



KIRKLAND & ELLIS

APRIL 21, 2022

Spotlight on Russia Credit Default Swaps

Based on public information.

This publication is distributed with the understanding that the author, publisher and distributor of this publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this publication may constitute Attorney Advertising. Kirkland & Ellis International LLP is authorised and regulated by the Solicitors Regulation Authority.

© 2022 Kirkland & Ellis International LLP. All rights reserved.

Overview

Sanctions imposed against the Russian Federation and Russian-domiciled entities and individuals (“Sanctioned Parties”) in response to Russia’s invasion of Ukraine have introduced several uncertainties regarding Credit Default Swaps relating to Sanctioned Parties that have outstanding foreign currency debt obligations (“Russia CDS”), causing spreads on 5 year Russia CDS to rise from \$216 on February 15, 2022 to a high of \$13,310 on April 15, 2022.

- ▶ While Trade sanctions have raised questions regarding the future condition of Russia’s economy and creditworthiness, it is the financial sanctions preventing Sanctioned Parties from using international payment systems and accessing foreign currency deposits, and Russia’s responses to those sanctions, that are having a more immediate and significant impact on Russia CDS.
- ▶ Financial sanctions and Russia’s responses have raised a number of CDS-related questions:
 - 1) Which debt obligations are Obligations capable of triggering a Credit Event?
 - 2) What circumstances with respect to Obligations will constitute a Credit Event?
 - 3) If one or more Credit Events occur(s), how will the applicable Russia CDS contracts be settled?
- ▶ Answers to those questions require a precise application of the 2014 ISDA Credit Derivatives Definitions to the statements and actions of Russian Issuers and to the terms of their debt obligations.
- ▶ Several questions have already been answered by the EMEA Determinations Committee (see pages 4 and 5) and, undoubtedly, there are more to come.
- ▶ CDS-related issues will need to be analyzed on an ongoing basis given the fluid state of the situation and ongoing actions and statements of governments in the US/EU/UK and Russia.
- ▶ Parties to Russia CDS should also consider whether or not to incorporate ISDA’s 2022 Russian Sanctions Additional Provisions into their current contracts (see page 6).

Russia CDS – Key Criteria

	RUSSIAN SOVEREIGN CDS	RUSSIAN CORPORATE LPN CDS	RUSSIAN CORPORATE CDS
CREDIT EVENTS	<ol style="list-style-type: none"> 1) Failure to Pay (Grace Period Extension Applicable) 2) Obligation Acceleration 3) Repudiation/Moratorium 4) Restructuring (Multiple Holder Obligation Not Applicable) 	<ol style="list-style-type: none"> 1) Bankruptcy 2) Failure to Pay (Grace Period Extension Applicable) 3) Obligation Acceleration 4) Repudiation/Moratorium 5) Restructuring - Multiple Holder Obligation: (a) Not Applicable with respect to Obligation Category “Bonds” and (b) Applicable with respect to Obligation Category “Loans” 	<ol style="list-style-type: none"> 1) Bankruptcy 2) Failure to Pay (Grace Period Extension Applicable) 3) Obligation Acceleration 4) Repudiation/Moratorium 5) Restructuring - Multiple Holder Obligation: (a) Not Applicable with respect to Obligation Category “Bonds” and (b) Applicable with respect to Obligation Category “Loans”
OBLIGATION CATEGORY	Bond	Bond or Loan	Bond or Loan
OBLIGATION CHARACTERISTICS	<ol style="list-style-type: none"> 1) Not Subordinated 2) Not Domestic Currency 3) Not Domestic Law 4) Not Domestic Issuance 	<ol style="list-style-type: none"> 1) Not Subordinated 2) Not Domestic Currency 3) Not Domestic Law 4) Not Domestic Issuance 	<ol style="list-style-type: none"> 1) Not Subordinated 2) Not Domestic Currency 3) Not Domestic Law 4) Not Domestic Issuance
DELIVERABLE OBLIGATION CHARACTERISTICS	<ol style="list-style-type: none"> 1) Not Subordinated 2) Specified Currency 3) Not Domestic Law 4) Not Contingent 5) Not Domestic Issuance 6) Transferable 7) Non Bearer 	<ol style="list-style-type: none"> 1) Not Subordinated 2) Specified Currency 3) Not Domestic Law 4) Not Contingent 5) Not Domestic Issuance 6) Transferable 7) Non Bearer 8) Assignable Loan 9) Consent Required Loan 10) Not Domestic Law 	<ol style="list-style-type: none"> 1) Not Subordinated 2) Specified Currency 3) Not Domestic Law 4) Not Contingent 5) Not Domestic Issuance 6) Transferable 7) Non Bearer 8) Assignable Loan 9) Consent Required Loan 10) Not Domestic Law
SETTLEMENT METHOD	Auction (primary) and Physical (fallback)	Auction (primary) and Physical (fallback)	Auction (primary) and Physical (fallback)
ASSET PACKAGE DELIVERY	No package observable bond	N/A	N/A
LPN ADDITIONAL PROVISIONS	N/A	Applicable ¹	N/A

