

## ISDA Digital Asset Derivatives Definitions

The ISDA Digital Asset Working Group (the "**Working Group**") published on January 26, 2023, the ISDA Digital Asset Derivatives Definitions (the "Digital *Definitions*") which represent a first step in standardizing documentation for derivatives on digital assets. The Digital Definitions are, however, quite narrow as they only cover non-deliverable forwards ("**NDFs**") and non-deliverable options ("**NDOs**") with Bitcoin ("**BTC**") and Ether ("**ETH**") underliers. The Working Group expects that as the industry gains experience, the Digital Definitions will be expanded to physical settlement derivatives and swaps (such as total return, perpetual or interest rate) on BTC, ETH and other liquid underliers.

As with other ISDA definitional booklets, the Digital Definitions are part of a framework that governs the relationship of the parties and how they confirm a transaction. The ISDA Master Agreement and Schedule contain terms that govern the parties' relationship rather than the terms of specific transactions - representations concerning the parties' capacity to enter into derivative transactions, events of default that entitle the non-defaulting party to terminate the agreement, how to close the agreement out in such an event and so forth. Any collateral arrangement will usually be set out in a Credit Support Annex or similar ISDA document which is typically an annex to, and part of, the ISDA Master Agreement. Specific transactions will be documented by a confirmation (or master confirmation and transaction supplement) which incorporates the relevant definitional booklet (where one exists) to provide definitions of common terms. This tends to limit the complexity of, and time necessary to negotiate, the confirmation. The confirmation and any referenced definitional booklet(s) will be regarded as part of the ISDA Master Agreement.

The Digital Definitions provide that parties will select an exchange or a composite price source as the price source for the Settlement Price. In so doing, parties will effectively agree to the rules or policies of that exchange or composite price source (in each case a "**Price Source**") to resolve most of the difficult questions that may arise, such as how to handle forks or pricing disruptions. The Digital Definitions then provide fallbacks if the Price Source rules are not dispositive with respect to price source disruptions or fork events. The definitions also provide mechanisms to address other events which may arise during the trade such as hedging disruptions, termination pricing elections and change in law, to name a few.

Below are some of the most relevant provisions of the Digital Definitions:

### A. Settlement Terms

**Designation of the Settlement Price Source** – As mentioned above, this will govern almost all of the important economic terms of the trade. The Digital Definitions include the "**Digital Asset Derivatives**

**Definitions Settlement Price Source Matrix**" which identifies the major exchanges, trading venues and aggregators that are available as Price Sources; however, parties are free to designate alternatives. Aside from pricing information, the source's rules, or decisions to quote, will determine the treatment of forks and price source disruptions as discussed below.

**Calendar Day Election** – This election allows exercise and settlement on a 24/7 basis. Collateral transfers, notice requirements and other time-based requirements, however, remain tied to Business Days.

**Business Day Convention** – If Calendar Day Election is not made, the parties can agree that if a relevant day does not fall on a Business Day one of these elections will apply:

- **Following** (the date will be adjusted to the first following Business Day),
- **Modified Following** (the date will be adjusted to the first following Business Day unless that day falls in the next calendar month, in which case that date will be the first preceding Business Day),
- **Nearest** (the date will be adjusted to the first preceding Business Day, if the relevant date falls on a day other than a Sunday or a Monday, and will be the first following Business Day, if the relevant date otherwise falls on a Sunday or a Monday), or
- **Preceding** (the date will be adjusted to the first preceding Business Day).

If no election is made, *Following* is the default.

## B. Disruption Events and Fallbacks

The parties can elect to have specific events be "**Disruption Events**" with respect to a trade and what the consequence of the Disruption Event will be. The Digital Definitions include four types of Disruption Events - Price Source Disruptions, Hedging Disruptions, Fork Disruptions and Change in Law Disruptions.

### 1. **Price Source Disruption**

If elected, a Price Source Disruption will occur in the following circumstances:

**Price Source Unavailability** – if the Settlement Price from the Settlement Price Source is not published in respect of the Valuation Time prior the Valuation Observation Window (one hour after Valuation Time unless modified by parties).

**Price Source Discontinuance** – if (i) an unambiguous statement is issued by or on behalf of the Settlement Price Source Provider that it has ceased or will cease to provide the Settlement Price Source permanently or indefinitely so that a price will not be available at the Valuation Date and Time, **and** (ii) the Settlement Price Source Provider has not unambiguously designated a successor Settlement Price Source Provider.

**Price Source Material Change in Methodology** – if an unambiguous statement is issued by or on behalf the Settlement Price Source Provider that it will make a material change in the formula or method of calculating the price, or in the policy for pricing after a fork, or other material modifications, or if such changes have occurred. The determination of whether a Material Change in Methodology has occurred is

made by the Material Change Determining Party specified in the confirmation, not by the Calculation Agent.

In the event a Price Source Disruption has occurred the parties can apply the following fallback sequence:

**Fallback Settlement Price** – One or more fallback sources can be designated in the confirmation (a "**Replacement Fallback Settlement Price Source**"). The parties can designate valuation times and dates or rely on the defaults in the Settlement Price Source Matrix if the sources are included there. It is possible that the Fallback Valuation Date for a Replacement Fallback Settlement Price Source will be earlier than the original Valuation Date. If that is the case, the Valuation Date will be the next Scheduled Publication Date.

