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Master Netting Agreement Developments in the Energy Industry

By Jeremy D. Weinstein

The recent past has seen, and the immediate future promises, several important developments in cross-product master netting agreements as they concern the energy industry. These include the Master Netting Agreement published by the Edison Electric Institute (EEI), the Energy Bridging Agreement published by the International Swaps and Derivatives Association (ISDA), and the ISDA Master Agreement Power Annex now being drafted for joint publication by ISDA and EEI. I serve on the drafting committees for the first and last named documents, although my contributions are minimal in comparison to those of my fellow committee members,[1] from whom it has been my great pleasure to learn.

The benefits and principles of these three documents will be obvious and in large part already well known to the readers of this journal. Therefore, this article focuses on a few practical intersections of real-world energy trading with the ISDA and other forms, either through bridging or coverage in a separate master netting agreement.

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Jeremy Weinstein is Senior Counsel to PacifiCorp and PPM Energy, Inc., working in corporate and commercial finance, derivatives and trading, climate change strategies, and renewable resource development. e-mail: jeremy.weinstein@pacificorp.com or jeremy.weinstein @ppmenergy.com. Mr. Weinstein's views are not necessarily those of PacifiCorp or PPM Energy, Inc.

In This Issue

Letter from the Editors:

Headlines and Trend Lines

In a commencement speech at Syracuse University, former President Bill Clinton advised the class of 2003 to distinguish between the headlines and the trend lines. Where the former may proclaim war, recession and of particular interest to his audience, unemployment; the latter, less noticed developments evidence a less dangerous world, where greater productivity and globalization should make us optimistic for the future.

The headline versus trend line comparison applies to our corner of the world, too.

The most recent headlines concern Freddie Mac and the OTC energy markets. In the case of Freddie Mac, it is said that the company failed to account for its complex derivatives positions properly, which resulted in an understatement of earnings. A criminal investigation is now underway. The energy markets are now familiar with such matters, as a number of firms and individuals have been charged with fraud and price manipulation.

Judging from just the headlines, derivatives are once again perceived as the devil's handiwork. At best, incomprehensible and therefore impossible to value. At worst, lethal to the companies and the careers of individuals that choose to use them.

What lies beneath the headlines, however, is evidence of something else. Federal Reserve Chairman Alan Greenspan has observed on a number of occasions that the wide use of financial derivatives has permitted the leading economies to

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Master Netting Agreement. . .

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Background

Mise en scène

Tempting as it may be to attribute these recent developments to frayed nerves following Enron's spectacular collapse, for the most part these or immediate antecedents were well underway before Enron's problems became transparent, and represent natural advances as energy and energy-related products became commoditized and capable of expression as financial instruments. Post-Enron credit concerns kept interest in developing these documents high despite greatly lessened energy trading activity. Additionally, lenders contemplating repossessing power plant loan collateral became potential energy trading counterparties interested in working with forms with which they were already familiar, such as the ISDA.

Nevertheless, the three new documents discussed here have arrived at a propitious time to help reduce trading risks in current energy market conditions, which are characterized by worries over counterparty credit quality and viability, a dearth of trading counterparties and liquidity on account of bankruptcies or trading operations thrown overboard in desperate attempts to shore up credit ratings, significant uncompleted market investigations and enforcement actions by the Federal Energy Regulatory Commission (FERC) and other state and federal regulators, fears as to the reliability and continued viability of physical transaction price index formation, and rating agencies overcompensating for having recently fallen down on the job.

Energy Trading Enabling Agreements

The two most commonly used energy trading enabling agreements are the EEI Master Power Purchase and Sale Agreement,[2] developed in 1999-2000 by EEI and National Power Energy Marketers Association,[3] and the Western Systems Power Pool Agreement ("WSPP").[4] The EEI is a typical bilateral master trading contract, operating much like the ISDA Master Agreement, with a significant difference being that the EEI is designed for trading physical products intended to be delivered. Much as the ISDA has a "Schedule" which parties use to fill in blanks and document specific bilateral terms that deviate from the printed form, the EEI has a "Cover Sheet" on which elections are made and to which are often appended additional terms.

The WSPP, on the other hand, is a multilateral membership arrangement, under which one becomes a party to a master trading agreement called the Western Systems Power Pool Agreement by paying a membership fee. The WSPP holds several meetings a year to discuss amendments to its contract, which can be passed with a 90% super-majority. The EEI drafting committee also continues to meet periodically to ensure that the EEI Master Agreement remains responsive to industry developments. There are other power pools, and other forms of enabling agreements, also in use.[5]

Each of the EEI and WSPP offer defined sets of energy products, and energy-related products such as capacity and transmission, which vary by factors such as delivery point responsibilities and the "firmness" or "contingency" of the product delivered. For example, an EEI a product called "Firm (LD)," if not delivered for any reason other than a Force Majeure event, entitles the buyer to liquidated damages. A WSPP product called "Service Schedule C Firm" is important for utilities requiring firm power on which they can count to fulfill obligations to serve customers, as Schedule C Firm bears North American Electric Reliability Council ("NERC") firm tags.[6]

One need not join the WSPP in order to trade WSPP products. In fact, these, and products from other power pools, are often traded under the EEI using language that reaches through the product definition, including force majeure terms, used in the underlying agreement offering the product definition.[7] Typically, the parties to an EEI will incorporate by reference the pre-existing transactions between them under the WSPP to bring them within the ambit of the EEI,[8] and transact going forward with each other under their bilateral EEI Master Agreement.

