Credit Derivatives

A Practical Guidance® Practice Note by
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This practice note focuses on credit default swaps (CDS) (both single-name and index) and provides a high-level overview of their functioning, with a particular emphasis on corporate CDS. Although the product may appear relatively simple at first sight, it is governed by a complex set of rules. Investors should seek to fully understand their terms before they trade the product in an effort to avoid falling into a trap for the unwary.

Credit derivatives are financial contracts enabling market participants to take, reduce, or transfer credit exposure on a sovereign or corporate entity (Reference Entities), and typically reference bonds and/or loans (Reference Obligations) of the underlying reference entity. The universe of credit derivatives encompasses a variety of derivatives and securitized products, including CDS, total return swaps, and credit-linked notes.

Credit derivatives are primarily used by (1) banks and loan portfolio managers to hedge the credit risk of their bond and loan exposures, (2) hedge funds and other assets managers to gain specific credit exposure to reference entities or in connection with various credit trading or relative value strategies, (3) insurance companies to enhance asset portfolio returns, and (4) corporations to manage credit exposure to third parties.

For further information relating to International Swaps and Derivatives Association (ISDA) documents, see ISDA Master Agreement: A Practical Guide. For regulation of swaps by the Commodity Futures Trading Commission and the Securities Exchange Commission, see Swaps and Security-Based Swaps under Title VII of the Dodd-Frank Act: U.S. Regulation and Swap Dealer and Major Swap Participant External Business Conduct Rules. For cross-border transactions, see Cross-Border Transactions Involving Swaps and Security-Based Swaps: U.S. Regulation.

CDS Basics

A CDS contract is a derivative contract under which one party buys, and the other party sells, credit protection on a set of debt obligations of an underlying corporate or sovereign reference entity (single-name CDS) or a basket of reference entities (index CDS). Upon the occurrence of certain events with respect to the reference entity (Credit Events—see the section titled Credit Events below), the CDS contract is triggered and the CDS protection seller typically pays an amount to the CDS protection buyer in order to cash settle the contract. This cash settlement amount is typically determined by reference to the value of the reference entity's debt obligations set via an auction process (discussed further in CDS Settlement below).

Credit Events are defined in the 2003 and 2014 Credit Derivatives Definitions (Definitions), which are published by ISDA. References to the Definitions and defined terms in this practice note are to the 2014 Credit Derivatives Definitions. The parties to the CDS contract specify applicable Credit Events, generally by reference to the

ISDA Credit Derivatives Physical Settlement Matrix listing applicable Credit Events based on market conventions in the location of the reference entity. In the U.S. for example, Credit Events applicable to a CDS referencing a corporate entity are Failure to Pay and Bankruptcy.

Determinations as to whether a Credit Event has occurred and other material issues impacting the CDS contract or its settlement are usually made by a 15-member ISDA Credit Derivatives Determinations Committee (DC). The DC is comprised of the 10 largest CDS dealers (based on CDS notional amount written) in the particular geographic area and 5 buy-side member firms (which are the same in all geographic areas). The DC decision-making framework is based upon the DC Rules, which are also published by ISDA. The DC typically follows the DC Rules but it does have the flexibility to deviate from those rules in certain instances if necessary.

When entering into a CDS contract as an end user, a market participant will typically face a swap dealer counterparty. Thus, for purposes of settlement and performance, payments and/or deliveries will occur between the market participant and its swap dealer counterparty.

The volume of CDS on a specific reference entity is publicly available, but not the identity of trading counterparties. It is, therefore, difficult to assess which market participants are actively trading the CDS product on any given reference entity and in which size.

Credit Events

Credit Event determinations are typically made by the DC for the relevant region (North America, EMEA, and Asia). Any CDS market participant may request the DC to make such a determination. Credit Events must have occurred within 60 calendar days preceding a request (accompanied by the requisite information) to be taken into account. This is referred to as a 60-day look-back period.

The Credit Events most commonly applicable in corporate CDS contracts are as follows.

Failure to Pay

The Failure to Pay Credit Event is generally very clear on its face. The low Payment Requirement ($1 million / €1 million) is noteworthy because relatively benign payment failures can potentially trigger settlement of the CDS contract. In addition, the Definitions give effect to any applicable grace periods in the underlying debt documentation or, if no contractual grace period applies, the Definitions imply a three-business day grace period. The definition is as follows:

> "Failure to Pay" means, after the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), the failure by the Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment Requirement under one or more Obligations, in accordance with the terms of such Obligations at the time of such failure.

