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New EU Regulation on Securities Financing Transactions and Reuse of Collateral

A Legal Update from Dechert's Financial Services Practice

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New EU Regulation on Securities Financing Transactions and Reuse of Collateral

Regulatory context

The regulation on transparency of securities financing transactions and of reuse (the "**Regulation**") stems from a belief that the 2007-08 global financial crisis revealed excessive speculative activities, important regulatory gaps, ineffective supervision, opaque markets and overly complex products in the financial system[1]. This Regulation is a product of the "shadow banking" stream of work at the EU level[2]. The Regulation defines shadow banking as "bank-like credit intermediation" and labels it "alarming" in terms of its scale[3]. The Regulation seeks to address securities financing transactions, which, in the Commission's view, allows the build-up of leverage, pro-cyclicality and interconnectedness in the financial markets[4]. In particular, the Commission says that a lack of transparency in the use of securities financing transactions has prevented regulators and supervisors as well as investors from correctly assessing and monitoring the respective bank-like risks and level of interconnectedness in the financial system in the period preceding and during the financial crisis[5] .

This Regulation piggybacks somewhat on EMIR transaction reporting in order to minimise additional operational costs for market participants[6], and many similarities with EMIR can be seen in the Regulation. For those comfortable with EMIR reporting it should be relatively straightforward to come into compliance with the new requirements.

Some definitions

The Regulation applies to certain counterparties to SFTs, and makes a distinction between "financial counterparties" and "non-financial counterparties".

A financial counterparty (**FC**) means[7]:

- An investment firm authorised under MiFID II[8].
- A credit institution authorised under CRD IV[9].
- An insurance undertaking authorised under Solvency II[10].
- A UCITS and, where relevant, its management company, authorised under the UCITS Directive[11].
- An AIF managed by AIFMs authorised or registered in accordance with AIFMD[12].

1 Recital 1 of the Regulation
2 For further information, see the Financial Stability Board's Policy Framework entitled "Strengthening Oversight and Regulation of Shadow Banking" dated 29 August 2013
3 Recital 1 of the Regulation
4 Recital 2 of the Regulation
5 Recital 2 of the Regulation
6 Recital 10 of the Regulation
7 Article 3(3) of the Regulation
8 Directive 2014/65/EU
9 Directive 2013/36/EU
10 Directive 2009/138/EU
11 Directive 2009/65/EC
12 Directive 2011/61/EU

- An institution for occupational retirement provision authorised under the Occupational Pension Funds Directive[13].
- A Central Counterparty (**CCP**) authorised under EMIR[14].
- A central securities depositary authorised in accordance with the Central Securities Depositary[15].
- A third-country entity which would require authorization or registration in accordance with the legislative acts referred to in points (a) to (h) if it were established in the EU.

A non-financial counterparty (**NFC**) means an undertaking established in the EU or in a third country other than the entities listed in the definition of financial counterparty[16]. Non-financial counterparties benefit from 21 month delay to the application of the reporting obligation. Additionally, where a non-financial counterparty is under certain thresholds (as discussed below), the financial counterparty to the trade is responsible for reporting the non-financial counterparty leg of the relevant trade.

The Regulation defines a SFT as[17]:

- A repurchase transaction[18].
- Securities or commodities lending and securities or commodities borrowing (where a commitment to return equivalent securities or commodities at a future date exists)[19].
- Buy/sell back transactions or sell/ buy back transactions[20].
- Margin lending transaction[21].

SFT reporting requirements

Similar in its effect to EMIR, the Regulation imposes an obligation on both counterparties to an SFT to report certain details of the transaction to a trade repository within one working day of the transaction's conclusion, modification or termination[22]. Counterparties must keep a record of any SFT that they have concluded, modified or terminated for at least five years following the termination of the transaction[23].

Where an FC trades with an NFC under certain thresholds[24], the FC is made responsible for reporting both sides of the trade. Where the FC in question is a UCITS or AIF, the Regulation places the responsibility to report on the

[13] Directive 2003/41/EC

[14] Regulation (EU) No 648/2012

[15] Regulation (EU) No 909/2014

[16] Article 3(4) of the Regulation

[17] Article 3(11) of the Regulation

[18] Further defined at Article 3(9) of the Regulation

[19] Further defined at Article 3(7) of the Regulation

[20] Further defined at Article 3(8) of the Regulation

[21] Further defined at Article 3(10) of the Regulation

[22] Article 4(1) of the Regulation

[23] Article 4(4)

[24] Where the NFC does not exceed the limits of at least two of three criteria laid down in Article 3(3) of Directive 2013/34/EU (the Accounting Directive – categories of undertakings and groups), namely (i) a balance sheet total of EUR 20,000,000; (ii) net turnover of EUR 40,000,000; and (ii) average of 250 employees for the during the financial year.

