The Securities Financing Transactions Regulation (SFTR) – updated 12 February 2020

The Regulation on Transparency of Securities Financing Transactions (known as the SFTR) entered into force and started applying from 12 January 2016. However, as described in more detail below, there were a number of phase-in periods that applied, so that the obligations imposed by the SFTR did not all apply from that date.

The SFTR imposes new obligations in relation to three principal areas:

- Mandatory reporting of securities financing transactions to authorised or recognised trade repositories (the Reporting Obligation);
- Documentary and operational requirements in respect of all collateral reuse arrangements (N.B. not just limited to those relating to securities financing transactions) (the Collateral Reuse Requirements); and
- Transparency and disclosure requirements for managers of UCITS and alternative investment funds (AIFs) in respect of securities financing transactions and total return swaps (the Transparency to Fund Investors Requirements).

It is worth noting that the SFTR is an EU Regulation, as opposed to an EU Directive, meaning that it has direct effect in each of the EU Member States, without the need for further implementing national legislation.

1. Background

The origin of the SFTR can be traced back to the structural measures introduced by European regulatory reforms designed to strengthen the traditional banking sector. These included strengthened capital requirements, rules on improved governance and supervision and resolution regimes.

Driven by a concern that such banking structural reforms would lead market participants to source credit from a less regulated, non- banking, sector (so-called "shadow banking"), the Financial Stability Board and the European Commission sought to increase the transparency, oversight and monitoring of credit activity in the shadow banking sector. The SFTR is one piece of that larger regulatory mosaic.

2. What is a Securities Financing Transaction?

Securities financing transactions (**SFTs**) are defined in the SFTR as the following products:

- Repurchase transactions;
- Securities or commodities lending or borrowing transactions;
- Buy-sell back or sell-buy back transactions;
- Margin lending transactions, which is defined broadly to capture any extension of credit "in connection with the purchase, sale, carrying or trading of securities."

3. Does the SFTR apply to you?

Each of the three principal obligations under the SFTR applies to different counterparties in the following way:

Reporting and Record Keeping(1)	• **Financial counterparty/non-financial counterparty established in EU** • **Third country entity equivalents, if SFT concluded in course of operations of EU branch**
Collateral Reuse	• Financial counterparty/non-financial counterparty established in EU • Third country entity equivalents, if: • SFT concluded in course of operations of EU branch • collateral arrangement is with EU financial counterparty/non-financial counterparty • collateral arrangement is with EU branch of a third country entity
Transparency to Fund Investors	• UCITS management companies (UCITS ManCos) and UCITS investment companies pursuant to Directive 2009/65/EC (**UCITS Directive**) • Alternative investment fund managers (**AIFMs**) authorised in accordance with Directive2011/61/EU (AIFMD)

(1) This is based on our reading of Article 4(1) of the SFTR, in conjunction with Article 2. For further discussion of this please see "The Reporting and Record Keeping Obligations: Who has to report and keep records?"

The definitions of "financial counterparty" and "non-financial counterparty" in the SFTR are broadly in line with the equivalent definitions under EMIR[2].

A financial counterparty includes the following:

- MiFID investment firm authorised in accordance with Directive 2004/39/EC (now MiFID 2);
- Credit institution authorised in accordance with Directive 2013/36/EC or Council Regulation 1024/2013;
- UCITS and, where relevant, its management company, authorised in accordance with the UCITS Directive;
- AIF managed by an AIFM authorised or registered in accordance with AIFMD; and
- Institution for occupational retirement provision (IORPs) authorised or registered in accordance with Directive 2003/41/EC.

The definition of financial counterparty also includes other EU regulated bodies such as insurance undertakings, central counterparties and central securities depositories, as well as third country entities that would require authorisation or registration in accordance with the named EU legislation, if they were established in the EU.

