Securities Lending—Lessons Learned from the Financial Crisis

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Securities lending transactions have come under special attention and scrutiny due to losses and difficulties that have become evident during the financial crisis. These negative experiences have led to higher awareness of the participants in these markets and have also caused important changes in the contractual documentation of these financial instruments. This article addresses, in a first part, the risks and issues experienced in connection with securities lending and, in a second part, lessons learned that have found their way into the international securities lending master agreements and protocols. In the next edition of this newsletter, we will address similar developments in other OTC financial instruments, such as cash equity transactions.

By Urs Pulver / Petra Ginter

1) Introduction

Securities lending instruments have come to the spotlight during the financial crisis. The struggle of many financial institutions has highlighted certain risks connected with these instruments which have not been apparant in the booming preceding years. This has caused major losses on the lenders' side and subsequently has led to a temporary decrease in these markets and finally to some important changes in the contractual documentation of these financial instruments.

2) Risks and Issues Connected with Securities Lending Transactions

The main risk involved with securities lending is that the borrower becomes insolvent *(borrower risk)* and the values of the collateral fall below the replacement cost of the securities that have been lent *(collateral risk)*. The financial crisis has made evident these risks.

In particular, some financial institutions lacked to have sufficient clarity on the *defaulting institution*. In particular, they were not clear on the group structure, which entities were in administration, set off/netting possibilities, and how to terminate transactions with other counterparties that were economically linked to the defaulting party. Even identifying which entity within a financial group was the counterparty for a contract was not always easy. With respect to *collateral,* identifying the collateral concerned was often an issue. In addition, difficulties arose when client positions were not segregated from the defaulting party's own positions. Since the value of collateral could deviate from the value of the covered positions, liquidation processes turned out to be time sensitive. Losses were reported when some collateral assets were liquidated due to the sharp decrease of the respective market prices. Regarding the valuation of collateral, the main issues to be addressed related to the precise default valuation time,

the different possibilities for evaluating the collateral and organising the right price feeds (to ensure the use of the same fixing as the counterparty in order to avoid a cause for dispute).

Some financial institutions faced issues in terminating existing contracts even when they became aware of the applicable termination procedure. Indeed, the rules were sometimes difficult to implement in the *highly volatile market environment,* depending on the contractually agreed method of close-out. Some institutions had problems in closing out deals as the relevant market was no longer accessible. There were no replacement/close-out prices available and it was difficult to obtain quotes from the brokers. Other financial institutions faced difficulties in dealing with certain *procedural aspects and formalities* of close-out procedures. In particular, there were uncertainties whether or not a termination notice was actually required, which resulted in implications for evidence of the early termination date. A number of problems related to supposably simple issues under the *contractual documentation.* In some cases, for instance, the contractual documentation was silent or impractical on several points with respect to the pricing of the transactions in question. In other cases, the address of the counterparty was outdated as the contracts were signed years ago. However, the address is of legal relevance for sending effective notification to the counterparty. Thus, respecting deadlines for notification sometimes became an issue.

Considering all these risks and issues, participants have not only become more realistic about what their financial instruments can deliver but they have also become much *more probing* and *risk averse*. There is no doubt that the Lehman Brothers collapse, bans on short selling and cash reinvestment problems have left their mark. Clients have put greater restrictions on their financial instruments, limiting how much they will lend, what type and quality of collateral are acceptable, as well as being more selective in with whom they do business. They are paying greater attention to the safety and protection of their assets and, as a result, are asking much more specific questions about risk and the potential exposure to both custodian and counterparty default.

3) Recent Developments in Securities Lending Transactions

Securities lending transactions are often concluded under market standard master agreements, such as the Global Master Securities Lending Agreement (GMSLA), the Overseas Securities Lender's Agreement (OSLA) or the Master Gilt Edged Stock Lending Agreement (GESLA). Under these master agreements the parties may enter into various loan transactions. As a consequence, all these loans are subject broad by to the same terms and conditions, are easy to be entered into, require only reduced capital (net basis) and reduce the risks of the parties by providing for a close-out netting mechanism. Accordingly, the agreements give the non defaulting party the right to terminate outstanding loans through a close-out netting mechanism if an event of default (such as the insolvency of one party) occurs. In this respect the master agree-

ments have proven their value in the financial crisis as they have offered a better level of legal certainty. However, the financial turmoil has also shown deficiencies of the master agreements which have led to some changes in the securities lending practice. As a consequence, a new set-off protocol (see section 4 below) has been introduced in order to replace the close-out netting clauses of outstanding older (or older versions of) securities loading master agreements. Besides, the GMSLA 2000 has been amended to some extent by the versions of 2009/2010 (see section 5 below).

4) ISLA 2009 Set-Off Protocol

The International Securities Lending Association (ISLA), a trade organisation established in 1989 to represent the common interests of participants in the securities lending industry, has published the ISLA 2009 Set-Off Protocol (Set-Off Protocol). The Set-Off Protocol is a means to replace the post-default provisions (close-out netting clauses) of outstanding older (or older versions of) master agreements, such as the 1994 OSLA, 1995 OSLA, MEFISLA, GESLA and/or 2000 GMSLA, between adhering parties with the post-default provisions of the 2009 GMSLA. The Set-Off Protocol is subject to English law.

