5-2-2002

An Introduction to the Documentation of OTC Derivatives

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May 2002

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I. TYPES OF DERIVATIVES TRANSACTIONS

The term "derivatives" today is used to refer to a vast array of privately negotiated over-the-counter ("OTC") and exchange traded transactions. Over the last decade, OTC derivatives transactions have grown to include not only interest rate and currency swaps, but also interest rate caps, collars and floors, swap options, commodity price swaps, equity swaps, credit derivatives, weather derivatives and other financial derivative products.

The chart below sets forth a representative list of the types of derivatives contracts and "derivative securities" that currently exist in the financial markets. The OTC derivatives contracts indicated in bold type are the primary subject of this paper.

Derivatives Contracts

Privately Negotiated (OTC) Forwards	***Privately Negotiated (OTC) Options***	*Exchange Traded Futures*	*Exchange Traded Options*
Forward Commodity Contracts	**Commodity Options** **Credit Derivatives**	Eurodollar (CME)	S&P Futures Options (Merc)
Forward Foreign Exchange Contracts	**Currency Options**	US Treasury Bond (CBT)	Bond Futures Options (LIFFE)
Forward Rate Agreements (FRAs)	**Equity Options**	9% British Gilt (LIFFE)	Corn Futures Options (CBT)
Currency Swaps	**FRA Options**	CAC-40 (MATIF)	Yen/$ Futures Options (IMM)
Interest Rate Swaps	**Caps, Floors, Collars**	DM/$ (IMM)	
Commodity Swaps	**Swap Options**	German Bund (DTB) *[now Eurex]*	
Equity Swaps	**Bond Options**	Gold (COMEX)	

Derivative Securities		
Structured Securities and Deposits	*Stripped Securities*	*Securities with Option Characteristics*
Dual Currency Bonds	Treasury Strips	Callable Bonds
Commodity-Linked Bonds	IO's and PO's	Putable Bonds
Yield Curve Notes		Convertible Securities
Equity-Linked Bank Deposits		Warrants

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II. DOCUMENTATION

A. Chronology of an OTC Derivative

1. ***The Oral Agreement and Terms Agreement.*** A typical OTC derivative transaction begins with a telephone call during which the basic economic terms of the transaction are established, together with any requirements for "credit support" (*e.g.*, collateral or margin, or a guarantee). The parties usually intend to be bound by the terms of the oral agreement.

One party (or a broker if one is involved) normally prepares and issues a letter or, at least historically, telex to the other party which sets forth the basic economic terms of the transaction established in the oral agreement and asks for a confirming reply. Many of these terms letters and telexes specifically state that they are intended to be binding agreements. The terms letter or telex, assuming it contains either all material terms or only the quantity term (depending upon the applicable "statute of frauds" (legislation requiring certain contracts, or certain terms of contracts, to be in writing)), should be enforceable against the party issuing it.

In transactions involving the provision of collateral consisting of securities (such as government bonds), it is not generally sufficient for the terms letter or telex to state that the party providing the collateral (the pledgor) intends to grant a security interest in the collateral to the party taking the benefit of the collateral (the secured party). The security interest generally also needs to be "perfected", which may require the transfer of the securities to the account or possession of the secured party or its agent.

2. ***Need for Superseding Documentation.*** Although most parties intend the initial exchanges of terms letters or telexes and confirmations to constitute binding agreements, these initial agreements typically do not contain all the noneconomic provisions that most parties require for arrangements that may last as long as 10 to 15 years. These initial agreements do not set the general ongoing legal and credit relationship between the parties. For example, the confirmation letter or telex often does not include provisions covering representations and warranties, covenants, events of default, liquidated damages, assignment, judgment currency, consent to jurisdiction and closing documents. Such letter or telex also does not contain express provisions for the netting of swap payment obligations. These provisions, together with provisions covering the economic terms of a transaction, are normally contained in the master swap agreement (such as that produced by ISDA as defined and discussed below) that incorporates the initial exchange of confirmation letters or telexes.

