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Securities Financing Transactions Regulation: Shining a Light on Shadow Banking

Introduction

On June 29, 2015, the Council of the European Union announced that its Committee of Permanent Representatives (Coreper) approved a final compromise text of the proposed regulation on reporting and transparency of securities financing transactions ("SFT Regulation")[1]. This compromise text finally brings consensus to variations between the European Commission's (EC) proposal published on January 29, 2014, (2014/0017 (COD)) and the European Parliament's draft report[2].

Background

Securities financing transactions (SFTs) historically have played an important role in providing liquidity and funding to financial market participants—lending securities facilitates settlement and covers short positions while repurchase transactions help parties to finance positions, obtain leveraged exposures and can facilitate liquidity management.

Unlike the traditional banking sector, the non-bank credit intermediation sector (i.e., shadow banking) was not subject to regulatory oversight, which led to an unknown build-up of leverage, pro-cyclicality and interconnectedness in the financial markets—the extent of which became apparent during and after the 2008 global financial crisis.

The Financial Stability Board (FSB) and the European Systemic Risk Board (ESRB) recognised that transparency was necessary in order to monitor future build-ups of leverage and the SFT Regulation was developed as a means to provide that transparency by requiring reporting of information about securities financing transactions undertaken in the shadow banking sector.

The SFT Regulation

The SFT Regulation calls for transparency through (1) an obligation to report SFT transactions to a trade repository; (2) enhanced disclosure to investors in undertakings for collective investments in transferable securities (UCITS) or alternative investment funds (AIF) products; and (3) the imposition of conditions upon the reuse of assets and enhanced disclosure to clients about the reuse of such assets.

A. What Is a SFT?

The SFT Regulation defines a SFT as:

- a repurchase transaction;
- securities or commodities lending and securities or commodities borrowing (where a commitment to return equivalent securities or commodities at a future date exists);

[1] http://www.parlament.gv.at/PAKT/EU/XXV/EU/07/08/EU_70867/imfname_10561260.pdf

[2] http://ec.europa.eu/internal_market/finances/docs/shadow-banking/140129_proposal_en.pdf

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- buy/sell back transactions or sell/buy back transactions; and
- margin lending transactions.

B. Which Counterparties Will Be Affected?

In the case of a counterparty engaging in a SFT, the SFT Regulation applies to:

- any EU counterparty (and its branches wherever located);
- a third country counterparty if the SFT is concluded in the course of operations of an EU branch of that counterparty;
- management companies of UCITS and UCITS investment companies in accordance with Directive 2009/65/EC; and
- managers of alternative investment funds (AIFMs) authorised in accordance with Directive 2011/61/EU.

In the case of a counterparty engaging in reuse, the SFT Regulation will apply to:

- any EU counterparty (and its branches wherever located); and
- a third country counterparty if either (1) reuse is effected in the course of operations of an EU branch, or (2) the reuse concerns instruments provided under a collateral arrangement by an EU counterparty or an EU branch of a third country counterparty.

Note that financial and non-financial counterparties are caught by this regulation, and the SFT Regulation will have extraterritorial impact on many counterparties.[3]

C. What Are the Specific Transparency Requirements?

Article 4 - Reporting Obligation and Safeguarding

Counterparties are required to report the details of a SFT to a registered trade repository (or where no trade repository is available, to the European Securities and Markets Authority (ESMA)) and the details must be reported no later than one working day following the conclusion, modification or termination of the transaction (T+1). Records for these transactions must be kept by the counterparties for a minimum period of five years following the termination of the transaction. At this point, the SFT Regulation requires a dual-reporting regime similar to the European Markets Infrastructure Regulation (EMIR).

A counterparty may delegate the reporting to a third party and, in certain circumstances, a financial counterparty may bear the responsibility of reporting for a non-financial counterparty as well.

Further draft regulatory technical standards are expected from ESMA, which will provide additional details on the types of information that will be required to be provided when reporting a SFT, and will vary depending on the type of counterparty and SFT involved.

Articles 11 and 12 - Transparency Toward Investors

One area of concern specifically highlighted by the EC is related to the perceived lack of comprehensive disclosure by UCITS management companies and AIFMs to their investors regarding the extent to which SFTs are used as part of the investment strategy and the extent to which assets were being reused by counterparties.

The SFT Regulation now requires UCITS management companies, UCITS and AIFMs to inform their investors on the use they make of SFTs and total return swaps. The disclosures are required to be made in: (1) the financial reports (UCITS half-yearly and annual, and AIFMs annual report), and (2) in the pre-contractual documents (i.e., prospectus or offering memorandum) prior to an investor making an investment decision.

