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The Securities Financing Transactions Regulation

On 23 December 2015, the Regulation on Transparency of Securities Financing Transactions and of Reuse (2015/2365) (the SFTR or the Regulation) was published in the Official Journal of the European Union. It will enter into force on 12 January 2016. As part of the EU initiative on shadow banking, the Regulation aims to improve transparency in securities and commodities lending, repurchase transactions, margin loans and certain collateral arrangements.

The SFTR will require:

- all securities financing transactions (SFTs) to be reported to recognised trade repositories;
- the disclosure by investment funds of their use of SFTs and total return swaps (TRS) to investors in pre-investment documentation and regular reports; and
- express consent from, and disclosure of risks to, counterparties entering into rights of use and title transfer collateral arrangements in relation to securities.

Transactions covered

The disclosure and reporting requirements of the Regulation apply to SFTs, which include the following types of transactions or arrangements:

- repurchase transactions relating to securities or commodities;
- securities or commodities lending and securities or commodities borrowing;
- buy-sell back transactions or sell-buy back transactions relating to securities or commodities; and
- margin lending transactions, defined as transactions in which a counterparty extends credit in connection with the purchase, sale, carrying or trading of securities, but not including other loans that are secured by collateral in the form of securities. This is likely to cover prime brokerage agreements as well as transactions in the form of loans or derivatives under which credit is extended for such purposes. This definition does not distinguish between title transfers of collateral and secured transactions.

The definition is wide enough to include some liquidity and collateral swaps, but excludes "derivative" transactions which will be subject to the requirements of the European Markets and Infrastructure Regulation (EMIR).

In addition, provisions of the SFTR which require disclosure to investors in certain funds also apply to TRSs, meaning a derivative contract as defined in point (7) of Article 2 of EMIR in which one counterparty transfers the total economic performance, including income from interest and fees, gains and losses from price movements, and credit losses, of a reference obligation to another counterparty.

The provisions of the SFTR relating to reuse of collateral apply to "collateral arrangements" which is defined to mean:

- title transfer financial collateral arrangements as defined in the Directive on Financial Collateral Arrangements (2002/47/EC) (the FCD) between counterparties to secure any obligation; and
- security financial collateral arrangements as defined in the FCD between counterparties to secure any obligation.

This definition will overlap with SFTs to the extent that the latter constitute financial collateral arrangements within the meaning of the FCD. However, a "collateral arrangement" is also broader in that it could apply to collateral provided in connection with transactions which are not SFTs, for example, collateral provided under an ISDA credit support annex or credit support deed in support of derivative transactions, where the collateral arrangement falls within the definition of a financial collateral arrangement under the FCD. Such "collateral arrangements" are covered by the

disclosure and consent requirements under Article 15 of the Regulation, which is explained further below.

Counterparties covered

The requirements relating to SFTs and collateral arrangements will apply to "counterparties" to those SFTs and collateral arrangements. "Counterparties" are defined as i) financial counterparties (such as credit institutions, investment firms, insurance companies, undertakings for collective investments in transferable securities (UCITS) and their managers, alternative investment funds managed by EU authorised or registered alternative investment fund managers (AIFs), occupational pension schemes, central counterparties, central securities depositories, each established and authorised in the EU), and entities which would be financial counterparties if they were established in the EU; and ii) non-financial counterparties, including those which would be non-financial counterparties if established in the EU. Also, unlike EMIR, there is no exemption under the Regulation for entities that enter into low volumes of transactions.

However, a counterparty will only be caught by the requirements in the following circumstances:

- with respect to reporting and transparency of SFTs – where it is a counterparty to a SFT and is either i) established in the EU, or ii) established in a third country and the SFT is concluded in the course of operations of an EU branch of that counterparty;
- with regard to the provisions on reuse – where it is a counterparty engaging in "reuse" and is either i) established in the EU or ii) established in a third country if either:
  - the reuse is effected in the course of operations of an EU branch of that counterparty; or
  - the reuse concerns financial instruments provided under a collateral arrangement by a counterparty established in the EU or an EU branch of a counterparty established in a third country.

In addition, the provisions relating to disclosure of SFTs and TRSs to investors in certain funds apply to:

- EU authorised managers of UCITS and EU UCITS investment companies; and
- EU authorised or registered managers of AIFs.

Reporting obligation (Article 4)

Counterparties to a SFT are required to report details of the SFT that they have concluded, modified or terminated to a trade repository established in the EU and registered with the European Securities and Markets Association (ESMA), which must also meet the requirements for registration under EMIR. Where a trade repository is not available these details are required to be reported to ESMA. These details are required to be reported no later than the working day after the SFT is entered into, modified or terminated.

The details required to be reported will be documented in regulatory technical standards (RTS) to be developed by ESMA and the European System of Central Banks (ESCB) and which must be submitted in draft to the Commission by 13 January 2017. The details will include at least the information set out in the inset box below. For pools of assets, position level collateral data should be sufficient (although this will be confirmed in the RTS).

