THE BIG BANG: ADHERENCE PERIOD OPENS FOR CREDIT DEFAULT SWAP MARKET PARTICIPANTS TO ELECT NEW CDS GOVERNANCE PROVISIONS FOR THEIR EXISTING AND PROSPECTIVE CDS TRANSACTIONS

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Credit Default Swap ("CDS") dealers and end-users, under the auspices of the International Swaps and Derivatives Association, Inc. ("ISDA"), have developed significant new provisions to govern CDS transactions (the "New CDS Governance Provisions").[1] To quickly and efficiently implement these New CDS Governance Provisions for existing CDS transactions, CDS market participants are using a "Big Bang" CDS implementation protocol (the "Big Bang Protocol"). To participate in the Big Bang Protocol, each CDS market participant must submit one or more adherence letters to ISDA (the "Adherence Letter") during the time period beginning on Thursday, March 12, 2009 and ending on Tuesday, April 7, 2009 (the "Adherence Period").

To enhance the CDS marketplace's operational efficiency and transparency, New CDS Governance Provisions have been developed by CDS market participants. These New CDS Governance Provisions include: (i) adopting an auction methodology to settle CDS transactions following a credit event; (ii) establishing Derivatives Determinations Committees to, among other things, supersede in part, the traditional role of the calculation agent; (iii) adding the concepts of a credit event backstop date and a succession event backstop date; (iv) eliminating the perceived inequity relating to foreign exchange provisions with respect to the Notice of Physical Settlement (the "NOPS"); and (v) adding a voluntary compression mechanism to facilitate the settlement of loans following a CDS settlement auction.

In addition to the changes set forth in the New CDS Governance Provisions, there are a number of CDS market practice changes proposed by ISDA and market participants that may also be implemented in the near term. These market practice changes include: (1) switching to a fixed coupon of 100 or 500 basis points for CDS transactions and the payment of upfront fees to adjust for market fluctuations; (2) recouponing existing CDS transactions to a fixed coupon of 100 or 500 basis points; (3) standardizing fixed quarterly payment dates for all CDS transactions; (4) phasing out restructuring as a credit event trigger for North American corporates; and (5) eliminating specified reference obligations for all senior unsecured transactions. These market practice changes are not mandated by the New CDS Governance Provisions and are not summarized in this Client Alert. Should any client require further details regarding these proposed changes, a Lowenstein Sandler Derivatives Practice Group attorney is available to provide such information.

Addition of a CDS Auction Settlement Protocol

Almost all single reference entity CDS transactions provide 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. However, as demonstrated by prior CDS settlements following a credit event, the value of CDS transactions written on a particular reference entity is substantially in excess of the value of the references entity's outstanding debt. This imbalance could prevent the orderly settlement of CDS transactions thereby causing severe market disruptions during the settlement process. To mitigate these market disruptions, CDS market participants, through the auspices of ISDA, have participated in ad hoc multilateral CDS auction protocols to facilitate the settlement of CDS transactions. Most recently, CDS auction settlement protocols have been published by ISDA for Station Casinos, Inc., Aleris International, Inc. and Ferretti S.p.A. These CDS auction protocols amend the settlement method pertaining 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 add auction settlement as the settlement method for CDS transactions and adopt standardized auction procedures. These standardized auction procedures are designed to remain consistent from one CDS settlement auction to the next. The adoption of the auction settlement will provide consistency in CDS settlement auction protocols and will eliminate the need for (i) ISDA to publish auction protocols each time a credit event occurs and (ii) protection buyers and sellers to adhere to multiple ad hoc CDS settlement protocols.

Formation of Determinations Committees and External Review Panels to Make Determinations Governing CDS Transactions

Currently, various determinations required for CDS transactions are made by a bilaterally agreed calculation agent (typically the dealer in a dealer/end-user CDS transaction). These determinations include, among others, whether or not a credit event or succession event has occurred. The New CDS Governance Provisions provide that these determinations will be made by newly constituted regional Determinations Committees instead of calculation agents. In addition to making determinations regarding credit and succession events, 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 will be five regional Determinations Committees (the Americas, Asia Ex-Japan, Australia-New Zealand, EMEA (Europe, the Middle East and Africa) and Japan). Each regional Determinations Committee will decide issues involving reference entities traded under transaction types for the relevant region. The regional Determinations Committees will consist of two-thirds dealers representatives and one-third end-user representatives. If a consensus cannot be reached by the relevant Determinations Committee, then an External Review Panel (comprising individuals nominated by ISDA members) shall decide the issue. Determinations made by the Determinations Committees, or, if applicable, the External Review Panels, shall be binding upon market participants adhering to the New CDS Governance Provisions.

