Master Confirmation Agreements for Equity Derivatives

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Having a Master Confirmation Agreement ("MCA") in place to cover equity derivative transactions - primarily swaps or options on shares, indices or baskets - has clear advantages for many participants on both sides of the market. Equity derivative confirmations are notoriously difficult to negotiate as the documentation contains many terms apportioning risk between parties with different priorities. In addition, some provisions if triggered can result in the termination of a trade or adjustments to its economic terms.

Among the most important reasons for having one or more equity MCAs in place are the following:

- ***Ease of documentation***. Having the most difficult terms for an equity derivative trade negotiated in advance can save a lot of time when individual trades are entered into. A simple transaction supplement containing the specific economic terms of a trade (such as the Initial Price, the Trade Date and Valuation Dates) can be easily agreed for a specific trade if an MCA is in place.

- ***Unclear terms***. If an equity derivative trade is entered into and its confirmation is subject to a protracted negotiation, it can leave the parties without clear terms to refer to if an event, such as a merger event, occurs before the confirmation is agreed.

- ***Regulatory compliance and cost savings***. The execution of an equity MCA will help dealers comply with regulatory demands that they document trades quickly and save end-users time and costs they would incur if they had to negotiate the complex terms each time they wanted to enter into a trade.

What is an MCA? The ISDA documentation architecture involves the parties agreeing to a Master Agreement, Schedule, and typically a Credit Support Annex for pledging collateral (the "ISDA"). Then each trade - whether on an interest rate, FX, commodity, equity or other underlying economic variable - entered into between the parties to the ISDA will be documented with a confirmation, usually incorporating a number of general terms contained in an ISDA definitional booklet. For equity transactions this will usually be the 2002 ISDA Equity Derivatives Definitions. The confirmations for a number of underlying economic variables are relatively simple. However, the terms of equity derivative transactions are multifaceted, ranging from deciding how to determine the price of the relevant share at the maturity of the trade, or how to deal with a merger that takes place in relation to the share during the term of the trade, to dealing with the consequences of a dealer losing or experiencing other issues with its hedge. Documenting such trades can be complicated, time consuming and contentious. An MCA resolves the issue of dealing with this each time a party transacts, by agreeing to most or typically all of the complex or difficult terms upfront.

Which MCA form should be used? If the parties decide to enter into an equity MCA, it is important that they choose the right MCA. There is not a single MCA that covers all equity derivatives. There are different ones for swaps and options which are often differentiated by underlyer and further by jurisdiction. ISDA has several forms but they do not cover all products or all markets. Dealers will sometimes use the ISDA forms but also have in-house forms, especially for swaps, that can be geared towards the way they prefer to book and manage trades. Choosing the wrong MCA can make a negotiation unnecessarily arduous. For example, many in-house swap MCAs cover multiple jurisdictions and given that the form must cater to all of those jurisdictions, to one degree or another, they can often contain unnecessarily restrictive terms. Predictably, where developing economies are covered, the terms will be tougher, to account for the additional risks in those markets. Therefore, if a party is looking to trade only shares or indices in the US or Western Europe, they should select an MCA that exclusively covers those jurisdictions. As such, there will be no need to include more rigorous terms that seek to address the uncertainties and risks which exist in developing jurisdictions.

The parties should also decide which underlyers they want covered. If they only plan on trading indices, it may make sense to have an MCA restricted to indices because, again, such MCAs typically have lower risk profiles than those for single shares.

Consult with the Traders. It is worth noting that an equity MCA is not simply a set of terms related to legal risks or regulatory requirements. The bulk of an equity MCA addresses trading risks such as, how to determine the Final Price, what to do if a tender offer occurs, what will happen if a sponsor stops determining the level of the index or how to deal with issues with a party's hedge, to name a few. Finding the best answer to these various questions involves an interaction between those reviewing the documentation and those who trade or otherwise manage the risk of the underlying products.

While there are many advantages to equity MCAs, they may not always be appropriate. For example, if a party expects highly bespoke terms that are not easily negotiated, it may be easier to include these in one-off confirmations. Therefore, in such an instance, the other party will not agree to apply the terms to all share swaps, but only to the particular share associated with a specific trade. The parties might be able to agree to those terms for that share but not for many others. Also, should a party only trade equity derivatives very rarely, the upfront costs and time in putting an equity MCA in place may not make sense.

Questions regarding MCAs for equity derivative trades may be directed to GuyLaine Charles at guylaine@charleslawpllc.com. This client update is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to castle@charleslawpllc.com.