



LSTA Market Advisory  
October 1, 2008

Physical Settlement of Credit Default Swap Transactions  
Referencing Tembec Industries Inc.

**A. Background**

The Loan Syndications and Trading Association, Inc. (“LSTA”), in cooperation with the International Swaps and Derivatives Association, Inc. (“ISDA”), is issuing this Market Advisory (the “Advisory”) in connection with the Credit Event of Tembec Industries Inc. (“Tembec”) in the Credit Default Swap (“CDS”) market, and the corresponding publication by ISDA of the 2008 Tembec CDS Protocol (the “Tembec Protocol”).<sup>1</sup> The purpose of the Tembec Protocol is to facilitate the settlement of certain open CDS positions following the Tembec Credit Event.

We understand that the Deliverable Obligations of Tembec under the Tembec Protocol are limited to the term loan (the “Tembec Loan”) issued under the Loan Agreement (the “Tembec Loan Agreement”), dated as of February 29, 2008, by and among Tembec, Tembec Inc., Tembec Investments Inc., the Lenders that are signatories thereto, and Wells Fargo Bank, National Association, as administrative agent and as collateral agent (the “Agent”).

We also understand that physical settlement -- the delivery of the Tembec Loan from the Buyer under the relevant CDS transaction (“Protection Buyer”) to the Seller under the relevant CDS transaction (“Protection Seller”) -- will apply to CDS transactions generated by the auction process pursuant to the terms of the Tembec Protocol (“Protocol Transactions”)<sup>2</sup> and may apply to CDS transactions settled outside the Tembec Protocol (“Direct Transactions” and, together with Protocol Transactions, “Physically Settled Transactions”). For participants delivering the Tembec Loan under Physically Settled Transactions, guidance for physical settlement is found in Section 8.2 of the governing 2003 ISDA Credit Derivatives Definitions (the “Credit Derivatives Definitions”), which provides that “Delivery shall be effected using documentation substantially in the form of the documentation customarily used in the relevant market for Delivery of such Loan at that time.”

With respect to Protocol Transactions, all capitalized terms used but not defined in this Advisory shall have the meanings ascribed thereto in the Tembec Protocol or, if not defined in the Tembec Protocol, in the Credit Derivatives Definitions, and with respect to Direct Transactions, all capitalized terms used but not defined in this Advisory shall have the meanings ascribed thereto in the Credit Derivatives Definitions.

**B. Physical Settlement on Par Documentation**

The LSTA, after a review of the relevant trading data, has determined that the Tembec Loan is predominantly trading in the secondary loan market on par documentation at this time.

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<sup>1</sup> The Tembec Protocol can be found at [www.isda.org](http://www.isda.org).

<sup>2</sup> The submission of bids, offers and “Physical Settlement Requests” in connection with the Tembec Protocol will result in new CDS transactions subject to physical settlement.

Accordingly, parties to Physically Settled Transactions should use existing par documentation customarily used in the secondary loan market to effect physical settlement of such transactions, as modified below.

### **C. The Tembec Loan Agreement**

The Tembec Loan Agreement can be found at [www.sedar.com](http://www.sedar.com), and should be reviewed by parties intending to enter into Physically Settled Transactions. The Tembec Loan Agreement permits transfers to “Eligible Transferees,” as defined therein, and interest payable under the Tembec Loan is governed by Section 2.7 of the Tembec Loan Agreement. As a general rule, the minimum amount of Tembec Loan that may be transferred under the Tembec Loan Agreement is \$250,000. In addition, a processing fee of \$2,500 is payable to the Agent in order for an assignment to become effective.

### **D. Specific Guidance for Par Documentation**

Within the standard par documentation framework, we advise market participants to make the following modifications in order to ensure efficient settlement and allow the secondary loan market and the CDS market to resolve, on a consistent basis, key settlement issues:

1. The parties should be guided by the terms of an LSTA Par/Near Par Trade Confirmation (the “LSTA Par Confirmation”) and the Standard Terms and Conditions for Par/Near Par Trade Confirmations (the “LSTA Standard Terms”)<sup>3</sup>, each as published by the LSTA in its most recent form as of the date hereof.

2. The following modifications should be made to the LSTA Par Confirmation and the LSTA Standard Terms, as applicable:

(a) The “Trade Date” should be the first day on which delivery of a Notice of Physical Settlement is effective.

(b) The outstanding principal balance of any Deliverable Obligation shall be determined as of the Trade Date, and any reductions in the outstanding principal balance of any Deliverable Obligation attributable to Permanent Reductions (as such term is defined in the LSTA Standard Terms) should not allow Protection Buyer to Deliver additional Deliverable Obligations.

