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Memorandum

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Bullet LCDS: A New Direction for the U.S. Loan Credit Default Swap Product

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"In addition to harmonizing the U.S. LCDS product with the evolving CDS product, the launch of Bullet LCDS fosters liquidity by resolving an intractable valuation challenge created by the cancellable nature of the original LCDS product…"

On April 5, 2010, the International Swaps and Derivatives Association, Inc. ("ISDA") launched a new version of the U.S. LCDS product ("Bullet LCDS") by publishing revised transaction documentation and announcing market practice changes to the LCDS market. In addition to harmonizing the U.S. LCDS product with the evolving credit default swap product, the launch of Bullet LCDS fosters liquidity by resolving an intractable valuation challenge created by the cancellable nature of the original LCDS product, and capitalizes on an opportunity to make further incremental improvements to the LCDS market.

This memorandum summarizes the key changes in the new Bullet LCDS product, including (i) migration to a "bullet maturity" product through the removal of the early termination feature in the LCDS product ("Legacy LCDS") and (ii) implementation of documentation and market practice changes consistent with modifications made to the CDS product with the introduction of the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions (the "2009 Supplement").[1]

BULLET MATURITY

The Legacy LCDS product allowed either party to terminate an LCDS contract at no cost if the reference entity had no secured loans available for delivery for a period of at least 30 business days.[2]

This early termination feature was intended to address protection buyers' concerns about "orphan contracts" – swap contracts under which no deliverable obligations exist, but which nonetheless require premium payments by the protection buyer until the scheduled termination date.

Although the early termination feature of Legacy LCDS provided protection buyers with the ability to avoid payment obligations under orphan contracts, this feature created significant valuation issues in the LCDS market and ultimately hindered liquidity. Because it is impossible to anticipate if or when a reference entity will release the security on or repay its loans,[3] assigning a value to the cancellation

1 For a description of certain modifications implemented in connection with the 2009 Supplement, please see our previous memorandum, *Understanding the New Standard North American Credit Default Swap: Evolving Documentation and Market Practice*. Although this memorandum does not describe the enhancements to the 2009 Supplement published in July of 2009 relating to the Restructuring credit event in the CDS market, those enhancements are not expected to impact Bullet LCDS where Restructuring is not identified as a credit event.

2 In the case of LCDX, the index product relating to Legacy LCDS, early termination was automatic and not optional.

3 These are two examples of situations where no secured loans will be available for delivery by the protection buyer upon the occurrence of a credit event.

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feature, and thus accurately pricing new trades and unwinds, became a difficult exercise.

In order to resolve this issue, Bullet LCDS is "non-cancellable" and has a single "bullet" maturity date, meaning that a Bullet LCDS contract will remain outstanding until the scheduled maturity date even if the reference entity has no secured deliverable loans outstanding.

RELATED SUCCESSION EVENT/ REFINANCING EVENT CHANGES

While removal of the cancellation feature in Bullet LCDS eases pricing difficulties in Legacy LCDS, the "bullet" maturity creates a new issue relating to "successor" reference entity determinations. The "successor" provisions contained in Section 2.2 of the 2003 Credit Derivatives Definitions provide that CDS and Legacy LCDS contracts will migrate to a new reference entity if that entity "assumes or becomes liable for" certain debt obligations of the original reference entity. These provisions are intended to allow trades to follow deliverable obligations when the original reference entity's debt obligations are transferred in connection with a merger or other corporate event.

However, because the provisions were developed for CDS referencing bonds, they do not adequately address the structure of a typical syndicated secured loan refinancing, where a new entity draws down on a new loan and uses the proceeds to repay the reference entity's existing loans. This type of loan refinancing may not result in the new entity becoming the "successor" reference entity under these provisions because the new entity never "assumes or becomes liable for" the obligations under the existing loans. Removal of the cancellation feature therefore heightens protection buyers' concerns about orphan contracts.

Bullet LCDS amends the CDS "successor" provisions to capture typical structures used in loan refinancings by introducing a new definition of "Refinancing Event" that requires migration of Bullet LCDS contracts in the following refinancing scenarios:

- Repayment of reference entity's secured loans with proceeds of new loans or bonds of a new entity;
- Acquisition of assets securing reference entity's loans with proceeds of new loans or bonds of a new entity;
- Reference entity's secured loans are discharged and assets securing those loans instead secure loans or bonds of a new entity;
- Amendment to credit agreement or corporate recapitalization or restructuring results in new entity becoming obligor on reference entity's secured loans; and
- Any other event that has substantially the same effect as the above.

With respect to widely-traded names, determinations under these amended provisions, including the identification of a successor reference entity, will be made by a law firm in accordance with the terms of the "Continuity Procedures" published by ISDA on April 5, 2010, and Markit Group Limited ("Markit") will act as the administrator under the Continuity Procedures. All market participants agree to be bound by any determinations made by the law firm.[4]

IMPLEMENTATION OF CDS DOCUMENTATION CHANGES

A number of significant market-wide changes were made to the CDS product in 2009 in an effort to promote standardization, liquidity and transparency. At the time, LCDS contracts were excluded from these product modifications. With the launch of Bullet LCDS, certain key standardization enhancements have been applied to LCDS through the incorporation of the 2009 Supplement (with certain modifications) into the Bullet Syndicated Secured Loan Credit Default Swap Standard Terms Supplement (the "Bullet Standard Terms").

