BETTER LATE THAN NEVER: THE LSTA'S NEW DELAYED COMPENSATION STANDARD FOR ASSIGNMENTS OF PAR/NEAR PAR LOANS

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In a long-awaited development, the delayed compensation standard for late settlement of par/near par loans is changing in important ways starting on September 1, 2016. On that date, the no-fault system for delayed compensation will be supplanted by a requirements-based standard under which parties to loan assignments must meet certain basic requirements in order to receive delayed compensation for late-settling trades. The implementation of this new regime is intended to reduce settlement delays in the loan trading market by giving market participants financial incentives to settle trades quickly.

This article will describe some of the conditions that have led to settlement delays in secondary market loan trading, the risks that late settlement poses for loan market participants and mitigants to the problem, including the no-fault delayed compensation regime that is being replaced. It will then discuss the new delayed compensation standard in detail, including differences in trades settled in paper and those settled electronically, as well as exceptions and some nuances of coverage.

THE PROBLEM OF DELAYED SETTLEMENT IN SECONDARY MARKET LOAN ASSIGNMENTS

Conditions Leading to Delayed Settlement

Most secondary market par/near par loan trading in the United States is based on standard documentation published by the Loan Syndications & Trading Association (the "LSTA"), principally the trade confirmation and the standard terms and conditions for trade confirmations (collectively, "Trade Confirmations").[1] The trade itself can be effectuated by oral agreement, which is legally binding on the parties as a matter of New York law so long as the essential terms of the trade are agreed upon, and the trade is thereafter settled upon execution of documentation and payment of the purchase price. Where the parties have elected to settle a trade by assigning the loan, they will also typically use the form of assignment agreement appended to the relevant credit agreement to effect the transaction (the "Assignment Agreement").

Ideally, the period between the trade date and the settlement date is three business days (T+3), and that is typical settlement timing for trading in high-yield bonds. However, the average period between the trade date and the settlement date for par/near par loan market trading has averaged closer to three weeks; according to the recent LSTA Settlement Data Study for the second quarter of 2016, only 23 percent of par trades in the U.S. loan market settled within seven business days (T+7). The definition of late-settling trades for all purposes on and after

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September 1, 2016, will be: (a) with respect to trades for which the trade date is on or prior to the sixth business day after the initial funding date or closing date of a credit facility ("Early Day Trades"), the date that is 14 business days after such funding or closing; and (b) with respect to all other trades, the date that is seven business days after the trade date (T+7).

Several factors have contributed to delays at each step in the settlement process for loan assignments in circumstances where the failure is not caused by lack of cash by the buyer to make the trade. Electronic settlement platforms ("ESPs") used to facilitate the transfer of syndicated loans, such as ClearPar or Trade Settlement Inc., are not immune from delays and may present unique issues.

- *Trade Entry.* To the extent the parties are making use of ESPs, there may be delays in entering the trade into the system. This could be a result of a lack of an automatic feed from a broker/dealer's internal system to the ESP or, where there is an automatic feed, the skipping of backdated trades. Also, credit agreements and facilities may not be built into the ESP.
- *Allocation.* Allocations may not be available on the trade date. In addition, allocations must often be provided or entered into an ESP manually.
- *Trade Confirmation.* Where there are disputes over the economic or other terms of a trade, finalizing the Trade Confirmation will be delayed. Different participants in the review and execution process, including closers and signatories, may also slow the process when they are unable to promptly perform their role.
- *Assignment Agreement.* Some institutions will not sign an Assignment Agreement until the Trade Confirmation has been fully executed. Also, some Assignment Agreements may include additional representations stemming from the relevant credit agreement that may require further diligence. On ESPs, these often appear as "pop-up" questions. Where it is determined that the buyer is not an "eligible assignee" under the credit agreement, there may be extensive or terminal delays.
- *Closing Approvals; Managing Balance Sheet.* For a variety of reasons, both sellers and buyers may postpone agreement on a settlement date. Sellers may be short or they may be trying to coordinate an upstream buy with their sale. Similarly, buyers may delay their purchase until they can also close a downstream sale. These intentional delays are used to manage cash and balance sheet risk. In addition, those parties using ESPs may experience delays because a buyer is waiting for the seller to "check off on SDC," indicating that they are ready to close.
- *Third-Party Acknowledgements and Consents.* Administrative agents often do not have the capacity to review every trade that is approved for closing within one business day. Delays related to administrative agent review and acknowledgement of an assignment often last three or more days. An administrative agent may also be seeking tax validations related to the Foreign Account Tax Compliance Act ("FATCA") or the borrower's consent to the transfer, which can lead to further delays. Additionally, loan trading under facilities may be periodically put on hold for a variety of reasons, including during times of repricing, commitment reductions, and amendments. During these holds, administrative agents typically are not able to process assignments.[2]

