

Practice Notes to the 2005 BARRIER OPTION SUPPLEMENT to the 1998 FX and Currency Option Definitions

The *2005 Barrier Option Supplement to the 1998 FX and Currency Option Definitions* (“Supplement”) is being published by the Foreign Exchange Committee (FXC) with the support of the Financial Markets Lawyers Group (FMLG) and the Supplement’s cosponsors, the International Swaps and Derivatives Association, Inc. (ISDA) and EMTA, Inc. (EMTA). The FXC published confirmation templates in September 2000 that can be used to document knock-in/knock-out barrier options and binary options under the *1998 FX and Currency Option Definitions* published by ISDA, EMTA, and the FXC (“1998 Definitions”). The Supplement is intended to supersede and update these confirmations by amending the 1998 Definitions to provide terms for various types of Barrier and Binary Currency Option Transactions (hereinafter, “Barrier Options” and “Binary Options,” respectively). Specifically, the Supplement contains terms that can be used to confirm single and double knock-in and knock-out Barrier Options (deliverable or non-deliverable) and single and double no-touch and one-touch Binary Options. The Exhibits to the Supplement illustrate how these Barrier and Binary Options may be confirmed under the terms of the Supplement and the 1998 Definitions. Nonetheless, the Supplement’s terms are flexible and allow for the confirmation of other types of Barrier and Binary Options.

These practice notes provide an explanation of terms in the Supplement. All capitalized words in these practice notes have the meanings given to them in the 1998 Definitions or Supplement, unless otherwise specified herein.



Section 1.6(d):

Currency Pair

The definition of Currency Pair in the 1998 Definitions covers Deliverable FX Transactions (Section 1.6(a)), Non-Deliverable FX Transactions with a Reference Currency and Settlement Currency (Section 1.6(b)), and Currency Option Transactions with a Put Currency and a Call Currency (Section 1.6(c)). While Section 1.6(c) specifies the Currency Pair for a Barrier Option, none of these definitions applies to a Binary Option. The Supplement adds Section 1.6(d), which provides that the Currency Pair for a Binary Option means the currencies specified as applicable to the Barrier Level in the related Confirmation.

Section 1.16(a):

Rate Calculation Date

The definition of Rate Calculation Date in Section 1.16(a) of the 1998 Definitions is revised to include a Barrier Event Determination Date. This amendment is intended to facilitate the use of a Settlement Rate Option from Annex A of the 1998 Definitions for purposes of defining a Barrier Event Rate Source used to determine whether a Barrier Event has occurred. That is, each Settlement Rate Option in Annex A provides the Spot Rate for a Rate Calculation Date for purposes of valuing a Non-Deliverable Transaction. By specifying that the Rate Calculation Date also includes a Barrier Event Determination Date, the Spot Rate also can be used for purposes of determining whether a Barrier Event has occurred. For further discussion of discrete Barrier Options and Binary Options, see Section 3.9(d) below.

Section 3.1(h):

Barrier Determination Agent

Section 3.9(l):

Notification of Barrier Event

Barrier Determination Agent is a new term. Presumptively, the Barrier Determination Agent is the Calculation Agent, unless the parties specify otherwise in the related Confirmation. The parties may agree that a third party will serve as Barrier Determination Agent. A Barrier Determination Agent determines whether a Barrier Event has occurred in good faith and in a commercially reasonable manner (see Section 3.9(b)). A Barrier Determination Agent's notice that a Barrier Event has occurred is to be provided pursuant to Section 3.9(l), which addresses the methods by which notice may be provided. Although master agreements have provisions that specify how notices may be sent as a general matter, Section 3.9(l) contains at least one limitation, that facsimile transmissions should be acknowledged by the receiving party. This limitation is intended to ensure that the receiving party is aware of the fact that the Barrier Determination Agent has sent a notice that a Barrier Event has occurred.

