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Redefining CDS – ISDA's 2014 Credit Derivatives Definitions Protocol

On August 21, 2014, the International Swaps and Derivatives Association ("**ISDA**") published the 2014 ISDA Credit Derivatives Definitions Protocol (the "**Protocol**"), the newest installment of ISDA's well-tested mechanism aimed at facilitating the multilateral and standardized amendment of swap trading documentation. The Protocol enables market participants to incorporate the 2014 ISDA Credit Derivatives Definitions (the "**2014 Definitions**") into their existing credit default swap ("**CDS**") documentation. This Client Alert describes key features of the 2014 Definitions that will influence a market participant's decision regarding Protocol adherence and explains how to adhere to the Protocol.

I. The 2014 ISDA Credit Derivatives Definitions

Overview

The 2014 Definitions, which will go into effect on September 22, 2014, simultaneously preserve the core mechanics of the 2003 ISDA Credit Derivatives Definitions (together with the various supplements[1] that, among other things, introduced an extensive auction settlement procedure and the Credit Derivatives Determination Committees, the "**2003 Definitions**") and provide a wholesome revision reflecting both anticipated changes in legislation concerning restructuring and resolution of financial entities and lessons learned in the past ten years from such events as the European sovereign debt crisis. Among the most important features of the 2014 Definitions are the introduction of the Standard Reference Obligation, the Governmental Intervention Credit Event, the Asset Package Delivery provisions and the Financial Reference Entity Terms, and the replacement of the Succession Event with the Steps Plan.

Standard Reference Obligation

In an effort to promote liquidity and standardization in the CDS marketplace and facilitate smooth central clearing, the 2014 Definitions introduce the concept of a "Standard Reference Obligation" (the "**SRO**"). Unless parties to a CDS contract affirmatively elect otherwise, the SRO will serve as the Reference Obligation with respect to all such contracts between the parties referencing the same Reference Entity and seniority level. SROs will be published by ISDA (or its designee) in an "SRO List" for certain frequently traded Reference Entities. With certain limited exceptions, if a SRO is removed from the SRO

[1] *See, e.g.*, the 2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the ISDA 2003 Credit Derivatives Definitions, *available at* http://www.isda.org/companies/auctionhardwiring/auctionhardwiring-cddc.html.

List, the transaction will be deemed to have no Reference Obligation until a new SRO is included in the SRO List. It should be noted that market participants are free to specify a Reference Obligation of their choosing and must do so for Reference Entities not covered by the SRO List.

Governmental Intervention Credit Event

In light of the recent experience with, and anticipated legislation regarding, government "bail-outs" of major financial institutions and corresponding "bail-ins" by creditors, the 2014 Definitions add a new Credit Event to clarify when and if such bail-ins should trigger CDS contracts. This new Credit Event – "Governmental Intervention" – is a variant of the Restructuring event, capturing reductions in principal and/or interest, subordination, expropriation, postponement and other structural changes to indebtedness that result specifically from government action, even in the absence of deterioration in the creditworthiness of the Reference Entity. As a result, holders of CDS referencing an entity subject to a government's decision to force creditors to "bail in" and contribute in a bail-out scenario with respect to such Reference Entity will be able to clearly determine whether or not a Credit Event under such CDS has occurred.

Asset Package Delivery

Partly in response to settlement issues raised in connection with the Greek sovereign debt default, the 2014 Definitions introduce "Asset Package Delivery" and "Asset Package Credit Event" to address the difficulties faced by market participants in settling CDS contracts referencing indebtedness that has been exchanged or converted, whether pursuant to a bail-in, forgiveness of sovereign debt, or other restructuring of a financial institution not otherwise addressed by the 2003 Definitions.

In the case of financial institution debt, the 2014 Definitions permit the delivery upon CDS settlement of an asset package conveyed through an exchange or conversion in consideration of "Prior Deliverable Obligations". In the case of sovereign debt, an asset package conveyed in consideration of one or more "Package Observable Bonds" may be delivered. A list of such bonds, selected by ISDA (or its designee) by reference to bonds that would generally satisfy the definitional standards for deliverable obligations in the context of sovereign CDS, will be publicly available at all times.

