

GMSLA 'Pledge' Documentation

Overview & Frequently Asked Questions (FAQs)

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Overview

ISLA has developed documentation for securities lending activity where the collateral is provided by way of security interest (referred to informally and elsewhere as ‘pledge’), instead of being provided pursuant to the title transfer mechanism that has been embedded in all previous versions of ISLA’s industry standard securities lending documentation.

The documentation provides market participants with an additional structure to transact securities lending activity. The pledge structure may not suit all situations and all parties, and it is envisaged that both the pledge structure and the title transfer structure will be used in the market as alternatives. Counterparts wishing to transact using the pledge GMSLA will be required to execute a complete set of new documents.

Prior to green lighting the pledge initiative, ISLA undertook a survey of the ISLA membership to obtain input on pledge activity in the market and the appetite for ISLA to develop market standard documentation. Based on the survey findings, the ISLA board appointed Clifford Chance to produce the documentation.

The ‘Pledge’ Structure

The ISLA pledge documentation has been developed to be used in conjunction with certain tri-party custodians (see the section below entitled “Tri-party custody documentation”).

The following documentation is intended to be used in connection with the ISLA pledge structure:

- Global Master Securities Lending Agreement (Security Interest over Collateral - 2018 Version);
- Security Agreement relating to a Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version); and
- Tri-party custody documentation.





Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version)

Developed for ISLA members in association with Clifford Chance, the pledge GMSLA (formally referred to as ‘Security Interest over Collateral – 2018 Version’) is an adapted version of the Global Master Securities Lending Agreement (GMSLA) 2010.

The modifications that have been made to the GMSLA 2010 during the process have generally focused on the changes required to adapt the collateral provisions in the document so that collateral is provided by way of a security interest, rather than a title transfer mechanism. As a result, much of the document remains unchanged from the GMSLA 2010 title transfer version.

The document has been designed to be used only in conjunction with tri-party custody documentation. The pledge GMSLA is intended, like the title transfer version of the GMSLA, to be used in a wide range of markets, both cross border and domestic.

The pledge GMSLA is an English law document and contains the terms relating to the securities loans and the provision of collateral. Whilst the broad approach has been to try and develop an arrangement that is as similar as possible to that which applies in relation to the title transfer version of the GMSLA, there are inevitably differences between the arrangements.

Features of the Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version)

- The documentation contemplates that a single Borrower will transact with a single Lender or an Agent Lender and that, where an Agent Lender is used, there will be separate secured accounts opened with the tri-party custodian in relation to each principal. Transactions with pooled principals are not documented under the pledge GMSLA unless the parties agree bespoke provisions to effect such a structure.
- Under the pledge version of the GMSLA, the Lender transfers ownership of the borrowed securities to the Borrower outright (as it would have done under the GMSLA 2010 title transfer version). The collateral provided by the Borrower is, however, not transferred to the Lender outright. Instead, collateral securities or collateral cash are transferred to the secured accounts and the Borrower grants security of the posted collateral in favour of the Lender.

- The collateral is held in an account at the tri-party custodian in the name of the Borrower and security over this account is created in favour of the Lender*. The collateral is therefore not held in the Lender's proprietary account as is the case with the title transfer version of the GMSLA. The tri-party custodian is only permitted to make transfers in and out of the secured account(s) in accordance with the terms of the tri-party custody documentation. (*The exception to this is where collateral is held with Euroclear, in which case it is held by Euroclear Bank acting in its own name but for the account of the Pledgee).
- The pledge GMSLA agreement does not permit the Lender to rehypothecate or re-use the collateral.
- To the extent collateral subject to a record date has not been substituted out of the secured accounts prior to that date, the dividends or other distributions received by the custodian on the collateral are required to be added to the secured accounts as posted collateral, and there will be no need for manufactured payments in respect of them. Manufactured payments will continue to be relevant to loaned securities.
- The procedures involved in realising and liquidating collateral are different. Whilst they are intended to put the Lender in a situation where it can cover its exposure through an ability to liquidate the collateral, there are differences in the way it is implemented, which may have financing consequences.
- Under the pledge GMSLA structure, the Lender as secured party would need to follow an enforcement process to access the collateral and liquidate the collateral. As noted, the secured accounts are held with the tri-party custodians under control terms agreed between the parties. By contrast, under the title transfer version of the GMSLA, a Lender would own and could immediately realise the collateral upon the occurrence of an Event of Default without taking any further steps to obtain control of the collateral.
- On the default of the Borrower, the Lender would terminate the outstanding transactions, value the obligations of the Borrower, claim the amount owed from the Borrower, take control from the tri-party custodian of the collateral, and enforce its security to the extent required to discharge the Borrower's obligations. Any surplus collateral would be returned to the Borrower.
- Similarly, the process by which the Borrower might obtain any unused excess collateral back (or claim the value of any excess collateral) from the Lender differs.

