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Securities Financing Transactions Regulation

Shadow banking in the spotlight

Introduction

The regulation on reporting and transparency of securities financing transactions (the "**SFTR**") was published in the Official Journal of the European Union on 23 December 2015. It will come into force on 12 January 2016, with its various requirements being phased in over a period of time thereafter.

The primary aim of the SFTR is to address perceived risks in the use of "securities financing transactions" ("**SFTs**"), although it has a broader ambit in some respects, requiring risk disclosures and consents to be given with respect to any collateral arrangement involving (i) collateral in the form of financial instruments being taken by way of title transfer or (ii) the collateral-taker having a right to reuse the collateral.

The principal measures introduced by the SFTR are:

> reporting and record-keeping obligations in respect of SFTs;

> requirements for risk warnings and express prior consent for reuse of collateral; and

> enhanced requirements for disclosure to investors by funds of their use of SFTs and total return swaps.[1]

The SFTR has been broadly drafted in high-level terms, and further clarity is needed in some instances as to what activities will be captured, and what will be needed in practice to comply with the new requirements. As well as the delegated legislation that is mandated in the SFTR, it seems likely that the European Securities and Markets Authority ("**ESMA**") will need to publish further guidance in the future. Industry initiatives such as documentation to achieve standardised representations of status, waivers of confidentiality and delegation of reporting, and updates of legal opinions, will likely also be required.

[1] Article 3(18) defines a "total return swap" as a derivative contract as defined in point (7) of Article 2 of Regulation (EU) No 648/2012 ("**EMIR**") in which one counterparty transfers the total economic performance of a reference obligation to another counterparty.

Contents

Background

The SFTR forms part of the EU's overall financial markets reform programme in response to the financial crisis, and reflects policy recommendations made by the Financial Stability Board (the "**FSB**") as part of its examination of the shadow banking[2] sector.

The FSB published its "*Policy Framework addressing Shadow Banking Risks in Securities Lending and Repos*" in August 2013 which provided a number of policy recommendations aimed at reducing the potential systemic risk posed by SFTs. While SFTs provide a vital secondary market liquidity function and are central to financial intermediaries' abilities to make markets, concerns had arisen from the use of these transactions to create short-term "money-like" liabilities (such as borrowing short-term to fund longer term liabilities, or liquidity transformation). In particular, as significant activity in the sector, including by hedge funds and asset managers, sits outside the prudential regulations applicable to banks, there was regulatory concern over opaque and excessive build-up of leverage. Due to the pro-cyclical nature of funding, excessive leverage may then lead to volatile swings in the availability of funding when the financial system is stressed.

The FSB policy recommendations include reporting and other disclosure requirements designed to enhance transparency of securities market financing, regulation of non-bank entities' use of collateral and rehypothecation of client assets, as well as structural changes to the securities financing markets. The list of recommendations was expanded in a further paper in October 2014[3] to include mandatory haircuts for collateral in non-centrally cleared SFTs involving non-bank counterparties.[4] The Basel Committee on Banking Supervision proposes to implement the FSB recommendation on haircuts by setting significantly higher capital requirements for banks that enter into SFTs with lower collateral haircuts.[5]

Securities financing transactions

SFTs are defined in Article 3(11) as (in summary):

> repurchase transactions, buy-sell back transactions and sell-buy back transactions in relation to the transfer of securities or commodities;[6]

> securities or commodities lending and borrowing; and

What is an SFT?

The definition covers repos, buy-sell back transactions and stock loans, as well as margin loans in connection with the purchase of securities. As well as standard trades, more complex structures which include these types of transactions will need to be considered.

Margin lending for other purposes, e.g. credit lines in connection with futures trading, is not covered. In the context of prime brokerage and other credit facilities that may be used for different purposes, it may be difficult to identify whether a particular drawdown falls within the definition of SFT or not.

