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Alert

New 2014 ISDA Credit Derivatives Definitions to Go into Effect — Protocol Adherence Period Open

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On Aug. 21, 2014, the International Swaps and Derivatives Association ("ISDA") published the 2014 ISDA Credit Derivatives Definitions Protocol (the "Protocol") to permit parties to credit default swaps ("CDS") to apply the 2014 Credit Derivatives Definitions (the "2014 Definitions") to certain of their existing CDS governed by the ISDA 2003 Credit Derivatives Definitions (the "2003 Definitions"). ISDA adopted the 2014 Definitions in February 2014, and CDS trading using the 2014 Definitions is expected to begin on Sept. 22, 2014, the next quarterly "roll date" for traded CDS. By adhering to the Protocol, a party consents to the incorporation of the 2014 Definitions (subject to certain exceptions described in this *Alert*) in its CDS that are "Covered Transactions" governed by the 2003 Definitions with each of its counterparties that have also adhered to the Protocol. The Protocol is now open for adherence through Sept. 12, 2014, and a party may adhere to the Protocol on ISDA's website; as discussed herein, market participants must decide whether to adhere to the Protocol prior to Sept. 12, 2014, because the 2014 Definitions may result in significant changes to CDS transactions that are currently governed by the 2003 Definitions.

This *Alert* provides a general overview of the 2014 Definitions and the Protocol and summarizes the implications of adherence to the Protocol.

Overview of the 2014 Definitions

Two broad trends drove the development and adoption of the 2014 Definitions: (1) the need to update the 2003 Definitions to reflect changes in CDS market practices over the past 11 years and to consolidate the various amendments, updates and protocols to the 2003 Definitions (including, most importantly, the 2009 "Big Bang Protocol" that hardwired into CDS the auction settlement process under the auspices of ISDA's Credit Derivatives Determinations Committee); and (2) a desire among market participants to address failures in the 2003 Definitions that were exposed during and after the global financial crisis.

The 2014 Definitions introduce provisions intended to:

- Address the effect of "bail-ins" and similar interventions by governments on distressed financial institutions;
- Permit the settlement of CDS for which credit events have occurred, notwithstanding the disappearance (whether by exchange or expropriation) of reference obligations or deliverable obligations; and

- Reduce the risk of “orphan CDS” caused by the inflexibility of the Succession Event provisions of the 2003 Definitions.

Financial Reference Entities

A number of the most significant changes introduced in the 2014 Definitions relate to Reference Entities that are financial institutions (“Financial Reference Entities”) to which new “Financial Reference Entity Terms” will apply. Financial Reference Entities will be subject to the new Government Intervention Credit Event, senior/subordinated Reference Obligation split and Asset Package Delivery Terms, in each case as described below. Although the final Physical Settlement Matrix terms for use with the 2014 Definitions have not yet been published, ISDA has indicated that the Financial Reference Entity Terms will apply only to financial institutions in Europe (excluding Emerging Market Europe), Asia, Australia and New Zealand.

Governmental Intervention

In 2013, the Dutch government nationalized the failing SNS Bank BV (“SNS”) and expropriated all of its subordinated bonds as part of a bail-in to impose losses on SNS’s junior creditors. The expropriation of obligations of a Reference Entity is not addressed in the terms governing Restructuring Credit Events in the 2003 Definitions, and the specific facts of the expropriation were such that neither a Failure to Pay nor a Bankruptcy Credit Event could be deemed to have occurred. Although the ISDA Credit Derivatives Determination Committee eventually determined that a Restructuring Event had in fact occurred (based on the *de facto* reduction in principal of SNS’s subordinated bonds), the 2003 Definitions’ failure to fully address government-imposed bail-ins (both in the specific case of SNS and, more generally, in the terms of the EU Bank Recovery and Resolution Directive set to come into force in 2016) created significant market uncertainty.