(c) “Purchase Price:” Protection Seller shall pay an amount (or, if negative, Protection Buyer shall pay the absolute value of an amount) equal to the “Purchase Price” (as defined in the LSTA Standard Terms) that corresponds to the Tembec Loan, assuming a “Purchase Rate” (as defined in the LSTA Standard Terms) equal to the Final Price, in the case of Protocol Transactions, and the Reference Price, in the case of Direct Transactions, in lieu of the Physical Settlement Amount.

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<sup>3</sup> The LSTA Par Confirmation and the LSTA Standard Terms can be found by [clicking here](#).

(d) Notwithstanding anything to the contrary in the Tembec Loan Agreement or in the Form of Assignment and Acceptance Agreement attached as Exhibit A thereto, “Trades Flat” should be specified as the applicable convention for “Interest and Accruing Fees.” “Trades Flat” shall mean “All Interest and Accruing Fees, whether accruing before, on or after the Trade Date, if and when paid on or after the Trade Date, shall be for the account of Protection Seller and, if paid to Protection Buyer after the Settlement Date (as defined in the LSTA Standard Terms), shall promptly be paid by Protection Buyer to Protection Seller. ”

(e) In lieu of Section 6 of the LSTA Standard Terms, the following “Compensation for Delayed Settlement” provisions should apply:

(i) On the Settlement Date (as defined in the LSTA Standard Terms) or the Cash Settlement Date (as defined in the Credit Derivatives Definitions), as applicable, Protection Seller shall pay to Protection Buyer an amount equal to interest on, as applicable, the Purchase Price (as defined above), the Cash Settlement Amount (as defined in the Annex) or the amount payable by Protection Buyer on the Cash Settlement Date (as defined in the Credit Derivatives Definitions), in each case calculated at the Average LIBO Rate for each day during the Delay Period.

(ii) “Delay Period” shall mean the period from (and including) the date seven (7) Business Days (as defined in the LSTA Standard Terms) after the Trade Date to (but excluding) the Settlement Date (as defined in the LSTA Standard Terms) or the Cash Settlement Date (as defined in the Credit Derivatives Definitions), as applicable.

(iii) “Average LIBO Rate” shall mean, for the Delay Period (i) the sum of all the individual LIBO Rates for each day in the Delay Period (ii) divided by the total number of days in the Delay Period.

(iv) “LIBO Rate” means, for any day, the 1-month London Interbank Offered Rate for deposits in the applicable currency as set by the British Bankers Association (“BBA”) and published by the BBA at approximately 11:00 a.m. London time on such day. For any day that is not a Business Day, the LIBO Rate for such day shall be the rate published by the BBA on the immediately preceding Business Day.

(f) Unless otherwise specified in an applicable CDS confirmation or related documentation or unless otherwise agreed by the parties, the “Form of Purchase” should be “Assignment”, subject to the following terms:

(i) The parties should use commercially reasonable efforts to effect Delivery by assignment.

(ii) To the extent any consent, approval, acknowledgment or notice required to effect settlement by assignment is not received on or before the date twenty (20) Business Days after the Trade Date, the parties should attempt to settle on the basis of a mutually agreeable alternative structure or other arrangement that affords the parties the economic equivalent of the Physically Settled Transaction (including, without

limitation, settlement pursuant to a par participation agreement, provided that, unless otherwise agreed by the parties, the applicable participation agreement shall not entitle Protection Seller to exercise voting rights.)

(iii) To the extent settlement is not effected on or before the date thirty (30) Business Days after the Trade Date (the “Cash Settlement Trigger Date”), then Cash Settlement pursuant to the Partial Cash Settlement terms in Section 9.8 of the Credit Derivatives Definitions should apply, as modified pursuant to the Annex hereto.

(g) For the avoidance of doubt, the provisions contained in Sections 16 through 19 (inclusive) of the LSTA Standard Terms should not apply.

Calculation Agent, acting in good faith and in a commercially reasonable manner, should determine or resolve (after consultation with the parties) any remaining issues related to the Delivery of the Tembec Loan in accordance with these recommendations.

3. The Assignment and Acceptance Agreement in the form stipulated in the Tembec Loan Agreement will constitute the transfer documentation specified in Section 10 of the LSTA Par Confirmation.

4. Unless otherwise specified herein, with respect to Protocol Transactions, in the event of any inconsistency between the LSTA Par Confirmation or the LSTA Standard Terms and the Tembec Protocol, the Tembec Protocol should govern.

