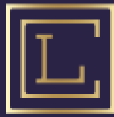

Hedging Disruptions in Equity Derivatives

Negotiating a confirmation for an equity derivatives transaction can be a time-consuming undertaking, often involving not only documentation and legal resources but also trading, credit and compliance. Several terms in the confirmation that attract the greatest scrutiny are not, fundamentally, legal in nature but relate more to trading or other risks. Agreeing to such terms on a trade-by-trade basis will often take significant periods of time. Where the parties seek to agree to the terms for a specific transaction prior to trading, the negotiation can cause delays. When done after trading, a party is at risk of getting weaker terms, as the transaction is a *fait accompli*. As a result, it will often make sense to put a master confirmation agreement (***MCA***) in place as the most contentious terms are negotiated and agreed in the MCA to ensure that, at the time of trading, only the economic terms need to be confirmed in a transaction supplement.

Typical OTC equity derivative transactions are swaps or options on a share or share index or a basket of shares or indices.

The issues involved in agreeing to ***Hedging Disruption*** can highlight how negotiating equity derivatives confirmations can be complex. Hedge Disruption is one of the ***Additional Disruption Events*** the parties can agree to apply in their confirmation. Additional Disruption Events refer to several elective events set out in the 2002 ISDA Equity Derivatives Definitions (***2002 Definitions***). They describe which events connected to a party's hedge will allow the hedging party to take specified steps to account for such event. Additional Disruption Events also include, Change in Law, Increased Cost of Hedging, Loss of Stock Borrow and Increased Cost of Stock Borrow, amongst others, which we will discuss in subsequent alerts.

Hedging Disruption is defined in the 2002 Definitions as a situation where the hedging party is unable, after using commercially reasonable efforts, to hedge the equity price risk of the transaction or recover or realize proceeds from its hedges. Parties must agree on the following:

(i) whether Hedging Disruption will apply;

(ii) if applicable, whether they want to make changes to the definition of Hedging Disruption in the 2002 Definitions; and

(iii) if applicable, whether they want to make changes to the consequences of a Hedging Disruption set out in the 2002 Definitions.

It is typical for Hedging Disruption to apply for equity swaps and sometimes for equity options (in relation to options, whether Hedging Disruption applies will often depend on the jurisdiction in which the exchange is located or the dealers' preferences). However, both dealers and end-users (hedge funds, pension funds, etc.) frequently seek to amend the provision in the 2002 Definitions.

The dealers' preference will typically be for the Hedging Disruption to apply to hedges for the broadest set of risks. As a result, dealers will seek to expand the hedges to which the provision applies. Under the 2002 Definitions the provision only applies to those which hedge the "equity price risk of the

transaction". In the ISDA working group discussions (composed of buy and sell side representatives) that resulted in the publication of the ISDA MCAs for swaps in Europe and the more developed markets in Asia - Hong Kong, Singapore, Australia, and New Zealand, but excluding Japan- the parties agreed to extend this to hedges for "dividend risk" as well. Some dealers seek risks beyond these, e.g., interest rate risk, currency risk, regulatory risk or often just to any risk they deem appropriate given the trade[*].

The end-user on the other hand, will seek to limit this set of risks to those initially contemplated in the 2002 Definitions or at least to a finite list, so that the end-user's trading desk is aware of what those risks are and with which dealer they have the higher risk of a disruption to the trade being called.

Which risks the dealer may insist on including could be impacted by (i) the jurisdiction of the exchange(s) on which the share or index is traded or (ii) the type of underlying (Hedging Disruption provisions for transactions on indices are often easier to negotiate than those on shares). One approach to address this in an MCA that covers many jurisdictions and underlyings, would be to have the Hedging Disruption provision cover a narrower set of risks for western European trades and a broader set of risks for trades in developing markets, reflecting the greater risks in the latter.

As mentioned above, the parties will also need to agree on whether the consequences of a Hedging Disruption occurring, which are set out in the 2002 Definitions, should be amended. Under the 2002 Definitions the hedging party can elect to close the trade out and determine its value (***cancellation amount***), in each case, as contemplated by the 2002 Definitions. Parties may seek to negotiate alternatives - for example where the end-user can direct the dealer to an alternative hedge source to avoid termination or where the end-user has dispute rights over the determination of the cancellation amount. These latter changes are not as common as the ones discussed above but can be proposed depending on the end-user's preferences.

An end-user may seek other changes. For instance, excluding from the definition of Hedging Disruption events which relate to the dealer's credit worthiness or those which the dealer could have avoided by taking commercially reasonable steps.

Although Additional Disruption Events have been rare, the consequences can be significant and therefore it is important to have terms such as these agreed in advance of trading.

Questions regarding the above may be directed to GuyLaine Charles at guylaine@charleslawpllc.com or Steven Gray at steven@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 be added to our distribution list and/or obtain a copy of any past or future publications by sending an e-mail to Maria Castle at castle@charleslawpllc.com.

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[*] Note that for the US and Canada, the ISDA working group could not agree on a single version of Hedging Disruption. As a result, alternatives were included in those MCAs.