In response, the 2014 Definitions introduce a new credit event, Governmental Intervention. Governmental Intervention covers any action or announcement made by a governmental authority against a Reference Entity or its Obligations resulting in binding changes to one or more of such Obligations, including: (1) a reduction or postponement of principal of or interest on any such Obligation; (2) further subordination of any such Obligation; (3) an expropriation, transfer or other event which mandatorily changes the beneficial holder of the Obligation; or (4) a mandatory cancellation, conversion or exchange of any such Obligation.

Although the Governmental Intervention Credit Event and the Restructuring Credit Event are similar in a number of ways, there are two key differences: the Governmental Intervention Credit Event requires neither a deterioration of creditworthiness of the Reference Entity nor the satisfaction of the conditions applicable to a Multiple Holder Obligation (if the Multiple Holder Obligation were to apply to the Reference Obligation for purposes of a Restructuring Credit Event). Additionally, a Governmental Intervention Credit Event can occur even if the relevant event is expressly contemplated by the terms of an Obligation.

For new transactions entered into on or after Sept. 22, 2014, the Governmental Intervention Credit Event can apply (depending on the election of the parties) to Western Europe, Japan, Asia Ex-Japan (including Singapore), Australia and New Zealand Financial Reference Entities; the Governmental Intervention Credit Event will not apply to U.S., Emerging EMEA and Latin America Financial Reference Entities.

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Separation of Senior and Subordinated Reference Obligations
The 2014 Definitions introduce a distinction between the senior and subordinated obligations of a Financial Reference Entity in two circumstances. First, if a Financial Reference Entity experiences a Governmental Intervention or a Restructuring Credit Event solely with respect to its subordinated obligations, the relevant Credit Event will only occur under CDS referencing the subordinated obligations, and any CDS referencing the senior obligations will be unaffected. For any other Credit Event applicable to the Reference Entity, the foregoing split of Reference Obligations does not apply; any such Credit Event will trigger a Credit Event under all CDS, regardless of whether the Credit Event occurs with respect to senior or subordinated obligations.

Second, when determining Successors pursuant to the 2014 Definitions (discussed below), if a Financial Reference Entity's senior and subordinated obligations are assumed by separate Successors, the CDS referencing the senior obligations will subsequently reference the Successor assuming the senior obligations, and the CDS referencing the subordinated obligations will subsequently reference the Successor assuming the subordinated obligations.

In addition to the foregoing, the Asset Package Delivery Terms described below will also apply to Financial Reference Entities.

Successors
Under the 2003 Definitions, the Successor to a Reference Entity was required to be determined within 90 days after the occurrence of a "Succession Event," defined as "an event such as a merger, consolidation, amalgamation, transfer of assets or liabilities, demerger, spin-off or other similar event in which one entity succeeds to the obligations of another entity, whether by operation of law or pursuant to any agreement" (2003 Definitions, Section 2.2(b)) that results in the succession of one or more entities to the obligations of a Reference Entity. If a Successor could not be determined within the 90-day limit, or if one or more entities assumed a Reference Entity's obligations in the absence of a Succession Event (or in multiple stages, with the transfer at each stage below the minimum threshold required for the determination of a Successor under the 2003 Definitions), the Reference Entity could have no Reference Obligations outstanding and no Successors, leaving a buyer of CDS protection on the Reference Entity with an "orphan CDS" on which the protection buyer remained obligated to pay fixed amounts, although it could never receive a credit protection payment.

The 2014 Definitions address these issues arising under the 2003 Definitions by:

- Eliminating the Succession Event requirement, so that a Successor (or Successors) may be determined upon the assumption of a specified percentage of a Reference Entity's obligations;
- Introducing the concept of a Universal Successor, a single entity that assumes all of a non-Sovereign Reference Entity's obligations in circumstances where the Reference Entity has ceased or will cease to exist or is in the process of being dissolved;
- Eliminating the 90-day "look-back" limit for non-Sovereign Reference Entities succeeded by a Universal Successor by establishing a single backstop date of Jan. 1, 2014 for all Universal Successors;

- For non-Sovereign Reference Entities whose obligations are assumed by more than one Successor, pursuant to a Steps Plan (as described below) or otherwise, eliminating the requirement that the events giving rise to succession be completed within any set period; and
- Permitting a Successor to be determined pursuant to a Steps Plan, in which a series of transfers of a Reference Entity's obligations occurring pursuant to a pre-determined transfer plan (which may occur in multiple steps) are aggregated for purposes of determining whether a sufficient percentage of the Reference Entity's obligations have been assumed in order to designate a Successor.

