From Russia With FUD:

Settlement of Credit Derivatives Transactions Referencing Entities Under Western Sanctions and Kremlin Capital Controls

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Russia's war against Ukraine has led in record time to the implementation of extensive anti-Russian sanctions by the United States, the European Union, and the United Kingdom, among others. While some analysts believe those robust sanctions may increase the chance of Russian international debt default, others believe these fears are overblown and that prices of certain Russian bonds do not reflect the real risk of default and recovery. These differences of perspective are fundamental to the role of credit default swaps (CDS) as instruments that protect investors against the risk of default on debt. However, just when there is intense focus on CDS as hedges for bond investors, price dislocations have led to a growing concern that CDS may not provide effective protection against default of Russian bonds. CDS on Russian companies face an uncertain future.

This raises several key questions for participants in CDS transactions. Do sanctions and countermeasures restrict the scope of credit protection provided by a CDS on Russian bonds and loans? If a loan or bond default is triggered by Western sanctions and Russian countermeasures, is the character of the default affected in a way that might impair the crystallization of a payment entitlement on the CDS? Assuming the credit protection afforded by a CDS transaction is not legally or contractually impaired, do sanctions and countermeasures adversely affect the practical realization of rights under the CDS transaction by making it impossible to settle on terms that effectively compensate for losses on the underlying debt?

This white paper will first discuss the principal sanctions and countermeasures that affect CDS referencing Russian reference entities and will summarize Russian bonds, loans, and CDS that may be affected. It will then discuss documentation of CDS with special reference to Russian entities and will assess how sanctions and countermeasures may affect the practical realization of credit protection under CDS referencing Russian entities and their affiliates. It will then give a brief overview of CDS documentation, definitions and settlement conventions with special reference to CDS referencing Russia-affiliated

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A. Sanctions and Countermeasures Affecting Russian Debt Capital Markets

Shortly after the invasion of Ukraine, many countries and international organizations identified in footnote 4 imposed a wide range of sanctions on Russian entities and individuals that affect capital markets. New economic sanctions imposed by the United States in the week of 24 February 2022 included prohibitions on dealing in Russian sovereign debt, and blocking sanctions on certain Russian individuals and entities. These include the Russian Central Bank, the State Corporation Bank for Development and Foreign Economic Affairs, Vnesheconombank, Promsvyazbank, VTB Bank, Bank Otkritie, Sovcombank OJSC, Novikombank, together with numerous subsidiaries of each bank, as well as the Nordstream 2 pipeline. U.S. financial institutions are also prohibited from opening or maintaining any “correspondent account” or “payable-through account” for Sberbank, Russia’s largest financial institution and its subsidiaries, subject to certain licenses such as that permitting U.S. banks to wind down preexisting contractual obligations.[3]

The United Kingdom for the first time used newly expanded powers to impose sanctions on Russia. British individuals and entities are now prohibited from any dealings with, or providing any funds to or for the benefit of certain Russian individuals and banks including the Russian Central Bank, Black Sea Bank for Development and Reconstruction, Joint Stock Company Genbank, IS Bank, and Promsvyazbank.[4]

On 26 February 2022, the world learned that several Russian banks were to be removed from the SWIFT international bank payments system. On 3 March 2022, Clearstream announced that with immediate effect, the Russian rouble would no longer be an eligible settlement currency. On the same date the London Stock Exchange suspended trading in several global depository receipts of several Russian firms. These sanctions join others affecting wide swathes of Russian cross-border trade and finance.

[2] The focus of this white paper is on how legislative and regulatory actions affecting Russian corporate and sovereign bonds and loans may affect the ability of a credit protection purchaser to obtain an effective recovery through settlement of a CDS. It does not address on how the rights under a CDS or other swap transaction would be affected if one or both of the counterparties were subject to sanctions or Russian countermeasures. Therefore, it assumes a transaction between two creditworthy non-Russian affiliated parties under a New York or English law master agreement with U.S. dollars as the specified currency of payment and referencing a Russian corporate or sovereign entity. It further assumes that the only potential credit event under a CDS is one that arises because of Russian sanctions or countermeasures thereto. This white paper does not address the impact of Russian sanctions under ISDA master agreements generally (such as through *force majeure* provisions) or under equity derivatives, commodity derivatives, interest rate derivatives, or currency options.

[3] For overviews of US sanctions imposed in response to Russia’s invasion of Ukraine, see the following alerts that appear on the K&L Gates Hub: U.S. Imposes Initial Sanctions in Response to Russia’s Threat to Undermine Ukraine’s Sovereignty and U.S. Imposes Additional, “Severe” Sanctions on Russia in Response to Russia’s Military Advance into Ukraine.

[4] For overviews of UK sanctions imposed in response to Russia’s invasion of Ukraine, see the following alerts that appear on the K&L Gates Hub: UK Imposes Further Sanctions in Response to Russia’s Invasion of Ukraine; Sanctions Update: Monetary Penalty Imposed by OFSI.