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2 The FSB defined shadow banking as "the system of credit intermediation that involves entities and activities (fully or partially) outside the regular banking system". See, in particular, "*An Overview of Policy Recommendations for Shadow Banking*" and "*Policy Framework for strengthening Oversight and Regulation of Shadow Banking Entities*", August 2013.

3 "*Regulatory framework for haircuts on non-centrally cleared securities financing transactions*", October 2014.

4 This is not addressed in the SFTR but the SFTR requires the Commission to report within 21 months of the SFTR coming into force on progress of the FSB proposals on haircuts, and their appropriateness for the European market.

5 Consultative document: Haircut floors for non-centrally cleared securities financing transactions (5 November 2015)

6 The definition also covers repurchase transactions relating to "guaranteed rights relating to title to securities or commodities where that guarantee is issued by a recognised exchange". "Commodity" is as defined in point (1) of Article 2 of Commission Regulation No 1287/2006 (MiFID Level 2 Regulation). "Securities" is not defined.

> margin lending transactions, which are defined as transactions where one counterparty extends credit in connection with the purchase, sale, carrying or trading of securities. Loans that are merely secured by collateral in the form of securities are expressly excluded.

Recital 7 clarifies that the definition of SFT does not include derivative contracts as defined in EMIR but includes "transactions commonly referred to as liquidity swaps and collateral swaps" which do not fall under the EMIR definition. Such transactions will generally be repurchase transactions or stock loans and therefore SFTs.

Article 29(1) requires ESMA to review the effectiveness of the operation of the SFTR periodically, which shall include considering extending the reporting obligation to transactions having equivalent effect to SFTs but which are not included in the current definition.

Reporting of SFTs

The reporting obligation (and the record-keeping obligations) with respect to SFTs will apply to:

> a counterparty[7] to an SFT established in (i) the EU (in which case SFTs effected through all branches, including non-EU branches, must be reported) or (ii) in a third country, if the SFT is effected through an EU branch;

> management companies for undertakings of collective investment in transferable securities ("**UCITS**"), and UCITS investment companies; and

> managers of alternative investment funds ("**AIFMs**") authorised under the AIFM Directive.[8]

There is an exemption from reporting for members of the European System of Central Banks (the "**ESCB**"), other bodies in EU states performing similar functions or the Bank for International Settlements. In the case of transactions with ESCB members, the counterparty to such a transaction will also be exempted from reporting such transactions.[9]

Counterparties to SFTs will be required to report details of such transactions, including any modifications or terminations, to a registered EU trade repository (or a trade repository outside the EU that becomes recognised by ESMA[10]). There is a streamlined process enabling a trade repository that is already approved for EMIR purposes to extend its registration to cover SFTs

Who needs to report?

All persons engaging in SFT activities from the EU (and the non-EU branches of EU persons) will need to report entry into, modification or termination of all SFTs.

[7] It appears that EU individuals are intended to be caught if they enter into SFTs, not just "undertakings" established in the EU.

[8] Directive 2011/61/EU.

[9] Article 2(3). The exemption from record-keeping also applies but in practice most counterparties will be subject to other similar regulatory requirements for record-keeping.

[10] Article 19 permits recognition only where the trade repository is in a non-EU country with an "equivalent" supervisory regime and which requires the repositories to provide ESMA and other EU authorities with direct access to the data collected by the repository.

as well. If a trade repository is not available to record the details, counterparties will need to report directly to ESMA.[11]

If both parties to an SFT are within the scope of the SFTR, both will need to report the transaction.[12] Reporting may be delegated to a third party. We assume that delegation to the other party to the SFT, or to another person, would be permitted but that, in either case, the delegating party would retain responsibility for any reporting failures by its delegate.

However, where a financial counterparty[13] concludes[14] an SFT with a non-financial counterparty[15] that is a small or medium-sized undertaking for accounting purposes[16] (a "**SME**"), the financial counterparty will automatically be responsible for reporting on behalf of both parties.