The term "Obligation" for the purposes of the Failure to Pay definition is very broad. In the U.S. and Europe, obligations include any form of "Borrowed Money," which covers any bond or loan obligation of the Reference Entity. That said, CDS contracts are generally tied to the seniority of the obligations they reference. As a result, a CDS contract written on the senior obligations of a Reference Entity may not be settled using subordinated obligations of the same Reference Entity. "Subordination" refers to contractual subordination, disregarding security and collateral arrangements and the existence of preferred creditors arising by operation of law.

Historically, Failure to Pay was perhaps the most clear-cut Credit Event. However, the simplicity of the definition has been taken advantage of in recent years in the context of defaults engineered by market participants with the cooperation of the reference entity (so-called narrowly tailored Credit Event). In order to prevent misuse, narrowly tailored Credit Event terms have been incorporated into corporate CDS contracts and now require a payment failure to result from or in a credit deterioration of the reference entity in order for a Failure to Pay Credit Event to occur. The relevant amendment became effective on January 27, 2020, for most CDS contracts. It specified that a failure to pay will not be deemed a Failure to Pay Credit Event if it doesn't directly or indirectly result from (or in) the deterioration of an entity's creditworthiness or financial condition, as long as the Confirmation includes a credit deterioration requirement.

ISDA also published interpretive guidance setting out certain factors that the relevant DC should take into account when considering a Failure to Pay Credit Event. These factors are only indicators of whether a deterioration in creditworthiness is implicated (or not) and are not intended to be exhaustive or conclusive.

This interpretative guidance introduces an element of subjectivity (and, therefore, uncertainty) into the DC's determination for the Failure to Pay Credit Event. While the added uncertainty is designed to serve as deterrent against market participants' misuse of the Definitions to their

economic advantage, it makes the product somewhat less predictable and potentially more susceptible to inaccurate determinations.

Bankruptcy

The Bankruptcy Credit Event is, in most circumstances, a clear-cut event as it typically involves a bankruptcy or other insolvency filing. That said, certain prongs of the definition, such as those relating to proceedings seeking "similar relief under any bankruptcy or insolvency law or other law affecting creditors' rights," are relatively complex and their resolution may require fair amount of analysis. Bankruptcy is defined as follows:

> "Bankruptcy" means the Reference Entity (a) is dissolved (other than pursuant to a consolidation, amalgamation or merger), (b) becomes insolvent or is unable to pay its debts or fails or admits in writing in a judicial, regulatory or administrative proceeding or filing its inability generally to pay its debts as they become due, (c) makes a general assignment, arrangement, scheme or composition with or for the benefit of its creditors generally, or such a general assignment, arrangement, scheme or composition becomes effective, (d) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other similar relief under any bankruptcy or insolvency law or other law affecting creditors' rights, or a petition is presented for its winding-up or liquidation, and, in the case of any such proceeding or petition instituted or presented against it, such proceeding or petition (i) results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for its winding-up or liquidation, or (ii) is not dismissed, discharged, stayed or restrained in each case within thirty calendar days of the institution or presentation thereof, (e) has a resolution passed for its winding-up or liquidation (other than pursuant to a consolidation, amalgamation or merger), (f) seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets, (g) has a secured party take possession of all or substantially all its assets or has a distress, execution, attachment, sequestration or other legal process levied, enforced or sued on or against all or substantially all its assets and such secured party maintains possession, or any such process is not dismissed, discharged, stayed or restrained, in each case within thirty calendar days thereafter, or (h) causes or is subject to any event with respect to it which, under the applicable laws of any jurisdiction, has an analogous effect to any of the events specified in Sections 4.2(a) to (g).

Restructuring

Restructuring is generally not specified as an applicable Credit Event in North American corporate CDS contracts. This is primarily due to the fact that corporate entities typically restructure under Chapter 11 of the Bankruptcy Code in the U.S., which would trigger a Bankruptcy Credit Event. Restructuring is defined as follows:

> (a) "Restructuring" means that, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs in a form that binds all holders of such Obligation, is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation to bind all holders of the Obligation or is announced (or otherwise decreed) by the Reference Entity or a Governmental Authority in a form that binds all holders of such Obligation (including, in each case, in respect of Bonds only, by way of an exchange), and such event is not expressly provided for under the terms of such Obligation in effect as of the later of the Credit Event Backstop Date and the date as of which such Obligation is issued or incurred:
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> (i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals (including by way of redenomination);
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> (ii) a reduction in the amount of principal or premium payable at redemption (including by way of redenomination);
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> (iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest, or (B) the payment of principal or premium;
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> (iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation; or
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> (v) any change in the currency of any payment of interest, principal or premium to any currency other than the lawful currency of Canada, Japan, Switzerland, the United Kingdom and the United States of America and the euro and any successor currency to any of the aforementioned currencies (which in the case of the euro, shall mean the currency which succeeds to and replaces the euro in whole).

