The Securities Financing Transactions Regulation

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The Regulation on Transparency of Securities Financing Transactions and of Reuse (2015/2365) (the SFTR) is a key part of the EU's initiative to reform shadow banking following the 2007-2008 financial crisis. Its aim is to improve transparency in securities and commodities lending, repurchase transactions, margin loans and certain collateral arrangements.

When was the SFTR adopted?

The SFTR was adopted in November 2015 and published in the Official Journal of the European Union on 23 December 2015. It applies from 12 January 2016. However, a combination of staggered effective dates and the need to wait for Level 2 measures means that most of its requirements will become effective after 13 July 2016.

Overview of requirements

The SFTR requires "counterparties" established in the EU and EU branches of non-EU counterparties that are parties to securities financing transactions (SFTs) or a collateral arrangement to:

- report SFTs to recognised trade repositories (TRs), or to the European Securities and Markets Authority (ESMA) if trade repositories are not established (**Reporting**);
- keep a record of SFTs for five years after their conclusion, modification or termination (**Record Keeping**); and
- in order to be able to reuse financial instruments obtained as collateral under collateral arrangements, disclose the risks of such arrangements to, and obtain express consent from, the party that transferred the collateral (**Reuse of Collateral**).

The SFTR also requires managers of UCITS and alternative investment fund (AIFs) to disclose to investors in the fund some key information about SFTs and total return swaps (TRSs) to which the fund is a party.

The SFTR's requirements will be phased in, with some of the rules such as those on disclosures by fund managers already in force on 12 January 2016 and others, such as the ones on Reuse of Collateral, effective as early as 13 July 2016. At the end of this article we provide the complete timeline of the different obligations.

Transactions and other arrangements in scope

For the purpose of Reporting and Record Keeping, the definition of SFT covers the following types of transactions:

- securities or commodities lending and securities or commodities borrowing (e.g. transactions under GMSLA and loans of gold or other precious metals);
- buy/sell-back transactions or sell/buy-back transactions relating to securities or commodities (i.e. sell/buy-backs of securities that are documented as two separate

transactions – in order to benefit from true sale analysis, or otherwise – certain types inventory finance/monetisation structures relating to commodities);

- repurchase transactions relating to securities or commodities (e.g. transactions under GMRA); 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 would include prime brokerage agreements where a broker extends credit to the client against the client's securities portfolio with that broker).

The definition is wide enough to encompass collateral swaps, namely the lending of liquid assets (such as highly rated government bonds) in return for the receipt of less liquid collateral combined with the payment of a fee. Depending on how such transactions are structured, they could be characterised as derivatives. However, recital 7 of the SFTR is clear in excluding from its scope "derivative" transactions as these are defined in EMIR.

That said, in relation to the disclosure obligations of fund managers, the SFTR also covers TRS transactions (which are derivatives under EMIR).

The SFTR's requirements around Reuse apply to "collateral arrangements" defined as:

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

The definition of "collateral arrangement" overlaps with the definition of SFT where – as is the case under a repo under GMRA – the provision of securities as collateral is part of the SFT transaction.

However, "collateral arrangement" is broad enough to cover collateral in the form of securities that is not provided in connection with SFTs, such as "eligible credit support" provided under a credit support annex to an ISDA Master Agreement documenting derivatives transactions.

Definition of "counterparty" and territorial scope

The requirements of the SFTR apply to "counterparties". "Counterparty" is defined by Article 3(2) to include both "financial counterparties" and "non-financial counterparties". The definition of "financial counterparty" in Article 3(3) of the SFTR originates from Article 2(1) of EMIR and covers:

- investment firms authorised in accordance with MiFID 2;
- credit institutions authorised in accordance with CRD 4;
- insurers and reinsurers authorised in accordance with Solvency 2;
- central counterparties (CCPs) authorised in accordance with EMIR;
- central securities depositories authorised in accordance with the Central Securities Depository Regulation;
- UCITS and their management companies authorised under the UCITS Consolidation Directive;
- AIFs managed by AIF managers authorised under the AIF Managers DIrective;
- occupational pensions institutions (IORPs) authorised under the IORP Directive; and
- third-country (i.e. non-EU) entities which would require authorisation or registration under any of these pieces of legislation if established in the EU.

Non-financial counterparties are undertakings "established" in the EU other than financial counterparties. An undertaking is considered to be "established" in the EU where the counterparty has its head office (if a natural person) or registered office (if a legal person) in the EU.

Unlike under EMIR, which provides an exemption from mandatory clearing (although not reporting) for non-financial counterparties *below certain thresholds*, the SFTR does not have a lighter regime for non-financial counterparties with smaller books of SFTs.

