

# The Securities Financing Transactions Regulation (SFTR) Revisited

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## Do you need to take action?

You should not need to take immediate action. This AB Brief is an update on existing requirements under the SFTR, as well as a summary of transaction reporting requirements, expected to take effect from October 2018.

## Brief recap

In our AB Brief from June 2016, we summarised the requirements of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse, also known as the Securities Financing Transactions Regulation ("SFTR"), with our AB Brief focusing on 'information statements' (see below).

## Information statements

### Requirement already in effect

The requirement to send an 'information statement' to counterparties under Article 15 of the SFTR is already in effect. The purpose of the information statement is for a recipient of collateral to 'warn' its counterparty about the risks and consequences of the recipient's 'reuse' of the counterparty's collateral. (The term 'reuse' would include rehypothecation or re-pledging, the overall effect being that the recipient party has full use of the collateral.) The requirement to send an information statement came into effect on 13 July 2016 and applies to all parties who accept collateral under a title transfer arrangement or under a security arrangement with a right to reuse the collateral. The commonly-held view is that the requirement to send an information statement arises when a party enters into an agreement whereby it may accept collateral, irrespective of whether or not such party in fact accepts collateral.

### Template form

In April 2016, the Association for Financial Markets in Europe (AFME), the FIA (formerly the Futures Industry Association), the International Capital Market Association (ICMA), the International Swaps and Derivatives Association, Inc. (ISDA) and the International Securities Lending Association (ISLA) jointly published a template form of SFTR information statement ("SFTR Information Statement") which market participants have been using as the basis of the notices which they give to their counterparties.

The SFTR Information Statement is drafted in a generic way to cover a range of agreements, with the intention that parties may, but should not need to, amend its provisions. Market participants have been sending their SFTR Information Statements direct to their counterparties, or including a form of SFTR Information Statement in their ISDA Master Agreements or Credit Support Annexes.

### Notice to be given just once

The SFTR Information Statement is drafted as one statement to cover all relevant agreements (both present and future) with a counterparty, so it should need to be given only once. This should remain the case, whether parties choose to include a form of SFTR Information Statement in a specific agreement such as an ISDA Master Agreement or Credit Support Annex, or whether they choose to send separate notices.

## If in doubt...

If in doubt as to whether an SFTR Information Statement is necessary, parties would be advised to include or send one, as there is no downside in doing so.

## Other requirement under the SFTR: which transactions are covered?

### Meaning of SFT

The term SFT is short for 'securities financing transaction' and refers to a transaction involving the temporary exchange of cash or securities against collateral.

More specifically, the SFTR defines "SFTs" as:

- repurchase (or 'repo') transactions;
- buy-sell back transactions on securities (which are similar to repo transactions);
- lending and borrowing transactions on securities; and
- margin lending transactions.

### Application to total return swaps

The SFTR also applies to total return swaps ("TRS"), although the recitals to the SFTR indicate that SFTs do not include derivative contracts as defined in the European Market Infrastructure Regulation ("EMIR"). However, under the SFTR, the term "SFT" does include transactions that are commonly referred to as liquidity swaps and collateral swaps, which do not fall under the EMIR definition of derivative contracts (Recital 7 of the SFTR).

(TRSs are swap contracts whereby one party receives the 'total return' on an asset (generally, income and changes in capital value) during the life of the swap, in return for which the other party pays a set financing rate during the life of the swap.)

SFTs and TRSs frequently have a similar economic effect and are commonly used by fund managers to enhance returns or to fulfil investment objectives. The move towards increased transparency under the SFTR arises from a perception by policymakers that SFTs and TRSs increase the risk profile of a fund, but that the risks may not be fully disclosed to investors.

## Disclosure in pre-contractual documents

### Who is affected?

UCITS funds and alternative investment funds ("AIFs") managed by an alternative investment fund manager ("AIFM") authorised in the European Union ("EU") must adhere to the SFTR's pre-contractual disclosure requirements. Where such funds are using, or propose to use, SFTs or TRSs, the prospectus or private placement memorandum ("PPM") in respect of the fund must disclose clearly the intention to use these investment techniques and set out details of the risks they entail. The SFTR is detailed and prescriptive in relation to the information to be disclosed.

