

**IN THE MATTER OF NOVO BANCO S.A. AND OF AN EXTERNAL REVIEW UNDER THE
2016 ISDA CREDIT DERIVATIVES DETERMINATIONS COMMITTEES RULES**

BRIEF ON BEHALF OF THE CONVENED DC MEMBERS WHO SUPPORT THE NO POSITION

INTRODUCTION

1. This is an External Review under section 4 of the 2016 ISDA Credit Derivatives Determinations Committees Rules (“**the Rules**”).¹ The question² to be determined is “*Has a Governmental Intervention Credit Event³ occurred with respect to Novo Banco S.A. on or about 29 December 2015?*” (“**the Question**”).
2. The answer to the Question will affect open credit derivatives transactions which include Novo Banco S.A. (“**NB**”) as a Reference Entity and will also guide the market⁴ as to what governmental actions will or will not constitute a Credit Event in the future. It is therefore a matter of considerable interest to the credit derivatives market.
3. The Question was originally voted on at a meeting of the EMEA Credit Derivatives Determinations Committee (“**the DC**”)⁵ on 12 January 2016. The DC, which is made up of representatives of (a) ten dealers of credit derivatives and (b) five non-dealers, voted 11-

¹ The External Reviewers have been provided with a copy of the Rules by the DC Secretary. It is the first time that this review process has been used in the EMEA region although there have been two previous such reviews in the Americas region.

² Referred to in the Rules as the Reviewable Question.

³ Governmental Intervention Credit Event (“**GICE**”) is defined in the 2014 ISDA Credit Derivatives Definitions (“**the 2014 Definitions**”).

⁴ The DC process does not create binding precedent on the construction of the 2014 Definitions generally but considers whether a particular event is a Credit Event.

⁵ Determinations Committees have been in operation since 2009. The reason why they were constituted and the role they play is helpfully explained in the ISDA publication at Tab 1 of the Exhibits Bundle.

4 in favour of answering the Question “No”.⁶ In performing their obligations, the members of the DC are obliged to act in “*a commercially reasonable manner*”.⁷

4. This External Review is taking place because a supermajority of 80% of the DC (12 members) was not reached on the vote. As more than 60% of the DC voted “No”, the decision of the DC will only be overturned if each of the External Reviewers (who must each select one of the Presented Positions i.e. “Yes” or “No”) concludes that the “Yes Position” is the “better answer” to the Question (Rule 4.6(d)(i)).
5. This brief on behalf of the Convened DC Members who voted “No” explains why the answer to the Question should be “No”. It is accompanied by a bundle of documentary exhibits and a bundle of authorities pursuant to Rule 4.5(c)(ii).

FACTUAL BACKGROUND

6. The Question arises from an action (“**the Re-transfer**”) taken on 29 December 2015 by the Bank of Portugal (“**BoP**”), the Portuguese Resolution Authority, in respect of NB by which five series of senior bonds (“**the Affected Bonds**”) were re-transferred to Banco Espirito Santo, S.A. (“**BES**”), a Portuguese bank in resolution. The Affected Bonds had originally been issued by BES and were transferred to NB by an earlier resolution measure adopted by the BoP on 3 August 2014.⁸ The two Positions agree the background facts set out in the Statement of Agreed Facts document.⁹

⁶ The decision of the DC is set out in the document at Tab 2 of the Exhibits Bundle.

⁷ Rule 2.5(b).

⁸ An English translation of the minutes of the extraordinary meeting of the Board of Directors of the BoP held on 3 August 2014 (from the BoP website) is at Tab 3 of the Exhibits Bundle and the Portuguese version of the minutes is at Tab 4. The DC considered two questions in relation to this resolution measure under the 2003 ISDA Credit Derivatives Definitions, as supplemented (“**the 2003 Definitions**”). It was decided unanimously that (a) a Bankruptcy Credit Event had not occurred in respect of BES and (b) a Succession Event had occurred by reason of the transfer of more than 75% of all bonds and loans issued by BES to NB.

⁹ Document entitled “Statement of Agreed Facts” at Tab 5 of the Exhibits Bundle.

