

December 30, 2016

To: the ISDA Credit Derivatives Determinations
Committee (Americas)

iHeart Communications, Inc: Auction Date

Background

This statement is submitted in connection with the general interest question posted to the ISDA Credit Derivatives Determinations Committee (the “DC”) regarding the Auction Date for the Auction to be held with respect to iHeart Communications, Inc (“iHeart”). Capitalized terms used but not defined in this statement have the meanings ascribed to them in the 2014 ISDA Credit Derivatives Definitions (the “2014 Definitions”) or the 2016 ISDA Credit Derivatives Determinations Committee Rules (the “DC Rules”).

On December 23, 2016, the DC issued the following statement (the “DC Statement”):

“The DC has heard concerns about a substantial coupon payment due by February 1, 2017 and as a result market participants have raised concerns about the impact on the Auction if settlement of Representative Auction-Settled Transactions were to occur prior to this date. The DC therefore anticipates holding the Auction on or after February 1, 2017, consistent with the provisions of Section 3.2(d) of the DC Rules to avoid prejudice to buyers or sellers compared to Physical Settlement.”

Reference is also made to the statements dated December 22, 2016 submitted to the DC under references 2016122201 and 2016122202 in support of a deferral of the Auction Date (the “Proposals”). In this statement we explain why the Auction Date should *not* be deferred.

Comparison with Physical Settlement

As the DC Statement notes, the Auction mechanics are intended to place the parties to a credit default swap in the same economic position that they would be in if Physical Settlement applied. The starting point, therefore, should be to consider what the position would be in these circumstances.

Where Physical Settlement applies, on the Physical Settlement Date, the Buyer must deliver Deliverable Obligations with an Outstanding Principal Balance equal to the Floating Rate Payer Calculation Amount (Section 8.1 of the 2014 Definitions). The “Outstanding Principal Balance” is determined by reference to the Reference Entity’s principal payment obligations (Section 3.8(a)(i) of the 2014 Definitions), excluding accrued interest (unless “Include Accrued Interest” is specified in the related Confirmation) (Section 3.12(a) of the 2014 Definitions). “Include Accrued Interest” is not a standard election under transactions referenced to iHeart.

It is not permitted to strip some or all of the interest components from any Bond that is delivered (Section 3.7 of the 2014 Definitions) and so, where a Bond is delivered, it must be delivered together with any rights to accrued but unpaid interest that exist on the Physical Settlement Date. As the Seller is not required to pay more than the Floating Rate Payer Calculation Amount, the

Buyer receives no credit for the rights to accrued interest that are transferred with the Bond. The position is different where “Include Accrued Interest” is specified (when the amount of accrued but unpaid interest that is due will be included in the Outstanding Principal Balance).

Notwithstanding Section 9.7 of the 2014 Definitions (which gives the Seller the right to terminate the transaction and exercise a buy-in after five business days), a failure to perform on the Physical Settlement Date would be a breach of contract, for which damages would be available.

The Proposal submitted under reference 2016122201 states:

“as often is not the case in typical CDS auctions, the Deliverable Obligations with respect to iHeart CDS are still performing, and current interest thereon is expected to be timely paid in full...

If participating bidders submit bids for the Deliverable Obligations that reflect the likelihood of payment and expected receipt of such interest, the Auction Final Price in the iHeart auction will be artificially inflated due to the considerable accrued interest component reflected in the bids. Ordinarily, an Auction Final Price does not reflect an expectation of a significant, if any, interest payment, since Reference Entities experiencing a Failure to Pay Credit Event typically are not paying current interest on any of their obligations. However, since iHeart is expected to continue to pay current interest on the 14% Notes, any auction settlement prior to the February 1, 2017 interest payment date for the 14% Notes will result in protection buyers receiving a payment from protection sellers that effectively deducts the accrued and unpaid interest on the 14% Notes, and any protection buyers who beneficially own the 14% Notes will be effectively deprived of the accrued and unpaid interest earned during the period they held the 14% Notes.”

As explained above, however, the 2014 Definitions expressly contemplate that any Deliverable Obligations will be delivered together with accrued interest. The possibility of receiving a payment in respect of such interest will be factored into the prices that are quoted in any Auction.

Implications in the case of iHeart’s technical default

In the present case, iHeart is expected to pay the interest that is scheduled for February 1, 2017 in respect of iHeart’s 14% Senior Notes due 2021 (the “14% Notes”). However, that is a reflection of the fact that there has been, at most, a technical default on certain selected obligations of iHeart (the 5.50% Senior Notes due 2016 held by its wholly-owned subsidiary, Clear Channel Holdings, Inc). That is no basis for seeking to mirror the position that would apply if there had been a genuine default, and hence an expectation that interest will not be paid when due.

The 2014 Definitions contemplate the inclusion of accrued interest

The Proposal referred to above also states:

“An Auction Final Price that incorporates accrued and unpaid interest on the 14% Notes will not be consistent with quoted prices for the 14% Notes and would distort the settlement for ... other related [credit derivative] products. This would likely have the effect of artificially creating a materially different Auction Final Price when compared to the observable market clearing price for the cheapest to deliver Deliverable Obligation traded in the market at the same time as the auction, inconsistent with previous CDS auction results”.

This is an argument that assumes its own conclusion. The reason that the Auction Final Price will be materially different from the observable market clearing price is that, in contrast to the observable market clearing price, the Auction Final Price will include an allowance for accrued interest. To argue it is artificial is merely to say that accrued interest should not be factored in. The same is true of the argument that this would “distort” the settlement for other related products. Whether settlement would be “distorted” depends on whether the Auction Final Price (which the parties to those products have chosen to reference) should be influenced by the existence of any accrued interest, which is precisely the point at issue. As noted above, it is not what the 2014 Definitions contemplate.

Arguments for changing the settlement timetable have no justification

The Proposal submitted under reference number 2016122202 advances two alternative arguments in favour of changing the settlement timetable, purportedly on the basis that using the Auction Date contemplated by the DC Rules would “create disruption in the market”. It plain, however, that the objective is not to avoid market disruption but to avoid accrued interest being factored into the Auction Final Price. The alleged concerns about market disruption have merely been used as a pretext for this.

First, it is argued that market disruption would be created if the Auction Date were immediately prior to the Martin Luther King holiday weekend. Even if this were credible, an Auction Date that is a day or two *earlier* would address the concern, as well as being consistent with the normal treatment of accrued interest, as discussed above.

Secondly, it is suggested that the way in which the DTC deals with interest payments “creates the possibility of confusion over who is entitled to payment of the accrued interest and how the accrued interest should be factored into the Auction Final Price”. The entitlement to accrued interest is, however, a function of the rules of the DTC, which provide for payment to be made to the holders of record on the relevant interest payment date. There is therefore little scope for confusion.

Conclusion

In conclusion, we suggest that there is no justification for modifying the normal settlement timetable in order to avoid accrued interest being taken into account in the Auction process, contrary to the architecture of the 2014 Definitions. The fact that iHeart is expected to pay the scheduled interest on the 14% Notes is not a relevant consideration, especially in circumstances in which the Failure to Pay determined by the DC has been manufactured by iHeart itself.