

The ISDA Credit Derivatives Determinations Committees

1. INTRODUCTION

Since 2009, each of the five regional Credit Derivatives Determinations Committees (each, a **DC**) has made binding contractual determinations for issues relating to credit default swaps (**CDS**). The terms of a standard CDS contract incorporate a uniform set of definitions, the Credit Derivatives Definitions published by ISDA,¹ as well as transaction-specific elections. At the point in time when a CDS contract is entered into, the two parties thereto agree that the contract will be governed by the Credit Derivatives Definitions and that the determinations of the relevant DC will be binding on the contract.

The role of the DC is to compare the facts of specific events, based on publicly available information, with the provisions of standard CDS contracts (including the Credit Derivatives Definitions) to make determinations regarding key provisions of such contracts, including:

- (a) whether a Credit Event (an event that would trigger the settlement of the CDS and allow the protection buyer to obtain payment for the credit protection purchased) has occurred;²
- (b) whether an auction should be held to determine the final price for CDS settlement; and
- (c) which obligations should be delivered or valued in the auction.

Determinations regarding possible credit events receive a great deal of focus in the market and in the media. On 83 occasions, the DCs have been asked to consider whether a credit event had occurred. In 63 of those cases, the DCs decided that a credit event had in fact occurred.

This note describes the role of the DCs as market-wide interpretive bodies. Section 2 describes how the DCs were established, how the members of the DCs are selected and the structural checks and balances embedded in the DC Rules to ensure a robust deliberative process. Section 3 describes the economic and policy drivers that led to the establishment of the DCs, including a description of requests from regulators for a market-wide CDS auction settlement process.

2. CURRENT STRUCTURE OF THE ISDA CREDIT DERIVATIVES DETERMINATIONS COMMITTEES

2.1 Establishment of the DCs

The DC Rules establish the composition, powers, responsibilities and obligations of the DCs and their respective members.

- (a) The DCs were formally established in 2009 with the publication of the DC Rules in connection with the **Big Bang Protocol** and the March 2009 Supplement to the Credit Derivatives

¹ See the 2003 ISDA Credit Derivatives Definitions, as supplemented by the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions, published on July 14, 2009 (as supplemented, the **Credit Derivatives Definitions**). See also the Credit Derivatives Determinations Committees Rules (July 11, 2011 Version) (the **DC Rules**), as published by ISDA. Capitalized terms used but not defined in this note have meanings given to such terms in the Credit Derivatives Definitions and the DC Rules.

² Note that a DC's determination of whether or not a Credit Event has occurred is not binding with respect to any contract that has not expressly incorporated the Credit Derivatives Definitions. A Credit Event determination does not necessarily mean that the Reference Entity is in default under the terms of any of its contractual obligations, and similarly not all defaults by a Reference Entity will trigger a Credit Event.

Definitions³. The DC Rules were developed following commitments to regulators as part of a public drafting process administered by ISDA and supported by such regulators.⁴ This drafting process extended over three months (from January to March 2009) and involved multiple public distributions of interim drafts to regulators and market participants. The DC Rules were revised during this process to incorporate comments received from market participants, including both dealers and non-dealers. In addition, input was received from regulators.

- (b) The DC Rules were further revised in connection with the **Small Bang Protocol** and July 2009 Supplement to the Credit Derivatives Definitions,⁵ again with public input.

2.2 Composition of the DCs

Pursuant to the DC Rules, the DCs are structured to represent a variety of market perspectives and to ensure that each DC member has market expertise.

- (a) Each of the five DCs is a regional committee composed of ten voting dealers and five voting non-dealer members, with membership reassessed on an annual basis. Membership is at an institutional, rather than an individual, level, and membership details (including votes) are made public on ISDA's website.
 - (i) Each year, dealer members are selected based on aggregate CDS trading volumes both globally and in the geographical market of the relevant DC, assessed by reference to market data reported to the DTCC Trade Information Warehouse. Dealer members are selected in accordance with objective criteria based on their overall trading volume and participation in the CDS markets during the prior year to ensure overall expertise in the product. Dealers may be long, short or risk neutral with respect to any particular Reference Entity that is the subject of a DC determination.
 - (ii) Non-dealer members that meet certain size criteria may nominate themselves for DC membership. If the number of nominees exceeds the number of available DC membership positions, non-dealer members are chosen at random to participate in the DCs and rotate on an annual basis.
- (b) Including experienced market participants on the DCs enhances decision-making and ensures that each DC arrives at its decisions after a robust consideration of the Credit Derivatives Definitions, appropriate trading conventions and commercial expectations.