Risks of Delayed Settlement

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Settlement delays create a variety of risks for both parties to a secondary market loan trade, including liquidity risk and market risk. Liquidity risk arises because delayed settlement interferes with a party's ability to realize the proceeds of loan sales in a timely way and may also tie up the seller's capital for a position on its balance sheet for which it is paying the cost of carry without receiving compensation. Market risk arises because the market price of the loan may move materially against one or the other of the parties between the trade date (when the purchase price is agreed) and the settlement date (when the purchase price is paid). Both of these risks are magnified the longer it takes to settle a loan trade.

The liquidity implications of late settlement of secondary market loan assignments has recently been the focus of attention from mutual funds and exchange-traded funds ("ETFs") as a result of the Securities and Exchange Commission's proposed liquidity management rules, which were released for comment in September 2015. Proposed Rule 22e-4 under the Investment Company Act of 1940 would require funds to establish and implement written liquidity risk management programs containing multiple elements. Specifically, a program would be required to (1) classify the liquidity of each portfolio asset into one of six categories based on the amount of time such assets could be converted into cash without market impact, (2) periodically assess and review a fund's liquidity risk, (3) establish a minimum amount of assets that can be readily liquidated in three business days without materially affecting the assets' market value prior to completing the sale ("three-day liquid assets"), and (4) institute board approval and a review process. The purpose of the liquidity management rules is to ensure that investors can redeem their shares and receive their assets in a timely manner.[3]

Addressing Settlement Delays

Several mechanisms exist to help parties to loan trades address some of the risks associated with settlement delays. Some of these are within the terms of LSTA documentation, while others are separate types of contractual arrangements.[4]

Non-LSTA Mechanisms

- *Liquidity Facilities.* Liquidity facilities can help provide access to cash needed to settle trades and can also substitute for the cash shortfall that may be caused by late settlement of trades. However, while liquidity facilities may alleviate the symptoms of delayed settlement, they do not solve the underlying problem.
- *T+3 Settlement Facilities.* Since the first quarter of 2016, financial institutions have been offering so-called "T+3 settlement facilities" to mutual funds and ETFs in response to proposed Rule 22e-4. By providing a contractual basis for an intermediary to guarantee to purchase positions and settle the trade within T+3 business days, this new product category permits loans subject to assignment to be considered three-day liquid assets under Rule 22e-4. However, T+3 settlement facilities may be limited in their application and their utility. They tend to be subject to conditions on availability that may adversely impact their practical availability. For example, they may limit the amount of loans that can be purchased from a particular seller by way of participation, or they may charge fees or impose other conditions that raise issues of best execution and allocation among funds in a given fund family. Furthermore, they fill a specific compliance need for certain types of collective investment vehicles that has arisen within the text

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of proposed Rule 22e-4, and therefore, they may not appear relevant or available to other categories of market participants.