Where a person within the scope of the reporting requirements enters into a SFT with a counterparty outside the territorial scope of the SFTR, the former will have to report the transaction, though the latter will be under no reporting obligation. Whilst Article 4(7) provides that reporting will not be considered an infringement of any restriction on the disclosure of information imposed by contract or by any legal, regulatory or administrative provision, this will only be effective within the EU, and parties that are subject to the reporting requirement will need to consider whether reporting would infringe confidentiality requirements in other jurisdictions.

What information will need to be reported?

Article 4(9) provides that the details of the reports will be specified in regulatory technical standards ("**RTS**") to be developed by ESMA. At a minimum, this must include the details of the parties (or beneficiaries if different), principal amount, currency, collateral assets, method used to provide collateral, whether the collateral is to be reused or has been reused, any substitution of collateral, the repurchase rate, lending fee or margin lending rate, haircut, value date, maturity date, first callable date and market segment. Depending on the type of SFT, details of any cash collateral reinvestment and the securities or commodities being lent or borrowed will also be required.

What needs to be reported?

It is envisaged that very detailed information will need to be reported on each SFT, including information on cash collateral reinvestment.

[11] Article 4(5).

[12] This dual-sided reporting follows the same approach as under EMIR, which has created practical difficulties in reconciling reports. The SFTR provides for ESMA to report, within 12 months of the reporting obligation commencing, on the appropriateness of moving to single-sided reporting.

[13] A ""financial counterparty" is defined in Article 3(3) as an investment firm, credit institution, insurance undertaking, reinsurance undertaking, UCITS and its authorised management company, alternative investment fund ("**AIF**") managed by an AIFM, institution for occupational retirement provision authorised or registered under the Occupational Pension Funds Directive (Directive 2003/41/EC), CCP, CSD and any third country entity which would, if established in the EU, require the same authorisation as the foregoing categories of financial counterparty .

[14] It is not clear whether this is intended to apply to amendments or terminations of SFTs as well, but we assume this is the case.

[15] A "non-financial counterparty" is defined in Article 3(4) as an undertaking established in the EU or a third country, other than a financial counterparty.

[16] Where the non-financial counterparty's balance sheet does not exceed the limits of at least two of the three criteria set out in Article 3(3) of Directive 2013/34/EU on annual financial statements, consolidated financial statements and related reports of certain undertakings.

In producing the RTS, ESMA is likely to follow closely the FSB's "*Standards and Processes for Global Securities Financing Data Collection and Aggregation*"[17], which were issued in final form in November 2015.

It is difficult to assess, based on the current drafting, how these reporting requirements will be applied in practice. For instance, where cash collateral under a securities lending agreement is paid outright to a lender, will the lender be required to track how it is "used", and disclose such use as "cash collateral reinvestment"? Nor is it clear, notwithstanding references to the RTS taking into account "technical specificities of pools of assets" and providing for "reporting position level data where appropriate", how net margining of transactions under a single GMRA or GMSLA, or cross-product margining across a pool of products, may be applied in conjunction with the need to disclose the collateral applicable to each transaction.

When does the reporting obligation come into effect?

The date on which the reporting obligation applies (each, an "**effective date**") depends on the type of counterparty:[18]

> For investment firms and credit institutions it will apply **12 months** after the date the RTS comes into force;

> For central counterparties ("**CCPs**") and central securities depositaries ("**CSDs**"), it will apply **15 months** after the date the RTS comes into force;

> For insurance undertakings, reinsurance undertakings, UCITS, authorised UCITS management companies, alternative investment funds managed by AIFMs and occupational pension funds, it will apply **18 months** after the date the RTS comes into force; and

> For non-financial counterparties, it will apply **21 months** after the date the RTS comes into force.

Note that each of the above categories also includes third country entities that would fall within the relevant category if established in the EU (although this does not change the fact that such third country entities are only subject to the reporting requirement at all if acting through an EU branch).

The SFTR does not specify what is required if the reporting obligation has come into effect for one counterparty but not the other – for instance, where a bank enters into a SFT with an non-financial counterparty between 12 to 21 months of the RTS coming into force. Presumably the bank would need to report but the non-financial counterparty would not.

