

WHAT YOU NEED TO KNOW ABOUT THE EU SECURITIES FINANCING TRANSACTIONS REGULATION

WHAT IS THE SFTR?

Following the onset of the global financial crisis, in 2011 the Financial Stability Board (the FSB) and the European Systemic Risk Board (the ESRB) determined to address certain risks posed by securities financing transactions (SFTs), specifically a build-up of leverage and lack of transparency which prevented regulators and investors from accurately assessing this type of non-bank credit activity. In August 2013, the FSB adopted a policy framework to address these (and other) risks in securities lending and repos, entitled "Strengthening Oversight and Regulation of Shadow Banking," which was endorsed in September 2013 by G20 Leaders.

Against this backdrop, the European Commission took the view that the transparency, monitoring of systemic risk and disclosure of SFTs had to be improved, through the introduction of regulation in order to ensure a proper oversight of these trading activities.

On 16 November 2015 the European Council adopted the text of the Regulation on Transparency of Securities Financing Transactions (the SFTR or Regulation), following its adoption by the European Parliament on 29 October 2015. The SFTR was published in the Official Journal of the European Union on 23 December 2015 and comes into force today, 12 January 2016. The Regulation will apply to all SFTs from today with the exception of certain obligations set out below.

This briefing note provides an overview of the SFTR and its practical implications for entities that engage in SFTs.

WHAT ARE SFTs?

SFTs are transactions that allow counterparties to use their assets as a means to finance themselves, implement efficient liquidity and collateral management and execute investment strategies.

Specifically, SFTs are defined in Article 3(11) of the SFTR as:

- ◆ repurchase transactions (including reverse repurchase transactions);
- ◆ securities lending and securities or commodities borrowing (where there is a commitment to return equivalent securities or commodities);
- ◆ buy-sell back or sell-buy back transactions; and/or
- ◆ margin lending transactions.

These may arise under specific contracts such as Global Master Repurchase Agreements, or as services under broader agreements such as prime brokerage agreements or terms of business.

Parts of the SFTR also apply to total return swaps (TRS), which it defines as derivative contracts 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 counterparty¹.

WHAT ARE THE KEY REQUIREMENTS OF THE SFTR?

The SFTR introduces:

- ◆ mandatory record keeping and reporting for all SFTs to trade repositories by both parties to the trade (subject to two exceptions below) (the Reporting Obligation);
- ◆ detailed disclosure requirements by UCITS funds and alternative investment fund managers (AIFMs) on their use of SFTs and certain TRSs in their prospectuses and periodic reports (the Transparency Obligation); and
- ◆ transparency conditions in relation to the reuse of collateral, such as prior risk disclosure to counterparties and obtaining written consent prior to the rehypothecation or reuse of assets (the Reuse Obligation).

WHO IS AFFECTED BY THE SFTR?

Article 2 states that the Regulation covers the following entities:

- ◆ Counterparties to an SFT that are established:
 - in the EU, including all of its branches irrespective of where they are located (i.e., non-EU branches); or
 - outside the EU if the SFT is concluded in the course of the operations of an EU branch of that counterparty.
- ◆ UCITS funds and their management companies irrespective of where they are established;
- ◆ AIFMs authorised or registered in accordance under AIFMD irrespective of where their AIFs are established; and
- ◆ in relation to the Reuse Obligation only, counterparties established outside the EU, in either of the following circumstances:
 - the reuse is effected in the course of the operations of an EU branch; or

¹ Article 3(18) of the SFTR.

- the reuse concerns financial instruments provided as collateral by a counterparty established in the EU or an EU branch of a third country entity (i.e. a non-EU entity reuses an EU entity's collateral).

HOW ARE COUNTERPARTIES CATEGORISED?

The SFTR categorises “*counterparties*”, as financial counterparties (FC) or non-financial counterparties (NFC), in the same way as under EMIR. However, the definition of FC and NFC used in the SFTR is broader than under EMIR as it extends to non-EU entities (third country entities or TCEs) that would be FCs/NFCs (as appropriate) if they were in the EU. This is because EU branches of these entities are in scope for SFTR, and for the Reuse Obligation these entities will be in scope themselves if they receive and reuse collateral from an EU entity (see “Who is affected by the SFTR” above).