The empire was not slow to strike back. On 28 February 2022, President Vladimir Putin issued a decree (Decree 79) "On Special Economic Measures in connection with the Unfriendly Actions of the United States of America and Other Foreign Countries."[5] Among other countermeasures, Decree 79 prohibits Russian residents from making foreign-exchange payments under loan agreements to non-residents of Russia from 1 March 2022. More generally, Decree 79 bans payments to banks and other financial-market organizations outside of Russia as well as money transfers through foreign payment service providers.[6]

On 28 February 2022 the Russian Central Bank issued instructions (the RCB Instructions) prohibiting the Russian National Settlement Depository (the RNSD) and other depositaries and registrars from transferring to foreign persons any payment on securities of Russian issuers.

On 5 March 2022, Russian President Vladimir Putin signed a decree (the 5 March Decree) that permits the Russian government, Russian companies and citizens of Russia on a temporary basis to satisfy foreign-currency obligations owed to overseas creditors from "unfriendly countries" in roubles irrespective of the original currency denomination or the governing law of that debt. Under the 5 March Decree, payments will be considered to have been validly made under the instrument in question if they are made in roubles at the official rate published by the Russian Central Bank. Debtors can ask a Russian bank to create a special "C" rouble-denominated account in the name of foreign creditors for settlement, while local creditors will be paid through the RNSD or other Russian depositories. The 5 March Decree applies to amounts in excess of ₽10 million per month.

On 6 March 2022, the Russian Central Bank announced (notwithstanding the 5 March Decree) that foreign creditors from countries that have not imposed sanctions may be able to receive debt service payments in the currency in which the debt is denominated if the Russian Central Bank grants the debtor permission to make such payment.

Between 3 March and 8 March 2022, the Russian Federation was downgraded to "C" by Fitch Ratings, "Ca" by Moody's, and "CCC-" by Standard & Poor's, in each case a level that indicates that a debt default on sovereign debt (and sovereign-sensitive private debt) may be imminent.

B. Russian Debt and CDS on the Edge of Sanctions

The market for Russian bonds and loans is compact yet substantial, with significant outstanding issues by the Russian Federation and Russian corporate groups.

1. Russia Sovereign Debt Obligations

The Russian Federation and its political subdivisions (collectively, the Russia Sovereign) has several outstanding sovereign bond issuances denominated in euros and U.S.

[5] The countries, international organizations, and territories considered "unfriendly" include: Australia; Albania; Andorra; United Kingdom; including Jersey, Anguilla, British Virgin Islands, and Gibraltar; the member states of the European Union; Iceland; Canada; Liechtenstein; Micronesia; Monaco; New Zealand; Norway; Republic of Korea; San Marino; North Macedonia; Singapore; the United States; Taiwan; Ukraine; Montenegro; Switzerland; and Japan.

[6] Additional countermeasures and capital controls were promulgated on 1 March 2022 by presidential decree No. 81, entitled "On Additional Temporary Measures of Economic Nature to Secure Financial Stability of the Russian Federation."

dollars. Several of these (the Specified Currency Sovereign Debt Obligations) only permit the issuer to satisfy its obligations by making payments in those currencies or in some cases other hard currencies. Some others (the Alternative Payment Currency Sovereign Debt Obligations) have alternative payment currency fallback provisions that allow the issuer to make payments in roubles.[7] The Russian Federation has also issued several rouble-denominated bonds (the Local Currency Sovereign Debt Obligations) that are subject to settlement with the RNSD.

On 2 March 2022, the Russian Federation made a debt service payment of ₽11.2 billion on Local Currency Sovereign Debt Obligations known as Obligatsyi Federal'novo Zaima (OFZs) due February 2024. RNSD received the money and paid domestic bondholders, but it did not transmit the funds to foreign bondholders because of the Russian Central Bank's capital controls under Decree 79, the RCB Instructions, and other guidance that bar payments to foreign creditors. The payment made, but blocked by the RNSD, has generated debate over whether or not that constituted a potential event of default on the OFZs.

One effect of sanctions and countermeasures on Specified Currency Sovereign Debt Obligations will be tested today (16 March 2022) because two coupon payments are due on Specified Currency Sovereign Debt Obligations in an aggregate amount equivalent to US$117.2 million. These bonds have a 30-day grace period before a payment default becomes an event of default under the relevant indenture, meaning that a failure to pay on those Specified Currency Sovereign Debt Obligations on that date would not mature into an event of default until 15 April 2022. While the Russian Finance Ministry has announced that it initiated a payment order, as of publication of this paper it is unclear whether the order will go through or if the payment will be made in roubles.

2. Russian Corporate Bonds

Russian corporate issuers are estimated to have US$98 billion of foreign currency bonds outstanding (mainly denominated in euros or U.S. dollars). Approximately US$17 billion of that amount is scheduled to mature in 2022, with approximately another US$30 billion of bonds coming due in the next three years.[8] Energy companies such as Rosneft, Transneft, and Gazprom account for approximately 50% of total issuance. Some Russian corporate issuers are domiciled in Russia (the Russia Domiciled Corporates).[9] However,

[7] The following Alternative Payment Currency Sovereign Debt Obligations of the Russian Federation that include Russian roubles as one of the alternative payment currencies were identified in a request to the ISDA European determinations committee as discussed below: (a) 2.875% Bonds due 2025 (ISIN: RU000A0ZZVE6), (b) 1.125% Bonds due 2027 (ISIN: RU000A102CK5), (c) 4.375% Bonds due 2029 (ISIN: RU000A0ZYYN4), (d) 1.850% Bonds due 2032 (ISIN: RU000A102CL3), (e) 5.10% Bonds due 2035 (ISIN: RU000A1006S9), and (f) 2.65% Bonds due 2036 (ISIN: RU000A1034K8).

