ISDA RELEASES NEW DOCUMENTATION FOR REPURCHASE AND SECURITIES LENDING TRANSACTIONS UNDER THE ISDA MASTER AGREEMENT - SAME, BUT DIFFERENT?

On the face of it, repurchase transactions and securities lending transactions ("**SFTs**") documented under master agreements have several features in common with transactions under ISDA Master Agreements, including incorporating similar risk reducing concepts (for example the use of collateral and close-out netting). But look closer at the SFT products and there are significant distinctions in how they and their relevant markets operate, which reflects how their master agreements have developed. The nature of SFTs necessitates distinct terms to reflect market practice (for example SFTs have different possible remedies following defaults) and there are variations in methodologies used to achieve the commercial agreement (such as in calculating margin and valuing any close-out amount). Though it has always been possible (in theory) to document a SFT under the ISDA Master Agreement, in reality, the three markets have historically traded under their own master agreements (with each also following their own market practices) and market participants have navigated around their intricacies. However, this may change (to some degree), following the publication by ISDA of provisions and definitions enabling SFTs to be documented under a single ISDA Master Agreement.

Incentives for Harmonisation

The suggestion that OTC derivatives and SFTs could be documented more easily under the ISDA Master Agreement was publicly raised in October 2020, when ISDA published a Whitepaper (Collaboration and Standardization Opportunities in Derivatives and SFT Markets) setting out an opportunity for greater alignment, standardisation and improved efficiencies across these markets. Parallels between the respective agreements for regulatory and bankruptcy related requirements, a reliance on close-out netting (supported by legal opinions) and the potential to consolidate collateral payments into single amounts (with beneficial implications for funding costs), were some of the

Key issues

- An ISDA Whitepaper in 2020 suggested that a common documentation structure to work across the derivatives, repurchase and securities lending markets could lead to increased efficiencies and opportunities for technological innovation.
- ISDA has now published the 2022 ISDA Securities Financing Transaction Definitions and the ISDA Securities Financing Transactions Schedule Provisions. These incorporate the necessary terms and amendments to the ISDA Master Agreement to provide for repurchase transactions and securities lending transactions under the ISDA Master Agreement. The SFT Schedule Provisions include certain elections and supplements that will be relevant for SFTs and the SFT Definitions provide relevant defined terms and the "mechanical" provisions.
- Key features of the industry standard repurchase and securities lending master agreements have been included in ISDA's new SFT documentation.
- Whilst certain SFTs, or groups of SFTs, may be terminated and closed-out by recreating "mini close-outs", the SFT provisions also include the option of applying close-out netting across all transactions under the ISDA Master Agreement.

reasons given in favour of the proposal. Technological initiatives aimed at achieving standardisation of documentation (along with protocols and negotiation platforms) and other efficiencies (such as processing transaction confirmations and regulatory reporting) were also considered as possible incentives for combining the arrangements.

The Core Proposal

The Core Proposal set out in the Whitepaper was to incorporate additional provisions into the Schedule to the ISDA Master Agreement (1992 or 2002 version) as a new "Part", together with a separate set of SFT specific Definitions, which taken together would provide the terms to enable parties to document SFTs alongside OTC derivatives under the single ISDA Master Agreement.

A specific ISDA Working Group was formed, with participants from across the SFT and ISDA markets, to look at implementing the proposal. As part of this process, they compared key terms across the English law and New York law market standard agreements for SFTs with the ISDA Master Agreement provisions. Following Working Group discussions on a common approach, they subsequently developed the documentation.

Final version of the documents were published by ISDA on 28 February 2022. These are:

- **SFT Schedule Provisions**, as a new “Part” of the Schedule to the ISDA Master Agreement (1992 or 2002 version). These provide elections and amendments which apply to all SFTs subject to the ISDA Master Agreement. Many of the SFT Schedule Provisions refer to and apply the associated provisions in the SFT Definitions;

- **SFT Definitions**, are the operative and mechanical provisions specific to SFTs. These are incorporated into the ISDA Master Agreement through the new Part of the Schedule and apply to SFTs between the parties; and

- **Forms of SFT Confirmation,** for standard repurchase and securities lending transactions.

The terms and operative provisions used within these documents are aligned with those used in market standard SFT documentation and will be familiar to existing users.