For the purposes of the SFTR, similar to EMIR, FCs are defined as investment firms, credit institutions, insurance and reinsurance companies, pension funds, UCITS, and where relevant their management companies, AIFs managed by AIFMs registered or authorised by AIFMD (i.e. onshore AIFMs not offshore ones), central clearing counterparties (CCPs) authorised under EMIR, central securities depositories (CSDs) authorised under the Central Securities Depository Regulation (CSDR) and (as noted above) non-EU entities that would be regulated as any of the foregoing if established in the EU. NFCs are entities that are not FCs. However, as with EMIR, the SFTR does not apply to individuals.

THE REPORTING OBLIGATION

What is the Reporting Obligation?

With the exceptions below, both parties to an SFT will have to report details of any SFT concluded, modified or terminated by them to a recognised trade repository on a T+1 BD basis². Where a trade repository is not available to record details of SFTs, counterparties will have to ensure details of these transactions are reported directly to the European Securities and Markets Authority (ESMA).

A party subject to the Reporting Obligation may delegate the reporting of the details of the SFTs to its counterparty or a third party in the same way as under EMIR, though the delegating party will retain the regulatory responsibility. We expect to see industry-standard delegated reporting agreements being circulated in due course.

The Reporting Obligation mirrors EMIR, other than where indicated below. However, the SFTR does provide in Article 29(1) for a review within two years of whether reporting should be improved, and in particular, whether single-sided reporting (as under Dodd Frank) would be more appropriate.

Exceptions

The exceptions referred to above are:

- ◆ Where a counterparty to an SFT is an AIF or a UCITS fund, the reporting obligation will expressly fall on the AIFM or UCITS management company respectively, rather than the relevant fund itself (in comparison to EMIR, where the obligation is commonly assumed to remain on the fund)³.
- ◆ Secondly, NFCs that are defined as “medium sized undertakings” under the Directive on Financial Statements (2013/34/EU, Article (3)), will not have to report their SFTs with FCs. These are undertakings that do not exceed any two of the following thresholds on their balance sheet date: (i) a €20,000,000 balance sheet size; (ii) a €40,000,000 net turnover; and (iii) an average of 250 employees during the previous financial year. The reporting obligation for these transactions will fall on the FC counterparty, which must report on behalf of both parties.

When will the Reporting Obligation apply?

The level 2 regulatory technical standards relating to reports for different types of SFTs (the Reporting RTS) are being developed by ESMA and the ESRB. Article 33(2)(a) of the SFTR provides a phased implementation schedule for the entry into force and application of the SFTR for each counterparty, based on when the Reporting RTS comes into force. The reporting obligation will apply to SFTs concluded by a counterparty on or after the date on which the reporting obligation commences (see the table below for phased implementation timetable of the reporting obligations under SFTR).

Category of Counterparty	Composition of Category (including third country equivalents)	ESMA proposed phase-in of reporting obligation (the Application Date)
FC	Investment firms and credit institutions	12 months after entry into force of the Reporting RTS
FC	CCPs and CSDs	15 months after entry into force of the Reporting RTS
FC	AIFs, UCITS and all other FCs	18 months after entry into force of the Reporting RTS
NFCs	All (subject to medium-sized undertakings exemptions)	21 months after entry into force of the Reporting RTS

² Article 4(1) of the SFTR.

³ Though we note that this is open to interpretation, as the EMIR definition of Financial Counterparty does in respect of UCITS include “where relevant, its management company”.

What must be reported?

Details of the SFT reports will vary depending on the type of SFT. However, we expect that the requirements will broadly be consistent with the requirements for derivatives under EMIR. The SFTR specifies minimum requirements for reporting, including the parties to the SFT; the principal amount; the currency; the assets used as collateral and their type; whether collateral is available for reuse; the repurchase rate, lending fee or margin lending rate; any haircut, the value date, maturity date; the first callable date; and the market segment.

As with EMIR, ESMA must submit draft Level 2 Regulatory Technical Standards within 12 months of the date of entry into force of the SFTR, so by 12 January 2017, specifying the details of the reporting requirements and the format and frequency of reports.