DC Determinations of Credit Events

Under the 2009 Supplement, an ISDA-sponsored "Determinations Committee" makes certain market-wide determinations under CDS contracts

4 Richards Kibbe & Orbe LLP has been selected to act as the primary "Designated Law Firm" to make these determinations.

relating to credit events, auctions, deliverable obligations and other key issues. The Determinations Committee framework has been incorporated into the structure of Bullet LCDS, and certain committee resolutions, including any determination that a credit event has occurred with respect to a reference entity, will be binding on all parties to Bullet LCDS contracts. It is important to note that under Bullet LCDS transactions, certain decisions are not made by the committee but instead are made either by a law firm (as discussed above) or by a group of dealers actively participating in Bullet LCDS (as discussed below under "Auction Hardwiring") in accordance with the Bullet LCDS Auction Rules (the "Bullet Auction Rules"), published by ISDA on April 5, 2010.

Backstop Dates for Credit Events and Succession/ Refinancing Events

The concept of "backstop dates" implemented in the CDS market in connection with the 2009 Supplement has been applied to the Bullet LCDS product. Bullet LCDS contracts are generally only impacted by credit events that occur within 60 days prior to the date of notice of the event to ISDA, and succession/refinancing events that occur within 90 days prior to the date of notice of the event to Markit. Because these fixed dates apply to all outstanding Bullet LCDS transactions, basis risk between trades with different trade dates will be avoided.

Auction Hardwiring

Due to the complexities of physical settlement of loans, U.S. LCDS transactions have been required to cash settle in accordance with any applicable auction mechanism since 2007. The application of the 2009 Supplement to Bullet LCDS harmonizes the LCDS auction mechanics with those applicable to the CDS market, but some important distinctions are retained through the application of the Bullet Auction Rules. For example, the LCDS dealers, not the Determinations Committee, make certain key auction-related decisions, such as whether an auction will be held and the identity of the deliverable obligations under any auction.

Market Convention Changes: Full First Coupon and Standard Fixed Coupons

Certain changes in market practice that were made in the CDS market in 2009 are now made in the LCDS market to promote standardization and liquidity. First, LCDS dealers quote Bullet LCDS transactions on the basis of standard fixed coupons of 100, 250 or 500 basis points. The standard coupon is used to determine the annual premium amounts payable by protection buyer, and any related upfront payment is made at the time of the trade. Second, the protection buyer under Bullet LCDS contracts is required to make a full coupon payment on the first quarterly payment date, no matter when the trade date occurred, and any required rebate for pre-trade date accrual amounts are paid at the time of the trade by protection seller.

OTHER CHANGES AND IMPROVEMENTS

The LCDS working group also made several improvements to the existing LCDS architecture to address issues that have arisen in the Legacy LCDS market.

CAM Deliverability

The Bullet Standard Terms provide that if a Collateral Allocation Mechanism ("CAM") or similar provision in a credit agreement requires that deliverable loans be exchanged for other loan obligations under the credit agreement, such new loan obligations will not be disqualified from deliverability solely because the reference entity is not an obligor thereunder. This provision is intended to resolve an issue that arose in certain LCDS auctions over the past few years, with the Lyondell Chemical Company auction as a prime example. In Lyondell, holders of the reference entity's deliverable loans were automatically deemed to hold a pro rata portion of loans extended to non-U.S. entities pursuant to the operation of a CAM provision. These loans were not deliverable under Lyondell LCDS transactions because the LCDS reference entity was not an obligor, resulting in significant issues in the auction and the physical settlement process. The new CAM provision should eliminate this issue in Bullet LCDS transactions.

Syndicated Secured Modifications
The definition of "syndicated secured," which defines one of the deliverability characteristics on which the LCDS dealers vote, has been expanded to include loans that "would be expected to trade as," in addition to loans that "trade as," loans of the designated priority. This change is intended to avoid interpretational issues that may arise when a loan is not yet trading at the time of the relevant dealer poll. In addition, the definition of "syndicated secured" has been revised to instruct the LCDS dealers to take any relevant subordination provisions into account when responding to a dealer poll. This represents a substantive change to Legacy LCDS and is designed to prevent secured loans that are subject to payment or other subordination provisions as compared to other loans of the same lien priority, such as "first loss" tranches, from being designated as deliverable into LCDS transactions of the relevant lien priority.

Physical Settlement Improvements
The Loan Syndications and Trading Association, Inc. ("LSTA") made a number of improvements to the Physical Settlement Rider (the "Rider") governing the physical settlement of Bullet LCDS transactions that do not cash settle. Among the key modifications, the revised version of the Rider specifies that an LSTA trade confirmation will be deemed to be entered into by parties to physically-settled LCDS transactions, and that physical confirmations should not be executed and delivered. In addition, the revised Rider enables the protection seller to elect to settle by participation if settlement by assignment would subject it to a lock-up or similar agreement.

CONCLUSION

Bullet LCDS is a further evolutionary step in the process of designing a liquid and viable CDS product tailored for the loan market. In addition to eliminating the uncertainty and pricing difficulties created by the early termination feature in Legacy LCDS, the Bullet LCDS product incorporates the latest ISDA technology developed in 2009 for CDS and includes multiple enhancements designed to address the complexities of the loan market.

QUESTIONS

If you have 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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