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### **Note on First to Default Template**

The following Note sets forth several hypothetical situations to illustrate the operation of Paragraphs 6 and 7 of the First to Default template published by the International Swaps and Derivatives Association, Inc. on July 15, 2004.

This Note does not purport to offer legal advice and it is recommended that in the event of any questions on the application of the First to Default template, firms consult with counsel. In addition, this Note is not part of the First to Default template or the 2003 ISDA Credit Derivatives Definitions (the "Definitions") and is not offered as an interpretation of either publication.

#### Substitution

The First to Default template allows users to select whether Substitution is applicable to the Transaction. Users should make their own commercial and legal assessment of which option is appropriate for their Transaction.

Where Substitution is "Not Applicable", the "Provisions for Determining a Successor" in Section 2.2 of the Definitions will apply. Following the occurrence of a Succession Event, the first to default Transaction will be divided into the same number of new first to default Transactions as the number of Successors. Each new Transaction will include one of the Successors together with the other Reference Entities that were not subject to the Succession Event. Users should note that where one Reference Entity transfers its Bonds and Loans to one or more other Reference Entities, the total number of Reference Entities may be reduced. If the Seller merges with a Reference Entity, the first to default Transaction will terminate in accordance with Section 2.31 of the Definitions.

Where Substitution is "Applicable", the same process will be followed. In the event that the Buyer and the Seller fail to comply with the Substitution process, the FTD template contains fallback provisions whereby the existing Reference Entity will continue to be the Successor and the Transaction will operate as if Substitution was not applicable.

Users should also note that where the Seller merges with a Reference Entity, the Transaction will not terminate in accordance with Section 2.31 of the Definitions. Instead, a new entity is included in the portfolio of Reference Entities to replace the position that would otherwise be occupied by Seller.

Worked Examples*Substitution is Not Applicable*

If the parties have specified that Substitution is not applicable, so that the provisions of Paragraph 6 apply, upon the occurrence of a Succession Event, the Surviving Reference Entity shall be deemed a Successor to the Legacy Reference Entity.

Example One: Reference Entities A, B, C and D are the constituents of the basket, with a notional amount of \$50 million. The parties have elected that Substitution is not applicable to their trade. As a result of a Succession Event, Reference Entity A distributes its Bonds and Loans to Reference Entity B and Reference Entity C.

The result is two new trades. One trade will have Reference Entities B, B, C and D with a \$25 million notional amount. The second trade will have Reference Entities B, C, C and D, with a \$25 million notional amount.

Paragraph 5 provides that where a Reference Entity is specified twice in a Transaction, it shall be deemed to be specified only once. Therefore, each of the new trades will have Reference Entities B, C and D and each will have a \$25 million notional amount.

Example Two: Reference Entities A, B, C and D are the constituents of the basket, with a notional amount of \$50 million. The parties have elected that Substitution is not applicable to their trade. As a result of a Succession Event, Reference Entity A distributes its Bonds and Loans to Reference Entity B and X.

The result is two new trades. One trade will have Reference Entities B, B, C and D with a \$25 million notional amount. The second trade will have Reference Entities X, B, C and D with a \$25 million notional amount. Again, Paragraph 5 will apply to the first trade to prevent duplication and B will appear only once.

Example Three: Bank X has sold protection on a basket of Reference Entities A, B, C and D to Bank Y. Bank X then merges with Reference Entity A and Bank X is deemed the Successor to Reference Entity A. The parties have elected that Substitution is not applicable to their trade.

The result is a trade to which Section 2.31 of the Definitions applies. An Additional Termination Event under the 2002 ISDA Master Agreement is deemed to have occurred with Bank X as the sole Affected Party and the trade is terminated.

*Substitution is Applicable*

If the parties have specified that Substitution is applicable, so that the provisions of Paragraph 7 apply, upon the occurrence of a Succession Event, the Surviving Reference Entity is not deemed to be a Successor to the Legacy Reference Entity and a Replacement Reference Entity is selected. The Surviving Reference Entity, however, remains in the basket.

Example Four: Reference Entities A, B, C and D are the constituents of the basket, with a notional amount of \$50 million. The parties have elected that Substitution is applicable to their trade. As a result of a Succession Event, Reference Entity A distributes its Bonds and Loans to Reference Entity B, Reference Entity C and X.

The result is three new trades. Pursuant to the operation of “Selection of Replacement Reference Entity”, Y replaces B and Z replaces C. One trade will have Reference Entities X, B, C and D with a \$16.66 million notional amount. The second trade will have Reference Entities Y, B, C and D with a \$16.66

million notional amount and the third trade will have Reference Entities Z, B, C and D with a \$16.66 notional amount.

Example Five: Reference Entities A, B, C and D are the constituents of the basket, with a notional amount of \$50 million. The parties have elected that Substitution is applicable to their trade. As a result of a Succession Event, Reference Entity A distributes its Bonds and Loans to Reference Entity B and X.

The result is two new trades. Pursuant to the operation of “Selection of Replacement Reference Entity”, Y replaces B. One trade will have Reference Entities X, B, C and D with a \$25 million notional amount. The second trade will have Reference Entities Y, B, C and D with a \$25 million notional amount.

Example Six: Bank X has sold protection on a basket of Reference Entities A, B, C and D to Bank Y in a notional amount of \$50 million. Bank X then merges with Reference Entity A. The parties have elected that Substitution is applicable to their trade.

Pursuant to “Seller Merger”, Bank X is viewed as the Surviving Reference Entity and is subject to replacement in accordance with the Substitution provisions. Z replaces Bank X and the result is a trade with the Reference Entities Z, B, C and D and a \$50 million notional amount.

Example Seven: Reference Entities A, B, C and D are the constituents of the basket, with a notional amount of \$50 million. The parties have elected that Substitution is applicable to their trade. As a result of a Succession Event, Reference Entity A distributes its Bonds and Loans to Reference Entity B and X.

Pursuant to the operation of “Selection of Replacement Reference Entity”, a replacement should be selected for B. However, Buyer fails to deliver a Reference Entity List or Buyer and Seller fail to select a Replacement Reference Entity in accordance with “Selection of Replacement Reference Entity”.

The result is two trades. One trade will have Reference Entities X, B, C and D with a \$25 million notional amount. The second trade will have Reference Entities B, C and D with a \$25 million notional amount. Note that Paragraph 5 applies to the second trade to prevent duplication so that B will appear only once.

Example Eight: Bank X has sold protection on a basket of Reference Entities A, B, C and D to Bank Y in a notional amount of \$50 million. Bank X then merges with Reference Entity A. The parties have elected that Substitution is applicable to their trade.

Pursuant to “Seller Merger”, Bank X is viewed as the Surviving Reference Entity and is subject to replacement in accordance with the Substitution provisions. However, the Buyer fails to deliver a Reference Entity List or both parties fail to select a Replacement Reference Entity in accordance with “Selection of Replacement Reference Entity”. Thus, there is no replacement for Bank X and the result is a trade with the Reference Entities B, C and D and a \$50 million notional amount.