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring:

(i) the payment in euros of interest, principal or premium in relation to an Obligation denominated in a currency of a Member State of the European Union that adopts or has adopted the single currency in accordance with the Treaty establishing the European Community, as amended by the Treaty on European Union;

(ii) the redenomination from euros into another currency, if (A) the redenomination occurs as a result of action taken by a Governmental Authority of a Member State of the European Union which is of general application in the jurisdiction of such Governmental Authority and (B) a freely available market rate of conversion between euros and such other currency existed at the time of such redenomination and there is no reduction in the rate or amount of interest, principal or premium payable, as determined by reference to such freely available market rate of conversion;

(iii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) due to an administrative adjustment, accounting adjustment or tax adjustment or other technical adjustment occurring in the ordinary course of business; and

(iv) the occurrence of, agreement to or announcement of any of the events described in Sections 4.7(a)(i) to (v) in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity, provided that in respect of Section 4.7(a)(v) only, no such deterioration in the creditworthiness or financial condition of the Reference Entity is required where the redenomination is from euros into another currency and occurs as a result of action taken by a Governmental Authority of a Member State of the European Union which is of general application in the jurisdiction of such Governmental Authority.

(c) For purposes of Sections 4.7(a), 4.7(b) and 4.10 (Multiple Holder Obligation), the term Obligation shall be deemed to include Underlying Obligations for which the Reference Entity is acting as provider of a Guarantee. In the case of a Guarantee and an Underlying Obligation, references to the Reference Entity in Section 4.7(a) shall be deemed to refer to the Underlying Obligor and the reference to the Reference Entity in Section 4.7(b) shall continue to refer to the Reference Entity.

(d) If an exchange has occurred, the determination as to whether one of the events described under Sections 4.7(a)(i) to (v) has occurred will be based on a comparison of the terms of the Bond immediately prior to such exchange and the terms of the resulting obligations immediately following such exchange.

One key consideration in the restructuring definition is that at least some creditors must be forced into a restructuring in order to trigger a restructuring Credit Event. In other words, if all creditors consent to the amendment(s) contemplated by the definition of restructuring, a Credit Event will not occur. This feature took a prominent role during the restructuring of Greek (Hellenic Republic) sovereign debt, which ultimately resulted in an amendment to the debt documentation allowing for a drag-along of dissenting creditors, which in turn enabled the CDS to get triggered on that basis.

Another notable feature of the Restructuring Credit Event is that it contains a Credit Deterioration Requirement. Specifically, any restructuring of an obligation must arise directly from a deterioration in the creditworthiness or financial condition of the reference entity. In determining whether such credit deterioration has occurred, the DC will look for public information to that effect. This is designed to distinguish a restructuring from a refinancing. This issue took central stage in Cemex S.A.B. de C.V. a number of years ago, where the determination was ultimately sent to External Review.

A Restructuring Credit Event may also lead to a more complex settlement process than for contracts triggered by other Credit Events because certain CDS contracts will limit the debt obligations that can be taken into account to settle the CDS contract by reference to the maturity of the CDS contract. Generally speaking, only obligations with similar maturity to the CDS contract in question are eligible to settle the CDS contract. This results in different obligations being eligible to settle CDS contracts with different maturities.

The Definitions provide for two procedures for establishing the relevant maturity buckets, known as Mod-R and Mod-Mod-R. Mod-Mod-R is typically applicable for European corporate entities. The maturity buckets are calculated by establishing set periods after the restructuring date and including all CDS contracts maturing on or before the last day in such period in the relevant bucket. The relevant periods are as follows:

- 2.5 years (Mod-R only)
- 5 years
- 7.5 years
- 10 years
- 12.5 years
- 15 years
- 20 years

Under Mod-R and Mod-Mod-R, CDS contracts in each bucket may be settled only by obligations maturing on or before the end date of the applicable maturity bucket. However, obligations not affected by the restructuring event and maturing within 2.5 years of the restructuring date or, for the purposes of Mod-Mod-R only, obligations affected by the restructuring event and maturing within 5 years of the restructuring date are also eligible to settle any CDS contract.