B. Development of Standard Documentation

Definitive OTC derivative documentation originally took the form of separate 15- to 25-page agreements for each transaction; however, since many provisions remained unchanged from one transaction to the next, parties soon began using master agreements with short one- or two-page supplements to set forth the economic terms of each transaction.

1. *Industry Organizations.* Additional streamlining of documentation has taken place as a result of the efforts by the industry trade association, the International Swaps and Derivatives Association, Inc. (originally the International Swap Dealers Association, Inc.) ("ISDA"). A group of 18 swap dealers and their counsel began work in 1984 to develop standard terms for interest rate swaps. In early 1985, ISDA was formed. ISDA currently includes over 550 members worldwide, including most major derivatives dealers and many large derivatives end-users, as well as associated service providers and consultants. One of its most important roles has always been to prepare standard documentation for use by participants in the OTC derivatives markets.

In June 1985, ISDA published the 1985 Edition of the Code of Standard Wording, Assumptions and Provisions for Swaps (the "Code"). An expanded 1986 Edition of the Code was published in September 1986. In the spring of 1987, ISDA went beyond providing standard terms and provisions when it published two suggested standard forms of master agreements for swaps (the "1987 ISDA Master Agreements"). One, entitled "Interest Rate Swap Agreement", is designed for U.S. dollar interest rate swaps; the second, entitled "Interest Rate and Currency Exchange Agreement", is designed for both single currency and multicurrency interest rate swaps and currency swaps (including U.S. dollar interest rate swaps). Also in 1987, ISDA published the 1987 Interest Rate and Currency Exchange Definitions (as further discussed below).[1] ISDA published standard form addenda to the 1987 ISDA Master Agreements in the spring of 1989 to facilitate their use for interest rate caps and floors and again in the summer of 1990 to facilitate their use for swap options. As discussed below, in 1991 ISDA completed an updated version of the Interest Rate and Currency Exchange Definitions, the 1991 ISDA Definitions.

In 1992 ISDA completed its next generation of documentation, including two new suggested standard forms of master agreements (the "1992 ISDA Master Agreements") for derivative products entitled the "Multicurrency—Cross Border" Master Agreement (the "Cross Border Agreement") and the "Local Currency—Single Jurisdiction" Master Agreement (the "Single Jurisdiction Agreement"). The 1992 ISDA Master Agreements are designed for derivative products such as interest rate swaps, currency swaps, commodity swaps, equity swaps, caps, collars and floors, currency options, foreign exchange transactions, equity and equity index options, commodity options and bond options (and options on the foregoing). ISDA also published the User's Guide to the 1992 ISDA Master Agreements (1993 edition) (the "User's Guide"). The User's Guide has since been translated into the Mandarin, Japanese and Spanish languages.

In October 2001, following a comprehensive review of certain aspects of the 1992 ISDA Master Agreements, ISDA published various suggested amendments to the agreements. These amendments were attached to a Form of Amendment Agreement.[2] The Form of Amendment Agreement was designed to

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[1] ISDA's definitional booklets are discussed in Section 3 of this paper. By providing certain standard definitions and provisions, they enable parties to streamline the documentation of the economic terms of individual transactions under a master agreement.

[2] Available on ISDA's website, www.isda.org.

enable parties that wished to adopt any or all of the suggested amendments to do so bilaterally. At the date of this paper, building on the review completed in October 2001, ISDA is in the process of developing a new 2002 form of master agreement.

Also in 1992 ISDA produced market-specific definitional booklets (see further Section 3 below), including the 1992 ISDA FX and Currency Option Definitions and the 1992 ISDA U.S. Municipal Counterparty Definitions.[3] In 1998, ISDA (together with the Emerging Markets Traders Association and The Foreign Exchange Committee) published the 1998 FX and Currency Option Definitions, which expand the 1992 FX and Currency Option Definitions to cover a much wider range of currencies and transactions. In 1999, ISDA published a User's Guide to the 1998 FX and Currency Option Definitions. In 2000, ISDA published a revised Annex A to the 1998 FX and Currency Option Definitions, containing updated currency and currency spot rate definitions.

