

Client Alert

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Single-Name Credit Default Swaps: A Primer

By Vincent Basulto and Richard J. Lee

The last few months have seen a revival in interest in single-name credit default swaps (“CDS”) by hedge funds and other buy-side firms looking to hedge or otherwise express a market view in the midst of elevated volatility in the credit markets. At the same time, reversing a trend, new dealer firms have entered or announced intentions to enter the single-name CDS market. Nonetheless, significant challenges remain before the market can begin to approach pre-crisis levels of trading activity. Given the increasing conversation around single-name CDS, we take this opportunity to recap the current state of the market and highlight some considerations for parties looking to re-enter the market.

STANDARD TERMS OF CDS

Standard CDS transactions are now governed by the 2014 Credit Derivatives Definitions (the “Definitions”) published by the International Swaps and Derivatives Association (“ISDA”). The Definitions clarified certain aspects, and attempted to address some shortcomings, of the prior version published in 2003. Additionally, the “Settlement Matrix” published by ISDA¹ sets forth the relevant Credit Events and other conventions for each type of standard CDS contract. For those unfamiliar with the basic structure of credit default swaps, the annex to this memorandum provides a brief overview of the fundamental workings of a single-name CDS transaction.

The last few years have also seen the increased prominence of the regional ISDA Credit Derivatives Determinations Committees (the “DC”), which are charged with making a variety of binding market-wide determinations with respect to CDS contracts. Notably, the DC decides whether a “Successor” must be named with respect to a Reference Entity, whether certain events constitute Credit Events, and whether to hold an auction to determine a price for cash settlement of contracts. Each DC is comprised of ten dealer and five non-dealer firms.² Each party to a standard single-name CDS contract agrees to be bound by the determinations of the applicable DC, so market participants have little recourse independently to challenge any decision, no matter how controversial,³ though the members of the DC are governed by certain published rules.⁴

1. Available [here](#).

2. The full list of current member firms is available [here](#).

3. See Richards Kibbe & Orbe LLP Client Alert, [What the Novo Banco Decision Tells Us](#), February 29, 2016.

4. See <http://dc.isda.org/dc-rules/>

In an effort to revive what had become a moribund market, ISDA late last year recommended a change to the market convention for timing of rolls for on-the-run single-name CDS, switching from a quarterly schedule to a semi-annual March and September schedule, which matches the convention for the Markit CDX indices and was designed to promote liquidity in contracts. The convention took effect on December 20, 2015 and, as a consequence, the current on-the-run five year maturity single-name CDS contract will next roll forward on September 20, 2016.

REGULATORY ENVIRONMENT

Against this backdrop, the regulatory environment for single-name CDS in the United States remains uncertain. Under the provisions of Article VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities and Exchange Commission ("SEC") has authority to regulate "security-based swaps" such as single-name CDS contracts. While the SEC has proposed rules to implement aspects of the Dodd-Frank Act, its efforts to finalize rules continue to lag significantly behind those of the Commodity Futures Trading Commission, which has authority to issue regulations governing swaps such as CDS index trades. Final SEC rules are expected to bring needed clarity to the market by increasing pre- and post-trade transparency and improving disclosure. Market participants should closely monitor developments with respect to clearing and margin for single-name CDS contracts.

CLEARING

To reduce counterparty risk, the Dodd-Frank Act introduced mandatory clearing through a central counterparty of those instruments determined to be clearable by the CFTC or the SEC. While ICE Clear Credit has offered clearing for various single-name credits since 2009, clearing of single-name CDS contracts currently remains voluntary. In an effort to spur

the movement to increased clearing, in December 2015 a group of 25 large asset managers in conjunction with ISDA and other trade associations committed voluntarily to clear single-name CDS contracts. In addition, reports suggest that certain dealers offer advantageous pricing for cleared single-name CDS transactions, and buy-side firms may potentially seek direct access to clearinghouses and execution facilities for single-name CDS to fill any voids left by traditional dealers.

Nonetheless, a regulatory requirement to clear single-name CDS contracts may be necessary to allow trade volume to grow meaningfully. As the SEC develops its rules, parties should carefully track the effects of the clearing mandate on its operations. It is expected that only constituents of the major CDS indices and other regularly-traded credits would need to be cleared. Parties will also need to consider any necessary changes to the terms of their existing clearing agreements and the collateral terms of their ISDA Master Agreements, as well as whether any additional arrangements will need to be put in place, such as cleared derivatives execution agreements or custodial agreements for segregated collateral.

MARGIN AND CAPITAL

The SEC originally proposed rules in relation to margin and capital requirements in 2012.⁵ Though timing of the rulemaking remains uncertain, the ultimate terms of margin methodologies for cleared single-name CDS trades and margin requirements for uncleared contracts will need to be considered. As is currently the case with CFTC-regulated swaps,⁶ parties will need to assess the initial margin and variation margin implications of maintaining cleared and, to the extent not mandated, uncleared portfolios of single-name CDS trades. These considerations may inform parties' decisions as to whether to migrate legacy uncleared positions to newer cleared contracts and any margin offsets which may be permissible between single-name CDS and index CDS positions. The transition to a fully-regulated environment

5. See <http://www.sec.gov/rules/proposed/2012/34-68071.pdf>

6. See Richards Kibbe & Orbe LLP Client Alert, [Prepare for Uncleared Swaps Margining: What a Financial End-User Needs to Know](#), February 22, 2016.

for single-name CDS may also be an opportunity for parties to reconsider the general terms of their trading arrangements with prime brokers and dealers.

