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Client Alert

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Casting Light on Shadows: New Transparency Rules for Securities Finance Transactions

This article summarises potential new European regulatory obligations that may arise for any financial entity, whether located inside or outside of the European Union, that regularly or occasionally enters into securities finance transactions (including repurchase agreements, securities / stock lending or borrowing or margin lending).

On 3 November 2015, the Council of the European Union (the "Counsel") adopted the European Commission's proposal for a regulation on reporting and transparency of securities financing transactions (the "Proposed Regulation")[1].

Background

The roots of European regulatory focus on securities finance transactions ("SFTs") extend to the aftermath of the recent financial crisis and the search for causes of instability in global financial markets. Following reports by the Financial Stability Board ("FSB")[2], the European Commission[3] and the review led by Erkki Liikanen[4], each covering (amongst other things) the key role of financial intermediaries that are not credit institutions (but which offer bank-like credit intermediation services) and their interconnectedness with the regular banking system, the realm of so-called "shadow banking" was highlighted as a source of potential systemic risk and concern.

In August 2013, the FSB adopted a policy framework entitled "*Strengthening Oversight and Regulation of Shadow Banking*" (the "FSB Framework")[5], which was subsequently endorsed by the G20. One of the five key areas highlighted by the FSB as requiring legislation to mitigate potential risks associated with shadow banking, concerns "*pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress*". The Proposed Regulation seeks to address some of the FSB's recommendations by enhancing transparency and regulating securities financing, thereby strengthening the oversight and regulation of shadow banking.

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[1] http://data.consilium.europa.eu/doc/document/PE-41-2015-INIT/en/pdf.

[2] Shadow Banking: Strengthening Oversight and Regulation: 27 October 2011, by the Financial Stability Board: www.financialstabilityboard.org/wp-content/uploads/r_111027a.pdf.

[3] Green Paper on Shadow Banking: 19 March 2012, by the European Commission: http://ec.europa.eu/finance/bank/docs/shadow/green-paper_en.pdf.

[4] Reforming the structure of the EU banking sector: 2 October 2012, by the High-level Expert Group chaired by Erkki Liikanen: http://ec.europa.eu/finance/bank/docs/high-level_expert_group/report_en.pdf.

[5] www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf.

Scope of the Proposed Regulation

The Proposed Regulation applies to any "counterparty" to an SFT that is either established in the EU, or in a third country in circumstances where the SFT is concluded by a branch of that counterparty which is located in the EU. Accordingly, the regulation's scope is intentionally broad, covering both regulated and unregulated entities, in a way that is similar to the application of the reporting requirement in the European Market Infrastructure Regulation (Regulation No. 648/2012, "EMIR"). EMIR reporting also applies generally to "counterparties" and does not distinguish between financial (i.e., regulated) and non-financial (unregulated) entities[6].

The Proposed Regulation also applies to management companies in undertakings of collective investment in transferrable securities ("UCITS")[7], managers of alternative investment funds ("AIFs")[8] and to counterparties engaging in "reuse" arrangements. In the latter case, such a counterparty is caught by the Proposed Regulation if it is in the European Union. A counterparty established outside the EU would also be caught when acting through a branch of that counterparty located in the EU, or where the reuse concerns financial instruments provided under a collateral arrangement by a counterparty established in the Union (or an EU branch of a counterparty established in a third-country).

As with EMIR, certain exemptions apply to EU-based central banks (and other public bodies performing similar functions) and the Bank for International Settlements. In addition, provision is made for extending the central-bank exemption to cover those managing the public debt of third-countries, although such an exemption would depend upon the outcome of a comparative analysis of the treatment of central banks within the framework of various third-countries. Noticeably, however, multilateral development banks have not been exempted.

Reporting Obligation

An SFT includes:

- a repurchase transaction;
- securities or commodities lending or borrowing;
- a buy-sell back transaction or a sell-buy back transaction; or
- a margin lending transaction[9].