A non-financial counterparty is an undertaking established in the EU or in a third country that is not a financial counterparty. It is important to note in this context that the definition uses the term "undertaking" which is likely to include trusts and partnerships as well as corporate entities. As far as individuals are concerned, the EU Commission's FAQs on EMIR indicated that individuals carrying out an economic activity are capable of being considered to be undertakings (and thus classified as non-financial counterparties) provided they offer goods and services in the market. This conclusion is based on an analysis of the jurisprudence of the European Court of Justice in the context of competition law, which, according to the European Commission, has consistently held that the concept of an undertaking covers any entity engaged in an economic activity, regardless of its legal status or the way in which it is financed.

There remains some ambiguity in relation to the appropriate classification of certain third country entities, such as non-EU AIFs with an AIFM not authorised or registered under AIFMD.

4. When do the SFTR obligations apply to you?

Although the SFTR entered into force on 12 January 2016, each of the three principal obligations was subject to different phase-in periods. In the case of the Reporting Obligation, the length of the phase-in period differs depending on the type of counterparty. The applicable phase-in periods are set out in the table below. Where an obligation is already in effect this is noted, with the date that the obligation was effective from listed also.

	MiFID firms Credit institutions TCE equivalents	**UCITS** AIFs with authorised **AIFM** Insurance/reinsurance firms **IORPs** TCE equivalents	Non-financial counterparties TCE equivalents
Reporting	**11 April 2020** (12 months after Reporting RTS enters into force on 11 April 2019)	**11 October 2020** (18 months after Reporting RTS enters into force on 11 April 2019)	**11 January 2021** (21 months after Reporting RTS enters into force on 11 April 2019)
Record Keeping	**Already in effect (12 January 2016)**	**Already in effect (12 January 2016)**	**Already in effect (12 January 2016)**

(2) Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories

Collateral Reuse	**Already in effect (13 July 2016)**	**Already in effect (13 July 2016)**	**Already in effect (13 July 2016)**
Transparency to Fund Investors (Report)	Not applicable	**UCITS ManCos/ AIFMs only** **Already in effect (13 January 2017)**	Not applicable
Transparency to Fund Investors (Prospectus)	Not applicable	**UCITS ManCos/ AIFMs only** Funds constituted before the date the SFTR entered into force: **Already in effect (13 July 2017)** Funds constituted on or after the date the SFTR entered into force: **Already in effect (12January 2016)**	Not applicable

5. The Reporting and Record Keeping Obligations

Reporting: What do you have to do?

Under Article 4 of the SFTR, counterparties are required to report prescribed details of SFTs to a trade repository, which is either: (i) established in the EU and registered by ESMA in accordance with Article 5 of the SFTR; or (ii) established outside the EU and recognised by ESMA in accordance with Article 19 of the SFTR. If there is no available trade repository, the reporting must be made to ESMA. The Reporting Obligation covers all SFTs which:

- are concluded on or after the reporting start date; or
- were concluded before, and remained outstanding on, the reporting start date and either: (i) had a remaining maturity exceeding 180 days after the reporting start date; or (ii) had an open maturity and actually remain outstanding for 180 days after the reporting start date

The Reporting Obligation is triggered each time the relevant SFTs are concluded, modified or terminated.

The applicable reporting start date is the phased-in date set out in the above table, being 12 months, 18 months or 21 months after the Reporting RTS mentioned below in "What needs to be reported?" enters into force on 11 April 2019.

Record Keeping: What do you have to do?

In addition, Article 4 of the SFTR provides an obligation to keep a record of any SFT that has been concluded, modified or terminated for at least five years following the termination of the SFT in question (the **Record Keeping Obligation**). There is no phase-in for this Record Keeping Obligation, and it therefore applied immediately from the SFTR entering into force on 12 January 2016.

Who has to report and keep records?

