KEY POINTS

- For the first time, market participants in the UK will be able to use a standardised, true-security collateral structure for securities lending transactions (with regulatory capital implications for market participants required to hold regulatory capital).
- Market participants should prepare now for the introduction of mandatory trade reporting, which begins in April 2020.
- Market participants that use the 1995 version of the GMRA should consider repapering with the newer 2000 or 2011 GMRA or risk being unable to access the repo market.

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2019: a year of change in the repo and securities lending markets

2019 is likely to be a significant year for the €15trn repo and securities lending markets, with the introduction of a new securities lending agreement, the death of an existing repo agreement, and preparations for the commencement of mandatory trade reporting.

In contrast to the derivatives market which, in less than three years, has had to tackle the challenges imposed by the introduction of mandatory clearing and the initial and variation margin requirements (each necessitating new legal documentation as well as systems and processes to implement, comply with and monitor these requirements), the sale and repurchase (repo) and securities lending markets have seen significantly less upheaval from a legal and regulatory perspective.

2019, however, brings three developments of which market participants should be aware. These developments matter to a market that has an aggregate size estimated to be in excess of €15trn, measured by outstanding transactions (and with a turnover of approximately €3trn per day), and which is used not only by investment banks and market-makers, but insurance companies, pension schemes, asset managers and other institutional investors, and is key to providing liquidity, safe forms of investment and low-cost borrowings.

GMSLA "PLEDGE" STRUCTURE

The first significant development is the introduction of a new kind of securities lending agreement. The International Securities Lending Association (ISLA) produces the market standard master agreement used in the UK, the Global Master Securities Lending Agreement (GMSLA). To date, all GMSLAs have operated on a title-transfer basis, whereby legal title to the collateral exchanged to support a loan is transferred from the collateral provider to the collateral taker. The collateral taker is therefore able to do what it wishes with the collateral and the collateral provider retains no proprietary rights in the collateral.

In contrast, under the GMSLA (Security Interest over Collateral – 2018 Version) (Pledge GMSLA) collateral is provided by way of a security interest over an account held at a third-party custodian. For accounts held in the UK, this means that market participants will need to consider whether best practice would be for the security to be registered at Companies House. At the time of going to press, the legal opinions commissioned by ISLA in respect of the Pledge GMSLA (which will opine upon whether the Pledge GMSLA and accompanying security structure constitute a financial collateral arrangement) had not been published.

From a legal perspective, the basic architecture of the Pledge GMSLA will be familiar to practitioners used to negotiating GMSLAs which provide for the use of title-transfer collateral (TT GMSLA), the Pledge GMSLA being based upon the most recent, 2010, version of the TT GMSLA. One key difference between the Pledge GMSLA and TT GMSLAs is that pooled principal transactions (where an agent, such as an asset manager, aggregates multiple securities lending transactions into a larger, single block) are not envisaged under the Pledge GMSLA. This is not to say that pooled principal transactions could not be effected under the Pledge GMSLA, but practitioners would need to ensure that any changes to the architecture of the Pledge GMSLA would not take it outside the purview of the legal opinions commissioned by ISLA (on which market participants usually rely) and consider carefully how the accompanying security structure would operate.

TT GMSLAs are often (but do not need to be) accompanied by tri-party collateral documentation, under which a third-party is appointed to manage the exchange of collateral between the principals to the transaction. The principals can, however, manage the exchange of collateral between themselves on a bilateral basis. In contrast, use of the Pledge GMSLA will necessitate the involvement of a third-party custodian. The documentation will differ to that used for tri-party title-transfer arrangements and so market participants who intend to switch from using title-transfer collateral to security interest collateral will need to re-paper not only their GMSLA but, most likely, their tri-party documentation.

ISLA has produced a series of standard form security agreements to accompany the Pledge GMSLA. No equivalent agreement is required for title-transfer collateral. While the Pledge GMSLA is an English-law agreement, the ISLA security agreements are governed by English, Belgian and Luxembourg law, respectively, and have been drafted to interact with custody services offered by The Bank of New York Mellon, JP Morgan, Euroclear and Clearstream. Market participants should select their custodian and security agreement based on the type of collateral and location of the secured collateral account. While the ISLA security agreements are largely standardised, market participants should consider taking local law advice when taking security outside their jurisdiction.

It is not envisaged that the Pledge GMSLA will replace TT GMSLAs – the two are complementary and allow market participants to choose which suits them better. More risk-adverse market participants may prefer the Pledge GMSLA, which could be viewed as offering a higher level of protection than TT GMSLAs. The two alternative approaches also generate different capital requirements for those market participants required to hold regulatory capital.

Another key consideration is likely to be one of timing. Under a TT GMSLA, following

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a default the collateral taker (who holds legal title to the collateral) can appropriate the collateral immediately. In contrast, under the Pledge GMSLA the collateral taker would need to follow an enforcement process, which may vary from jurisdiction to jurisdiction, and therefore the collateral taker is likely to face a longer wait, and potentially higher costs, before realising the value of the collateral.