In the area of equity derivatives, ISDA published, again in 1992, a standard long-form confirmation for OTC equity index option transactions, followed, in 1994, by a standard long-form confirmation for single share option transactions that are physically settled.[4] In early 1995, ISDA published the 1994 ISDA Equity Option Definitions, which includes standard short-form confirmations for equity index options and single share option transactions that are physically settled. Finally, in 1996, ISDA published the 1996 ISDA Equity Derivatives Definitions.[5]

In the area of commodity derivatives, ISDA has published the 1993 ISDA Commodity Derivatives Definitions, and updated those definitions through the 2000 Supplement to the 1993 ISDA Commodity Derivatives Definitions.

In addition, ISDA followed the publication of a standard long-form confirmation for OTC bond options (in 1993) with the publication of the 1997 ISDA Government Bond Option Definitions, which includes a standard short-form confirmation for a government bond option transaction. Also in 1997, ISDA published the 1997 ISDA Bullion Definitions.

The most recent type of privately negotiated derivatives transaction to be the subject of a set of ISDA definitions is the credit default swap. In 1999, ISDA published the 1999 ISDA Credit Derivatives Definitions and, in 2001, it published three supplements to these definitions.[6]

Attached as **Appendix I** is a chart illustrating the history of ISDA documentation to date.

Generally speaking, the 1992 ISDA Master Agreements and related documentation are designed, among other things, to facilitate cross-product netting and allow parties to document all derivative transactions under a single master agreement.

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[3] ISDA also produced a tailored schedule to be used with the Single Jurisdiction Agreement for transactions with U.S. government entities.

[4] A long-form confirmation is a confirmation that itself sets out, in full, all the terms and provisions applicable to a transaction. In contrast, a short-form confirmation is a confirmation that incorporates (and relies upon) one or more sets of ISDA definitions (*see* further Section 3 of this paper).

[5] At the date of this paper, a review of the 1996 ISDA Equity Derivatives Definitions is in progress.

[6] At the date of this paper, a review of the 1999 ISDA Credit Derivatives Definitions is in progress.

Independent from the ISDA process, the British Bankers' Association, at the urging of the Bank of England, established standard terms for London interbank swap transactions with maturities of two years or less; and groups in other jurisdictions, including Australia, France and Hong Kong, have issued standard terms or standard form agreements for swaps denominated in the local currency.

In September 1990, the Australian Financial Markets Association published a guide to using the 1987 ISDA Master Agreements under Australian law; this guide has been updated to keep abreast of developments in derivative products and has been revised to address the use of the 1992 ISDA Master Agreements. The Australian law firm of Mallesons Stephen Jaques drafted the guide, and ISDA made contributions to its preparation. The guide sets forth a few provisions that should be added to schedules to the 1987 ISDA Master Agreements and the 1992 ISDA Master Agreements to ensure that swaps and swap-related transactions thereunder will be enforceable under Australian law and that the netting provisions in the 1987 ISDA Master Agreements and the 1992 ISDA Master Agreements will be applicable thereto. A similar guide exists for ISDA Master Agreements subject to New Zealand law.

In 1999, in cooperation with ISDA, the Hungarian Forex Association published a standard Supplement (the Hungarian Forex Association Supplement to the 1992 ISDA Master Agreements) for use with a 1992 ISDA Master Agreement that is entered into by at least one party organised or resident in Hungary. It also published a set of definitions (the 1999 Hungarian Forex Association Definitions) for use in documenting individual transactions that involve the Hungarian Forint or any other relevant Hungarian underlying cash market.

Market participants in the Czech Republic are looking at developing similar documentation.

2. *How the 1992 ISDA Master Agreements Work.* The Cross Border Agreement and the Single Jurisdiction Agreement were published in June 1992 by ISDA.[7] Set forth below is a general description of how the relevant provisions of the 1992 ISDA Master Agreements operate.

