

## 2011 ISDA Equity Derivatives Definitions

The **2011 ISDA Equity Derivatives Definitions** (the “**2011 EDD**”) were published on 8 July 2011 after a process lasting more than 17 months and involving more than 60 market participants on both the buy and sell side. The 2011 EDD significantly alters the way that OTC equity derivatives are documented and expands, amongst other things, the type of products that are subject to the core definitions and the risk allocation provisions.

### 1. Objectives

The key objectives that needed to be accomplished with the 2011 EDD were to:

- **consolidate, update** and, where applicable, **expand** the 2002 ISDA Equity Derivatives Definitions (the “**2002 EDD**”) in light of market events over the last nine years including those arising out of the financial crisis. Consolidation in particular was required due to an increase in the variety of equity derivatives products since 2002 and an ever growing number of product specific master confirmation agreements (“**MCAs**”) in relation to such products;
- **standardise terms** to aid in the electronic processing, matching and reporting of transactions. Indeed product standardisation is an extremely important driver in the context of the 2011 EDD as this has guided the format and structure (known as the “architecture”) of the 2011 EDD which, as we shall see, is in many respects unique amongst the various definitional booklets that ISDA has published. As market participants will be aware, product standardisation is one aspect of the general push towards central clearing of OTC derivatives generally; and
- **allow for new products to be created** pursuant to a common framework as markets change without the need to create entirely new documentation (e.g. MCAs) for each such product.

### 2. New Structure

The publication of the 2011 EDD comprises more than a straightforward update of the 2002 EDD and establishes a new architecture for documenting equity derivatives. It is anticipated that a standard transaction documented under the 2011 EDD will usually combine four key documents:

- the Main Book;
- the Appendix;
- an ISDA Transaction Matrix; and
- a short form Transaction Supplement (the “**T-Supp**”).

#### 2.1 The Main Book

The Main Book comprises a menu of the key definitions, events, consequences and provisions upon which certain further terms and provisions can be built. These are the building blocks for transactions. The extent of the changes to the 2011 EDD from the 2002 EDD are immediately apparent in the Main Book as this runs to just over 300 pages as opposed to 54 pages for the 2002 EDD.

#### 2.2 The Appendix

The Appendix is an appendix to the Main Book and will contain tables that assemble the core terms and provisions from the Main Book in certain ways according to transaction type as well as incorporating any new core definitions or provisions that may be required for a particular transaction. These combinations are then defined to be used in one or more ISDA Matrix Transaction Supplements. As a result, the Appendix will be amended, restated and republished on a fairly frequent basis as the 2011 EDD are increasingly used. As of the date of this Law-Now, the published Appendix contains only template headings and has not been populated. The Main Book together with the Appendix comprises the 2011 EDD.

## 2.3 ISDA Transaction Matrices

ISDA Transaction Matrices will combine various elections and definitions from the Main Book and the Appendix in relation to a particular product type. The industry has committed to producing the first two ISDA Transaction Matrices for US and EU Variance Swaps by 31 August 2011.

## 2.4 T-Supp

The T-Supp comprises a short form confirmation which will incorporate by reference the relevant ISDA Transaction Matrix where it is intended that all of the operative provisions will be. The T-Supp will at its core contain only the trade specific economic terms for that transaction such as the underlying, dates and amounts.

### Other documents

In addition (or alternatively) to the documents stated above, parties may wish to enter into other bespoke transactions such as long form confirmations or bilateral agreements which incorporate and/or amend an ISDA Transaction Matrix or just use certain bespoke definitions and terms (whether based upon those from the 2011 EDD or not). It is anticipated that parties may wish to include bespoke representations and warranties in relation to particular trades.

## 3. Main changes and differences from 2002 EDD

Apart from the structural changes outlined above, the 2011 EDD consolidates, expands and updates the 2002 EDD. In particular the 2011 EDD provides for:

- an expansion of the types of underlying to include, for example, depositary receipts and derivative contracts (including such things as futures contracts);
- the incorporation of commonly used provisions (e.g. observation periods);
- a revision and expansion of market disruption events (now called "Pricing Disruption Events");
- substantial expansion and amendment of the risk allocation provisions (i.e. the "Extraordinary Events");
- the inclusion of a new calculation agent dispute resolution procedure;
- a substantial amendment to the potential methods of calculation of the Cancellation Amount; and
- a new framework for creating provisions and defined terms through the use of methodologies, features, toggles and suffixes and prefixes.