Which SFTs must be reported?

The reporting obligation applies not only to SFTs concluded, modified or terminated on or after the relevant effective date, but also to any SFTs which have an outstanding maturity of more than 180 days as at the relevant

Timing?

The reporting obligation will be phased-in following finalisation of the regulatory technical standards on reporting. Transactions already existing when the reporting obligation arises will need to be reported if they continue for 180 days thereafter.

[17] Policy document issued on 18 November 2015.
[18] Article 33(2).

effective date.[19] This could have significant administrative implications for SFT market participants with substantial existing positions that will continue for 180 days or more.

When does the SFT need to be reported?

SFTs concluded, modified or terminated on or after the relevant effective date must be reported within one working day following the conclusion, modification or termination of the transaction.[20]

Counterparties have 190 days after the relevant effective date to report SFTs already in existence as at such date and to which the reporting obligation applies.[21]

Record Keeping

Counterparties to SFTs that are within the scope of the SFTR will be required to keep records of any SFT they have concluded, modified or terminated for at least five years following the termination of the transaction.[22]

Reuse of financial instruments[23] received as collateral

Article 15 sets out the conditions for reuse of financial instruments received as collateral. The definition of reuse makes it clear that these requirements apply not only with respect to SFTs but to all financial collateral arrangements (whether security collateral arrangements ("**SCA**") or title transfer collateral arrangements ("**TTCA**")) that involve financial instruments.[24]

Where collateral is taken on a title transfer basis, the transferee becomes the owner of the assets and therefore has the full right to use the assets. It is counter-intuitive to treat any such use as a "reuse" that is equivalent to the situation where collateral is taken by way of security but with the collateral-taker having a right to reuse, or rehypothecate, the assets.[25] However, the SFTR treats these two situations as broadly equivalent.

What are the conditions to reuse?

There are two conditions that must be satisfied before collateral may be reused:

> ***Risk warning***: The collateral-taker must inform the providing counterparty, in writing, of the risks and consequences of either granting a right of use of the collateral under an SCA, or concluding a

What is a title transfer collateral arrangement?

A "title transfer collateral arrangement" is defined in Article 3(13) and has a similar meaning to "title transfer financial collateral arrangement" in Directive 2002/47/EC (the "**FCAD**"), but extended to arrangements securing any obligation, not just financial obligations.

What is a security collateral arrangement?

A "security collateral arrangement" is defined in Article 3(14) and has a similar meaning to "security financial collateral arrangement" in the FCAD but extended to cover arrangements that secure any obligation.

What is "reuse"?

"Reuse" is defined in Article 3(12) as the use by a receiving counterparty, either in its own name or on the account of another party of financial instruments under a collateral arrangement.

This is specified to comprise transfer of title or the exercise of right of use in accordance with Article 5 of the FCAD. It excludes the liquidation of such an instrument in the event of default of the providing counterparty.

[19] Article 4(1). This includes SFTs with an open maturity which remain outstanding for more than 180 days following the date the SFTR comes into force.
[20] Article 4(1).
[21] Article 4(1). It is unclear what needs to be reported if a pre-existing transaction is modified or terminated during the 180 day period.
[22] Article 4(4).
[23] "Financial Instruments" has the meaning given in Directive 2014/65/EU (MiFID II).
[24] The FCAD also covers financial collateral arrangements relating to cash or credit claims, which are not within the scope of the SFTR.
[25] See letter from the Financial Markets Law Committee to the European Commission dated 10 February 2015.

TTCA, as the case may be. At a minimum, the information must explain the risks and consequences of the default of the collateral-taker.[26]

> ***Consent/Agreement***: The collateral-provider must have (i) granted its prior express signed consent in writing, or legally equivalent manner, to the terms which provide the right of use in the case of an SCA, or (ii) expressly agreed to provide collateral by way of a TTCA.[27]

It is unclear whether the risk warning can be included in the same document that creates the SCA or TTCA.[28]

Recital 23 states that infringement of the conditions of reuse should not diminish the protection afforded to TTCAs under the FCAD, and that any breach of the risk warning requirements of the SFTR should not affect national laws concerning the validity or effect of a transaction.