The 1992 ISDA Master Agreements state that the parties have entered or will enter into one or more transactions with each other from time to time and will execute and exchange a document or other confirming evidence (each a "Confirmation") setting forth the particular terms of each transaction.

The 1992 ISDA Master Agreements also state that the parties enter into transactions in reliance on the fact that each 1992 ISDA Master Agreement and Confirmations relating thereto form a single agreement between the parties and the parties would not otherwise enter into any transactions. *See* Section l(c) of the 1992 ISDA Master Agreements. The 1992 ISDA Master Agreements provide that each Confirmation is a binding supplement to the 1992 ISDA Master Agreement. *See* Section 9(e)(ii) of the Cross Border Agreement and Section 8(e)(ii) of the Single Jurisdiction Agreement.

The 1992 ISDA Master Agreements provide that on each payment date all amounts otherwise owing in the same currency under the same transaction are netted so that only a single amount is owed in that currency. The 1992 ISDA Master Agreements also provide, if the parties so elect, for such netting of

[7] The Single Jurisdiction Agreement is designed to be used for transactions in a single currency between two parties organised or operating out of the same jurisdiction. The Cross Border Agreement is designed to be used for transactions in any currency between two parties irrespective of their jurisdiction or organisation. Both 1992 ISDA Master Agreements may be governed by either New York law or English law as the parties elect. Apart from differences relating to the multicurrency and cross border aspects of the Cross Border Agreement (such as provisions relating to withholding tax), the two 1992 ISDA Master Agreements are essentially the same in substance.

amounts in the same currency among all transactions identified as being subject to such election that have common payment dates and booking offices. *See* Section 2 of the 1992 ISDA Master Agreements. The obligation of each party to make scheduled payments or deliveries with respect to the transactions is subject to the conditions that (i) no event of default in respect of the other party (including, without limitation, a payment or delivery default) shall have occurred and be continuing, and (ii) no early termination date shall have occurred or been designated. *See* Section 2(a) of the 1992 ISDA Master Agreements. The failure by a party to make a payment or delivery with respect to any transaction constitutes an event of default under the 1992 ISDA Master Agreements as it relates to all transactions. *See* Section 5(a)(i) of the 1992 ISDA Master Agreements. Also, the default-based termination of any other specified derivative agreements between the parties constitutes an event of default under the 1992 ISDA Master Agreements. *See* Section 5(a)(v) of the 1992 ISDA Master Agreements.

The 1992 ISDA Master Agreements permit, in most cases, the designation of an early termination date following the occurrence of an event of default or termination event specified in the 1992 ISDA Master Agreements. The 1992 ISDA Master Agreements provide that, in such case, no further scheduled payments and deliveries in respect of the transactions will be required to be made. In addition, the 1992 ISDA Master Agreements provide that, in the case of a default based termination, the designated early termination date will be the early termination date for all transactions. *See* Section 6 of the 1992 ISDA Master Agreements.[8] The 1992 ISDA Master Agreements allow parties to elect, at the time they enter into a 1992 ISDA Master Agreement, for all the outstanding transactions under the 1992 ISDA Master Agreements to terminate automatically upon certain insolvency events, instead of requiring the nondefaulting party to designate an early termination date.

In the event of a default based termination, the 1992 ISDA Master Agreements provide for a lump sum amount (reflecting the positive or negative values of all transactions) to be calculated in connection with an early termination date (commonly referred to as "close-out netting"). *See* Section 6 of the 1992 ISDA Master Agreements. The 1992 ISDA Master Agreements contain alternatives for calculating this lump-sum amount upon early termination, which the parties elect at the time they enter into a 1992 ISDA Master Agreement.

