# Voting Rights on Equity used as Financial Collateral

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*Abstract*— **The right to vote in a company's general meeting is one of the key statutory rights for shareholders. Regularly it is an irrefutable presumption that a shareholder is only the person who is registered as a shareholder. In the case of equity used as financial collateral, it can be questionable who is entitled to voting rights attached to the financial collateral. Securities lending and repos are the two main types of securities financing transactions in the European market. In both, the collateral provider transfers the legal ownership of equities to the collateral taker. If a collateral provider wishes to exercise the voting rights attached to the transferred equities, he needs to recall the collateral. The main master agreements widely used in the European repo and securities lending market employ different solutions regarding the right of a collateral provider to substitute the financial collateral. These distinctions are explored in the paper, along with the analysis of the relevant provisions of the Financial Collateral Directive.**

***Keywords- voting rights; securities lending; repurchase agreement; financial collateral; Financial Collateral Directive.***

## I. INTRODUCTION

Repos and securities lending are the two main types of the securities financing transactions in the European cross-border market. Securities financing transactions are transactions under which securities are used as collateral to borrow cash or other securities. Due to their similarities, repos and securities lending can be used as substitutes for each other, depending on the economic motives of the parties which drive these transactions.

In both repos and securities lending, one party transfers the full legal title to securities to the other party for a limited period of time. Therefore, repo and securities lending agreement are both covered by the definition of a 'title transfer financial collateral arrangement' provided in the Article 2/1/b of the Financial Collateral Directive [1], which states that a 'title transfer financial collateral arrangement' means an arrangement 'under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations'.

The Financial Collateral Directive is intended to eliminate the so-called re-characterization risk associated with the collateralized transactions which transfer the ownership of the collateral from the collateral provider to the collateral taker. The re-characterization risk is a risk that the transfer of title in these transactions would be treated under national law as a security interest, under which not ownership but only a limited property interest is delivered. Article 6/1 of the Financial Collateral Directives imposes the obligation of the Member States to 'ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms'. The elimination of the re-characterization risk in title transfer financial collateral arrangements is explicitly stated as the aim of the Financial Collateral Directive in its recital 13: 'This Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterization of such financial collateral arrangements (including repurchase agreements) as security interests'.

The provisions of the Financial Collateral Directive are to be applied to the title transfer financial collateral arrangements, as well as to the security financial collateral arrangements, regardless of 'whether or not these are covered by a master agreement or general terms and conditions' (Article 2/1/a of the Financial Collateral Directive). Both repos and securities lending transactions are typically entered into under a master agreement concluded between the parties to these transactions. The purpose of the master agreement is to provide a framework under which individual transactions can be concluded and documented. The industry's standard master agreements are widely used in the European repo and securities lending market. The repo market in Europe is represented by the European Repo and Collateral Council (ERCC) of the International Capital Market Association (ICMA), whereas the securities lending market is represented by the International Securities Lending Association (ISLA). The standard master agreement for repos published by ICMA is the Global Master Repurchase Agreement (GMRA). The present version of the GMRA is the one revised in 2011 [2]. Securities lending transactions are typically documented and governed by the Global Master Securities Lending Agreement (GMSLA), which was updated by ISLA in 2012 [3].

Securities lending market typically uses government bonds and equity securities, such as ordinary shares, as a collateral. In repos the fixed-income instruments, such as bonds, are most-widely used as collateral, but a part of the repo market also deals with equities as collateral. As GMRA generally does not apply to equity repos (see paragraph 1(a) of the GMRA), parties wishing to use equity as collateral in

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repo have to amend and supplement their master repo agreement with a separate annex. For this purpose, a standard annex to the GMRA is provided by ICMA and widely used in the repo market: GMRA Equities Annex [4].

Section II of the paper highlights the main features of repos, while the structure of the securities lending transactions is explained in the Section III. The provisions of the standard master agreements governing these two types of transactions which are concerned with the voting rights attached to the equity used as collateral are analyzed in the Section IV. Conclusion is given in the Section V of the paper.

## II. THE MAIN FEATURES OF REPOS

Although the modern form of repo and a cross-border repo market emerged in Europe in the late 1980s, the European repo market started to rapidly grow in mid-1990s [5]. According to the latest survey conducted by the ERCC of the ICMA, the total value of European cross-border and domestic repos in December 2016 was 5,656.2 billion euro [6].

'Repo' is an abbreviation of 'sale and repurchase agreement'. The term 'repo' is commonly used in the market jargon as a generic term for two similar transactions: (1) repurchase agreement (also known as classic repo, US-style repo or all-in repo), and (2) sell/buy-back transaction.