Financial Reference Entity Terms

In an attempt to prevent a Governmental Intervention or other Restructuring with respect to subordinated debt from triggering all CDS contracts referencing a given Reference Entity, the 2014 Definitions permit market participants to elect "Financial Reference Entity Terms" and effectively differentiate Credit Events affecting the referenced debt from those affecting debt junior to the referenced debt. For example, if "Financial Reference Entity Terms" is specified as applicable, a Credit Event with respect to an obligation of a Reference Entity will not, on its own, constitute a Credit Event with respect to a senior obligation of that Reference Entity.

Key Changes to Succession Events

The 2014 Definitions include provisions to reduce the creation of "orphaned" CDS following certain restructurings. First, in order to address a circumstance where a Succession Event in respect of a non-sovereign Reference Entity is not identified until after the expiration of the prescribed 90-day look-back period, the 2014 Definitions will assign the "Universal Successor" (i.e., the entity that assumes all of the obligations of the Reference Entity) as the Successor regardless of the backstop date so long as the Succession Date occurred on or after January 1, 2014. Additionally, in an effort to capture successions that occur gradually in stages that would otherwise not trigger a Succession Event under the 2003 Definitions, the 2014 Definitions replace the concept of "Succession Event" in its entirety with the concept of a "Steps Plan," which allows for determination of Successors, including through exchange offers, based on a series of successions to Reference Entities or their obligations that may occur over a period of time.

Other Changes

In the interest of brevity, the above represents only a highlight of some of the key changes in the 2014 Definitions that may influence a market participant's decision whether or not to adhere to the Protocol. There are a number of other changes and technical amendments to the 2014 Definitions beyond the scope of this Client Alert.

II. Adhering to the Protocol

How Does the Protocol Work?

The Protocol adopts a similar approach to prior ISDA protocols. Adherents must submit an adherence letter to ISDA at ISDA's website. Unlike the recent ISDA August 2012 DF Protocol and the ISDA March 2013 DF Protocol, adherents need not exchange questionnaires with other market participants.

What am I Agreeing to by Adhering?

By adhering to the Protocol, you are agreeing to apply the 2014 Definitions to your existing CDS relationships, with certain limited exceptions. For instance, the Protocol does not apply to CDS referencing entities listed on the "Excluded Reference Entity List" published by ISDA from time to time (which includes a number of sovereigns, financial institutions and some corporations). The precise impact of adherence will depend on the dynamics of the trade(s) to which the 2014 Definitions will apply. Note that the Protocol explicitly contemplates that market participants may bilaterally choose to exempt certain transactions from the scope of Protocol adherence.

What is the Timeline for Adherence?

Market participants may adhere to the protocol until September 12, 2014 (the "**Cut-off Date**"). While ISDA retains the right to extend the Cut-off Date to a date not later than September 18, 2014, such an extension is not guaranteed. It is important to note, however, that the Protocol terms can always be bilaterally incorporated into existing and future documentation outside the ISDA Protocol process.

How Do I Adhere?

In order to adhere, market participants must provide ISDA (via ISDA's website) with an adherence letter indicating their desire to adhere to the Protocol. While the process of downloading, signing, and uploading the signed letter is simple, high volume may lead to delayed response times from ISDA. Accordingly, clients wishing to adhere are advised to process their adherence letters sooner than later.

Where Do I Obtain an Adherence Letter? Is There a Fee for Adhering?

Adherence letters may be obtained on ISDA's website at the following URL (login required):

https://www2.isda.org/functional-areas/protocol-management/submit-adherence-letter/.

ISDA charges a $500 fee for the submission of each letter.

Is Adherence Necessary?

Adherence is not necessary and should be carefully considered. It is expected that a considerable majority of market participants will adopt the 2014 Definitions, and dealers will likely request that their buy-side clients adhere and/or incorporate the Protocol terms in future ISDA negotiations. Clients prioritizing CDS execution on liquid market terms to facilitate trading may generally wish to adhere to the Protocol. However, where specific CDS positions referencing certain Reference Entities constitute a significant role in strategy, the costs and benefits of adherence should be carefully weighed.

As of the date of this publication, 28 market participants (mostly dealers) have adhered. A list of current adhering parties is available at:

http://www2.isda.org/functional-areas/protocol-management/protocol-adherence/19/.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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