

The “Big Bang” Protocol and its effects on credit default swaps

by Rebecca E. Lee

Many alternative investment funds buy or sell protection on bonds (or a portfolio of bonds) through credit default swaps (CDS). Recent changes in documentation and market practice for CDS may affect the terms or tax characterization of these products. Many of these changes were optional and may not affect alternative investment funds that did not “opt in” to change their practices. The facts and circumstances surrounding each fund’s changes should be evaluated to determine the tax effect, if any.

For example, the so-called “Big Bang” Protocol has changed the execution of credit default swaps for many alternative investment funds. Prompted by the calls for standardization in the credit markets in light of the credit crisis and the failure of Lehman Brothers Inc., the Big Bang Protocol may have a substantial commercial impact on our clients. The discussion below highlights some of the tax considerations implicated by the Big Bang Protocol and other recent events in the CDS market.

The Big Bang Protocol and related market practice changes for CDS

On April 8, 2009, a number of changes were made to CDS documentation and market practice (referred to collectively here as the Big Bang Protocol) that may affect alternative investment funds’ structures for both new and existing CDS. These changes come at a time when the Obama administration has been considering substantial regulatory reform of the financial markets as a whole.

Changes to the standard ISDA documents

On April 8, 2009, the International Swaps and Derivatives Association Inc. (ISDA) issued the 2009 Supplement to the 2003 ISDA Credit Derivatives Definitions, the governing documents for most ISDA-documented CDS. These changes related

primarily to the determination of whether a credit event has occurred and the manner of settlement, rather than on the determination of the settlement price on the occurrence of such event.

The 2009 Supplement applies to CDS entered into on or after April 8, 2009. CDS participants can opt in and apply the 2009 Supplement for existing CDS. The period to modify CDS ran from March 12, 2009 to April 7, 2009. Certain kinds of credit derivatives, such as standardized CDS including LCDS and LCDX, are excluded from the new protocol.

As a follow-up to the Big Bang Protocol, in mid-July 2009, ISDA published the 2009 ISDA Credit Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions and proposed supporting revisions to the Credit Derivatives Determinations Committees Rules. These additional changes, referred to in part as the “Small Bang” Protocol, are intended to provide further stability to the CDS market by standardizing the terms and pricing of the settlement of CDS triggered by debt restructurings.

Changes in market practice

At the same time, CDS dealers have agreed to make changes to market practices for North American corporate CDS to create new standardized products for this market. The changes bring these practices in line with prior changes in the CDS index market.

The most visible change is the standardization of the coupon payments on CDS to fixed payments of either 100bps (for investment-grade credits) or 500bps (for high-yield credits). For the vast majority of CDS, this will require an upfront payment by one counterparty to the other to customize the coupon rate to match the credit profile of the underlying bond.

Other changes to make CDS uniform include standard quarterly settlement dates, standardized accrual terms, and a prohibition against restructuring the CDS during its term.

Market participants still have freedom to execute nonstandardized CDS transactions in certain circumstances.

Additional regulation

Two additional developments may affect the CDS market.

First, as part of its financial regulatory reforms, the Obama administration has proposed the regulation and oversight of over-the-counter derivatives. These regulatory measures, if enacted, likely would cover CDS.¹ These measures have been gaining popularity in Congress as well.²

Second, certain exchanges have already received permission to begin processing and clearing CDS. A CDS may begin as an exchange-traded transaction or may begin “off-exchange” and be moved onto the exchange during its term.

Tax considerations

There are three primary tax considerations from the changes in ISDA documents and market practice described above.

Section 1001 considerations

Many alternative investment funds may choose to adopt the standardizing changes with respect to existing CDS. In most cases, this requires amendments to the terms of the CDS (for example, changing the coupon rate to the standardized rate, coupled with an upfront payment). Changes to existing CDS must be tested to determine whether they rise to the level of a material change in kind or extent (i.e., a realization event under section 1001). Unlike in the debt modification area, there are no bright-line tests for determining whether a realization event has occurred.³

In general, the changes in the contractual terms of the swap, such as changes to the manner in which

the final payment is determined and the time in which final settlement must be paid, likely do not represent “material changes in kind or extent” on the CDS unless the particular change (or set of changes) is economically significant.

Similarly, cumulative changes to the terms of the CDS (like an upfront payment paired with a change in coupon rate to the standardized rate) that keep the economics of the CDS identical to the economics of the old CDS (for example, keeping the coupon rate and exposure the same) likely do not rise to the level of a section 1001 event.

Resetting the pricing of the coupon payments to current interest rates and credit spreads on the underlying risk may result in a realization event under section 1001. Other changes, such as an effective change in counterparty when a CDS becomes exchange-traded, may rise to the level of a section 1001 event. Evaluating whether a section 1001 event has occurred, however, is a facts and circumstances analysis and must be done on a CDS-by-CDS basis.