The Security Agreement Relating to a Global Master Securities Lending (Security Interest over Collateral – 2018 Version)

Under the Security Agreement, the party acting as Borrower creates a security interest over the posted collateral.

The parties are expected to use the appropriate Security Agreement based on the location of the secured account(s) in which the posted collateral is maintained and, in the case of Euroclear and Clearstream, these documents also contain specific terms relating to the relevant tri-party collateral documentation.

The Security Agreements produced as part of the ISLA pledge documentation are as follows:

- English law Security Agreement relating to a Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version);
- Euroclear Security Agreement relating to a Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version);
- Belgian law Security Agreement relating to a Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 Version);

- Clearstream Security Agreement relating to a Global Master Securities Lending Agreement (Security Interest over Collateral - 2018 Version); and
- Luxembourg law Security Agreement (JP Morgan) relating to a Global Master Securities Lending Agreement (Security Interest over Collateral - 2018 Version).

The English law version is intended for use with The Bank of New York Mellon accounts opened with its London branch, the Belgian law Security Agreement is intended for use with accounts held with The Bank of New York Mellon SA/NV and the Luxembourg law Security Agreement (JP Morgan) is intended for use with accounts opened with JP Morgan Bank Luxembourg S.A. The Euroclear version is governed by Belgian law and the Clearstream version is governed by Luxembourg law. The latter two agreements are intended to be used where the secured accounts are maintained with Euroclear or Clearstream, respectively.

Tri-party Custody Documentation

The tri-party custody documentation is executed between the Borrower, the Lender and the tri-party custodian. It governs how the collateral is to be held and dealt with by the tri-party custodian and acts as a separate 'control' agreement between the parties. Early in the process it was evident that it would not be practical to produce a single standard tri-party custody document for use with all tri-party providers. ISLA worked with several tri-party providers to negotiate a standard template document for use with each tri-party custodian.

The tri-party custodians that ISLA have worked with in the development of the ISLA pledge documentation are as follows:

The Bank of New York Mellon, London Branch
The Bank of New York Mellon SA/NV
Clearstream, Luxembourg
Euroclear, Brussels
JP Morgan, Luxembourg



The Bank of New York Mellon, The Bank of New York Mellon SA/NV and JP Morgan each has a form of Account Control Agreement which can be entered into between the parties. Euroclear and Clearstream, by contrast, each has a tri-party collateral management documentation which may be used in relation to pledge structures.

ISLA has reviewed the tri-party custody documentation from a security perspective only and sought to amend the documentation where, for instance, the relevant provision (or associated operational mechanism) appeared inconsistent with the intended security arrangement (please see the Clifford Chance opinions for the analysis, assumptions and reservations on this topic). In general, ISLA has sought to ensure that the tri-party documentation ties in with the pledge GMSLA and the relevant Security Agreement.

However, please note that where an aspect of the tri-party custody documentation was thought not to counteract the intended security arrangement, ISLA has not sought to amend it. This means there could be elements in the tri-party custody documentation which parties may consider to be commercial issues. Parties should therefore ensure that they have reviewed and identified for themselves any such issues. The tri-party documents are templates only in the sense that they have been aligned with the other documents and their impact on the security has been reviewed.

Legal Opinions

The ISLA pledge documentation is supported by legal opinions from Arendt & Medernach, Clifford Chance, and Freshfields Bruckhaus Deringer.

Clifford Chance provide an enforceability opinion in respect of each Security Agreement under its governing law. Each opinion also looks at the financial collateral arrangement analysis under that governing law by reference to the Security Agreement and the relevant tri-party custody documentation. The English law opinion covers the enforceability of the Global Master Securities Lending Agreement (Security Interest over Collateral – 2018 version) under its governing law.

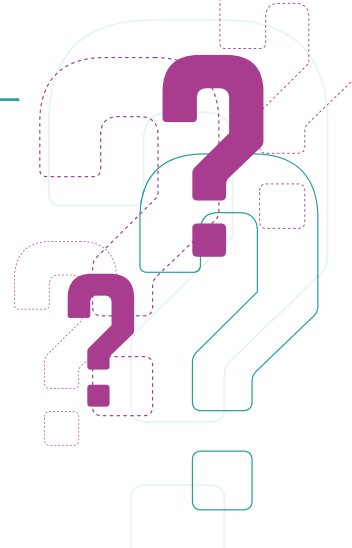
These enforceability opinions do not consider aspects of the legal analysis arising in respect of any Borrower. This means that the opinions do not consider whether any potential Borrower might lack capacity to enter into the ISLA pledge documentation or whether any regulatory issues might arise as a result of a Borrower entering into the pledge GMSLA arrangements. Importantly the opinions do not address whether any security interest created under the Security Agreements would be enforceable against a Borrower in its insolvency.