Since their publication, ISDA have also published two papers; one providing an overview and one providing technical guidance to assist in completing the documentation.

SFT Schedule Provisions at a glance:

The SFT Schedule Provisions form a new "Part" of the Schedule to the ISDA Master Agreement and add SFTs as transactions under the ISDA Master Agreement. Looking at the elections under the SFT Schedule Provisions highlights the distinctiveness of SFTs from other transactions commonly traded under an ISDA Master Agreement. SFT Schedule Provisions incorporate the SFT Definitions and set out certain elections that will be relevant for certain SFTs only. The SFT Schedule Provisions also include certain amendments which will apply to both OTC derivative transactions and SFTs under the ISDA Master Agreement. Other terms of the ISDA Master

Agreement remain unchanged and apply to each type of transaction without amendment. Key features of the SFT Schedule Provisions include:

- Elections that are specific to SFTs, where it is intended that these will apply to all SFTs under the ISDA Master Agreement. These include: (i) the currency of cash and type of securities which may be used as margin, (ii) the base currency of the SFTs, (iii) whether to have substitutions, (iv) applicable interest rates and payments, and (v) distributions and corporate actions relating to the transferred or margin securities. Transaction terms can include different elections with these being made in the relevant Confirmation.

- Amendments to the ISDA Master Agreement standard credit support arrangements, to (i) exclude SFTs from the scope of these under the ISDA Master Agreement and (ii) provide specific SFT credit support and possible credit support providers solely for SFTs (for example third party security or a guarantee which applies only to securities lending transactions).

- New representations, covenants and disclosure.

- The optional disapplication of the 'flawed asset' provision in Section 2(a)(iii) of the ISDA Master Agreement for SFTs, which would otherwise enable a party to withhold performance of its obligations under the SFTs if its counterparty is subject to an Event of Default or Potential Event of Default.

- The application of the ISDA Events of Default and Termination Events to (i) bring SFTs within their scope and (ii) tailor if and how they apply to all transactions under the ISDA Master Agreement, including:

  - an Acceleration Option, which may apply in relation to one or more SFT. As a starting point, the parties may elect that this option applies to either securities lending, or repurchase transactions, or both. They must then further specify the types of SFT related scenarios to which the Acceleration Option will apply by listing these in the SFT Schedule Provisions, categorised according to whether they apply with or without notice (in the latter case the Acceleration Date occurs immediately upon the occurrence of the relevant event). Interestingly, a Bankruptcy related Event of Default may be selected as an Acceleration Option either with or without notice, enabling all SFTs to be terminated separately instead of pursuant to an Event of Default under the ISDA Master Agreement. When an Acceleration is triggered, a Termination Date/Repurchase Date (as applicable) for each accelerated SFT will occur and the parties' obligations to make any payments or transfers will be deemed due on that date, the parties may continue to perform their obligations under any or all accelerated SFTs and if the obligations are not performed (on that date or any other agreed date) the non-defaulting/failing party may terminate and close-out all affected SFTs without triggering an Event of Default or Additional Termination Event under the wider ISDA Master Agreement. An "Acceleration Amount" will then be calculated by the non-defaulting/failing party using the Acceleration Date as the relevant date for any valuations of securities and margin (as distinct from the procedure for a close-out following an Event of Default or Termination Event where valuations are calculated as of the Early Termination Date). Payment of the Acceleration Amount by the relevant party will satisfy each party's obligation to perform its outstanding payment and transfer obligations, but a failure to pay this will be treated as a Potential Event of Default under Section 5(a)(i) (*Failure to Pay*);

- the option to designate certain representations as applicable only to OTC derivatives or SFTs and treat breach of these as an Additional Termination Event rather than as a Misrepresentation Event of Default; reflecting that a misrepresentation affecting only one or more SFTs may not be a risk event that is relevant to all transactions under the ISDA Master Agreement;

- an Additional Termination Event (which may be elected to apply only to SFTs, or all transactions under the ISDA Master Agreement) relating to a suspension from a securities exchange. This is traditionally included in SFT documentation, but not in the ISDA Master Agreement;

- the option to disapply a particular Event of Default in respect of either OTC derivatives or SFTs, thereby avoiding such event leading to the termination of all transactions under the ISDA Master Agreement. The affected transactions (i.e. all STFs or all OTC derivatives) will instead be subject to an Additional Termination Event; and

- the option to exclude SFTs from some or all Termination Events, as well as that SFTs have their own Additional Termination Events.