Cross-Product Netting

Companies often trade under multiple master agreements- financial derivatives under the ISDA Master Agreement, physical energy under the EEI Master Agreement, natural gas under the NAESB or GISB Base Contract, and even emissions under the Emissions Marketing Association's Master Agreement. Risks may be reduced if parties can integrate all these master agreements into a single trading relationship with global, cross-product netting and setoff. The EEI has published a Legal Landscape for its Master Netting Agreement written by Cadwaller, Wickersham & Taft,[9] which provides an excellent background on the legal issues relating to master netting agreements. The remainder of this article will assume familiarity with this Legal Landscape.

Bankruptcy Code Amendments

The Bankruptcy Code provides that certain protected categories of contracts, including swap agreements and forward contracts, are not subject to certain infirmities that magically appear upon the bankruptcy of one of the parties, such as the automatic stay, preference claims, and the ipso facto clause. It is not completely clear that one can net across protected categories of contracts in bankruptcy in a fashion that is itself entitled to all the protections. However, since master netting agreements mitigate systemic risk, they are highly favored by financial regulators, and amendments to the Bankruptcy Code specifically blessing them are in the recently reintroduced omnibus bankruptcy reform bill, as they were present in the previous omnibus bills.[10] These provisions have also often been considered for legislation in bills separate from the omnibus reform legislation, most recently in May 2003.

Collateral Thresholds

Most trading relationships include collateral agreements or annexes under which the parties secure their positions with each other by cash or other liquid collateral above "collateral thresholds" tied to their credit ratings. Generally, the lower a party's credit rating, the lower the collateral threshold, and the lower the dollar amount of an adverse position that may be left unsecured. For example, a collateral annex may provide that a party with an AA rating may need only post collateral as the market is more than $20,000,000 against its positions, but at BBB+, that leeway declines to $5,000,000, and to zero if the party drops below investment grade. The worse a company's credit, the more cash it needs to secure its trading positions.

An important advantage offered to trading counterparties by all three of the agreements discussed here is the ability to establish a single collateralization requirement for an entire trading relationships, rather than tie up capital separately collateralizing different trading agreements. By aggregating all trading relationships for margining purposes, instead of a party posting margin under an ISDA while receiving it under an EEI, these are netted into a single requirement.

The Newly Published Contracts

The EEI Master Netting Agreement

Late last year the EEI published its Master Netting, Setoff, Security and Collateral Agreement.[11] This cross-product master netting agreement was the result of a tremendous amount of effort by its drafting committee, and enables users to set up between them a comprehensive cross-product master netting arrangement. Like any powerful tool, it should be used with caution and as directed. It contains new covenants, and can alter, by making uniform, various provisions of the underlying master agreements.

One of the strengths, but also one of the difficulties presented to its users, of the EEI Master Netting Agreement is that some of the strong personalities in the drafting process show through by a plethora of user options available in the final product. The great flexibility is a strength because the user is forced, like the user of an HP12C calculator, to really think about what he or she is doing. Fortunately, Fritz Henze of Jones Day has written an excellent User's Guide[12] and helpful powerpoint summary.[13] The Master Netting Agreement could have been even more complex-the drafting committee examined the work done by the Bond Market Association to implement cross-affiliate netting arrangements, but chose to await further developments before implementing cross-affiliate netting.

The EEI Master Netting Agreement contains a collateral annex under which all trading relationships are aggregated for margining purposes and one collateral threshold is used. The drafting committee is also preparing a form of Master Netting Agreement without the Collateral Annex.

ISDA Energy Bridging Agreement

The ISDA Energy Bridging Agreement[14] is a tailored version of the 2001 ISDA Cross-Agreement Bridge.[15] Parties to an ISDA Master Agreement can use the bridge to achieve a form of cross-product netting by agreeing that, upon the occurrence of certain "Bridging Events" under agreements to which the ISDA is "bridged" to terminate transactions under those agreements and to incorporate the net close-out amounts calculated under those other agreements within the close-out provisions of their ISDA Master Agreement. The ISDA Credit Support Annex can be used to collateralize the overall relationship with one set of collateral thresholds.

The Energy Bridge turns the ISDA Master Agreement itself into a master netting agreement. Although using the Energy Bridge offers no specific legal advantage in terms of netting financial swaps against physical forwards that is not offered by other master netting agreements, the simplicity of the form makes it capable of being rapidly implemented by counterparties eager to quickly establish cross-agreement netting in their trading relationship.