[1] LPN Additional Provisions can be found on the ISDA website. Generally speaking, the LPN Additional Provisions address the pass-through nature of the LPNs.

Questions posed to the EMEA Determinations Committee (“EMEA DC”)

DATE SUBMITTED	DATE DECIDED	QUESTION	DECISION
March 8, 2022	March 11, 2022	Do six bonds issued by the Russian Federation (“ RUB Fallback Bonds ”) that contain provisions allowing for payment in Russian Rubles without noteholder consent, when, for reasons beyond its control, the Russian Federation is unable to make payments of principal or interest (in whole or in part) in U.S. Dollars or Euro, as applicable (the “ Toggle Feature ”), satisfy the Not Domestic Currency and Specified Currency Obligation Characteristics?	The RUB Fallback Bonds do not satisfy the Not Domestic Currency or Specified Currency Obligation Characteristics and, accordingly, are not capable of triggering a Credit Event or being delivered into a CDS auction, regardless of whether the Toggle Feature is invoked
March 11, 2022	March 17, 2022	Has a Potential Repudiation/Moratorium occurred in respect of Russian Federation bonds due for final redemption on March 31, 2030? The question noted (i) an Executive Order of the Russian Federation prohibiting from March 1, 2022 the implementation of foreign exchange transactions related to the provision by Russian residents in favor of non-residents of non-Ruble payments under loan agreements and (ii) a Decree of the Russian Federation establishing a temporary procedure for the fulfillment by Russian issuers of non-Ruble denominated obligations by the payment of Rubles to specified accounts.	No Potential Repudiation/Moratorium occurred.

Questions posed to the EMEA DC (cont'd)

DATE SUBMITTED	DATE DECIDED	QUESTION	DECISION
April 1, 2022	April 13, 2022	<p>Has a Failure to Pay Credit Event occurred with respect to Joint Stock Company “Russian Railways” (“JSCRR“)?</p> <p>The Eligible Market Participant raising the question referenced an official notice of the Swiss Stock Exchange indicating that JSCRR failed to make an interest payment to RZD CAPITAL PLC, the lender under a loan to JSCRR (the “JSCRR Loan“) and issuer of limited recourse pass-through notes backed by the JSCRR Loan as a result of the impact of sanctions on JSCRR’s ability to transact through its correspondent banking network.</p> <p>Note that the JSCRR Loan is not Russia Sovereign debt and this decision does not directly affect Russia Sovereign CDS.</p>	<p>Yes, a Failure to Pay Credit Event occurred on March 28, 2022; however, no CDS Auction will be held. No auction is required if the 300/5 criteria aren’t met (at least 300 transactions with at least 5 dealer counterparties).</p>
April 11, 2022	April 20, 2022	<p>Has a Potential Failure to Pay occurred in respect of The Russian Federation under Section 1.48 of the 2014 Definitions.</p> <ul style="list-style-type: none">▶ Russia sent USD 649.2 million to foreign banks to satisfy payments coming due on its 2022 (interest) and 2042 (principal) Eurobonds. Those payments were rejected based on sanctions compliance, following which, the Russian Federation sent the Ruble equivalent of USD 650 million to its own National Settlement Depository.	<p>Yes, a Potential Failure to Pay has occurred.</p> <ul style="list-style-type: none">▶ A Potential Failure to Pay is not a Credit Event per se (it helps determine whether a corresponding “Failure to Pay” will be captured by CDS contract that matures during the grace period); however, a finding of a Potential Failure to Pay will likely presage a subsequent finding of a Failure to Pay unless there is a change in circumstances prior to the lapse of the grace period.