The New CDS Governance Provisions contain detailed provisions regulating the purpose, authority, membership and activities of the various Determinations Committees and External Review Panels.

Establishment of Credit Event and Succession Event Backstop Dates

The most fundamental change to CDS transactions contained in the New CDS Governance Provisions is the establishment of a credit event backstop date and a succession event backstop date. Currently, a credit event or succession event under a specific CDS transaction can only be declared if the event occurs between the transactions' effective date and termination date. The New CDS Governance Provisions mandate that, to declare a credit event, the credit event must have occurred no more than sixty calendar days prior to the date that notice of the credit event is made to a Determinations Committee. Similarly, a succession event must have occurred no more than ninety calendar days prior to the date that notice of the succession event is made to a Determinations Committee. Any market participant may request that the relevant Determinations Committee make a determination whether or not a credit or succession event has occurred.

The new credit event and succession event backstop dates (i) implement a time limitation on when such events can be declared and (ii) allow a credit or succession event occurring prior to the effective date of a CDS transaction to be a triggering event for such CDS transaction. These backstop dates place an additional burden on protection sellers. Protection sellers must ensure that no credit event or succession event occurred in the relevant time frame prior to selling such 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 or succession event cannot be declared beyond a relatively short period of time.

Elimination of Perceived Inequity Relating to Foreign Exchange Provisions with Respect to the NOPS

Pursuant to the current 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 upon which a NOPS is originally delivered. However, if a NOPS is amended prior to the physical settlement date (as the current definitions allow), the foreign exchange rate is reset to such 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 set forth in the original NOPS.

Addition of a Voluntary Compression Process for Physical Settlement of Loan CDS Transactions

The New CDS Governance Provisions allow parties to voluntarily compress 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 and Timing to Adhere to New CDS Governance Provisions

The New CDS Governance Provisions will be added to the 2003 ISDA Credit Derivatives Definitions as a supplement. Accordingly, CDS market participants who desire to have the New CDS Governance Provisions govern their prospective CDS transactions need only state in their ISDA transactional documentation that the CDS documentation and transactions governed by such documentation are subject to the 2003 ISDA Credit Derivatives Definitions, as supplemented by the March 2009 Supplement.

CDS counterparties who seek to have the New CDS Governance Provisions govern all their existing CDS transactions should participate in the Big Bang Protocol by submitting one or more Adherence Letters, as applicable, to ISDA during the Adherence Period. Alternatively, CDS counterparties may bilaterally amend their ISDA Master Agreements, individual Confirmations or their CDS Master Confirmation Agreements to incorporate the New CDS Governance Provisions.

The Big Bang Protocol provides for the following phase-in / timing of the New CDS Governance Provisions: (1) the establishment of the Determinations Committees, External Review Panels and auction settlement process will occur on April 8, 2009; (2) 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 sixty and ninety day backstop dates, as applicable, will apply; (3) all market standard documentation will be deemed amended prospectively to include the New CDS Governance Provisions until January 1, 2011; and (4) all novated transactions with a trade date on or prior to January 1, 2011 will be deemed covered by the Big Bang Protocol.

The Big Bang Protocol will not apply to loan only, municipal, ABS, MBS, CDO and certain bespoke portfolio CDO transactions. Of course, as with all ISDA derivative transactions, counterparties are free to amend one or more of their transactions on a bilateral basis to customize such transactions as the counterparties deem appropriate.

As previously stated, participation in the Big Bang Protocol requires the submission of an Adherence Letter to ISDA during the time period beginning on Thursday, March 12, 2009 and ending on Tuesday, April 7, 2009.

The Lowenstein Sandler Derivatives Practice Group attorneys are available to counsel on the benefits and detriments of adhering to the Big Bang Protocol, to assist our clients in preparing and delivering appropriate Adherence Letters, to counsel our clients regarding other CDS market practice changes and to otherwise provide advice regarding CDS transactions or other derivative transactions.

Lowenstein Sandler's Derivatives Practice Group will continue to monitor and report on developments regarding the issues affecting investment managers, pooled investment vehicles and other matters of interest to our clients.

Please contact any of the following attorneys for further information on the matters discussed in this Client Alert.

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1 The summary of the New CDS Governance Provisions set forth in this Client Alert is current as of March 11, 2009. The New CDS Governance Provisions are subject to change until the commencement of the Adherence Period (although we expect changes, if any, will be nonsubstantive). Lowenstein Sandler will continue to monitor any developments and promptly notify our clients if there are any material changes to the proposed New CDS Governance Provisions.

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