Although the form does not offer as many user options as presented by the EEI Master Netting Agreement, the ISDA Energy Bridging Agreement is three pages long, as opposed to the 67 pages of the EEI Master Netting Agreement. Note that much of the savings in length is achieved by the ISDA philosophy of taking an existing master agreement and credit support annex between the parties and amending it to achieve a master cross-product netting effect and collateralization, as opposed to the EEI Master Netting Agreement, which cross-product nets and collateralizes from scratch. The Energy Bridge keeps the agreements between the parties essentially separate from each other, and simply places the close-out mechanics of the ISDA Master Agreement "on top" of the specified Bridged Agreements if a Bridging Event is triggered. In contrast, the EEI Master Netting Agreement can implement significant changes to the terms of the underlying master agreements.

ISDA/EEI Power Annex

A joint ISDA/EEI drafting committee is developing a "Power Annex" to the ISDA Master Agreement for physically settled power transactions. It may well have been released by the time this article is published, and it achieves cross-product netting by simply replicating a large chunk of the EEI Master Agreement as an annex to the ISDA Master Agreement. Collateralization will be through the ISDA Credit Support Annex. No other documentation is necessary.

The ISDA Power Annex will thereby net the financial swaps typically documented on the ISDA form against the physical forward power sales typically documented under an EEI. Energy traders get the EEI Master Agreement terms with which the market is familiar, and banks, the newest energy market participants, get the ISDA security blanket they are used to, so this new form should be a crowd pleaser.

One minor issue that will attract the notice of sharp-eyed attorneys: the Power Annex, like the EEI Master Agreement, uses the term "Schedule" as a verb for what happens to power; this should not be confused with the "Schedule" to the ISDA itself on which counterparty-specific terms supplementing the printed ISDA form are set out. Practitioners should avoid changing the "Schedule" as a verb to avoid the duplicated defined terms.

A Few Legal Issues

FDICIA

As noted above, there may be some uncertainty concerning netting across protected categories of protected transactions under the Bankruptcy Code. One way to achieve certainty is for parties to provide each other mutual representations that each qualifies as a "financial institution" under the Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. §4401 et seq. ("FDICIA").[16] FDICIA provides any "financial institution" can net any obligation it has to make payment to another financial institution against its entitlement to receive payment from the other financial institution.

"Financial institution" is defined as a broker or dealer, a depository institution, a futures commissions merchant, or any other institution as determined by the Board of Governors of the Federal Reserve System (12 U.S.C. §4402(9)). The Federal Reserve Board has exercised its authority to expand the list of entities that qualify as "financial institutions" to include a person that represents that it will engage in financial contracts as a counterparty on both sides of one or more financial markets and either (i) had one or more financial contracts of a total gross dollar value of at least $1 billion in notional principal amount outstanding on any day during the previous 15-month period with counterparties that are not its affiliates; or (ii) had total gross mark-to-market positions aggregated across counterparties in one or more financial contracts of $100 million on any day during the previous 15-month period with counterparties that are not its affiliates (12 C.F.R. §231.1).

Therefore, most counterparties in the market of any size and activity, whether or not they are a traditional financial institution such as a bank, can avail themselves of the expanded definition provided by the Federal Reserve Board and protect their cross-product master netting expectations by making mutual FDICIA representations.

Cross-Security Interests

The EEI Master Netting Agreement contains a grant of a security interest by each party to the other in all obligations owed each other. Any utility (and others) using the EEI Master Netting Agreement should be especially careful with respect to this, as granting this security interest may be a breach of a bank covenant prohibiting a lien on collateral pledged to the bank. Fortunately, the EEI Master Netting Agreement permits a party to opt out of this security interest by checking a box. The effectiveness of the master netting provisions are most likely not impaired by foregoing this cross-security interest, because the master netting agreement integrates the contact into one agreement, making setoff a permissible recoupment under the Bankruptcy Code, and subjecting the rights of the secured party to Sections 9504 and 9505 of the Uniform Commercial Code, just as a secured creditor on the proceeds of an ISDA is subject to the risk of another schedule being added to that ISDA. However, to ensure this is the case, it would be wise to cause every confirm under every master agreement underlying a master netting agreement to reference that it is subject to the master netting agreement.

Bankruptcy Code Section 553(b) provides that except with respect to single product netting, if offset rights have increased during the 90 day preference period, in the event of an offset pre-petition during that period the amount of that increase can be avoided. For example, suppose Smith owes Bank $100, with whom he has on deposit $50, and one day before Smith files bankruptcy he deposits a further $25. Bank's offset rights increased within the 90 days, and if Bank setoff the full $75 pre-petition, the $25 is avoidable. The intent of the section is to discourage banks from taking offsets prepetition and pushing people towards filing bankruptcy. So if offset rights have increased in the 90 days pre-petition, for example by rights granted in a master netting agreement to proceed against another protected category, and one exercises such rights prepetition, one might encounter an argument one otherwise wouldn't if foreclosing on collateral prepetition, which may be used to justify the need for a security interest across to the other protected category. One could respond by arguing that use of a master netting agreement is not setoff, but rather recoupment, and §553(b) doesn't apply. However, that may not be as good as a security interest, because the line between setoff and recoupment is unclear. Note, though, that to foreclose on collateral post-petition if one of the offset obligations is not in a protected category would require relief from stay, which is not as good as recoupment or post-petition setoff. However, for those who cannot avail themselves of mutual FDICIA representations, the proposed amendment to the Code for master netting agreements will fix this issue. For lien priorities, the amendment to the Code for master netting agreements would be strong evidence that UCC §§9404 and 9405 would apply to an integrated agreement, especially if the confirms all referenced the master netting agreement.