**Price Source Termination Event** – If elected in the confirmation, and no fallback source is available, either party can terminate the transaction.

**Calculation Agent Determination** -- if no fallback source is available and termination has not been elected in the confirmation or neither party decides to terminate, the Calculation Agent will make reasonable adjustments to the transaction to apply an alternative price source.

## **2. Hedging Disruptions**

**Hedging Disruption** - A party the ("**Hedging Party**") is unable, after using commercially reasonable efforts, to enter into, maintain or exit its hedge of a digital asset price risk (a "**Hedge Position**") or cannot freely deal with the proceeds of, or amounts connected with a Hedge Position.

**Increased Cost of Hedging** – There are materially increased amounts of tax, duty, expense or costs with regard to entering into, maintaining or exiting a Hedge Position or dealing with Hedge Position proceeds (but excluding brokerage commissions, income taxes and costs of returning airdropped cryptoassets). For a Hedging Disruption, the Hedging Party can elect to terminate the transaction. There are no other specified alternatives. For Increased Cost of Hedging, the Hedging Party may propose a price adjustment to the transaction. If the non-hedging party agrees, the transaction may be amended to reflect the price adjustment or the non-hedging party may make an upfront payment in lieu of a continuing price change. Otherwise, the transaction terminates.

## **3. Fork Disruptions**

Fork Disruptions are the only novel concepts in the Digital Definitions, as they are specific to virtual currency. Fork Disruptions may occur following a Fork Event. A Fork Event is defined in the Digital Definitions as follows:

*"A "**Fork Event**" means that, as a result of a Protocol Change in respect of the blockchain underlying a Reference Asset immediately prior to such Protocol Change (an "**Original Blockchain**"), two or more digital assets which are native to blockchains that emanate from the Original Blockchain (each a "**Successor Asset**") are available for trading simultaneously on one or more exchanges."*

The Digital Definitions provide that whether a Fork Event leads to a Fork Disruption will initially be determined by the Settlement Price Source Provider. If after a Fork Event the Price Source Provider either (i) states unambiguously that one of the prices it lists is the continuation of the Settlement Price Source specified by the parties or (ii) continues to provide one single price with respect to the Successor Asset, a "**Price Source Provider Determination Condition**" will have been met and therefore there will not be a Fork Disruption. However, if the Price Source Provider Determination Condition is not met, the Fork Determining Party (as determined by the parties) will determine that a Fork Disruption Event has occurred. Ideally both parties would be Fork Determining Parties. If the Fork Event has created inconsistencies in the transaction's terms concerning the Reference Asset, the price of the Reference Asset and the determination of the Settlement Price Source Provider, the Calculation Agent will propose appropriate amendments to the transaction and the parties agree to act in good faith to adopt them.

Otherwise, if a Fork Disruption Event has occurred and the Fork Determining Party has delivered a Fork Disruption Notice, the following fallbacks may be elected.

**Calculation Agent Fork Adjustment** - if elected in the confirmation, and the Calculation Agent determines that the transaction can continue on amended terms, the Calculation Agent will amend the terms of the transaction to designate the Reference Asset and Settlement Price Source, and related matters. Factors that the Calculation Agent may consider include the trading venues and price source providers, pricing behavior, trading volumes, transaction validation metrics and active wallet addresses for the Successor Assets. If the Calculation Agent determines that the transaction's terms cannot be adjusted, either party can provide a termination notice and the transaction will terminate.

**Fork Termination Event** - if elected in the confirmation and Calculation Agent Fork Adjustment is not elected and the Fork Determining Party determines that there is a Fork Disruption Event, either party may terminate the transaction.

#### **4. Change in Law**

**Performance Illegality** – It has become illegal for a party to perform its obligations under, or to be a party in, the transaction.

**Hedging Illegality** – It has become illegal or will become illegal for a party to enter into, maintain or exit its Hedge Position or to realize on the proceeds of or amounts connected with a Hedge Position. If a Change in Law Disruption Event is specified as applicable, the party affected by the Change in Law (the "**Change in Law Party**") determines whether a Change in Law Disruption Event has occurred and may give a termination notice to the other party. While a Change in Law includes changes in tax law, a Change in Law termination can only occur if the tax law change makes performance or hedging illegal, not merely more difficult or more costly. Note that the Master Agreement contains other provisions addressing tax law events.

**Transaction Early Termination** –The Digital Definitions also provide procedures for effecting an early termination of a transaction. Parties will specify in the confirmation for each Disruption Event that triggers an early termination whether valuations will be made at mid-market or on the side of one of the parties.

C. What is not addressed in the Digital Definitions

The Digital Definitions are currently silent as to credit support matters such as valuation of exposures and collateral, timing of collateral transfers and permitted collateral and haircuts. Existing ISDA credit support documentation may need to be carefully adapted to meet the special requirements of digital assets and consistency with the new Digital Definitions. Similarly, because the Digital Definitions only cover NDFs and NDOs, they only contemplate a single settlement date on termination or exercise with a single valuation from a single source made as of that date. The Digital Definitions do not deal with interim valuations or payments as would occur under a Credit Support Annex.

Questions regarding the Digital Definitions may be directed to GuyLaine Charles at [guylaine@charleslawpllc.com](mailto:guylaine@charleslawpllc.com) or Joseph Heyison at [joe@charleslawpllc.com](mailto:joe@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](mailto:castle@charleslawpllc.com).

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