Article 4(1) of the SFTR refers to the Reporting Obligation and the Record Keeping Obligation applying to "counterparties", which is defined as both financial counterparties and non-financial counterparties. As discussed above, the definitions of financial counterparties and non-financial counterparties in the SFTR are broader than in EMIR in that they also capture third country entities, suggesting that the Reporting Obligation and the Record Keeping Obligation might apply on an extra-territorial basis to third country entities.

However, our view is that the Reporting Obligation and the Record Keeping Obligation would not apply to third country entities, unless the SFT in question has been concluded in the course of operations of that third country entity's EU branch. This is based on our reading of Article 2(1)(a) of the SFTR, which contains the reference to a third country entity's EU branch. In addition, Recital 10 of the SFTR indicates the clear intention that the SFTR Reporting Obligation should be as identical as possible to the EMIR reporting obligation. By way of reminder, under EMIR, only parties established in the EU or EU regulated firms (including AIFs with an authorised or registered AIFM) are subject to the EMIR reporting and (record keeping) obligation.

There was greater ambiguity as to whether the Reporting Obligation and the Record Keeping Obligation apply to a non-EU AIF with an authorised AIFM. Although such a non-EU AIF is a financial counterparty and is subject to the EMIR reporting and record keeping obligations, Article 2(1)(a) of the SFTR can be read as suggesting that it is not subject to such obligations because it is neither established in the EU nor operating out of an EU branch.

However, in February 2020, the European Commission formally responded and explicitly confirmed in writing to AIMA confirmed that "Non-EU AIFs, i.e. AIFs not established in the Union, are not subject to the [reporting obligation], even if the AIFM is authorised or registered in accordance with [AIFMD]."

There is therefore now a clear distinction between the application of the EMIR reporting obligation, which does apply to non-EU AIFs with EU AIFMs, and the SFTR reporting obligation, which now does not.

As under EMIR, the Reporting Obligation may be delegated, including to the other counterparty to the SFT. However, the SFTR introduces two key deviations from the EMIR reporting obligation:

- A financial counterparty will be required to report on behalf of both counterparties where it concludes a SFT with a non-financial counterparty which on its balance sheet does not exceed the limits of at least two of three of the following criteria:
    - balance sheet total of EUR 20,000,000;
    - net turnover of EUR 40,000,000;
    - average number of 250 employees during the financial year;
    - Where the counterparty obliged to report is a UCITS or an AIF, the Reporting Obligation applies to the management company and the AIFM, respectively.

What is the deadline for submission of the reports?

- The reports must be submitted no later than the working day following the conclusion, modification or termination of the SFT in question.
- In respect of SFTs concluded before the reporting start date, the reports must be submitted within 190 days after the reporting start date.

What needs to be reported?

The regulatory technical standards specifying the details of the SFTs that need to be reported (the **Reporting RTS**) entered into force on 11 April 2019 together with the implementing technical standards in relation to the format and frequency of the reports. In January 2020, ESMA provided further clarificatory guidance in its Final Report and Guidelines on the Reporting Obligation.

The details to be reported must include at least the following:

- the parties to the SFT and, where different, any underlying beneficiary; and
- the principal amount, currency, assets used as collateral (including type, quality and value), collateral method used, whether collateral reuse is applicable and whether it has been reused, cash reinvestment and funding sources data, collateral substitution, repurchase rate, lending fee or rate, haircut, margin data, value date, maturity date, first callable date and market segment.

The reporting format for SFTs has been made consistent with that prescribed for the reporting of derivatives contracts under EMIR. Counterparties in reports should be identified by using the legal identity identifier (**LEI**) system. In order to identify SFTs, counterparties are expected to use a unique trade identifier (**UTI**) agreed by them until a global UTI system is finalised and suitable for the purpose of reporting SFTs. In terms of frequency, SFT reports are required to be provided in the chronological order in which the reported events occurred.

6. The Collateral Reuse Requirements

What does it cover?

The Collateral Reuse Requirements are broad in their coverage and apply to reuse of financial collateral under all collateral arrangements, not just those in respect of SFTs.