First, the 1992 ISDA Master Agreements require the parties to elect a payment measure based upon Market Quotation (market values of the terminated transactions based upon the parties' future scheduled payment or delivery obligations) or Loss (a general indemnity). If the parties elect Market Quotation, the lump-sum amount includes (i) all Unpaid Amounts (amounts which were or would have been due prior to termination) relating to the transactions and (ii) an amount that reflects the netting of positive (*i.e.*, each amount that would be payable by the nondefaulting party to replace transactions under then-current market conditions) and negative (*i.e.*, each amount that would be received by the nondefaulting party to replace transactions under then-current market conditions) Market Quotations. As a result of such netting, the defaulting party is given credit for such negative market value of any transaction under which it would (absent the existence of an event of default or potential event of default under the 1992 ISDA Master Agreements) have then been entitled to receive payments from the nondefaulting party, even though the nondefaulting party would not, by virtue of the conditional payment obligation provisions set forth in the 1992 ISDA Master Agreements, otherwise have been obligated to make such payments. If

[8] If an early termination date is designated as the result of the occurrence of an event of default or a decline in the credit quality of a party following the occurrence of certain merger-related events, all transactions under the 1992 ISDA Master Agreements terminate. In the unlikely event, however, that an early termination date is designated as a result of the occurrence of certain events relating to the imposition of withholding taxes or a change in law as a result of which a counterparty’s performance becomes illegal, only the transactions affected by such events terminate.

the parties elect Loss, then any payment upon termination will be equal to the nondefaulting party's total net losses and costs (or gains, in which case expressed as a negative number) under the 1992 ISDA Master Agreements as a result of termination.[9]

Second, the 1992 ISDA Master Agreements also require the parties to elect between the "First Method" of calculating termination payments and the "Second Method". Under the First Method, in the case of an event of default, if the lump-sum termination amount is positive, then it is paid by the defaulting party to the nondefaulting party, but, if it is negative, then no payment is due: the nondefaulting party is not required to make a termination payment to the defaulting party after an event of default. Under the Second Method, if the lump-sum termination amount is a positive number, then the defaulting party will pay it to the nondefaulting party; if that amount is a negative number, then the nondefaulting party will pay the absolute value of that number to the defaulting party.[10]

3. *Definitions*. A wide range of ISDA definitional booklets has been published to provide parties with a means of streamlining the documentation of the economic terms of individual transactions. By incorporating one or more relevant sets of definitions into the confirmation for a particular transaction, the parties are able to use standard shorthand terms in the confirmation (those terms being defined in the applicable definitional booklet(s)). The definitional booklets also provide various standard operational provisions, so the parties do not need to set these out in full in the confirmation. Such a confirmation is thus described as a "short-form" confirmation.

As mentioned above, in connection with the development of the Interest Rate and Currency Exchange Agreement, ISDA published the Interest Rate and Currency Exchange Definitions, which contain a set of floating rate indices, developed by ISDA, in 15 currencies and set forth the mechanics for specifying these rates, together with other mechanical provisions for establishing fixed and floating amounts under the Interest Rate and Currency Exchange Agreement. In April 1991, ISDA published the 1991 ISDA Definitions which, among other things, added new floating rate indices and five new currency definitions. Essentially, both the Interest Rate and Currency Exchange Definitions and the 1991 ISDA Definitions consist of Articles of the Code, expanded to include multicurrency rates and provisions. The 1991 ISDA Definitions also include definitions relating to commodity and other price swap transactions and currency option transactions. In 1998, ISDA published the 1998 Supplement to the 1991 ISDA Definitions, which updated certain parts of the 1991 ISDA Definitions and included certain new provisions. Also in 1998, ISDA published the 1998 Euro Definitions, which were developed to assist in the smooth and efficient functioning of the financial markets (and, in particular, the OTC derivatives markets) as the euro was introduced in participating member states of the European Union.

In addition to these sets of definitions, ISDA has published the following sets of definitions for use in documenting specific types of derivatives transactions (some of them are now out of date):

- 1992 ISDA FX and Currency Option Definitions
- 1993 ISDA Commodity Derivatives Definitions (plus 2000 Supplement)
- 1994 ISDA Equity Option Definitions
- 1996 ISDA Equity Derivatives Definitions

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[9] One of the optional amendments published in 2001 provides an alternative payment measure: "Replacement Value". *See* the October 2001 Form of Amendment to the 1992 ISDA Master Agreements, available on ISDA's website, www.isda.org. Payment measures are being reviewed again as part of the process to develop the 2002 form of master agreement.