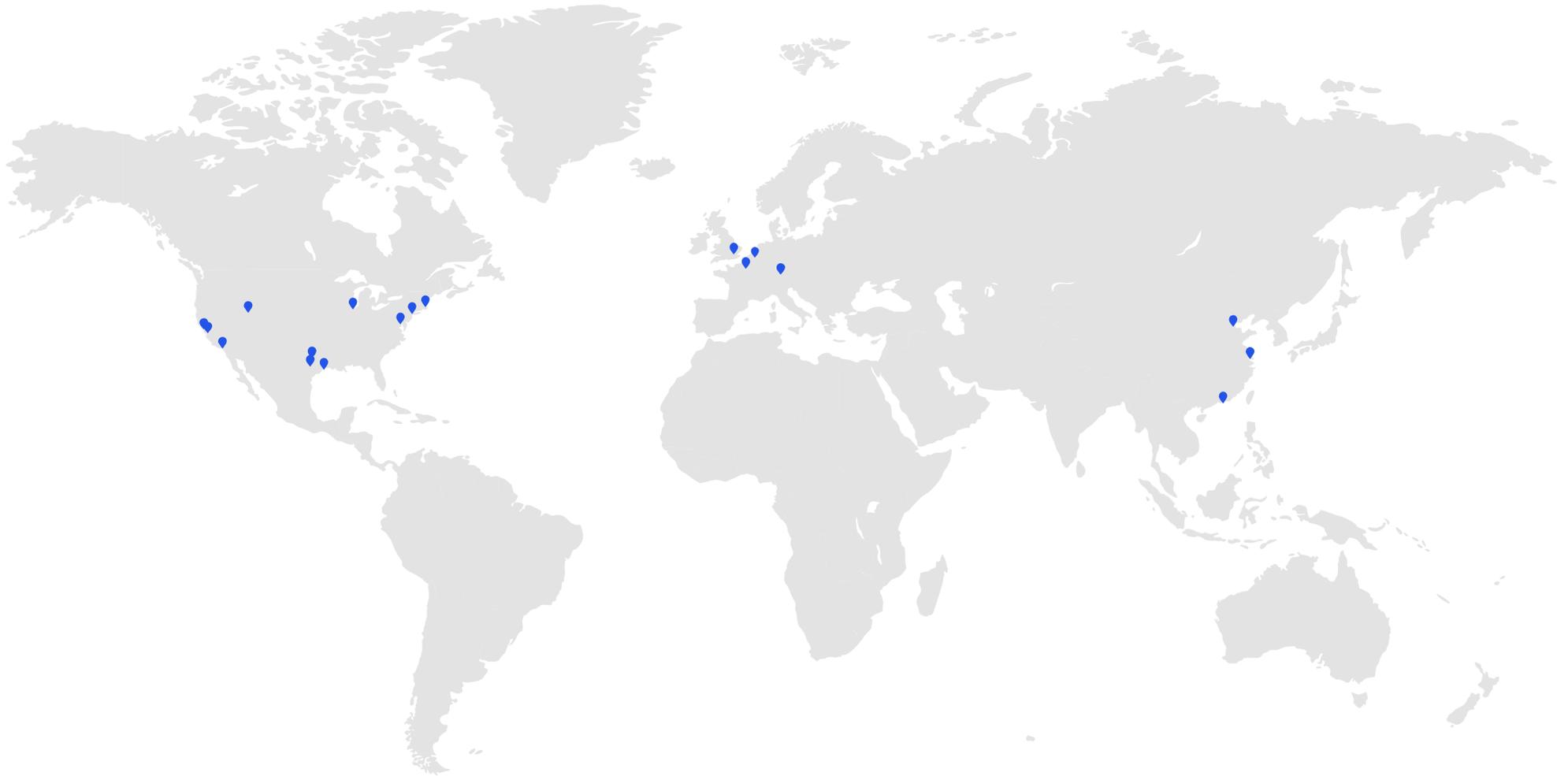
Obligations, Deliverability and ISDA Protocol