Management Company and AIFM, respectively[25]. Fund groups will need to consider their documentation to ensure that where necessary an entity with the ability to report has been assigned responsibility for reporting[26].

EMSA is to release certain regulatory technical standards (**RTSs**) within 12 months of the entry into force of the Regulation, taking into account work done under EMIR reporting, to provide further details of how this reporting obligation will work[27]. The Regulation in current form stipulates that the reports must contain:

- The parties to the SFT (and, where different, the beneficiary of the rights and obligations arising therefrom).
- The principal amount and currency.
- The assets used as collateral and their type, quality and value.
- The method used to provide collateral.
- Any substitutes of the collateral[28].

The reports should also include certain data fields as required by EMIR, namely legal entity identifiers (**LEIs**), international securities identification numbers (**ISINs**) and unique trade identifiers (**UTIs**)[29].

Within 24 months of the entry into force of the Regulation, ESMA must report on the efficiency of reporting in terms of reporting coverage and quality, as well as on the potential reduction of reports to trade repositories and market developments. The Regulation also makes explicit that ESMA is to consider the appropriateness of a move to single-sided reporting in such a report, paving the way for any progress in moving EMIR to a single-sided regime (to converge with the US approach under Dodd-Frank for the purposes of equivalence) to be transposed to SFT reporting[30].

UCITS and AIF disclosures

The Regulation also imposes disclosure obligations on UCITS management and investment companies and AIFMs[31]. UCITS management and investment companies must provide information to investors in the half-yearly and annual reports[32], whilst AIFMs must provide the same information in their annual report[33]. Details of the SFTs and total return swaps which UCITS management and investment companies and AIFMs are authorised to use must be included in their prospectus[34] (for UCITS) and disclosure[35] (for AIFs/AIFMs). The form of both the periodical and contractual disclosures are prescribed by the Regulation[36].

[25] Article 4(3) of the Regulation
[26] As permitted by Article 4(2) of the Regulation
[27] Article 4(9) of the Regulation
[28] *Ibid.*
[29] Article 4(10) of the Regulation
[30] Article 29(1), *para* 2
[31] Articles 13 and 14 of the Regulation
[32] Reports referred to in Article 68 of Directive 2009/65/EC (UCITS Directive)
[33] Report referred to in Article 22 of Directive 2011/61/EU (AIFMD)
[34] Prospectus referred to in Article 69 of Directive 2009/65/EC (UCITS Directive)
[35] Disclosure referred to in Article 23(1) and (3) of Directive 2011/61/EU (AIFMD)
[36] As set out in full in the Annex to the Regulation

As a result of these new obligations, UCITS management and investment companies and AIFMs will need to:

- Review their policies and procedures to ensure the periodical disclosure requirements are caught within compliance processes, as well as to allow employees to report infringements of the transaction reporting and transparency of reuse provisions[37].

- Review their pre-contractual documents to ensure the details and risks of permitted SFTs and total return swaps are adequately disclosed[38].

- Review management agreements and internal fund structuring documents to ensure that the responsibility to report and disclose the required information is effectively delegated to the most suitable entity and recorded contractually.

Rehypothecation – Reuse of collateral

The Regulation also affects the "reuse" of securities[39]. Reuse means the use by a receiving counterparty, in its own name and on its own account or on the account of another counterparty[40], of financial instruments received under a collateral arrangement, where such use comprises transfer of title or exercise of a right to use in accordance with the Financial Collateral Directive[41]. The definition of reuse excludes the liquidation of a financial instrument on the default of the providing counterparty[42].

All counterparties (FCs and NFCs) must provide sufficient transparency of reuse arrangements, and any right of counterparties to reuse financial instruments received as collateral shall be subject to the providing counterparty being notified by the receiving counterparty of the risks involved in granting such rights[43]. Further, the providing counterparty must grant its prior express consent (evidenced by signature) to a security collateral arrangement, or its express agreement to provide collateral by way of title transfer[44]. Any exercise by counterparties of their right to reuse collateral must be in accordance with the terms specified in the relevant collateral agreement, and the financial instruments received must be transferred from the account of the providing party[45].

