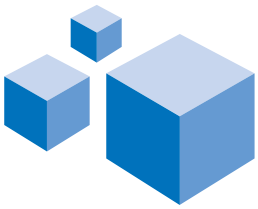

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The SFT Regulation

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The SFT Regulation

Introduction

The Securities Financing Transactions Regulation *[EU 2015/2365]* (SFT Regulation) introduces mandatory reporting for securities financing transactions (SFTs) and sets minimum disclosure and consent requirements on the re-use of collateral, with the aim of reforming shadow banking and improving transparency in the SFT market. The SFT Regulation was formally adopted by the EU on 16 November 2015 and was published in the Official Journal on 23 December 2015. The SFT Regulation will come into force 20 days after its publication in the Official Journal, namely 12 January 2016, with the exception of certain provisions set out in Article 33.

Purpose of the SFT Regulation

According to a factsheet published by the European Commission on 29 October 2015, the shadow banking sector needs to be better monitored because of its size, its close links to the regulated financial sector and the systemic risks that it may pose. There is also a particular need to prevent the shadow banking system from being used for regulatory arbitrage. Increasing transparency and reducing risks associated with SFTs have been identified as two of the Commission's main priorities, which the SFT Regulation aims to address. It will notably allow supervisors to access detailed, reliable and comprehensive data to monitor risks originating in shadow banking and to intervene when necessary.

Scope of the SFT Regulation

The SFT Regulation will:

(i) require all SFTs to be reported to trade repositories, similar to the reporting obligation imposed on derivatives under EMIR;

(ii) place additional disclosure and reporting requirements on investment managers, similar to those imposed on UCITS managers and AIFMs pursuant to the UCITS Directive and AIFMD respectively; and

(iii) require prior risk disclosures and written consent before assets can be re-used or rehypothecated.

What are SFTs?

An SFT consists of any transaction that uses assets belonging to a counterparty to generate financing means. Thus, SFTs comprise:

(a) repurchase transactions;

(b) securities or commodities lending, securities or commodities borrowing;

(c) any transaction having an equivalent economic effect, in particular a buy/sell-back or sell/buy-back transaction; and

(d) margin lending transaction

What is re-use or rehypothecation?

Re-use or rehypothecation allows financial counterparties to use assets that have been given to them by clients or counterparties as collateral for their own purposes, such as to secure their own borrowing. Where rehypothecation takes place, the ownership of the relevant asset is transferred to the financial counterparty and replaced with a contractual claim to the return of an equivalent asset. This means that in the event of the financial counterparty's insolvency, the client or counterparty will be an unsecured creditor of the financial counterparty in relation to its claim for equivalent assets.

In practice, the same asset can be used to create multiple obligations and, according to the Commission, this amplified leverage and the uncertainty surrounding the extent to which assets have been reused can create financial stability risks.

The SFT Regulation applies only to the reuse of financial instruments, not cash.

To whom will the SFT Regulation apply?

The SFT Regulation will apply to:

(i) a counterparty to an SFT that is:

  (a) an EU entity (i.e. established in the EU)

  (b) an EU entity's non-EU branch; and

  (c) a non-EU entity if the SFT is effected by an EU branch of that non-EU entity;

(ii) UCITs managers;

(iii) AIFMs; and

(iv) a counterparty engaging in rehypothecation that is:

  (a) an EU entity

  (b) an EU entity's non-EU branch; and

  (c) a non-EU entity if the rehypothecation is effected by an EU branch of that non-EU entity.

For the purposes of the SFT Regulation, a '*counterparty*' includes:

(i) financial counterparties (as defined in Article 2(8) of EMIR) e.g. MiFID investment firms, UCITS funds and their managers and AIFs managed by AIFMs. In the case of UCITS and AIFs, the responsibility for reporting is placed on the fund manager;

(ii) non-financial counterparties (as defined in Article 2(9) of EMIR) i.e. only those non-financial counterparties whose transactions exceed a certain threshold. Thus, small and medium enterprises below the threshold (namely where the non-financial counterparty does not exceed at least two of the thresholds of: (i) a balance sheet total of €20 million; (ii) €40 million net turnover; or (iii) 250 employees on average during the financial year) will not have to report their transactions with financial entities themselves; these transactions will be reported by their financial counterparty; and

(iii) central counterparties (CCPs).

Exemptions

The SFT Regulation will not apply to members of the European System of Central Banks (ESCB), EU public bodies charged with, or intervening in, the management of public debt or the Bank for International Settlements (BIS).

Reporting requirements

Counterparties to an SFT will be obliged to report details of each SFT to trade repositories, and, as under EMIR, this information will be centrally stored and will be directly accessible to ESMA, the ESCB and the European Systemic Risk Board for identification and monitoring of financial stability purposes.

Counterparties are required to:

(i) report details of each SFT to a trade repository no later than the working day following the conclusion, modification or termination of a transaction; and

(ii) keep a record of each SFT for at least five years following the termination of the transaction.

In accordance with Article 33, investment firms are required to report SFTs to a trade repository with effect from 12 months after the entry into force of the SFT reporting RTS, UCITS managers and AIFMs with effect from 18 months and non-financial counterparties with effect from 21 months of such date.

Rehypothecation requirements

The SFT Regulation requires the following conditions to be met before a counterparty has the right to rehypothecate:

(a) it must disclose to the providing party in writing the risks that may be involved in the providing party granting its consent to the re-use of collateral, particularly in the event of default of the counterparty; and

(b) the providing counterparty must grant its prior express written consent to the re-use of its collateral.

Upon the granting of such express consent, the counterparty may only exercise its right of rehypothecation if the re-use is undertaken in accordance with the terms specified in the written agreement and the relevant assets are transferred from the account of the providing party to that of the counterparty.

Counterparties are required to comply with the rehypothecation requirements with effect from 6 months after the SFT Regulation's entry into force.

UCITS and AIFM disclosure requirements

The SFT Regulation imposes additional obligations upon UCITS management companies and AIFMs to report certain specified information to investors about their use of SFTs and other financing structures, such as total return swaps to enable such investors to become aware of the risks associated with their use. These disclosure requirements relate closely to those required under the UCITS Directives and the AIFMD, namely the provision of pre-investment and periodical information to investors. The form of both pre-investment and periodical disclosures are set out in the SFT Regulation.

Pre-investment disclosure

The following information must be included in the prospectus of the UCITS or AIF:

- a general description of the SFTs and total return swaps used by the fund and the rationale for their use
- the type of assets, the expected proportion and the maximum proportion of AUM that can be subject to them

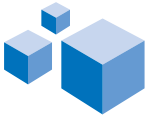
The pre-investment disclosure requirements come into effect 18 months after the SFT Regulation's entry into force for UCITS and AIFs that are already constituted by 12 January 2016.

Periodical disclosure

The use of SFTs and total return swaps must be disclosed by the UCITS manager in their half-yearly and annual investor reports (as required under the UCITS Directives) and by AIFMs in their annual investor report (as required under the AIFMD).

The periodical disclosure requirements come into effect 12 months after the SFT Regulation's entry into force.

This document is for general guidance only. It does not constitute advice
January 2016



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