

The calculation agency role with respect to certain derivative linked securities

1. Introduction

The International Capital Market Association (ICMA) and the International Swaps and Derivatives Association (ISDA) are jointly publishing this explanatory note summarising certain issues which arise in the context of issuance of debt securities with embedded derivatives ("derivative securities").

The purpose of this explanatory note is to promote awareness among the full range of market participants of certain issues as requiring careful consideration on a case-by-case basis. Market practice in this area is continually evolving and individual transactions are structured according to their specific circumstances, including the jurisdictions which may be relevant. Commercial considerations may also vary. This explanatory note is therefore not intended to prescribe or endorse particular structures or practices or recommend standard solutions to the issues highlighted.

The issues addressed in this explanatory note relate principally to:

- (a) the role of the calculation agent appointed to make determinations relating to the embedded derivative - for instance, adjustments for corporate events in relation to an underlying share issuer; and
- (b) the interrelationship between the derivative securities and any associated hedge, particularly where the hedge provider is also calculation agent under both the hedge and the derivative securities (often the case where the hedge provider is arranger, manager or dealer in relation to the derivative securities and not uncommon even where the hedge provider has no such involvement).

This explanatory note is not intended as a full discussion of all the considerations relating to the role of Calculation Agent under an OTC derivative; specifically, the note is not intended to suggest that the role and responsibilities of the Calculation Agent as defined in various ISDA publications, including the 2002 ISDA Equity Derivatives Definitions and the 2003 ISDA Credit Derivatives Definitions, should be amended.

Executive Summary

The purpose of this explanatory note is to highlight, in the context of securities with embedded derivative features, the importance:

- (1) of identifying as early as possible who is to be calculation agent in relation to the securities and to allow adequate time to agree the terms of its appointment; and*
- (2) of clarity as to the role and responsibilities of the calculation agent in relation to the derivative securities, so that in particular:*
 - any operational or infrastructure requirements are identified and understood;*
 - any additional responsibilities over and above those that the calculation agent may have as calculation agent under an associated hedge are identified and understood;*
 - any liability issues can be considered by the prospective calculation agent;*
 - the parties can be satisfied that the remuneration to be paid takes account, to the extent appropriate, of any additional liabilities; and*
 - any disclosures, particularly any relevant risk disclosures, that may be appropriate with respect to the calculation agency arrangements can be made in the issuance documentation.*

2. Calculation Agency role

2.1 Identification

Identifying who will act as calculation agent for an issue of derivative securities (and any associated hedge) should be settled at an early stage.

Many securities programmes contemplate that the fiscal agent or principal paying agent will perform the role of calculation agent, unless otherwise agreed. However, while the appointment of fiscal agents and principal paying agents as calculation agents is common for rate-fixings in relation to vanilla floating rate notes, fiscal agents and principal paying agents may not be willing, nor indeed well placed, to perform the more specialised calculation agent role contemplated in derivative securities.

Where the arranger, manager or dealer (the "arranger") in relation to derivative securities is also the hedge provider, and the calculation agent under the hedge, it is common, and often logical, for the arranger to be the calculation agent in respect of the derivative securities.

Where the hedge provider is otherwise independent of an issue of derivative securities, before it accepts appointment as calculation agent under the derivative securities, it should consider the differences between the role of

the calculation agent under the bilateral hedge and under the derivative securities. For example: the scope of the role under the derivative securities usually includes not only making the relevant determinations but also additional administrative duties such as notification requirements. In the case of derivative securities, the calculation agent's determinations are relevant, and thus of interest, to the holders of the securities. This should be borne in mind by the calculation agent, particularly where the determinations to be made are either complex or dependent on data that are not widely available. A prospective calculation agent should satisfy itself that it considers it is being appropriately remunerated for the responsibilities (and any risks) it may be undertaking by assuming this role.

The appointment of the calculation agent should be appropriately documented.

2.2 *Timing*

The calculation agent appointment for an issue of derivative securities may raise timing issues, particularly where the hedge provider is not involved in the issue as arranger, manager or dealer. See further paragraph 4 below.

2.3 *Notifications*

Notifications are an important practical part of the calculation agency role under derivative securities.

Under a bilateral hedge, the calculation agent simply notifies the two parties (or, in practice, since the calculation agent is typically one of the parties, the other party) of its determinations. In the case of derivative securities, parties interested in being informed of the outcome of a determination will include the issuer, the principal paying agent or fiscal agent, the trustee (if any) for the holders of the securities and the holders themselves. Those who agree to act as calculation agent therefore need to have the systems in place to give the required notices - and if they do not, then the terms of the derivative securities should allocate this responsibility to another party (for instance, by providing for notification by the calculation agent of its determinations to the fiscal agent, and thereafter by the fiscal agent to the holders of the derivative securities)¹.