Under the 2014 Definitions, if a Steps Plan applies, a Successor can be determined as of the Succession Date, which is the earlier of the effective date of the final transfer pursuant to such Steps Plan, or the date on which a transfer can result in no greater percentage of obligations being assumed by the relevant Successor.

Asset Package Delivery Terms

A response in part to Greece's 2012 debt restructuring, the 2014 Definitions permit settlement of Restructuring or Governmental Intervention Credit Events occurring with respect to Financial Reference Entities and Sovereign Reference Entities in circumstances where all Deliverable Obligations have been expropriated or exchanged for obligations that do not satisfy the relevant Deliverable Obligation Criteria. In these circumstances, the 2014 Definitions include the Asset Package Delivery Terms, which provide a basis for the settlement of Reference Obligations that no longer exist at the time of settlement. The Asset Package Delivery Terms will apply only to Financial Reference Entities and Sovereign Reference Entities. For Financial Reference Entities, the Asset Package consists of the proceeds of the Prior Deliverable Obligation (an existing Deliverable Obligation immediately prior to the relevant Credit Event), and the Asset Package Delivery Terms provide for the delivery of the assets resulting from the conversion of the relevant Deliverable Obligations into the CDS Auction or under the CDS. For Sovereign Reference Entities, the 2014 Definitions provide instead for valuation to be based on a Package Observable Bond, which is a benchmark obligation of the relevant Sovereign that is identified by ISDA for these purposes and published on its website.

For new transactions entered into on or after Sept. 22, 2014, the Asset Package Delivery Terms can apply (depending on the election of the parties) to: (1) in the case of Financial Reference Entities, Western Europe, Japan, Australia and New Zealand Financial Reference Entities; and (2) in the case of Sovereign Reference Entities, U.S., Western Europe, Japan, Australia and New Zealand Sovereign Reference Entities. The Asset Package Delivery Terms will not apply to Emerging EMEA and Latin America Reference Entities.

Additional Terms

The 2014 Definitions provide that the Reference Obligation for each Reference Entity is the Standard Reference Obligation, which is the Obligation of the Reference Entity of the relevant Seniority Level, as determined by ISDA and included on the SRO List published on ISDA's website. If no Standard Reference Obligation is specified for a Reference Entity (or for a particular Seniority Level for a Reference Entity), or if the parties opt out of the Standard Reference Obligation terms, the parties to a CDS may agree on the Reference Obligation that will apply to the CDS. The inclusion of Standard Reference Obligations both reduces the risk of trade breaks, because parties will no longer need to match the Reference Obligation,

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and eliminates the potential for basis risk between CDS referencing the same Reference Entity but different Reference Obligations.

The 2014 Definitions make a number of additional changes intended to address various provisions of the 2003 Definitions that are inadequately defined or for which the market practice has changed. While beyond the scope of this *Alert*, these provisions include (among others) changes to the definitions of Restructuring (and the variants thereof, Mod R and Mod Mod R), Outstanding Principal Balance and Qualifying Guarantee. Additionally, the 2014 Definitions expressly provide for a Eurozone member state to leave the Euro; the redenomination of a state's currency from Euro to a new currency will generally not constitute a Restructuring Credit Event, as long as the successor currency is freely tradable.