Mechanisms Within the LSTA Documentation

- *BISO.* The buy-in/sell-out provisions ("BISO Provisions") contained in the standard terms of Trade Confirmations represent another device that may be used to mitigate late settlement risk.[5] The BISO Provisions were designed to encourage timely settlement by giving a performing party the ability to terminate its open trade and enter into a "cover" transaction with a third party under certain circumstances. The nonperforming party would then indemnify the performing party for any market losses resulting from the substitute transaction. Parties may take advantage of the BISO Provisions at T+20 business days, which can help to unblock a terminally stalled settlement process. However, the BISO Provisions take effect too long after a trade date to mitigate delayed settlement risks in less dramatic situations. The BISO Provisions also do not apply where settlement delays result from administrative agent or borrower acknowledgements or consents not being timely delivered.

- *Delayed Compensation.* The principal way in which the LSTA's standard documentation addresses delayed settlement is by establishing "delayed compensation" for late-settling loans.[6] Delayed compensation is meant to put the parties to a loan trade in the same position they would have been in had the settlement date not been delayed by entitling the buyer to receive the contractual interest accruing under the assigned loan during the period of delay net of a fixed amount that the seller is entitled to retain. If a par/near par trade does not settle by T+7 business days, delayed compensation begins accruing to a buyer under most circumstances regardless of whether a loan trade has actually closed. However, many have argued that this "no-fault" delayed compensation standard actually aggravates the delayed settlement phenomenon. Buyers may not be motivated to settle trades when they are guaranteed delayed compensation, and dealers standing between counterparties may not be inclined to use their balance sheets to settle trades until the ultimate buyer is ready, where delayed compensation will ultimately put all parties in the same position they would have otherwise been. In addition, delayed compensation does not prevent short-sellers from entering into loan trades they cannot cover. The LSTA has devised the new requirements-based delayed settlement regime in the expectation that it will induce parties to reduce settlement times.

THE LSTA'S NEW DELAYED COMPENSATION STANDARD FOR PAR/NEAR PAR LOAN ASSIGNMENTS

The new requirements are being instituted in two phases. During the first phase, from September 1 through October 31, 2016, parties to a loan trade will generally be required to meet all documentation requirements (the Trade Confirmation, which includes the trade date, and the Assignment Agreement) by T+6 business days or, for Early Day Trades, within 12 business days after the initial funding or closing of the facility. Beginning on November 1, 2016, these same requirements must be met by T+5 business days or, for Early Day Trades, within 10 business days after the initial funding or closing of the facility. Requiring that the documents be fully executed by such deadlines will allow the administrative agent to notify the parties early enough to achieve prompt settlement of the trades, absent intentional misconduct on the part of the buyer or third-party delays, for which the delayed compensation will apply.

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Though the revised terms of the standard terms for Trade Confirmations distinguish between paper and settlement platform requirements, the framework is largely the same. It is worth noting that unless the parties specify in the Trade Confirmation, a transaction will settle pursuant to the settlement platform requirements rather than the paper requirements.[7]

Applicability of Requirements-Based Regime to Paper Trades

For trades settling on paper, the buyer must meet the documentation requirements outlined below (the "Paper Requirements") and pay the purchase price in accordance with the timing requirements below for delayed compensation to apply to the transaction, unless an exception applies.[8]

Documentation Requirements

The Paper Requirements vary depending on who is the drafting party.

Where the seller is the drafting party, the seller must deliver the Trade Confirmation and the Assignment Agreement to the buyer by T+1 business day, and the buyer, in turn, must sign and deliver the Trade Confirmation and the Assignment Agreement to the seller:

- with respect to a Trade Confirmation with a trade date on or before October 31, 2016, by T+6 business days, or in the case of an Early Day Trade, within 12 business days after the date of the initial funding or closing under the facility; or
- with respect to a Trade Confirmation with a trade date on or after November 1, 2016, by T+5 business days, or in the case of an Early Day Trade, within 10 business days after the date of the initial funding or closing under the facility.

