

July 19, 2007

## Using the 2006 ISDA Definitions – Is Now the Time?

At the beginning of this year, the International Swaps and Derivatives Association, Inc. (“ISDA”) announced the publication of the 2006 ISDA Definitions (the “2006 Definitions”), to be used in the documentation of interest rate and currency exchange transactions. The 2006 Definitions are intended to update and replace the terms and provisions set forth in the 2000 ISDA Definitions (the “2000 Definitions”).<sup>1</sup> New features in the 2006 Definitions include (i) eliminating the separate annex of rate options, (ii) amending and adding interest rate and currency options, (iii) amending and adding day count fraction definitions, and (iv) adding mark-to-market currency swap provisions and swaption straddle provisions. These and other changes are summarized under the attached “Overview of 2006 Definition Changes.”

On July 16, 2007, ISDA announced that the market remains on course for a “go live” date of July 30, 2007. This date was agreed to by ISDA’s Operations Interest Rate Products Working Group and was their target date for making the relevant systems and platform changes necessary to implement the new definitions. To date, many market participants have not chosen to document their interest rate and currency swap transactions using the 2006 Definitions and it is likely that many market participants will not be prepared to adopt the new definitions on the “go live” date. Such a delay in the implementation of new ISDA documentation, including updated versions of its various definitions, is not unusual as market participants take time to understand the documentation and evaluate its impact on existing, as well as future transactions.

Notwithstanding the foregoing, market participants should consider migration to the new definitions. We have recently seen a growing number of transactions and new ISDA Master Agreements incorporate the 2006 Definitions and it is likely this trend will continue following the “go live” date. It is inevitable that these definitions will eventually supersede the 2000 Definitions, if for no other reason than ISDA will no longer update the 2000 Definitions to reflect new reference rate sources, interest rates or currencies. While individual changes in the 2006 Definitions might not be dramatically significant to most market participants’ transactions, the aggregate impact could be significant since the definitions relate to transactions that make up the vast majority of the \$500 trillion derivatives market and their implementation will require changes to the systems that calculate, track and process derivatives payments.

Determining whether to incorporate the 2006 Definitions in Confirmations and ISDA Master Agreement Schedules may not be as difficult for future transactions because the 2006 Definitions merely update certain provisions of the 2000 Definitions and reflect what is now the market standard. **Most of the 2000 Definitions remain unchanged.** Documentation of this decision can either be made in the Confirmation relating to a particular transaction, in which case the 2006 Definitions should only apply to that specific

---

<sup>1</sup> While the 2006 Definitions and 2000 Definitions and their predecessor definitions are to be used primarily for interest rate and currency swap transactions, these definitions are also incorporated into Confirmations and ISDA Master Agreements for other types of transactions, e.g., FX, equity, commodity and credit derivatives transactions that use the other ISDA definitions specifically designed for such transactions to the extent necessary to address interest rate and currency terms not addressed in the other ISDA definitions.

transaction<sup>2</sup> or in an amendment to the Schedule, in which case the new 2006 Definitions would apply to all transactions under the ISDA Master Agreement. The amendment could also specify that only transactions entered into after the effective date of the amendment will be governed by the 2006 Definitions. Under either approach, the parties must be satisfied that they have made appropriate adjustments to their systems for calculating, tracking and processing payments. In cases where transactions are entered into for the purpose of hedging another financial or physical transaction, it may also be necessary to determine if adjustments required to conform to the new 2006 Definitions can be made to the transaction being hedged.

Market participants should also be aware that unless limited in the Confirmation or Schedule, standard language used to incorporate a particular set of definitions may indicate that the definitions are incorporated as “amended and supplemented” through the date the Confirmation is entered into by the parties. If particular amendments or supplements are not to be included, the parties must make this clear in the Schedule or Confirmation. We note there is an argument that Confirmations or Schedules incorporating the 2000 Definitions with language to the effect of “as amended, supplemented or superseded” allows a party to take the position that the 2006 Definitions, as an amendment or supplement to the 2000 Definitions, would apply to transactions effected since the new definitions were published, **even if the parties have not expressly decided to use the new definitions.**

It may be less appropriate to amend Confirmations or ISDA Master Agreements to incorporate the 2006 Definitions into existing transactions. Parties making this decision should carefully review their existing transactions using the 2000 Definitions (or the earlier 1991 ISDA Definitions) before a decision is made to change to the 2006 Definitions.<sup>3</sup> If it is determined that the 2006 Definitions should apply to outstanding interest rate and currency swap transactions for consistency or other reasons, a letter should be sent to counterparties expressly requesting such counterparties’ express acknowledgement that the 2006 Definitions are to apply to those transactions or the parties should enter into an agreement to amend the existing Master Agreement to reflect the incorporation of the 2006 Definitions.