All this should, of course, be rendered moot once the bankruptcy code amendments pass.

Damages Considerations

Some problems inherent in using the ISDA form straight bridged to energy trading arise from issues relating to termination. The 1992 ISDA Master Agreement permitted an election between "First Method" and "Second Method" for calculating damages. Under the First Method, the non-defaulting party walks away. Under the Second Method, whichever party's position is out of the money is required to pay the other that value, even if it means the non-defaulting party has to pay the defaulting party. Long-term energy supply contracts calculated as forward contracts could lead to potentially enormous damages, when the parties could have preferred different remedies. Although the EEI Master Agreement and the WSPP Agreement are both second method contracts, most in the energy industry document long-term deals on separate power purchase agreements that do not have close-out payments, rather than as transactions under an EEI or WSPP Agreement. The 2002 ISDA Master Agreement has removed the First Method/Second Method election, becoming solely a second method contract. Therefore, users of the bridging agreement or power annex should exercise caution with respect to determining which power contracts should properly be bridged without further revision.

Conclusion

The foregoing market-driven solutions to market-presented problems, written by volunteers under the umbrella of industry bodies, provide significant risk mitigation and liquidity enhancement benefits to the energy trading sector. These will likely be further developed over time as the market takes advantage of, and learns from, these forms. ■

Notes

1 Steve Bunkin of Goldman Sachs chairs or co-chaired the ISDA drafting committees, and Dede Russo of Reliant chaired the EEI drafting committee. Speaking only for the two documentation products on which I was involved, other committee members without whom the final products would not have been possible include Liz Sager, now of UBS Warburg; Carol St. Clair, now of Sempra Energy; Eyvette Lopez of Reliant; Nicole Daggs and Vince Duane of Mirant; Ed Zabrocki of Morgan Stanley, Marty Jo Rogers of Entergy-Koch; Lisa Mellenkamp of Duke Energy; David Perlman, now of FERC; Kimberly Summe of ISDA; and Fritz Henze of Jones Day, to name but a few; and the law firms who advised the committees, including Cleary Gottleib Steen & Hamilton; Jones Day Reavis & Pogue; Cadwaller, Wickersham & Taft; Allen & Overy; Schiff Hardin; and Bracewell Patterson.

2 Available from the EEI at http://www.eei.org/issues/contract.htm .

3 See Andy Katz's excellent history of the development of the agreement, in Katz, *Using the EEI-NEM Master Contract to Manage Power Marketing Risks*, 21 Energy Law J. 269 (2000).

4 Available from the WSPP at http://www.wspp.org/Web%20Pages/WSPP%20Current%20Documents.htm .

5 The North American Energy Standard Board (NAESB) held a series of meetings earlier this year to determine whether the WSPP Agreement and EEI Master Agreement should themselves be "replaced" by a third master agreement to be promulgated by NAESB. NAESB had previously promulgated the industry-standard short term natural gas trading contract in 1996, which it still maintains. However, no clear articulation was made as to what required the wholesale replacement of either agreement with a third contract, and so the effort was redirected.

6 Note that selling "non-firm" power as "firm" power with the "intent" of financially firming it was one of the strategies described in the infamous Enron memos. Although a financial market participant not familiar with the way energy is delivered to utility customers might not see the harm, this strategy, by leaning on the system, was perhaps the most antisocial of the trading and scheduling strategies described in the Enron memos. See FERC Staff, Docket No. PA02-2-000, *Initial Report on Company-Specific Separate Proceedings and Generic Reevaluations* (August 2002); and *Final Report on Price Manipulation in Western Markets* (March 2003); California ISO Dept. of Market Analysis, *Analysis of Trading and Scheduling Strategies Described in Enron Memos* (Oct. 4, 2002).

7 Examples are available at http://www.eei.org/issues/contract/provisions.htm .

8 Typical language is available at http://www.eei.org/issues/contract/incorporation.DOC .

9 Available from the EEI at http://www.eei.org/issues/contract/mna/legal_landscape_10-25-O2.pdf .

10 Section 907 of H.R. 975, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003, amends §556 and §559 of the Bankruptcy Code and adds a §561 to the Code permitting a contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts. The Bill also adds new §101(38A) defining "master netting agreement." See also Allen & Overy, U.S. Netting Legislation The Financial Contract Provisions - Title IX of the Bankruptcy Reform Act of 2001 (S. 420 and H.R. 333) (April 2, 2001), summarizing the earlier proposed legislation, available from ISDA at http://www.isda.org/speeches/pdf/Memorandum_for_ISDA-US-Netting-Legislation.pdf .