A counterparty will be caught by the SFTR if:

- with respect to Reporting and Record Keeping, it is a counterparty to an SFT and is established either in:

  i) the EU (including any branch, regardless of where the branch is); or

  ii) a third country and the SFT is concluded in the course of operations of its EU branch; and
- with regard to Reuse of Collateral, it is a collateral taker and is established either in:

  i) the EU (again, including all branches, anywhere); or

  ii) a third country if either:

  - the reuse is effected in the course of operations of its EU branch; or
  - the reuse concerns financial instruments provided under a

collateral arrangement with a counterparty established in the EU or an EU branch of a counterparty established in a third country.

Reporting and Record Keeping (Article 4)

The Reporting obligation consists of reporting, not later than *one working day* after the SFT has been entered into, modified or terminated, the salient information about such SFT, to a TR established in the EU and registered with ESMA, a third-country TR recognised by ESMA or, where a TR is not available, directly to ESMA.

The information to be reported will be specified in regulatory technical standards (RTS) that ESMA must submit to the Commission for approval by 13 January 2017 and that are therefore likely to come into force in the second quarter of 2017.

Transaction reports will have to include the following information as a minimum:

- 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;
- 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.

When will the Reporting obligation apply?

Under Article 33, the Reporting obligation will apply:

- 12 months after the coming into force of the RTS for EU and non-EU investment firms and credit institutions;
- 15 months after the coming into force of the RTS for EU and non-EU CCPs and central securities depositories;
- 18 months after the coming into force of the RTS for EU and non-EU insurance undertakings, AIFMs, UCITS and IORPs; and
- 21 months after the coming into force of the RTS for non-financial counterparties.

The Reporting obligation applies to SFTs that have been entered into after the relevant application date referred to above but also SFTs that are existing at that date and either: (i) have a remaining maturity of 180 days; or (ii) have an open maturity (e.g. "rolling" SFTs) and remain outstanding for 180 days after the effective date (Existing SFTs).

Existing SFTs must be reported within 190 days of the Reporting application date. This is effectively a "backloading" mechanism.

As is the case under EMIR, Reporting can be delegated but the ultimate responsibility to comply with such obligation remains solely with the counterparty.

Where an SFT has been entered into by a financial counterparty and a non-financial counterparty, the financial counterparty is responsible for reporting for both parties if the non-financial counterparty does not exceed more than one of the thresholds below:

- balance sheet total of €20 million;
- net turnover of €40 million; and
- average of 250 employees during the financial year.

For investment funds, the UCITS or AIF manager is responsible for Reporting.

Article 4(4) provides that counterparties must keep a record of the SFTs they are a party to for five years from the termination of the transaction. This Record Keeping obligation applies to every counterparty irrespective of whether it carries out the Reporting or delegates it. The SFTR does not specify when the Record Keeping obligation becomes effective. Our view is that the obligation will become effective when the RTS comes into force.

A breach of Article 4 will not affect the validity of the terms of an SFT.

Reuse of Collateral (Article 15)

"Reuse" is defined under Article 3(12) of the SFTR as "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 of title or exercise of a right of use in accordance with the FCD but not including the liquidation of a financial instrument in the event of the default of the providing party".

This is the broadest possible definition of reuse, encompassing both "rehypothecation" of collateral that is subject to a security interest in favour of the collateral taker (as in the case of many terms of business for trading futures, but not the ISDA Credit Support Deed, which

prohibits this) but also the use of collateral received under a title transfer arrangement (as is the case under the English law Credit Support Annex or the margin provisions of the GMRA). Reference to collateral is intended as a reference to collateral that is a "financial instrument" as defined in MiFID (bonds, shares etc. – not cash and letters of credit).

Article 15 of the SFTR provides that the right of the taker of collateral to reuse it is conditional on:

- the collateral provider being notified in writing by the collateral taker of the risks and consequences involved in: (i) granting consent to a right to rehypothecate the collateral transferred under a security agreement and/or (ii) concluding a title transfer agreement. The notification will have to include at least the risks and consequences that may arise in the event of the default of the collateral taker, namely that such assets will *not* be protected in the case of the collateral taker's insolvency and that the collateral provider will rank as an unsecured creditor for an amount equal to the value of such assets. There is no requirement for this warning to be acknowledged by the collateral provider. So this requirement can be achieved via a unilateral disclosure, for example in the general terms of business, and does not need to be referred to in the master agreement in question; and
- the collateral provider having prior written (or equivalent) consent to use collateral under a security collateral arrangement or prior written (or equivalent) consent to a title transfer collateral arrangement. This requirement should be met by the execution of market standard securities financing or credit support documentation.

In addition to such ex-ante requirements, the exercise of the right of reuse is also subject to:

- the reuse being undertaken in accordance with the terms specified in the collateral arrangement; and
- the financial instruments received under the collateral arrangement having been transferred directly from the account of the providing counterparty, provided that such counterparty is established within the EU and its security account is maintained in the EU.