Transactions reports for SFTs will be required to include at least the following information:

- the parties to the SFT;
- the principal amount;
- currency;
- assets used as collateral and their type, quality and value;
- the method used to provide collateral;
- whether collateral is available for reuse and, if so, whether it has been reused;
- any substitution of collateral;
- the repurchase rate;
- lending fee or margin lending rate;
- any haircuts;
- the value date;
- maturity date;
- first callable date;
- market segment; and
- where applicable, details of cash collateral reinvestment and securities or commodities being lent or borrowed.

The reporting obligation applies to all new SFTs entered into from various dates (in each case the "Reporting Effective Date") which depend on the status of the relevant counterparty. For banks and investment firms and non-EU equivalents, the Reporting Effective Date falls 12 months after the date the RTS referred to above come into force, which, if they are submitted to the Commission on

time, is likely to be in mid-2017. This means that banks and investment firms will need to start reporting trades from mid-2018. The Reporting Effective Date for central counterparties and central securities depositories falls 15 months after the date the RTS come into force, for all other financial counterparties and non-EU equivalents it falls 18 months after the date the RTS come into force, and for non-financial counterparties and non-EU equivalents it falls 21 months after the RTS come into force.

The reporting obligation also applies to SFTs existing at the relevant Reporting Effective Date provided that as at that date they either have a remaining maturity in excess of 180 days or an open maturity and remain outstanding 180 days after that date (Existing Transactions). Counterparties to Existing Transactions must report them within 190 days of the Reporting Effective Date. However, this obligation does not apply to any SFT to which any member of the ESCB is a party – so the various central bank liquidity schemes which fund using open market repos will be exempt.

Although all counterparties may delegate the task of reporting, the ultimate responsibility for complying with the reporting obligations under the SFTR remains solely with the counterparty. However, where a financial counterparty enters into an SFT with a non-financial counterparty which falls below certain balance sheet thresholds set out in Directive 2013/34/EU on annual financial statements (essentially medium-sized undertakings or smaller), then the financial counterparty is responsible for reporting on behalf of both counterparties.

All counterparties must however keep a record of their SFTs for five years from the termination of the transaction.

Disclosure to UCITS and AIF investors (Articles 13 and 14)

From 13 January 2017, EU-authorised management companies of UCITS, EU UCITS investment companies and EU-authorised managers of AIFs must disclose to their investors their use of SFTs and TRSs in their annual (and half-yearly in the case of UCITS) reports. The information disclosed must include at least the information in the inset box below.

- Global data on the amount of securities and commodities on loan as a proportion of total lendable assets (i.e. excluding cash or equivalent)
- The amount of assets engaged in each type of SFTs and TRSs expressed as an absolute amount (in the collective investment undertaking's currency) and as a proportion of the collective investment undertaking's assets under management
- Concentration data such as the ten largest collateral issuers across all SFTs and TRSs used by the fund, and the top ten counterparties
- Aggregate transaction data - e.g. type of collateral currency, maturity, jurisdiction, and settlement method
- Data on reuse – e.g. the proportion of collateral received that is reused, and cash collateral reinvestment returns
- Safekeeping/Custodian data, including segregation/pooling data
- Cost and return data

From 12 January 2016, the Prospectus or other disclosure document for an AIF or UCITS must also specify the SFTs and TRSs the manager is authorised to use, and include a clear statement that those transactions are used by the fund. It must also include the information in the inset box below.

- General description of the SFTs and TRSs used by the collective investment undertaking and the rationale for their use
- Criteria for use of SFTs and TRSs, types of assets and maximum and expected proportion of assets under management to be subject to them
- Criteria for selection of counterparties
- Acceptable collateral
- Methodology and frequency of valuation for collateral
- Risk disclosure (e.g. operational, custodian, liquidity, counterparty)
- Restrictions on reuse (regulatory or self-imposed)
- Policy on sharing of return on collateral, costs and fees

These disclosure requirements for Prospectuses and offer documents will also apply to AIFs and UCITS funds constituted before 12 January 2016, but for these funds the applicable date is postponed to 13 July 2017.

Reuse of financial instruments under a collateral arrangement (Article 15)

The SFTR restricts the instances in which counterparties have the right to reuse "financial instruments" received as collateral under collateral arrangements. There is no grandfathering under this requirement, hence counterparties will need to address the new requirements in existing collateral arrangements as well as new collateral arrangements by 13 July 2016.

What is a right of reuse?

Rights of use are a technique commonly used in financing transactions in conjunction with a charge over tradeable securities in an account. Under a charge, the chargor usually retains beneficial ownership of the securities, which means that it has the benefit of proprietary rights in the event of the secured party's insolvency. Without an express right of reuse, the secured party is not entitled to dispose of the securities unless there is an event of default. In contrast, where a right of reuse is given, the secured party is entitled to transfer legal and beneficial interest in the securities to itself or a third party (often referred to as "re-hypothecation"). This is a useful way of raising finance as the securities can be sold or used as collateral for other transactions. The disadvantage for the chargor is that, once the securities have been transferred, it only has a personal contractual right to receive equivalent securities from the secured party and is no longer the beneficial owner of the original securities. This means that it has a credit risk against the secured party for the return of the securities, subject to any netting rights which might apply under the terms of the relevant documentation.

