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Managing Volatility in a Pandemic? Document your Derivatives Transactions Appropriately

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The emergence of the COVID-19 pandemic and the response of governments worldwide have resulted in market volatility unprecedented not only in its magnitude, but also in its reach across asset classes. While the natural result of such market turbulence has been to stifle (or at least pause) dealmaking and related financing activity in public and private company M&A, it has resulted in opportunities for market participants seeking to capitalize on either (or both) depressed asset prices and volatility itself by entering into derivatives transactions, including options and swaps.

There are a wide range of derivative transactions market participants might consider depending on their particular circumstances. For example, a fund holding a security or other asset may choose to sell or "write" a call option to its counterparty to increase the return on its holding of such security or asset. We also have seen publicly traded issuers employ another call option strategy, a "call spread" or "capped call" transaction[1] on a convertible note issuance, in order to protect shareholders against dilution of the issuer's earnings per share in the event that noteholders exercise their conversion right. Such a trade may prove especially attractive given expectations in certain industries that, given the current state of affairs, share prices can only trend upward. There are myriad other strategies a market participant might find attractive at this time, including entering into currency forwards to protect against the depreciation of foreign currencies against a party's reporting currency (where such party holds assets denominated in foreign currencies) or, depending on its position on volatility, entering into variance or volatility swaps.

Given the rapid pace at which markets are moving, it is tempting to execute such transactions on tight timelines and with as little documentation as possible (or in some cases, no documentation). However, parties to such trades should resist this urge. In not giving due consideration to the contractual terms underlying over-the-counter ("OTC") derivatives transactions, parties are potentially leaving critical negotiating points on the table and foregoing important protections that can reduce the risk profile of a trade.

Below are a few areas in which parties entering into OTC derivatives transactions might benefit from the proper documentation and negotiation of transaction terms. The topics covered below are by no means an exhaustive list, but are instead offered as examples of some of the issues parties to potential derivative transactions should consider.

1. Remedies for Events of Default and Similar Events

Nearly all OTC derivative transactions entered into are documented on confirmations referencing, and which are subject to, the 2002 or 1992 forms of Master Agreement published by the International Swaps and Derivatives Association, Inc.

[1] Such transactions, although documented differently, can be described generally as the concurrent (1) purchase of a call option on the shares into which a note is convertible with a strike price equal to the conversion rate of the notes and (2) sale of a call option on the shares with a higher strike price, each of which is exercisable upon conversion of the notes.

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("ISDA"). One of the key features of either form of the ISDA Master Agreement is its inclusion of standard Events of Default[2] and Termination Events[3] as well as a process by which, generally, the non-defaulting party (or non-affected party) can close out transactions governed by the ISDA Master Agreement upon the occurrence of such events and exercise various default remedies, including the ability to net and set off obligations across multiple transactions, if applicable.

Documenting a derivative transaction on a confirmation incorporating the standard close-out rights set forth in the ISDA Master Agreement can benefit parties on both sides of the transaction. For instance, a party that has failed to pay or perform under a transaction between the parties (and/or certain of their affiliates) will know how many days it has to cure such payment or performance failure.[4] In addition, the non-defaulting party can follow a clear procedure for exercising its close-out rights, which sets forth when it needs to serve notice to the defaulting party of the occurrence of such default and how many days it has to close out transactions under the ISDA Master Agreement.[5] Both parties can benefit from provisions detailing how terminated transactions will be netted and valued for the purpose of determining a payment by one party to the other upon close-out. Both parties can also benefit from the fact that ISDA has published netting opinions regarding the enforceability of the ISDA Master Agreement's termination and close-out netting provisions in at least 75 jurisdictions globally.

However, any party executing documentation for an OTC derivative, on ISDA forms or otherwise, should be careful to review and modify any close-out rights included in such documentation as necessary to make sure it accounts for the credit risk of its counterparty and the risk profile of the contemplated transaction(s). For instance, a party to a swap or other derivative transaction may want to address the credit risk of its counterparty by including an "Additional Termination Event" giving it a right to close out the transaction if at some point before maturity of the swap its counterparty fails to maintain a minimum credit rating for its senior unsecured long-term debt (if the counterparty is a bank or dealer) or its counterparty's net asset value declines by a certain amount (if the counterparty is a fund). As another example, a party to a "physically-settled" (see below) total return swap or option in which one party is required to deliver a security to the other party upon maturity of the swap (or exercise of the option) may want to include a close-

[2] "Events of Default" under the ISDA Master Agreement can be thought of as events affecting a party's ability to perform thereunder where such party is "at fault," and include the following events under both the 1992 and 2002 ISDA Master Agreements, as more fully described therein: "Failure to Pay"; "Breach of Agreement"; "Repudiation of Agreement"; "Credit Support Default"; "Misrepresentation"; "Default under Specified Transaction"; "Cross Default"; "Bankruptcy"; and "Merger Without Assumption."