[10] The First Method, which is today rarely used, is not likely to be included in the 2002 form of master agreement.

- 1997 ISDA Bullion Definitions (long-form and short-form)
- 1997 ISDA Government Bond Option Definitions
- 1998 FX and Currency Option Definitions[11] (plus revised Annex A)
- 1999 ISDA Credit Derivatives Definitions (plus supplements)

In July 2000, ISDA published the 2000 ISDA Definitions. These definitions represent the result of a thorough review of the 1991 ISDA Definitions and the 1998 Supplement. One of the major changes is that, in light of the publication by ISDA of various product-specific definitions as set forth above, the 2000 ISDA Definitions are more specifically drafted for use in documenting interest rate and currency derivatives transactions. For example, they no longer contain provisions relating to equity indices or commodity prices.

Finally, as noted above, ISDA has also published a separate set of definitions for use in documenting transactions with U.S. governmental entities: the 1992 ISDA U.S. Municipal Counterparty Definitions.

4. *Mark-to-Market Credit Support Documents*. In 1994, ISDA published a standard form mark-to-market collateral document (or "credit support document") (the "New York Credit Support Annex") to be used to document bilateral security arrangements between counterparties for transactions documented under ISDA Master Agreements (1987 or 1992) that select New York law as the governing law and provide that collateral will be located in New York, so that New York law governs questions of perfection and the priority of competing interests in the collateral. The New York Credit Support Annex is intended to supplement and form part of the ISDA Master Agreement to which it relates as a "Credit Support Document" thereunder. ISDA has also published a user's guide to the New York Credit Support Annex (User's Guide to the 1994 ISDA Credit Support Annex) that describes the variables used and elections that can be made in the New York Credit Support Annex.

ISDA has also published two credit support documents governed by English law to be used in connection with collateral held in England. The "Credit Support Deed" permits a pledge of collateral, while the English law "Credit Support Annex" contemplates the transfer of collateral with related set-off provisions. In 1999, ISDA published a user's guide to the two English law documents (User's Guide to the ISDA Credit Support Documents under English Law). ISDA has also published a Credit Support Annex subject to Japanese law, which is used primarily by counterparties in Japan.

In 2001, ISDA published the 2001 ISDA Margin Provisions. This new document is intended to replace the existing forms of credit support documents. It includes, in one document, both operational provisions and jurisdiction-specific provisions that allow the parties to apply one governing law to the whole or part of the arrangement between them (New York law or English law). It also incorporates Japanese law provisions for limited purposes. The new document is more practitioner-oriented than the existing documentation, and follows a "plain English" approach. The new document also represents a change in architecture in that it applies short-form confirmation architecture to ISDA's credit support documentation.

The chart attached as **Appendix II** illustrates the current structure of the standard form documentation produced by ISDA.

[11] Published by ISDA, the Emerging Markets Traders Association and The FX Committee.

III. SOME DEFINITIONS

For purposes of distinguishing different types of privately negotiated derivatives, the following definitions generally apply:

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional rate and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (*e.g.*, WTI Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Equity or Equity Index Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) shares of an issuer or a basket of shares of several issuers at a specified strike price. The option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, whether sovereign or non-sovereign, at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Foreign Exchange Transaction. A transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap).

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor) or a specified price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate or floating commodity price payer on the cap and the other party is the floating rate or floating commodity price payer on the floor.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Credit Protection Transaction.[12] A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and

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[12] Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity") upon the occurrence of one or more specified credit events with respect to the Reference Entity (*e.g.,* bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a "basket" of two or more Reference Entities.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a "spot" or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (*e.g.,* Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, "Bullion" means gold, silver, platinum or palladium and "Ounce" means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce.

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

ALLEN & OVERY
May 2002

This paper does not constitute legal advice and should not be relied upon as such.