[8] For an overview of Russian corporate bond maturities, *see* Tommy Stubbington & George Steer, *Bond Investors Left in the Dark After Some Russian Borrowers Pay Up*, FIN. TIMES Mar. 11, 2022,.

[9] In addition to sanctioned entities mentioned above, Russia Domiciled Corporates include Rosneft Oil Co., Gazprom PJSC, and MMC Norilsk Nickel OJSC. Some of these entities are "quasi-sovereigns" in the sense that they are owned or controlled by the Russian government, including Gazprom PJSC, Rosneft Oil Co., and Russian Railways. Rosneft Oil Co. is the intermediate successor of the Ministry of Oil Industry of the Union of Soviet Socialist Republics (the Soviet Union); Gazprom was created in 1989, when the Soviet Union's Ministry of Gas Industry was converted to a corporation; Russian Railways is the successor of the Soviet

over 90% of Russian corporate bonds have been issued by units or subsidiaries domiciled outside of the Russian Federation (the Russia External Corporates).[10] It is also estimated that 75% of the Russian corporate issuers that have coupon payments due in the coming months are Russia External Corporates that are foreign subsidiaries of Russia Domiciled Corporates. Some of these entities are domiciled outside Russia or have issued bonds through subsidiaries in the European Union or the United Kingdom. Like Russia Sovereign Debt bonds, some of these may have alternative payment currency toggles permitting payment in roubles.

In light of the financial uncertainty unleashed in late February, the bond markets (and CDS credit protection sellers) sighed in relief when significant payments were made on time in early March by several Russian corporates. On 3 March 2022, Yandex NV made a coupon payment on its US$1.25 billion bond due 2025. On 7 March 2022, Gazprom (Via Gaz Capital SA) repaid in full a US$1.3 billion bond due 2022. On 10 March 2022, Rosneft (via Rosneft International Finance DAC) repaid in full its US$2 billion bond due 2022.

These recent payments may show that many Russian corporate issuers with large operations outside of Russia may be currently willing to use funds on deposit outside Russia to service debt for now. However, it is also possible that these payments were already in motion before the promulgation of the 5 March Decree and the RCB Instructions and could not be reversed even if the issuer had become unwilling to pay.

The extent to which Russian corporate issuers remain willing to avoid default on maturity in the changed environment will come later this month. US$483 million of bonds issued by mineral resources company Polyus (recently downgraded by Fitch Ratings) are due to mature on 28 March 2022. In early April there will be several other upcoming bond maturities: US$625 million of bonds issued by Russian Railways will mature on 5 April 2022; US$156 million bond issued by Borets Finance DAC on behalf of Borets International Limited will come due on 7 April 2022; and a US$500 million bond issued by MMC Finance DAC on behalf of MMC Norilsk Nickel OJSC will come due on 8 April 2022. Coupon payments due in mid and late March on bonds of several Russian corporate issuers.

3. Russia CDS

It has been estimated that CDS contracts insure US$41 billion of Russian sovereign debt through approximately US$4.5 billion of CDS are referenced specifically to the Russian government and an additional US$1.5 billion located inside derivative indexes. CDS contracts insure US$41 billion of Russian sovereign debt.

Railways, which was directly under the control of the Soviet Union's Ministry of Railways.

[10] Examples of Russia External Corporates include Netherlands company Yandex NV; UK companies Polyus Finance PLC and RZD Capital PLC, which act as the issuer for Russian Railways; Irish entities Gtlk Europe Capital DAC, Eurochem Finance DAC, MMC Finance DAC as issuer for MMC Norilsk Nickel OJSC; Borets Finance DAC as issuer for Borets International Limited, and Rosneft International Finance DAC, an Irish designated activity company that acts as an issuer for Rosneft Oil Co; and Luxembourg company Gaz Capital SA, which acts as the issuer for Gazprom PJSC.

C. Overview of CDS with Special Consideration of Russian Reference Entities

A CDS is a credit derivative contract that transfers the credit exposure of fixed income products from one party (the credit protection buyer) to another party (the credit protection seller). A CDS can reference a company, a sovereign, or other entity (the reference entity) either on a stand-alone basis or as part of an index. The credit protection buyer pays the credit protection seller a premium that reflects in part the expected likelihood of default by the reference entity during the term of the CDS, which is normally five years. If a credit event affects a relevant obligation during the term of the CDS transaction, the credit protection buyer is entitled to commence the settlement process to realize its protection.

A CDS covers a specifically referenced debt obligation of the reference entity, either as the primary obligor or as a qualifying guarantor, and often also provides protection on other obligations of the reference entity that fit within a designated "obligation category" and satisfy specified "obligation characteristics." (This white paper sometimes refers to the reference obligation and other obligations collectively as "relevant obligations" of a reference entity).

Parties can enter into CDS to hedge credit exposures or to speculate on the likelihood of a default by the reference entity on relevant obligations and the associated loss of value of other specific debt obligations of the reference entity (the deliverable obligations) that are used as the basis for determining the amount of loss.[11] The protection buyer's CDS position is in the money if an event of default on the fixed income product not only triggers a payout on the CDS (a credit event) but also causes the underlying indebtedness to lose significant value. The protection seller on the other hand is wagering that the issuer will pay its creditors, or alternatively that defaulted debt obligations will trade relatively close to par.