7. The basis for and nature of the Re-transfer was described by the BoP as follows:¹⁰

“6. *Banco de Portugal has a legal power, exercisable at any time prior to the withdrawal of the authorisation of BES for the exercise of activity or the sale of Novo Banco, to order further transfers of assets and liabilities between Novo Banco and BES (the “Re-transfer Power”). The Re-transfer Power is provided for in Chapter III (Resolution) of Title VIII of the [General Legal Framework of Credit Institutions and Financial Companies, enacted by Decree-Law 298/92, of 31 December 1992] and was specifically provided for in paragraph 2 of Annex 2 to the Decision of 3 August.*

7. *Pursuant to the exercise of the Re-transfer Power, this decision:*

(a) *Orders the re-transfer from Novo Banco to BES of the issuances of non-subordinated debt set out in Annex I, originally transferred from BES following the decision of 3 August; and*

(b) *Provides for certain matters ancillary to the re-transfer.”*

8. The formal decision itself is recorded at the end of the minutes as follows:

“A) *All rights and liabilities of Novo Banco under the non-subordinated debt instruments listed in Annex I to this decision...are hereby re-transferred from Novo Banco to BES, with effect from the date of this decision.”*

9. All of the terms of the Affected Bonds including as to the amount of interest payable, the amount of principal payable and the dates for payment of interest and principal remained unchanged following both the original transfer from BES to NB and the Re-transfer.

10. The Affected Bonds retained the same ISIN¹¹ numbers that they had had since their original issue by BES. They remain the same instruments.

INTERPRETATION

11. There does not appear to be any dispute that the Question is to be determined as a matter of English Law.

¹⁰ The English translation (from the BoP website) of the minutes of the meeting of the board of directors of the BoP which took place on 29 December 2015 is at Tab 6 of the Exhibits Bundle. The Portuguese version of the minutes is at Tab 7 of the Exhibits Bundle and a press release issued by the BoP is at Tabs 8 (English translation from BoP website) and 9 (Portuguese version) of the Exhibits Bundle.

¹¹ International Securities Identification Number, a unique number assigned to each security within particular classes, including bonds. See Bloomberg screenshots for the Affected Bonds at Tab 10 of the Exhibit Bundle.

12. It is a matter of contractual interpretation. The 2014 Definitions are a form of standard terms and conditions which, if incorporated by reference into a credit derivatives transaction, form part of the contractual terms of that transaction.

13. The principles by which the contractual documentation is to be interpreted are well established. In the most recent Supreme Court case, Arnold v Britton [2015] AC 1619,¹² at [15] Lord Neuberger said:

“When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to “what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean”, to quote Lord Hoffmann in Chartbrook Ltd v Persimmon Homes Ltd [2009] AC 1101, para 14. And it does so by focussing on the meaning of the relevant words, in this case clause 3(2) of each of the 25 leases, in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions.”

14. The nature of the 2014 Definitions as a form of standard terms and conditions which have been drafted by an industry body (ISDA) but apply to a wide range of credit derivatives transactions between market counterparties, highlights a further issue, namely the need for the 2014 Definitions to be construed in a way which promotes certainty and predictability. See Briggs J in relation to the ISDA Master Agreement in Lomas v JFB Firth Rixon [2010] EWHC 3372¹³ at paragraph [53] and earlier Lord Diplock in Pioneer Shipping Ltd v BTP Tioxide Ltd ("The Nema") [1982] AC 724 at 737:

“... it is in the interests alike of justice and of the conduct of commercial transactions that those standard terms should be construed ... as giving rise to similar legal rights and obligations in all [cases] in which the events [that] have given rise to the dispute do not differ from one another in some relevant respect. It is only if parties to commercial contracts can rely upon a uniform commercial construction being given to standard terms that they can prudently incorporate them in their contracts without the need for detailed negotiation or discussion ...”

¹² Tab 1 of the Authorities Bundle.

¹³ Tab 2 of the Authorities Bundle.