We turn to some of these in a little more detail below.

## 4. Pricing Disruption Events

Pricing Disruption Events are the renamed and expanded Market Disruption Events from the 2002 EDD. There are now 60 Pricing Disruption Events which allow, amongst other things, for events affecting specific components of baskets of securities to be tailored to those particular components. Similarly, the range of consequences that can be applied to these events are now much wider (28 in all) and can be further refined by the use of various suffixes (such as "- Calculation Agent Modification" to allow the Calculation Agent to take into account what would have happened in relation to a hypothetical or actual hedge position).

## 5. Risk Allocation Provisions

5.1 The concept of Extraordinary Events has been retained albeit on a substantially expanded basis and comprises either those which are automatically applied (unashamedly called "**Automatically Applied Extraordinary Events**") and those which are elected by the parties ("**Additional Disruption Events**").

5.2 Notable changes to the Automatically Applied Extraordinary Events include:

- the inclusion of the Potential Adjustment Event as an Automatically Applied Extraordinary Event (rather than as a separate provision) and its requirement to have a "material effect either on the theoretical value of [the relevant Securities] or on the [equity derivative transaction]";
- the split of Merger Event into two distinct events (Merger Event and Reverse Merger Event);
- the amendment of Delisting to capture delisting without there being any announcement and requirement that there is reasonable certainty that the relevant security is not or will not be (or where the delisting has been announced, the requirement that the Calculation Agent determines that there is reasonable certainty that the security will not be) relisted on certain securities exchanges (known as "Acceptable Securities Exchanges"); and
- the amendment of Nationalization to allow, amongst other things, for specific thresholds to be stated (instead of the "all or specifically all" test in the 2002 EDD) and to recognise Nationalization by the acquisition of securities over a period of time by the government.

- 5.3 The Additional Disruption Events allow for the parties to specify a more detailed risk allocation between the parties and contain, amongst other things:
- three (as opposed to one in the 2002 EDD) Change in Law provisions (Change in Law, Transaction Illegality and Increased Performance Cost due to Change in Law) which in turn allow for the parties to specify certain elections (Legal Uncertainty or Inadvisability) and, in relation to Change in Law itself, Avoidance that allows for further fine-tuning (as to which see below);
  - five (as opposed to two in the 2002 EDD) Hedging related provisions (Increased Cost of Hedging, Market Wide Hedging Disruption, Hedging Party Hedging Disruption, Increased Capital Charge Event and Foreign Ownership Event);
  - seven (as opposed to two) Securities lending provisions (Loss of Securities Borrow, Inability to Borrow, Increased Cost of Stock Borrow, Increased Collateral Percentage Event, Increased Long Divergence Event, Increased Short Divergence Event, Loss of Synthetic Securities Borrow);
  - new Governmental Intervention and Modified Governmental Intervention Events to cover events where the government intervenes which are not a Nationalization; and
  - new Dislocation events.
- 5.4 Certain Additional Disruption Events (for example, Change in Law) allow for the parties to specify that the hedging party must take “*all commercially reasonable action .... that would satisfy all of the Avoidance Conditions in order to avoid the relevant [Additional Disruption Event]*” before that party may take actions in relation to such Additional Disruption Event. This concept is similar to the requirement in the 2002 EDD that a Hedging Disruption can only occur if the Hedging Party is “*unable, after using commercially reasonable efforts, to [hedge]*” but attempts to provide clarity around what is “reasonable” by setting out nine specific Avoidance Conditions, all of which must be satisfied.

As a general rule, the parties are free to choose one or more consequences (called “Consequences”) to apply to an Extraordinary Event (for example Cancellation and Payment or Calculation Agent Adjustment). In certain cases however and in relation to what are called “Prescribed Consequence Events” (e.g. Change in Law or Hedging Party Hedging Disruption) a certain Consequence or Consequences must apply as other permutations would not be logical (for example, a Failure to Deliver may only lead to Delivery and Cancellation). In addition and other than in relation to Prescribed Consequence Events, the parties may choose a waterfall of Consequences in relation to that event (e.g. Security Substitution followed by Calculation Agent Adjustment etc.). One Consequence, as with the 2002 EDD, of any Extraordinary Event, is cancellation and payment of the Cancellation Amount.

## 6. Cancellation Amount

Cancellation Amount (which was previously a one page provision in the 2002 EDD) has been expanded considerably and now covers more than ten pages.