MANDATORY REPORTING TO A TRADE REPOSITORY

The second significant development relates to the Securities Financing Transactions Regulation ((EU) 2015/2365) (SFTR). While SFTR has been in force for some time, the requirements imposed by it are being phased in gradually.

Most market participants will be aware of the need to notify their counterparties of the risks associated with the exchange of title-transfer collateral (using so-called "Article 15" notices). This year, the rules that apply a mandatory reporting regime have come into force.

The dates from which transactions must be reported vary from April 2020 (for credit institutions, such as banks, and investment firms, who manage, advise upon or arrange regulated investments) to January 2021 for non-financial counterparties (such as listed and unlisted corporates). Market participants are advised to begin preparing as soon as possible (if they have not done so already) because significant work may be required to ensure that they are ready to report.

The SFTR reporting regime is designed to be similar to the reporting regime under the European Markets Infrastructure Regulation ((EU) 2012/648) (EMIR) which has been in force since 2013 and which applies to the derivatives market.

Market participants will need to establish internal procedures to deal with the collection of data and its provision to a trade repository or third-party service provider. They will also need to provide a not insignificant amount of static data (broadly information that does not change regularly, such as an institution's legal entity identifier) as well as dynamic data (information that relates to a specific transaction) on a transaction-by-transaction basis.

Market participants will need to establish a legal framework to govern their reporting, either directly to a trade repository or with a service provider. Many service providers who provide EMIR trade reporting intend to offer a similar service for SFTR trade reporting. This is an area where practitioners are likely to be involved. If, as expected, SFTR trade reporting will be provided by banks and credit institutions to their clients on a cost-free basis, it is unlikely that clients will be able to negotiate significant amendments to the terms of such arrangements. Market participants who avail themselves of delegated reporting should be aware that, like EMIR trade reporting, while some of the administrative burden of reporting can be delegated, ultimate responsibility (and legal liability) cannot be.

THE DEATH OF THE 1995 GMRA

The third significant development relates to the likely phasing out of a version of one of the most commonly used repo agreements. The International Capital Markets Association (ICMA) has announced that it will no longer continue to support the 1995 version of the market standard repo agreement, the Global Master Repurchase Agreement (GMRA).

Currently ICMA commissions legal opinions in respect of the GMRA and upon which repo users rely. These legal opinions are refreshed annually to ensure they are up-to-date with relevant legal and regulatory developments. The most recent ICMA legal opinions, published in April, no longer extend to the 1995 GMRA.

We expect the impact will be that market participants will not be able to enter into new repo trades unless they update their documentation to the newer 2000 version or 2011 version of the GMRA. While market participants could commission their own bespoke legal opinion, the cost of doing so (and in maintaining such an opinion year on year) is likely to be disproportionate compared to that of updating their documentation.

Market participants with 1995 GMRAs who wish to continue to access the repo markets will need to consider whether the terms of the 2000 or the 2011 GMRA suit them better. In particular, practitioners should draw attention to the changes made to the events of default (two new events of default being added by the 2000 GMRA), a new close-out methodology (added by the 2011 GMRA) and the inclusion of an optional condition precedent (in both the 2000 GMRA and 2011 GMRA) which makes performance by one party to a repo transaction subject to the other party not being in default or potentially being in default.

While the number of 1995 GMRAs in active use may be low, to draw another parallel with the derivatives market, the enduring popularity of the 1992 ISDA Master Agreement (notwithstanding the introduction of a newer 2002 version) and ISDA's continuing support of the 1992 version in its legal opinions, suggests that parties will not necessarily move to newer documentation when it becomes available. In this case, however, the discontinuation of legal opinion support for the 1995 GMRA may mean there is little option other than repapering.

OSLAs AND MGESLAs

ISLA announced in April that its legal opinions will no longer extend to the Overseas Securities Lender's Agreement (October 1994 Version), the Overseas Securities Lender's Agreement (December 1995 Version), and the Master Gilt Edged Stock Lending Agreement (April 1996 Version). Users of those agreements should consider updating their documentation to the 2000 or 2010 version of the TT GMSLA.

CONCLUSIONS

It would be fair to conclude that these changes to the repo and securities lending market are less seismic than the recent changes to the derivatives market. Nonetheless, the new Pledge GMSLA may open the securities lending market to new participants who might not otherwise have considered it because of the reliance upon title-transfer collateral (with the associated risk and regulatory capital treatment). The SFTR reporting regime will affect all market participants and the phasing out of the 1995 GMRA will inevitably mean a repapering exercise for some market participants if they still wish to engage in repo. All of these developments bring challenges, operational and administrative as much as legal, but also offer opportunities for practitioners to assist market participants to adapt to, or access, these markets. ■