Section 3.3:

Option Type

Sections 3.3(c) and 3.3(d) provide definitions of the Barrier Option and Binary Option types of Currency Option Transactions. A Barrier Currency Option Transaction changes terms upon the occurrence or non-occurrence of a Barrier Event, as the case may be, in the manner defined in the Event Type specified in the related Confirmation (subject to any applicable condition precedent or provision of Article 5



of the 1998 Definitions). A Binary Option is a type of Barrier Currency Option Transaction that changes its terms in a specific way upon the occurrence or non-occurrence of a Barrier Event—the Buyer would become entitled to receive from the Seller a Settlement Amount in the manner defined in the Event Type specified in the related Confirmation (subject to any applicable condition precedent or provision of Article 5 of the Definitions).

Section 3.4(c):

Premium Payment Refund

Section 3.4(a) of the 1998 Definitions provides that a Buyer is obligated to pay the Seller a Premium on the Premium Payment Date. Section 3.4(c) is added to make clear that a Premium is not refundable or rebatable. This presumption applies unless the parties specify otherwise in the related Confirmation; for example, parties may wish to document certain reverse knock-out options in which the premium is rebated.

Section 3.7(c):

In-the-Money Amount

Section 3.7(c)(iii) provides that the In-the-Money Amount of a Binary Option will be the Settlement Amount specified in the related Confirmation.

Section 3.9(a):

Automatic Termination

Section 3.9(a) defines Automatic Termination for purposes of specifying that, when a Barrier Event in accordance with the Event Type applicable to a Barrier Option occurs or fails to occur, as the case may be (see the Event

Types in Section 3.9(f)(i)-(viii)), the Barrier Option will terminate and be deemed canceled effective on the date specified for such termination in the related Confirmation, or otherwise in accordance with the Event Type, without payment of any settlement amount, breakage costs, or other amounts representing the future value of the Transaction.

Section 3.9(b):

Barrier Event

The definition of Barrier Event in Section 3.9(b) recognizes that the Event Types specified in Section 3.9(f) are not exclusive, and the parties may agree to other Event Types in the related Confirmation. This definition provides flexibility to confirm different Barrier and Binary Option products under the terms of the Supplement and the 1998 Definitions.

Section 3.9(c):

Barrier Event Determination Date

Section 3.9(d):

Barrier Event Rate Source

Section 3.9(n):

Spot Exchange Rate

Section 3.9(p):

“ Spot Market ”

The two parts of the definition of Barrier Event Determination Date in Section 3.9(c) and of the definition of Spot Exchange Rate in Section 3.9(n) correspond to two types of Barrier or Binary Options—discrete or non-discrete—that may be documented.

A discrete option uses a specific rate source for purposes of determining whether a Barrier Event has occurred. Section 3.9(d) provides that such a rate source specified in the



related Confirmation is the Barrier Event Rate Source. For example, for a discrete Barrier Option, the parties may specify a reference rate for a major G-10 currency (which would need to be defined in the related Confirmation). For a discrete Barrier Option in an emerging market currency, the parties may specify that a Settlement Rate Option from Annex A of the 1998 Definitions (which ordinarily is used for purposes of determining the value of a Non-Deliverable Transaction) is the Barrier Event Rate Source. Section 3.9(c)(i) provides that a Barrier Event Determination Date for a discrete option is “any day in the Event Period on which the Barrier Event Rate Source should be and is available.” Section 3.9(n)(i) provides that, for a discrete option, the Spot Exchange Rate used for purposes of determining whether a Barrier Event has occurred is the Spot Rate based on the price for a foreign exchange transaction involving the Currency Pair (or cross-rates constituting such Currency Pair) as determined on each Barrier Event Determination Date in accordance with the Barrier Event Rate Source.

A Barrier Event Rate Source should not be available on a day that is not a local business day where the Settlement Rate Option for the particular currency is published; for example, a day that is a Saturday, Sunday, or scheduled holiday in a local market as of the Trade Date. Accordingly, such a day would not be a Barrier Event Determination Date. However, there is a risk that, because of an unscheduled holiday or other unforeseen circumstances as of the Trade Date, a Barrier Event Rate Source may not be available on a particular day during an Event Period when it otherwise should have been available. In such an event, the market practice has been to continue to treat that day as a

Barrier Event Determination Date and seek a rate in the Spot Market where there is sufficient liquidity. Section 3.9(c)(ii) takes this approach by providing that, in the event the Barrier Event Rate Source is not available on a day that otherwise would have been a Barrier Event Determination Date, that day still will be a Barrier Event Determination Date if a Spot Exchange Rate may be determined pursuant to Section 3.9(n)(ii). The fallback on any day(s) during the Event Period that present such circumstances will be the Spot Exchange Rate determined pursuant to Section 3.9(n)(ii).