For each maturity bucket, the DC will determine whether or not to hold an auction under its standard processes (outlined in more detail below). If the DC resolves not to hold an auction for any maturity bucket, both parties have the right to move their CDS contract into another maturity bucket for which an auction is being held. The so-called "Movement Option," if exercised by the buyer, results in the CDS contract moving to the next shortest-dated bucket for which there is an auction. If the seller exercises the option, the CDS contract is moved to the longest-dated bucket for which an auction is held. If both parties elect the option, the buyer's election prevails.

Governmental Intervention

The Government Intervention Credit Event applies to non-U.S. financial Reference Entities and was added as a new Credit Event in 2014 when the new 2104 Credit Derivatives Definitions were published. The necessity for the new Credit Event became obvious in early 2013 when the Dutch government nationalized SNS Bank and expropriated all of its subordinated bonds. This action created significant market uncertainty since government bail-in was not expressly covered by the Restructuring Credit Event under the 2003 Definitions. Government Intervention is therefore a useful complement to Restructuring and provides certainty to market participants when governments take certain bail-in actions in respect of financial institutions, especially since new European legislation has facilitated those types of intervention.

The definition is as follows:

> (a) "Governmental Intervention" means that, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs as a result of action taken or an announcement made by a Governmental Authority pursuant to, or by means of, a restructuring and resolution law or regulation (or any other similar law or regulation), in each case, applicable to the Reference Entity in a form which is binding, irrespective of whether such event is expressly provided for under the terms of such Obligation:
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> (i) any event which would affect creditors' rights so as to cause:
>
> (A) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals (including by way of redenomination);
>
> (B) a reduction in the amount of principal or premium payable at redemption (including by way of redenomination);
>
> (C) a postponement or other deferral of a date or dates for either (I) the payment or accrual of interest, or (II) the payment of principal or premium; or
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> (D) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation;
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> (ii) an expropriation, transfer or other event which mandatorily changes the beneficial holder of the Obligation;
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> (iii) a mandatory cancellation, conversion or exchange; or
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> (iv) any event which has an analogous effect to any of the events specified in Sections 4.8(a)(i) to (iii).
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> (b) For purposes of Section 4.8(a), the term Obligation shall be deemed to include Underlying Obligations for which the Reference Entity is acting as provider of a Guarantee.

Pursuant to the 2014 Credit Derivatives Definitions, a Governmental Intervention Credit Event is triggered when a government's action or announcement results in binding changes to certain Obligations of a Reference Entity including a reduction or postponement of principal or interest or further subordination of the Obligation, an expropriation, transfer, or other event which mandatorily changes the beneficial holder of the Obligation, or a mandatory cancellation, conversion, or exchange of the Reference Entity's Obligations.

While Government Intervention and Restructuring overlap to some extent, there are noteworthy differences between the two Credit Events. Importantly, a Government Intervention Credit Event can be triggered regardless of whether there has been a deterioration in the creditworthiness of the Reference Entity and even if the government intervention event is expressly contemplated by the terms of the Obligation.

Publicly Available Information

The occurrence of a Credit Event must be evidenced by publicly available information. Any public information released by the reference entity itself, a court, regulator, agent, or trustee under a debt obligation generally qualifies. Alternatively, two public sources such as financial press articles are required. Naturally, this makes the content of any press articles critical and can, on occasion, lead to activism from CDS market participants seeking to push information supporting their desired position into the market.

CDS Settlement

If the DC finds that a Credit Event has occurred, the DC will also decide whether an auction should be held to determine the market value of certain qualifying (deliverable) obligations of the reference entity.

Before the advent of auction settlement, CDS contracts were in most instances physically settled. Under physical settlement, the CDS protection buyer would deliver to the CDS protection seller Deliverable Obligations of the reference entity with a face amount equal to the notional amount of the CDS contract, in exchange for a payment generally equal to the notional amount (i.e., receiving par for the Deliverable Obligations). Protection buyers had an incentive to source and deliver the “cheapest” Deliverable Obligation in the capital structure so as to maximize the return on their CDS positions. However, in instances where the net notional amount (volume) of CDS written on a given reference entity vastly exceeded to the amount of accessible Deliverable Obligations of that reference entity, the need to source the Deliverable Obligations for purposes of CDS settlement increased demand for the debt, thereby driving up its price and reducing the economic benefits of the CDS contracts to the protection buyers who were forced to purchase the Deliverable Obligations at an inflated price.