CONCLUSION

Single-name CDS has long been a vital tool in the credit markets for hedging positions in debt instruments, efficiently expressing an investment thesis and for price discovery. This formerly robust market, however, has met significant challenges in recent years. Despite efforts to increase liquidity in single-name CDS, regulatory uncertainty continues to overhang the market. Furthermore, recent events have demonstrated that complicated and unexpected actions by issuers, governmental authorities and other market participants may not be clearly addressed by the terms of a CDS contract. These issues present both risks and opportunities for investors in CDS looking to express investment views on a Reference Entity. With confidence rising in the market that single-name CDS will experience significant growth in the near future, we hope this primer serves as a starting point for market participants to review the state of the product, the regulatory environment and their preparedness for increasing use of single-name CDS.

ANNEX

A single-name credit default swap ("CDS") is a financial contract which allows a seller of credit protection (a "Protection Seller") to transfer the credit risk of a single issuer (a "Reference Entity") to a buyer of credit protection (a "Protection Buyer") without transferring ownership of an underlying debt obligation of that Reference Entity. A CDS contract will have an agreed notional amount and maturity date.

In a standard CDS contract, the Protection Buyer pays a fixed quarterly premium to the Protection Seller. In exchange, upon the occurrence of certain defaults ("Credit Events") by a Reference Entity under its debt obligations, generally unsecured bonds or loans ("Obligations"), the Protection Seller will make a

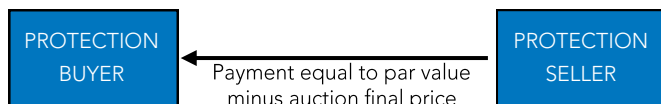
protection payment equal to the notional amount of the contract minus the recovery value of an Obligation meeting certain requirements.



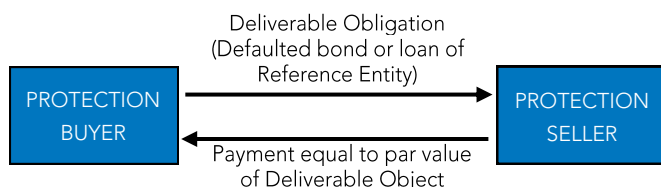
The Credit Events under a CDS include a subset of the following seven Credit Events: (i) bankruptcy of the Reference Entity, (ii) a payment default by the Reference Entity, (iii) a default by the Reference Entity other than a payment default, (iv) an acceleration of certain Obligations, (v) a repudiation or moratorium of certain Obligations coupled with a failure to pay or restructuring of Obligations, (vi) a restructuring of Obligations resulting from the deteriorating financial condition of the Reference Entity and (vii) a governmental intervention in connection with the resolution of a financial Reference Entity. The exact terms are specified in the Definitions. The subset of Credit Events that applies to any particular standard CDS contract depends on the geographical region (e.g. North America, Europe, Latin America, etc.) and the type (e.g. corporate, financial or sovereign) of the Reference Entity. ISDA publishes a "Settlement Matrix" which sets forth the Credit Events, and other standard settlement terms, that apply to the different categories of Reference Entities.

If no Credit Event occurs during the term of the CDS transaction, the Protection Buyer pays its premium until the Scheduled Termination Date, on which date the contract terminates and all obligations of both parties are cancelled. If a Credit Event occurs on or before the Scheduled Termination Date of the CDS contract, then standard CDS transactions are cash-settled in accordance with an auction mechanism sponsored by ISDA. The auction mechanism results in a market-wide final price for the Obligations issued by the Reference Entity meeting certain requirements (a "Deliverable Obligation"). The Settlement Matrix sets forth the requirements for an obligation to be a Deliverable

Obligation for different types of standard CDS transactions. The Protection Buyer ultimately receives the notional amount of the contract less the auction final price (which is meant to approximate the recovery value) of a Deliverable Obligation.



In non-standard or bespoke CDS transactions, parties may elect to "physically settle", which means that the Protection Buyer will deliver a Deliverable Obligation in exchange for payment of the notional amount of the related contract.



CDS terms also provide for consequences when certain Obligations of the Reference Entity are assumed by, or exchanged for debt obligations of, a different entity. If 25% (subject to several qualifications) or more of the qualifying Obligations of the Reference Entity are so assumed or exchanged, then the CDS contract is modified to reference one or more new obligors. These provisions attempt to address corporate events, such as mergers and acquisitions and exchange offers, which may change the obligor and therefore change the credit risk profile that was underlying the existing CDS contract. The rationale is that if the relevant Obligations of a Reference Entity have migrated to a more (or less) creditworthy entity, the CDS contract should be modified to reference that new entity in order to maintain the same credit exposure to those Obligations.

The foregoing is meant to provide only a short overview of the most fundamental principles of a CDS contract. It is important to emphasize that CDS is a complex financial contract, requiring a careful and thoughtful analysis of the Definitions and any related agreements.

QUESTIONS

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

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