Securities Financing Transactions Regulation

Overview

Background

The Securities Financing Transactions Regulation (Regulation (EU) 2015/2365) ("SFTR") entered into force on 12 January 2016. The SFTR relates to securities financing transactions ("SFTs"), total return swaps and reuse of assets received under a collateral arrangement and is part of EU-level attempts to address the perceived lack of transparency and monitoring in the "shadow banking" sector.

As an EU Regulation, the SFTR is directly applicable across all the EU Member States (including the UK). On 22 September 2016 the FCA published an instrument that made changes to its Collective Investment Schemes sourcebook ("COLL") and Investment Funds sourcebook ("FUND") to implement certain elements of the SFTR under the UK regulatory regime.

In this article we take a look at the objectives behind SFTR, the scope and implications of it, as well as the UK's implementation.

Objectives

The SFTR aims to increase transparency by introducing the following requirements:

- transactions must be reported to a trade repository to allow increased monitoring of the risks associated with SFTs (the "Reporting Requirements");
- practices relating to the use of SFTs and total return swaps must be disclosed by UCITS management companies ("ManCos"), UCITS investment companies and alternative investment funds managers ("AIFMs") in their reports as well as their pre-contractual documentation (the "Disclosure Requirements"); and
- reuse of financial instruments received under a collateral arrangement must meet minimum conditions, such as requirements to (i) disclose associated risks and (ii) gain express consent of the counterparty (the "Reuse Requirements").

Scope

Transactions covered

The SFTR defines an “SFT” as comprising the following:

(a) repurchase transactions;
(b) lending and borrowing of securities or commodities;
(c) buy-sell back and sell-buy back transactions; and
(d) margin lending transactions;

each as more fully defined in the SFTR, but in summary each concerns the raising of finance through the use of assets owned by a counterparty to the transaction.
Notably, although the regulation does not cover derivative contracts, the definition of SFTs does include liquidity swaps and collateral swaps, which do not currently fall under the European Markets and Infrastructure Regulation (“EMIR”) definition.

The SFTR also requires disclosure of certain information pertaining to total return swaps. A “total return swap” is defined as a derivative 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.

Application

Subject to certain exemptions, the SFTR applies to both financial counterparties (such as investment firms, credit institutions, insurance undertakings and central counterparties) and non-financial counterparties. Counterparties established in the EU but acting through a non-EU branch are within scope, as are non-EU counterparties acting through an EU branch.

The SFTR also applies to ManCos, UCITS investment companies and AIFMs.

Exemptions

The SFTR provides for certain limited exemptions. Obligations under the new regulation do not apply to the European System of Central Banks and EU public bodies with similar functions, nor do they apply to EU public bodies involved in the management of debt. The Bank for International Settlement is also exempt.

Reporting Requirements

Article 4 requires counterparties to an SFT to report details of any SFT they have concluded, modified or terminated to a trade repository no later than the working day following the conclusion, modification or termination of the transaction or, if no trade repository is available, to the European Securities and Markets Authority (“ESMA”).

The basic features of SFT trade reporting are similar to those of EMIR trade reporting in respect of over-the-counter derivatives, which went live in February 2014, although the form and content requirements differ from the equivalent EMIR requirements in certain respects. The reporting process may therefore be familiar to firms which have already got to grips with the EMIR trade reporting process, but such firms may need to adjust their systems to ensure the required data is captured and reported.

Details that need to be reported will include the parties to the SFT, principal amount and currency, and assets used as collateral. In addition, where a non-financial counterparty, on its balance sheet date, does not exceed at least two of the following three thresholds, the financial counterparty will have an obligation to report on behalf of both itself and that non-financial counterparty: (i) balance sheet total of EUR 20 million; (ii) net turnover of EUR 40 million; and (iii) an average of 250 employees during the financial year.