In addition, they also capture arrangements where collateral is taken and received by way of title transfer as well as where collateral is taken and received by way of a security interest.

Therefore, by way of example, the Collateral Reuse Requirements also apply to collateral taken under both an English law ISDA Credit Support Annex and a New York law Credit Support Annex, as well as prime brokerage agreements and derivatives clearing agreements.

The Collateral Reuse Requirements are also retroactive in effect in that they capture all collateral reuse arrangements that are in existence at the date on which the Collateral Reuse Requirements come into force – 13 July 2016.

Does it apply to you?

As can be seen from the above table[3], the Collateral Reuse Requirements apply not only to EU counterparties, but also on an extra-territorial basis to third country entities that have a right of reuse of collateral received from an EU counterparty or an EU branch of a third country entity under a collateral arrangement.

By way of example, a non-EU AIF with an AIFM that is neither authorised nor registered under AIFMD is be subject to the Collateral Reuse Requirements to the extent that it receives collateral from an EU counterparty or an EU branch of a third country entity pursuant to an English law Credit Support Annex.

What do you have to do?

Where the Collateral Reuse Requirements are applicable, the counterparty receiving collateral (the **Collateral Receiver**) is only be entitled to reuse that collateral if both of the following conditions are met:

- The counterparty providing the collateral (the Collateral Provider) has been informed in writing by the Collateral Receiver of the risks and consequences of granting consent to a right of reuse in connection with a security interest collateral arrangement or of concluding a title transfer collateral arrangement, as applicable. This must at least include disclosure of the risks and consequences that may arise in the event of a default of the Collateral Receiver; and
- The Collateral Provider has granted its prior express consent to the collateral arrangement that includes the right of reuse, which consent must be evidenced by a written signature or in another legally equivalent manner.

In addition, a Collateral Receiver's actual exercise of their right of reuse is subject to both of the following two conditions:

- The reuse must be undertaken in compliance with the terms of the collateral arrangement; and
- The collateral being reused must be transferred from the Collateral Provider's account to the Collateral Receiver's account (or the reuse must be evidenced by any other appropriate means where the Collateral Provider is established, and the Collateral Provider's account is in, a third country).

In the majority of cases, the Collateral Reuse Requirements are not expected to be onerous as a practical matter, as appropriate legal documentation will usually be executed that would satisfy the consent requirement, and exercise of the reuse would already be expected to comply with the operational requirements.

In addition, in respect of the risk warning requirement, UK prime brokerage firms and their clients will have already gone through a similar exercise following the UK Client Asset Sourcebook (CASS) changes in 2011 which required the production of a prime brokerage disclosure annex that set out the risks of rehypothecation of client assets.

(3) See "Does the SFTR apply to you?"

ISDA and other industry associations have jointly published a standard risk warning statement which is from the perspective of banks and other "sell-side" participants. We can provide a statement for use by funds and other "buy-side" participants.

7. The Transparency to Fund Investors Requirements

What does it cover?

The transparency requirements apply not only to SFTs, but also to total return swaps (TRSs). The justification given in Recital 15 of the SFTR for the inclusion of TRSs in the transparency requirements is that they can be used in a similar way to SFTs to gain exposure to certain strategies or to enhance returns and that they can increase the general risk profile of a fund in a similar way to SFTs.

There are two transparency requirements: one in relation to half-yearly and annual reports from the UCITS management companies, UCITS investment companies and annual reports in respect of AIFs (the **Report Requirement**) and the other in relation to pre- investment disclosure (the **Disclosure Requirement**).

What is the Report Requirement?

This obligation applies to UCITS management companies, UCITS investment companies and AIFMs.

Article 13 obliges these entities to inform investors of the use they make of SFTs and TRSs. This information must be included in:

- For UCITS management companies and UCITS investment companies, their half-yearly and annual reports required by Article 68 of the UCITS Directive;
- For AIFMs, the annual report in respect of the relevant AIF required by Article 22 of AIFMD.

