



Securities Law Newsletter Switzerland

Securities Lending: Voting Rights Lost In Transit, What Happens in Insolvency?

Where are the Shares?

The British investment company Olivant has apparently lost access to UBS shares in connection with the Lehman Brothers Insolvency.

According to an article published in the Neue Zürcher Zeitung on October 2, 2008, the former President and Chairman of the Group Executive Board of UBS AG, Luqman Arnold has no idea where the shares acquired by the Olivant Group in UBS with a market value of more than CHF 1.5 billion have remained. The Neue Zürcher Zeitung comments that it appears that many hedge funds may have been negligent in lending securities.

While - for the time being - the issue with the UBS shares "lost in transit" is one of voting rights only, it could become a more serious one since the question of ownership (title) to the shares may also become an issue.

This newsletter analyzes the legal framework of securities lending and the risks involved for the lender and for the account holders who have permitted their bank to use the securities credited to their account in security lending transactions.

Securities Lending

Securities lending is a practice, which has been established many years ago and in which one broker, the lender, lends fungible securities to another broker, the borrower, for a fee, with the contractual obligation of the borrower to retransfer equivalent securities (same kind and number) to the lender upon expiration of a defined term or upon demand (see: <http://www.isla.co.uk/docs/intro%20to%20securities%20lending%20v1%20-%20chapter%201.pdf>).

Standard agreements drawn up by the industry associations are being used for such transactions. In general, the lender will require collateral, to secure

the borrowers obligation to return equivalent securities. Security lending agreements are also usually covered by a master agreement which permits either party to proceed with a close out and netting in the event of the counterparty being in default.

Title and Rights to and in the Securities

Under a securities lending transaction, title to the securities are transferred from the lender to the borrower. Since in today's world securities are largely uncertificated or immobilized ("book entry securities"), title passes, under Swiss law, by way of an assignment in writing, with no physical delivery of securities taking place.

According to Art. 685f para 1 Swiss Code of Obligations ("CO"), where registered shares are acquired on a regulated stock exchange, title and all rights associated with registered shares pass to the acquirer upon acquisition. However, since securities lending transactions are OTC transactions, the rights (voting and economical) to the registered shares in relation to the company will pass to the acquirer (as far as the company is concerned) upon the filing of a request for registration only (Art. 685f para 1 CO). Until the acquirer is registered by the company as a shareholder, the voting rights and the rights associated with the voting rights cannot be exercised. (Art. 685f para 2 CO).

In relation to the seller or lender and third parties, however, the economic rights to the shares pass to the borrower or purchaser upon execution of the assignment and as of that date such securities and the economic rights associated therewith do no longer form part of such lender's or seller's estate. Art. 685f CO was not intended to modify the Swiss law on assignment of rights. It only deals with the exercise of shareholders' rights against the company.



Borrower's Insolvency

Since in a security lending transaction title to the securities is passed on the borrower, such securities will form part of the borrower's estate in insolvency. The lender will only have a contractual claim against the estate in insolvency for redelivery of equivalent securities which claim will be accelerated and monetized according to Art. 208 para 1 Swiss Debt Enforcement and Bankruptcy Law. The lender, however, cannot request segregation of such securities and therefore bears the full counterparty risk, except to the extent the borrower did deliver collateral to the lender.

Security Lending Authorization by Account Holders

As a general rule, securities credited to a customer account do not form part of the bank's estate and, in an insolvency of the bank, such securities are segregated for the benefit of the banks' customers. For securities which are credited to the customer account, the customer does therefore not have to bear the risk of the bank insolvency.

In the past, Swiss banks have been asking their customers to authorize the bank to use such customer's securities for security lending transactions in the name of the bank. Such authorization must be given in a separate form. The bank will then pool the customers' securities and use them in securities lending transactions.

This authorization, however, as benign it may seem, carries a substantial risk for the bank's customer.

When the securities belonging to the customer are used by the bank for securities lending transactions, the customer loses title to such securities. Should subsequent to the transaction the bank become insolvent, the customer cannot request segregation of these securities which have been lent by the bank. The customer will have only a contractual and unprivileged claim against the bank for redelivery of such securities.

Securities lending is for professionals only who are in a position to assess the risks. For a small investor authorizing his bank to use the securities for securities lending transactions, the risk greatly outweighs the benefit of participating on a pro rata

basis in the securities lending fee charged by the bank to the borrower.

October 3, 2008

David Känzig

For further information please contact:
David Känzig (d.kaenzig@thouvenin.com)