Where the buyer is the drafting party, the timing for satisfaction of the Paper Requirements depends on when the buyer delivers the Trade Confirmation and the Assignment Agreement to the seller:

- if the buyer delivers the Trade Confirmation and the Assignment Agreement to the seller by T+1 business day, the buyer must deliver its executed signature page to the Trade Confirmation to the seller and the fully executed Assignment Agreement to the administrative agent for purposes of settling the trade within one business day of receiving the seller's executed signature pages to the Trade Confirmation and Assignment Agreement;
- if the buyer does not deliver the Trade Confirmation and the Assignment Agreement to the seller by T+1 business day, the seller may notify the buyer that it has failed to deliver the documents by T+3 business days. Upon being notified, the buyer must then deliver the executed Trade Confirmation and Assignment Agreement to the seller by T+5 business days (or for Early Day Trades, within 10 business days after the date of initial funding or closing); provided that upon receipt from the seller of its executed signature pages to the Trade Confirmation and Assignment Agreement, the buyer must deliver the Assignment Agreement to the administrative agent within one business day of such receipt to the administrative agent for purposes of settling the trade. If the buyer does not satisfy these requirements, it shall be deemed not to have met its obligations for purposes of delayed compensation; or

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- if the seller does not notify the buyer by T+3 business days that the documents were not delivered, then the buyer is deemed to have met its requirements for purposes of delayed compensation.

Purchase Price Payment Timing

The requirements for when the purchase price must be paid similarly vary depending upon who must obtain the necessary consents and approvals. All times referenced below are to New York time.

Where the seller is the party responsible for obtaining consents and the transaction does not settle by T+7 business days (or, with respect to an Early Day Trade, within 14 business days after the initial funding or closing under the facility), the seller must deliver its executed signature page to the Assignment Agreement to the buyer and, once it has reasonably determined that all consents and approvals will be obtained, propose a delayed settlement date no later than 6:00 p.m. on the business day immediately preceding such date.

If the seller does not provide the buyer with timely notice of a proposed delayed settlement date, the buyer shall pay the purchase price no later than the business day following the date the seller provides the buyer with notice that the loan transfer has been made effective on the books and records of the administrative agent and/or borrower ("Assignment Effective Date").

If the seller provides the buyer with timely notice of the proposed delayed settlement date and provides the buyer with notice of the Assignment Effective Date, then the buyer shall pay the purchase price:

- on the date the buyer receives notice of the Assignment Effective Date, if such notice is received on or before 11:00 a.m.
- on the business day immediately following the date the buyer receives notice of the Assignment Effective Date, if such notice is received after 11:00 a.m.

Where the buyer is the responsible party and the transaction does not settle by T+7 business days (or, with respect to an Early Day Trade, within 14 business days after the initial funding or closing under the facility), the buyer shall pay the purchase price:

- on the date the buyer receives notice of the Assignment Effective Date, if such notice is received on or before 11:00 a.m.
- on the business day immediately following the date the buyer receives notice of the Assignment Effective Date, if such notice is received after 11:00 a.m.

Applicability of the Requirements-Based Regime to Settlement Platform Trades

For trades settling on an ESP, such as ClearPar or Trade Settlement Inc., the framework is similar,[9] but instead of an obligation to deliver the Trade Confirmation and Assignment Agreement by T+1 business day, there is an obligation to submit the details of the trade to the ESP by T+1 business day. In transactions where only one party is a dealer, the dealer has the obligation to submit trade details whether it is the seller or the buyer. Where both parties to a transaction are dealers or where neither party is a dealer, the obligation is on the seller to submit the trade details.

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- If a seller who has the obligation to submit trade details fails to do so by T+1 business day, delayed compensation will not apply to the transaction.
- If a buyer who is the only dealer in the transaction fails to submit trade details by T+1 business day, the seller must provide a notice to the buyer including the trade details by T+3 business days. If such a notice is provided, then the buyer must submit the trade details to the ESP by T+5 business days (or, in the case of an Early Day Trade, within 10 business days after the initial funding or closing under the facility) and meet its other requirements for delayed compensation to apply. If such a notice is provided by the seller and the buyer does not meet the requirements above, or if the seller does not provide such notice, delayed compensation will not apply to the transaction.