Technically, financial institutions may declare to adhere to the Set-Off Protocol and be bound by its terms by completing and delivering a letter substantially in the form of the adherence letter (Exhibit 1 to the Set-Off Protocol). With the notice of adherence of both parties of a master agreement to the Set-Off Protocol the new provisions of the Set-Off Protocol prevail over the respective provisions under the older (or the older version of the) master agreement. As per January 2011, nine parties have declared adherence to the Set-Off Protocol which are published on the ISLA website.

5) Changes in the GMSLA

The 2000 GMSLA has been amended in 2009 and 2010 mainly to reflect lessons learned from the financial crisis. The changes from the 2009 to the 2010 version of the GMSLA are only minor in nature and do not alter or affect the Set-Off or events of deleted provisions in either the 2009 GMSLA or the Set-Off Protocol.

Amendments of the Default Valuation Provisions (See Paragraph 11 and Definition of "Market Value" in the 2010 GMSLA): The primary purpose for producing the 2010 GMSLA was to update the default valuation provisions. During the financial crisis, the default valuations of the 2000 GMSLA and its predecessor agreements proved to be less flexible than corresponding provisions in other master agreements, particularly in relation to illiquid securities. As a consequence, the default valuation provisions which are used to determine the value of securities that have to be delivered by and to the defaulting party have been amended significantly. The new provisions provide a non defaulting party with greater flexibility when valuing relevant securities. This is partic-

ularly relevant in the case of illiquid securities where it might not be possible to obtain market prices or quotes from market makers or dealers, or where such quotes are not commercially reasonable. In such case the provisions enable a non defaulting party to determine a "net value" of securities.

The new provisions also allow a non defaulting party to extend the five day default valuation period if "owing to circumstances affecting the market" in the securities in question, it is not reasonably practicable for the non defaulting party to determine a net value of such securities which is commercially reasonable.

Finally, the provisions for converting the currency into the "base currency" have been amended, again to provide greater flexibility for the non defaulting party. They now state that the conversion takes place using the spot rate at such date and times determined by the non defaulting party acting reasonably.

Events of Default (Paragraph 10 of the 2010 GMSLA): Under the 2009/2010 GMSLA, the transfer of, or the order to transfer, all or any material parts of the assets of the lender or borrower to a trustee (or a person exercising similar functions) by a regulatory authority pursuant to any legislation qualifies as an event of default. It will, however, no longer be an event of default if a party's assets are transferred to a trustee. Regulatory or exchange prohibition or suspension will constitute an event of default only if it is on the grounds of failure to meet financial resource or credit rating requirements. A failure to deliver equivalent securities or non-cash collateral is no longer an event of default (see comments on mini close-out below).

Automatic Early Termination (Paragraph 10.1 (d) of the 2010 GMSLA): Under the older agreements specific events had triggered an automatic early termination of the agreement (AET), *i.e.* the non defaulting party is not required to serve written notice on the defaulting party. Under the 2009/2010 GMSLA, however, AET only applies if, and to the ■■■ that, the parties have elected AET in the schedule to the agreement. The effect of such an election is that the presentation of a petition for winding-up (or any analogous proceeding) or the appointment of a liquidator (or analogous officer) is an event of default without the need to serve written notice. Parties will usually elect to do so when recommended in a legal opinion. The Swiss opinion recommends to elect AET to apply in the event of the opening of bankruptcy and the filing for composition proceedings regarding the Swiss ■■■ party in order to mitigate cherry-picking risks. For all the other events covered by the definition of an act of insolvency ■■■ opinion ■■■, however, to provide for an option of the non defaulting party to give a notice of early termination, as aposed to AET, in order to improve the position/flexibility of the non defaulting party under the respective agreement where enforceability under Swiss law is not at stake.

No Interest is Due if Counterparty is Unable to Receive a Payment (Paragraph 15 of the 2010 GMSLA): In the Lehman Brothers case some debtors could not affect payments to certain Lehman Brothers entities as there were no open accounts where the funds could be paid. As a consequence of this negative experience, the 2009/2010 GMSLA sets forth that no interest is payable in respect of any day on which one party endeavours to make a payment to the other but the other party is unable to receive it.

Mini Close-out (Paragraph 9 of the 2010 GMSLA): With the 2009/2010 GMSLA a so-called mini close-out has been introduced. The mini close-out allows for the liquidation of a single loan in an analogous manner as the close-out netting mechanism which concerns all transactions entered into under a master agreement. In particular, the mini close-out may be invoked by a party in case of (i) a failure by the borrower to deliver equivalent securities or ii) the lender to deliver equivalent (non-cash) collateral. Under the mini close-out mechanism, termination takes place in accordance with the default valuation provisions as if an event of default had occurred (but it is stated expressly that any failure to deliver is not an event of default). However, the "non defaulting" party is not allowed to effect the close-out netting of all transactions under the master agreement in these events.

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Firm Sales vs. Irrevocable Tender Undertakings in Public Tender Offers

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In the context of a public tender offer, the offeror often seeks to secure a significant stake in the target company before announcing the transaction. This article compares two of the routes available to a bidder for achieving this result: the firm sale and purchase of target shares and the irrevocable tender undertaking.

By Hans-Jakob Diem

1) Background

The outcome of a public tender offer is uncertain by nature. Usually, an offeror will explore possible ways designed at increasing the probability of success and maximizing its share interest in the target resulting from the offer. One of the instruments regularly considered in this process is the acquisition of shares before announcement of the transaction. In the context of an unsolicited bid, the offeror may contemplate building-up a stake by acquiring target shares on-exchange before approaching the target