11 Available from the EEI at http://www.eei.org/issues/contract/mna/ .

12 Available from the EEI at http://www.eei.org/issues/contract/mna/users_guide.pdf .

13 Available from the EEI at http://www.eei.org/issues/contract/mna/users_guide_summary.ppt

14 Available from ISDA at http://www.isda.org/press/pdf/2002isdaenergybridge.pdf ; a Commentary to the Bridging Agreement is available from ISDA at http://www.isda.org/press/pdf/2002isdacommentary.pdf .

15 Available from ISDA at http://www.isda.org/press/pdf/Supp_ISDA_Cross_Bridge_argmnt.pdf , a Commentary on the Bridge is available from ISDA at http://www.isda.org/press/pdf/Com_on_Bridge.pdf

16 An example of such a clause is:

> As of the Effective Date and the date of each subsequent Transaction, each Party represents and warrants to the other Party that it is a "financial institution" as defined in and pursuant to Title VI of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"). Each Party intends that this Agreement constitute a "netting contract" as defined in and subject to FDICIA, and each payment entitlement and payment obligation under this Agreement constitute a "covered contractual payment entitlement" and "covered contractual payment obligation," respectively, as defined in and subject to FDICIA.

The 2002 ISDA Equity Derivatives Definitions

By Glen A. Rae

Ushering in a new era in derivatives documentation, the International Swaps & Derivatives Association ("ISDA") recently published the 2002 Equity Derivatives Definitions (the "2002 Definitions"). The ISDA Equity Derivatives Committee (the "Committee") set out to draft the 2002 Definitions to offer a "toolbox" of standardized and elective provisions that deal with not only the mechanics of a transaction, but also many of the events that could affect the underlying share or index.

The Committee is comprised of leading dealers as well as significant end users and their counsel. After 15 months of consultations and discussions amongst the members, the Committee unveiled the 2002 Definitions, which build on the framework of the 1996 Equity Derivatives Definitions (the "1996 Definitions") and accommodate changes in the market since those definitions were published.

The 2002 Definitions revise and expand the 1996 Definitions and can now be used to more easily document (i) several types of forwards (including prepaid variable share forwards, one of the most common hedging strategies used in the U.S.), (ii) Bermuda options (which give the buyer the right to exercise at maturity and also on predetermined dates during the term of the option) and (iii) barrier transactions (contracts where the payments or deliveries are contingent upon the occurrence or non-occurrence of certain events). Furthermore, the 2002 Definitions also provide elections that are intended to provide flexibility for parties to customize their confirmation to address particular transaction issues (including the hedging strategy of the parties), while nevertheless representing the prevailing best practice of the industry under those circumstances.

The intent of this article is to provide a general overview of the 2002 Definitions (using the terms defined therein), focusing in particular on some of the most important provisions that have been updated, namely the Consequences of Merger Events and the approach to trading market disruptions.

Merger Events

The prime example of the "toolbox" approach is contained in the section dealing with the Consequences of Merger Events. There are seven different elections that the parties may select:

- Alternative Obligation;
- Options Exchange Adjustment;
- Cancellation and Payment;
- Partial Cancellation and Payment;
- Calculation Agent Adjustment;
- Modified Calculation Agent Adjustment; and
- Component Adjustment.

The Alternative Obligation and Options Exchange Adjustment elections are generally the same as in the 1996 Definitions. However, the Cancellation and Payment provisions have been significantly revised.

More specifically, for share option transactions, the 2002 Definitions provide two alternatives. The first, Calculation Agent Determination, gives the Calculation Agent broad flexibility to determine the amount payable upon the cancellation of the option. The second alternative, the Agreed Model, sets out in considerable detail how the value of the option must be calculated.

The concept behind the Agreed Model is that the Calculation Agent determines the value of the option on the Closing Date of the Merger Event and then makes an adjustment based on the change in the value of the option on the Announcement Date of the Merger Event, due to the change in the level of implied volatility of the underlying shares.

The Agreed Model is best illustrated by an example:

> On the Closing Date of the Merger Event, the Calculation Agent determines the value of the option based on a pre-agreed method to calculate the inputs for dividends, stock price, term, interest rate and stock loan rate plus its determination of the implied volatility at specified times prior to, and including, such Closing Date. For our hypothetical, assume that this calculation results in the Seller having to pay the Buyer $1,000,000.
>
> The Calculation Agent then determines the change in the value of the option reflecting the change in the implied volatility of the underlying shares around the time of the Announcement Date of the Merger Event. It does this by ascertaining the difference between two calculations using another pre-agreed method to calculate the inputs for dividends, stock price, term, interest rate and stock loan rate, but with two different volatility numbers. The first volatility number is the Calculation Agent's determination of the implied

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Glen A. Rae is a Vice President and Assistant General Counsel at Goldman, Sachs & Co. in New York, specializing in equity capital markets and over-the-counter equity derivative products. He is the chairman of the ISDA Equity Derivatives Committee for North America and served as the Co-Chair of the working group that drafted the 2002 ISDA Equity Derivatives Definitions.

volatility at designated times prior to the Announcement Date of the Merger Event. The second is based on similar determinations at designated times on, and following, such Announcement Date.