GOVERNMENTAL INTERVENTION CREDIT EVENT

15. As referred to above, the Question concerns whether a GICE, as defined in section 4.8 of the 2014 Definitions, occurred in respect of NB as a consequence of the Re-transfer.
16. If a GICE did occur then credit derivatives transactions (referred to hereafter by the abbreviation “CDS”) with NB as a Reference Entity will automatically be triggered because a GICE is a ‘hard trigger’ (as compared with the similar “M(M)R” restructuring credit event¹⁴ where either party has an option to trigger settlement if that event occurs). The effect of such a hard trigger is considered further in paragraphs 66-67 below.
17. Before dealing with the detail of section 4.8, it should also be noted that (a) a CDS provides protection in respect of obligations of the Reference Entity as a whole rather than any particular obligation (unless the parties expressly elect otherwise which would not be a transaction on standard terms and therefore not subject to DC determinations) and so the consequences of a GICE here would be to trigger any standard CDS with NB as a Reference Entity, (b) a protection buyer under a CDS with NB as a Reference Entity does not have to hold any of the Affected Bonds (or indeed hold any obligations of NB) and (c) the 2014 Definitions concern the interests of both the buyer of a CDS and the seller of that CDS, so it would be wrong to consider the construction by reference only to a notional holder of Affected Bonds who is also a buyer of a CDS with NB as a Reference Entity.
18. Several preliminary matters can be disposed of shortly.

Conditions for the application of the GICE definition and Sections 4.8(a)(i) and (ii)

19. There is no dispute that the preliminary conditions for the existence of a GICE identified in the first paragraph of section 4.8(a) of the 2014 Definitions were satisfied in respect of

¹⁴ It is clear from Section 14.1(b)(ii) of the 2014 Definitions that a Credit Event Notice must be sent in respect of an M(M)R Restructuring Credit Event for an Event Determination Date to occur. For the avoidance of any doubt, "M(M)R" is applicable to European Reference Entities.

the Re-transfer because: (a) the Affected Bonds constitute Obligations; (b) the aggregate amount of the Affected Bonds is in excess of the Default Requirement (the Euro equivalent of \$10 million: section 4.9(a)); (c) the BoP is a Governmental Authority; and (d) the action which the BoP took on 29 December 2015 was pursuant to a restructuring and resolution law or regulation and is binding.

20. Likewise, sections 4.8(a)(i) and (ii) can be addressed shortly.
21. Starting with the events identified in section 4.8(a)(i), the Re-transfer does not affect the rights of the holders of the Affected Bonds in any of the ways specified. They remain entitled to the same rates of interest and the same amounts of principal as before, each payable on the same terms and at the same time as when the Affected Bonds were originally with BES and when they were with NB. The Affected Bonds were and remain senior obligations and have not been subordinated to any other obligation of the Reference Entity.
22. Section 4.8(a)(ii) is aimed at events which deprive an Obligation's beneficial owner of its asset. In this case however, the beneficial owners of the Affected Bonds remain unchanged. The Obligations have not been expropriated from them nor have they been transferred away from them.

Sections 4.8(a)(iii) and (iv)

23. The Question therefore turns on whether the Re-transfer amounts to (a) a mandatory cancellation, conversion or exchange of the Affected Bonds; or (b) an event which has an analogous effect to any of these three events.
24. This document addresses the interpretation of these provisions under the following headings: (a) the context of the addition of the GICE in the 2014 Definitions; (b) the

language used in sections 4.8(a)(iii) and (iv); (c) the need to interpret the 2014 Definitions as a coherent whole; and (d) the effect of the Yes Position.

