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# Alert

## ISDA Proposes Supplement to 2003 Credit Derivatives Definitions

### February 11, 2009

In an effort to further standardize the over-the-counter ("OTC") credit derivatives market and to create transparency, the International Swaps and Derivatives Association, Inc. ("ISDA") has proposed a supplement to the 2003 ISDA Credit Derivatives Definitions (the "2003 Definitions"). The supplement will fundamentally change the way in which credit default swaps trade and operate by addressing critical issues such as how to determine whether a credit event has occurred and what obligations may be delivered.

The proposed supplement implements six main concepts: (i) a committee of rotating ISDA members (the "Determinations Committee") for each region that will determine the details of each credit event and succession event, (ii) a 60-day "look-back" limitation on the determination of credit events and succession events, (iii) a new auction settlement method based on ISDA's recent credit derivative auction protocols, (iv) standard quarterly payment dates and accrual periods for fixed amounts under all credit default swaps, (v) changes to the determination of the currency exchange rate for physical settlement, and (vi) a new method to accelerate the physical settlement process for loans.

ISDA intends that the proposed supplement be incorporated automatically into all future trades that reference the 2003 Definitions unless the parties specify otherwise in their documentation. ISDA will also publish a protocol (the "Big Bang protocol") by which parties may elect to incorporate the supplement into their pre-existing trades. ISDA has stated that adherence to the Big Bang protocol by all participants in the OTC credit derivatives market is an important step to ensuring that the market remains liquid. ISDA intends to circulate a draft of the Big Bang protocol on Feb. 12.

Under the proposed supplement, the role of the Determinations Committee will be to determine the details of each credit event and succession event, including, as applicable, (i) the type and date of the event, (ii) the date of a valid notice of publicly available information, (iii) the date of receipt of a credit event notice, (iv) what obligations constitute deliverable obligations, and (v) what obligations constitute substitute reference obligations. These determinations, as made by the Determinations Committee, will bind all adhering counterparties. The Determinations Committee will also decide whether to hold an auction to settle the related credit default swap transactions and will control the terms of and participation in such auction.

There will be one Determinations Committee for each of the three major regions: the Americas, Europe and Asia. Each Determinations Committee will comprise (i) eight global dealers, (ii) two regional dealers from the applicable region, and (iii) five buy-side members. The members of each Determinations Committee will rotate, periodically and as needed, pursuant to a system set forth in the Determinations Committee rules.

The criteria for membership on the Determinations Committee, like the rest of the proposed supplement, are subject to further discussion. Under the current draft, to be eligible for membership on the Determinations Committee, a party must adhere to the Big Bang protocol. For dealer members, each must have participated in ISDA's credit default swap auction protocols and preference will be given initially to those with the largest notional trade volumes. For buy-side members, each must have at least $1 billion in assets under management and $1 billion in notional single-name credit default swaps. Also, the group of buy-side members must contain at least one hedge fund and at least one traditional asset manager.

When determining whether a credit event or a succession event has occurred, ISDA has proposed a 60-day "look-back" limitation on the Determinations Committee's review. Under the current draft of the supplement, the Determinations Committee will be able to declare a succession event only if it receives notice within 60 days of the occurrence of the event. ISDA intends that the determination of credit events will be subject to the same limitation which will be included in future drafts of the proposed supplement.

The proposed supplement will add auction settlement as a settlement method under all credit default swaps. The auction methodology and mechanics are based on those used in ISDA's recent credit default swap auction protocols. During an auction, dealers submit bids and offers, on behalf of themselves and their clients, to the auction administrators who determine the final price for the affected reference obligation. Once a final price is determined, only a small number of trades physically settles; all others cash settle using the final price determined by the auction. If the auction fails to determine a final price (or if the Determinations Committee decides not to hold an auction), trades will default to physical settlement or, if the parties thereto so specify, cash settlement.

A significant economic change under the proposed supplement is the implementation of standard quarterly payment dates and accrual periods for fixed amounts under all credit default swap transactions. Currently, parties to a credit default swap transaction may specify in the related confirmation any dates they choose as the accrual periods and payment dates for fixed amounts. The proposed supplement changes all fixed rate payer payment dates to March 20, June 20, Sept. 20 and Dec.20. Additionally, fixed amounts will begin to accrue not on the effective date of the trade, but on the quarterly payment date on or immediately prior to the trade date. This means that protection buyers will pay for protection from prior to the trade date and, accordingly, credit events and succession events that occur prior to the trade date will affect the trade.

The proposed supplement also amends the method by which the currency rate conversion is calculated when the protection buyer delivers a deliverable obligation that is denominated in a currency other than the settlement currency. Under the current 2003 Definitions, a protection buyer can take advantage of fluctuations in currency exchange rates by amending its notice of physical settlement even if it does not change the deliverable obligations thereunder. The proposed supplement locks in the currency rate for each deliverable obligation, and determines the currency rate for each updated deliverable obligation based on the one that it replaced.

Finally, the proposed supplement allows parties to voluntarily "compress" the physical settlement process for loans. If a loan must be delivered several times during physical settlement before reaching its final holder, under the proposed supplement the protection buyer that first transfers the loan will have the option, subject to necessary consents, to skip the intermediate parties and deliver the loan directly to the ultimate protection seller. The intermediate parties will then settle their respective back-to-back trades through cash settlement.

The information herein is based on the Feb. 6 draft of the proposed supplement and is subject to change with the release of future drafts. ISDA expects to publish the final version of the supplement, including the auction rules and Determinations Committee rules, and to offer the Big Bang protocol for adherence, on March 2.

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If you have any questions concerning the effects of the proposed settlement, please contact:


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