A repurchase agreement or classic repo is an agreement that one party (the seller) will sell securities to another party (the buyer) at a certain date (the purchase date) at an agreed price (the purchase price), with a simultaneous commitment by the seller to buy equivalent securities from buyer at a future date or on demand (the repurchase date) at a different price (the repurchase price). The transaction is referred to as a 'repo' when looked at from the point of view of the seller, whereas from the buyer's point of view the same transaction is referred to as a 'reverse repo'. 'Every repo is a reverse repo, and the name given is dependent on whose viewpoint one is looking at the transaction' [7].

In the repo market jargon, the securities sold on the opening leg of the repurchase transaction are referred to as 'collateral'. However, these securities are not collateral in the traditional legal sense of this term. While in secured lending the secured lender is given a property interest in the asset provided as collateral and the borrower remains the owner of the asset, in classic repo the full legal title to the securities delivered as 'collateral' is transferred outright from the seller to the buyer. The buyer in a classic repo can deal with the securities as he wishes, while his main contractual obligation is to deliver the equivalent securities to the seller at the closing leg of the repurchase transaction.

At the repurchase date the securities equivalent to the securities purchased at the purchase date (i.e., the securities that are of the same issuer, are part of the same issue and are of an identical type, nominal value, description and amount as the purchased securities) are delivered to the seller against the payment of the repurchase price, which is higher than the purchase price paid by the buyer on the purchase date. The repurchase price equals the sum of the purchase price and the agreed pricing differential, which is calculated on the basis of the agreed repo rate [8].

Although the transaction is legally structured by the parties as a combination of two sale agreements, parties to the repurchase agreement are usually not economically motivated by the need for securities that are sold and repurchased between them. Most repurchase agreements are for general collateral and therefore are usually cash-driven transactions in which the parties are motivated by the need to borrow and lend cash. Cash-driven repurchase agreements are in their economic substance essentially secured loans of cash (see [7]). However, a segment of the repo market is driven by the demand to borrow particular securities (special collaterals or 'specials'). The party that needs collateral that is 'on special' will be willing to lend funds at a lower repo rate in order to obtain the collateral [9]. The difference between general and special collaterals in equity repo market is of little significance; since almost all trades in equity repo market are specific securities-driven transactions (see [7] and [10]).

The same practical effects as with the repurchase agreements or classic repos can be achieved through similar transactions known as sell/buy-backs [11]. As in repurchase transaction, in a sell/buy-back transaction the full legal title to the securities delivered as collateral is transferred outright to the buyer. Therefore, sell/buy-backs are also covered by the definition of a 'title transfer financial collateral arrangement' provided in the Article 2/1/b of the Financial Collateral Directive. Unlike repurchase agreements, in which the two legs of the transaction form a single contract, in a sell/buy-back transaction the opening and the closing leg of the transaction form two separate contracts. In a sell/buy-back transaction, parties enter simultaneously in a spot sale and a forward repurchase. The repo rate is not explicit as in repurchase agreement, but is however implied in the forward price agreed on the onset of transaction [7]. Parties wishing to document their sell/buy-back transactions may do so by supplementing their master repurchase agreement with a separate annex. The standard GMRA Buy/Sell-Back Annex is published by ISMA for this purpose [12]. Despite the availability of the standard GMRA Buy/Sell-Back Annex, in Europe still exists a large market in undocumented sell/buy-backs which is mainly concentrated in domestic markets, whereas in the European cross-border market documented sell/buy-backs are more common [5].

## III. THE MAIN FEATURES OF SECURITY LENDING

The structure of the security lending transaction is similar to the structure of a classic repo. A security lending agreement is an agreement that one party (the lender) will transfer securities to another party (the borrower) at a certain date against the transfer of collateral (cash or other securities) by borrower to lender, with a simultaneous commitment by the borrower to transfer to the lender equivalent securities at a future date or on demand against the transfer of assets equivalent to collateral to borrower by lender (see [8] and [13]).

Although securities lending market jargon uses the expressions 'borrower' and 'lender', in secured lending

transaction the full legal title to the 'borrowed' securities is transferred outright from the 'lender' to the 'borrower' (see paragraph 2.3 of the GMSLA). Similar to repurchase agreement, the main contractual obligation of the borrower is to deliver equivalent securities to the lender at the closing leg of the security financing transaction.

The securities lending agreement is legally structured as a combination of two loan agreements under a single contract. From the perspective of the borrower, securities lending is a specific securities-driven transaction in which the borrower is motivated by the need to borrow special securities. These special securities are typically either equity securities or government bonds. In recent years, the European securities lending market has seen most growth in the segment which deals with the government bonds [14].

## IV. VOTING RIGHTS ATTACHED TO THE EQUITIES USED IN REPOS AND SECURITIES LENDING

When equities are used as financial collateral in repos and security lending transactions, the question arises who is entitled to exercise the voting rights attached to the equities during the lifetime of the transaction. As both repos and security lending transactions transfer the full legal title to the equities used in transaction, in both types of transactions the new owner is entitled to exercise the voting rights.