[3] "Termination Events" generally include events where neither party is strictly "at fault" for non-performance and, in the 1992 ISDA Master Agreement include, as more fully described therein, "Illegality"; "Tax Event"; "Tax Event Upon Merger"; "Credit Event Upon Merger"; and any "Additional Termination Event" agreed by the parties. The 2002 ISDA Master Agreement contains an additional Termination Event not included in the 1992 form, "Force Majeure Event." Both the 1992 and 2002 forms of ISDA Master Agreement allow the parties to specify "Additional Termination Events" so that the parties can add close-out rights for events not contemplated by the ISDA Master Agreement, but that the parties consider relevant given the risk profile of the proposed transaction(s), creditworthiness of the parties or for legal or regulatory reasons.

[4] As an example, a party failing to make a payment or delivery under the 1992 ISDA Master Agreement has three Business Days to cure such failure upon receiving notice of such default.

[5] The non-defaulting party must generally provide notice to the other party of the occurrence of such default and then specify an "Early Termination Date" as of which all transactions under the ISDA Master Agreement will be terminated, which can be no more than 20 days from the date of such notice.

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out right if its counterparty comes into possession of material non-public information at or prior to settlement to mitigate insider trading concerns that may arise from delivery of the security under applicable law.

Regardless of the form used to document a derivative transaction, it is important for the parties to review and negotiate close-out rights carefully to make sure they adequately protect each party's interests.

2. Valuation and Settlement

Valuation and settlement methods for OTC derivatives come in many flavors and, depending on the reference asset, documenting and understanding the mechanics of valuation and settlement are critical to the economics of the transaction.

Pricing for derivatives referencing publicly traded securities is often based on the volume-weighted average price ("VWAP") of the underlying security on the relevant exchange or the price of such security at the open or close of trading for such security on the relevant exchange. The initial price for a swap (or, in the case of an option, the strike price) is typically determined by calculating the price of the underlying security over one or more pre-agreed trading days on or around the trade date. The final price of a swap (or, in the case of an option, the fair market value at exercise) is determined pursuant to a similar method for determining the price of the underlying security at or around the maturity of a swap (or, in the case of an option, upon exercise). Parties wishing to have their trades priced as of a particular date or time should be careful to review the valuation provisions of any trade documentation to ensure that the number of days over which the pricing is determined as well as the time at which it is determined aligns with the commercial understanding between the parties.

For derivatives referencing less liquid instruments, including loans and/or baskets of privately-placed-debt, the initial price is often more highly negotiated and pre-agreed. However, the process for determining the final price for such instruments typically needs to be specified in the trade confirmation. Some parties may prefer that the final price of a reference instrument be equal to, or determined by reference to, the arithmetic average of bids obtained from leading dealers in the underlying instrument. Others may want the price to be determined by a third-party valuation consultant or will even be comfortable relying on subjective language allowing one of the parties (usually the dealer or financial institution party to the transaction) to determine the final price, subject to a general duty to act in good faith and in a commercially reasonable manner.

Once the value of a trade is determined, parties may agree to settle performance of a trade in one or more ways. For many categories of OTC derivatives, settlement of the difference in value of the derivative since the trade date (or the last reset date) in cash in a pre-agreed currency (i.e., "cash settlement") is the only or preferred method of settlement.[6] However, for other transactions, such as forwards on G10 currencies or those referencing securities or loans, the parties will want to specify in the confirmation, or give one or both parties the right to elect, that the underlying reference asset be delivered at settlement (i.e., "physical settlement"). In such case, the party expecting delivery may require the party making delivery of the reference asset to covenant that it can do so free from any liens or other

[6] For example, this would be the case, generally, for vanilla interest rate swaps and credit default swaps.

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restrictions to resale, particularly under any applicable securities laws.[7] Such representations and warranties will need to be tailored to the applicable body of law governing the underlying reference asset.

3. Disruption Fallbacks

In addition to including and negotiating valuation and settlement mechanics in their derivatives trade documentation, parties should consider including fallbacks to account for the circumstance where a disruption in the normal functioning of the market or price source used to determine the price of the underlying asset makes it impossible or impracticable to value the underling asset. For many asset classes, parties seeking the benefit of such fallbacks may choose to incorporate and tailor in their trade documentation the various disruption fallbacks specified in ISDA's product definitions, including the 2002 ISDA Equity Derivatives Definitions, the 1998 FX and Currency Option Definitions and the 2005 ISDA Commodity Definitions, and/or other industry standard documentation such as the Emerging Markets Traders Association-recommended template terms for various currency pairs.