Once the trade details have been timely submitted to the ESP and a Trade Confirmation and Assignment Agreement have been generated by the ESP, the buyer must sign and return its signature pages to the Trade Confirmation and the Assignment Agreement to the ESP and elect on the ESP that it is financially able to settle the transaction from T+7 business days forward (or within 14 business days after the initial funding or closing of the facility for an Early Day Trade).

Purchase Price Payment Timing

The buyer must also timely pay the purchase price, the timing of which varies depending upon whether the trade date for a transaction is before or after November 1, 2016. Generally, the payment obligation is triggered by receipt of notice from the ESP that the necessary consents and approvals to transfer the loans on the books and records of the administrative agent and/or borrower have been obtained ("Electronic Assignment Notification").

In addition, a buyer may elect on the ESP to receive advance notice that the transfer of loans will be made effective on the books and records of the administrative agent and/or borrower ("Advance Notification Setting"). When a buyer makes such an election, the Assignment Agreement will not be made effective until the advance notice period has concluded, giving the buyer additional time to coordinate payment. Until October 31, 2016, buyers may elect an Advance Notification Setting of one or more business days. However, beginning November 1, 2016, delayed compensation will not apply to any transaction where a buyer has elected an Advance Notification Setting of more than one business day. If a buyer elects an Advance Notification Setting of one business day and an Electronic Assignment Notification is received either before 11:00 a.m. or after 6:00 p.m., delayed compensation will still apply to the transaction, but the buyer will forfeit one day of delayed compensation for the ability to fund the purchase price one day later.

The details of the timing of purchase price payments with respect to settlement platform trades are as follows:

For transactions with a trade date on or before October 31, 2016, the buyer must pay the purchase price on the Assignment Effective Date.

For transactions with a trade date on or after November 1, 2016, the buyer must pay the purchase price:

- on the date the Electronic Assignment Notification is provided, if such notice is received on or before 11:00 a.m. and no Advanced Notification Setting is elected;
- on the business day immediately following the date the Electronic Assignment Notification is provided: (i) if such notice is received on or before 11:00 a.m. and an Advanced Notification Setting of one business

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day is elected, (ii) if such notice is received after 11:00 a.m. but before 6:00 p.m., or (iii) if such notice is received after 6:00 p.m. and no Advanced Notification Setting is elected; or

- on the second business day following the date the Electronic Assignment Notification is provided, if notice is received after 6:00 p.m. and an Advanced Notification Setting of one business day is elected.

In one of the final revisions to the delayed compensation provisions, the LSTA added an override provision for settlement platform trades. This provision gives the seller and the buyer the right to override the purchase price payment timing described above and to agree to make the Assignment Agreement effective on a different business day, but only after receiving the Electronic Assignment Notification. If the administrative agent makes the Assignment Agreement effective on the day agreed by the parties, the buyer must pay the purchase price on that day.

Circumstances Not Impacting Delayed Compensation

Regardless of whether a buyer has met the applicable documentation requirements and paid the purchase price, delayed compensation will still apply to a transaction under several circumstances:

- Where the seller is the drafting party, and the seller does not deliver the Trade Confirmation and Assignment Agreement to the buyer by T+1 business day.
- If the buyer has not paid the purchase price because it reasonably believes that the calculation prepared by the seller is incorrect, has provided the seller with a notice detailing the error on or before the day the purchase price is due and has otherwise met the applicable documentation requirements.
- Where the seller is the drafting party, and the buyer executes the Trade Confirmation on time but does not execute the Assignment Agreement because the buyer believes there is a material error in the Assignment Agreement, such as a reference to the wrong credit agreement, borrower, or loan facility, and the buyer provides notice to the seller by T+3 business days. However, if the seller corrects the Assignment Agreement by T+4 business days, then the buyer must still satisfy the documentation requirements and pay the purchase price on time for delayed compensation to apply.
- If the buyer has notified the seller that it is a new CLO issuer before T+7 business days, the buyer may select a blackout period during which the seller shall direct the administrative agent not to make the transfer effective.
- For settlement platform trades only, where a buyer is unable to meet its requirements because of circumstances relating to the functionality of the ESP that are beyond the buyer's control and cannot be prevented or overcome by the buyer (force majeure).