The current basic terms of CDS are contained in the 2014 Credit Derivatives Definitions (the 2014 Definitions) published by the International Swaps and Derivatives Association (ISDA).[12] Many transactions rely on standardized elections for applicable credit events, relevant obligation categories and characteristics, and deliverable obligation categories and characteristics for various particular types of reference entities as published in physical settlement matrices published by ISDA and updated from time to time. This white paper is based on the ISDA physical settlement matrix as published on 29 July 2021 (the Matrix).

Of particular relevance to Russian CDS, the Matrix has different standard terms for "emerging European" corporates, "standard European" corporates, and "emerging European" sovereigns. For purposes of the Matrix, the Russia Sovereign is an emerging European sovereign reference entity, a Russia Domiciled Corporate is an emerging European corporate reference entity, and a Russia External Corporate is a standard

[11] CDS prices and prices of the fixed income obligations themselves reflect fixed-income investors' views and assumptions about default and recovery expectations. Sophisticated fixed-income investors often seek to exploit disparities between the prices of CDS and fixed-income products they reference through "spread trades" and other transactions that arbitrage discrepancies in the implied risk of default in the derivative and cash markets.

[12] This white paper assumes that CDS transactions are governed by the 2014 Definitions, which are materially different in many respects from the earlier version of the ISDA credit derivatives definitions published in 2003. The analysis of issues discussed in this white paper could be materially different if considered under the 2003 definitions.

European corporate reference entity.

In relation to the Russian Federation (but not other components of the Russia Sovereign), the Matrix terms are further amended by the Additional Provisions for the Russian Federation: Obligation Characteristics and Deliverable Obligation Characteristics (published on 13 August, 2004) (the Russian Federation Additional Terms). The Russian Federation Additional Terms address certain legacy issues that the Russian Federation inherited from the Soviet Union.[13]

D. Credit Events Affecting Russian Reference Entities

This section discusses credit events and relevant obligations with special reference to Russian reference entities and then assesses particular issues that may be relevant to the determination of particular credit events that are most likely to be implicated by sanctions and countermeasures.

1. General

The 2014 Definitions list six well-defined credit events: (i) bankruptcy of the reference entity, (ii) failure to pay principal of or interest on a relevant obligation, (iii) repudiation of or declaration of a moratorium with respect to a relevant obligation,[14] (iv) acceleration of relevant obligations in excess of an aggregate threshold amount, (v) the occurrence of an event of default under relevant obligations in excess of an aggregate threshold amount, and (vi) restructuring.

In the absence of a different agreement between the parties to a CDS, the specific credit events that would apply to a CDS referencing Russian debt would be based on the Matrix and the specific type of debt involved.

- A Russia Sovereign CDS presumptively applies the following four credit events: “failure to pay” (grace period extension applicable), “obligation acceleration,” “restructuring” (Mod Mod R), and “repudiation/moratorium.”
- A Russia Domiciled Corporate CDS would presumptively apply the following five credit events: “bankruptcy,” “failure to pay” (grace period extension applicable), “obligation acceleration,” “restructuring” (multiple holder obligation not applicable only with respect to bonds), and “repudiation/moratorium.”
- A Russia External Corporate CDS would presumptively apply the following three credit events: “bankruptcy,” “failure to pay” and “restructuring” (Mod Mod R).

[13] The Russian Federation Additional Terms exclude from consideration as “obligations” and as “deliverable obligations” certain restructured debt of the Soviet Union and certain obligations issued in exchange for obligations of the Soviet Union, which are known as IANs, MunFins, OVYZs, Taiga Bonds, and PRINs, respectively.

[14] An act of repudiation or moratorium does not crystallize into a credit event unless (i) the repudiation or moratorium occurs during the scheduled term of the transaction and (ii) a failure to pay or restructuring occurs with respect to any amount of debt under relevant obligations on or prior to a date (the “repudiation/moratorium evaluation date”) that occurs 60 days after the act of repudiation or moratorium or (in the case of relevant obligations that consist of bonds) the lesser of such period or the time to the first payment date under the relevant obligations that are bonds.

2. Relevant Obligations

In addition to the reference obligation, the relevant obligations that are taken into consideration in determining whether a credit event has occurred are (i) "bonds" for a Russia Sovereign, (ii) "bonds and loans" for a Russia Domiciled Corporate, and (iii) "borrowed money" for a Russia External Corporate, including qualifying guarantees in each such case.[15]

As an "emerging European" reference entity, the obligations of a Russia Sovereign and a Russia Domiciled Corporate must have the following characteristics to be protected under a CDS: "not subordinated," "not domestic law," "not domestic currency," and "not domestic issuance." The relevant obligations of a Russia External Corporate do not have to satisfy any particular characteristics, consistent with the greater degree of flexibility afforded by the Matrix to "standard European" reference entities.

