

ISDA® Equity Derivatives Committee Market Practice Issues

ISDA provides a forum for market practitioners to discuss market events that may have an impact on the over-the-counter equity derivatives markets. In recent years, market participants have discussed the following events which are described in detail below:

February 12, 2008: Mercado Oficial de Futuros y Opciones Financieros en España (“MEFF”)

November 7, 2007: London Stock Exchange (“LSE”)

January 2, 2007: U.S. Exchange and Market Closings in observance of former President Ford

January 18, 2006: Temporary Suspension of Transactions at the Tokyo Stock Exchange (TSE)

June 1, 2005: New York Stock Exchange (NYSE) End of Day Trading Halt

June 11, 2004: U.S. Exchange and Market Closings in observance of former President Reagan

February 12, 2008: Mercado Oficial de Futuros y Opciones Financieros en España (“MEFF”)

Background and Issue

The MEFF, “Related Exchange” for OTC equity derivatives on the IBEX-35 index, experienced a technological failure on February 12 from approximately 45 minutes prior to the scheduled closing time up to and including the regularly scheduled closing time (17:35PM CET). The MEFF subsequently reopened at 17:45PM CET for a 5 minute auction and closed at 18:00PM CET. During this time the Bolsa de Madrid (“Exchange” for the individual shares in the IBEX-35) remained open. ISDA understands that market participants in general were restricted from effecting trades in contracts on the IBEX-35.

ISDA circulated a proposal on 12 February regarding a possible common market approach to the treatment of affected equity derivatives trades for discussion by equity market participants on February 13. As with other ISDA market practice discussions following exchange disruptions, ISDA’s intention in convening market participants was to facilitate the consensus building process and make appropriate recommendations to industry, in order to provide direction and clarity to the market.

Summary of ISDA Discussion and Outcome

On February 13, participating ISDA member firms came to the following agreements:

INDEX VARIANCE SWAPS: With respect to the MEFF’s disruption on 12 February, participating ISDA member firms agreed that in the context of the ISDA Revised 2007 ISDA European Variance Swap Master Confirmation Agreement (published June 25, 2007) (“EUR VAR MCA”):

1. An Exchange Disruption occurred on 12 February for Index Variance Swaps only because the Index (MEFF) was disrupted during the five minute period that ended at the Valuation Time (assuming parties have agreed to the fallback definition of Scheduled Closing Time as the Valuation Time).

- An Exchange Disruption did not occur on the Bolsa de Madrid for the individual shares in the IBEX-35

2. The Observation Day, 12 February is therefore a Disrupted Day and Pt for such Observation Day is deemed to be equal to Pt-1.

SHARE VARIANCE SWAPS: With respect to the MEFF's disruption on 12 February, participating ISDA member firms further agreed today that in the context of the EUR VAR MCA:

The Observation Day, 12 February is not a Disrupted Day because the EUR VAR MCA does not take into account the Related Exchange in the determination of a Scheduled Trading Day or a Disrupted Day. Please refer to the following definitions in the EUR VAR MCA: "Related Exchange" and the last paragraph of "Market Disruption Event" which removes sub-clause (ii) from each of Section 6.3(b) and (c) of the 2002 ISDA Equity Derivatives Definitions.

- This change was incorporated into the EUR VAR MCA with the 25 June 2007 publication, following member consultation.
- Market participants that adhered to ISDA's European Variance Swap Protocol (5 February through 21 March) upgraded either the Interdealer European Variance Swap Master Confirmation Agreement ("Interdealer MCA") as developed in 2005 or the ISDA 2007 European Variance Swap Master Confirmation Agreement published March 7, 2007 ("March 2007 MCA") to the terms of the EUR VAR MCA; thereby covering existing and future variance swaps to the 25 June 2007 standards.