When a UCITS managed by a ManCo is a counterparty to SFTs, the ManCo will have the responsibility to report on behalf of that UCITS. When an alternative investment fund is a counterparty to SFTs, its AIFM will have the responsibility to report on behalf of that alternative investment fund.

Counterparties to a SFT will also have to keep a record of all SFTs that they have concluded, modified or terminated for a period of at least five years following the termination of such transaction.

Implementation Dates

ESMA is obliged to submit draft regulatory technical standards (“RTS”) and draft implementing technical standards (“ITS”) by 13 January 2017. The RTS and ITS will provide further details of the information that counterparties must report. ESMA published a consultation on 30 September 2016 that includes its draft RTS and ITS. The consultation is open for responses until 30 November 2016.

The implementation of the Reporting Requirements will be phased in after the finalised RTS enter into force. Depending on the firm’s status, firms have to start reporting from 12 to 21 months after the entry into force of the RTS.
Disclosure Requirements

Articles 13 and 14 of the SFTR place obligations on ManCos and AIFMs to disclose information to investors on their use of SFTs and total return swaps.

Pre-contractual disclosure

Article 14 of the SFTR requires ManCos and AIFMs to disclose information on SFTs and total return swaps in the offering documents for the funds they manage, which for ManCos and AIFMs of UK regulated funds will mean the prospectuses of the UCITS/AIFs they manage and for which they engage in SFTs and/or total return swaps.

The offering document must disclose the SFTs and total return swaps which the ManCo/AIFM is authorised to use and include a clear statement that those transactions and instruments are used in practice. Certain other prescribed information must also be set out in the offering document:

a) A general description of the SFTs and total return swaps used by the fund and the rationale for their use;

b) The overall data to be reported for each type of SFTs and total return swaps, namely: (i) the types of assets that can be subject to them; (ii) the maximum proportion of AUM that can be subject to them; and (iii) the expected proportion of AUM that will be subject to each of them;

c) The criteria used to select counterparties (including legal status, domicile and minimum credit rating);

d) A description of acceptable collateral with regard to asset types, issuer, maturity and liquidity as well as the collateral diversification and correlation policies;

e) A description of the collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margins are used;

f) A description of the risks linked to SFTs and total return swaps, as well as risks linked to collateral management;

g) Information on how assets subject to SFTs and total return swaps and collateral received are safe-kept;

h) Information on any restrictions (regulatory or self-imposed) on reuse of collateral; and

i) The policy on sharing of returns generated by SFTs and total return swaps, and a description of the proportions of the revenue generated by SFTs and total return swaps that is returned to the fund, and of the costs and fees assigned to the manager or third parties, and whether these are related parties to the ManCo/AIFM.

Disclosure in periodic reports

Article 13 requires information on the use of SFTs and total return swaps to be disclosed by ManCos and AIFMs in the half-yearly and annual reports relating to the UCITS that they manage or in the annual reports of their AIFs, respectively.

The information which must be included in the reports comprises seven categories of data, including:

a) Global data: (i) amount of securities and commodities on loan as a proportion of total lendable assets; and (ii) absolute and relative amounts of assets employed in each type of SFTs and total return swaps;

b) Concentration data: the ten largest issuers across all SFTs and total return swaps and the top ten counterparties of each type of SFT and total return swap;

c) Aggregate transaction data: data must be provided separately for each type of SFT and total return swap and broken down across: (i) type and quality of collateral; maturity tenor of collateral; maturity tenor of SFTs and total return swaps; currency of collateral; country in which counterparties are established; and form of settlement and clearing;

d) Data on reuse of collateral: share of collateral reused compared to maximum amount specified in prospectus or in disclosure to investors; and cash collateral reinvestment returns to the fund;
e) **Safekeeping of collateral received by the fund as part of SFTs and total return swaps:** number and names of custodians and amount of collateral assets safe-kept by each custodian;

f) **Safekeeping of collateral granted by the fund as part of SFTs and total return swaps:** proportion of collateral held in segregated accounts, pooled accounts or any other accounts; and

g) **Data on return and cost for each type of SFTs and total return swaps:** breakdown between the fund, ManCo/AIFM and third parties, both in absolute terms and as a percentage of overall returns for that type of SFTs and total return swaps.