Retrospective reporting obligation

As well as having to report SFTs entered into after the appropriate start date, the SFTR also stipulates that counterparties must report SFTs that have been concluded prior to the entry into force of the Reporting RTS, which (a) have a remaining maturity of at least 180 days following the relevant start date; or (b) have an open maturity and do remain outstanding for at least 180 days after the relevant start date.

Record keeping

In the same way as under EMIR, counterparties will have a duty to keep a record of any SFT that they have concluded, modified or terminated for at least five years following the termination of the transaction. The record keeping requirements for all counterparties will apply immediately from today.

THE TRANSPARENCY OBLIGATION

What does this involve?

The SFTR requires management companies of UCITS, UCITS investment companies and AIFMs to inform their investors of their use of SFTs and TRSs. They will be required to make these disclosures in:

- ◆ their financial reports (for UCITS, half yearly and annual reports, and for AIFMs, annual reports) – “periodical disclosure”⁴; and
- ◆ in their pre-contractual documents (i.e., prospectuses or offering memoranda) prior to an investor making an investment decision – “pre-contractual disclosure”⁵.

Entities that are not UCITS funds or their management companies or AIFMs, are not subject to this obligation.

What has to be disclosed?

Periodical disclosure

Section A of the Annex to the SFTR requires the relevant parties to include particular information in half-yearly and annual reports. This is set out in Appendix 1 of this note.

Pre-contractual disclosure

UCITS prospectuses and AIFs' disclosures to investors by the AIFM will need to specify whether they will enter into SFTs and/or TRSs and, if so, include the following information (set down in Section B of the Annex to the SFTR):

- ◆ a general description of the SFT and TRS used by the fund and the rationale for their use;
- ◆ the following data to be reported for each type of SFT and TRS:
 - the types of assets that can be subject to them;
 - the maximum proportion of assets under management (AUM) that can be subject to them; and
 - the expected proportion of the fund's AUM that will be subject to each of them,
- ◆ the criteria used to select counterparties;
- ◆ what is acceptable collateral;
- ◆ a description of the collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margining are used;
- ◆ risk management – a description of the risks linked to SFTs and TRS including risks linked to collateral management, such as operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from its reuse;
- ◆ a description of how assets subject to SFTs, TRSs and collateral received are safe-kept (e.g. with fund custodian);
- ◆ details of any restrictions on reuse of collateral; and
- ◆ the fund's policy on sharing of returns generated by SFTs and TRSs.

We expect the form of language used to disclose the above in offering documents to become broadly standardised once the obligation is in force.

⁴ Article 13 of the SFTR.

⁵ Article 14 of the SFTR.

When will this apply?

Periodical disclosure will apply 12 months after the SFTR comes into force, so from 12 January 2017.

The pre-contractual disclosure requirement will apply from today for funds constituted on or after today. Older investment funds will have 18 months, so until 12 July 2017, to amend their existing pre-contractual and disclosure documents from the entry into force of the SFTR.

THE REUSE OBLIGATION

What are the requirements for rehypothecation or reuse of collateral under the SFTR?

Article 15 of the SFTR requires the following formalities to be met before a counterparty has the right to reuse collateral. "Reuse" means, under SFTR, for a collateral taker to take title to collateral, either under (i) a title transfer collateral arrangement; or (ii) a right of use in a security interest collateral arrangement.⁶

- ◆ **disclosure** - The party providing collateral must be informed in writing by the receiving counterparty of the risks and consequences involved in granting consent to reuse collateral. Specifically the potential risks if the receiving party defaults should be highlighted to the providing party; and
- ◆ **written consent** - The providing party must grant its prior consent in a written agreement or in a legally equivalent manner to reuse under a security collateral arrangement or the providing party must have expressly agreed to provide collateral by way of a title transfer arrangement with a right of reuse.

When the following additional conditions are met, counterparties are then entitled to exercise their right to reuse:

- ◆ 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 to an account opened in the name of the receiving counterparty.

Although the SFTR is wider in scope than the EU Directive on Financial Collateral Arrangement 2002/47/EC on financial collateral arrangements (Financial Collateral Regulations), the SFTR does not amend the Financial Collateral Regulations, but instead supplements it. It is stipulated in the SFTR that a breach of the SFTR relating to the reuse of collateral will not affect national laws on the validity or effect of a transaction.