OTHER VARIANCE TRANSACTIONS: While other variance transactions are not covered by ISDA officially published documentation, certain members on the ISDA conference call on 13 February agreed that Transaction Supplements for options are often added to the EUR VAR MCA. These firms agreed that they would apply the same methods described above for variance options, although ISDA was not in a position to make a recommendation on this point.

NON-VARIANCE TRANSACTIONS:

1. With respect to non-variance transactions, members agreed that an Exchange Disruption (as defined in the 2002 ISDA Equity Derivatives Definitions) occurred on 12 February (assuming parties had agreed to the fallback definition of Scheduled Closing Time as the Valuation Time) because market participants in general were restricted from effecting trades in contracts relating to the IBEX-35.
2. Whether or not a Market Disruption Event had occurred, however, in relation to an individual transaction was dependent upon (a) whether the Valuation Time chosen by the parties was the Scheduled Closing Time or otherwise fell during the period of the disruption (so that the disruption occurred during the one hour period prior to the agreed Valuation Time) and (b) whether the Calculation Agent determined that the disruption is material.
3. As with the LSE disruption in November 2007 (described below), the position for non-variance trades was likely to be more complex and varied depending on the terms of individual deals. Therefore, ISDA recommended and members agreed that firms should revert to bilateral discussions and to relevant trade documentation to decide the treatment of affected non-variance trades.

ISDA'S RECOMMENDATIONS:

Further to the consensus determined on 13 February, ISDA made the above recommendations in the context of (i) the event on the MEFF on 12 February and (ii) counterparties having signed the EUR VAR MCA (whether via bilateral negotiations or via the above described Protocol). As mentioned above, ISDA was not in a position to comment on variance transactions not covered by standard ISDA documentation.

As with all ISDA guidance that ISDA disseminates, parties were free to choose alternative methods of addressing the above-mentioned event. The summary and accompanying recommendations were and are intended to provide guidance and to promote clarity and cooperation of market participants on the points addressed, however the summary and recommendations should not be construed as legal advice. Each firm should conduct its own review and analysis of its contractual arrangements with other market participants and not rely on this summary for that purpose.

November 7, 2007: London Stock Exchange (“LSE”)

Background and Issue

The LSE experienced a “technical problem” (prior to and continuing through the 4:30PM scheduled LSE close) on November 7, 2007 that affected the ability of market participants to execute orders. As a result, the LSE extended the close until 5:30PM at which time a closing auction was held and price data was produced. Equity market participants met on the morning of November 8 and later again that afternoon to discuss their experiences on the day and the treatment of affected equity derivatives trades – and in particular variance swaps which take daily observations.

Summary of ISDA Discussion and Outcome

Participating ISDA member firms came to the agreement that for share and index variance swaps documented under the ISDA 2007 European Variance Swap MCA (which does not include a materiality test for the determination of a Market Disruption Event):

- a Market Disruption Event occurred on November 7 because the market was disrupted during the 5 minute period that ended at the Valuation Time (Scheduled Closing Time if no Valuation Time was indicated) and that any re-opening of the closing auction process subsequent to the Scheduled Closing Time was not relevant.
- closing price data from the LSE’s Tuesday, 6 November fixing was used in calculations for all affected FTSE indices and shares, including indices with more than 20% UK names

The group agreed these points only in the context of (i) the November 7 event on the LSE and (ii) counterparties having signed the ISDA EU Variance Swap MCA.

With respect to any other equity derivatives trades, the group agreed that they should be reviewed on a case by case basis with relevant determinations made by the Calculation Agent, subject to applicable ISDA documentation. While firms agreed that a disruption had also occurred with respect to non-variance swaps, firms were not prepared to commit themselves to a recommended practice at the time.

January 2, 2007: U.S. Exchange and Market Closings in observance of former President Ford

Background and Issue

The American Stock Exchange, New York Stock Exchange, Nasdaq Stock Exchange and New York Mercantile Exchange (including the COMEX Division), among other exchanges, announced that their respective exchanges would be closed on January 2, 2007. The Securities Industry and Financial Markets Association recommended on Thursday, December 28, 2006, that the trading of U.S. dollar-denominated fixed-income securities in the U.S close early at 2:00 p.m., EST, on January 2.