- Amendments to the provisions relating to failures to deliver/transfer securities. Commonly, repurchase and securities lending markets will rely on unwinding transactions affected by such a failure, initiating a "mini close-out" rather than treating this as an Event of Default, as the failure to transfer securities may be unrelated to counterparty credit issues. This optionality has been retained in the SFT documentation and the remedies available following a failure to transfer are categorised according to when such failure occurs:

  - for failures to transfer securities to the Borrower/Buyer on the Initial Settlement Date/Purchase Date: the starting point for determining the consequences of such failure is whether an "Initial Settlement Date/Purchase Date Securities Transfer Failure" has been selected as applicable in the SFT Schedule Provisions. If so, the first point to note is that such failure will not be treated as an Event of Default under Section 5(a)(i) (*Failure to Pay*) of the ISDA Master Agreement, although it will be treated as a failure to perform an obligation for the purposes of Section 5(a)(ii)(1) *(Breach of Agreement; Repudiation of Agreement*) of the 2002 version of the ISDA Master Agreement (Section 5(a)(ii) (*Breach of Agreement*) under the 1992 version). In respect of either a repurchase or securities lending transaction, if the Borrower/Buyer has already paid the purchase price or has transferred margin to the Lender/Seller, the Borrower/Buyer may require a repayment of the purchase price or a transfer of equivalent margin. Alternatively, for repurchase transactions, the Buyer may (i) require the Seller from time to time to pay it cash margin equal to any transaction exposure it has, and/or (ii) terminate the transaction and require the Seller to pay it an amount equal to the excess (if any) of the repurchase price (on the relevant date of termination) over the purchase price, and/or (iii) designate the "Relevant Rate" for any day on which this is negative to be zero. If any obligations remain unpaid or undelivered following the application of any of the above procedures, the failure shall be treated as a Potential Event of Default under Section 5(a)(i) (*Failure to Pay*). Alternatively, the parties may specify that such failure to transfer will be subject to the Acceleration Option in respect of all SFTs to which the failure applies; and

– for failures to transfer securities or margin on the Termination Date/Repurchase Date; similar to the above, the available remedies depend on whether a "Termination Date/Repurchase Date Securities Transfer Failure" has been selected as applicable in the SFT Schedule Provisions. If so (as with an "Initial Settlement Date/Purchase Date Securities Transfer Failure") such failure will not be treated as a Potential Event of Default under Section 5(a)(i) (*Failure to Pay*). Instead, for repurchase transactions, the Seller may require the Buyer to repay the repurchase price if it has already paid this, and pay it cash margin from time to time equal to any Transaction Exposure it has. The failure to transfer shall constitute an Additional Termination Event in respect of that affected SFT. Alternatively, the parties may specify that such failure to transfer will be subject to the Acceleration Option in respect of all SFTs to which the failure applies.

In both of the above cases the available remedies have consequences for the affected transaction(s) only, thereby isolating the default from the remaining transactions under the ISDA Master Agreement so that these can continue unaffected. However, if neither of the available elections are made in the SFT Schedule Provisions then any such failure to transfer would amount to a potential Failure to Pay Event of Default under Section 5(a)(i) (*Failure to Pay*), with potential consequences for all transactions under the ISDA Master Agreement.

- Amendments to the provisions dealing with early termination and close-out mechanics to include separate and distinct processes for the closing-out of SFTs and the calculation of the Settlement Amount or Loss (for the 1992 version of the ISDA Master Agreement) in relation to these SFTs.

- The potential to carve-out SFTs from specific ISDA Protocols incorporated into the ISDA Master Agreement.