2.3 Voting

The DC voting process is governed by the DC Rules and is intended to ensure robust deliberations while mitigating conflicts of interest.

- (a) While the DC membership is composed of both dealers and non-dealer members, the more important distinction for purposes of conflicts of interest with respect to a given Credit Event is the distinction between protection buyers and protection sellers. It is highly likely that any DC convened for a given Credit Event will feature both protection buyers and protection sellers.

³ See Section 3 below and the ISDA website for further information on the Big Bang Protocol and March 2009 Supplement (available online at: <http://www.isda.org/companies/auctionhardwiring/auctionhardwiring.html>).

⁴ See Section 3.2 below for a discussion of regulatory support for auction hardwiring and the establishment of the DCs.

⁵ See Section 3 below and the ISDA website for further information on the Small Bang Protocol and the July 2009 Supplement (available online at: <http://www.isda.org/smallbang/index.html>).

- (b) For all determinations that require an interpretation of the Credit Derivatives Definitions (for example, a determination that a Credit Event has occurred), an 80% supermajority consensus (12 out of 15 DC members) is required for the DC to reach a decision. In the event that the 80% supermajority voting threshold is not met, the question proceeds to the External Review process described in Section 2.4 below.⁶ This high level of consensus safeguards against either protection buyers or protection sellers unilaterally making a determination as a single block. Similarly, to address concerns that dealer members may all be on one side of the market with respect to a given issue, the threshold is high enough to ensure that dealer members cannot reach a decision by 80% supermajority without the support of at least two non-dealer members. In practice, there have been no dealer vs. non-dealer voting splits.⁷
- (c) The voting mechanism is designed so that the broader market can be comfortable that questions are being resolved with a high level of consensus, based on the DC's collective market expertise. More contentious questions that do not achieve an 80% supermajority are referred to an independent External Review, as discussed below.
- (i) Of the more than 900 DC questions considered to date, approximately 96% have been decided unanimously. This is because the vast majority of determinations made by the DCs are determined by straightforward application of publicly available facts to the relevant provisions of the Credit Derivatives Definitions. The following statistics are as of March 7, 2012:
- (A) For the last ten Credit Events, the average DC deliberation time between the date the DC was asked whether a Credit Event had occurred and the date on which a Credit Event was announced was one day in the Americas and three days in Europe. For the last five Credit Events in Asia & Oceania, the average time was five days⁸.
- (B) For the last ten Auctions, the average time between the date the DC was asked whether a Credit Event had occurred and the Auction Date was 38 days in the Americas⁹ and 23 days in Europe. For the last four Auctions in Japan, the average time was 72 days¹⁰.
- (ii) The Credit Derivatives Definitions are drafted to ensure that an individual DC member cannot profit by causing delays; all time periods for settlement are tolled once a question is validly submitted to the DC by a market participant.
- (d) DC decisions are published promptly by ISDA on a public webpage devoted to activity of the DCs. Until such publication, DC members are subject to applicable securities laws restricting the ability to trade on material non-public information and are contractually bound by confidentiality obligations. The industry has made significant progress towards a situation where regulators will have full transparency on the positions held in DTCC by DC members and will

⁶ Administrative decisions may be made by a simple majority vote.

⁷ In the CEMEX case – the only DC question to go to External Review – the voting split was three dealers and three non-dealers in favor of determining that a Credit Event had occurred, with seven dealers and two non-dealers in favor determining that a Credit Event had not occurred.

⁸ This figure represents the average timing for the last five Credit Events to occur in the combined Asia ex Japan, Australia-New Zealand, and Japan regions.

⁹ Note that this average value includes two significant outliers: the Auctions for Ambac Assurance Corporation (71 days) and CEMEX S.A.B. de C.V (129 days). With these two outliers removed, the adjusted average of time between the date that a request was made to the DC regarding a Credit Event and the subsequent Auction is 23 days.

¹⁰ This figure represents the average timing for all four Auctions that have occurred in the Japan region. No Auctions have taken place in either Asia ex-Japan or Australia-New Zealand.

be in a position to readily determine, by comparing DTCC trade information to the public votes on a given topic, whether a DC member has been "voting its book".