Summary of ISDA Discussion and Outcome

ISDA, in consultation with market participants published the following guidance on December 29, 2006 for parties to equity derivative transactions that were affected by the closing of U.S. exchanges on January 2, 2007:

Unless parties otherwise agree, January 2 should not be treated as an Exchange Business Day (under the 1996 ISDA Equity Derivatives Definitions and the 2002 ISDA Equity Derivatives Definitions) or a Scheduled Trading Day (under the 2002 ISDA Equity Derivatives Definitions), and as such the date should be adjusted in accordance with the relevant provision of the applicable definitions. For example, if a Valuation Date in respect of an Option Transaction is specified as January 2 and is governed by the 2002 ISDA Equity Derivatives Definitions, such valuation should be pushed forward to the next Scheduled Trading Day. This guidance is intended to apply to all Transaction types under the 2002 ISDA Equity Derivatives Definitions and the 1996 ISDA Equity Derivatives Definitions, with the exception of variance swap transactions.

For variance swap transactions documented under the 2004 Americas Interdealer Master Equity Derivatives Confirmation Agreement, the date of closure will not be an Observation Day and, accordingly, for transactions entered into when the relevant exchanges were expected to be open on January 2, N will be reduced by 1, unless January 2 is the Valuation Date. In the case of a variance swap with January 2 as the Valuation Date, N will not be reduced by 1, but rather the stock price or Index level for the Valuation Date will be the price or level on January 3. Where the parties are using the default definition for Expected N, the number of Scheduled Trading Days is determined as of the Trade Date. Parties who have traded variance swaps this week should consult with each other to determine when January 2 was or was not expected to be a Scheduled Trading Day.

June 30, 2006: Changes to Hang Seng Index Compilation Methodology

Background and Issue

HSI Services Ltd, the service provider to the Hang Seng Index announced on May 12, 2006 that it had discussed with market participants possible changes to the Hang Seng Index compilation methodology. On June 30, 2006, HSI Services Limited announced three proposed changes:

- imposing a cap on the maximum weighting of a stock in the Hang Seng Index;
- adjusting the weighting of each stock in the Hang Seng Index by a free float adjusted market capitalization weighted formula;
- including five (5) eligible H-shares (companies based in mainland China with a listing in Hong Kong) in the Hang Seng Index which have previously not been permitted. This will bring the total number of shares in the Index to thirty-eight (38).

HSI Services Limited, will gradually phase in these three changes on 3 adjustment days (September 8, 2006, March 9, 2007 and September 7, 2006) over a 1-year period. HSI Services will consider which H-share(s) is/are to be included into the Hang Sang Index as from its next review scheduled to occur in August 2006, and such inclusion will occur gradually. For more information on the above, please refer to the HSI Press Release at:

<http://main.hsi.com.hk/hsicom/announce/20060630e.pdf>

A list of H-shares meeting the conditions for inclusion in the stock universe for HSI review (as of July 31, 2006) is available at: http://main.hsi.com.hk/hsicom/new/hshares_e.pdf

Summary of ISDA Discussion and Outcome

On August 2, 2006, ISDA members discussed (a) the changes to the Hang Seng Index and (b) the potential impact to trades documented using the 2002 ISDA Equity Derivatives Definitions, including whether or not such changes were material. The group discussed whether the Hong Kong Futures Exchange, where Hang Seng Index futures and option contracts are traded, would adjust its listed contracts. We understand that the Exchange will not make an adjustment to the listed contracts. The group also discussed other precedents. HSI Services, which also sponsors the Hang Seng China Enterprises Index (also known as the H-shares index) introduced maximum weighting and free float adjustments to the H-share index (in the same fashion as the current proposed changes to the Hang Seng Index) on March 6, 2006. No adjustment was made to H-shares index futures and options on the Hong Kong Futures Exchange on that occasion.