- ▶ In addition to RUB Fallback Bonds not being capable of triggering a Credit Event and not being deliverable in a CDS Auction as a result of their Toggle Feature (see page 4), other obligation eligibility issues have resulted from the implementation of sanctions.
- ▶ The trading and/or financing of Russian Federation debt issued after March 1, 2022 (“**Blocked Debt**”) is prohibited in the United States. Other jurisdictions have implemented similar sanctions.
- ▶ Blocked Debt would not be able to be delivered into a CDS Auction and could pose issues for accurate CDS settlement pricing.
- ▶ Recognizing this, on March 25, 2022, ISDA published Additional Provisions for Certain Russian Entities: Excluded Obligations and Excluded Deliverable Obligations (the “**2022 Additional Provisions**”). The 2022 Additional Provisions contain new terms governing CDS referencing the Russian Federation or Gazprom Public Joint Stock Company that limit debt that can trigger a Credit Event or be delivered in a CDS Auction to debt issued (i) before February 24, 2022 and (ii) after February 24, 2022 and not restricted by sanctions imposed by Canada, the EU, Japan, Switzerland, the UK, and the US.
- ▶ The 2022 Additional Provisions will apply to (i) existing CDS between pairs of parties both of which have adhered to the ISDA 2022 Russia Additional Provisions Protocol (currently open for adherence until April 27, 2022), (ii) bilateral CDS entered into after publication of a new version of the ISDA Credit Derivatives Physical Settlement Matrix (which will add the 2022 Additional Provisions into the relevant Transaction Types (currently anticipated to be May 2, 2022)), and (iii) cleared CDS where the Additional Provision have been incorporated into the clearing rules (which is expected).
- ▶ Certain other obligations are also specifically excluded pursuant to an ISDA 2004 supplement to Russia CDS terms.

Potential Issues to Consider

- ▶ Certain issuances of Russian sovereign bonds clear through the National Settlement Depository (“NSD”), a Russia domiciled clearinghouse, rather than clearinghouses domiciled in Western Europe, such as Euroclear and Clearstream.
 - **Potential Issue:** Will a Failure to Pay Credit Event be triggered if NSD receives payment but the beneficial holders are prevented from receiving payments from NSD due to the effects of sanctions?
- ▶ In order for an Obligation to be a Deliverable Obligation, it must be “Transferable.”
 - **Potential Issue:** Will the effects of sanctions cause certain Obligations to fail to meet the “Transferable” definition if, due to sanctions imposed by the UK, EU, and the US, an Obligation is not permitted to be transferred by or to an institutional investor in those countries, but is capable of being transferred between institutional investors in other countries that have not imposed such sanctions?
- ▶ The seldom-used fallback mechanism contained in Section 9.6 of the 2014 ISDA Credit Derivatives Definitions may become relevant to the extent sanctions are expanded to prohibit secondary trading of Obligations.

International Reach



Austin

Brussels

Houston

New York

Washington, D.C.

Bay Area

Chicago

London

Paris

Beijing

Dallas

Los Angeles

Salt Lake City

Boston

Hong Kong

Munich

Shanghai