Context of the addition of the GICE in the 2014 Definitions

25. The GICE was included for the first time when the 2014 Definitions were adopted to replace the previous 2003 Definitions.¹⁵ It was part of a set of changes to the 2003 Definitions to address, in particular, issues arising from the financial crisis and credit events caused by that crisis.¹⁶ It is important to understand the context of this addition and the significance of the choice of language in section 4.8(a)(iii) against that context.
26. As to this, both the words chosen and the explanation given by ISDA¹⁷ of the addition of the GICE link this credit event to bail-ins, one of the methods of resolving financial institutions which had been developed and deployed by regulatory authorities in response to the global banking crisis. During the same period those authorities had also developed and deployed other methods of dealing with a financial institution requiring resolution, including the division of its assets and liabilities between a “good bank” and a “bad bank”.
27. These are different approaches with different consequences. Bail-ins are characterised by creditors immediately bearing part of the burden of the resolution of the relevant institution and suffering an immediate impairment to their rights. Other forms of resolution measure are characterised by a transfer – the concept used in the BoP resolution measure in this case - of assets and liabilities, where the impact on a transferred security is, or may be, either beneficial or detrimental depending on the particular case (see further paragraphs 66-67 below).

¹⁵ The 2014 Definitions were published in February 2014 and trading on them commenced in full on 6 October 2014 (although some market sectors began to use the 2014 Definitions on 22 September 2014): see ISDA Frequently Asked Questions dated 2 October 2014 at Tab 11 of the Exhibits Bundle.

¹⁶ A blackline of the 2014 Definitions against the 2003 Definitions showing the changes made is at Tab 12 of the Exhibits Bundle.

¹⁷ In the ISDA Frequently Asked Questions dated 2 October 2014 at Tab 11 of the Exhibits Bundle.

28. Bearing in mind that these different forms of resolution and their effect were both (a) familiar in the market, having been used in respect of various financial entities and (b) in the process of being placed into a statutory form in the European legislation which was being developed (and which became the Bank Resolution and Recovery Directive¹⁸ (“**BRRD**”)), it is telling that the definition of GICE does not include the obvious word which would have been used if it had been intended to include events such as the Re-transfer within the definition of GICE, namely “transfer”.
29. This is all the more so given that the word “transfer” was used in the immediately preceding sub-section – section 4.8(a)(ii) – to describe an event where the benefit of the Obligation (i.e. the security or instrument) is transferred so that the beneficial ownership of such Obligation changes.
30. Had the drafter intended to cover the case of imposing a new obligor on a security which otherwise remained entirely unchanged it could and would have used the concept of “transfer” again.
31. Developing this context further:
- 31.1. The banking crisis gave rise to a range of responses from regulatory authorities. The early period was characterised by bail-outs at taxpayer expense and in which bondholders had not had to participate. As the crisis developed there were examples of both (a) the splitting of the assets and liabilities of failing institutions between a “good bank” and a “bad bank” such as with Bankia in Spain and BES and (b) the bailing-in of creditors such as with SNS Bank NV.
- 31.2. The practical response was matched by a process in Europe and elsewhere of giving legislative force to the resolution methods which had been developed. For example,

¹⁸ Tab 4 of the Authorities Bundle.

on 6 June 2012, the European Commission made a proposal for a Directive which would establish a framework for the recovery and resolution of credit institutions and investment firms.¹⁹ This proposal (which ultimately resulted in the BRRD) identified, in particular, four resolution “tools” which should be available to resolution authorities: sale of business, bridge institution, asset separation and bail-in.

31.3. The various resolution measures that had been applied in practice gave rise to a number of issues with the 2003 Definitions including (a) whether the various governmental interventions gave rise to a restructuring credit event, (b) the fact that the Successor provisions (dealt with further below) related to the obligations of the Reference Entity taken as a whole whereas the bad bank/good bank splits that had occurred distinguished between senior and subordinated obligations, and (c) a problem with what obligations could be delivered/valued for settlement following an implementation of resolution measures.²⁰

31.4. The BRRD and the 2014 Definitions were developed in the same timeframe. For example, during the course of 2013 the ISDA Credit Derivatives Definitions Working Group was working on the drafting of what became the 2014 Definitions²¹, while in December 2013, the European Council and the European Parliament reached agreement on the BRRD.²² The 2014 Definitions were published in February 2014 and were followed shortly by the BRRD which was published in the Official Journal of the European Union on 12 June 2014.

32. The ISDA document referred to in paragraph 26 above described the introduction of the GICE as follows:

¹⁹A copy of the European Commission press release relating to the proposal is at Tab 14 of the Exhibits Bundle.