Members agreed that the proposed compilation methodology changes for the Hang Seng Index were not material and therefore parties would continue to adopt the Hang Seng Index as calculated without any adjustment to deal with these changes.

January 18, 2006: Temporary Suspension of Transactions at the Tokyo Stock Exchange (TSE)

Background and Issue

On January 18, 2006, TSE suspended trading of all equities, convertible bonds, and exchangeable bonds at 14:40 until the end of the day, in light of the possibility that the number of executions might exceed its processing system's capacity.

- On January 18, 2006 TSE made an announcement that it may need to temporarily suspend trading of all equities, convertible bonds, and exchangeable bonds (see the link: http://www.tse.or.jp/english/news/2006/200601/060118_a.html)
- Later, TSE made another announcement that it would suspend trading of all equities, convertible bonds, and exchangeable bonds at 14:40 until the end of the day (see the link: http://www.tse.or.jp/english/news/2006/200601/060118_b.html)
- Equities, convertible bonds, and exchangeable bonds were not traded after 14:40
- Futures and options were traded normally
- TSE confirmed that the close of the trading session for January 18, 2006 was at 15:00

Summary of ISDA Discussion and Outcome

On January 19, 2006, ISDA members discussed whether this was a Market Disruption Event under the 2002 ISDA Equity Derivatives Definitions. Participants agreed that the event did not constitute an "Early Closure" because there was no "closure" of TSE prior to its Scheduled Closing Time. Participants agreed that the event may have constituted either a "Trading Disruption" or an "Exchange Disruption". Whether or not it constituted a Market Disruption Event would have depended on the Calculation Agent's materiality determination.

June 1, 2005: New York Stock Exchange (NYSE) End of Day Trading Halt

Background and Issue

The NYSE halted trading at 3:56PM (EDT) on June 1, 2005 due to a communications problem. Trading did not resume on June 1, 2005.

Summary of ISDA Discussion and Outcome

The ISDA Equity Derivatives Committee met on June 2, 2005 to discuss the interpretation of this event under the 2002 ISDA Equity Derivatives Definitions and the 1996 ISDA Equity Derivatives Definitions. Under the 2002 Definitions, market participants agreed that the event was an Early

Closure and therefore a Market Disruption Event had occurred on June 1, 2005. The occurrence of a Market Disruption Event has various consequences for averaging, valuations, variance swaps etc. Under the 1996 Definitions, there was no consensus reached as to whether the event constituted a Market Disruption Event. The group agreed that ISDA did not need to issue a statement

June 11, 2004: U.S. Exchange and Market Closings in observance of former President Reagan

Background and Issue

The American Stock Exchange, New York Stock Exchange, Nasdaq Stock Exchange and New York Mercantile Exchange (including the COMEX Division), among other exchanges, announced that their respective exchanges would be closed on June 11, 2004. The Bond Market Association recommended on Monday, June 7, that all fixed-income cash markets close on June 11, 2004.

Summary of ISDA Discussion and Outcome

ISDA, in consultation with market participants during the week of June 7, 2004, published guidance on June 9, 2004 for parties to over-the-counter derivative transactions that were affected by the closing of U.S. exchanges and bond markets on Friday, June 11, 2004. Market participants agreed that guidance was required in the interest of mitigating market risk and the promotion of orderly valuation and settlement of positions by market participants. In brief, market participants agreed that June 11 should not be treated as an Exchange Business Day (under the 1996 ISDA Equity Derivatives Definitions and the 2002 ISDA Equity Derivatives Definitions) or a Scheduled Trading Day (under the 2002 ISDA Equity Derivatives Definitions), and as such should have been adjusted in accordance with the relevant provision of the applicable definitions. Please refer to the ISDA Statement for more detail: <http://www.isda.org/speeches/pdf/Statement060904.pdf>