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## **Review of ISDA equity derivatives definitions**

Thank you for your instructions to assist in the revision of the Guide to OTC Documents (“**Guide**”) by reviewing the equity derivatives definitions published by ISDA.

In this advice, we set out:

- the materials which we have reviewed;
- our opinion;
- the qualifications to which this opinion is subject; and
- a brief discussion of the key changes in the new equity derivatives definitions, when compared to the provisions of the previous equity derivatives definitions.

### **1 Materials reviewed**

#### ***2002 Definitions***

1.1 We have reviewed the following documents published by ISDA:

- (a) the 1996 ISDA Equity Derivatives Definitions (the “**1996 Definitions**”); and
- (b) the 2002 ISDA Equity Derivatives Definitions (the “**2002 Definitions**”).

The 1996 Definitions and the 2002 Definitions are referred to in this letter as the “**Equity Derivatives Definitions**”.

1.2 Terms used but not defined in this letter have the meaning given to them in the Equity Derivatives Definitions. If a term has different meanings in the 2002 Definitions and

the 1996 Definitions, when used in this letter the term takes the meaning given to it in the 2002 Definitions.

- 1.3 In this letter, we make no comment on any ISDA Definitions or other ISDA documentation other than Equity Derivatives Definitions.

## 2 **Opinion<sup>1</sup>**

- 2.1 The Equity Derivatives Definitions give rise to no regulatory or legal issues under the laws of the Australian Jurisdictions which apply to equity derivative transactions generally and which do not apply to other derivative transactions.
- 2.2 It may be that, in a particular factual scenario, a regulatory or legal issue will arise in connection with the Equity Derivatives Definitions and an equity derivative transaction. However, these issues are dependent on the particular facts surrounding the relevant equity derivative transaction on which we cannot meaningfully comment in this letter.

## 3 **Qualifications**

- 3.1 Mallesons Stephen Jaques is qualified to advise on the laws of the Commonwealth of Australia, New South Wales, Victoria, Queensland, Western Australia and the Australian Capital Territory (“**Australian Jurisdictions**”). We express no opinion about the laws of any other jurisdiction. The opinions expressed in this analysis are limited to the laws of the Australian Jurisdictions.
- 3.2 We make no comment on:
- (a) taxation issues, including in respect of stamp duty and goods and services tax;
  - (b) the enforceability of any particular equity derivative transaction;
  - (c) issues which may arise in connection with the ability to perform the settlement of any equity derivative transaction in the manner set out in the Equity Derivatives Definitions, such as the ability to physically settle a transaction or issues arising in attempting to settle a transaction which has become subject to an illegality under the laws of the Australian Jurisdictions;
  - (d) the application of insider trading laws to equity derivatives;
  - (e) any intellectual property rights issues which arise when referring to an index in an equity derivative;

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<sup>1</sup> This opinion remains subject to the detailed reasoning and assumptions and qualifications contained in this letter.

- (f) capital treatment on, or accounting issues in connection with, equity derivatives;
- (g) issues that can arise under laws and rules applying to takeovers in the Australian Jurisdictions in connection with the entry into of equity derivative transactions;
- (h) legal or regulatory matters which arise in connection with derivatives generally. For example, we do not comment on the requirement to hold an Australian Financial Services Licence in order to “deal” in derivatives under the Corporations Act or the ability to bind a Calculation Agent which is not a party to the equity derivative transaction; or
- (i) the commercial effect of the Equity Derivatives Definitions or the differences between them or whether the terms of the Equity Derivatives Definitions reflect current Australian or international market conventions or practice. For example, we make no comment on the appropriateness or suitability of any formula, election, timing or quotation conventions contained in the Equity Derivatives Definitions. We assume that every market participant will make its own independent assessment as to whether they will adopt the Equity Derivatives Definitions.

3.3 This opinion is of general legal advice only. This analysis is not intended to be an opinion upon which market participants can rely in actual situations. This is because the application of the Equity Derivatives Definitions to a particular transaction ultimately depends on the terms of the transaction and the relevant facts. Accordingly, while every care has been taken in preparing this analysis, Mallesons Stephen Jaques does not accept responsibility for any losses suffered or liabilities incurred arising from use of this analysis in respect of a particular transaction.

#### **4 Summary of the key changes in the 2002 Definitions**

- 4.1 On 6 January 2003, ISDA published the 2002 Definitions for use in confirming equity derivatives transactions governed by agreements including the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement.
- 4.2 The 2002 Definitions are intended to reflect a global market standard. It is recognised by ISDA that in documenting a specific Transaction, parties may need to address specific considerations applicable to their jurisdiction. The 2002 Definitions provide for this by including variations to provisions which may be selected depending on the requirements of a jurisdiction.