Please call or email Elliot Ganz (212.880.3003 / [eganz@lsta.org](mailto:eganz@lsta.org)) or Bridget Marsh (212.880.3004 / [bmarsh@lsta.org](mailto:bmarsh@lsta.org)) at the LSTA with any questions regarding this Advisory.

Annex

All capitalized terms used in this Annex but not defined in the Advisory or this Annex shall have the meanings ascribed thereto in the Credit Derivatives Definitions or, if not defined in the Credit Derivatives Definitions, in the LSTA Standard Terms.

(a) The applicable amount of the relevant Deliverable Obligation will be deemed to be an “Undeliverable Obligation”, and the Latest Permissible Physical Settlement Date shall be deemed to be the first Business Day after the Cash Settlement Trigger Date.

(b) The “Purchase Price Differential” with respect to an Undeliverable Obligation will be an amount equal to (i) the “Purchase Price” that would be payable for such Undeliverable Obligation under Section 4 of the LSTA Standard Terms assuming a “Purchase Rate” equal to the Reference Price (as such term is defined in the definition of “Representative Auction-Settled Transaction” in the Tembec Protocol, for purposes of Protocol Transactions, and as such term is defined in the relevant CDS confirmation, for purposes of Direct Transactions) minus (ii) the “Purchase Price” that would be payable for such Undeliverable Obligation under Section 4 of the LSTA Standard Terms assuming a “Purchase Rate” equal to the Final Price (as defined in the Credit Derivatives Definitions), provided that in calculating the “Purchase Price” under clause (2) of this paragraph, clauses (c) and (d) of Section 4 of the LSTA Standard Terms shall be deemed to have been deleted; provided, further, that, in each case, it is assumed that the Trade Date, as such term is used in the LSTA Standard Terms, is the first day on which delivery of a Notice of Physical Settlement is effective and the Settlement Date, as defined in the LSTA Standard Terms, is the applicable Valuation Date under Section 9.8(d) of the Credit Derivatives Definitions.

(c) Notwithstanding Section 9.8(a) of the Credit Derivatives Definitions, if the Purchase Price Differential is greater than or equal to zero, the Purchase Price Differential shall be the Cash Settlement Amount; and if the Purchase Price Differential is less than zero, Protection Buyer will pay to Protection Seller on the Cash Settlement Date (as defined in the Credit Derivatives Definitions) an amount equal to the absolute value of the Purchase Price Differential.

(d) Section 9.8(k) of the Credit Derivatives Definitions shall be amended by deleting clauses (i), (ii) and (iii) thereof and inserting the following:

(i) The Calculation Agent shall attempt to obtain Full Quotations with respect to the Valuation Date from five or more Dealers. Upon receipt of any Full Quotation, the Calculation Agent shall use commercially reasonable efforts to provide Protection Buyer with the details of such Full Quotation in sufficient time for Protection Buyer to enter into a transaction with the relevant Dealer pursuant to such Full Quotation.

(ii) If fewer than two Full Quotations are obtained by the Calculation Agent, the Calculation Agent shall, following consultation with the parties, determine the Final Price.

(iii) All Quotations shall be obtained as if “Exclude Accrued Interest” is specified. For the avoidance of doubt, all Quotations should reflect that Protection Seller will receive the benefit of all accrued interest payable on the Tembec Loan on the next Interest Payment Date (as defined in the Tembec Loan Agreement) but will not pay any additional amount in respect of accrued interest, as is consistent with the “Trades Flat” interest convention outlined in the Advisory and referenced below.

(e) In addition to the requirements of Section 7.10 of the Credit Derivatives Definitions, each Full Quotation shall (i) be for a transaction with Protection Buyer in which Protection Buyer is obligated to deliver the Undeliverable Obligation substantially in accordance with the Advisory (with such modifications as are necessary in the circumstances including, without limitation, to the “Trades Flat” interest convention, which shall be read as if the “Trade Date” is the applicable Valuation Date under Section 9.8(d) of the Credit Derivatives Definitions) and (ii) provide that, if Protection Buyer agrees to deliver the Undeliverable Obligation to the Dealer submitting the relevant Full Quotation (“Bidding Dealer”) on the terms set forth herein, such Bidding Dealer agrees to settle such transaction substantially in accordance with the Advisory and to pay the “Purchase Price” that would be payable for such Undeliverable Obligation under Section 4 of the LSTA Standard Terms assuming a “Purchase Rate” equal to such Bidding Dealer’s Full Quotation and a “Trade Date” of the applicable Valuation Date under Section 9.8(d) of the Credit Derivatives Definitions.