On the other hand, a non-discrete or “spot market” Barrier Option does not have Barrier Events that are determined by reference to a specific rate source. Accordingly, the existence of a Barrier Event Determination Date in Section 3.9(c)(ii) of the Supplement is not conditioned on the availability of a particular Barrier Event Rate Source. Section 3.9(n)(ii) specifies that the Spot Exchange Rate for purposes of determining whether a Barrier Event has occurred will be the Spot Rate that is based on the price for one or more actual foreign exchange transactions in the Spot Market involving the Currency Pair (or cross-rates constituting such Currency Pair) for settlement in accordance with the convention for the Currency Pair, as determined on each Barrier Event Determination Date in good faith and in a commercially reasonable manner by the Barrier Determination Agent. Section 3.9(c)(ii), together with Section 3.9(n)(ii) and Section 3.9(p), which defines Spot Market, provide that a non-discrete Barrier Option’s Barrier Event Determination Date can occur on any day in the Event Period during which the global spot foreign exchange market is open continuously



from 5:00 a.m. Sydney time on a Monday in any week to 5:00 p.m. New York time on the Friday of that week.

In the case of either a discrete or non-discrete option, parties may decide to provide in the related Confirmation that the Barrier Event Determination Date will take place on certain days within the Event Period; for example, on Wednesday of each week during the Event Period. Section 3.9(c) allows for such limitations. If no such limitations are specified, a Barrier Event Determination Date can be any day in the Event Period that meets the applicable requirements of Section 3.9(c).

Section 3.9(e):
Barrier Level

Section 3.9(f):
Event Type

Section 3.9(k):
Lower Barrier Level

Section 3.9(o):
Spot Exchange Rate Direction

Section 3.9(q):
Upper Barrier Level

Section 3.9(f) sets out each Event Type that constitutes a Barrier Event applicable to a Transaction when the relevant Event Type is specified in the related Confirmation. The Event Types in Section 3.9(f) may be used to confirm single and double knock-out and knock-in Barrier Options, as well as single and double no-touch and one-touch Binary Options. In addition, an Event Type that does not appear in Section 3.9(f) may be defined in the related Confirmation for a Barrier or Binary Option that does not fall within this set of products.

The Event Types use the terms Barrier Level defined in Section 3.9(e), Upper and Lower Barrier Level defined in Sections 3.9(q) and 3.9(k), and Spot Exchange Rate Direction defined in Section 3.9(o). The Spot Exchange Rate Direction specified in the related Confirmation is used to determine whether a Barrier Event has occurred by requiring that the Spot Exchange Rate must touch or cross the Barrier Level from a certain direction. If the Confirmation specifies that the Spot Exchange Rate Direction is “Greater than or equal to the Barrier Level,” the Spot Exchange rate must start lower than and then reach or exceed the Barrier Level. Conversely, if the Confirmation specifies that the Spot Exchange Rate Direction is “Less than or equal to the Barrier Level,” the Spot Exchange Rate must start greater than and then reach or fall below the Barrier Level. An Initial Spot Price may be specified in the related Confirmation for purposes of determining the direction from which the Spot Exchange Rate has crossed the Barrier Level, although an Initial Spot Price is an optional provision.