- (e) Active participation on the DCs is required of each DC member. DC members who fail to participate in DC meetings at which votes are held may be removed from the DCs. As a result, a DC member cannot restrict its participation to only those questions that are of unique economic or institution-specific interest. Dealer members must also participate as Participating Bidders in CDS auctions held for purposes of settling Credit Events (i.e., make a two-way market in the obligations of the defaulted Reference Entity as part of the auction process) or risk being removed from the DCs.

2.4 External Review

If an 80% supermajority is not achieved, the question proceeds to External Review.

- (a) The robustness of the External Review process derives from its reliance on independent, third-party professionals with market and/or legal expertise (such as British Queen's Counsels, academics, and other independent legal experts who specialize in the derivatives market).
 - (i) Any question for which it has not been possible to reach an 80% supermajority within the relevant DC is sent to a panel of three independent experts for External Review.
 - (ii) External Review involves formal arbitration-style briefing and argument, with all written arguments made public.¹¹ Any ISDA Primary Member or Subscriber Member (not just DC members) can submit a brief in connection with the reviewed question.¹²
 - (A) In CEMEX, the DC was split six "Yes" votes to nine "No" votes over whether a Restructuring Credit Event had occurred, so the question was sent to External Review. Pursuant to the DC Rules, three independent arbitrators were selected, each of whom had considerable industry experience.¹³ Each side of the debate then engaged its own counsel to marshal its arguments, submit written briefs and participate in oral argument before the external reviewers.
 - (iii) As with all DC decisions, the results of the External Review process are published promptly. DC members are bound by the confidentiality provisions of the DC Rules and applicable law until the External Review results are published.
 - (iv) The results of the External Review process are binding on all market participants in the same way as other DC resolutions.

2.5 Voting Standards and DC Member Obligations

The DC review process allows flexibility, but within the bounds of the 2003 ISDA Credit Derivatives Definitions.

- (a) DC members are bound under the DC Rules by the language of the Credit Derivatives Definitions and information presented to the DC. DC members do not have the discretion to

¹¹ See, for example, the briefs submitted in connection with the CEMEX External Review, available online at: <http://www.isda.org/dc/view.asp?issuenum=2009100901>.

¹² There are currently more than 500 ISDA Primary Members and Subscriber Members, representing a broad cross-section of derivatives market participants. The full list of ISDA members is available online at: <http://www.isda.org/membership/isdamemberslist.pdf>.

¹³ In the CEMEX case, the three external reviewers were selected by the DC in a unanimous vote.

disregard the terms of the contract. That said, DC members are sensitive to the broader context of the CDS market and are able to draw on their experience and expertise to take a more purposive interpretation of the Credit Derivatives Definitions than a court might. Again, in the event that such an interpretation does not achieve a supermajority consensus, the question would be resolved by the independent arbitrators that are elected to sit on the External Review panel.

- (b) DC members must perform their obligations as DC members in a commercially reasonable manner (Section 2.5(b) of the DC Rules).
- (c) Each DC member undertakes contractually with ISDA, as DC Secretary, to abide by the DC Rules and to perform its obligations as a DC member in accordance with the DC Rules, including the duty of confidentiality embedded in the DC Rules.
- (d) DC members are of course also bound by all applicable legal requirements, including securities laws restricting the ability to trade on material non-public information and anti-manipulation laws. Individuals attending DC meetings are also bound by the legal and compliance policies specific to their firm.

3. DEVELOPMENT OF THE ISDA CREDIT DERIVATIVES DETERMINATIONS COMMITTEES

The DC is an essential component of the hard-wired auction process, as CDS contract standardization has made it necessary to have an objective system for reaching decisions relating to each auction.

3.1 History of the Voluntary Auction Protocols

Before the establishment of the DCs in 2009, the CDS markets managed Credit Event settlement using physical settlement, cash settlement and eventually voluntary auction protocols.

- (a) To facilitate central clearing and to address concerns regarding increasing operational complexity and economic risks associated with bilateral dispute resolution and traditional cash or physical settlement, market participants and ISDA began to develop a third type of settlement for CDS contracts – Auction Settlement.
- (b) Initially, market participants could elect whether or not to adopt the Auction Settlement mechanic for purposes of settling their CDS contracts by choosing whether or not to adhere to a market-wide protocol that would amend all relevant CDS contracts to apply the Auction Settlement method. The election was made at a point in time after the Reference Entity had suffered a Credit Event.
- (c) The CDS auction settlement terms evolved and became more sophisticated over time. As the market learned from the experience of early auctions, successive auction settlement terms adapted to incorporate anti-manipulation mechanisms (for example, market position requirements, adjustment amount provisions and cap amount limitations), while preserving the ability of market participants to use the auction to settle their CDS contracts through cash payments (i.e., by reference to the auction final price) or physical delivery of bonds (i.e., bonds of the defaulted Reference Entity bought or sold in the auction).
- (d) The voluntary auction process was very successful: more than 25 auctions were successfully held before March 2009 (the date the Big Bang Protocol was implemented, as discussed below), and the Fannie Mae/Freddie Mac protocol was adhered to by more than 600 market participants.

