

# Reuse of collateral under the Securities Financing Transactions Regulation (SFTR)

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01 - Jun - 2016

## Transactions Regulation (SFTR): are you ready to send your Information Statement?

### Do you need to take action?

Yes, if your fund is party to a two-way collateral arrangement, such as a GMRA (market standard repurchase agreement), GMSLA/OSLA (market standard securities lending agreement) or a bilateral ISDA Credit Support Annex, you will need to arrange for delivery of an Information Statement to counterparties prior to 13 July 2016.

### Brief summary

13 July 2016 is the deadline for compliance with the disclosure requirements under Article 15 of the SFTR regarding reuse of collateral which are applicable to counterparties receiving collateral under certain collateral arrangements.

If you have not already done so, you will need to determine to what extent your fund receives and reuses collateral (or has the right to do so), and whether it needs to comply with the SFTR requirements. If it does, the fund will have an obligation under the SFTR to make disclosure to its collateral-providing counterparties in writing as to the risks and consequences of any reuse by the fund of the received collateral.

Disclosure can be made using the SFTR Information Statement jointly prepared by five industry associations.

### Who needs to comply?

A broad range of counterparties established in the European Union (EU) will need to comply, as well as funds established outside of the EU, where either (1) the reuse is effected in the course of the operations of an EU branch (normally not applicable to funds) or (2) the reuse concerns financial instruments provided as collateral by a counterparty established in the EU or an EU branch of a third country entity (i.e., in the case of (2), a non-EU entity reuses an EU entity's collateral).

Funds which are categorised (in a similar way to categorisation under the European Market Infrastructure Regulation (EMIR)) as financial counterparties (FCs) because either (i) the fund is a UCITS fund or (ii) the fund or 'AIF' is established outside of the EU but is managed by a manager or 'AIFM' authorised or registered in accordance with the Alternative Investment Fund Managers Directive (AIFMD), will need to comply.

In addition, funds not categorised as FCs but which use EU-based prime brokers or have EU-based trading counterparties, and have relevant collateral arrangements with those EU-based entities, will also need to comply.

### Which collateral arrangements are subject to the disclosure requirements under Article 15?

Article 15 applies to receiving and reusing collateral under the following collateral arrangements:

- title transfer collateral arrangement – which captures any arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing financial obligations; and
- security collateral arrangement – which captures any arrangement under which a collateral provider provides financial collateral by way of security in favour of a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider.

To fully understand the reach/scope of Article 15, it is important to highlight that the above arrangements cover a wide range of transactions under which the counterparty receiving collateral has the right to reuse collateral (also sometimes called rehypothecation). Relevant transactions would include repurchase and securities lending transactions, and collateral arrangements including transfers of collateral under the English Law ISDA Credit Support Annex (CSA) and the New York Law ISDA CSA.

## What are the conditions to reuse under Article 15, and what needs to be done?

Under Article 15 of the SFTR, a counterparty shall only be allowed to reuse financial instruments under a title transfer or security collateral arrangement if it first:

1. discloses to the providing party the risks and consequences of either (i) granting a right of use of collateral provided under a security collateral arrangement, or (ii) concluding a title transfer collateral arrangement (together, the “Disclosure Obligation”); and
2. obtains the providing party’s (i) express written consent to a security collateral arrangement that includes a right of reuse; or (ii) express agreement to the provision of collateral under a title transfer collateral arrangement (together, the “Consent Obligation”).

It therefore follows that a counterparty must ensure that both the Disclosure Obligation and the Consent Obligation are satisfied before it can reuse collateral.

## What does ‘financial instruments’ mean, and what about cash?

The Disclosure Obligation applies to the collateral in the form of financial instruments. It does not apply to collateral in the form of cash.

The term ‘financial instruments’ would most commonly refer to securities (most typically, fixed income securities).

When cash is transferred to a counterparty, the counterparty always takes ‘ownership’ of the cash, and in this sense the concept of reuse is not applicable to cash.

## My fund has a right to reuse collateral under the relevant agreement(s), but does not in fact exercise that right – do I still need to comply?

The Disclosure Obligation and the Consent Obligation are conditions precedent to a counterparty being allowed to reuse financial instruments. As a technical matter, a counterparty would be deemed to be ‘allowed’ to reuse financial instruments if it has executed an agreement containing a right for it to do so. Whether or not it in fact does so (i.e., exercises the right of reuse), is another matter.

In any event, if a fund is party to a relevant agreement (such as a GMRA, GMSLA/OSLA or bilateral ISDA Credit Support Annex, all of which confer a right of reuse) with a counterparty, it should serve an Information Statement on that counterparty.

## What are the consequences of non-compliance?

The SFTR suggests that non-compliance with the Disclosure Obligation and/or the Consent Obligation would not invalidate the act of reuse of collateral under national law. However this should not be taken as definitive as it still may be possible for a counterparty to argue,

under national law, that compliance with the SFTR is a condition precedent to the validity of the reuse arrangements.