4.3 Provisions for the following types of transaction are included in the 2002 Definitions:

***Options***

- (a) OTC single index option transactions;
- (b) OTC single share option transactions;
- (c) OTC index basket option transactions;
- (d) OTC share basket option transactions;

***Forwards***

- (e) OTC single index forward transactions;
- (f) OTC single share forward transactions;
- (g) OTC index basket forward transactions;
- (h) OTC share basket forward transactions;

***Swaps***

- (i) OTC single index swap transactions;
- (j) OTC single share swap transactions;
- (k) OTC index basket swap transactions;
- (l) OTC share basket swap transactions.

4.4 The types of Forward Transactions which can be documented under the 2002 Definitions are OTC equity forwards relating to a single index, a single share or other security, a basket of indices or a basket of shares or other securities.

4.5 The 2002 Definitions include terms for documenting barrier Options, Equity Swaps and Forwards. If the relevant provisions are specified in a Confirmation, a party's right to exercise an option, or its right to receive, or its obligation to make, a payment or delivery under a Transaction will be conditional on the occurrence or non-occurrence of a Knock-in Event or Knock-out Event. The barrier terms do not relate to a specific type of instrument and therefore may be applied to any type of Transaction.

4.6 Three option styles are included in the 2002 Definitions:

- (a) American options: these are options exercisable on any Scheduled Trading Day during an exercise period;
- (b) European options: these are options exercisable only on the Expiration Date;
- (c) Bermuda options: these are options exercisable only on certain specified dates during an exercise period.

***Modular approach to settlement***

- 4.7 The 2002 Definitions provide for a modular approach to the settlement of transactions. Parties are now able to elect for any transaction to be physically settled or cash settled.
- 4.8 In the 2002 Definitions parties are able to elect “Settlement Method Election” which is designed to address products where a party may choose between physical and cash settlement during the life of the transaction. If the electing party fails to make a choice, settlement will be determined by the relevant default provision.

***Business Days and Disruptions***

- 4.9 The definition of what constitutes a business day and the disruption of it is critical to the operation of the 2002 Definitions. The 2002 Definitions modify the definition of “Exchange Business Day”, to mean a day when exchanges are open for trading and introduce a new concept of “Scheduled Trading Day” for when exchanges are scheduled to be open.
- 4.10 What constitutes a disruption to a business day is addressed in the definition of “Disrupted Day”. Two types of disruption are relevant for determining whether a Disrupted Day has occurred:
- (a) failure to open; or
  - (b) Market Disruption Event.

In addition, the relevant day must also be a day on which valuation, averaging, exercise or expiration should have occurred.

- 4.11 The concept of Market Disruption Event is subdivided into three events in the 2002 Definitions:
- (a) Trading Disruption: a suspension or limitation of trading in shares (or, where relevant, a certain proportion of shares in an index) or in related listed derivatives;

- (b) Exchange Disruption: an event (other than Early Closure) that disrupts or impairs the ability of market participants generally to effect transactions on the exchange with the result of affecting the shares or related listed derivatives, rather than relating to the shares the subject of the Transaction; and
- (c) Early Closure: the closure on an Exchange Business Day of an exchange before its scheduled closing time unless the early closure is announced at least one hour before to the earlier of the actual closing time or, if earlier, one hour before the submission deadline for orders to be entered for execution at the Valuation Time on that Exchange Business Day.

#### ***Consequences of disruptions***

- 4.12 In the 2002 Definitions, if a Scheduled Trading Day is a Disrupted Day, then the prescribed valuation procedure may be delayed for up to eight Scheduled Trading Days (instead of five Exchange Business Days as per the comparable provision under the 1996 Definitions). If the disruption is continuing, then on the eighth Scheduled Business Day, the Calculation Agent will determine its good faith estimate of the value of underlying equity at the appropriate time on that eighth Scheduled Termination Day. This differs from the 1996 Definitions, which required the Calculation Agent to determine the value that would have prevailed but for the Market Disruption Event.

#### ***Extraordinary Events***

- 4.13 The provisions relating to Extraordinary Events have been redrafted extensively in the 2002 Definitions. The 2002 Definitions retain the concept of “Merger Event” and “Nationalisation” and “Insolvency” and introduce new provisions relating to:
- (a) Tender Offers;
  - (b) Additional Disruption Events;
  - (c) Delisting; and
  - (d) Index Adjustment Event.

#### ***Consequence of Merger Events and Consequence of Tender Offers***

- 4.14 Article 12 of the 2002 Definitions contains the various options which parties may select as the Consequences of Merger Events or the Consequences of Tender Offers. These are:
- (a) Alternative Obligation;

