**American College of Investment Counsel Annual Meeting**
**Outline for Derivatives Panel: "The Pardoner's Tale"**
**October 18, 2018**

## Introduction

- This panel will focus on the use of credit default swaps (CDS) as a means of providing favorable refinancing terms to the debt issuer that is the subject of the CDS via engineered credit events.
- Our discussion will be separated into three parts:
  - We will begin by explaining what CDS are and how they work.
  - We will then provide two concrete, real-world examples: McClatchy and Hovnanian.
  - Using the two examples, we will discuss the implications of using CDS in this manner.

## Part I – Laying a Foundation

- What is a credit default swap?
  - An agreement whereby one party, the protection buyer, makes periodic payments to the other party, the protection seller, in exchange for the protection seller's agreement to pay the protection buyer its premium and all interest payments that would have been paid by the entity that is the subject of the CDS, i.e., the "reference entity," should a "credit event" occur in respect of such reference entity.
- CDS are typically documented using an International Swaps and Derivatives Association (ISDA) Master Agreement, an industry form. This is relevant because the Master Agreement incorporates ISDA's Credit Derivatives Definitions (most recently updated in 2014, though there are 1999 and 2003 versions) and ISDA's Credit Derivatives Determinations Committees Rules (last updated in 2016).
  - The ISDA Credit Derivatives Definitions identify the "credit events" in respect of a reference entity that would trigger payment by a protection seller to a protection buyer. They include:
    - Bankruptcy;
    - Failure to make payments;
    - Debt restructuring.
  - The Determinations Committees determine whether a credit event in respect of a reference entity has occurred pursuant to the ISDA Credit Derivatives Definitions.
    - ISDA has five regional Credit Derivatives Determinations Committees, each of which has 10 sell-side and five buy-side members.
    - Insofar as the determinations are concerned:
      - A determination can only be made based on publicly available information submitted to the Determinations Committee;
      - The Determinations Committee cannot make subjective decisions;
      - The Determinations Committee cannot consider the intent or good faith of the parties that put in place the arrangements leading to a potential credit event.
- Who enters into CDS, and why?
  - Historically, CDS were used a means of hedging against the potential default of the reference entity.

  - As Hovnanian and McClatchy will demonstrate, we are seeing the CDS market evolve, and CDS are becoming more of an opportunistic investment strategy for protection buyers, arguably at the expense of protection sellers.

**Part II – Case Studies: McClatchy and Hovnanian**

- Discussion of the McClatchy case.
  - The players:
    - McClatchy = newspaper publisher. Has been suffering losses for some time and has a significant amount of debt. A substantial amount of CDS is written on McClatchy.
    - Chapman = holder of McClatchy's debt and CDS protection seller on McClatchy.
  - In April 2018, Chapman agrees to refinance McClatchy's debt. Agrees to provide McClatchy a $418+ million loan on the conditions that such re-financing be used to buy back debt owned by Chapman and that new debt obligations be held in a new subsidiary.
  - The effect:
    - There would be almost no debt remaining at McClatchy, i.e., the reference entity, resulting in orphan CDS.
  - Current status:
    - McClatchy subsequently clarified that it would guarantee the new debt obligations held by its subsidiary.
- Discussion of the Hovnanian case.
  - The players:
    - Hovnanian = a large construction firm specializing in residential housing. Suffered financial losses during the 2008 financial crisis.
    - GSO = protection buyer on Hovnanian.
    - Solus Alternative Asset Management = protection seller on Hovnanian.
  - GSO and Hovnanian agree to a refinancing of Hovnanian's debt, at preferential terms to Hovnanian, on the condition that Hovnanian not pay interest in May 2018 on certain of its debt.
  - The effect: potential failure to pay credit event if Hovnanian does not make interest payments on debt that are due in May 2018.
  - Current status:
    - Solus sues Hovnanian and GSO in January 2018 alleging manipulation of the CDS market.
    - Solus sought an injunction, which was denied.
    - Case settled in May 2018.

**Part III – Implications of these Unconventional CDS Transactions**

- Do the actions of McClatchy and Chapman or Hovnanian and GSO raise market manipulation concerns?
  - If single-name CDS, the CDS is considered a security and manipulation would be governed by Section 10(b) of the Exchange Act and related Exchange Act rule 10b-5.
- How do you see this "unconventional" use of CDS affecting the CDS market?
- Can ISDA do anything?

  - ISDA's board of directors released a short public statement in April 2018 indicating that narrowly tailored defaults that are defined to result in CDS payments that do not reflect the creditworthiness of the underlying corporate borrower and could negatively impact the efficiency, reliability and fairness of the overall CDS market.
    - Instructed ISDA staff to consult with market participants and advise the board as to whether the ISDA Credit Derivatives Definitions should be amended.
- How can protection sellers protect themselves (absent action by ISDA)?
  - Parties are always free to negotiate/amend the ISDA Master Agreement form, including how the ISDA Credit Derivative Definitions will apply.