

Federal Reserve Announces Agreement for Central Credit Derivatives Counterparty

On June 9, 2008, the Federal Reserve Bank of New York announced that it had reached an agreement with a group of 17 major dealers in the credit default swap market to create a central counterparty for the trading of credit default swap transactions. The Clearing Corporation, an independent derivatives clearinghouse that has historically provided clearing services for global exchanges and OTC traded derivatives, will act as the central counterparty. At least three non-dealer, buy-side firms and four industry groups were reported to have participated in the discussions, as well as the respective supervisors of the participating dealers.

On May 29, 2008, The Clearing Corporation announced a partnership with The Depository Trust & Clearing Corporation (DTCC), a global information repository that manages a centralized post-trade infrastructure for the credit default swap market, to integrate DTCC's credit default swap servicing capabilities and to otherwise facilitate central counterparty services. The Clearing Corporation expects to start guaranteeing OTC credit derivative contracts in the 3rd quarter of 2008, increasing the credit default swaps products covered throughout 2008-9. The Clearing Corporation has stated that it anticipates first providing central counterparty services with respect to credit default swaps referencing the CDX high yield and investment grade indexes.

The development of a central counterparty represents a further step taken by market participants at the urging of regulators to improve the OTC derivatives market infrastructure and further reduce potential systemic risk to the financial markets posed by existing market infrastructure. The Federal Reserve has been working with major credit derivatives dealers for several years now in an effort to reduce such potential systemic risks, as evidenced by the significant efforts undertaken by major dealers and buy-side firms trading in credit derivatives to reduce the backlog in unconfirmed derivatives transactions and to address perceived shortcomings in the derivative transaction novation process. Recent market events, including the uncertainty surrounding Bear Stearns prior to its purchase by JPMorgan, have heightened the focus on the potential systemic risks posed by the failure of a major derivatives counterparty and what regulatory measures can be taken to mitigate against such risks.

The Federal Reserve announced that, in addition to the agreement to establish a central counterparty, participants in the discussions also agreed to work to further increase the standardization and automation of credit derivative trade processing, to incorporate cash settlement mechanisms into standard credit derivatives documentation (anticipated to be effected through a supplement to the 2003 ISDA Credit

Derivatives Definitions or the publishing of another version of such definitions, and to reflect mechanics similar to the Dutch-auction style mechanics utilized in settling credit events most recently in respect of Quebecor World Inc. and Movie Gallery Inc.), and to apply infrastructure improvements developed with respect to the credit default swap market to other derivatives markets, including the equities, commodities and interest rate markets.

Participants agreed to report back to the Federal Reserve by the end of July 2008 with details of plans for further implementing the efforts described above.

Kramer Levin's derivatives practice group is comprised of members of our corporate, banking, bankruptcy, distressed trading and tax departments and regularly represents investment banks, hedge funds and other financial institutions. Our practice involves the negotiation of ISDA and other derivatives facilities and the structuring and negotiation of customized derivatives transactions.

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