

ISDA Circulates Proposed Revisions to the Equity Derivatives Definitions

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The ISDA Equity Definitions Legal Group recently released a first revised draft of the 2002 ISDA Equity Derivatives Definitions (Versionable Edition) (the "Equity Definitions"). The draft Equity Definition updates include substantive additions and modifications to the Equity Definitions, as well as cleanup and conforming revisions. Below is a brief summary of the notable proposals, along with related open items for consideration.

- **Share Basket Swap Transactions:** The proposed revisions to the Equity Definitions include two new sections relating to basket transactions: "Substitution Election" and "Separate Valuation/Combined Calculation".

Substitution Election: Proposed Section 5.11 relates to share basket swap transactions and introduces a new toggle that would permit substitution rights (both basket additions and/or removals) to be hardwired into the confirmation if "Substitution Election" is specified as applicable. While related terms such as "basket substitution conditions", "eligible shares" and substitution-related mechanics (substituting party, notice & effectiveness) are also added, the majority of the specifics are left to the related confirmation, and would require express agreement between the parties thereto. The provisions as drafted are intended to be flexible enough to cover "portfolio" swaps where one party has the general discretion to add and remove basket components and fixed or capped notional "facility" swaps where the parties can impose additional criteria relating to the equity notional amount (however defined).

Basket Valuation Timing: Proposed Section 5.12 introduces the term "Separate Valuation/Combined Calculation". If specified as applicable for a basket transaction, then basket-specific terms such as Scheduled Trading Day, Exchange Business Day, Valuation Date, Disrupted Day and Valuation Time would be determined with respect to each individual basket component, rather than requiring e.g. a Valuation Date be a valid Exchange Business Day for all basket components. Thus, each component would be valued independently and then combined to produce a single value for the Basket once each basket component has been determined.

- **Futures Lookthrough:** Proposed Section 6.9 adds the term "Futures Lookthrough", which would be specified as applicable via the related confirmation if the reference asset were an exchange-traded futures contract relating to a share or index, as opposed to the share or index itself. The remainder of the section incorporates and, as necessary, modifies other underlier-specific definitions such as valuation, disruption and adjustment. Open points include whether corrections to the official settlement price of the relevant futures contract should have the same effect as corrections by an exchange or index sponsor and whether futures-specific distinctions should be made to the "Early Closure" definition.

- **VWAP and TWAP:** Proposed Section 6.10 creates definitions for volume-weighted average price (VWAP) and time-weighted average price (TWAP). While use of these terms is not uncommon, the provisions are generally counterparty-specific and, in the case of VWAP, determined by reference to the relevant Bloomberg AQR screen. For those reasons, the utility of these new terms may be limited because it is likely that VWAP and TWAP, where applicable, would continue to require express negotiation in the relevant confirmation despite their addition to the Equity Definitions. Beyond VWAP and TWAP inclusion generally, open points include, for VWAP, the relevant time window and whether to include a 10b-18 VWAP definition and, for TWAP, the default time interval.
- **Dividend Recovery:** Proposed Section 10.8 introduces the option for "Dividend Recovery" with respect to share and share basket transactions and certain index swap transactions where the underlying index is a total return index. If "Dividend Recovery" is specified as applicable, then upon the occurrence of certain specified events, the calculation agent may make adjustments it considers appropriate to the terms of the transaction, including the amount of any adjustment or repayment, the effective date of any such adjustment and any interest payable on any repayment amount. Events that could trigger such adjustments include, but are not limited to, a mismatch between a declared dividend and the gross amount actually paid and a failure to pay a declared dividend within one settlement cycle of the relevant payment date.

The dividend recovery language with respect to in-scope index swap transactions is based on the 2023 ISDA Dividend Recovery Event Model Language. Open items include, for in-scope index swap transactions, the dividend recovery provisions should be included in advance of the full Component Security Index Annex provisions being added to the Equity Definitions.

- **ETF-Related Disruption Events:** Proposed Section 12.10 establishes an election for disruption events specific to exchange-traded funds ("ETFs"), some of which were lifted from the 2006 ISDA Fund Derivatives Definitions (which gained relatively little market traction). ETF-specific events established in this Section include "ETF Strategy Breach", "ETF Termination", "ETF Currency Change", "ETF Regulatory Action", "ETF Reporting Event", "ETF Modification", "ETF Reclassification", "ETF Redemption or Subscription Event", "Fund Service Provider Cessation", "NAV Trigger Event", "Holding Event" and "ETF Insolvency". If ETF Disruption is specified as applicable in the related confirmation, then upon the occurrence of such an event the calculation agent would either make adjustments to the terms as it "determines appropriate to account for the economic effect [of such event on the relevant transaction]" or provide notice of cancellation and payment. An open item is whether the list of ETF events is exhaustive.
- **Depository Receipt Provisions:** This draft features a new Article 14 that effectively incorporates both the 2007 Partial Lookthrough Depository Receipt Supplement and the 2007 Full Lookthrough Depository Receipt Supplement into the Equity Definitions. Accordingly, the related confirmation for depository receipt-linked trades would simply require an election as to whether the Full DR Lookthrough (Sections 14.2 and 14.3) or Partial DR Lookthrough (Sections 14.2 and 14.4) is applicable.
- **Hedging Party:** The draft also expands the defined term "Hedging Party" to include Affiliates of the Hedging Party. An open item is whether this addition should be hard-wired or included as an

optional election. The effect of inclusion as an election would be to maintain the status quo, where the addition of Affiliates requires express agreement between the parties.

These revisions only represent the first draft at this point. There has been mixed market reactions regarding a number of the provisions. Market participants are encouraged to provide their feedback and, if not already a member, to join the ISDA Equity Definitions Legal Group.

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