Scope of the requirements

Like the SFT reporting obligations, the "conditions to reuse" will apply to EU persons (including UCITS and AIFMs and where collateral is taken through a non-EU branch), and to EU branches of third country entities.

The requirements on reuse are also expressed to apply to a non-EU person where the reuse concerns financial instruments provided under collateral arrangements by a counterparty established in the EU or by the EU branch of a counterparty established in a third country. This appears to be an attempt to impose extra-territorial requirements and it is unclear how the EU authorities could impose sanctions on a non-EU person that (for example) takes collateral from an EU person under a TTCA without providing a risk warning. As noted above, it is not intended that a breach of the risk warning requirement should affect the validity of transactions.

Conditions to reuse - territorial scope?

The collateral reuse provisions are applied to non-EU persons that take collateral from EU persons (including from EU branches of non-EU persons).

When will the conditions to reuse requirements apply?

6 months after the SFTR comes into force i.e. 13 July 2016.

To which transactions will the conditions to reuse requirements apply?

Prime brokerage arrangements, and numerous types of secured lending (whether or not constituting margin loans falling within the definition of SFT) will be SCAs. Credit support arrangements documented under ISDA's New York law Credit Support Annex and English law Credit Support Deed are also SCAs. The requirements will therefore apply if the SCA gives the collateral-taker a right of use. The English law Credit Support Deed does not (unless amended) give a right of use, but the New York law Credit Support Annex does, unless an election to the contrary was made.

Stock loans and repos under English law GMSLAs, GMRAs and other industry-standard forms of stocklending and repo agreement will be TTCAs,

Conditions to reuse – which transactions?

The scope of these provisions is wide, covering prime brokerage and other secured financings involving a right of use, and stock loans and repos and other title transfer collateral arrangements.

[26] Article 15(1)(a).
[27] Article 15(1)(b).
[28] Note that the current FCA rules (CASS 9) require prime brokers that have a right of use to set out a clear summary of such right in a separate disclosure annex to the prime brokerage agreement.

as will credit support arrangements documented under the ISDA English law Credit Support Annex (“**CSA**”). Numerous more complex financing structures which involve stock loans or repos, or collateral being posted under a CSA or similar document, will also be caught.

The conditions to reuse requirements apply to all collateral arrangements existing as at 13 July 2016, as well as to new arrangements entered into after that date. In the case of existing SCAs, the terms of the SCA may well be sufficient to constitute “express consent” (and may also provide an adequate risk warning, though it may be prudent to send out a further risk disclosure to demonstrate compliance with the SFTR in any event). In the case of an existing TTCA, it will probably be necessary for a risk warning to be sent out to existing counterparties when the requirement comes into force.

In view of the wide ambit of Article 15, the number of arrangements potentially caught by the conditions to reuse requirements is likely to be substantial. In the case of agreements under which either party may be taking collateral (such as GMSLAs, GMRAs and two-way credit support arrangements under an ISDA CSA or Credit Support Deed), it appears that both parties will need to provide a risk warning to the other (unless, for future arrangements, it becomes market practice to comply with the SFTR by including a risk warning in the document itself). For existing arrangements documented under industry-standard documents, sending out an information statement may be the favoured method of complying with the requirement to provide a risk warning to counterparties.