**Implementation Dates**

The SFTR provides for transitional periods in respect of the investor disclosure requirements in Articles 13 and 14.

Article 14 will apply from 13 July 2017 in respect of UCITS or AIFs that are constituted before 12 January 2016. UCITS/AIFs authorised or otherwise constituted on or after 12 January 2016 cannot avail themselves of this transitional provision.

Article 13 will apply from 13 January 2017, meaning that UCITS half-yearly and annual reports and AIF annual reports published from that date onwards will need to provide the required information on SFTs and total return swaps.

**Reuse Requirements**

"Reuse" is defined in the SFTR as the use by a collateral taker, in its own name and on its own account or on the account of another counterparty, of financial instruments received under a collateral arrangement, such use comprising transfer of title or exercise of a right of use (but not including the liquidation of a financial instrument in the event of default of the providing counterparty).

**Reuse Requirements**

Article 15 of the SFTR prohibits the re-use by counterparties of financial instruments as collateral arrangement except in one of two situations:

a) first, where the providing counterparty has been notified in writing by the receiving counterparty of the risks and consequences that may be involved in either granting consent to a right of use of collateral under a security collateral arrangement or concluding a title transfer collateral arrangement; and

b) second, where the providing counterparty has granted its prior express consent, evidenced by a signature, in writing or in a legally equivalent manner, of the providing counterparty to a security collateral arrangement, the terms of which provide a right of use or has expressly agreed to provide collateral under a title transfer collateral arrangement.

**Implementation Dates**

The Reuse Requirements took effect on 13 July 2016 and apply to collateral arrangements existing on and from that date. As such, the regulation imposes retroactive obligations on relevant transactions that were entered into prior to 13 July 2016. This deferral of the Reuse Requirements taking effect for six months was to provide counterparties with sufficient time to adapt their outstanding collateral arrangements and to ensure compliance with the requirements.

**Sanctions**

For non-compliance with the Reporting Requirements and Reuse Requirements, the competent authorities of the Member States will have the power to apply various administrative sanctions and other administrative measures, from a cease and desist order to an administrative penalty of up to the greater amount of EUR 5 million or equivalent currencies (in case of non-compliance with the Reporting Requirements) or EUR 15 million or equivalent currencies (in case of non-compliance with the Reuse Requirements) and 10% of the total annual turnover of the legal person.
For non-compliance of the Disclosure Requirements, the competent authorities of the Member States will have the power to apply various administrative sanctions and other measures under the UCITS Directive and Alternative Investment Fund Managers Directive.

UK Implementation

The changes to COLL include guidance on the additional information to be included on SFTs and total return swaps:

a) in the prospectus or other pre-sale documents for UCITS, non-UCITS retail schemes (“NURS”) and qualified investor schemes (“QIS”); and

b) in annual and half-yearly reports of UCITS, NURS and QIS.

This guidance is set out in COLL 4.2.5AG. In addition, the provisions of the SFTR setting out the relevant disclosure obligations have been copied out into COLL 4.2.5BEU and 4.2.5CEU.

The FCA has set out transitional provisions which address when the obligations to provide the mandated pre-contractual information will commence. These transitional provisions mirror those under the SFTR, as described above. In the FCA’s SFTR consultation on proposed amendments to its handbook of rules and guidance, the FCA stated that in its view sub-funds constituted after 12 January 2016 would not benefit from the transitional provision regarding pre-contractual disclosures, even if the umbrella fund of which they are part was constituted before that date. This position is reflected in the finalised transitional provisions to COLL.

The changes to FUND are broadly the same as those in COLL. It is however noteworthy that FUND cross-refers to COLL; a novel approach from the FCA given that COLL does not apply to AIFMs of unregulated funds.

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