Article 4 of the Proposed Regulation states that counterparties to SFTs are required to report to a registered or recognised trade repository[10] the details of any SFT that they have concluded, modified or terminated. The nature of such details shall be set out in regulatory technical standards ("RTS") prepared by the European Securities and Markets Authority ("ESMA") and adopted by the European Commission. However, the Proposed Regulation provides that reportable information shall include (amongst other items) details of the parties to the SFT (and any beneficiaries), principal amount, currency, collateral (type, quality, value etc.), whether collateral is available for reuse or has been reused, repurchase rate, lending fee, margin lending rate, haircuts, value date and maturity date.

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[6] Although it is worth noting that, unlike the Proposed Regulation, the reporting obligation under EMIR does not have extra-territorial application.
[7] Authorised in accordance with Directive 2009/65/EC.
[8] Authorised in accordance with Directive 2011/61/EU.
[9] It remains open to the European Commission to expand the list of SFTs by delegated act.
[10] Such repository must meet EMIR's criteria for registration. In the absence of such a trade repository, reporting can be made to ESMA.

Reporting should take place no later than the working day following such conclusion, modification or termination.

In addition, counterparties are required to keep records of any SFT that they have concluded, modified or terminated for at least five years following termination of the transaction.

Phase-In of Reporting Obligations

The reporting requirement in Article 4 is to be phased in after adoption of the RTS. Reporting requirements will apply on or after a date (the "Phase-in Date") occurring a certain number of months after the RTS are adopted. The applicable number of months depends upon the type of counterparty that has entered into the SFT:

Number of Months After RTS Adoption	**Type of Entity**
12 months	Investment firms or credit institutions (in each case authorised in accordance with EU legislation) or third-country entities which would require authorisation or registration as investment firms or credit institutions if they were established in the EU
15 months	Central securities depositories (authorised in accordance with EU legislation) and third-country entities which would require authorisation as central securities depositories if they were established in the EU
18 months	Insurance and re-insurance undertakings, UCITS funds, AIFs, institutions for occupational retirement provision and central counterparties (in each case authorised in accordance with EU legislation) or third-country entities which would require authorisation as such entities if they were established in the EU[11]
21 months	Non-financial counterparties established in either the EU or in a third-country

In addition to SFTs traded on or after the applicable Phase-in Date, back-loading of transactions will apply to transactions in existence prior to the Phase-in Date where:

- the applicable SFT has a remaining maturity, on the Phase-in Date, exceeding 180 days; or
- the applicable SFT has an open maturity and remains outstanding for 180 days after the Phase-in Date.

[11] There appears to be an error in the current draft legislation, which makes reference to a missing Article 33(a)(j). Accordingly, it may be intended that there is another type of entity that will be phased in at 15 months after the adoption of the RTS, although this is presently unclear.

Such back-loaded transactions shall be reported within 190 days of the applicable Phase-In Date.

Reuse Provisions

A "reuse" is defined as the use of financial instruments by an entity receiving such instruments under a collateral arrangement in its own name and on its own account, or on the account of another counterparty, including a natural person (the "receiving counterparty"). Such use can comprise transfer of title[12] or exercise of a right of use in accordance with a security financial collateral arrangement[13], but does not include the liquidation of a financial instrument in the event of default of the entity providing the collateral (the "providing counterparty").

Article 15 of the Proposed Regulation states that if a receiving counterparty has a right to reuse financial instruments it receives as collateral, then such right of reuse is subject to the following conditions:

- the providing counterparty is informed in writing of the risks and consequences in (1) granting consent to a right of use of collateral under a security financial collateral arrangement, or (2) concluding a title transfer collateral arrangement;
- the providing party grants its express signed consent (in writing or other legally equivalent manner) to (1) the applicable security financial collateral arrangement containing a right of use of collateral or (2) provide collateral by way of a title transfer collateral arrangement;
- the reuse is carried out in accordance with the terms of the applicable collateral arrangement; and
- the financial instruments received by the receiving counterparty are transferred from the account of the providing counterparty.

