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The Big Bang Protocol and A New Structural Framework for Credit Default Swaps

Beginning on April 8, 2009, a new framework will apply to trading in credit default swaps referencing North American corporate credits. To give effect to the new framework, the International Swaps and Derivatives Association, Inc. ("***ISDA***") published the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement (the "***2009 Supplement***") to the 2003 Credit Derivatives Definitions (the "***2003 Definitions***") and the related so-called "***Big Bang Protocol***." The Big Bang Protocol is open for adherence until 5:00 p.m. New York time on April 7, 2009. Contemporaneously with the effectiveness of the 2009 Supplement and the Big Bang Protocol, the credit derivatives industry has agreed to new trading conventions for North American Corporate transactions. The new framework is aimed at further streamlining the CDS market and preparing existing and future CDS trades for central clearing.

The 2009 Supplement

The 2009 Supplement has three main objectives: the establishment of Credit Derivatives Determinations Committees ("***DCs***"); the incorporation of auction settlement provisions as the standard settlement method for credit derivatives transactions; and the introduction of Credit Event and Succession Event Backstop Dates.

The 2009 Supplement amends the 2003 Definitions by establishing DCs for each of the five ISDA regions: the Americas, Asia excluding Japan, Japan, Australia-New Zealand and EMEA. The voting section of each DC will be comprised of eight global and two regional dealers and of five non-dealer ISDA members. ISDA will serve as secretary of each DC. The 2009 Supplement contains detailed rules concerning the composition, procedures and resolutions of the DCs. A DC meeting may be requested by any party to a credit derivatives transaction that is subject to the terms of the 2009 Supplement by notifying ISDA of an issue it believes should be deliberated by such DC. Convened DCs will resolve (1) whether and when a Credit Event has occurred, (2) whether or not to hold an auction to settle credit derivatives transactions for which it was resolved that a Credit Event had occurred, (3) the list of Deliverable Obligations of the relevant Reference Entity, (4) whether and when a Succession Event has occurred, and the identity of the Successor(s) or Substitute Reference Obligations, and (5) matters of contractual interpretation relevant to the credit derivatives markets in general. Market Participants may propose to ISDA supplemental Deliverable Obligations to be added to the list, as well as challenge the inclusion in such list of specified obligations. Resolutions of the DCs generally require a supermajority of 80% of a quorum of DC members (resolutions regarding determinations of the sort described in clause (2) above require a majority of 50%). If a supermajority cannot be obtained as required, the relevant question before the DC will be referred to an external review panel for a final decision. The resolutions of the DCs are binding on a going-forward basis on all transactions that have incorporated the 2009 Supplement. All requests received and all resolutions by the DC will be promptly published by ISDA on a dedicated portion of its website.

The 2009 Supplement further amends the 2003 Definitions to 'hardwire' the CDS auction settlement mechanics as a standard settlement method. The publication of the 2009 Supplement and the Big Bang Protocol is intended to standardize the auction settlement process across different credit derivatives transactions and Credit Events. As a result of being embedded into the 2003 Definitions, ISDA will no longer publish auction protocols for individual Credit Events. The auction settlement methodology incorporated into the 2003 Definitions by the 2009 Supplement is based on the previous auction terms and substantially conforms to the familiar standards. Certain changes have been incorporated, mainly to facilitate simplified settlement of loan delivery obligations that may be created in connection with physical settlement requests. Parties will be able to select 'Auction Settlement' as the settlement method for their trades and will no longer need to monitor and submit adherence letters to have trades covered by the auctions. The DCs will decide whether to hold auctions in respect of each Credit Event and if so, will determine the necessary auction-specific terms applicable to the standard auction settlement terms. No auctions will be held for Restructuring Credit Events, and DCs may decide not to hold an auction for illiquid Reference Entities. If no auction is held, or parties have not selected 'Auction Settlement' in their confirmations or have not adhered to the Big Bang Protocol, relevant transactions will be settled in accordance with the applicable fallback settlement method specified in the confirmations.

Finally, the 2009 Supplement creates a 60-day backstop date for Credit Events and a 90-day backstop date for Succession Events. Under current credit derivatives transactions, parties have the right to trigger the contract based upon events that occur between the Effective Date and the Scheduled Termination Date (subject to possible extensions). This leaves investors exposed to possible basis risk: if an investor enters into offsetting trades with different Effective Dates but otherwise identical terms, he will not be fully hedged to the extent a Credit Event or Succession Event had occurred between the two Effective Dates as only the first trade but not the second trade would be subject to exercise. The rolling Effective Date concept achieves consistency across transactions. Under the new backstop dates, a credit derivative transaction can only be triggered by a Credit Event and/or affected by a Succession Event that occurs during the 60-day or 90-day period, respectively, before the earlier of (1) the date on which a request to the DC regarding such event is submitted (assuming the DC decides to resolve the question) and (2) the date on which a Credit Event Notice and Notice of Publicly Available Information (if required) or Succession Event Notice, as applicable, are effectively delivered to the other party. To be clear, the rolling look-back period also extends to the 60/90-day period prior to the Trade Date. The single look-back period allows parties to fully hedge their positions through offsetting trades even if those trades are not entered into on different Trade Dates.