Starting in 2005, CDS market participants established a mechanism to cash settle the CDS contracts on a number of reference entities using an auction process to establish the price at which the CDS contract would be settled for all CDS market participants electing to participate in the process (via a protocol published by ISDA). In 2009, auction settlement was incorporated into the CDS contract via a supplement published by ISDA and became the standard settlement method for the vast majority of CDS contracts. If an auction is not held to settle the contract, physical settlement applies as a fallback.

Deliverable Obligations

Only certain qualifying debt, or “Deliverable Obligations,” of the reference entity are eligible to be used in connection with the settlement of the CDS contract (i.e., delivered to the protection seller under physical settlement or bided upon in a CDS auction). Deliverable Obligations are determined based upon certain criteria and characteristics set forth in the Definitions.

Generally speaking, bonds or loans documented on market-standard terms qualify as Deliverable Obligations. That said, some of the main characteristics that must be satisfied in order for an obligation to be a Deliverable Obligation are as follows:

- **Not subordinated.** This term refers exclusively to contractual subordination. Any security and collateral arrangements (such as collateral subordination or collateral proceeds priorities) and the existence of preferred creditors arising by operation of law do not impact an obligation’s deliverability.
- **Transferable (bonds).** A bond must be generally transferable to institutional investors without any additional contractual, regulatory, or statutory restrictions. Common restrictions such as 144A/Reg S or regulatory limitations on investments for pension funds or insurance companies are permissible.
- **Assignable / consent required loan.** Similar to bonds, loans must also be generally transferable. For a loan containing no borrower/agent consent requirements, a loan must be transferable to commercial banks or financial institutions. For loans containing a borrower and/or agent consent right, the loan must generally be capable of assignment with such consent. The External Review Panel in Sears Roebuck Acceptance Corp. held that limitations on eligible assignees for a Consent Required Loan may still be permissible provided such limitations were consistent with market practice and did not serve to materially restrict the universe of assignees.
- **Maximum maturity.** A Deliverable Obligation may have a maximum of 30 years left to maturity from the date deliverability is determined.

One critical component of the Deliverable Obligation determination is the requirement that the obligation, and the terms demonstrating its compliance with the relevant characteristics, must be publicly available. The DC Rules require the DC to consider whether an obligation satisfies the requirements to be listed as a Deliverable Obligation based upon publicly available information. Market participants may also identify obligations to the DC and provide the DC with additional information as part of that process. However, any market participant submitting information to the DC in that respect must represent that the information it is providing is (or can be) made publicly available.

Guarantees

Guarantees by the reference entity of qualifying debt issued by a reference entity's affiliates may also constitute Deliverable Obligations as long as both the debt and the guarantee satisfy certain criteria. North American CDS contract terms provide that only qualifying guarantees of debt obligations issued or borrowed by so-called downstream affiliate are taken into account as a Deliverable Obligation. A downstream affiliate is defined as an entity whose outstanding voting shares are more than 50% owned, directly or indirectly, by the reference entity.

CDS Auction

The determination as to whether or not to hold an auction is made by the DC based on certain criteria set forth in the DC Rules. If there are at least 300 CDS transactions on a reference entity providing for auction settlement as the primary settlement method and at least five major swap dealers are party to those transactions and elect to participate in the auction, CDS contracts should settle via auction settlement. The auction process enables CDS market participants to use cash settlement in their CDS contracts using the Final Price for the Deliverable Obligations set by the auction. In addition, CDS market participants who wish to replicate physical settlement for up to the net position of their CDS contracts may elect to participate in the auction by submitting requests to either buy the Deliverable Obligations (for a CDS protection seller) or sell the Deliverable Obligations (for a CDS protection buyer), in each case at the Final Price set for the Deliverable Obligations in the CDS auction.

