

# ISDA consults on proposed changes to Credit Derivatives Determinations Committees

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In May 2024, ISDA published a [report](#) on the function, governance and membership of the Credit Derivatives Determinations Committees. The report was commissioned by ISDA in December 2023 at the request of market participants and suggests several improvements to the Committees.

The proposed changes are subject to [market consultation](#) until 26 July 2024. They include:

- addressing perceived conflicts of interest by appointing independent, legally qualified members, with one acting as chairperson;
- allowing questions to be referred to an independent panel by a simple majority;
- establishing a separate governance body to increase accountability;
- reducing the number of dealer- and non-dealer members to eight and four, respectively;
- facilitating access to buy-side members by reducing the eligibility criteria and allowing participation in a single Committee;
- modifying the question submission procedure and requiring enhanced disclosure in relation to Committee decisions; and
- establishing a working group to consider the viability of a transaction-based funding approach.

The report was prepared by Linklaters LLP in an independent capacity and is based on feedback received from a range of stakeholders, as well as Linklaters' analysis of the issues. ISDA has not endorsed any of the recommendations and any changes made will be decided by the Committees, based on consultation feedback. The report does not consider previous decisions made by the Committees or the auction process.

This briefing provides a high-level summary of the report's recommendations. Capitalised terms that are not otherwise defined have the meanings given to them in the 2014 ISDA Credit Derivatives Definitions or the Credit Derivatives Determinations Committees Rules (the **DC Rules**).

## Background and Committee structure

The Committees were established in 2009 to centralise and standardise the settlement process after the occurrence of a Credit Event. Until then, the process was often uncertain and inefficient, with cumbersome and error-prone notifications. Often, market views differed on whether a Credit Event had occurred, and which obligations constituted Deliverable Obligations. The ensuing disputes affected the settlement process and caused market disruption. This, in turn, made it more difficult for credit derivatives to be subject to clearing, as clearing necessitates a standardised approach to settlement.

The Committees were introduced to resolve these issues. The principal role of the Committees is to make determinations as to:

- whether a Credit Event has occurred in respect of a particular Reference Entity;
- whether an auction is required;
- which obligations are deliverable; and
- whether a corporate event has created a Successor to the Reference Entity.

The structure and functioning of the Committees are governed by the DC Rules. Under these rules, Committee determinations are binding on entities that have transacted on terms that incorporate the 2014 ISDA Credit Derivatives Definitions (or the previous, but updated, version of the 2003 ISDA Credit Derivatives Definitions).

There are five Committees, each covering a particular geographical region. Each Committee theoretically comprises up to ten dealer members and up to five non-dealer members, with membership reassessed annually. However, there are currently only nine dealer members (eight in the case of the Australia and New Zealand Committee) and three non-dealer members. There are also three non-voting clearing house members.

Eligible market participants can initiate the determination process by making a request to the DC Secretary. To be considered by the Committee, the request must then be accepted by a minimum number of members.

## **Key issues and recommendations**

### **DC composition**

According to the report, Committee membership has decreased over time, largely due to (i) the prohibitive commitment of resources and costs, (ii) onerous compliance procedures, and (iii) legal and reputational risk. The report also observes that, although many questions are resolved swiftly, this is not always the case and Committee meetings can be adjourned repeatedly, resulting in delayed decisions.

Several of the report's recommendations address these issues. For example, it suggests reducing the desired number of dealer - and non-dealer members to eight and four (from ten and five), respectively, to align the requirement with the current position.

Market feedback suggests that more buy-side participation would be welcomed, so the report suggests facilitating access to non-dealers by lowering the notional amount eligibility threshold from USD 1 billion and permitting non-dealers to choose to join one Committee only, instead of being required to join all five.

### **Conflicts of interest**

Perceived conflicts of interest can arise if a Committee member holds credit derivative positions that could influence their decision. Clearly, members should make, and - importantly - be seen to make, unbiased determinations, to preserve market confidence. According to the report, a number of respondents raised this concern, as did several regulators.

In response, the report concludes that, although the DC Rules already contain certain safeguards, including member representations as to conflict management, both the Committee structure and

members' internal conflict management procedures could be improved to increase market confidence.

Suggested improvements in this area include:

- the appointment of up to three Committee members who (i) are legally qualified, (ii) are not affiliated to an organisation that takes credit derivatives positions, and (iii) have experience of the financial markets. The example cited by the report is that of a retired judge;
- Committee meetings to be chaired by one of the independent members;
- allowing questions to be referred to an independent panel by a simple majority (rather than only if an 80% supermajority is not achieved, as is currently the case);
- the introduction of a code of conduct or similar for members; and
- the ability for members to recuse themselves on the grounds of conflicts of interest.

## **Governance**

Although ISDA's Credit Steering Committee provides feedback on the Committees, there is currently no formal supervision or governance of Committee operations. This gives rise to a lack of accountability and can result in possible improvements being overlooked.

To address this, the Report recommends establishing a separate governance body to oversee the Committees, including by seeking and actioning market feedback, and to update the DC Rules as necessary.