The SFTR defines "reuse" more widely to include not only rights or reuse under a security interest, but also transfer of securities under a title transfer collateral arrangement, as follows:

"*the use by a receiving counterparty, in its own name and on its own account or on the account of another counterparty, including any natural person, of financial instruments received under a collateral arrangement, such use comprising transfer or title or exercise of a right of use in accordance with Article 5 of Directive 2002/47/EC but not including the liquidation of a financial instrument in the event of default of the providing counterparty*".

The restrictions on reuse do not however apply to reuse of collateral in the form of cash or other assets which are not "financial instruments" as defined in Annex 1 of MiFID. This means that the types of collateral caught by the restrictions on reuse may differ from those caught by the definition of "SFT" for the purpose of the reporting obligation, which requires only that the transaction related to "securities or commodities".

There are two conditions that must be satisfied for the right to reuse collateral to apply. Firstly, the collateral provider must be informed of the "risks and consequences" of granting its consent to reuse of the collateral in a security collateral arrangement, or its entry into a title transfer collateral arrangement (which of itself creates a right to reuse the collateral), and must at least be informed in writing of the risks of default of the receiving counterparty. Mutual disclosure may be required for collateral agreements where both parties may be providing collateral, and there is no disapplication of this requirement where the collateral provider is itself a regulated entity. There is no requirement for this disclosure to be included in the transaction agreement itself, or for it to be acknowledged by the counterparty. This requirement could therefore be dealt with either by specific disclosures in master agreements or related credit support documents, or disclosure through notices or terms of business.

Secondly, the collateral provider must have granted prior express consent in writing or equivalent to a right of use in a security collateral arrangement, or must have expressly agreed to provide collateral by way of a title transfer collateral arrangement. This requirement should be met by the execution of market standard securities financing/credit support documentation.

Any exercise of a right of reuse is subject to the following further conditions:

- reuse is undertaken in accordance with the terms specified in the collateral arrangement; and
- the financial instruments received under a collateral arrangement are transferred from the account of the providing counterparty.

The latter requirement would require account entries to be made recording that the securities had been transferred out of the account.

There is a safeguard which provides that Article 15 shall not affect national law concerning the validity or effect of the collateral arrangement. This is an

important protection which means that a breach of the requirements should not render a transfer of title in collateral invalid as this would be a matter for the applicable law under which the transfer takes place. This is particularly relevant where the party receiving the collateral intends to dispose of such collateral to a third party, as the viability of such transfers depend on certainty as to the effectiveness of rights of reuse. It also means that the enforceability of security or close out netting rights under the relevant collateral arrangements should not be affected by a breach of the Article 15 requirements.

Report on recommendations for minimum haircuts (Article 29)

Whilst there are no provisions for risk mitigation for non-centrally cleared SFTs in the SFTR, Article 29 requires that the Commission will be required to submit a report to the European Parliament and Council by 13 October 2017 on progress on international efforts to mitigate risks associated with SFTs, and the appropriateness of those measures for European markets. Specifically, this includes the Financial Stability Board (FSB) recommendations for haircuts on non-centrally cleared SFTs. It is likely that further rules will be introduced following that report.

The FSB published its final framework for minimum haircuts (the FSB Framework) on 12 November 2015. The FSB Framework proposes haircut floors for non-centrally cleared SFTs in which financing against collateral other than government securities is provided to non-banks. The scope of the FSB Framework is therefore narrower than that of the SFTR.

On 5 November 2015, the Basel Committee on Banking Supervision (BCBS) also issued a consultation paper on haircut floors for non-centrally cleared SFTs, based on the FSB's earlier October 2014 proposals. The BCBS consultation proposes that where parties use haircut floors lower than those required, they will be required to hold a higher amount of regulatory capital for those positions. It remains to be seen whether the FSB Framework is adopted by the Commission ahead of any finalisation of the BCBS proposals.

Timeline for implementation

The timeline for implementation is set out below:

- 23 December 2015 – Regulation published in Official Journal
- 12 January 2016 – Regulation comes into force, and Article 14 pre-contractual disclosure for UCITS and AIFs constituted on or after this date comes into force immediately
- 13 July 2016 – Article 15 disclosure and consent requirements in force for collateral arrangements including those existing prior to 13 July 2016
- 13 January 2017 – Article 13 disclosure by UCITS and AIFMs in annual and half yearly reports comes into force
- 13 January 2017 – ESMA to submit RTS to the Commission on transaction reporting for SFTs
- 13 July 2017 – Article 14 disclosure in pre-contractual documents for UCITS and AIFs constituted before 12 January 2016 comes into force
- 2018 – 2019 (estimated) – transaction reporting enters into force following adoption of the RTS as a Commission "delegated act" as follows:
  - 12 months after entry into force of the delegated act for credit institutions and investment firms and third country equivalents
  - 15 months after entry into force of the delegated act for central counterparties and central securities depositories
  - 18 months after entry into force of the delegated act for other financial counterparties and third country equivalents
  - 21 months after entry into force of the delegated act for non-financial counterparties and third country equivalents.

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