A practical consideration is that it could be helpful for market participants to establish a mechanism for maintaining records of calculation agent appointments, to make it easier for issuers, fiscal agents and others to contact the right person to obtain information about calculation agent

¹ The importance of notification arrangements was highlighted by the Financial Services Authority in a "Dear CEO" letter in February 2005 (titled "Operations and risk management in the credit derivatives market"), which noted that mechanisms for disseminating rate-fixing information used for calculating interest and principal payments are not always effective - particularly in financial institutions originating structured debt with an associated derivative which accept the role of calculation agent but not of paying agent. Although contained in a letter specifically addressing credit derivatives, the issue is not specific to credit derivatives, and is equally applicable for a range of derivative securities. The letter stated that calculation agents should ensure that they have effective systems for advising paying agents and issuers on a timely basis of rate or index determinations, so that custodians and investors may in turn be notified of impending cash movements.

determinations (albeit the responsibility for giving any required notification will remain with the calculation agent).

2.4 *Disclosures to investors*

Disclosure documentation relating to derivative securities will include disclosure of the terms of the calculation agency appointment. The calculation agent should satisfy itself as to the accuracy of such disclosure.

In addition, if the calculation agent has accepted any restrictions on its exercise of its discretion, that should usually be disclosed (for example, where an issue of derivative securities is hedged through several different hedges, each with a different hedge provider, and the calculation agent with respect to the derivative securities has agreed to co-ordinate its determinations with respect to the derivative securities with the determinations made under the various different hedges).

If any activities of the calculation agent (for example, its proprietary trading activities) could give rise to a possible conflicts of interest, that too is likely to require disclosure, and may require specific reference in the risk factors disclosed with respect to the particular issue of securities.

3. **Matching of terms**

- 3.1 While issuers of derivative securities wish the terms of the securities to match the hedge, they may not always appreciate that a complete match is impracticable. For instance, where the hedge is governed by an ISDA Master Agreement, there will be events, such as illegality affecting the ability of one of the parties to perform its obligations under the hedge or various party specific default events, which will not be reflected in the terms of the derivative securities, and which could result in the hedge being terminated early, but with the securities remaining outstanding. Similarly, changes in tax treatment could affect the hedge but not the securities or *vice versa*.

These risks could in theory be passed through to the investors in the securities, for instance by permitting the issuer to redeem the securities early if the hedge terminated early. However, quite apart from necessitating disclosure of the hedge arrangements, this would result in the holders of the securities being subject to risks arising out of the issuer's hedging relationship. This is generally not likely to be acceptable to the market.

- 3.2 Some issuers request the hedge provider to agree that, if there is any discrepancy between the hedge terms and the terms of the derivative securities, the latter will prevail. Hedge providers are unlikely to be in a position to agree. First, it is not necessarily appropriate that all terms should match (as explained in 3.1 above), and any such agreement may have to recognise appropriate exceptions, identifying and negotiating which may take time and incur expense. Secondly, at a practical level, hedge providers are likely to want their hedge documents to match standard OTC derivative market terms so as to match the terms on which they can themselves hedge in the commercial market. If they agree to the terms of the securities

prevailing, this could make hedging considerably more difficult. Moreover, for a hedge provider which is not involved in the issue of the securities, it may be difficult to see any commercial rationale for accepting this additional layer of risk.

4. **Timing issues**

- 4.1 An important practical issue is allowing adequate time before the closing of an issue for the parties to review and negotiate the detailed terms of the hedging arrangements (taking into account matching considerations as noted above) and the terms of an appointment as calculation agent under the derivatives securities.

A period of not less than 7 working days from initial circulation of draft documentation ought generally to be allowed for finalising the hedge documentation and the terms of a calculation agent appointment. In particular circumstances, a reasonably lengthy period may be appropriate, for instance, where other parties such as rating agencies need to be included in reviewing the terms of the appointment or the hedge. Another example would be where an institution, which is not otherwise involved in the underlying transaction, is invited to bid for a calculation agency role and needs a longer period to review its rights and responsibilities because the transaction documentation is in an unfamiliar language or subject to an unusual governing law or otherwise in a form, or on terms, which are not typical for such transactions.

- 4.2 The form of the hedge will typically be a privately negotiated bilateral (or "over-the-counter") derivative transaction applying one of the sets of terms ("definitions") published by ISDA, such as the 2002 Equity Derivative Definitions or the 2003 Credit Derivatives Definitions. The detailed terms and conditions of the derivative securities will generally need to reflect equivalent provisions, as nearly as the circumstances permit. While some note and warrant programmes incorporate ISDA definitions based provisions into their base programme terms and conditions, many do not and address this through additional drafting in the documentation of the particular issue. Due time allowance should be made for this in determining the period allowed between the trade date and the settlement date.