Including auctions since the Big Bang Protocol, more than 60 CDS settlement auctions have been successfully held.

3.2 Supervisory Expectations for CDS Standardization

ISDA and market participants actively developed standardized CDS and engaged with regulators in this process. Regulators also encouraged market participants to commit to timelines for auction hardwiring.

- (a) The development of the voluntary auction protocol process in the years prior to the Big Bang Protocol reduced operational complexity and economic risk from the CDS market, but did not eliminate legal and basis risks, as market participants continued to possess the flexibility to decide on a case by case basis whether to apply Auction Settlement to their CDS transactions. As a result, liquidity providers sitting in the middle of two ostensibly off-setting CDS transactions could be forced to settle one transaction by reference to the traditional Physical Settlement or Cash Settlement method, while the other transaction would settle by reference to the auction final price.
- (b) In March 2008, the President's Working Group on OTC Derivative Market Infrastructure (the **PWG**) recognized the risk of market disruption if "one or more major market participants chose not to adopt the protocol following a Credit Event".¹⁴ The PWG recommended that regulators "urge the industry to amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a Credit Event in accordance with the terms of the cash settlement protocol[s] that have been developed but not yet incorporated into standard documentation".¹⁵
- (c) The Federal Reserve Bank of New York, among other regulators, was actively involved in establishing timelines for dispute resolution and auction hardwiring.¹⁶
- (d) Market participants voluntarily expressed their commitment to auction hardwiring in public letters to regulators, including the July 31, 2008 letter to the Over-the-Counter Derivatives Supervisors Group (the **ODSG**).¹⁷ In their public summary of industry commitments contained in the July 31, 2008 letter, the ODSG noted that incorporating auction settlement "into standard documentation will increase certainty following Credit Events by ensuring full participation and a transparent and orderly settlement process".¹⁸
- (e) Upon publication of the Big Bang Protocol and March 2009 Supplement, the Federal Reserve Bank of New York noted: "The New York Fed, along with other supervisors involved in OTC market improvement efforts support the permanent incorporation of the auction-based mechanism in order to increase the certainty, transparency and orderliness of settling CDS transactions following a Credit Event. Supervisors encourage all market participants to adopt the new standard before the April 7 deadline."¹⁹ Staff from the New York Fed have since described auction hardwiring as an "improvement to the over-the-counter [derivatives] market spurred by regulators" and "prompted by the collective efforts starting in 2005 of the bank supervisors of the largest OTC derivatives dealers".²⁰

¹⁴ Available online at: <http://fic.wharton.upenn.edu/fic/Policy%20page/presidentworkinggroup.pdf> at p 19.

¹⁵ Available online at: <http://fic.wharton.upenn.edu/fic/Policy%20page/presidentworkinggroup.pdf> at p 6.

¹⁶ See Duffie, Li and Lubke, "Federal Reserve Bank of New York Staff Reports: Policy Perspectives on OTC Derivatives Market Infrastructure", available online at: http://www.fednewyork.org/research/staff_reports/sr424.pdf at p 4.

¹⁷ Available online at: http://www.newyorkfed.org/newsevents/news_archive/markets/2008/73108RegulatorsLetter.pdf.

¹⁸ Available online at: http://www.newyorkfed.org/newsevents/news_archive/markets/2008/CommitmentSummaryTable.pdf at p 3.

¹⁹ See "New York Fed Welcomes CDS Auction Hardwiring", Federal Reserve Bank of New York press release dated March 12, 2009, available online at: http://www.newyorkfed.org/newsevents/news_archive/markets/2009/ma090312.html.

²⁰ See Duffie, *supra* n 16, at p 3 (n. 6 and accompanying text).

- (f) Standardization was an important factor in the movement of CDS transactions towards clearing at central counterparties, another key goal of the G-20,²¹ the PWG and, subsequently, the Dodd-Frank Act, European Market Infrastructure Regulation (**EMIR**) and other regulatory initiatives. In order for two ostensibly identical CDS contracts to be appropriately risk managed by a central clearinghouse, they need to have identical terms (including identical Settlement Methods) and be interpreted in an identical manner.