Competent authorities in EU member states will be empowered to impose sanctions for breaches of the Disclosure Obligation and/or the Consent Obligation, including public statements of censure, bans on relevant persons exercising managerial responsibilities, fines and withdrawal of authorisations.

## How does one comply with the Disclosure Obligation and the Consent Obligation?

A number of industry bodies, namely the International Capital Market Association (ICMA), the International Swaps and Derivatives Association, Inc. (ISDA), the International Securities Lending Association (ISLA), the Futures Industry Association (FIA) and the Association for Financial Markets in Europe (AFME), have jointly published a statement that can be used to help market participants comply with the Disclosure Obligation, i.e., to inform their counterparties of the risks involved in entering into a title transfer arrangement or granting a right to reuse collateral under a security arrangement. The statement can be tailored to suit each counterparty's own specific circumstances. In relation to the Consent Requirement, it is expected that this will be satisfied in the vast majority of cases through using signed legal contracts which effect the reuse of collateral, for example the relevant industry standard documents such as GMRAs, GMSLAs/OSLAs and ISDA CSAs.

## How does the Information Statement work?

The Information Statement aims to provide a template form of disclosure for counterparties subject to the Disclosure Obligation. Delivery of the Information Statement is not done via an ISDA protocol, so it will need to be sent to all relevant counterparties on a bilateral basis (i.e., one for each counterparty entity).

The Information Statement is drafted in a generic manner and can be sent directly to providing counterparties without tailored changes. It informs counterparties as to the risks and consequences involved in reuse arrangements, the most obvious one being the loss of the collateral in the event of the counterparty's bankruptcy.

Appendix 2 of the Information Statement sets out a wide range of examples of the types of agreements to which the Information Statement may apply.

## Where should the Information Statement be served/delivered?

Many EU dealers are setting up centralised inboxes for receipt of Information Statements from their counterparties. Fund managers should obtain relevant details from their counterparties for serving Information Statements and should retain evidence of service.

## Haven't we seen disclosure requirements before, namely prime broker disclosure under the FCA Rules (prime brokerage agreement disclosure annex)?

The Information Statement can be seen as an extension of the requirement under CASS 9.3 of the FCA Rules whereby a FCA-authorized firm acting as a prime broker must ensure that its prime brokerage agreements contain a disclosure annex detailing the right for the prime broker to use safe custody assets. Such disclosure annexes include similar 'warnings' relating to reuse/rehypothecation.

Future AB Briefs will contain information specific to each timing 'milestone' under the SFTR. Meanwhile, there follows a brief overview of the SFTR.

## A summary background to the SFTR

Regulation (EU) 2015/2365 on Transparency of Securities Financing Transactions (SFTR) was published in the Official Journal of the European Union on 23 December 2015 and came into force on 12 January 2016 in response to Financial Stability Board's recommendations set forth in the "Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos" which call for strengthening oversight and regulation of the shadow banking system and for enhancing the transparency of securities financing markets. In order to achieve these objectives the SFTR imposes the following requirements upon parties involved in Securities Financing Transactions (SFTs) and upon counterparties to certain collateral arrangements:

a requirement to keep record of any SFT for at least five years following the termination of the transaction (Art. 4(4));

- a requirement to report the details of any SFT to a trade repository no later than the working day following the conclusion, modification or termination of the transaction (Art. 4(1));
- a requirement for UCITS and Alternative Investment Fund Managers (AIFMs) to inform investors on the use of SFTs and total return swaps (Art. 13);
- a requirement for UCITS and AIFMs to inform investors on the use of SFTs and total return swaps in their pre-contractual documents (Art. 14);
- a requirement to inform collateral providing-counterparties in writing regarding the risks and consequences of reuse under certain collateral arrangement (Art. 15);
- a requirement to obtain consent from collateral providing-counterparties and to adhere to the terms of a collateral arrangement (Art. 15).

Parties engaged in SFTs and counterparties to certain collateral arrangements need to bear in mind the following key implementation deadlines:

Record retention under Art. 4(4) applicable to counterparties engaged in SFTs	12 January 2016
Disclosure requirements under Art. 14 regarding pre-contractual documents applicable to UCITS concluded after 12 January 2016	12 January 2016
Disclosure requirements under Art. 15 regarding reuse of collateral applicable to counterparties receiving collateral under certain collateral arrangements	13 July 2016
Disclosures requirements under Art. 13 for UCITS and AIF managers regarding periodical reports	13 January 2017
Disclosure requirements under Art. 14 for UCITS and AIF managers regarding pre-contractual documents applicable to UCITS concluded before 12 January 2016	13 July 2017
Reporting obligations under Art. 4(1) applicable to investment firms and credit institutions based in EU and third countries	Q1 2018
Reporting obligations under Art. 4(1) applicable to central counterparties and central securities depositories based in the EU and third countries	Q2 2018
Reporting obligations under Art. 4(1) applicable to all remaining financial counterparties based in the EU and third countries	Q3 2018

Reporting obligations under Art. 4(1) applicable to non-financial counterparties	Q4 2018
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