## Overview of 2006 Definition Changes

### Consolidated Structure

The 2000 Definitions include a separate booklet, the Annex to the 2000 ISDA Definitions (the “Annex”), for certain definitions and provisions, including rate options and related provisions, that ISDA anticipated would need periodic updating. It was contemplated that amendments and supplements to the Annex would be published on ISDA’s website and periodically a new Annex would be published; however that never occurred. The 2006 Definitions contain no such Annex. All of the definitions and provisions

---

<sup>2</sup> While it is possible to amend an ISDA Master Agreement with respect to all transactions under the agreement through a Confirmation, such amendments are not the norm and, in some cases, are specifically prevented by the terms of the Schedule to the agreement.

<sup>3</sup> While it is less likely that the “amended, supplemented or superseded” language would cause the 2006 Definitions to apply to the terms of outstanding transactions, we often advise that the language included in the Schedule or Confirmation relating to the applicability of particular ISDA definitions indicate that an amendment, supplement or successor to such incorporated definitions shall not apply to transactions already entered into unless the parties expressly agree to have the amendment, supplement or successor provisions apply.

included in the 2006 Definitions are listed in the single 2006 Definitions booklet. Amendments and supplements will be published on the ISDA website.

As was the case with the 2000 Definitions, unless otherwise agreed to by the parties, a Confirmation or agreement incorporating the 2006 Definitions will be deemed to incorporate the 2006 Definitions as amended and supplemented through the date of the corresponding transaction. Therefore, if the parties wish to exclude any particular amendments or supplements, they must state in the Confirmation which amendments or supplements they wish to exclude or alternatively specify that the 2006 Definitions as amended and supplemented through a specific date will be incorporated into the Confirmation.

### Day Count Fractions

ISDA surveyed its membership on the usage of the day count fraction provisions in the 2000 Definitions to ensure that the 2006 Definitions would be in accordance with current market practice. In response to the feedback received from this survey, ISDA replaced the “Actual/365,” “Act/365” and “A/365” terms with “Actual/Actual (ISDA),” “Act/Act” and “Act/Act (ISDA),” as the survey suggested that the former terms were rarely used in current market practice and had been replaced with the latter terms. The substantive definition of these terms has not been changed in the 2006 Definitions.

An “Actual/Actual (ICMA)” or “Act/Act (ICMA)” definition has been added based on Rule 251 of the statutes, by-laws, rules and recommendations of the International Capital Market Association (the “ICMA”). A “30E/360 (ISDA)” definition has also been added, which is designed to yield the same results as the “30E/360” definition included in the 2000 Definitions. The “30E/360” day definition is retained in the 2006 Definitions but has been changed to reflect the formulation used by organizations such as the ICMA and the Fédération Bancaire Française, the Microsoft Excel spreadsheet software and certain financial software vendors.

### Mark-to-Market Currency Swap Provisions and the MTM Matrix for Mark-to-Market Currency Swaps

Article 10 of the 2006 Definitions includes definitions and provisions for mark-to-market currency swap transactions. Mark-to-market currency swap transactions involve two currencies in which one party is subject to a floating currency amount (the “Variable Currency Amount”) and the other party is subject to a fixed currency amount (the “Constant Currency Amount”). The Variable Currency Amount is adjusted periodically during the term of the transaction by reference to the then-prevailing currency exchange rate for the relevant currencies, and an amount is payable on each payment date by one party to the other based upon any such adjustment in the Variable Currency Amount, which amount is in addition to any Fixed and/or Floating Amount due. The 2006 Definitions include in an exhibit, the additional provisions to be used in a Confirmation of a mark-to-market currency swap transaction.

Additionally, ISDA has published the 2006 MTM Matrix for Mark-to-Market Currency Swaps (the “MTM Matrix”). The MTM Matrix will be deemed to apply to mark-to-market currency swaps that involve a currency pair that is included in the MTM Matrix and will set forth elections that the parties otherwise would need to include in the Confirmation for a transaction. However, parties may specify in the Confirmation that the MTM Matrix will not apply to a transaction. The MTM Matrix will allow ISDA to add dynamically to the reference rates, source pages and fixing dates and times for various currency pairs. The MTM Matrix is posted on ISDA’s website and new versions may be posted from time to time.