3.3 The Push Toward Standardization

Market-makers also pushed for CDS standardization as a means of mitigating or eliminating basis risks.

- (a) As the notional amount of outstanding CDS contracts grew, liquidity providers increasingly made two-way markets (acting as both sellers to buyers of protection and as buyers to sellers of protection). For dealers that are striving to be "flat" from a risk perspective, when intermediating two ostensibly off-setting CDS transactions, it is crucial that such CDS transactions indeed offset. Taken as a whole, if the CDS transactions on one side of the market perform in a way that is different from the CDS transactions on the other side, the risk of cascading failures would significantly increase.
- (i) **Legal/Interpretation Basis Risk** – Two transactions will only be truly offsetting if legal and other basis risk is eliminated as much as possible – that is, if all CDS contracts on identical contractual terms referencing the same Reference Entity are interpreted the same way, with uniform determinations made with respect to Credit Events and other material contractual provisions.
- (ii) **Economic Basis Risk** – To avoid economic basis risk, all transactions need to settle using the same Settlement Method. One downside to the system of protocols was that parties had the option, following the occurrence of a particular Credit Event, to elect not to adhere to the protocol and consequently not to apply the Auction Settlement process to their CDS contracts in respect of a particular Credit Event. This would result in two otherwise off-setting transactions settling by reference to different settlement methods, one by reference to Auction Settlement, the other by reference to Physical Settlement or traditional Cash Settlement. Applying different settlement methods transactions is likely to introduce economic basis risk – the Auction Final Price may not be identical to the value of the particular bonds delivered in Physical Settlement, for example.
- (b) To avoid the uncertainty created by this optionality, ISDA published in 2009 two separate protocols, the Big Bang and Small Bang Protocols, and two supplements to the 2003 ISDA Credit Derivatives Definitions which allowed market participants to elect to settle their CDS contract by reference to Auction Settlement at the time of execution of the transaction, rather than having to wait until after a Credit Event to amend their CDS contracts by means of a Credit Event-specific protocol. Given the complexity of the auction hardwiring process, the Big Bang and Small Bang Protocols were done in stages to allow for market input. 2,092 market participants voluntarily adhered to the Big Bang Protocol,²² which established the contractual framework for auction settlement and established the DC Rules. 2,612 market participants

²¹ See, e.g. the G-20 Pittsburgh Communiqué, available online at: http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

²² Available online at: <http://www.isda.org/companies/auctionhardwiring/auctionhardwiring.html>.

eventually adhered to the Small Bang Protocol,²³ which included refinements to permit auctions for Restructuring Credit Events.²⁴

3.4 Forum to Address Market Events

The DCs provide a formal, objective process for resolving auction-related determinations.

- (a) In the bilateral pre-DC context, if the parties to a particular CDS contract failed to agree that a Credit Event had occurred, they had no recourse other than informal dispute or formal legal proceedings. As described above, the resulting legal and economic basis risk to liquidity providers was undesirable, as highlighted in the PWG's view of the CDS market.
- (b) With each CDS auction held prior to the publication of the Big Bang and Small Bang Protocols, ISDA and Participating Bidders in the auction were confronted with new challenges that required the Credit Event-specific protocols and the Auction Settlement process to be adapted to the specific circumstances of a particular Credit Event. Prior to the establishment of the DCs, such decisions were reached without formal structure or process, leaving market participants not involved in the decision-making process to "vote with their feet" – should they disapprove of the decisions made by the Participating Bidders with respect to the auction process, they had the flexibility not to sign up to the protocol.
- (c) By adopting the Big Bang and Small Bang Protocols, market participants agreed to apply Auction Settlement to their covered CDS contracts and to be bound by the determinations of the DCs; similarly, on a prospective basis, parties could incorporate the 2009 supplements at the time of contract formation to ensure that Auction Settlement would apply to a new transaction. Since market participants no longer had the flexibility to review the terms of the auction process before deciding whether it should apply in any specific instance, it was necessary to institute a more formal process for the resolution of auction-related determinations. The result was the establishment of the DCs.

²³ Due to market demand, the adherence period for the Small Bang Protocol was re-opened to allow parties to sign up to the protocol until January 31, 2011.

²⁴ Available online at: <http://www.isda.org/smallbang/index.html><http://www.isda.org/smallbang/index.html>.