When will this requirement come into force?

The Reuse Obligation will take effect six months after the SFTR comes into force and so will apply from 12 July 2016 retrospectively to existing collateral arrangements and subsequent collateral transactions. As per the scope of SFTR as set out above, these obligations will apply extra-territorially to non-EU counterparties receiving collateral from counterparties in the EU. As such non-EU funds entering into SFTS with European banks will be subject to the Reuse Obligation.

How will this requirement be dealt with?

In relation to the risk disclosure obligation, the following industry bodies, the International Capital Markets (ICMA), International Swaps and Derivatives Association, Inc (ISDA), International Securities Lending Association (ISLA) and Association for Financial Markets in Europe (AFME) are working on draft risk warning language relating to the risks and consequences involved generally in consenting to a right of use of collateral provided under a security collateral arrangement, or of concluding a title transfer collateral arrangement.

In relation to the written consent requirement, we expect this to be satisfied in the vast majority of cases through using signed legal contracts to effect the reuse, notably through industry standard documents such as GMRA, GMSLAs and ISDAs.

INTERNAL POLICIES

To support the Reporting Obligation and the Reuse Obligation, counterparties that are in scope also need to put in place appropriate internal policies to ensure that any breaches by them of these obligations are reported to the competent authorities (e.g. the Central Board of Ireland, the Financial Conduct Authority, the Luxembourg CSSF)⁷. In turn, competent authorities will set up mechanisms to allow these reports to be made.

This is a brief overview of the impact of SFTR. Please contact your usual contact in the Macfarlanes Derivatives and Trading team or the Macfarlanes Financial Services team if you have any further questions.

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⁶ The right of reuse by a prime broker in a security interest financial collateral arrangement is commonly described as "rehypothecation". SFTR does not use the word rehypothecation but instead adopts the more easily understood label of "reuse".

⁷ Article 24(3) of the SFTR.

APPENDIX 1

INFORMATION TO BE DISCLOSED IN HALF-YEARLY AND ANNUAL REPORTS

Global data	<ul style="list-style-type: none"> ◆ Amount of securities and commodities on loan as a proportion of total lendable assets defined as excluding cash and cash equivalents; and ◆ Amount of assets engaged in each type of SFTs and total return swaps 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 (AUM).
Concentration data	<ul style="list-style-type: none"> ◆ Ten largest collateral issuers across all SFTs and total return swaps (break down of volumes of the collateral securities and commodities received per issuer's name); and ◆ Top 10 counterparties of each type of SFTs and total return swaps separately (Name of counterparty and gross volume of outstanding transactions).
Aggregate transaction data for each type of SFTs and total return swaps separately to be broken down according to the following categories	<ul style="list-style-type: none"> ◆ Type and quality of collateral; ◆ Maturity tenor of the collateral broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open maturity; ◆ Currency of the collateral; ◆ Maturity tenor of the SFTs and total return swaps broken down as follows: maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open transactions; ◆ Country in which the counterparties are established; and ◆ Settlement and clearing (e.g. tri-party, Central Counterparty, bilateral).
Data on reuse of collateral	<ul style="list-style-type: none"> ◆ Share of collateral received that is reused, compared to the maximum amount specified in the prospectus or in the disclosure to investors; and ◆ Cash collateral reinvestment returns to the collective investment undertaking.
Safekeeping of collateral received by the collective investment undertaking as part of SFTs and total return swaps	<ul style="list-style-type: none"> ◆ Number and names of custodians and the amount of collateral assets safe-kept by each of the Custodians.
Safekeeping of collateral granted by the collective investment undertaking as part of SFTs and total return swaps	<ul style="list-style-type: none"> ◆ The proportion of collateral held in segregated accounts or in pooled accounts, or in any other accounts.
Data on return and cost for each type of SFTs and total return swaps	<ul style="list-style-type: none"> ◆ Broken down between the collective investment undertaking, the manager of the collective investment undertaking and third parties (e.g. agent lender) in absolute terms and as a percentage of overall returns generated by that type of SFTs and total return swaps.

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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