A key issue in the analysis of Russian actions such as Decree 79, the 5 March Decree and the RCB Instructions is whether, by requiring payment to be made in roubles, they cause indebtedness of a Russia Sovereign (whether Specified Currency Sovereign Debt or Alternative Payment Currency Sovereign Debt) or of a Russia Domiciled Corporate to cease being "obligations" by virtue of failing to satisfy the "not domestic currency" characteristic. If such indebtedness does not constitute an "obligation," a credit event cannot attach to it even if there is a corresponding event of default under that indebtedness and the credit protection purchaser cannot recover for credit losses on the indebtedness. As discussed below, the ISDA determinations committee for Europe has been asked to rule on this question.

3. Credit Events Potentially Occasioned by Sanctions and Countermeasures

The currency controls, currency redenomination, trading restrictions and payment disruptions that follow the sanctions and Kremlin countermeasures under Decree 79, the 5 March Decree, the RCB Instructions or other Russian laws or decrees may give rise to a failure to pay credit event, a restructuring credit event or a credit event for repudiation/moratorium. However, the specific analysis in each case may depend on whether the CDS references a Russia Sovereign, a Russia Domestic Corporate or a Russia External Corporate. The analysis may also be affected by whether a CDS covers guarantees, which type of entity provides the guarantee, and the relevant obligation characteristics of the underlying guaranteed obligation.

a. *Failure to Pay*

The "failure to pay" credit event occurs if, after the expiration of any applicable grace period (and after satisfaction of any conditions precedent to the commencement of such grace period) the reference entity fails to make, when and where due, any payments in an aggregate threshold amount specified in the CDS confirmation, under one or more relevant obligations in accordance with the terms of such relevant obligations *at the time of such failure*.[16]

[15] If the parties to a CDS transaction agree to have "reference obligation only" apply to the CDS transaction, there are no other relevant obligations other than the reference obligation. This discussion assumes that "reference obligation only" does not apply.

[16] The Matrix makes "grace period extension" applicable by default for CDS referencing a Russia Sovereign or a Russia Domestic Corporate, but it does not apply this feature to CDS referencing

Whether Decree 79, the 5 March Decree, the RCB Instructions, or other guidance has proximately caused a failure to pay on any relevant obligations would depend in the first instance on whether the relevant obligation had an alternative payment currency fallback that permitted payment in roubles and secondarily whether the alternative payment currency fallback was effective at the time of the failure to pay. The analysis would be different as between Russia External Corporates on one hand and Russia Sovereign and Russia Domestic Corporates on the other hand because the Matrix excludes “domestic currency” and “domestic law” as good obligation characteristics for emerging European entities such as Russia Sovereigns and Russia Domiciled Corporates. As discussed below, ISDA’s determinations committee for Europe has been asked to address this issue in respect of certain bonds of the Russian Federation.

In theory, the redenomination of a specified currency obligation into a local currency obligation by legislation under the law governing the indenture or other contract might not itself cause a payment default giving rise to a failure to pay credit event, provided that the obligor or its credit support provider had sufficient access to roubles to enable it to pay its obligations at the official rate of exchange. This would require an analysis of whether Decree 79, the 5 March Decree, and the RCB Instructions (or similar capital controls) are considered to be such legislation in any particular case. However, this argument would only be theoretically available to CDS referencing a Russia External Corporate because (unlike a Russia Sovereign and a Russia Domestic Corporate) the “obligations” of a standard European reference entity do not exclude instruments governed by Russian law. However, as a practical matter, the relevant obligations of a Russia External Corporate would likely be governed by the law of New York, England and Wales, or Germany rather than of Russia.

Even if capital controls and payment barriers cause a payment default on relevant obligations, that payment default would not be immediately or automatically a CDS credit event for failure pay, even if it appears likely that a reference entity would not be able to satisfy its payment obligations. Rather, it would be necessary to wait until the following payment date and expiration of any grace periods specified in the contracts governing the relevant obligation.

Furthermore, because “grace period extension” is applicable to CDS referencing a Russia Sovereign or a Russia Domiciled Corporate, if the reference entity fails to make a scheduled bond payment on or near the scheduled termination date of the CDS the termination date of the CDS is automatically extended by the number of days in the contractual grace period for the bond as of the date of such potential failure to pay even if the CDS transaction has a scheduled termination date that occurs during the grace period. On the other hand, if a Russia External Corporate reference entity defaults on a payment date that occurs after the scheduled termination date for a CDS transaction, the credit protection on that reference entity would expire without value to the credit protection purchaser.[17] This weakness in protection may be mitigated to the extent that Russian

a Russia External Corporate. Under “grace period extension,” if a potential failure to pay credit event occurs on or shortly before the scheduled termination date of the transaction, the credit protection remains outstanding until the expiry of the applicable grace period. If “grace period extension” does not apply, if the scheduled termination date occurs during a grace period for a payment default, the CDS expire ends without having triggered a failure to pay credit event.

[17] In respect of failure to pay, the Matrix is more favorable to credit protection purchasers under CDS on “emerging European” reference entities like Russia Sovereigns and Russia Domiciled

corporate issuers (particularly Russia External Corporates) have hard currency deposits in banks outside Russia as noted above, particularly since Western sanctions against Russian entities make it unlikely that Russia External Corporate entities will be able to dividend or loan those funds to Russia Domiciled Corporate parents or affiliates.

b. *Restructuring*

The capital controls introduced by Decree 79, the 5 March Decree and the RCB Instructions would appear to implicate the credit event for restructuring. That credit event occurs if (inter alia) there occurs "any change in the currency of any payment of interest, principal or premium to any currency other than the lawful currency of Canada, Japan, Switzerland, the United Kingdom, the United States of America and the euro and any successor currency to any of the aforementioned currencies."