Once again, assume that the above calculation results in the value of the option being $100,000 lower after the Announcement Date of the Merger Event because the volatility of the acquiring company's shares is less than the target's shares. This $100,000 is added to the $1,000,000, resulting in the Seller having to pay the Buyer $1,100,000 upon the cancellation of the option.

The Agreed Model allows the parties to clearly specify how the option is to be valued upon a cancellation. However, depending on the structure of the particular transaction, the parties may want more flexibility in the valuation and therefore can elect Calculation Agent Determination.

The Calculation Agent Determination and the Agreed Model elections are not applicable to share forward and swap transactions. In these cases, the Determining Party specified in the confirmation calculates the Cancellation Amount. This calculation methodology is based on the Close-Out Amount provision in the 2002 ISDA Master Agreement and reflects the replacement cost of the transaction based on its current fair value.

The remaining four elections were not contained in the 1996 Definitions, but the concepts have often been used in the market for customized transactions.

The first of these, ***Partial Cancellation and Payment***, allows flexibility for basket transactions. Many users may not want to cancel the whole transaction because one stock out of a hypothetical 30-stock basket becomes the subject of a Merger Event. This provision allows the transaction to continue on the remaining 29 stocks and have a cash payment reflecting the deletion of the stock that is the subject of the Merger Event from the basket.

The next two new elections are ***Calculation Agent Adjustment*** and ***Modified Calculation Agent Adjustment***. Both elections allow the Calculation Agent to adjust the terms of the transaction to account for the economic effect of the Merger Event and to proceed to Cancellation and Payment in the event that, in its view, no adjustment could be made to the transaction that would produce a commercially reasonable result. In those cases, (i) the Calculation Agent Determination method will apply to option transactions, and (ii) for forward and swap transactions, the Determining Party will calculate a Cancellation Amount, each as described previously under the Cancellation and Payment provisions. The main difference between the two elections is that, under Modified Calculation Agent Adjustment, the Calculation Agent may adjust the terms of the transaction to account for changes in volatility, expected dividends, stock loan rate or liquidity relevant to the underlying shares. However, such adjustments are prohibited under the Calculation Agent Adjustment election. The Modified Calculation Agent Adjustment provision reflects a compromise amongst dealers, who do not want to take volatility risk on a new underlying share if there is a Merger Event, and end users, who do not want their hedging transaction to cancel if there is a Merger Event since they now own the acquiring company's shares.

The final new election, ***Component Adjustment***, applies to a Share-for-Combined Merger Event and is a shorthand way of providing that, when the Merger Event consideration consists of both New Shares and Other Consideration, the consequence of Share-for-Share applies to the New Share consideration received in the Merger Event and the consequence of Share-for-Other applies to the remainder of the consideration.

Before discussing the other important provisions of the 2002 Definitions, it is worthwhile noting some of the additional changes that were made to the Merger Event section:

(i) the definition of New Shares has been revised to require that in order to constitute a Share-for-Share Merger Event, the new shares must be ordinary or common shares that are listed or quoted on an exchange or quotation system in the same country (or within the EU if the original Exchange is within the EU) and not be subject to additional currency or trading controls, restrictions or limitations. Under the 1996 Definitions, the share consideration could be any type of shares without the requirement that they be listed. This modification allows parties to express their intention that the transaction be based on listed or quoted shares in a particular jurisdiction. If that jurisdiction changes, the parties now have the flexibility to elect to restructure the transaction to reflect the new circumstances; and

(ii) the Merger Event definition now includes so called "reverse mergers", where the target company is the surviving entity in an acquisition, and mergers in which there has been a change in control of the underlying company as a result of an acquisition (e.g., where the shareholders of the underlying company own less than 50% of the outstanding shares of the surviving entity after the acquisition). However, it is important to note that the Merger Event definition does not include partial tender offers. The parties can instead elect the Tender Offer provisions to apply to their transaction upon the completion of a tender offer for more than 10% but less than 100% of the outstanding voting shares. The possible consequences for Tender

> Offers are similar to those for Merger Events, except that there is no corollary to Alternative Obligation because this election would not result in any adjustments being made to the transaction (users can provide for this consequence by specifying that the Tender Offer provisions are not applicable to their transaction).

As described above, these provisions reflect significant changes from the 1996 Definitions. The Committee expects that these revisions will allow the parties to more easily customize the documentation for their particular transaction.

Trading Market Disruptions

As mentioned earlier, one of the main goals of the Committee was to incorporate market changes into the 2002 Definitions. Many events have occurred since the 1996 Definitions were published that have impacted the market, however, none more so than the tragic events of September 11th. Readers may remember that in the subsequent days following this event there was uncertainty as to whether the days that the New York exchanges were closed were considered Exchange Business Days on which a Market Disruption Event occurred or were not Exchange Business Days at all. This distinction is important because the fallback in the Market Disruption Event provisions required that if there were six Exchange Business Days (original Valuation Date plus the five thereafter) upon which a Market Disruption Event occurred, the Calculation Agent would determine the value of the shares based on its good faith estimate of the exchange-traded price that would have prevailed but for the occurrence of the Market Disruption Event. Days that were not Exchange Business Days were not included in the six-day period and therefore delayed the requirement that the Calculation Agent make the determination. Based on a consensus of members, ISDA issued a guidance statement that such days were not days on which valuations or expirations of options should occur.