For example, the 2002 ISDA Equity Derivatives Definitions provide a mechanism by which trade valuation will be postponed if trading in a listed stock underlying a derivative is suspended on the relevant exchange, an event occurs that disrupts or impairs market participants' ability to effect transaction in or obtain market values for such shares or the relevant exchange closes less than an hour before its scheduled close. Often, parties will seek to modify or expand the definition of what constitutes a disruption to include any early closure (if trades are priced based on the VWAP of the underlying shares) or to include a "regulatory disruption event" for market disruptions that are the result of a change in applicable law or regulations. The inclusion of such a regulatory disruption event is particularly important where a party (typically the party establishing the hedge position) would rather postpone pricing than pursue an alternative remedy, such as valuing or terminating the trade based on a stale price.

As another example, by incorporating and making the appropriate elections under the 1998 ISDA FX and Currency Option Definitions, parties to foreign exchange derivatives can avail themselves of a wide range of fallbacks for determining the relevant currency exchange rate should it become impossible to obtain such rate, if such rate diverges materially from a secondary quotation agreed to by parties or if it generally becomes impossible for a party to perform its obligations under a transaction because of an event that has occurred in the jurisdiction of a reference currency.[8] In such cases, the parties may agree to, among other things, postpone the determination, specify a fallback rate or have one of the parties determine the relevant exchange rate.

4. General Legal and Other Considerations

In addition to the areas specified above, derivatives are subject to a wide body of regulation, which can differ greatly based upon the transaction type, the underlying asset and the jurisdiction of the parties to the transaction and of the issuer of the underlying asset. Such regulations typically set forth requirements relating to clearing, margining, reporting, recordkeeping and documentation of such derivatives, among others. For trades subject to U.S. regulation, one point to

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[7] One restriction under U.S. law would be, for instance, a restriction on transfer due to the applicable holding period not having been tolled under Rule 144 promulgated under the Securities Act of 1933.
[8] See, e.g., "Pricing Source Disruption," "Price Materiality" and "Material Change in Circumstance" under the 1998 ISDA FX and Currency Option Definitions.

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note is that, as it currently stands, there is significant divergence in the treatment of "swaps" subject to the U.S. Commodity Futures Trading Commission ("CFTC") regulation and "security-based swaps" and "securities" subject to the U.S. Securities and Exchange Commission's ("SEC") regulation. Parties to derivatives transactions should be sure to consult with counsel to determine the applicability of such requirements, which are subject to change as the SEC's swap regulatory regime is finalized and the CFTC continues to review and modify existing regulations.

There are other considerations relating to OTC derivatives transactions of which a party to such a transaction may want to be mindful. For example, a "long" party to a derivatives transaction expecting to receive delivery of an underlying asset may require that the "short" party pledge the asset as security for its obligation to deliver the asset upon maturity of the transaction. Such pledge may necessitate the opening of a separate control or custodial account and negotiation of separate pledge documentation. Entrance into a derivative may also necessitate a party's obtaining a waiver under existing debt, deal or constitutive documentation, to the extent entrance into the contemplated derivative is not currently permissible thereunder. Additionally, under mandatory minimum margin regulations adopted by U.S. and foreign regulators, most funds are required to exchange daily mark-to-market or "variation" margin with bank and dealer counterparties, and requirements to exchange initial margin are being phased in for some entities. Funds entering into derivative transactions that are subject to these rules need to have sufficient liquid assets and operational procedures in place to exchange margin on a daily basis.

Finally, a manager of a fund or any other investment vehicle with more than one investor interested in trading OTC derivatives must also consider whether it and related entities, as well as a manager of a separately managed account, need to register with the CFTC as a "commodity pool operator" or "commodity trading advisor" (or claim an exemption from such registration requirement) as a result of its derivatives trading activity. CFTC registrants are subject to a wide range of regulations governing, among other things, disclosure, reporting and recordkeeping. There are also a number of legal, regulatory and compliance obligations applicable to registered investment companies that must be carefully considered in connection with entering into derivative transactions.

5. Conclusion

Recent market volatility across asset classes has made certain derivative strategies attractive to market participants as a way to manage their risk and meet investment objectives. It may not be possible, however, to effect such strategies by entering into exchange-traded derivatives, and instead, such strategies would need to be implemented by entering into OTC derivatives transactions. In executing such transactions, parties should carefully consider documenting and negotiating the terms of such transactions to manage their credit and market risk. Parties entering into OTC derivatives should also be mindful of legal and other considerations that may arise by virtue of entering into such transactions.

Please contact Leigh Fraser, Isabel Dische, Anna Lawry, Deborah Monson, Molly Moore, Egan Cammack, Andrew Des Rault or the Ropes & Gray attorney who usually advises you if you have any questions in connection with the issues addressed above or would like advice on preparing, negotiating and reviewing derivatives trade documentation and related regulatory matters.

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