Whereas the approach taken in the 2002 EDD was for the determining party to determine losses, costs or gains in replacing the relevant transaction, the 2011 EDD sets out a variety of options and data inputs that the relevant determining party can take into account when determining the value of the Cancellation Amount to cover, amongst other things, scenarios where no replacement transaction is possible (e.g. where the relevant share is no longer available due to Nationalization). In addition, how hedging gains and losses are taken into account can be tailored by the parties according to each transaction. The Calculation Agent Dispute Resolution Procedure mentioned below, can also be specified to apply to the determination of the Cancellation Amount and indeed is deemed specified if, amongst other things, the Calculation Agent is the only party determining the Cancellation Amount.

## 7. Calculation Agent Dispute Resolution Procedure

The 2011 EDD contain a new Calculation Agent Dispute Resolution Procedure. This reflects, amongst other things, a desire to try to standardise a variety of calculation agent dispute provisions in the market and in particular “co-calculation agent” provisions which have not always been entirely satisfactory.

At its core, there are two separate routes within the new dispute resolution procedure:

- the Standard Resolution Process where the parties can each appoint up to two dispute resolution calculation agents (the “**DRCAs**”); and
- the Anonymous Dispute Resolution Procedure where the parties appoint a dispute agent who then appoints up to four DRCAs while maintaining the anonymity of the appointing parties.

Once the DRCAs have been appointed, the DRCAs can make determinations in relation to the relevant dispute being categorised as either mathematical determinations or non-mathematical determinations including as to whether something is commercially reasonable. Before this process is undertaken, the disputing party must have paid all amounts due and will have elected whether to pay the undisputed amount only, the original amount claimed, half the disputed amount or to have the disputed amount placed in escrow.

In addition to the Calculation Agent Dispute Resolution Procedures, ISDA is proposing the establishment of an Equity Derivatives Determinations Committee for making determinations to assist the market on a similar basis to that in the credit derivatives world.

## 8. Implication for equity linked product programmes

Many structured product programmes (e.g. for notes, certificates and warrants) contain equity linked provisions at their core. As the OTC market will take time to adopt and use the 2011 EDD for transactions, an immediate amendment of any such programme is not required but will need careful consideration, particularly when taken in conjunction with the proposals set out in the recent consultation paper (the “**Consultation Paper**”) published by the European Securities and Markets Authority (“**ESMA**”) on 15 June 2011.

Key considerations in incorporating the 2011 EDD into any structured product programme are:

- the fact that the Main Book contains only definitions and provisions which need to be combined through the Appendix and an ISDA Transaction. Whilst one approach could therefore be to only include definitions that are to be used for a particular ISDA Transaction Matrix or for a particular trade, this will mean that new 2011 EDD definitions will need to be incorporated for any subsequent issue which requires different terms (e.g. a different ISDA Transaction Matrix); and
- ESMA’s conclusion that, in summary, final terms should only contain very specific information (e.g. pricing information) and that the relevant base prospectus should contain all other information (e.g. redemption formulae) in relation to the terms and conditions of the relevant product.

As a result of these factors and in particular the current ESMA conclusion, one option is to (1) incorporate the Main Book (and certain aspects of the Appendix) fully into the relevant programme albeit amended to account for the fact that the products are funded and not bilateral contracts and (2) for product specific sections to be set out in the terms and conditions for each type of product that the issuer wishes to issue (e.g. barrier reverse convertible notes). In this scenario, the product specific sections would be conceptually similar to the ISDA Transaction Matrix with the Final Terms purely containing the relevant pricing information. As additional or further products are to be issued, supplements to the base prospectus (incorporating the relevant additional product specific conditions) would need to be issued. All options which allows for a variety of products to be issued into the market on an ongoing basis will however and, if the conclusions of the ESMA paper are followed through, involve more work at the base documentation level for the relevant programme.

## 9. Next steps

As mentioned above, as of the date of this Law-Now, the published Appendix contains only template headings and has not been populated. It is not anticipated that this will occur until the first ISDA Transaction Matrices (being EU and US Variance Swaps) are published, currently scheduled for the end of August.

Once the ISDA Transactions Matrices are published, it is anticipated that market participants will gradually adopt the 2011 EDD through the ongoing adoption of new ISDA Transaction Matrices. Until (and even after) then, parties can continue to document the transactions pursuant to the 2002 EDD and the various MCAs or can incorporate certain provisions from the 2011 EDD (e.g. from the new Risk Allocation Provisions) into their trades.

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