

ISDA Publishes New LevX Standard Terms and Revised Single-Name ELCDS Standard Terms

By Jon Kibbe and Julia Lu Fu

In July 2007, we reported the publication by the International Swaps and Derivatives Associations, Inc. (“ISDA”) of standard terms of credit default swaps on leveraged loans for the European market (“2007 Single Name Standard Terms”, or “2007 Terms”). After the July 2007 launch of the 2007 Single Name Standard Terms, the market anxiously awaited the launch of an ISDA-approved index product. March 17, 2008 — the date the Markit iTraxx LevX indices rolled into Series 2 (“LevX Series 2”) — marks the launch of the ISDA-approved European index product.

This memorandum briefly describes the development and key provisions of the 2007 Terms, the recent amendments to the 2007 Terms (as amended, the “2008 Single Name Standard Terms” or “2008 Terms”), and the iTraxx LevX standard terms supplement for use with credit derivative transactions on leveraged loans (the “LevX Standard Terms”). Taken together, these documents comprise the family of leveraged loan credit default swap products available to participants in the European credit markets, and represent a substantial codification and harmonization of the documentation and trading practices that existed before ISDA’s involvement.

Background -- 2007 Single Name Standard Terms

As described more fully in our memorandum dated July 30, 2007, a loan credit default swap in the European market under the 2007 Single Name Standard Terms is a Reference Obligation-based product, and only the specified Reference Obligation or a Senior

Loan are deliverable into the swap upon a Credit Event. Under the 2007 Single Name Standard Terms, lien priority of the loan is defined by reference to a legal standard, in contrast to a “trading standard” determined by a dealer poll in the case of a standard U.S. loan credit default swap.

A key product development in the 2007 Terms is non-cancelability (or less cancelability) in case of a Refinancing. Loans, unlike bonds, are more often refinanced than assumed, which gives rise to the issue that the Succession provisions in the 2003 and ISDA Credit Derivatives Definitions do not adequately address a loan refinancing scenario. Since the European LCDS is a Reference Obligation-based product, the Refinancing rules were designed to ensure that the swap follow the Reference Obligation or assets securing the Reference Obligation. Under the 2007 Terms, Calculation Agent makes the important decisions with respect to Refinancing, including identifying Substitute Reference Obligation(s) for the new credit derivative transaction(s) after a Refinancing. Credit Events include Bankruptcy, Failure to Pay (Reference Obligation) and Restructuring (Old “R”). Restructuring is amended to include lien subordination and full release of collateral securing the loan. Unless “Cash Settlement Only” is selected as applicable in the confirmation, the settlement method is by default Physical Settlement, which consists of an initial Physical Settlement phase, followed by Seller’s Cash Settlement Election, then Buyer’s Cash Settlement Election, and finally a termination date in the event of delayed Delivery.

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Memorandum

May 8, 2008

“The launch of the ISDA-approved iTraxx LevX product is a critical step towards increased liquidity in the European market.”

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Amendments Under 2008 Single Name Standard Terms

The 2008 Single Name Standard Terms have retained the salient features of the 2007 Terms. The main modification under the 2008 Terms relates to the determination of the outcome of a Refinancing. To the extent that the relevant Reference Obligation under the “non-cancelable” single name transaction is included in the Markit RED Database for European Leveraged Loans (the “RED Database”), the outcome of any Refinancing will, subject to the limitations below, be governed by what is determined pursuant to Markit RED Continuity Procedures for European LCDS (“Continuity Procedure”), which is discussed in greater length below.

However, in light of the scarcity of public information about loans trading in the European leveraged loan market, the 2008 Terms allow swap counterparties to deliver to Calculation Agent, and Calculation Agent to consider, information providing evidence for a Refinancing determination that is inconsistent with a determination made pursuant to the Continuity Procedure. This design compromise allows the product to accommodate the desire to eliminate any basis risk between a single name transaction and a LevX transaction with a uniform Refinancing determination, on the one hand, and a degree of freedom to allow a different Refinancing determination in a single name transaction if the parties are in possession of relevant contrary information that cannot be shared with the market.