### Swaption Straddle Provisions

Article 11 of the 2006 Definitions incorporates the swaption straddle provisions that were previously published in a supplement to the 2000 Definitions. A swaption straddle is a swap transaction consisting of two swaptions, each with a different underlying swap. Under one of the underlying swaps, the buyer is the fixed rate payer (the “Underlying Payer Swap”) while under the other underlying swap, the buyer is the floating rate payer (the “Underlying Receiver Swap”). The 2006 Definitions further provide definitions for the exercise of a European, American and Bermuda style swaption straddle. Under the European style swaption straddle, the buyer may exercise either the Underlying Payer Swap or the Underlying Receiver Swap on the expiration date of the swaption straddle. Under an American or Bermuda style swaption straddle, if the buyer exercises either the Underlying Payer Swap or the Underlying Receiver Swap before the expiration date of the swaption straddle, the buyer may then exercise the other swap on a subsequent day up to and including the expiration date of the swaption straddle. An exhibit to the 2006 Definitions provides additional provisions to be used in a Confirmation of a swaption straddle.

### ISDA Settlement Matrix for Early Termination and Swaptions

Provisions relating to the ISDA Settlement Matrix for Early Termination and Swaptions (the “Settlement Matrix”) can be found in Article 19 of the 2006 Definitions. The matrix removes the need of the parties to specify certain terms within each Confirmation since terms would be incorporated by virtue of the inclusion of the ISDA Settlement Matrix. The Settlement Matrix was published in January of 2005 as a supplement to the 2000 Definitions and in order for the matrix to apply to a transaction, the parties had to include language in the Confirmation. Under the 2006 Definitions, the Settlement Matrix is deemed to apply to (i) transactions that feature early termination provisions and (ii) swaptions, in each case where they involve a currency that is included in the Settlement Matrix. Parties must specify in the Confirmation if they do not want the Settlement Matrix to apply to a transaction.

ISDA separately updated the Settlement Matrix for use with the 2006 Definitions and anticipates that it will be updated and/or expanded from time to time. Various versions of the matrix are available on the ISDA website. When parties enter into a transaction where the Settlement Matrix applies, the most recently published version will be deemed to apply. As is the case with amendments and supplements to the 2006 Definitions, the parties may agree to use an earlier version of the matrix in the Confirmation to the transaction.

### Rate Options

The 2006 Definitions have amended many of the rate option definitions that were contained in Section 7.1 of the 2000 Definitions. The disappearance of Telerate necessitated the revision of many definitions. The 2006 Definitions relating to individual rate options that reference screen-based rate sources refer to only one Information Vendor as there is only a need to provide for one authoritative source in the event of a dispute. However, multiple rate option definitions for certain floating rates, with each one referencing a different Information Vendor, have also been included in the 2006 Definitions to allow the parties to choose from a greater selection of Information Vendors. Under the 2006 Definitions, parties may obtain rate information from Information Vendors other than the sources listed in a specific rate option. However, in the event of a discrepancy between the Information Vendor used and the source referred to in the rate option definition, the source provided in the rate option definition will prevail.

### Additional Changes

In addition to the changes listed above, the 2006 Definitions incorporate a few additional changes. The 2006 Definitions incorporate the concept of “Arrears Setting” into the definition of “Reset Date” applicable to the floating amount payable by a party. Under the definition of Reset Date in Section 6.2(b)(i) of the

2006 Definitions, if Arrears Setting is specified for the swap transaction or a party, the Reset Date is the first day of the next following calculation period, or in the case of the final calculation period, the termination date. The 2006 Definitions also add the concept of “FRA Yield Discounting” and include a formula for calculating the FRA amount when FRA Yield Discounting is specified or deemed to be applicable. Finally, the 2006 Definitions simplify the determination of the settlement rate on the automatic exercise or fallback exercise of options.



*If you have any questions regarding this alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

James M. Cain	202.383.0180	<a href="mailto:james.cain@sablaw.com">james.cain@sablaw.com</a>
Warren N. Davis	202.383.0133	<a href="mailto:warren.davis@sablaw.com">warren.davis@sablaw.com</a>
William H. Hope II	404.853.8103	<a href="mailto:william.hope@sablaw.com">william.hope@sablaw.com</a>
Harlan E. Murphy	713.470.6109	<a href="mailto:harlan.murphy@sablaw.com">harlan.murphy@sablaw.com</a>
Robin J. Powers	212.389.5067	<a href="mailto:robin.powers@sablaw.com">robin.powers@sablaw.com</a>
Paul B. Turner	713.470.6105	<a href="mailto:paul.turner@sablaw.com">paul.turner@sablaw.com</a>