The provisions relating to reuse potentially have wide extraterritorial scope. They apply to counterparties engaging in reuse that are established in a third country, where that reuse is effected by a branch of that counterparty in the EU. Further, the reuse provisions apply to third country counterparties where the reuse concerns financial instruments provided under a collateral arrangement by a counterparty established in the EU (or a branch in the EU of a third country counterparty)[46].

Third country issues

The Regulation creates some issues with regards to extraterritoriality and equivalence with third country regimes (similar to EMIR). The Commission may adopt implementing acts determining the equivalence of third country reporting regimes for SFTs where such rules ensure the secrecy of information and are effectively applied and

[37] As required by Article 24 (3) of the Regulation
[38] As measured against the prescribed disclosures listed in the Annex to the Regulation
[39] Article 15 of the Regulation
[40] Including any natural person, as per Article 3 (12) of the Regulation
[41] Directive 2002/47/EC
[42] Article 3 (12) of the Regulation
[43] Article 15(1) of the Regulation
[44] *Ibid.*
[45] Article 15 (2) of the Regulation
[46] Article 2(1)(d)(ii) of the Regulation.

enforced in a manner commensurate with the European regime[47]. A similar process is set out for making an equivalence determination in relation to third country trade repositories[48].

Sanctions

Member states may impose their own civil or criminal penalties for breach of this Regulation[49]. For legal persons, the maximum administrative pecuniary sanctions must be at least:

- €5million or up to 10% of total annual turnover for infringements of the transaction reporting requirement[50].
- €15million or up to 10% of total annual turnover (according to the last available accounts) of the management body for infringements of provisions relating to the reuse of collateral[51].

Additionally, the sanctions and other measures[52] applicable to UCITS investment and management companies and AIFMs, under UCITS and AIFMD respectively, shall be applicable to the disclosure obligations placed on UCITS and AIFMS under Articles 13 and 14[53].

Entry into force

The Regulation will enter into force on the 20th day following the day of its publication in the Official Journal[54]. The Regulation provides for phased implementation of certain rules, as follows[55]:

Time from entry into force of regulation	Requirement
6 months	Counterparties to comply with requirements on reuse of collateral (i.e. to obtain written consent and to disclose the risks and consequences of such reuse)
12 months	UCITS and AIFMs to start periodic disclosure of their use of SFTs and total return swaps via their half-yearly and annual reports (as applicable) Investment firms and credit institutions to report SFTs to a trade repository
15 months	Central securities depositories and central counterparties to report SFTs to a trade repository
18 months	UCITS and AIFMs to disclose their use of SFTs and total return swaps in their prospectus and pre-investment disclosure (as applicable) Insurance/reinsurance undertakings, UCITS/UCITS managers, AIFs/AIFMs and institutions for occupational retirement provision to report SFTs to a trade repository
21 months	Non-financial counterparties to report SFTs to a trade repository

[47] Article 21 of the Regulation
[48] Article 19 of the Regulation
[49] Article 22 of the Regulation
[50] Article 21(g)(i) of the Regulation
[51] Article 21(g)(ii) of the Regulation
[52] The Regulation uses the words “or other measures” without further definition or clarification
[53] Article 27 of the Regulation
[54] Article 33 of the Regulation
[55] Article 33(2) of the Regulation

Similar to backloading under EMIR, the obligation to report an SFT to a trade repository will apply to an SFT existing before the date on which the obligation takes effect if:

- The remaining maturity of the SFT exceeds 180 days.
- The SFT has an open maturity and remains outstanding 180 days after the date on which the obligation to report comes into force[56].

Future developments

The Financial Stability Board is due to complete work in 2016 on a set of recommendations on haircuts on non-centrally cleared SFTs to prevent excessive leveraging and mitigate concentration risk and default risk[57]. ESMA must submit draft regulatory technical standards to the Commission within 12 months of publication of the Regulation in the Official Journal[58].

Comment

As counterparties and regulators alike continue with efforts to improve EMIR reporting data[59], adapt to this Regulation, MiFID II enhanced transaction reporting and the implementation of commodity position limits, the potential for regulatory actions based on poor transaction data, and the systemic risk implications of such actions, can only increase.

For further information on the Regulation, please reach out to a member of the Dechert derivatives team, or your usual Dechert contact.

[56] Article 4(1)(a)(i)
[57] Recital (3) of the Regulation
[58] Article 4(9)
[59] *Trade repository data quality to impact Mifir and Emir review*

Thank You

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