In its updated Q&A on the application of AIFMD published on 6 October 2016, and on the application of the UCITS Directive published on 12 October 2016, ESMA has confirmed that the information must be included in the next annual or half-yearly report published after 13 January 2017, even though this may relate to a reporting period beginning before that date.

The following information must be included in the reports:

- Global data: the amount of securities/commodities on loan as a proportion of total lendable assets; the amount of assets engaged in each type of SFT/TRS, expressed in the fund base currency and as a proportion of the fund assets under management (**AUM**);
- Concentration data: the ten largest collateral issuers across all SFTs/TRSs, with volume breakdown per issuer name; top ten counterparties of each type of SFT/TRS, with counterparty name and gross volume of outstanding transaction;
- Aggregate transaction data for each type of SFT/TRS: type and quantity of collateral; maturity tenor of collateral broken down by seven maturity buckets; currency of collateral; maturity tenor of SFTs/TRSs broken down by seven maturity buckets; country of domicile of counterparties; settlement and clearing of trades (e.g. bilateral, tri-party, CCP);
- Data on reuse of collateral: amount of collateral reused, compared to maximum amount disclosed to investors; cash collateral reinvestment returns to the fund;
- Safekeeping of collateral received or granted by the fund as part of SFTs/TRSs;
- Number and names of custodians and the amount of collateral safe-kept by each;
- Proportion of collateral held in segregated, pooled or in other accounts;
- Data on the return and cost for each type of SFT/TRS, broken down between fund, fund manager and third parties (e.g. agent lenders) in absolute terms and as percentage of overall returns generated by relevant type of SFT/TRS.

ESMA is empowered (but is not obliged) to prescribe further details in relation to this required information, by way of a regulatory technical standard. However, ESMA has indicated that at present it does not consider that providing further details would be the best approach, but will monitor developments in market practice as well as the quality of reporting data in order to determine whether to work on these empowerments in future.

There is a certain amount of overlap between the information required by SFTR to be disclosed in the manager reports, and the information that may be already required to be disclosed – for example, the Annex IV reporting under Article 24 of AIFMD.

What is the Disclosure Requirement?

Pursuant to Article 14 of the SFTR, the UCITS prospectus referred to in Article 69 of the UCITS Directive and the pre-investment disclosure to investors required by Articles 23(1) and (3) of AIFMD (which will typically be included in the fund prospectus) must specify the SFTs and TRSs which the fund is permitted to use and include a clear statement that SFTs and TRSs are used.

The following information must also be included:

- General description of the SFTs/TRSs used, including the rationale for their use;
- Overall data for each type of SFT/TRS: type of assets; maximum and expected proportion of AUM that will be subject to each type of SFT/TRS;
- Counterparty selection criteria (including legal status, country of origin, minimum credit rating);
- Description of acceptable collateral with regard to asset types, issuer, maturity, liquidity, diversification and correlation;
- Collateral valuation methodology, including rationale and whether daily mark-to-market and daily variation margin is used;
- Description of risks of SFTs/TRSs and collateral management, including operational, liquidity, counterparty, custody, legal and reuse;
- Specification of how assets and collateral are safe-kept;
- Description of any restrictions (whether regulatory or self-imposed) on re-use of collateral; and
- Disclosure of policy on profit sharing, including proportion of revenue on SFTs/TRSs paid to the fund, costs and fees assigned to third parties (e.g. agent lenders).

Again, ESMA is empowered (but is not obliged) to prescribe further details in relation to this required disclosure, by way of a regulatory technical standard, but has indicated that it does not intend to do so for the time being.

Of particular note is the fact that the 18 month phased-in effective date for the Disclosure Requirement is only available for funds which are constituted before the entry into force of the SFTR. Funds constituted on or after 12 January 2016 need to comply with the Disclosure Requirement without the benefit of any phase-in.

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