Article 15(4) provides that the Reuse provisions of the SFTR shall not affect national law concerning the validity or effect of the collateral arrangement. This is an important safeguard which should avoid the Reuse provisions of the SFTR interfering with the enforceability of close out netting, which is fundamental for the orderly functioning of financial markets. By providing that no transfer is tainted by a breach of its provisions, Article 15 affords certainty in connection with the transfer of collateral to third parties.

Article 15 will apply from 13 July 2016 to all collateral arrangements, both existing and future. Where the collateral arrangement provides for two-way collateral, the requirements apply to each of the two parties to the collateral arrangement.

Disclosure to investors in UCITS and AIFs (Articles 13 and 14)

From 12 January 2016, or from 13 July 2017 in respect of an AIF or UCITS constituted before 12 January 2016, the prospectus or other disclosure document for a UCITS or AIF must 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 following (which ESMA may embellish upon in RTS):

- a 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); and
- policy on sharing of return on collateral, costs and fees.

From 13 January 2017 UCITS management companies, UCITS investment companies and AIFMs must disclose in their annual (or half-yearly in the case of UCITS) reports the following information on the SFTs and TRSs included in their portfolio:

- the total 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 SFT and TRS 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 10 largest issuers of

securities across all SFTs and TRSs, and the top 10 counterparties to the SFTs and TRSs;

- aggregate transaction data such as the type of collateral currency, maturity, jurisdiction, and settlement method;
- data on reuse of collateral such as the proportion of collateral received that is reused, and returns on cash collateral reinvestment;
- safekeeping/custodian data, including segregation/pooling such as assets in custody broken down by individual custodians; and
- cost and return data.

ESMA may embellish on these requirements in the RTS. Note they apply only to EU-authorised UCITS, UCITS managers and AIFMs – so their third-country equivalents may be caught by the extraterritorial nature of the Reporting requirement, but will not be subject to these disclosure requirements.

Consequences of breaches

The SFTR is an EU Regulation. As such its provisions have the force of law in EU Member States. However, the SFTR has also granted the competent authorities of Member States (the FCA in the UK) the power to establish reporting procedures for actual and potential infringements of Article 4 and Article 15.

Such procedures will mandate that counterparties to an SFT put in place appropriate internal procedures for their employees to report such actual and potential infringements.

For breaches of Article 4 or 15, the competent authorities will have the power to apply administrative sanctions as included in Article 22(4)(a) to (h) of the SFTR. These include a cease and desist order, a public warning and a temporary or permanent ban against anyone who is deemed responsible. In the UK, responsibility for regulatory reporting is one of the responsibilities PRA prescribes for senior management of all firms in the scope of the new individual accountability regime coming into force in March 2016, other than for small firms, credit unions and third-country branches. SFTR reporting will come within that senior manager's bailiwick.

Member States must notify the Commission and ESMA of the rules they put in place for criminal and administrative sanctions.

Conclusion

Many market participants may have paid little attention to the SFTR as it made its way through the EU legislative process. In many ways, keeping tabs on EMIR and assessing the potential impact of MiFID 2 and MiFIR will have been the focus of many.

But the SFTR is now effective, and those affected by it, and in particular senior managers and material risk takers, need to pay attention to the application dates of key provisions and ensure they are ready to comply.

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Timeline for implementation

Requirement	Date by which in force
SFT reporting requirements	
Investment firms and credit institutions to report SFTs to a trade depository or ESMA	Second or third quarter of 2018, namely 12 months after the entry into force of the SFT reporting RTS
Central securities depositories and central counterparties to report SFTs to a trade depository or ESMA	Third of fourth quarter of 2018, namely 15 months after the entry into force of the SFT reporting RTS
Insurance/reinsurance undertakings, UCITS/UCITS managers, AIFs/AIFMs and institutions for occupational retirement provision to report SFTs to a trade depository or ESMA	Fourth quarter of 2018 or first quarter of 2019, namely 18 months after the entry into force of the SFT reporting RTS
Non-financial counterparties to report SFTs to a trade depository or ESMA	First or second quarter of 2019, namely 21 months after the entry into force of the SFT reporting RTS
Reuse requirements	
Counterparties to comply with requirements on reuse of collateral (e.g. to obtain express written consent and to disclose the risks and consequences)	13 July 2016
UCITS/AIF disclosure requirements	
Prospectus or other disclosure document for an AIF or UCITS must specify SFTs and TRSs the manager is authorised to use, as well as indicate if such transactions are used and the details therof	12 January 2016
UCITS and AIFMs to disclose their use of SFTs and total return swaps in their half-yearly and annual reports (as applicable)	13 January 2017 for AIFs and UCITS that are constituted on or after 12 January 2016
UCITS and AIFMs to disclose their use of SFTs and total return swaps in their prospectus and pre-investment disclosure (as applicable)	13 July 2017 for AIFs and UCITS that are constituted before 12 January 2016