²⁰ See an article entitled “Credit Supernova” by Linklaters dated February 2014 at Tab 15 of the Exhibits Bundle.

²¹ See the article dated 18 November 2013 from IFR at Tab 16 of the Exhibits Bundle and ISDA guidance on the timing of the revised definitions is at Tab 17 of the Exhibits Bundle.

²² See the Commission statement dated 12 December 2013 at Tab 18 of the Exhibits Bundle.

“The 2014 ISDA Credit Derivatives Definitions introduce several new terms, including:

- *Bail-in/financial terms for credit default swaps (CDS) contracts on certain financial reference entities: incorporates a new credit event triggered by a government-initiated bail in...”*

33. ISDA referred to bail-in but did not refer to the other resolution tools available to regulatory authorities (and which were included within the BRRD). Indeed, there was no suggestion when the GICE was added to the 2014 Definitions that it was intended to be triggered by anything other than governmental intervention in the form of a bail-in.

34. When one looks at the BRRD itself, the absence of any reference to a “transfer” in section 4.8(a)(iii) becomes still more telling. The BRRD identifies the four different “resolution tools”:

34.1. The sale of business tool, which essentially involves the mandatory sale to a purchaser of (a) the shares or (b) any or all of the assets, rights, or liabilities of an institution in resolution (BRRD, Article 37). This tool also envisages the re-transfer of assets, rights or liabilities back to the original institution in resolution with the consent of the purchaser (Article 37(6)).

34.2. The bridge institution tool, which involves the transfer of (a) the shares or (b) any or all of the assets, rights, or liabilities of an institution in resolution to a bridge institution which is wholly or partially owned by one or more public authorities and controlled by the resolution authority (BRRD, Article 40). Again this tool expressly provides for the re-transfer of assets, rights or liabilities from the bridge institution back to the original institution in resolution (Article 40(6)). NB would now be called a bridge institution under the BRRD.

34.3. The asset separation tool, which involves the transfer of assets, rights or liabilities of an institution under resolution or a bridge institution to one or more asset

management vehicles (BRRD, Article 42). Again this tool expressly provides for the re-transfer of assets, rights or liabilities from the asset management vehicle to the original institution in resolution (Article 42(9)).

34.4. The bail-in tool, which is defined (in BRRD, Article 2(1)(57)) as the mechanism for effecting the exercise by a resolution authority of the write down and conversion powers in relation to liabilities of an institution under resolution.

35. Therefore when the 2014 Definitions were drafted, it was well known that there were a number of ways in which a governmental authority might intervene in a failing financial institution and that depending on which tool was used, different consequences would follow. While a bail-in would impose immediate losses on affected creditors, the outcome for creditors where other tools were used would depend on the operations of the purchaser/bridge institution/asset management vehicle.

36. However, rather than seeking to cover all such interventions and their consequences within the definition of GICE, the drafting covered bail-ins in particular. This is why the GICE does not refer to the transfer of liabilities from one entity to another – transfers are measures expressly provided within the other resolution tools but not in a bail-in.

37. Moreover, given the differing consequences, it is logical that a GICE would be triggered by a bail-in (where the effect on the rights of the holder of the instrument is immediate and negative, such as a reduction in the amount of principal) but not by a transfer (where there is no immediate effect on such rights of the holder and therefore any impact on the performance of the instrument is, at least, uncertain). There is no need for a Credit Event to be triggered at this point solely as a result of the transfer. Of course, the possibility of a Credit Event occurring subsequently in respect of an actual impairment of the transferee entity's obligations (such as a bail-in, liquidation or default) remains.