The 2009 Supplement is incorporated into the DTCC Operating Procedures and therefore will automatically apply to electronic trades executed through DTCC on or after April 8, 2009.

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The Big Bang Protocol

The 2009 Supplement applies to all future trades referencing the amended 2003 Definitions (including those traded under master confirmation agreements). Parties to existing trades that reference the 2003 Definitions who wish to give effect to the 2009 Supplement terms for those historic trades are given the opportunity to amend their existing trades on a multilateral basis with all other adhering counterparties by adhering to the Big Bang Protocol. Following adherence, covered existing transactions will be subject to the DC provisions after April 8, 2009. Similarly, the auction settlement provisions will readily apply to all covered transactions with the exception of certain ‘Covered Non-Auction Transactions.’ The Credit Event and Succession Event Backstop Dates will apply to historic trades only after June 20, 2009. The delayed effectiveness of the backstop dates gives parties the opportunity to notify the DC of, and hence “stop the clock” for, events that may affect their existing trades and that have occurred more than 60/90 days prior to adherence to the Big Bang Protocol.

Different from previous ISDA protocols, the Big Bang Protocol also covers future credit derivative transactions entered into or novated between adhering parties on or after April 8, 2008 but before January 31, 2011. The proactive amendment of future trades recognizes the industry practice to confirm transactions using standard trade documentation, which may have not yet been amended to incorporate the 2009 Supplement standard. The forward-looking coverage period allows ISDA time needed to update existing form documents.

The Big Bang Protocol covers the same broad range of credit derivatives transactions that were included in previous CDS auctions, including index transactions (CDX and iTraxx tranched and untranched), swaption transactions (single name and portfolio) and non-swaption transactions (including single name, Nth to default, recovery lock, bespoke portfolio transactions) as well as several types of so-called ‘Covered Non-Auction Transactions’ that traditionally have not been subject to auctions. Covered Non-Auction Transactions are Reference Obligation Only Transactions, Fixed Recovery Transactions, Preferred CDS Transactions and those transactions that parties expressly agreed to settle outside any auction. The Big Bang Protocol does not amend Loan Only Transactions, U.S. municipal transactions, CDS on ABS transactions and certain interdealer index trades.

Parties who choose to adhere to the Big Bang Protocol must complete and execute an adherence letter and submit scanned original and conformed copies of the letter by e-mail to ISDA. A copy of the text of the Big Bang Protocol and a copy of the adherence letter is available on ISDA’s website, www.isda.org. ***The Big Bang Protocol opened for adherence on March 12, 2009 and remains open for adherence until 5:00 p.m. New York time on April 7, 2009***. Parties may not revoke their adherence.

New CDS Trading Conventions

Concurrently with and in addition to the publication of the 2009 Supplement terms and the Big Bang Protocol, the credit derivatives industry has agreed to further standardize a number of trading conventions for Standard North American Corporate CDS trades (‘SNACs’). ISDA will facilitate trading in the new standards by amending applicable form documentation and by publishing an updated Physical Settlement Matrix that will apply to future contracts, also known as “100/500 contracts.” These new conventions will not apply to existing legacy trades but beginning on April 8, 2009, traders will commence quoting new contracts using these conventions.

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Future CDS contracts will be quoted with fixed coupons and upfront payments, and will trade No-R. CDS on investment grade Reference Entities will stipulate a fixed coupon of 100 basis points and be quoted with a flat curve spread. High-yield Reference Entities will trade on a fixed 500 basis points spread and be quoted in up-front points. Scheduled Termination Dates will always match one of the March 20, June 20, September 20 or December 20 quarterly roll dates applicable to index trades. Coupon accruals will commence no longer on the Effective Date but rather on the last quarterly roll date on or before the Trade Date. Stub periods will be dealt with through upfront payments. The trading standard for SNAC transactions will be No Restructuring. This will mainly impact trades on investment grade entities and ‘fallen angels’ as they routinely included Modified Restructuring as one of the applicable Credit Events. If parties desire, they may elect for Mod-R to apply for their bespoke transactions. The standardization will only apply to North American contracts and it remains to be seen if European markets will phase out their Mod-Mod-R standard to No-R, since European markets are subject to different capital requirements for hedges that do not include Restructuring, and applicable insolvency regimes prompt more out-of-court restructurings.

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This memorandum does not purport to and should not be considered to address all relevant issues under the Protocol. It is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on the content of this memorandum. For further information and questions regarding the issues discussed in this memorandum, please contact Manuel S. Frey at (212) 373-3127 or Jordan E. Yarett at (212) 373-3126.