If the Reference Obligation under the single name transaction is not covered in the RED Database, if no determination is made pursuant to the Continuity Procedure, or if the single name transaction is a “cancelable” transaction, then Calculation Agent will make the determinations with respect to Refinancing or Cancellation (i.e., the full repayment and termination of the Reference Obligation), as applicable.

Among other changes, the 2008 Terms eliminated Specified Currency as the Deliverable Obligation Characteristic and Substitute Reference Obligation Characteristic. As a result, all Reference Obligations and Senior Loans will be Deliverable Obligations, and the Substitute Reference Obligations no longer need to meet the Specified Currency characteristic.

LevX Standard Terms

LevX Series 2, administered by Markit Group (“Markit”), is comprised of a senior and a subordinated loan credit default swap index. The senior index consists of 75 equally-weighted first lien Reference Obligations; the subordinated index, 45 equally-weighted second or third lien Reference Obligations. Traded with a five-year maturity to June 20 or December 20 of the relevant year, the LevX indices roll on March 20 and September 20 of every year.

A LevX Series 2 Senior Index transaction is a portfolio of 75 single name loan credit default swap Component Transactions; a LevX Series 2 Subordinated Index transaction, a portfolio of 45 Component Transactions. The LevX Standard Terms provide that the relevant Reference Credit Agreement Weighting is reduced to zero upon settlement of a Credit Event under a Component Transaction, or upon Cancellation of a Component Transaction. Each Component Transaction is a non-cancelable LCDS transaction largely based on the 2008 Single Name Standard Terms, denominated in euro and settled via Physical Settlement.

Determinations with respect to Refinancing or Cancellation in a Component Transaction will be made in accordance with the Continuity Procedure, which sets forth a process in which: (a) a dealer can notify Markit and initiate the process by providing information about a corporate event that has occurred and that may constitute a Refinancing or Cancellation; (b) Markit will notify all of its European RED LCDS subscribers of such an event; (c) dealers (and customers through dealers) may submit

supporting information to a law firm designated by Markit until the day falling two Business Days prior to the 65th calendar day after the effective date of the event; (d) the designated law firm will return a preliminary determination (referred to as an “Interim Summary”) to the dealer who submitted the supporting information; (e) the dealer receiving the Interim Summary will submit the same to Markit and Markit will publish such Interim Summary, on the 80th calendar day following the event; (f) dealers (and customers through dealers) may submit further information to the designated law firm for 10 additional calendar days; (g) the designated law firm will return a final determination (referred to as a “Final Summary”) to the dealer who submitted the information; and (h) the dealer receiving the Final Summary will submit the same to Markit and Markit will publish such Final Summary, on the 100th calendar day following the event (or sooner if the event constitutes a cancellation and there is no Substitute Reference Obligation).

The Interim Summary and Final Summary will set forth the conclusion of the designated law firm’s review of the information provided by dealers, and will not provide any reasoning for such conclusion. The RED Database will be updated in accordance with the conclusion set forth in the Final Summary. In event that the information provided is insufficient for the designated law firm to make the determination, or the designated law firm for any other reason is unable to reach a conclusion, the Final Summary will specify that a conclusion in respect of Refinancing or Cancellation has not been reached. In that situation the RED Database will not change in any way, unless a Cancellation has in fact occurred.

The Continuity Procedure is intended to address the issue of lack of public information about loans trading in the European leveraged loan market and relies on dealers and other parties to provide information to the designated law firm and share the conclusion of the designated law firm with the market.

Conclusion

The launch of the LevX Series 2 product in the European leveraged loan market is a critical step towards increased liquidity in the loan market. It enables investors to hedge or assume systemic risks more efficiently and serves as basis for future structured products such as tranching. Designed to provide more transparency in a non-transparent market, the Continuity Procedure to be used in connection with the Refinancing represents a distinctive European innovation -- one which is untested in the context of Substitute Reference Obligation or Succession Event and which is not derived from CDS or U.S. LCDS products.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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