Potentially, there is a substantial “repapering” exercise to be conducted, and unfortunately the requirements come into effect in July 2016, preceding the timing for amending existing collateral arrangements to comply with the new rules on taking initial margin and variation margin on uncleared derivatives, which are expected to be phased in from September 2016.[29]

Enhanced disclosure requirements for funds

Under Article 13, management companies of UCITS, UCITS investment companies and AIFMs will be required to inform investors how they make use of SFTs and total return swaps[30] in their annual reports (and, in the case of UCITS, in their half-yearly reports). This obligation will apply from 13 January 2017.[31]

Article 14 obliges such entities to also disclose their use of SFTs in their prospectus or other disclosure document.[32] This requirement will apply, in the case of UCITS and AIFs already established as at 12 January 2016, from 13

[29] See ESMA draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012.
[30] To be included in their half-yearly and annual reports, in the case of UCITS investment and management companies, or their annual reports in the case of AIFMs.
[31] Article 33(2)(b).
[32] To be included in their UCITS prospectus or the disclosure required under Articles 23(1) and (3) of Directive 2001/61/EU (AIFMD), as applicable.

July 2017.[33] Funds established after 12 January 2016 will need to include this information in their marketing documents from the outset.

The annexures to the SFTR set out details of the minimum information that must be disclosed. Further details may be set out in ESMA RTS, which may expand these requirements in line with existing requirements and evolving market practices relating to these entities.

Some practical considerations

Whilst there is a considerable amount of detail that will need to be clarified before the implications of the SFTR can be analysed with certainty, the following should be noted:

> A new reporting regime will apply to SFTs, similar to the requirement under EMIR for daily reporting of all derivatives transactions, and which will apply in addition to existing disclosure requirements that may be triggered by SFTs.[34] A proliferation of reporting requirements may be onerous and expensive to implement, especially as it appears that the SFTR and delegated acts to be made under it will require very detailed information on SFTs[35].

> The reporting regime will apply to entities such as pension funds and local authorities that may not have the infrastructure in place to report stocklending and repo activities, and presumably they will need to put in place procedures with third parties such as their agency lenders or investment managers to report such transactions on their behalf. In the prime brokerage context, we expect that the prime broker will report on behalf of its clients. For SPVs that become subject to reporting requirements, delegation agreements under which the arranger or lead manager agrees to make reports will be necessary.

> Further need to classify counterparties, in particular for financial counterparties to determine whether the counterparty to a SFT is a SME so that the financial counterparty is legally obliged to report on behalf of the SME. New standardised documentation for representing a party's status may need to be put in place.

> Potential difficulty in determining whether cash lending transactions fall within the definition of "margin lending" and therefore constitute SFTs, particularly in the prime brokerage context.

[33] Article 33(2)(c).

[34] For example, as a result of the Transparency Directive Amending Directive (2013/50/EU), stock loans and borrowings may trigger disclosure obligations for both the lender and borrower under rules implementing the Transparency Directive (Disclosure and Transparency Rules or DTRs).

[35] However, there will be an exemption from transaction reporting under Art 26 of MiFIR for securities financing transactions that (i) have been reported under the SFTR or (ii) have been effected prior to the reporting obligation under the SFTR coming into force but that would have been subject to the reporting obligation if it was in force.

> The need for express consent to a collateral-taker under a SCA having a right of reuse, and risk warnings. This does not appear controversial in relation to prime brokerage but, in view of the broad scope of SCAs, it may be necessary to carry out due diligence to identify other SCAs that may include a right of use.

> The need for risk warnings in relation to TTCAs, potentially to be provided by each party to the other. Again, we expect that an industry solution will be devised for complying with the SFTR in this respect. Review will be needed of legal opinions given in respect of TTCAs to consider whether they need revising in light of the SFTR.

> Any changes to SCAs and TTCA documentation to comply with the SFTR will need to be undertaken in parallel with changes that may be required to meet the new rules on margin for uncleared derivatives.

> Potentially, the onerous reporting requirements (and the impact of haircuts on collateral provided under uncleared SFTs, if introduced at a later date) will encourage the trend towards central clearing of repos and stock loans.

Generally, the SFTR will add further operating costs for businesses engaging in a wider range of financing activities. Its impact will be felt not just by the "shadow banking sector" but by regulated financial institutions including prime brokers and fund managers, and by investors such as pension funds.

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