CLIFFORD

CHANCE

Client briefing
July 2011

2011 ISDA Equity Derivatives Definitions

The publication of the Main Book of the 2011 ISDA Equity Derivatives Definitions (the 2011 Definitions) by the International Swaps and Derivatives Association, Inc. (ISDA) represents an important milestone in an ongoing project aimed at increasing the level of standardisation in documenting certain types of equity derivatives. For an asset class with a particularly broad range of variables at both product and geographic levels, the task of updating the 2002 ISDA Equity Derivatives Definitions (the 2002 Definitions) has seen ISDA adopt a new structure and approach to facilitate enhanced transparency and electronic confirmation of transactions – whilst at the same time amending many substantive provisions and maintaining flexibility to allow for product innovation.

Structures – old and new

The existing structure of ISDA's equity derivatives documentation will be familiar to all those with experience in the over-the-counter equity derivatives market. Whilst the 2002 Definitions provide a foundation, numerous master confirmation agreements (MCAs) including product annexes have been produced by ISDA over time to assist with the trading and documentation of certain product types. With almost 50 different forms of MCA in circulation, this approach does not lend itself to standardisation. This is reflected in the relatively small proportion of equity derivatives trades that are currently electronically confirmed when compared to credit derivative and interest rate derivative transactions.

The new documentation structure reflected in the 2011 Definitions is significantly different to its predecessor. The key building blocks of the new approach are:

- the "Main Book" - intended to be a universal framework document containing core definitions and provisions. Reflecting an open-ended approach, the Main Book provides a wide selection of terms (the Main Book alone stretches to over 300 pages), designed to be selected, grouped together and applied to new products as they emerge (without further drafting) to cater for the desired trading characteristics of such new products;
- the "Appendix" – alongside the Main Book, ISDA has also published a form of the Appendix to the Main Book. Although the task of populating the Appendix will follow, it is clear from the published form that it will be a largely tabular document intended to sort the extensive options and features offered by the Main Book into workable collections of provisions according to transaction type. As it is foreseen that the Appendix will be subject to ongoing update and restatement, it is likely also to house new definitions and operative provisions that have yet to be consolidated into the Main Book;

If you would like to know more about the subjects covered in this publication or our services, please contact:

London

Habib Motani +44 (0)20 7006 1718

Deborah Zandstra +44 (0)20 7006 8234

Will Winterton +44 (0)20 7006 4386

Elizabeth Clinch +44 (0)20 7006 2222

Emma Chell +44 (0)20 7006 2954

Hong Kong

Paget Dare Bryan +852 2826 2459

Francis Edwards +852 2826 3453

Paul Landless +852 2825 8974

New York

David Felsenthal +1 212878 3452

Gareth Old +1 212878 8539

Singapore

Lena Ng +65 6410 2215

Tokyo

Leng-Fong Lai +81 35561 6625

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

- "ISDA Transaction Matrices" - expected to be product specific spreadsheet-style documents setting out standardised elections for trading the relevant product. ISDA Transaction Matrices will use the standard definitions and provisions in the Main Book and Appendix (unlike MCAs in which provisions from the 2002 Definitions are often modified). Transactions documented using the 2011 Definitions will therefore be based on a common platform of definitions and provisions; and
- "Transaction Supplements" – documents which will set out the trade specific economic terms of particular transactions.

Substantive provisions – amendments and additions

Looking at the Main Book, those used to dealing with the 2002 Definitions will recognise that many changes have been made to existing provisions and new provisions added. ISDA working groups (consisting of both sell and buy side representatives) reviewed various provisions of the 2002 Definitions and made significant amendments to, among other things, the Cancellation Amount provision and the Extraordinary Event (including Additional Disruption Event) provisions and their consequences. A new detailed Calculation Dispute Resolution Procedure has also been introduced.

- **Cancellation Amount.** This provision has been amended heavily and now runs to over 10 pages. It sets out different optional methods of calculating the transaction value, rather than following a purely replacement value approach (as under the 2002 Definitions) which was considered not to be appropriate in all cases. Greater detail is also provided as to how and when the Cancellation Amount is to be determined, what data is to be taken into account and how losses/gains resulting from hedge close-outs are allocated.
- **Extraordinary Events.** Parties are given more choice as to the consequences of Extraordinary Events (other than where these are prescribed), including optional fallbacks. The range of automatically applied Extraordinary Events and optional Additional Disruption Events has also been greatly expanded, and the majority of existing provisions have been amended. Examples of the many new provisions include the "Governmental Intervention" and "Modified Governmental Intervention" Additional Disruption Events, which cast a significantly wider net than the "Nationalization" Extraordinary Event (which has also been broadened) and envisage a range of potential types of governmental intervention.
- **Calculation Dispute Resolution Procedure.** This new provision reflects the often less mechanical role played by the Calculation Agent in equity derivative transactions compared to other types of derivative transactions, and provides a number of procedural options for parties to choose from. The procedure applies not just to determinations made by the Calculation Agent, but also potentially to those made by a party determining a Cancellation Amount (which may or may not be the Calculation Agent).

Parties intending to adopt the 2011 Definitions, or to incorporate some of the changes or new provisions into their 2002 Definitions-based documentation, will need to devote considerable time to familiarising themselves with these and the many other substantive changes included in the Main Book. We discuss the expected timing of the industry's transition to the 2011 Definitions below.

Drivers for change

As well as updating the 2002 Definitions to reflect current market practice and take account of lessons learnt from the financial crisis, the changing regulatory environment and the political push for standardisation and transparency in the over-the-counter derivative markets have been important drivers behind the new approach taken with the 2011 Definitions. In a letter dated 31 March 2011 to the Federal Reserve and other supervisors, the G14 dealers and signatory buy side institutions recognised the importance of the 2011 Definitions project in increasing the level of electronically eligible equity derivative transactions and committed to increase the percentage of equity derivative trades processed through electronic platforms according to a set timetable, with further commitments in relation to the publication of the 2011 Definitions and ISDA Transaction Matrices.

No immediate implementation

The publication of the Main Book is a significant event in the equity derivatives world but there is much still to do. The next steps include the finalisation and release of ISDA Transaction Matrices - ISDA have indicated that the first 2 matrices, for US and EU variance swaps, will be published by 31 August 2011, with further matrices to follow.

At a practical level, the publication of the Main Book will not affect existing transactions documented applying the 2002 Definitions or under existing MCAs. No target date has been set for implementing the new definitions. Instead, implementation is expected to be gradual and coincide with the publication of ISDA Transaction Matrices. Until parties choose to move over to the 2011 Definitions, they will continue to use the 2002 Definitions, although parties will be free to incorporate any of the updated provisions if they wish.

Where now?

Whilst the Main Book provides bounteous food for thought, there is much more to come. Clifford Chance will issue further Client Briefings on this topic as the market comes to terms with the new definitions and contractual framework and as further documents are published.

Useful links

ISDA website: www.isda.org
ISDA bookstore: http://www.isda.org/publications/pubguide.aspx