Arendt & Medernach and Freshfields Bruckhaus Deringer provide opinions covering the segregation of the collateral in the event of the insolvency of the tri-party custodians from the perspective of the Borrower (as collateral provider). These opinions also consider the impact that any insolvency of the Lender (as secured party) may have on the analysis.



In general, ISLA has sought to ensure that the tri-party documentation ties in with the pledge GMSLA and the relevant Security Agreement.





Frequently Asked Questions

Q: Why has ISLA developed pledge documentation?

The ISLA pledge documentation (Security Interest over Collateral) was developed at the request of ISLA members. The intention was to provide an industry standard documentation framework for ISLA members who wish to be able to transact using a security interest structure in the securities lending market.

Q: Why is there a need for pledge documentation in the securities lending market to sit alongside the existing title transfer framework?

One issue for Borrowers with the title transfer version of the GMSLA is that the Borrower's exposure or claim on the Lender is a risk weighted asset for capital purposes. The title transfer version of the GMSLA will usually create an exposure to the Lender, as the Borrower will typically post additional collateral (a margin percentage or 'haircut') to the Lender which exceeds the market value of the loaned securities. The allocation of regulatory capital can be a very significant cost and Borrowers are attracted to the possibility of reducing their regulatory costs.

The pledge structure can also be advantageous to Lenders that accept large blocks of equities as collateral and risk being subject to notification and other obligations in relation to holding significant positions in the underlying shares. A provision of equities under a security interest arrangement may not have the same impact, depending on the applicable rules.

Q: How can I obtain copies of the ISLA pledge documentation?

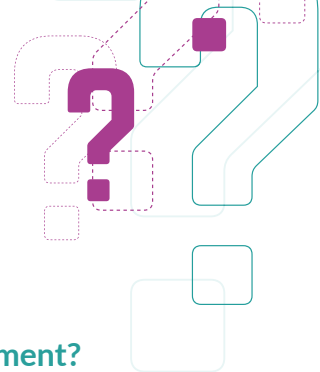
The ISLA pledge documentation is available to all ISLA members. The documentation can be accessed via the ISLA website (www.islaemea.org). To access the documentation, you are required to be an ISLA member and to have a valid login for the website. For ISLA members without a current login, access can be requested via the "Request login" function on the ISLA website.

Q: What if I am not an ISLA member?

If your organisation is not currently an ISLA member or your application is pending and you wish to discuss access to the ISLA pledge documentation, please contact support@islaemea.org.

Q: Is there a blacklined version of the GMSLA Security Interest over Collateral against the GMSLA 2010 Title Transfer agreement available?

Yes. This is available to all ISLA members via the ISLA website (www.islaemea.org)



Q: Does the ISLA pledge structure constitute a Financial Collateral Arrangement?

The enforceability opinions provided by Clifford Chance provide analysis on this matter.

Q: Can ISLA provide guidance on regulatory reporting or capital treatment pledge activity?

During the development of the ISLA pledge structure documentation, members requested information from ISLA regarding regulatory reporting and capital treatment for pledge transactions. It is not an area that ISLA has reviewed or is intending to review. ISLA members should seek their own advice in these matters as regulators may have differing interpretations of pledge structures.

Q: Is there a difference in risk profile if I access the market via the title transfer or security interest over collateral structure?

Accessing the securities lending market via a pledge structure could entail a change in risk profile, as there are differences in the default timelines. For instance, there are differences in the enforcement process and this may have an impact on timing. It is important that counterparts appreciate the differences between the structures and the potential risk implications. Counterparts should therefore seek their own independent advice and guidance as appropriate.

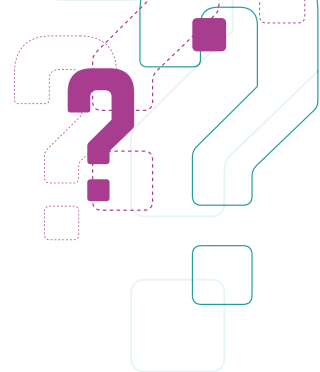
Q: Does the pledgor need to substitute collateral over an income date?

No. If the relevant items of posted collateral are not substituted out prior to the relevant income date, dividends or distributions received by the Lender on collateral will be added to the posted collateral in the secured accounts and there will be no manufactured payments in respect of them.

The pledge arrangements do contemplate withdrawal of excess collateral and to the extent that the dividends or distributions are or become excess collateral when or after they have been added to the collateral, there is scope for their withdrawal.