The language used in section 4.8(a)(iii)

38. The points made above about the context of the addition of the GICE are reflected in the words used – “cancellation”, “conversion” and “exchange”.
39. None of these is a term defined in the 2014 Definitions but the natural and ordinary meaning of each of these words in relation to a financial security or instrument such as the Affected Bonds is not apt to describe what took place when those Bonds were re-transferred from NB to BES.
40. In the context of securities or instruments of this kind, “cancellation” connotes the extinguishing, annulment or revocation of the security such that it no longer exists. It carries no suggestion that the security continues to exist but with a different obligor. In this case it cannot be said that the securities have been cancelled. Rather they have been re-transferred back to the original obligor. If they had been cancelled then that would have been reflected by the disappearance of the ISIN number they had but, in fact, the Affected Bonds retain the same ISIN.
41. “Conversion” in relation to securities of this kind connotes a change in the nature of the security, such as conversion of a debt instrument into equity or other capital instrument. This is one of the principal methods of bailing-in a bondholder in a financial institution in resolution. It would not be a natural reading of the word “conversion” to say that the Affected Bonds (which continue to exist with all the same terms) have been converted into something else.
42. This natural meaning is supported by the regular use of “convert” or “conversion” in the BRRD where it is applied to a change in the nature of an obligation from debt to equity or other instruments resulting from a bail-in. For example:

- 42.1. Article 43(2)(b) which refers, in the context of the bail-in tool, to “*convert to equity the principal amount of claims or debt instruments...*”.
- 42.2. Article 46(1)(b) which refers, again in the context of the bail-in tool, to “*the amount by which eligible liabilities must be converted into shares or other types of capital instruments in order to restore the Common Equity Tier I capital ratio...*”.
- 42.3. Article 59, which provides a separate power to write down or convert capital instruments, provides that resolution authorities shall have the power to “*convert relevant capital instruments into shares or other instruments or ownership...*”.
43. In each case the word “convert” refers to a change in the nature of the security.
44. “Exchange” in the context of securities of this kind connotes the substitution of one obligation of a Reference Entity for another different obligation by a process in which the original obligation is surrendered in return for the provision of a new security with different terms. Exchange offers are well known in relation to bonds or notes: they involve a new security being issued in exchange for the existing one. Of course in a GICE the exchange will be mandatory, but the essential element of an exchange is that there are two instruments. It is not apt to describe a case where there is one continuing instrument whose terms remain unchanged but with the obligor changing by operation of law.
45. Putting the words used together with the context in which the GICE was added to the Definitions, there is and can be no justification for stretching the meaning of the words specifically chosen in section 4.8(a)(iii) so as to encompass a transfer of the security when that term was known to and had been used by the drafter elsewhere but was not chosen for the provision in issue here.

46. The analogous effect provision in section 4.8(a)(iv):

47. If, as submitted above, the Re-transfer was not a cancellation, conversion or exchange, the question arises whether it is an event which has an “analogous effect” to any of these three events.

48. The first point to make is that this provision should be interpreted in such a way as to promote certainty in the market. An expansive or elastic construction would mean that many types of governmental intervention could potentially trigger a GICE. This would be inconsistent with the careful selection of the relevant events in section 4.8(a)(iii) (“a mandatory cancellation, conversion or exchange”) and the fact that the term “transfer” was not included despite being used elsewhere in section 4.8 and being a prominent feature of resolution tools other than bail-ins.

49. Likewise, it would be wrong to construe this provision by asking whether the effect of the relevant event could have been achieved by means of a cancellation, conversion or exchange. This is starting from the result and working backwards whereas the proper approach is to start with the specific terms used in section 4.8(a)(iii).

50. Moreover, to ask whether an effect could have been achieved by, for example, an exchange, would be to include within sub-paragraph (iv), virtually any change to the terms of an Obligation. Any change could be effected by an exchange since an old security could always be exchanged for a new one on different terms. But it is clearly not intended that any change in the terms of an Obligation arising from a relevant Government announcement will be a GICE. The changes in terms which are intended to amount to a GICE are those identified in sub-paragraph (i).

51. The purpose of sub-paragraph (iv) is to include events which do not carry the labels or descriptions “cancellation, conversion or exchange” but operate in a sufficiently similar

manner to fall within the clause. It operates in the same way as the same wording at the end of the Bankruptcy Credit Event in section 4.2 and reflects the fact that the 2014 Definitions will be applied to a wide diversity of Obligations (not just bonds but also loans and other borrowed money obligations) and credit derivatives transactions in a wide range of jurisdictions where different terminology may be used.