The CDS auction is highly complex but generally comprises the following two stages:

(1) Initial Market Midpoint and Physical Settlement Requests:

a) The DC-member dealers make submissions of bid and offer prices on the Deliverable Obligations. Qualifying quotations are average to produce a "market price," referred to as the Initial Market Midpoint, which will be used as the starting price in the second stage of the auction process.

b) Participating dealers, on behalf of themselves or their customers, submit requests (physical settlement requests) to either buy or sell a certain quantity of Deliverable Obligations. Physical settlement requests submitted by market participants must be in the same direction (i.e., a net CDS protection buyer may only submit a physical settlement request to sell the Deliverable Obligations) and not exceed the net position of the market participant submitting the request (either directly or via a participating dealer). For example, a market participant having bought $100mm of CDS protection may only submit an offer to sell Deliverable Obligations and may only make a physical settlement request to sell of up to $100mm. Those requests only indicate an amount of Deliverable Obligations that the CDS protection buyer/seller wishes to sell/buy in the auction. They may not designate a specific Deliverable Obligation or a price. The net of these buy and sell requests across all dealers, referred to as the Net Open Interest, determines whether traders in the second stage of the auction will bid to purchase or offer to sell the Deliverable Obligations in an amount equal to that Net Open Interest.

c) This first stage of the auction occurs in the morning, with the dealers being required to submit their initial market bids/offers and net physical settlement requests within a designated 15-minute window. Within 30 minutes following the end of that period, the results of the first stage of the auction are published on CreditFixings, here.

(2) Dutch Auction:

a) Following the publication of the results of the first stage, there is a 2–3 hour window during which a Dutch auction is run to fill the Net Open Interest. For a Net Open Interest to buy, the offers to sell Deliverable Obligations are floored at the Initial Market Midpoint minus 1%. This limit is auction-specific and specified in the auction settlement terms. Offers will be made at a price (in increments of .125) and for a specified face amount of Deliverable Obligations (typically in minimum increments of $1mm). The offers will be taken in ascending order until the total face amount of the offers reaches, or fills, the Net Open Interest. The price associated with the offer that fills the Net Open Interest constitutes the clearing "Final Price" at which the CDS contract cash settles. Conversely, if

there is a Net Open Interest to sell, there is a bid cap at the Initial Market Midpoint plus 1%. The bids will then be sorted in descending order.

While the auction is fundamentally a cash-settlement mechanism, market participants making physical settlement requests in the first stage of the auction may also physically settle their CDS contracts up to the amount they requested in the first stage (assuming the Net Open Interest is entirely filled). Those trades are called Representative Auction-Settled Transactions (RAST) and the RAST physically settle with the CDS protection buyer delivering Deliverable Obligations to the CDS protection seller (in the size of the physical settlement request) in exchange for the Final Price. Because CDS market participants do not select a Deliverable Obligation or designate a price when submitting a physical settlement requests, market participants assume that they will trade the cheapest Deliverable Obligation of the reference entity, and the Final Price tends to revolve around that price assuming sufficient supply.

For each auction, the DC publishes a set of Auction Settlement Terms setting out the auction procedure, metrics, timeline, and relevant rules governing the bidding process. These terms are generally uniform from auction to auction but the DC provides a blackline against the terms for the most recent prior auction to show any changes.

Succession Events

Succession events may cause the Reference Entity under a CDS contract to change depending on the amount of debt issued or borrowed by the Reference Entity assumed by or transferred to other (successor) entities.

Successions

A succession event occurs where one or more entities succeed to a sufficient amount of bonds and loans of the Reference Entity (typically more than 25%). In those instances, a determination is made as to whether the CDS contract written on the Reference Entity should reference one or more of such successor entities (and in which proportion). Any request to the DC to determine a successor will only be taken into account if the date of the event in question is not more than 90 days prior to the date of the request.

"Succession" (and "succeed") under the Definitions means that one or more successor entities have assumed the relevant obligations of a Reference Entity either by agreement or operation of law (e.g., a merger) or via an exchange offer where the Reference Entity's obligations are exchanged for new obligations issued by such successor entities. The Reference Entity may be a successor if it retains at least 25% of its qualifying bonds and loans. Once the number of successors has been determined, the notional amount of the CDS contract will be reallocated equally among the successors.

For purposes of determining whether an entity succeeds to the relevant obligations of the Reference entity and in which proportion, the assumed or exchanged for obligations are measured against all relevant obligations of the Reference Entity outstanding immediately prior to the succession event. Obligations succeeded to by an affiliate of the Reference Entity (only a "downstream" affiliate in the North American CDS contract), but that are guaranteed by the Reference Entity are not deemed to have been succeeded to because the Reference Entity continues to be an obligor with respect to those obligations.