The intent of the Committee was to create a provision that would allow parties to value and terminate their transactions in times of extended market crisis, and to do so in a manner consistent with other derivatives (i.e., foreign exchange) that they may have entered into as a hedge to the transactions. However, the Committee recognized that certain events were temporary in nature and the relevant market would soon function normally. In such cases, the 2002 Definitions provide sufficient time to allow for this to occur so that the transaction can be valued in an objective and efficient market.

The 2002 Definitions address these types of situations by introducing a new Scheduled Trading Day definition and revising the definitions of Exchange Business Day and Market Disruption Event. The result is that if there are nine consecutive Scheduled Trading Days (the original Valuation Date plus the eight thereafter) that would have been Valuation Dates had they not turned out to be Disrupted Days, the Calculation Agent shall determine the value of the shares as of the Valuation Time on such ninth day. This reflects a change from the six-day period in the 1996 Definitions and is now consistent with the time period in the 1998 ISDA FX and Currency Option Definitions. More importantly, the 2002 Definitions require that the Calculation Agent determine the current market value of the shares and not its good faith estimate of the exchange-traded price that would have prevailed but for the occurrence of a Market Disruption Event, as provided in the 1996 Definitions.

The new definition of Scheduled Trading Day and the revised definition of Exchange Business Day are at the core of the trading market disruption provisions. A Scheduled Trading Day is a day that the Exchange and Related Exchange are scheduled to be open for their regular trading sessions. An Exchange Business Day is now defined as a Scheduled Trading Day that the Exchange and Related Exchange(s) are open for trading for their regular trading sessions, even if they close prior to the Scheduled Closing Time.

The trading market disruption provisions build on the Scheduled Trading Day and Exchange Business Day definitions and focus on Disrupted Days. These occur when there is not an Exchange Business Day due to an exchange not opening for trading or when a Market Disruption Event occurs. The Market Disruption Event provisions are triggered by three possible events: (i) trading limitations on the specific shares during the one-hour period prior to the Valuation Time (similar to the 1996 Definitions); (ii) exchange-wide trading limitations during the one-hour period prior to the Valuation Time (e.g., the technological problems that occurred on NASDAQ on June 30, 2001, the day of the quarterly rebalancing of the Russell indexes); or (iii) early closure of the exchange, if such early closure is announced less than one hour prior to the actual early closing time or, if earlier, the submission deadline for the market-on-close orders on that day.

Another modification based on the events following September 11th addresses the case in which trading is temporarily moved from one exchange to another, as happened when trading in ETFs on the AMEX was moved to the NYSE. The 2002 Definitions handle this situation by including in the definition of Exchange, exchanges where trading on the original exchange has temporarily relocated provided that there is comparable liquidity on the new exchange.

In summary, the trading disruption sections draw on the experience of market participants in times of crisis in order to provide clear guidance regarding the effect and consequence of these events on future equity derivative transactions. The Committee expects that the 2002 Definitions will offer parties increased certainty in times of market upheavals.

Other Important Provisions

Other important provisions in the 2002 Definitions that users should be aware of are the duties of the Calculation Agent, Settlement, Dividends, De-listings, Additional Disruption Events and the disclaimers.

Significant discretion and flexibility is afforded to the Calculation Agent in many of the provisions of the 2002 Definitions. However, in order to be consistent with other ISDA documentation (e.g., the 2002 Master Agreement and Credit Derivatives Definitions), the Calculation Agent must act in good faith and in a commercially reasonable manner. Although the Calculation Agent is not required to get dealer quotations, the objecting party can use dealer quotations to support a claim that the Calculation Agent did not act in the required manner.

The cash or physical settlement sections are now de-linked from a particular product (options in the case of the 1996 Definitions) and can apply to any transaction documented under the 2002 Definitions. Moreover, they provide flexibility for transactions where one party has the choice of cash or physical settlement, in some cases having a fallback based on common market practice if no election is made (e.g., cash settlement for swaps, but note that a fallback election must be made for options since the Committee observed that both cash and physical settlement were commonly used).

The Committee recognized that the treatment of dividends varied in the market and accordingly the Dividends section of the 2002 Definitions contains significant flexibility on this issue. Parties may customize the dividend provisions in their confirmation based on whether the record, ex-dividend or payment date for the underlying shares occurs during the relevant Dividend Period.

De-listings of the underlying shares were not addressed by the 1996 Definitions, but such events have become more common during the last two years. The 2002 Definitions treat De-listings in the same way as a Nationalization or Insolvency (i.e., leading to Cancellation and Payment or Negotiated Close-out depending on the parties' election in the confirmation).