The need to interpret the 2014 Definitions as a coherent whole

52. One of the central purposes of the 2014 Definitions is the bringing of certainty to the credit derivatives market as to the consequences of events such as the Re-transfer.
53. One aspect of this certainty and predictability is the need to construe the 2014 Definitions as a coherent whole and to minimise or eliminate conflicts or lacunae between provisions. This is particularly relevant here because the events comprising the Re-transfer (and any similar transfer or re-transfer) fall to be considered not only in the context of the GICE definition but also under the separate set of provisions, in section 2.2, relating to the identification of “Successor” Reference Entities.
54. The Successor provisions apply to all standard CDS contracts and are triggered by transfers of obligations to new obligors (provided that they relate to at least 25% of the Relevant Obligations (which are bonds or loans) of the transferor Reference Entity) because they deal expressly with situations where one entity assumes or becomes liable for the Relevant Obligations of a Reference Entity including by operation of law (section 2.2(d)).
55. They provide a detailed code which determines whether or not, if Relevant Obligations of a Reference Entity are assumed by a new entity, that new entity becomes a Successor and therefore a new Reference Entity for CDS transactions which had the original entity as a Reference Entity. The question and effect of succession is determined by the percentage

of the Reference Entity's Relevant Obligations which are assumed by the new entity. For example, if the new entity succeeds to 75% or more of the original Reference Entity's Relevant Obligations, then the new entity becomes the sole Reference Entity for all CDS transactions (section 2.2(a)(i)). In other cases the CDS may be split between more than one successor (which may include the original Reference Entity).

56. In the case of Financial Reference Entities,²³ the Relevant Obligations are determined according to whether the CDS is a Senior Transaction (in which case only Senior Obligations are included) or a Subordinated Transaction (in which case Senior Obligations and Further Subordinated Obligations are excluded) (section 2.2(f)). Thus, where there is a succession it will only affect the CDS contracts which reference the seniority of obligation which is assumed by the new entity. This split was a change introduced into the 2014 Definitions in particular to reflect what had happened in previous bad bank/good bank splits.²⁴ If any transfer following from a governmental intervention was a GICE, the distinction drawn by the split would be unnecessary.
57. If, as the Yes Position contends, a transfer is capable of being a GICE, this gives rise to the possibility that one event – the transfer – could be both a GICE which would trigger the settlement and subsequent termination of relevant CDSs and a succession in which the transferee entity would become a Reference Entity for the same transactions which would remain in existence.
58. These two consequences would lead to difficult questions of interpretation which do not arise on the No Position. In a different context, in section 2.11(a)(iii), the 2014 Definitions set out how to resolve a conflict between two provisions by giving precedence to one event

²³ The entity type to which a GICE can apply.

²⁴ The fact that there were changes which deal with such splits but they were not expressly dealt with in Section 4.8 is another factor which supports the No Position.

over the other. However, there is no provision in the 2014 Definitions resolving the issue caused by an event being both a GICE and succession.

59. There are also the issues of timing and of identifying the Reference Entity. The Succession Date for the purposes of section 2.2 is the legally effective date on which one or more entities succeed to some or all of the Relevant Obligations (section 2.2(j)). Therefore, the Successor becomes the new Reference Entity for all or part of the credit derivatives transactions on the date of the event (i.e. when it assumes the liabilities of the original Reference Entity). The original Reference Entity ceases, from that date, to be a Reference Entity at all if there is a complete succession under section 2.2(a)(ii). However, the GICE definition requires one to look at the effect of the very same event on the Reference Entity. Under the Yes Position, this would create a paradox as the same event that causes the GICE is also capable at the same time of changing the Reference Entity. No such paradox arises under the “No” Position.
60. The Yes Position will therefore lead to considerable uncertainty. In the context of the Re-transfer, if the Affected Bonds constitute more than 25% but less than 75% of NB’s Relevant Obligations, the CDSs with NB as Reference Entity will split between NB and BES under the Successor provisions.²⁵
61. However, if a GICE is also held to have occurred with respect to NB, it will be unclear (a) whether the GICE has occurred in respect of all of the transaction or just the part remaining at NB; and (b) if the GICE has occurred with respect to the BES portion as well, whether this also triggers any pre-existing contracts with BES as the Reference Entity.
62. The No Position notes that there is still a potential conflict in the 2014 Definitions because section 4.8(a)(iii) refers to a mandatory “exchange” and the definition of succeed in

²⁵ The issue of whether the threshold has been passed is currently pending resolution by the DC.

section 2.2(d) includes an exchange of bonds issued by the original Reference Entity for bonds issued by a new entity (which will become the new Reference Entity if the thresholds in 2.2(a) are met).