Steps Plans

For multistage refinancings, the 2014 Definitions introduced the concept of a Steps Plan. Under a Steps Plan, all steps of a transaction contemplating a series of successions are aggregated for the purposes of the succession event analysis. In order to establish that a Steps Plan has occurred, there must be publicly available information indicating that a series of transactions are contemplated. For example, if disclosures surrounding a refinancing indicated that an exchange offer would occur with respect to certain relevant obligations of the Reference Entity and, some time later, another relevant obligation of the Reference Entity is assumed by a successor, all obligations subject to the exchange offer and the assumption would be aggregated for the purposes of the succession event analysis.

Universal Succession

In addition, the Definitions also addresses circumstances in which a Reference Entity is entirely replaced. A "Universal Successor" exists where an entity assumes all of the obligations of a Reference Entity and, at the time of determination, the Reference Entity has ceased to exist or is in the process of dissolution or winding up. Where there is a Universal Successor, no backstop date applies for the purposes of whether the DC will take into account a request.

Index CDS

In addition to single-named CDS (i.e., a CDS contract referencing a single reference entity), index CDS comprises a significant portion of overall CDS trading volume. An index CDS is a CDS contract referencing a basket of

multiple reference entities. Following a Credit Event, an index CDS contract is partially settled, with the affected component being removed from the index. The settlement payment is the product of the CDS auction Final Price and the portion of the notional amount attributable to the affected component. The notional amount is essentially divided between the number of components. For example, $100 million notional of a CDS index comprising 100 components would be divided $1 million per component.

Index components are reviewed periodically by Markit and the latest version of each index is posted on the Markit website. The relevant version of the index is specified in the trade confirmation. An index CDS is impacted by the same Credit Events as a single-name CDS, albeit those events will apply on a constituent-by-constituent basis. However, market participants holding only index CDS positions are not able to participate in the first stage of the CDS auction, meaning they cannot impact the Net Open Interest nor elect to establish physically settled trades as part of the auction.

Index CDS allows a market participant to take a broad view on segments of the market, such as North American investment grade or high yield reference entities. U.S. indices are generally included in the CDX family and EMEA and APAC indices are included in the iTRAXX family. Different indices have varying numbers of constituents, from around 10 in the smallest indices to 125 in the North American and European investment grade indices. It is also notable that index CDS is exclusively a cleared product, unlike single-name CDS for which there remains a sizeable OTC market. Index CDS is currently cleared through ICE.

Regulations

The underlying reference for most CDS is a single entity or an index of entities. Any swap that is triggered by an event relating to the financial statements, the financial condition, or the financial obligations of a single security issuer (such as an issuer bankruptcy or a default on one of the issuer's debt securities) is a security-based swap. Single-name CDS, on that basis, is clearly a security-based swap and, therefore, is regulated in the U.S. by the SEC.

With respect to index CDS, the question is a little more complicated and dependent upon the index in question. Where the underlying reference for an index CDS is either (1) itself a narrow-based security index, or (2) issuers of securities in a narrow-based security index, the index CDS is also a security-based swap. On the other hand, an index CDS where the underlying reference is not a narrow-based security index or the issuers of securities in a narrow-based security index (i.e., a broad-based index) is a swap. To define "issuers of securities in a narrow-based security index and narrow-based security index" in the context of index CDS, the SEC and CFTC adopted similar criteria to those that apply for the equity and futures markets, as well as some additional criteria. The criteria include the requirements that the index must be comprised of a small number of reference entities or securities (nine or fewer), whether the effective notional amount allocated to a reference entity or security included in the index comprises more than 30% of the index's weighting, or whether the effective notional amount allocated to the reference entities or securities of any five nonaffiliated issuers included in the index comprises more than 60% of the index's weighting.

Since the determination of whether a product is a swap or security-based swap is made at or prior to the time parties offer to enter into a transaction, the categorization of the swap does not change if the security index underlying the product subsequently migrates from broad to narrow (or vice versa). This categorization is significant as swaps (as opposed to security-based swaps) are regulated in the U.S. by the CFTC. This creates an interesting market dynamic whereby the CFTC regulates broad-based index CDS, and the SEC regulates single-name and narrow-based index CDS. Given the statutes granting the CFTC and SEC authority over their respective markets contain slightly different standards in some respects. Any party active in single-name CDS should therefore be aware if the relevant reference entity is included in any index as that could open any trade up to both SEC and CFTC scrutiny.

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