Annex A of the SFT Regulation provides the types of detail that should be provided in the financial reports, which is further summarised in the chart below. Both Sections A and B will be the subject of future draft regulatory technical standards.

Section B of Annex A sets forth the information required to be disclosed in the pre-contractual documents, and generally includes:

[3] The SFT Regulation contains an exemption from the reporting requirements for EU central banks, the Bank for International Settlements and "public bodies managing public debt."

- a general description of the SFT and other financing structure used by the fund and the rational for its use;
- the following data for each type of SFT and each type of other financing transaction:
  - types of assets that can be subject to them;
  - maximum proportion of assets under management (AUM) that can be subject to them; and
  - expected proportion of AUM that will be subject to each of them;
- criteria used to select counterparties;
- acceptable collateral;
- collateral valuation (a description of the valuation methodology and its rationale, and whether daily mark-to-market and daily variation margins are used);
- risk management; and
- description of how assets lent and collateral received are kept safe.

Section A of Annex A provides the information that is required to be contained in the periodical reports (a general summary can be found in the chart below).

Article 15 - Transparency of Reuse

Moving beyond simple disclosure, Article 15 seeks to impose rights on the ability of counterparties to engage in the reuse of a counterparty's assets, which are similar to other existing or proposed regulations in respect to collateral arrangements.

Reuse. One of the differences between the EC's proposal and Parliament's draft report related to a difference in view between using "rehypothecation" and "reuse." The compromise text makes it clear in Recital 18b that "reuse" shall be the same as the term used by the FSB's recommendations to promote international consistency.

Article 3, 1(7) defines reuse 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 includes transfer of title or exercise of a right of use in accordance with Article 5 of Directive 2002/47/EC but does not include the liquidation of the financial instrument in the event of default of the providing counterparty.

Rights of Reuse. Article 15 now requires that, at a minimum, the following conditions must be met by the providing counterparty:

- The owner must be duly informed in writing of the risks and consequences of the counterparty involved in: (1) granting consent to a right of use of collateral; or (2) concluding a title transfer collateral arrangement (information obligation).
- The providing counterparty has granted it's express consent to a security collateral arrangement or has expressly agreed to provide collateral by way of a title transfer collateral arrangement (execution obligation).

The following conditions must be met by a counterparty prior to exercising its right to reuse the assets:

- the reuse is done in accordance with the terms of the collateral contractual arrangement (compliance obligation); and
- the financial instruments received are transferred from the account of the providing counterparty (where a third country counterparty is involved and its account is maintained in, and subject to, the law of the third country, reuse shall be evidenced either by transfer from the account or by other appropriate means)(transfer obligation).

In most instances the execution obligation and compliance obligation already will be met, so we anticipate few market changes due to these obligations.

Next Steps

If approved by Parliament on October 27, 2015, as anticipated, the SFT Regulation could be in force as early as the first calendar quarter of 2016.

Once in force, Article 15 will have retroactive effect on existing collateral arrangements, which means that counterparties will need to take steps to ensure that all existing collateral arrangements meet the conditions set forth in Article 15.

INVESTOR DISCLOSURES – PERIODIC REPORTING	
Global Data	Amount of securities and commodities on loan as a proportion of total lendable assets
	Amount of assets engaged in each type of SFT and other financing structures expressed as an absolute amount and as a proportion of the fund's AUM
Concentration Data	Top 10 collateral securities and commodities received per issuer in regard of all types of SFT
	Top 10 counterparties of each type of SFT separately and other financing structure
Aggregate transaction data for each type of SFT and other financing transactions	Type and quality of collateral
	Maturity tenor of the collateral broken down in the following buckets: less than one day, one day to one week, one week to one month, one month to three months, three months to one year, above one year, and open maturity
	Currency of collateral
	Country of domicile of counterparties
	Settlement and clearing
Data on re-use and rehypothecation of cash collateral	Share of collateral received that is reused or rehypothecated, compared to the maximum amount specified in the prospectus or disclosure to investors
	Information on any restrictions on type of securities and commodities subject to rehypothecation or reuse
	Cash collateral reinvestment returns to the fund
Safekeeping of collateral received by the fund as part of SFT	Number of custodians and the amount of collateral assets kept safe by each one
Safekeeping of collateral granted by the fund as part of SFT	Proportion of collateral held either in segregated accounts or in pooled accounts, or in any other account
Data on return and cost for each type of SFT and each type of financing structure	Data broken down between the fund, fund manager and agent lender in absolute terms, and as a percentage of overall returns generated by that type of SFT and type of other financing structure

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