement of CDS transactions, thereby causing severe market disruptions during the settlement process. To mitigate these market disruptions, CDS market participants traditionally have participated in ISDA-sponsored multilateral CDS auction protocols to facilitate the settlement of CDS transactions.

Most recently, ISDA published CDS auction settlement protocols for Station Casinos, Inc.; Aleris International, Inc.; Ferretti S.p.A.; The Rouse Company LP; Chemtura; LyondellBasell Industries AF S.C.A.; Idearce, Inc.; Capmark Financial Group Inc.; Abitibi-Consolidated; and Charter Communications. These ad hoc protocols amend the settlement method applicable to existing CDS transactions from physical settlement to cash settlement, with the cash settlement price determined at a settlement auction involving dealers and other market participants.

The New CDS Governance Provisions provide for "hardwire" auction settlement as the settlement method for CDS transactions and adopt standardized auction procedures designed to be consistent from one CDS settlement auction to the next. The adoption of the auction settlement will eliminate the need for ISDA to publish auction protocols each time a credit event occurs and for protection buyers and sellers to adhere to multiple ad hoc CDS settlement protocols.

FORMATION OF DETERMINATIONS COMMITTEES AND EXTERNAL REVIEW PANELS

Prior to the implementation of the New CDS Governance Provisions, the calculation agent (typically, the dealer in a dealer-to-end-user CDS transaction, and the protection seller in a dealer-to-dealer CDS transaction) made various determinations required pursuant to the transaction's documentation. Regarding the critical determination of whether a credit event has occurred, the 2003 ISDA Credit Derivatives Definitions ("2003 Definitions") provide that, unless "Buyer" is specified in the confirmation as the party entitled to deliver the credit event notice, either "Buyer" or "Seller" may deliver the notice. Technically, this means that an event is a credit event if a party entitled to deliver the credit event notice has factual support for its position that it is a credit event. As a practical matter, however, when it has not been entirely clear that a credit event has occurred, the major dealers, unofficially organized by ISDA, usually have decided the issue, and the various interested parties have gone along with the dealers' determination. Under the 2003 Definitions, protection buyers or sellers have been free to ignore the dealers' decision and resolve the issue on their own, either by settlement or by seeking a judicial determination.

The New CDS Governance Provisions provide that the critical determination of whether a credit event has occurred, as well as other determinations previously made by the calculation agent, will now be made by newly constituted regional Determinations Committees. The Determinations Committees will determine, among other things, the timing of CDS settlement auctions, whether the procedures for any specific CDS settlement auction need to be amended, and the list of deliverable obligations for these CDS settlement auctions.

There are five regional Determinations Committees (the Americas; Asia Ex-Japan; Australia-New Zealand; EMEA (Europe, the Middle East, and Africa); and Japan), each consisting of two-thirds voting and non-voting dealer representatives and one-third voting and non-voting end-user representatives. Each regional Determinations Committee will decide issues involving reference entities traded under transaction types for the relevant region.

The voting dealer representatives on the Determinations Committees are Bank of America/Merrill Lynch, Barclays, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase Bank, Morgan Stanley, The Royal Bank of Scotland, and UBS. The non-voting dealer representatives are BNP Paribas; HSBC Bank; Societe Generale (for the Americas, Australia-New Zealand, EMEA, and Japan); and Standard Chartered Bank (for Asia Ex-Japan).

The voting end-user representatives on the Determinations Committees are Legal & General Investment Management Limited; Elliott Management Corporation; Pacific Investment Management Company LLC; Primus Asset Management, Inc.; and Rabobank International. The non-voting end-user representative is Prudential Investment Management.

The Credit Derivatives Determination Committees Rules ("DC Rules") published by ISDA provide that, while various decisions may be resolved by a simple majority of members participating in a binding vote, an 80% supermajority of members participating in a binding vote is required to determine whether a credit event has occurred. If the required vote regarding a matter before the relevant Determinations Committee cannot be achieved, an External Review Panel, comprising individuals from a pool nominated by ISDA members ("External Review Pool"), decides the issue. The relevant Determinations Committee must attempt to select, by unanimous vote, a five-member External Review Panel, which can be reduced to not less than three members due to resignations or conflict. If the Determinations Committee fails to select an External Review Panel, the External Review Panel will consist of members selected at random from the External Review Pool. The DC Rules provide that determinations made by the Determinations Committees, or if applicable, the External Review Panels, are binding on market participants that have adhered to the New CDS Governance Provisions.