Both GMRA Equities Annex and GMSLA explicitly regulate the question of whether the original owner of the transferred equities can give voting instructions that have to be carried out by the new title-holder. Paragraph 6.6 of the GMSLA provides that where any voting rights fall to be exercised in relation to either to loaned equities or the equities used as collateral, neither the borrower nor the lender have any obligations to arrange for voting rights to be exercised in accordance with the instructions of the other party. The parties to the securities lending agreement can agree otherwise in writing (see paragraph 6.6 in connection with paragraph 1.2 of the GMSLA). Whereas the previous version of the Equities Annex to GMRA provided as the main rule that the original title-holder can give voting instructions that have to be carried out by the transferee of equity securities (see [15]), Equities Annex to the GMRA 2011 has taken the equal stance as GMSLA. Paragraph 5(b) of the GMRA Equities Annex provides that where any voting rights fall to be exercised in relation to any purchased equities, the buyer is not obligated to arrange for voting rights to be exercised in accordance with the instruction of the seller, unless otherwise agreed between the parties. It should be noted that, even if the parties to the security lending agreement or to the repurchase agreement have expressly agreed that a new title-holder of equities is obliged to vote according to the instructions of the original owner, voting contrary to the given instructions nonetheless does not render void the decision delivered on the basis of that vote.

If the original title-holder of equities wishes to exercise the voting rights attached to the equities transferred under a security lending agreement or a repurchase agreement before the equivalent securities are delivered to him at the closing leg of the transaction, he can only do so if he is entitled to activate the technique of substitution of collateral. A right of substitution is governed in different manner in GMRA and GMSLA.

Paragraph 5.3 of the GMSLA entitles the borrower to call for the delivery of equities equivalent to those delivered to the lender at the opening leg, prior to the date on which the same would otherwise be deliverable. The borrower's right to recall of collateral is conditioned with the delivery of alternative collateral from borrower to lender. Alternative collateral must have a market value equal to the substituted collateral. The right of the lender to substitute the loaned securities is not explicitly governed by the GMSLA.

GMRA contains provisions on substitution of the delivered securities during the life of a repurchase transaction in the paragraph 8 of the GMRA. Under these provisions, the seller is not generally entitled to a right to substitute the previously sold securities. He may request the substitution from the buyer but the substitution technique will be executed only if the buyer agrees to the requested substitution. In exchange for the buyer's permission to substitute the collateral at any time between the purchase date and the repurchase date, the seller will usually agree to pay a higher repo rate [16].

In case of documented sell/buy-backs the provisions of GMRA regarding the substitution of securities are applicable in the same manner as in the case of repurchase agreements. In general, a seller in an undocumented sell/buy-back does not have the right to substitute collateral.

The Financial Collateral Directive seeks to protect the validity of such substitution mechanisms developed in the marked practice. Under the Article 8/3/b of the Financial Collateral Directive, where a financial collateral arrangements contains 'a right to withdraw financial collateral on providing, by way of substitution or exchange, financial collateral of substantially the same value', the Member States are obliged to ensure that substitution of the financial collateral shall not be treated as invalid or reversed or declared void on the sole basis that, inter alia, the relevant financial obligations were incurred prior to the date of substitution.

## V. CONCLUSION AND FUTURE WORK

The paper intended to explore and highlight the main common features as well as the basic differences between securities lending and repurchase agreements, in particular those connected to the issues of voting rights attached to the equities used as financial collateral in these transactions. As both transactions belong to the family of title transfer financial collateral arrangements, in both security lending agreement and repurchase agreement the voting rights are transferred to the new title-holder together with the transfer of the title to equity securities used in transaction. Under the current versions of standard master agreements, in both security lending and repurchase transactions the new title-holder is not obliged to vote in accordance to the instructions of the original title-holder, unless the parties had expressly agreed otherwise. A party wishing to exercise voting rights attached to the equities transferred to the other party may do so only if entitled with a right to substitute the transferred equities with equities equal in market value to the transferred

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equities. Whereas the borrower in security lending transaction usually has the right of recall of collateral, the seller in repurchase transaction is not allowed to recall the delivered securities unless a right of substitution is specifically agreed between him and the buyer.

A particular problem with the securities lending agreements and equity repos, which was not addressed in this short paper, is that these transactions may be used as means of obtaining voting control. As the voting rights attached to the borrowed securities will be transferred together with the full legal title to the borrower, while also in the case of equities used as collateral the voting rights attached to the collateral will be transferred to the lender, securities lending transactions could be used by the board of directors with an aim to influence the voting in the company's general meeting. The same can occur with the equity repurchase agreements. These issues will be explored in the continuation of the research.

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