## How to disclose?

A new, generic supplement may be added to a PPM to cover SFTR-related disclosures. Alternatively, SFTR-related disclosures may be included within the body of the PPM, including in sections dealing with risk factors and those concerned with prime brokers/counterparties.

## Disclosure deadlines

For funds (which includes sub-funds of existing funds) constituted before 12 January 2016, the pre-contract disclosure requirements have to be met by 13 July 2017.

For funds (again including sub-funds) constituted after 12 January 2016, the pre-contract disclosure requirements have to be met immediately (i.e., included in the PPM at launch).

### Disclosure requirements

The 'pre-contractual' disclosures to be included in the PPM include:

- a general description of SFTs and TRSs used by the fund, and the reasons for their use;
- criteria for the use of SFTs and TRSs, i.e., types of assets and maximum and expected proportion of assets under management subject to SFTs and TRSs;
- criteria for selecting counterparties;
- acceptable collateral;
- methodology and frequency of valuation for collateral;
- risks associated with SFTs and TRS (e.g., operational, liquidity, counterparty risk);
- restrictions on reuse (regulatory or self-imposed); and
- policy on sharing of return on collateral, costs and fees.

## FCA confirmations

For funds whereby PPMs are required to be filed with the FCA, so long as reference to these pre-contractual disclosures does not reflect a change in investment or risk strategy, and the PPM is simply updated to include these disclosures, the FCA has confirmed that it will not need to provide approval for the updates, and a revised version of the PPM should be filed with the FCA in the usual way. In addition, the FCA has confirmed that if these disclosures are not applicable, there is no need to include a negative statement in the PPM.

## Disclosure in periodic reports

The SFTR sets out further categories of information (set out in Section A of the Annex to the SFTR) which must be disclosed in the six monthly and annual reports applicable to UCITS funds as required under the UCITS Directive, or the annual report required under the Alternative Investment Fund Managers Directive ("AIFMD").

## When does the periodic reporting obligation become effective?

The requirements to comply with periodic reporting obligations became effective as of 13 January 2017.

## Is there not already a requirement to disclose such information?

The reporting requirement can be seen as an extension of pre-existing managers' duties of disclosure, such as required by way of Annex

IV Reporting under AIFMD. To this extent, disclosure obligations may overlap in certain respects.

## Transaction Reporting

In order to enhance transparency and enable regulators to better monitor risks, the SFTR introduces reporting requirements for SFTs.

### Similar to EMIR transaction reporting

The basic features of SFT transaction reporting are similar to those already applicable to the reporting of derivatives transactions under EMIR (the reporting requirements of which have applied since February 2014).

### When does the reporting obligation become effective?

On 31 March 2017, the European Securities and Markets Authority (“ESMA”) published its Final Report on draft Regulatory Technical Standards (RTS) and Implementing Technical Standards (ITS) under the SFTR (the “Final Report”) specifying, inter alia, how parties should fulfil reporting obligations.

The technical standards under the Final Report are subject to approval by the European Commission and European Parliament respectively before a process of translation and publication into the Official Journal. This process can take between four and six months, which means that the technical standards are expected to enter into force between August and October 2017.

### Phase-in process

The transaction reporting obligation will then go live twelve months later, i.e., probably October 2018, with phased requirements (according to counterparty type) continuing in three month cycles until at least Q2 2019. This phase-in process is not dissimilar to the phase-in of the clearing obligation under EMIR.

The intention behind the phase-in is that larger and more sophisticated market participants will be required to report first.

### How quickly must transactions be reported?

Article 4 of the SFTR sets out the transaction reporting requirements. Counterparties to an SFT will be required to report the details of the transaction to registered trade repositories (or to ESMA where there is no available trade repository) no later than the working day following the conclusion (i.e., the start), modification or termination of the transaction.

### Which SFTs must be reported?

In addition to SFTs concluded on or after the applicable phase-in date, certain SFTs must be reported with retrospective effect. SFTs concluded before, but remaining outstanding on, the applicable phase-in date, must be reported, if: (i) the remaining maturity of the SFT as of the relevant phase-in date exceeds 180 days, or (ii) the SFT has an open maturity and remains outstanding 180 days after the applicable phase-in date (these trades must be reported within 190 days of the applicable phase-in date).

