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- **Fund liquidity mismatches** – is the game up for gaming the gating?

Scrivener's errors

The festive season is a time to party. But often after the revelry there is a hangover. One may have over indulged. One may also have over spent! Let's face it, perhaps we are all guilty of relaxing some of our personal controls during the past month. In the month ahead, some of us will perhaps rue the financial cost, and New Year resolutions may involve some necessary belt tightening!

While many employed in the Financial Markets can wind down during December, **Capital Markets** staff often see a ramp up in their workload. A final feeding frenzy as deals are concluded before books close at year end. Companies may need to refinance and wish to capitalise on a feel-good factor. With the Federal Reserve signalling more benign policy ahead, the end of 2023 saw a push to get deals done.

For the busiest of bankers, there may have been a rush of similar deals. If you know the type of structures that suit your investing customers, then there is little point to finessing structures. Indeed, going "off-piste" could slow down the assessment process. Better to crank up the machine, draw down the **template**, and populate the terms. Literally running the printing press!

Prospectuses, Indentures, Termsheets, Offering Circulars are populated with reams of terms. The great majority of these are standardised, and as such don't need much updating from deal to deal. Those terms specific to the deal are the ones where changes are made. But as issuance cranks up and the number of deals increases, it can be the case that overworked Capital Markets staff, their legal counsel and external advisers take their eyes off the ball. The result can be that terms recorded into the documentation supporting a deal contain errors.

Thankfully apparent errors can be fixed. A court can correct the error or even reform contracts. So, what's the worry? The reality is that corrections come with a **cost**. Legal processes, while a critical spend, are costly. In our experience, SKADI has found that most of the cases we work on result from parties reviewing contractual clauses after the fact. There's far more scrutiny, and a grasp of the what-ifs, when things have gone wrong, rather than when parties enter into agreements. At the outset, the aroma of the financing has a tendency to drown out the stench of risk from poorly drafted clauses.

In SKADI's Emerging Risk Outlook, we predicted that 2024 would be a year for increased insolvencies. Precisely the backdrop for increased scrutiny of contractual clauses, as lenders and borrowers face off, in the aftermath of what has gone wrong. The result is that the legal costs come in bouts during the cycle rather than a steady manageable drip feed.

It also sounds very simple; the court corrects errors and parties move on. In reality, things can become complex very fast. Indeed, a look back at history provides insight into what the fallout from a Scrivener's error has the potential to be. It was on 20 December 2004 that Convertible Bond (CB) issuer Aristocrat Leisure delivered an unexpected Christmas present. Not a Christmas present for the CB investing community, but to Disputes and Litigation lawyers! In fact, for those in the CB community that held some of the US$130m 5% convertible bonds due May 2006, it made for a terrible Christmas...

Aristocrat Leisure, a supplier of gaming machines, had raised funds in May 2001. Bonds were issued under an Indenture which set out the obligations and rights of the issuer, bond holders and trustee. Aristocrat Leisure, whilst listed in Australia, operated globally, necessitating the raising of US$ financing. The Indenture to the bonds contained a Scrivener's error covering the exchange rate which would be used to convert US$ bonds into Australian listed shares of Aristocrat Leisure. Instead of reading "US$0.514 = A$1.00" the rate was quoted as "A$0.514 = US$1.00". All parties agreed that the exchange rate as written was a Scrivener's error.

In Convertible Bonds, Issuer's Calls are designed to encourage conversion, but in the case of the Call relating to the bonds in Aristocrat Leisure, the right to convert would terminate with the Call by the issuer for the redemption of the bonds. Because of this somewhat draconian right to call, when Aristocrat Leisure spotted the error, on the 22 November 2004, and approached the Trustee to correct the error, the Trustee refused the correction. The Trustee was aware that bondholders' right to convert would potentially disappear.

Nicolas Corry, SKADI's MD, and a former head of CB trading, explains what happened next:

"I was trading at Lehman Brothers at the time in Hong Kong. Things were winding down on the Monday of the week before Christmas. Suddenly the market came alive. Fortunately for us, Aristocrat was not a focus issue for us, so we weren't approached for prices, although in desperation accounts did start to approach us. Pretty rapidly prices disappeared in the street. There were two issues for the market that day. First, the market had assumed that the bonds were high parity and convertible. When the bonds were issued and set up in the systems of investors, it seems to be the case that people entered what they thought the exchange rate covering the bonds should be, as opposed to the one they saw recorded in the Indenture. Secondly, few in the market had read the detail on the Issuer's Call, and the termination of conversion rights. I confess, making prices in around 150 bonds across the Asian region, we were not aware either. Though Aristocrat was not a bond we regularly made prices in, we had a small position of around US$300,000. We took the decision to mark the bonds down to par. This

resulted in a painful loss of about US$100,000. Harrowing to book in the week before Christmas, just as bonus compensation was being decided!"

20 December 2004 was just the start of the story. Litigation would continue for a number of years. Even when the courts found in favour of the bondholders, matters were complicated on how to determine what compensation they should be awarded. There were a range of strategies that bondholders had adopted: some held the bonds unhedged, or outright, some held the bonds hedged with a short position in the underlying shares, or on swap. Some held bonds with a credit hedge, whether outright or on swap.

