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Standardization of Muni CDS

On March 5th, ISDA published the 2012 ISDA U.S. Municipal Reference Entity Supplement to the 2003 ISDA Credit Derivatives Definitions (the "March 2012 Supplement"), which is intended to standardize credit default swaps referencing U.S. municipal issuers or obligations as the reference entity or reference obligation ("muni CDS") with credit default swaps referencing corporate and sovereign CDS. The March 2012 Supplement generally applies to muni CDS certain industry standards that became applicable to corporate and sovereign CDS through the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions, which was adopted by the vast majority of the market through the "Big Bang Protocol."[1] At the time the Big Bang Protocol was implemented, the market focus was on standardizing the terms of the corporate and sovereign CDS sectors, which were much larger in comparison. Since that time, the trading volume of the muni CDS market has grown significantly, as has market interest in trading products that are liquid, fungible (generally, easier to offset with one another), and have the characteristics necessary for central clearing.

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The March 2012 Supplement generally subjects muni CDS to the resolutions of the ISDA Determinations Committees, mandatory auction settlement processes and "look-backs" on credit events and succession events by incorporating the Big Bang Protocol. Among other things, through the March 2012 Supplement, muni CDS transactions have been brought under the jurisdiction of the existing ISDA Determinations Committee for the Americas, which is the body that, *inter alia*, determines whether a credit event or succession event has occurred. Moreover, the auction mechanism for determining the "final price" of assets in connection with a credit event has been hardwired into muni CDS contracts, with cash settlement becoming the standard settlement method. Also, the Determinations Committees Rules have been amended in connection with muni CDS, such that: (i) holding an auction is mandatory where at least 3 dealers (as opposed to at least 5 dealers for corporate and sovereign CDS) are parties to 300 or more trades; and (ii) if one of the top 6 dealers by trading volume in single-name muni CDS and the *Markit* MCDX index (*i.e.*, an index comprised of 50 U.S. municipal credits, encompassing both general obligations and revenue obligations) fails to participate in an auction, then that dealer will be removed from the Determinations Committee for purposes of making muni CDS determinations.

To further facilitate the standardization of the muni CDS product, the dealer community has modified certain trading conventions in conjunction with the March 2012 Supplement, including providing for standardized fixed coupons of 100 basis points and 500 basis points, which is the same convention used for North American corporate names. All provisions of the March 2012 Supplement became effective on April 3rd, except for those

[1] For more information on the Big Bang Protocol, please click here.

relating to the look-back periods, which will become effective on June 20, 2012. However, the terms of the March 2012 Supplement also became applicable to muni CDS entered into prior to April 3rd if the counterparties thereto both elected to adhere to the 2012 ISDA U.S. Municipal Reference Entity CDS Protocol. Over 100 market participants signed up to this protocol during the period for adherence, which opened on March 5th and closed on April 2nd.

The March 2012 Supplement should make muni CDS more liquid and encourage trading. From initial data, it appears that the enhanced standardization has indeed succeeded in increasing muni CDS trading volumes. In fact, shortly after the terms of the March 2012 Supplement took effect on April 3rd, it was reported that trading volume in the *Markit* MCDX index increased to between $2 to 3 billion from a pre-standardization norm of between $500 million to $1 billion. Despite this marked increase in trading activity, some have cautioned that a large and vibrant muni CDS market could make it easy for speculators to zero in on an issuer perceived as struggling, sharply impacting that issuer's borrowing costs.