The report also suggests that the governance body could have the ability to appoint independent auditors to audit members' compliance procedures, and recommends seeking further views on this.

## **Transparency and Committee deliberations**

The report considers that Committee transparency is hampered by the disclosure of insufficient detail as to (i) the decision-making process - for example, the reasons for declining to consider a particular question, and (ii) the rationale behind material decisions - for example, deliberations on Credit Event questions or the modification of auction settlement terms.

The main propositions here recommend full disclosure on the Committee website of any material step taken in the decision-making process, as well as adequate reasons for all material decisions made. In general, a more user-friendly presentation of the Committee website is also recommended.

A further recommendation suggests that market participants should be able to present statements of case in support of an assertion that (for example) a Credit Event has, or has not, occurred. This would need to be within certain parameters, including that the submissions should be posted on the public Committee website. Currently, Committee members can read advocacy papers that have been submitted in favour of a particular approach without disclosing that information to market participants (and thereby affording those other market participants the opportunity to present alternative views). The report recommends that this practice be discontinued as it is inconsistent with general principles of procedural fairness.

Finally, the report suggests that the DC Rules should be amended to expressly state that:

- questions of contractual interpretation should be resolved by applying the relevant governing law, using a guide to the principles of interpretation under English and New York law (and, we presume, French and Irish law, to the extent that those versions of the ISDA Master Agreement are used) that should be prepared for such purpose;
- questions of fact are to be determined on a "balance of probabilities" basis; and
- conversations between members and relevant legal advisors are permitted outside official Committee proceedings.

## **Process initiation and determinations**

Currently, an eligible market participant can formulate its request to convene a Committee in a general manner; there is no prescribed process, no need to identify or describe the facts supporting a statement, and no requirement to provide information enabling the Committee to make a determination. This renders the process long and inefficient, leaving the burden on the Committee to identify and analyse the facts and seek additional information where necessary.

Furthermore, while the requirement for at least one member to accept the question ensures that only issues of market-wide importance are considered, where the issues are obviously pertinent for the whole market, this lengthens the determination process unnecessarily.

In respect of these issues, the report recommends that the DC Rules are modified so that:

- the submission of a question is accompanied by adequate supporting information;
- it is explicitly recognised that the Committees are not responsible for sourcing additional information;
- Committees can make a determination that it is "not proven" that a Credit Event has occurred where there is insufficient admissible evidence; and
- questions are automatically accepted if certain criteria are satisfied.

## **Funding**

The current funding model relies entirely on member contributions, while all market participants benefit from Committee determinations. The report notes that this model is unfair and, in light of the decreasing number of Committee members, unsustainable.

It is also of note that some of the proposals would, if implemented, give rise to increased costs.

The report suggests that Committee funding would ideally come from a levy on individual transactions, so that the costs are borne by all market participants, proportionately.

According to the report, some buy-side respondents indicated that they would be amenable to some form of transaction-based charge. One respondent suggested that all costs should be borne solely by dealers, on the basis that they are the main beneficiaries of the arrangements, but the report disagrees with this on the basis that the benefits of the Committee process are much wider and accrue, directly or indirectly, to all market participants.

Here, the report concludes by suggesting that a working group be established to consider the possible options and seek market feedback on these.

## **Other Issues**

The report also considered whether the Committees and the DC Rules rely too much on a legal approach to the detriment of a more commercial stance. However, the large extent to which members are represented by legal departments or firms does not appear to be a negative point for most respondents.

## **Market perception**

In our view, the report presents a fair and detailed description of perceived issues with the Committee process. The proposed solutions are generally reasonable and balanced, with well-reasoned pros and cons, and could help to promote transparency and boost market confidence in the functioning of the Committees.

Some of the proposed solutions should be easy to achieve, such as providing the Committees with guidance on contractual interpretation, and including independent members is a welcome idea as it enhances the existing framework while increasing safeguards against conflict.

However, having an independent panel make Committee determinations, even if on a voluntary basis, could be the precursor to a shift away from the ideology on which the Committees were first founded - namely, that market participants would have decisions made by their own community, by a group of institutions which collectively has an interest in ensuring a fair and robust process and outcome - which may, if not considered carefully, lead to unintended consequences. So far, while there are - as the report notes - areas for improvement, the Committee process has been considered to work sufficiently well that some market participants may consider that a more ideological change such as this is unnecessary.

## **Further commentary**

While market support for the Committees remains strong, the report concludes that targeted changes could increase their efficiency and make them more effective.

Ultimately, any changes will need to be agreed by the Committees, based on the consultation feedback. However, the report reveals a tension between the desire for improved governance and more transparency on the one hand, and the need for efficiency in decision-making and the ever-present spectre of increased costs on the other. Any changes to the Committee process will likely be incremental rather than wholesale, and only those that have a strong probability of success in enhancing the functioning of the CDS market without compromising efficiency in decision-making will likely pass muster.

Authors: Daniel Franks, Partner; Julia Lu, Partner; Kirsty McAllister-Jones, Counsel; Agathe Petit, Associate