63. Two points arise from this:

63.1. If, as the No Position contends, a transfer is not within the term “exchange” (and is not an event with an analogous effect to an exchange for the purposes of section 4.8) then the conflict does not have to be resolved in this case. Moreover, the No Position construction serves to minimise the potential lacuna in the 2014 Definitions (which itself provides greater certainty).

63.2. Section 2.2(d) itself recognises a distinction between (i) a succession by way of transfer where the new entity assumes or becomes liable for the obligations of the Reference Entity and (ii) a succession by way of exchange, which involves two separate and distinct bonds with one being swapped for the other. They are different and distinct methods by which it is possible to “succeed” within the 2014 Definitions. The Re-transfer would be within (i), and not an exchange as defined within (ii).

Consequences of the two Presented Positions

64. If a transfer of obligations between entities is captured by the wording of the GICE, this would also give rise to a number of unusual and uncommercial consequences.

65. The most obvious of these is that any transfer mandated by a governmental authority which changed the obligor, even one intended to preserve or improve the economic value of the obligations transferred, would nonetheless be a GICE and automatically trigger the CDS contracts.

66. This effect of this can be illustrated by the facts of this case. If the Yes Position were correct then a transfer such as the initial transfer between BES and NB in August 2014²⁶ would have been a GICE despite the fact that NB (the initial transferee) was effectively the “good bank” and BES (the initial transferor) was the “bad bank”.
67. It would, however, be most odd if the consequences of a GICE were triggered by a transfer that way. Considering the overall purpose of the GICE (to cater for government-initiated bail-ins in which creditors are expected to bear at least part of the pain of the resolution of the Reference Entity), it cannot have been intended that *any* transfer would trigger a GICE and impose (unfairly) an obligation on the protection seller to pay the protection buyer before it is clear whether the transfer of the Obligations has any impact. In some transfers, rather than bearing the pain, bondholders may be benefitting (for example if the senior bonds are transferred to the “good bank”) – it depends on the facts. Indeed, the prospect of a GICE being triggered by a transfer may raise the price of the CDS and would create a disconnection between the way bonds are priced and the cost of a related CDS
68. It may be said in response that, at least in a case like the present, the Re-transfer is inevitably detrimental to the holders of the Affected Bonds due to the identity of BES as the “bad bank” and the intention expressed by the BoP to liquidate BES in due course. However, there is no basis for section 4.8 to be construed so as to apply to certain transfers depending on their effect on the market value of the Obligations transferred or on expectations as to whether the Obligations will be honoured. There is nothing in the wording of that section which would justify the addition of a test based on the subsequent

²⁶ The 2014 Definitions had not come into effect at this point so no issue as to GICE arose in fact.

effect on the market value or the expectation that losses may occur. It would also be inherently uncertain.

69. In a case such as this involving a transfer of Obligations the answer is that the CDS does not trigger immediately but a later Credit Event is not precluded from occurring. In terms of section 4.8 the inherent uncertainty in the effect of a transfer is resolved by construing the 2014 Definitions so that a GICE (a hard trigger) does not occur but rather the succession provisions are applied and the relevant Reference Entities to be identified by reference thereto are then subject to the credit event provisions generally. In this case, if a transfer occurs which is a succession then, if BES is wound up, a Bankruptcy Credit Event will occur and so, in so far as credit derivatives transactions now have BES as a Reference Entity (applying the various thresholds in section 2.2), they will be triggered by this event.
70. For these reasons, the correct answer to the Question is “No”.

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