SFT Definitions

The SFT Definitions are intended to be used with SFT Confirmations and incorporate the operational provisions relating to SFTs that are largely missing from the ISDA Master Agreement. They are therefore more extensive than just being a series of defined terms. They address:

- the transfer of securities on the initial settlement date or purchase date and the consequences of a failure to do so (including "mini close-outs");

- if elected in the SFT Schedule Provisions as applicable: compensation for the transferee (to be paid promptly following notice of the relevant amount) for costs and expenses reasonably incurred as a direct result of the transferor failing to transfer equivalent securities or margin by the relevant required time, including those incurred as a result of a buy-in exercised against it by a third party, but excluding any arising as a result of negligence by the transferee and any indirect or consequential losses;

- specific margining arrangements for SFTs which are distinct from those for OTC derivatives, including provisions relating to the determination of market value, transfers, timing, calculation of margin exposure, cash margin as a fallback, as well as repricing and adjustment for repurchase transactions. The parties may elect that the margin arrangements apply to individual transactions or on an aggregate basis across a particular Margin Set (such as, for example, all repurchase transactions). Margin for SFTs is provided on a title transfer basis (although for securities lending transactions a US Pledge can apply (see below));

- the substitution of securities and return of securities on the termination date or the repurchase date;

- early termination mechanics linked to the Acceleration Option in the SFT Schedule Provisions;

- the determination of the "SFT Close-Out Amount" (or Loss) follows the existing approach for market SFTs by imposing that methodology into the ISDA Master Agreement (and replaces its traditional OTC derivatives close-out methodology). The calculation of the Close-Out Amount for SFTs pursuant to the SFT Definitions (whether by way of an Acceleration or Event of Default) involves the acceleration and valuation of each party's outstanding obligations under each SFT. These obligations are replaced by payable values which are then set-off to produce a single net balance payable on the next business day. Securities to be transferred and securities margin will therefore be replaced by cash values using the actual sale prices, or quotations from two or more third-party dealers, or (if neither is possible) their fair market value;

- interest, distributions and corporate actions; and

- a New York law governed U.S. Pledge, to reflect the market conventions for documenting margin for U.S. securities lending transactions (if elected in the SFT Schedule Provisions as applicable).

Close-out netting

Capturing both OTC derivatives and SFTs within a single netting set was one of the drivers behind this document programme. In circumstances where all outstanding transactions are being terminated, a net Early Termination Amount will take into account Close-Out Amounts under all OTC derivative transactions, SFT Close-Out Amounts and all Unpaid Amounts in respect of OTC derivative transactions and SFTs. We understand that the ISDA legal opinions regarding the enforceability of the close-out netting arrangements will, when updated, include the SFT documentation, with some updates potentially becoming available later this year. Certain markets may need to amend their netting legislation to accommodate SFTs within the broader netting set of the ISDA Market Agreement to permit clean opinions.

Market Application

Reflecting the well-established workings of SFT master agreements into an ISDA Master Agreement was not a straightforward task for the ISDA Working Group. The drive in producing the SFT documentation was not an expectation or desire to prioritise repapering SFT agreements. As mentioned, possible future technological and system developments may prompt further focus on documentation, but in the meantime, the publication of SFT documentation may have certain useful, if niche, applications for certain market situations including:

- Where market participants who are considering trading SFTs for the first time already have an ISDA Master Agreement. If one or both of the counterparties may be unfamiliar with existing SFT market documentation, the opportunity of trading under the ISDA Master Agreement may be an attractive option.
- In the development of new markets. For example, the new Chinese netting law will come into force on 1 August 2022. This legislation specifically recognises close-out netting under single agreement master agreements and the Chinese banking and insurance regulator (CBIRC) specifically references the enforceability of close-out netting for the ISDA Master Agreement in its Notice of November 2021. Parties to an ISDA Master Agreement who are facing counterparties in China may then be able to benefit from a positive close-out netting legal opinion once such opinion is prepared in connection with the ISDA Master Agreement and SFTs. We understand that the aim is for this to be issued around the time the legislation comes into effect and we shall be interested to see how and to what extent it addresses the SFT documentation and SFT trading.
- Where for the trading parties there is some convergence between the products of the two markets and the use of a single agreement to document both types of transaction provides the potential to minimise risk. For example, where a party sells equity options, and borrows securities to hedge its risks, it may wish to align its documentation and apply the same contractual terms to both types of transaction (thereby reducing any basis risk between the two).
- Margin lending in equities and other monetisation applications. Where parties already look to use ISDA Master Agreements and SFT documentation for financings they may see this as a useful precedent from which to start documenting these structured trades. Parties may also look at the wording of the documentation to provide lending or repurchase arrangements in relation to other assets which are outside the traditional securities lending and repurchase markets.

Finally, it is worth noting that those parties who are subject to capital requirements should also consider in advance of trading any possible consequences of the use of the SFT documentation for all types of their SFT transactions.

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