ESTABLISHMENT OF CREDIT EVENT AND SUCCESSION EVENT BACKSTOP DATES

The most fundamental change to the standard CDS product in the New CDS Governance Provisions is the establishment of a credit event backstop date and a succession event backstop date. The New CDS Governance Provisions mandate that, for a credit event to be viable, (1) notice of that credit event must be delivered to the applicable DC Committee or (2) a credit event notice and notice of publicly available information, if applicable, must be delivered—in either instance, not later than the 60th calendar day following the date that the credit event occurs. Similarly, a succession event must occur no more than 90 calendar days prior to the date that notice of the succession event is made to the applicable Determinations Committee.

Any market participant may request that the relevant Determinations Committee make a determination whether a credit or succession event has occurred. The new credit event and succession event backstop dates set a time limit within which these events can be declared. Significantly, according to the "Frequently Asked Questions" published by ISDA in connection with the Big Bang Protocol (see www.isda.org/bigbangprot/bbprot_faq.html), the backstop dates extend the seller's exposure back into the period prior to the effective date of the transaction. Historically, a credit event or succession event under a specific CDS transaction could be declared only if the event occurred between the transaction's effective date and its termination date.

Protection sellers must ensure that no credit event or succession occurred in the relevant period prior to selling that protection because the protection period commences prior to the effective date of the CDS transaction. On the other hand, protection sellers will benefit because a credit event or succession event cannot be declared beyond a relatively short period following the Determinations Committees' determination that such an event occurred.

ELIMINATION OF PERCEIVED INEQUITY RELATING TO FOREIGN EXCHANGE PROVISIONS FOR THE NOPS

Pursuant to the historic ISDA definitions, the foreign exchange rate relating to the physical settlement of CDS transactions following a credit event is set on, and as of, the date that a NOPS is originally delivered. However, if a NOPS is amended prior to the physical settlement date, the foreign exchange rate is reset to that date, thereby allowing a protection buyer to amend a NOPS to take advantage of a currency fluctuation (even if the deliverable obligations set forth in the underlying NOPS have not changed). The New CDS Governance Provisions shift the currency risk from the protection seller to the protection buyer—the counterparty that has the option of amending the NOPS—by locking in the foreign exchange rate and basing the foreign exchange rate for any amended NOPS on the foreign exchange rate in the original NOPS.

ADDITION OF A VOLUNTARY COMPRESSION PROCESS FOR PHYSICAL SETTLEMENT OF LOAN CDS TRANSACTIONS

The New CDS Governance Provisions provide a mechanism that allows the parties to compress, voluntarily, the physical settlement process for loan CDS transactions following a credit event. This provision will be particularly beneficial when a loan needs to be delivered several times between intermediate counterparties prior to reaching its final holder. The New CDS Governance Provisions allow counterparties in the delivery chain to agree that the loan will be delivered to the ultimate protection seller, permitting the intermediate counterparties to settle their respective back-to-back CDS transactions via cash settlement.

PROCEDURES FOR MARKET PARTICIPANT NOT ADHERING TO THE BIG BANG PROTOCOL

CDS counterparties who want the New CDS Governance Provisions to govern all of their existing CDS transactions, but did not adhere to the Big Bang Protocol, must bilaterally amend their ISDA Master Agreements, individual Confirmations, or CDS Master Confirmation Agreements, as appropriate, to incorporate the New CDS Governance Provisions. Alternatively, because the New CDS Governance Provisions have been added to the 2003 Definitions as a supplement, CDS market participants that want to have the New CDS Governance Provisions govern their prospective CDS transactions can amend their ISDA transactional documentation to provide for incorporation of the 2003 Definitions, as supplemented by the March 2009 Supplement.

The Big Bang Protocol does not apply to certain types of CDS transactions, such as loan only, municipal, CDS on ABS (asset-backed security) transactions, and certain excluded index transactions. Of course, as with all ISDA derivative transactions, counterparties are free to amend the ISDA standard documentation bilaterally to achieve their desired result.

PHASE-IN OF BIG BANG PROTOCOL PROVISIONS

The Big Bang Protocol provides for the following phase-in/timing of the New CDS Governance Provisions: (1) the credit event and succession event backstop dates for all CDS transactions will be the effective date of such CDS transactions until June 20, 2009, at which point the 60- and 90-day backstop dates, as applicable, will apply; (2) all market standard documentation will be deemed amended prospectively to include the New CDS Governance Provisions until January 1, 2011; and (3) all novated transactions with a trade date on or prior to January 1, 2011, will be deemed covered by the Big Bang Protocol.

CONCLUSION

The New CDS Governance Provisions represent a systemic change to the governance of CDS transactions and a major step by industry participants toward achieving the kind of transparency and liquidity in the CDS market that regulators and the general public have demanded.

Previously, the value of CDS transactions written on a particular reference entity substantially exceeded the value of the reference entity's outstanding debt.

The adoption of the auction settlement protocol will eliminate the need for ISDA to publish auction protocols each time a credit event occurs.