Adherence to the Protocol

The Protocol is now open for adherence through Sept. 12, 2014. ISDA may elect to extend the adherence period, depending on response from the market, but there is no guarantee of any extension, and ISDA may terminate the Protocol if market participation is limited. It is possible for a party to revoke its adherence to the Protocol prior to Sept. 12, 2014.

ISDA has established a website with information related to the 2014 Definitions and the Protocol. The website contains general information relating to the 2014 Definitions, including a link to a preliminary draft of the Physical Settlement Matrix that will apply to CDS beginning Sept. 22, 2014 (and to existing CDS to which the 2014 Definitions will apply pursuant to the Protocol) and the list of Excluded Reference Entities, as well as a link to the ISDA's Protocol adherence website, where parties can submit their adherence documentation (a $500 fee payable to ISDA applies to any party wishing to adhere). Additionally, prior to the Sept. 22, 2014 implementation of the 2014 Definitions, Markit will publish revised iTraxx and CDX Standard Terms Supplements and Confirmations to give effect to the 2014 Definitions for iTraxx and CDX transactions trading on and after the September roll date.

The Protocol applies only to Covered Transactions, which include Covered Index Transactions (including CDX and iTraxx Tranched and Untranched), Covered Swaption Transactions (single name and portfolio) and Covered Non-Swaption Transactions (e.g., Single Name, Fixed Recovery, Recovery Lock, Nth to Default and Bespoke Portfolio Transactions). Transactions that are not Covered Transactions, including Loan Only and U.S. Municipal Type transactions, and CDS on ABS, are not covered by the Protocol.

The Protocol expressly excludes transactions referencing Excluded Reference Entities, which are set forth in the list published on the ISDA website and generally include any Reference Entity to which the Financial Reference Entity Terms will apply and any Sovereign Reference Entity to which the Asset Package Delivery Terms will apply. These exclusions were adopted to avoid the substantial changes in economics that would result in a change to the 2014 Definitions in CDS including these Reference Entities. The 2003 Definitions will continue to apply to any transaction referencing Excluded Reference Entities (in whole or in part, as described in the next paragraph). For any existing transaction (1) where both parties have adhered to the Protocol, and (2) Financial Reference Entities and/or Sovereign Reference Entities that are not Excluded Reference Entities are involved, the Governmental Intervention Credit Event and Asset Package Delivery Terms will not apply to non-excluded Financial Reference Entities, and the Asset Package Delivery Terms will not apply to non-excluded Sovereign Reference Entities. For new transactions entered into on and after Sept. 22, 2014, the Governmental Intervention Credit Event and Asset Package Delivery Terms will apply to Reference Entities in the manner described

above under “Financial Reference Entities — Governmental Intervention” and “Asset Package Delivery Terms,” respectively.

Prior to the expiration of the adherence period, market participants should determine whether they wish to convert their existing CDS to the 2014 Definitions. There are material differences between the two sets of definitions that can affect market pricing and liquidity; for example, for a given Reference Entity, an event may constitute a Credit Event under one set of definitions, but not under the other. Most new CDS entered into on and after Sept.12, 2014 will be documented using the 2014 Definitions, and the 2014 Definitions are expected to eventually replace the 2003 Definitions across the marketplace. However, existing CDS referencing Excluded Reference Entities will continue under the 2003 Definitions, and basket or index trades referencing at least one Excluded Reference Entity will be governed in part by both sets of definitions; adherence to the Protocol by a party to basket or index trades will result in “mixed baskets,” with the Excluded Reference Entities governed by the 2003 Definitions, and the non-excluded Reference Entities governed by the 2014 Definitions.

Market participants should carefully analyze their CDS exposure by Reference Entity and counterparty before deciding whether to adhere to the Protocol. Additionally, market participants should review the list of adhering parties available on ISDA’s Protocol website. Basis risk could arise if some, but not all, of a market participant’s counterparties adhere to the Protocol — most obviously, in the case of offsetting CDS trades with different counterparties, where the original and offsetting CDS transactions are governed by different definitions because only one of the two counterparties elected to adhere to the Protocol.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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