Treatment of upfront payments

The new standardized CDS form will result in significantly more CDS providing for upfront payments (to adjust the 100 or 500 bps coupon to reflect the credit spread on the underlying bond). Given the uncertainty on the tax treatment of CDS, consideration must be given to the appropriate timing treatment of this payment.⁴ The controlling principle is that the deduction (or inclusion) of the upfront payment must be spread over the term of the CDS.

One straightforward approach for an alternative investment fund treating CDS as notional principal contracts (NPCs) could be to mechanically apply the rules for upfront payments under the NPC rules.⁵ In general, this would require that the upfront payment be broken up into deemed level payments over the term of the CDS (based on a particular interest rate). This calculation may be time and labor intensive, especially for an alternative investment fund entering into a high volume of CDS.

1 The Obama administration included these proposals as part of its white paper on financial regulatory reform. See Department of the Treasury, “A New Foundation: Rebuilding Financial Supervision and Regulation,” released June 17, 2009. The white paper recommendations were incorporated into the “Over-the-Counter Derivatives Markets Act of 2009,” unveiled by the Treasury Department on August 11, 2009.

2 See Release by Congressman Collin Peterson, Chairman, House Agricultural Committee, and Congressman Barney Frank, Chairman, House Financial Services Committee, July 30, 2009.

3 C.f. Treas. Reg. § 1.1001-3.

4 See Notice 2004-52, 2004-2 C.B. 168 (IRS soliciting comments on the treatment of CDS for tax purposes; no guidance has been issued since 2004).

5 See Treas. Reg. § 1.446-3(f).

It is not clear, however, that a CDS satisfies the definition of an NPC.⁶ Further, this calculation is not necessary for an alternative investment fund treating its CDS as a series of options rather than an NPC, because there are no specific rules for allocating a gross premium paid to a series of individual options.

The absence of specific rules for CDS (as opposed to the specific rules for NPCs) may permit more flexibility in determining the proper method to spread the upfront payment. Where financial accounting principles require an amortization of the upfront payment over the term of the CDS, this amortization may present a reasonable approach to spreading the upfront payment on the CDS for tax purposes.

Section 1256 considerations

The mark-to-market and character rules of section 1256 apply to regulated futures contracts. The definition of a regulated futures contract requires that a contract (1) is traded on, or subject to rules of, a qualified board or exchange and (2) requires the posting of variation margin.⁷ Although it is counterintuitive, the definition of a regulated futures contract does not require that the contract actually be a *futures* contract.

As CDS contracts become more heavily regulated and more commonly exchange traded, alternative investment funds need to assess whether their CDS contracts now represent regulated futures contracts. Section 1256 requires an annual mark-to-market to realize unrealized gain or loss and generally treats such gain or loss as 60 percent long-term capital and 40 percent short-term capital, regardless of holding period.

In the current market, CDS are generally not exchange traded. The question raised is whether the “clearing” of a CDS contract over a qualified board or exchange is sufficient to make it “traded on, or subject to” the rules of that exchange. The core benefits of exchange trading—such as reduced credit risk and standardized price determinations—extend to CDS contracts cleared through the clearinghouse mechanism.

It is important to note, however, that these considerations are not novel to CDS. Other kinds of over-the-counter derivatives, such as commodity swaps, now may be cleared through clearinghouse mechanisms such as ClearPort, which is part of the New York Mercantile Exchange. The literal language of the definition of regulated futures contract might be read as broad enough to include these exchange-cleared contracts.

It is clear, however, based on the Internal Revenue Service’s interpretation of many of the definitions under section 1256, that the determination of whether a type of contract is subject to section 1256 is based on not only the literal language of the statute, but also a thorough investigation of the legislative history.⁸ In the absence of further guidance from the IRS, it may be reasonable to consistently adopt either interpretation.

Alternative investment funds must continue to assess the tax consequences of their CDS transactions as the market evolves.

For additional information, please contact your PricewaterhouseCoopers engagement team or any of the partners in our practice.

⁶ See Treas. Reg. § 1.446-3(c). This matter has been hotly contested by commentators. See, e.g., New York State Bar Association, Tax Section, Report on Credit Default Swaps, September 9, 2005, reprinted at 2005 TNT 176-21.

⁷ Section 1256(g)(1).

⁸ For example, the IRS has taken a narrowly tailored view of the definition of a foreign currency contract under section 1256(g)(2) based on the legislative history. See Notice 2007-71, 2007-35 I.R.B. 472, modifying and superseding Notice 2003-81, 2003-2 C.B. 1223 (concluding that foreign currency contracts, although literally included in the definition of “foreign currency contract,” should not be treated as subject to section 1256 based on the legislative history).