- (b) Cancellation and Payment;
  - (c) Options Exchange Adjustment;
  - (d) Calculation Agent Adjustment;
  - (e) Modified Calculation Agent Adjustment;
  - (f) Partial Cancellation and Payment; and
  - (g) Component Adjustment.
- 4.15 Two of the three choices which remain from the 1996 Definitions are broadly unchanged: Alternative Obligation and Options Exchange Adjustment. The third existing choice, Cancellation and Payment has been reworked with two payment options alternatives available for options transactions. Of these two payment options, the first, Calculation Agent Determination, provides the Calculation Agent with a scope to determine the amount to be paid in respect of a Cancellation and Payment. The second option, Agreed Model, sets out a detailed model for calculating the amount to be paid on a cancellation of a Transaction.
- 4.16 The choice of Calculation Agent Adjustment (and Modified Calculation Agent Adjustment) affords the Calculation Agent significant flexibility in determining the relevant adjustment to the terms of the Transaction or payment (if the adjustment would not produce a commercially reasonable result). The main difference between the two is that, under Modified Calculation Agent Adjustment, the Calculation Agent may adjust the terms of the Transaction to reflect changes in volatility, dividends or liquidity, but is not able to do so under Calculation Agent Adjustment.
- 4.17 Component Adjustment is an alternative permitting parties to specify separate consequences for the different elements of a Share-for-Combined Merger Event.

***Additional Disruption Events***

- 4.18 The 2002 Definitions contain a series of Additional Disruption Events, which are set out below followed by a brief description. The occurrence of any of these events, if elected, may trigger the termination of the Transaction.
- (a) Change in Law: a change in law or regulation that makes the holding, acquiring or disposing of Shares relating to a Transaction illegal or materially increases the cost of performing its obligations under the Transaction.

- (b) Failure to Deliver: the failure of a party to deliver, when due, the relevant Shares under a Transaction, where such failure is due to illiquidity in the market for those Shares.
- (c) Insolvency Filing: the Issuer of the Shares, which are the subject of the Transaction, institutes or has instituted against it by a regulator insolvency proceedings.
- (d) Hedging Disruption: the Hedging Party is unable, after using commercially reasonable efforts, to acquire, maintain, unwind or dispose of transactions or assets necessary to hedge the equity price risk for entering into and performing its obligations under the Transaction.
- (e) Increased Cost of Hedging: the Hedging Party would incur a materially increased amount of tax, duty, expense or fee to acquire, maintain, unwind or dispose of transactions or assets necessary to hedge the transaction.
- (f) Loss of Stock Borrow: the Hedging Party is unable, after using commercially reasonable efforts, to borrow (or maintain borrowing of) Shares (“**Hedging Shares**”) that the Hedging Party deems necessary to hedge the equity price risk for entering into and performing its obligations under the Transaction
- (g) Increased Cost of Stock Borrow: a Hedging Party would incur a rate to borrow or maintain borrowing of the Hedging Shares that is greater than the initial stock loan rate specified in the related Confirmation.

#### ***Nationalisation, Insolvency and Delisting***

- 4.19 The occurrence of a Nationalisation, Insolvency or Delisting are events which in the 2002 Definitions could trigger a Close-out or Cancellation and Payment (and the new Partial Cancellation and Payment).
- 4.20 Delisting occurs when an exchange announces that shares cease to be listed, traded or publicly quoted on the exchange (other than as a result of a Merger Event or Tender Offer) and the shares are not immediately re-listed, re-traded or re-quoted on an exchange within the same country (or, where the exchange is within the European Union, in a member state of the European Union).

#### ***Index Adjustment Event***

- 4.21 The 2002 Definitions define three types of Index Adjustment Event: Index Modification, Index Cancellation and Index Disruption. Parties are able to elect in the related Confirmation the desired consequence for each type of Index Adjustment Event.



The three alternatives are: Calculation Agent Adjustment, Negotiated Close-out and Cancellation and Payment.

### ***Dividends***

- 4.22 The provisions relating to dividends are included in a separate Article and apply to all types of Transactions. A definition of Extraordinary Dividend is included in the Article, although recognising the difficulty in setting a global definition, parties are required to specify the amount per share or means for otherwise determining an Extraordinary Dividend in the Confirmation. The payment of an Extraordinary Dividend will be a Potential Adjustment Event.

### ***Calculation Agent***

- 4.23 Under the 2002 Definitions, whenever a Calculation Agent is required to act it must do so in “good faith and in a commercially reasonable manner.” This replaces the old standard that calculations and determinations would be “binding absent a manifest error.”

### ***Miscellaneous***

- 4.24 Under the 2002 Definitions parties may elect in the related Confirmation that a generic “Index Disclaimer” provision is to apply, as well as provisions relating to “Non-Reliance”, “Agreements and Acknowledgments Regarding Hedging Activities” and “Additional Acknowledgements”.

## **5 Benefit**

This opinion is addressed to you personally and may not, without our prior written consent, be:

- (a) relied on by another person;
- (b) disclosed, except to members of the Australian Financial Markets Association, who are subscribing to the Guide and persons who in the ordinary course of your or their business have access to your and their papers and records. Such disclosure is only made on the basis that such persons will make no further disclosure;
- (c) filed with a government or other agency or quoted or referred to in a public document.

This opinion is strictly limited to the matters stated in it and does not apply by implication to other matters.

This opinion is given in respect of the laws of the Relevant Jurisdictions in force at 9.00 am local time on the date of this letter.

Yours faithfully