Reliance on restructuring as a credit event avoids the need to address grace periods that may impact the timing of a failure to pay. However, restructuring poses some other issues in relation to Russian reference entities. Because "multiple holder obligation" is applicable to restructuring of loans under a CDS referencing a Russia Domestic Corporate, certain events that would normally constitute a restructuring of such loan (including a change of the interest rate or certain redenominations of the currency of payment) shall not be a restructuring credit event unless the relevant obligation is held by more than three holders that are not affiliates of each other and a supermajority of holders are required to consent to the change.

Because restructuring of a Russia Sovereign and a Russia External Corporate is subject to the "Mod Mod R" convention of the 2014 Definitions, if restructuring is the only credit event, there could be some limitations on the credit purchaser's discretion to select the cheapest-to-deliver deliverable obligations for settlement.

c. *Repudiation/moratorium*

Two things must occur for a repudiation or moratorium of debt to trigger the credit event for repudiation/moratorium. First, the Russian Federation or the reference entity must disclaim, repudiate, or impose a payment moratorium or standstill on relevant obligations having a minimum aggregate principal amount specified for the CDS transaction. Second, a failure to pay or a restructuring credit event occurs with respect to any amount owing under relevant obligations on or prior to the repudiation/moratorium evaluation date described above.

This credit event may require an analysis of whether Decree 79, the 5 March Decree, the RCB Instructions, or other guidance effectively imposes such a payment moratorium or standstill. In the case of relevant obligations issued by a Russian corporate entity, it also requires an analysis of the governing law of the instrument under which a relevant obligation was issued and of the basis on which the Russian Federation has jurisdiction over the issuer. This analysis would probably establish that repudiation/moratorium is more likely for a Russia Sovereign than for a corporate issuer and more likely for a Russia

Corporates than they are towards "standard European" reference entities such as Russia External Corporates because they provide that the "failure to pay" credit event for those reference entities is subject to grace period extension, with the effect that the scheduled termination date is extended following a payment default on a relevant obligation so that it coincides with the grace period provided in the relevant obligation.

Domiciled Corporate than for a Russia External Corporate.[18] As discussed below, ISDA's determinations committee for Europe has been asked to address whether a potential repudiation/moratorium has occurred with respect to certain bonds.

The act of repudiation or moratorium must occur before the scheduled termination date of a CDS to trigger potential credit protection, but the credit protection will remain outstanding until the repudiation/moratorium evaluation date, even if that date occurs after the scheduled termination date if one party to the transaction has delivered an extension notice to the other prior to the scheduled termination date of the CDS transaction.

d. *Bankruptcy*

The credit event for bankruptcy applies uniquely to corporate entities. Generally speaking, a bankruptcy credit event occurs if a reference entity is dissolved, becomes insolvent or unable to pay its debts in full, or seeks to become bankrupt or to become subject to a receivership or institutes or has instituted against it a proceeding seeking a judgment of bankruptcy or insolvency or other relief under bankruptcy or insolvency law. If a bankruptcy case or proceeding is instituted against the reference entity by a third party, the credit event does not crystallize until it has not been dismissed, discharged, stayed or restrained within 30 days of such institution.

Paradoxically, redenomination, capital controls, and other financial stability measures taken by the Russian Central Bank may reduce the likelihood that a Russia Domiciled Corporate would become bankrupt as a result of sanctions because of its ability to satisfy its obligations in roubles and also because of relief provided to companies by Decree 79 and other Russian financial stability measures. On the other hand, bankruptcy may become more likely for a Russia External Corporate with a significant amount of foreign-currency debt because the effective devaluation of its parent contributions (to the extent permitted by the sanctions regime and Russian capital controls) as well as any attendant exchange controls could result in the assets of the Russia External Corporate being insufficient to pay its foreign currency obligations as they become due. The resolution of this question would involve a far broader range of considerations with respect to the reference entity than those that would be involved in determining whether a credit event occurred on any particular relevant obligation.

F. Settlement of CDS With Special Consideration of Russian Reference Entities

This section will generally discuss settlement conventions on CDS and address specific settlement features that may be particularly affected by the nature of the reference entity or by constraints to settlement that have arisen under the regime of sanctions and

[18] In the case of a Russia External Corporate, there may be a question whether sanctions or action taken by the jurisdiction of its domicile or the jurisdiction whose law governs the debt instrument could constitute a repudiation or moratorium if it practically interferes with the ability of such entity to make payments. This issue may also arise in relation to debt obligations of nonsanctioned businesses owned by sanctioned entities. For an example of how such sanctions can collaterally affect obligations generally, *see* Nick Emms, *Revealed: Details of Chelsea's Special License After Roman Abramovich Sanctioned*, SPORTS ILLUSTRATED (Mar. 10, 2022) https://www.si.com/soccer/chelsea/news/revealed-details-of-chelseas-special-license-after-roman-abramovich-sanctioned#:~:text=Revealed%3A%20Details%20of,%C2%A9%202022. The present white paper focuses only on actions by the Russian Federation that could give rise to a repudiation/moratorium credit event.

countermeasures.