When determining how to calculate compensation there were a range of possible triggers. These included 20 December 2004, when Aristocrat first acted, and 31 May 2006, the maturity date of the bonds. The Trustee declared a technical default following the passing of the maturity date. Then there were a range of dates where those bondholders holding the position on swap may have decided to buy back the short shares.

So, a seemingly simple Scrivener's error, which it should be stressed, all parties agreed was an error, resulted in over 2 years of litigation. This involved the hiring of external counsel, independent experts, and indeed flights across time zones as bond holders tended to be based in Asia and Europe, but the litigation was undertaken in New York. It should be apparent that for a lead manager, the transaction fees (and more) can be easily eradicated if a dispute arises.

For control staff at Wholesale Financial firms we feel the following areas should be considered:

- Documentation: How easy would it be at your institution to identify concentrations of issuance? What controls do Capital Markets staff have around transaction documentation that utilises pre-existing templates? Do contractual arrangements with external counsel cover the risk of errors, oversights and omissions brought about by their staff?

- Reserving: If disputes were to arise, what policies and procedures would Front Office trading follow around determining how to prudently mark positions? What steps would IPV teams take to validate choices made by Front Office Trading over where to mark positions which are the subject of a dispute?

Anti-dilution Liquidity Management Tools

The tail end of December saw the long-awaited publication by the FSB and IOSCO of their "policies to address vulnerabilities from liquidity mismatch in open-ended funds" (OEFs). Part of these covered "anti-dilution Liquidity Management Tools" (LMTs) which, post the Covid-19 induced market turmoil, look to ensure that redeeming investors in OEFs, where there is a mismatch between dealing liquidity and underlying asset liquidity (for example, property funds), do not benefit at the expense of remaining investors.

A key paragraph from a control function's perspective is Point 1 from the IOSCO Final Report...

"Responsible entities should have appropriate internal systems, procedures and controls in place at all times in compliance with applicable regulatory requirements for the design and use of anti-dilution LMTs as part of the everyday liquidity risk management of their OEFs to mitigate material investor dilution and potential first-mover advantage arising from structural liquidity mismatch in OEFs."

What does this mean? Damian Taylor, SKADI Director, and ex-head of trading and hedge fund manager explains…

"The issue is this… if I have a holding in a fund that I know has not marked down certain illiquid positions, there is an advantage to me to redeem first, knowing that I will get paid out, and leaving the remaining investors to take the NAV hit whilst the fund is forced to fire-sell holdings at the wrong price".

IOSCO has identified 5 anti-dilution LMTs used in different jurisdictions globally: **swing pricing, valuation at bid or ask prices, dual pricing, anti-dilution levy and subscription/redemption fees**. The IOSCO descriptions are copied below…

Swing pricing: refers to a process for adjusting a fund's NAV (typically calculated at mid- price) by applying a swing factor that reflects the liquidity cost stemming from net subscriptions or redemptions. All investors pay or receive the same swung price.

Valuation at bid or ask prices: refers to an asset valuation procedure that switches from valuation at mid-price to valuation according to bid or ask-price, depending on the direction of net fund flows. Accordingly, the NAV is calculated based on bid-price when there are net outflows and based on ask-price when there are net inflows (a threshold may be set out). All investors pay or receive the same price.

Dual pricing: refers to the calculation of two NAVs per valuation point. One way of implementing dual pricing is to calculate one NAV which incorporates assets' ask prices and the other NAV which incorporates assets' bid prices. Subscribing investors pay the NAV calculated using ask asset prices; redeeming investors receive the NAV calculated using bid asset prices.

Anti-dilution levy: refers to a process whereby a variable levy / fee for the benefit of the fund is added to, or deducted from, the fund's NAV (typically calculated at mid-price), increasing the final price paid by subscribing investors or decreasing the price received by redeeming investors, to effectively pass on the liquidity cost. The levy can be based on the fund's net flows and the same levy may be applied to all subscribing / redeeming investors or, where possible, based on an individual investor's in / outflows and charged to each investor accordingly.

Subscription / redemption fees: refers to a process whereby a fixed levy / fee is added to / deducted from the fund's NAV in case of subscriptions / redemptions. The fee is charged to the transacting investors for the benefit of the fund to cover the cost of liquidity. This tool may be particularly appropriate for funds that invest in assets that have fixed transaction fees, such as real estate agency fees or notary fees, and / or for funds that have low-variation transaction costs.

We would recommend control functions look at the following areas...

- Ensure that any policies and procedures are designed to fulfill the "at all times" statement in the above italicised paragraph, and that they do not only kick in ex-post a liquidity event.
- Ensure that all relevant funds within the group are covered by LMTs. It may be that there are obvious candidates for coverage, such as property funds, but remember that liquidity is not always there when you need it! Many bond and credit funds, including Convertible Bond and Emerging Market Debt, can see liquidity dry up in a crisis.
- Be aware that certain funds may be sold/marketed in different jurisdictions so may need different LMTs to comply with local regulations.
- Ensure that there is transparency of estimated transaction costs/spreads that are used as an input in, for example the anti-dilution levy or subscription/redemption fees above. Also ensure that these are reviewed on a regular basis - this is especially relevant post the SEC Citigroup fine regarding recordkeeping failures concerning underwriting expenses.

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