General Circumstances Not Impacting Delayed Compensation Requirements

For trades settling on settlement platforms and on paper, there are a couple of circumstances that will not impact the application of delayed compensation to a transaction. So long as a buyer has met the applicable requirements as outlined above, delayed compensation will continue to apply even where necessary consents

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and approvals to the transfer have not been obtained from borrowers, administrative agents, or others as provided in the credit agreement. This provision keeps parties from being penalized when settlement delays are not their fault. Also, delayed compensation will continue to apply to a transaction where a buyer has not met its requirements because a seller has failed to provide due diligence information, such as "know your customer" information, previously requested by the buyer to onboard the seller. However, once such information is provided by the seller, the buyer must promptly finalize the onboarding process to facilitate settlement.

Application of the Requirements-Based Standard to Loan Participations

The new requirements-based delayed compensation standard will not apply to transactions originally entered into as participations. However, the new standard will apply to trades that were originally entered into as assignments and later settle as participations. Under these circumstances, the requirements outlined above must still be met, including the timely delivery of an executed Assignment Agreement, in order for delayed compensation to apply. It is not likely that this difference in the way participations are treated under the new delayed compensation standard will have a material impact on the frequency of their use in the market, given that assignments that settle as participations are often utilized when the required borrower consent to an assignment is not obtainable or the assignee does not meet assignee eligibility requirements under the credit facility.

CONCLUSION

The replacement of a no-fault regime based on reasonable efforts with an explicit requirements-based approach will require that market participants think differently about the settlement process. Parties to secondary market loan assignments should consider putting guidelines in place to help facilitate the transition to the new standard. Dealers and other market participants with large trading volumes may find the transition particularly challenging as they will need to diligently monitor the progress of large numbers of trades. To the extent ESPs are being used, there may be built-in mechanisms that can help parties to adhere to the new timing requirements. If these mechanisms are effective in keeping trades settling in a timely manner, there could be an increased shift from paper to electronic platform settlement.

By incentivizing market participants to speed up settlement of loan assignments, the LSTA's new delayed compensation standard should alleviate some of the factors that have contributed to blockages in the back office. However, the new standard will not solve all causes of delay, as witness the exclusion from the new delayed-compensation standard of delays owing to failure to obtain requested consents required by the credit agreements. The LSTA, and secondary loan market participants as a whole, may still have work to do if further reductions in settlement delays are the goal.

Notes:

[1] The LSTA has developed separate sets of documentation for loans trading at par or near par and for loans that are deemed to be distressed. Because the new requirements-based standard for delayed compensation only applies to secondary trades of par/near par loans at this time, this discussion is limited to the documentation and process for settling such trades and does not address documentation for distressed trades.

[2] LSTA Presentation: Best Practices for Secondary Trade Settlement (Apr. 28, 2015).

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[3] Press Release, SEC Proposes Liquidity Management Rules For Mutual Funds And ETFs, Securities and Exchange Commission (Sept. 22, 2015).

[4] Owing to the document-specific nature of many of the obstacles to settlement as discussed above, the development of blockchain technologies such as Utility Settlement Coin, SETLcoin, or Citicoin is unlikely to help speed settlement of assignments for some time, even if they become useful in other markets.

[5] LSTA Standard Terms and Conditions for Par/Near Par Trade Confirmations, Section 16.

[6] *Id.*, Section 6.

[7] *Id.*

[8] *Id.*, Section 6A.

[9] *Id.*, Section 6B.

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