1. General

Once a credit event has been determined to have occurred and the conditions to settlement are satisfied, a CDS is settled by one or more auctions of selected deliverable obligations conducted by regional "determinations committees" established by ISDA, each of which consists of buy-side and sell-side institutions active in the relevant CDS market. The auction process is intended to establish a clearing price for the deliverable obligations that establishes the loss of value on the relevant obligations of the reference entity for which the credit protection purchaser is entitled to be paid.

As a fallback, a CDS may be settled physically if the auction is illegal or otherwise impossible, and as a further fallback, the CDS can be cash-settled. In physical settlement, the credit protection buyer receives cash in an amount equal to the entire notional amount of the CDS in exchange for physical delivery of "deliverable obligations" having a face amount equal to the notional amount of the CDS. In cash settlement, the credit protection buyer receives a cash payment equal to the difference between the notional value of the CDS and the market value of a deliverable obligation having a face amount equal to the notional amount of the CDS. In either case, the credit protection buyer has significant discretion to propose the cheapest deliverable obligation of the reference entity that falls within agreed "category" and "characteristic" parameters of the deliverable obligation as discussed below.

2. Deliverable Obligations

For CDS referencing a Russia Sovereign, a Russia Domiciled Corporate or a Russia External Corporate, the deliverable obligations must consist of bonds or loans of the reference entity that satisfy the following characteristics as specified in the Matrix: "not subordinated," "specified currency," "assignable loan," "consent required loan," "transferable," and "not bearer."

There are some additional limitations that apply to particular categories of reference entity:

- A CDS referencing a Russia External Corporate is subject to the additional requirement that the remaining term to maturity of the deliverable obligation may not exceed 30 years.
- For a CDS referencing a Russia Sovereign CDS or a Russia Domestic Corporate, the deliverable obligation must also satisfy two further criteria: "not domestic issuance," and "not domestic law." This means that the deliverable obligation cannot be issued, reissued, or offered for sale primarily in the domestic market of the Russian Federation and cannot be governed by Russian law.
- A Russia Sovereign CDS referencing the Russian Federation is also subject to the Russian Federation Additional Terms, which exclude from the definition of deliverable obligation certain restructured debt of the Soviet Union.[19]
- If "restructuring" is the only credit event for a Russia External Corporate CDS, the

[19] The excluded deliverable obligations represent restructured debt of the Soviet Union or obligations issued in exchange for obligations of the Soviet Union, which are known as IANs, MunFins, OVYZs, Taiga Bonds, and PRINs, respectively.

deliverable obligation also must meet the additional requirements specified for "modified restructuring maturity limitation and conditionally transferable obligation." Under the first prong of this requirement, the deliverable obligation must have a final maturity date not later than the later of (a) the scheduled termination date for the CDS transaction and (b) a date between 30 months and 20 years following the date of the restructuring, provided that if the scheduled termination date is later than 10 years after the date of the restructuring the deliverable obligation may not have a maturity later than the scheduled termination date of the CDS. Under the second prong of this requirement, if the deliverable obligation is a loan it must be capable of being assigned or novated to any bank, financial institution, or other entity which is regularly engaged in or established for the purpose of making, purchasing, or investing in loans, securities, and other financial assets without the consent of the relevant reference entity, its guarantor or any other person, or as long as there is a contractual requirement in the deliverable obligation that such consent shall not be unreasonably withheld.

3. Standard Specified Currencies

The "specified currency" limitation of the Matrix will be a key gating issue determining the ability to settle CDS referencing Russian-affiliated entities, particularly Russia Sovereign and Russia Domiciled Corporate reference entities. The 2014 Definitions define "specified currency" to mean an obligation that is payable in the currency or currencies specified as such in the related confirmation or, if "specified currency" is specified in a confirmation and no currency is so specified, then the "specified currency" is each of the United States dollar, the Canadian dollar, the Japanese yen, the Swiss franc, the British pound, the euro, and any successor currency to any of the aforementioned currencies (which in the case of the euro, means a currency that succeeds to and replaces the euro in whole or in France or Germany).

Therefore, separate and apart from their potential effect on the analysis of credit events, Russian capital controls such as Decree 79, the 5 March Decree, and the RCB Instructions throw into question whether and to what extent bonds of the Russia Sovereign and Russia Domiciled Corporates in particular will satisfy the requirements to be "deliverable obligations" for auction settlement or physical settlement and cash settlement fallbacks.

Another issue that could affect the universe of potential deliverable obligations is whether Alternative Payment Currency Sovereign Debt Obligations with a toggle feature or fallback that permits the issuer to make payment in roubles (or similar obligations of a Russia Domestic Corporate) causes the bond or loan to cease to be a good deliverable obligation because it does not fulfill the "specified currency" requirement.

As discussed below, the determinations committee for Europe has been asked to rule on the effect of the foregoing issues on compliance with these deliverable obligation characteristics.

4. Short-Squeeze Risk

If a credit event has occurred on properly characterized relevant obligations, the practical ability of a credit protection purchaser to be compensated for credit loss could be practically impaired to the extent that obligations sought to be delivered in settlement are not good deliverable obligations. This could occur because supply the eligible deliverable obligations are of a short duration or have other characteristics that make it difficult to select relatively cheap deliverable obligations, and it could also occur if there simply are not enough deliverable obligations to provide a market-clearing price that reflects the credit loss on the relevant obligation.