In discussions of previous drafts of the Proposed Regulation, a number of trade associations (including the International Securities and Derivatives Association ("ISDA") and the International Securities Lending Association ("ISLA")) and other interested parties lobbied the European Commission extensively in an attempt to have title transfer collateral arrangements removed from Article 15. The reason for this was that you cannot restrict the reuse rights of a collateral receiver in these circumstances, given that (by virtue of the legal transfer of title that characterises a title transfer transaction) the collateral receiver becomes the legal owner of the collateral. It therefore makes little sense that, in order for the collateral receiver to use its own collateral, it must receive the express consent of the providing counterparty.

Nevertheless, in the adopted draft of the Proposed Regulation, a requirement remains for receiving counterparties to ensure that, in order to use collateral received under a title transfer collateral arrangement, they must ensure that the providing counterparty is aware of the risks of that arrangement and must receive the providing counterparty's consent to the provision of collateral in this way. By suggesting that such consent be provided in writing or other legally equivalent manner, ISDA appears to hold the view that documenting relevant transactions under standard documentation (such as the ISDA Master Agreement) will be sufficient to comply with this obligation.

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[12] A title transfer financial collateral arrangement is one where the collateral provider transfers full ownership of the financial collateral to a collateral receiver, for the purpose of covering the performance of relevant financial obligations. The collateral provider, in turn, typically receives a contractual claim against the collateral receiver for the delivery of financial instruments that are equivalent to those which were initially posted.

[13] See Article 5 of Directive 2002/47/EC (the "Financial Collateral Directive"), which introduced a framework to simplify the taking of collateral in the EU. Article 5 relates to a "right of use" for financial collateral under a security financial collateral arrangement. This is an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker but where full ownership of the financial collateral remains with the collateral provider.

Equivalence

As is the case with EMIR, the European Commission has the ability to adopt implementing acts which determine that the legal, supervisory and enforcement arrangements of a third-country are equivalent to certain aspects of the Proposed Regulation, including with respect to the Article 4 reporting requirements.

Sanctions

Member States are required to provide their competent authorities with the power to impose administrative sanctions and other administrative measures in respect of infringements of Article 4 (*Reporting*) and Article 15 (*Reuse*). These include cease and desist orders, public censure, withdrawal or suspension of authorisation, temporary banning orders or administrative pecuniary sanctions with statuary minimums applied.

In respect of an infringement of the reporting requirements, Article 22(5) of the Proposed Regulation makes clear that such infringement shall not affect the validity of the terms of the SFT or the possibility that the SFT can be enforced. This should provide some certainty of enforceability with respect to parties entering into SFTs to the extent that they fail to comply with their reporting obligations. However, the position with respect to a breach of the reuse conditions is not quite as clear. This is because there is no provision that is equivalent to Article 22(5). Instead, counterparties are forced to rely upon the effect of Article 15(4). This states that Article 15 shall not affect national law concerning the validity or effect of a transaction. This suggests that if a transaction is otherwise valid under national law, it should not be invalidated as a consequence of a breach of Article 15. For example, in the UK, Article 16(1) of the Financial Collateral Regulations[14] (which implements the EU Financial Collateral Directive) provides that if a security financial collateral arrangement provides for a collateral taker to use and dispose of financial collateral as if it were the owner of it, the collateral taker may do so in accordance with the terms of the arrangement[15]. This would suggest that, provided the reuse conditions of the contractual arrangement are complied with, it should remain enforceable, even if Article 15 were breached.

Next Steps

The Proposed Regulation will come into force on the 20th day after its publication in the Official Journal of the European. It is expected that this will happen in early 2016. However, the application of certain provisions (such as Article 4(1) as described above) will not become effective until the relevant time as stated in the Proposed Regulation's text.

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[14] The Financial Collateral Arrangements (No. 2) Regulations 2003 – SI 2003/3226.
[15] This provision tracks Article 5 of the EU Financial Collateral Directive, which requires that Member States ensure that collateral takers are entitled to exercise rights of use in relation to financial collateral provided under security financial collateral arrangements.

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