The following example illustrates how Spot Exchange Rate Direction works. If a Transaction provides for (1) the occurrence of a Barrier Event upon the Spot Exchange Rate reaching 102.00 JPY/USD, (2) an Event Period which commences on the Trade Date and ends on the Expiration Date, and (3) a Spot Exchange Rate Direction of “Greater than or equal to the Barrier Level,” the Spot Exchange Rate would have to have been at a number less than 102.00 JPY/USD (i.e., 101.999999 JPY/USD or lower) prior to breaching the Barrier Level and reach a number equal to or greater than 102.00 JPY/USD in order for a



Barrier Event to be deemed to have occurred. In this example, if the Spot Exchange Rate never reaches a number equal to or greater than 102.00 JPY/USD (i.e., remains less than 102.00 JPY/USD), a Barrier Event would be deemed not to have occurred. However, if the Spot Exchange Rate in this example began and remained at a number greater than or equal to 102.00 JPY/USD, a Barrier Event would be deemed not to have occurred upon the rate touching 102.00 JPY/USD. In this latter case, the Spot Exchange Rate would first have to descend below, and then ascend to or exceed, the Barrier Level in order for a Barrier Event to be deemed to have occurred.

When specifying the exchange rates relating to the Barrier Level(s) and the Initial Spot Price (if included) in the related Confirmation, it is important to use a consistent convention for the relevant Currency Pair. Use of a consistent convention will make it possible to compare the Spot Exchange Rate to the Barrier Level(s) and determine whether the Spot Exchange Rate has reached or crossed the Barrier Level(s) based on the Spot Exchange Rate Direction. The “Currency Pair Matrix” in Attachment 1 to these Practice Notes has been provided as a best practice to facilitate the development and use of a standard market convention for specifying these terms in the related Confirmation. Updates to the Currency Pair Matrix will be published on the websites of the cosponsors from time to time.

Section 3.9(g):

Event Period

Section 3.9(h):

Event Period End Date and Time

Section 3.9(i):

Event Period Start Date and Time

A Barrier Event Determination Date may fall on any day in the Event Period (provided other conditions specified in Section 3.9(c) are met). Section 3.9(g) specifies that the Event Period starts on the Event Period Start Date and Time (presumptively the Trade Date at the time the Transaction was entered into) and ends on the Event Period End Date and Time (presumptively the Expiration Date at the Expiration Time). Section 3.9(g) also clarifies that, for at-expiry options, the Event Period starts and ends on the Expiration Date at the Expiration Time.

Section 3.9(j):

Exercise

Section 3.6(c) of the 1998 Definitions provides that Automatic Exercise is deemed to apply to a Currency Option Transaction. Section 3.9(j) specifies that the occurrence (or non-occurrence) of a Barrier Event will effect whether this presumption will apply to a Barrier Option.

Section 3.9(m):

Settlement Amount

Section 3.9(m) provides a definition of Settlement Amount that may be used in a Confirmation related to a Binary Option. It is important to note that, even if a Barrier Event



occurs more than one time during the Event Period, the Settlement Amount is paid only once on the Settlement Date, unless otherwise specified in the related Confirmation. This result is made clear in Section 3.7(b) of the 1998 Definitions and in each of the Event Types relating to Binary Options in Section 3.9(f)(v)-(viii).

Attachment 1: Currency Pair Matrix

This Currency Pair Matrix dated December 6, 2005, is provided as a best practice to facilitate the development and use of a standard market convention for specifying the exchange rates relating to certain terms in a Confirmation that incorporates the provisions of the *2005 Barrier Option Supplement to the 1998 FX and Currency Option Definitions*, published by ISDA, Inc., EMTA, Inc., and the Foreign Exchange Committee (the “2005 Supplement”). These terms include the Barrier Level defined in Section 3.9(e) of the 2005 Supplement, Upper and Lower Barrier Level defined in Section 3.9(q) and 3.9(k) of the 2005 Supplement, and the Initial Spot Price, which

may be included in the Confirmation pursuant to Section 3.9(o) of the 2005 Supplement. The Matrix addresses the currencies set out in Section 4.3 of Annex A of the *1998 FX and Currency Option Definitions*. All Currency Pairs in the Matrix are presented in the form of a fraction (“Currency Pair Fraction”). The numerator of the Currency Pair Fraction is defined as the “Numerator Currency,” and the denominator of the Currency Pair Fraction is defined as the “Denominator Currency.” Each Currency Pair Fraction is expressed as the amount of Numerator Currency per one unit of Denominator Currency. Updates to the Matrix will be published on the websites of the cosponsors.