Limitations on deliverable obligations could adversely affect the likelihood that credit protection purchasers will obtain a recovery that approximates the losses on relevant obligations by causing or contributing to a short squeeze because bonds and loans are not available to be delivered into the settlement auction. If bonds and loans are effectively redenominated in roubles by the 5 March decree and the RCB Instructions, they are ineligible for inclusion as deliverable obligations in a settlement auction (or in physical or cash settlement) because they are not "specified currency"; in light of restrictions on convertibility and tradability of the rouble generally they might also be considered to represent a "domestic [re]issuance."

This definitional issue may be moot even if there are eligible deliverable obligations that cannot be practically delivered if secondary trading in Russian bonds and loans is banned because of sanctions (such as the refusal of Clearstream to clear rouble-denominated securities) and also because of the growing quasi-voluntary isolation of Russian financial markets from international financial markets, including growing reluctance to engage in Russia-facing transactions even in the absence of a prohibition. An illiquid trading market could lead to a repeat of the failed CDS auctions that were experienced following credit events on French rental car company Europcar in 2021 and Netherlands financial institution SNS Bank in 2013.

In the first case, the CDS settlement occurred in conjunction with a bankruptcy case that arose from the same facts that gave rise to the credit event. A lock-up of bonds in the bankruptcy meant that very few deliverable obligations were available to be tendered in the auction, and the resulting short squeeze resulted in a price of 100% (resulting in zero recovery) as against an expected auction price of approximately 73%, which would have resulted in an approximately 27% recovery.[20] In the second case, a restructuring credit event occurred with respect to relevant obligations of SNS Bank when the Netherlands government to bail-in subordinated debt holders of SNS Bank and expropriated the subordinated debt. But the refusal of the Netherlands government to release the expropriated subordinated bonds into the auction together with a very small float of other eligible deliverable obligations caused prices in the auction to rise to a level where the auction failed to deliver any loss amount to credit protection purchasers on CDS referencing SNS Bank.[21]

If an auction settlement fails, the CDS is subject to a physical settlement fallback and ultimately a cash settlement fallback. The same issues of illiquidity and lack of trading could radically impair the value of credit protection in physical settlement because the credit protection buyer would have to source deliverable obligations to deliver to the credit protection seller in exchange for the entire gross notional amount of the CDS. If there is

[20] *See* Robert Smith, *Europcar Debt Investors Left Empty-Handed After CDS 'Squeeze*', Fin. Times, Jan. 14, 2021

[21] *See* Lisa Pollack, *One Hundred and One Pains in the SNS for the CDS Market*, FIN. TIMES, Mar. 11, 2013. The Matrix has special terms for certain CDS referencing standard European financial institutions that were instituted in response to the SNS auction failure. This white paper does not address those special terms.

a shortage in the supply of bonds relative to the demand for bonds that can be delivered in settlement of CDS the cost to the buyer even of sourcing the cheapest deliverable obligations could be far greater than the payout on the CDS. If deliverable obligations are not available, the ultimate fallback would be cash settlement, in which the credit protection purchaser receives a net amount equal to the loss as measured by a dealer valuation of the deliverable obligation.

5. ISDA Determinations Committee Requests.

In early March 2022, in light of the developments in relation to Russia described above, ISDA's Credit Steering Committee submitted a request to ISDA's determinations committee with jurisdiction over Europe asking it to consider whether the rouble toggle in certain Alternative Payment Currency Sovereign Debt Obligations issued by the Russian Federation and described in footnote 8 would result in such obligation failing to satisfy either "not domestic currency" or "specified currency." The query requested consideration of the issue both in a scenario where the reference entity has utilized the rouble fallback toggle at the time that the relevant characteristic is being assessed and in a scenario where the reference entity has not yet used the toggle feature to make payment in roubles.

In mid-March 2022, a general-interest question was submitted to ISDA's determinations committee with jurisdiction over Europe, asking it to consider whether a "potential repudiation/moratorium" occurred with respect to the Russian Federation including in respect of its bonds due for final redemption on 31 March 2030 (CUSIP: 78307ACZ4).

These are likely the first of many requests for determinations over the coming weeks and months, and one that is likely to reveal fault lines between credit protection buyers and credit protection sellers.

Conclusion

The fiercely righteous response of democracies to Russia's war against Ukraine, and the countermeasures directed from Red Square, have dislocated global financial markets in new and unpredictable ways. International creditors will be affected differently depending on the type and location of the issuer and the nature of the debt. With apologies to Tolstoy, while happy international creditors are all alike every international holder of Russian debt and Russian CDS is unhappy in its own way.

With uncertainty about the length and severity of the war now in Ukraine, the schedule of payments and maturities on Russian debt this year and next will be a key focus of concern, along with analysis of currency fallbacks, grace periods, guarantees, and the like. Discrepancies in the pricing of Russian debt and CDS referencing that debt may create arbitrage opportunities but may also reflect risks if CDS do not provide effective credit protection in the current stressed environment. Key questions will include whether terms of debt make them ineligible for credit protection, whether timing and other limitations affecting credit events adversely affect a credit protection purchaser, and whether markets provide enough liquidity to support a valuation process in light of the barriers to trading imposed by sanctions and countermeasures.

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