Q: Is it possible to rehypothecate or have right of re-use of collateral using the ISLA pledge structure?

No. The ISLA pledge documentation does not allow for the Lender to have rehypothecation rights, or rights of use over posted collateral.



Q: What should Lenders consider when determining whether the pledge structure is suitable for them?

As noted above, depending on the applicable rules, there may be advantages to the pledge structure for Lenders that accept large blocks of equities as collateral.

Lenders should also consider whether they have capacity and authority to enter into the pledge structure and whether there are any regulatory concerns that could arise if they do so.

Lenders are advised to review the documents carefully to ensure they are comfortable with the differences between the different structures. In particular, Lenders should ensure they have considered the effect of the collateral structure and the effect it may have on the timing of any close-out. This may include reviewing the account control documentation to consider the process (and associated notices) for taking control of collateral in the pledge account in the event that the security is enforced.

To the extent that a Lender is considering acting through an agent it will be important to consider not only the legal rights but the operational considerations that will affect any close-out. Lenders may also want to consider any differences in the structures offered to them by such agents, for example if there are credit mitigants in respect of specific risks.

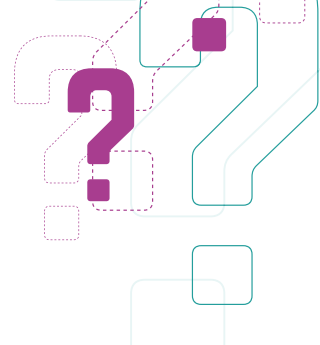
Q: Does ISLA consider the pledge structure to have a higher risk profile from a Lender's perspective? Is there a timing difference from the perspective of a Lender if closing out positions following the default of a Borrower?

ISLA fully supports the pledge structure as an alternative to the title transfer structure. The pledge structure and the title transfer structure offer very different risks from a legal perspective and parties will need to assess those risks, and the implications of those risks, before determining which structure(s) to use.

Parties should also consider the commercial factors arising from the structures, for example any increase in the time taken to liquidate positions upon a close-out could lead to greater fluctuations in the value of collateral and therefore the risk of a collateral shortfall. Changes to the timeline upon a Borrower default can arise from the fact that Lender does not hold the collateral under the pledge structure (because it is held at the tri-party custodian) and that there may be a delay in liquidating collateral until the close-out payment has been demanded. This is discussed in more detail in 'The Pledge GMSLA', which was published in 2018 and is available as a thought leadership piece on the ISLA website (www.islaemea.org). This article discusses the evolution of the pledge structure and highlights some key differences to the traditional title transfer structure. There is a detailed timeline for a Borrower close-out which helps illustrate some of the key differences between the two structures in a default scenario.

Parties should review the documentation for each structure carefully to determine how to weight the various risks.





Q: What additional resources would ISLA suggest firms consider when reviewing these topics?

Firms should conduct a full review of the documentation and take any advice that is appropriate before making any decisions in respect of the structure. Useful introductory resources for parties to consider in the context of their review include:

1. 'The Pledge GMSLA', a piece produced in September 2018 and that is available on the ISLA website (www.islaemea.org).
2. The netting legal opinions published by ISLA. The title transfer structure is supported by a library of legal opinions that consider the efficacy of the set-off mechanic that forms part of the close-out of transactions under the title transfer GMSLAs.
3. The legal opinions published by ISLA in connection with the pledge structure. The enforceability opinions provide comfort that the documents are capable of creating valid security and consider the extent to which the structure may constitute a security financial collateral arrangement under the governing law of the security interest but do not consider the enforceability of that security interest upon the default (or insolvency) of the collateral provider. The segregation opinions consider the nature of the Borrower's interest in the collateral and the impact of the insolvency of the applicable tri-party custodian and/or the Lender on that analysis.

Q: Does ISLA have an overview of the main differences between pledge and title transfer?

As discussed above, ISLA provide a blackline of the pledge GMSLA against the GMSLA 2010 but do not publish a detailed summary of the key differences. The aforementioned piece, 'The Pledge GMSLA', outlines some key differences but it is important to stress that this is merely an introduction. Parties should review each structure carefully and seek advice where appropriate.

Q: In the pledge structure, when does the Lender become the owner of the collateral?

In the title transfer structure, the Lender becomes owner of the collateral upon it being delivered to the Lender. In the pledge structure, the collateral is not delivered to the Lender during the ordinary course of transactions. The Lender only becomes the owner of the collateral if the Lender appropriates the collateral as part of the enforcement of the security granted under the security agreement. Even when the security is enforced, the Lender may decide to not appropriate the collateral and instead exercise another right under the security agreement, such as a power of sale.





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