There are also a number of elective provisions in the Additional Disruption Events section that parties can select to apply to their transaction: Change in Law; Failure to Deliver; Insolvency Filing; Hedging Disruption; Increased Cost of Hedging; Loss of Stock Borrow and Increased Cost of Stock Borrow. The occurrence of any of these events will trigger an early termination right for one or both of the parties. In certain cases, the other party may agree to adjustments to the transaction or additional payments in order to prevent a termination. These provisions allow parties to easily customize their confirmation based on the economics of the particular transaction.

Finally, the 2002 Definitions, similar to the 2002 ISDA Master Agreement, contain elective non-reliance, disclaimer and acknowledgement provisions that are commonly found in confirmations in the market for equity derivative transactions. The intent of these provisions is to make clear the relationship and understandings of the parties.

Implementation

The 2002 Definitions reflect a tremendous amount of work by members of the Committee and were designed to be flexible yet extremely detailed in providing a framework for parties to document their transactions. It is expected that these standardized provisions will reduce the length of the confirmations used in the market while retaining the trading protections requested by users. Readers are encouraged to review the 2002 Definitions in order to determine whether they are appropriate for their transactions.

In light of the significant changes to the 1996 Definitions and the level of detail in the 2002 Definitions, ISDA is in the process of preparing a Users' Guide, which will be published later this year. In addition to explaining the rationale behind many of the provisions, it will contain sample provisions that parties may use when they want to modify the standard provisions of the 2002 Definitions. These may include (i) barrier provisions that contemplate a determination of whether the Knock-in or Knock-out Event has occurred at any time during the regular trading session, as opposed to the one pre-determined time contemplated in the 2002 Definitions, (ii) currency disruption events, (iii) reinvestment of dividends based on the payment dates of such dividends rather than the reset dates of the transaction, and (iv) basket transactions where the components are correlated and must be valued on the same date as opposed to the "value what you can when you can" approach of the basket provisions in the 2002 Definitions.

In the meantime, ISDA is hosting several documentation conferences worldwide in order to guide users on how to use the 2002 Definitions to customize their transactions. Additionally sample confirmation forms are available on ISDA's website (www.isda.org). ■

Futures & Derivatives Law Twenty Years Ago

CTA Registration. Commission Staff advised that a company that would provide a commodity futures advisory service involving the reprinting of specific trading recommendations and price projections for disseminating to third persons would not be within the definition of a commodity trading advisor since this service would be solely incidental to the conduct of its electronic information and communications service business. Conditions included (a) the company would be operating as a general computer library in which subscribers as both users and providers of information would have access to its library files which includes many different types of information, (b) the commodity futures advisory service would be only one aspect of the company's electronic information services, (c) information networks operated by an agent of an FCM would be one of the many private customized information networks maintained by other persons through the company and (d) the company would not hold itself out to the public or to existing or prospective subscribers as a CTA. *Interpretative Letter No. 83-5.*

Omnibus Accounts. Commission Staff advised that an originating FCM intending to open an omnibus account with a carrying FCM in order to affect arbitrages between futures and physicals should deposit initial and maintenance margin on each position which it reports to the carrying FCM at a level no less than that established for customer accounts by the rules of the applicable contract market. The carrying FCM must collect the initial and maintenance margin on each position reported by the originating FCM. Individuals trading through the originating FCM would be its customers. The originating FCM would be a customer of the carrying FCM. Because customer funds in a regulated omnibus account in excess of margin required by the carrying FCM are not automatically available for transfer to a non-regulated omnibus account, the originating FCM must authorize the transfer after determining that excess funds exist and that the individual traders have authorized such a transfer. The originating FCM must affirmatively communicate to the carrying FCM its authority to make transfers between the omnibus regulated account and the omnibus non-regulated account each time such a transfer is desired. *Interpretative Letter No. 83-13.*

Leverage Transactions. The Commission proposed regulations to govern the offer and sale of leverage transactions for the delivery of silver bullion, gold bullion, bulk silver coins, bulk gold coins, copper and platinum. The proposed regulations included: (1) definitions of "leverage transaction" and "leverage contract", (2) whether persons engaged in a leverage business should become members of a self-regulatory organization, (3) the terms and conditions of leverage contract; and (4) customer protection, recordkeeping, reporting and financial requirements. ■

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Little Falls, NJ 07424

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Letter from the Editors: *(continued from page 2)*

absorb economic shocks without suffering irreparable damage. By the means of risk-shifting derivatives, economic exposures have been shared rather than concentrated.

When you consider that we have gone through the worst series of corporate bond defaults and mark downs since the Great Depression, that the Bubble's burst has erased trillions in equity value, and that the dollar is appreciable weaker, it is wonder that banks and other core financial institutions remain strong, well-capitalized, and vital. There have been no bank runs or other signs of panic. If Greenspan is correct, derivatives have contributed to the solidity of our greater economic system.

Moreover, the same headlines that advertise mis-pricing, in the case of Freddie Mac, and misbehavior, in the case of the energy traders, equally display the vigor of accountants and law enforcement in finally coming to grips with these difficult matters. The trend line shows that a new ethic is emerging in this post-Bubble economy. It is more conservative and more risk adverse. But that is not a bad thing, given where we were.

Our guess is that where the headlines seem to point lower, the trend lines point modestly higher. ■