### Lessons from EMIR reporting

The SFTR reporting technical standards have been developed based on the experience gained from reporting under EMIR, as well as other reporting regimes, in order to ensure alignment, and to minimise overlaps and avoid inconsistencies, with pre-existing infrastructures.

There is some scope for overlap with the reporting requirements under the Markets in Financial Instruments Regulation (“MiFIR”), although

the reporting obligations under the SFTR are similar to those already applicable to derivatives transactions under EMIR and as such should be distinct.

## Who will need to report?

The SFTR affects all counterparties to an SFT that are established within the EU (including EU and third country branches) as well as EU-domiciled branches of third country entities.

## Possibility to delegate

Similar to the EMIR reporting regime, both parties to an SFT are required to report the details of the transaction to a trade repository.

However, it is also possible to delegate the reporting of SFTs. Where a UCITS fund or AIF is a counterparty to an SFT, the UCITS fund's management company or authorised AIFM (as the case may be) is responsible for reporting on behalf of the fund.

## Definition of counterparty

ESMA has confirmed that, for the purposes of reporting under the SFTR, the definition of counterparty in Article 3 of the SFTR includes both financial counterparties and non-financial counterparties, in a similar way to the EMIR categorisations. For the purposes of the SFTR, 'financial counterparty' includes: (a) investment firms authorised in accordance with the revised Markets in Financial Instruments Directive known as "MiFID II"; (b) credit institutions; (c) insurance undertakings or reinsurance undertakings; (d) UCITS funds and, where relevant, their management companies; (e) AIFs managed by AIFMs authorised or registered in accordance with AIFMD; and (f) third country entities which would require authorisation or registration as any of the foregoing if they were established in the EU. A non-financial counterparty is an undertaking which is not a financial counterparty. As with EMIR, the SFTR does not apply to individuals.

Under Article 4(3) of the SFTR, where a financial counterparty concludes an SFT with a small non-financial counterparty, the financial counterparty is responsible for reporting the SFT on behalf of the small non-financial counterparty.

## Will transaction reports need to be made more than once for the same transaction?

In brief, counterparties will need to report the "conclusion (i.e., the start), modification and termination" of a transaction to an approved trade repository on a T+1 basis.

In terms of collateral reporting, the Final Report states that counterparties will need to report the associated collateral to an approved trade repository at the latest 'on the next business day after the value date'.

## What will need to be reported?

Details that need to be reported will include:

- parties to the SFT;
- principal amount and currency;
- assets used as collateral and their type, quality and value;
- method used to provide collateral;
- whether collateral is available for reuse;
- where collateral is distinguishable from other assets, whether it has been reused;
- any substitution of collateral;

- repurchase rate, lending fee or margin lending rate;
- haircuts;
- value date and maturity date; and
- market segment.

## Legal entity identifiers

Market participants must use legal entity identifiers (“LEIs”) to identify themselves and their counterparties. Most market participants will already have LEIs. We understand that LEIs are likely to be required for investment managers under MiFIR and MiFID II, but that SFTR reporting will be similar to EMIR reporting insofar as the emphasis will be in correctly identifying the transaction counterparty, without a requirement to identify an agent (i.e., investment manager or advisor) entering into a transaction on behalf of/in the name of the transaction counterparty.

## What format will the reporting adopt?

Article 4(10) of the SFTR provides ESMA with the power to specify the format of the required SFT reports to ensure a uniform application of the reporting obligation and, to the extent feasible, consistency with the reporting under EMIR and harmonisation of formats between trade repositories.

ESMA has confirmed in the Final Report that it proposes to adopt ISO 20022 to standardise the reporting of SFTs. ISO 20022 is a single standardisation approach (methodology, process and repository) for electronic data interchange between financial institutions, which is currently used for other regulatory reporting regimes and has widespread acceptance in the financial industry.

## Record-keeping

Similar to the record-keeping requirements in EMIR and MiFIR, counterparties subject to the SFTR are required to keep a record of any SFT concluded, modified or terminated for at least five years following the termination of the transaction. The record-keeping requirements applied from 12 January 2016.