

Investment Management Alert

November 19, 2015

The New Securities Financing Transactions Regulation

Summary

The Securities Financing Transactions Regulation (“SFTR”), which imposes requirements on managers authorised under the European Union (EU) Alternative Investment Fund Managers Directive (AIFMs) and the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) to make certain investor disclosures to investors, was adopted by the European Council on 16 November 2015. Some of the investor disclosure obligations under the SFTR will take almost immediate effect when the SFTR enters into force in January 2016, while further investor disclosure requirements will apply from 2017, although investor disclosure obligations may be postponed until 2017 for existing funds. In addition, the SFTR imposes certain other obligations in respect of securities lending transactions, repurchase agreements and other securities financing transactions, which will take effect later in 2016 and in 2017.

The SFTR is part of the EU’s package of legislative measures aimed at addressing perceived issues with shadow banking.

Key Requirements

The SFTR introduces new rules requiring:

- (1) AIFMs and UCITS management companies (“managers”) to disclose in the offering documents of the funds that they manage whether those funds utilise securities financing transactions and total return swaps and to provide investors with periodic reports on the use of such transactions and swaps by the fund (the “investor disclosure obligation”); managers will be required to comply with the investor disclosure obligation from January 2016 with respect to the offering documents and 2017 with respect to the periodic investor reports
- (2) parties to “securities financing transactions” (including margin lending transactions as well as securities and commodities lending or borrowing transactions, repurchase transactions, reverse repurchase transactions and buy-sellback and sell-buyback transactions) to report the terms of those transactions to trade repositories (the “reporting obligation”); the reporting obligation will take effect in 2018 after the relevant secondary legislation (the regulatory technical standards, or RTS) has been finalised, subject to a number of different phase in periods
- (3) the counterparty receiving collateral pursuant to any arrangement that permits the reuse of collateral to give certain information to the collateral provider regarding the effect of providing collateral with a right of reuse

(4) the prior explicit consent (evidenced by a formally concluded written agreement or similar) of the collateral provider to such collateral arrangement (including granting the right of reuse of the collateral) (together with (3) above, the “collateral documentation requirements”); the collateral documentation requirements will take effect in mid-2016.

While the investor disclosure obligation relating to the offering documents takes effect in January 2016, a transitional period under the SFTR allows managers to postpone compliance until mid-2017 in respect of funds that were constituted before January 2016.

Impact

Investor disclosure obligation. The SFTR will require managers to include in the offering documents of their funds a general description of the securities financial transactions/total return swaps used by the fund, and the rationale for their use. Additional disclosures include overall data regarding the types of assets that can be subject to such transactions/swaps, criteria used to select counterparties and a description of acceptable collateral.

Separately, managers must disclose in the fund’s annual and semiannual investor reports information regarding the fund’s use of securities financing transactions and total return swaps. Information to be disclosed will include at least the following:

- global data regarding the amount of securities/commodities on loan as a proportion of total lendable assets, and the fund’s assets engaged in each type of transaction or swap
- concentration data, including the 10 largest collateral issuers across all transactions/swaps and the 10 largest counterparties of each type of transaction/swap (including counterparty name and gross volume of outstanding transactions)
- aggregate transaction data for each type of transaction/swap, including type of collateral and maturity tenor of the transaction/swap
- data on the reuse of collateral and regarding the safekeeping of collateral in the course of the transactions/swaps
- data on the return and cost for each type of transaction/swap.

While the challenge to managers will be to ensure that they have all of the data required for the disclosures, the overall effect on trading practices is not expected to be substantive. However, the granularity of the information to be provided to investors and prospective investors will be a change to some managers, and there may be concerns about potentially commercially sensitive data leaking to the market.

Reporting obligation. The reporting obligation requires any counterparty to a securities financing transaction that is an undertaking established in the EU to make a report to an approved or recognised trade repository when the securities financing transaction is concluded, modified or terminated. The reporting obligation applies to securities financing transactions concluded on or after the reporting start

date, and to certain securities financing transactions that remain outstanding on the reporting start date. While the reporting obligation applies on an extraterritorial basis to a counterparty that is a non-EU undertaking, it is likely that it applies to such non-EU counterparty only if it is acting through a branch located in the EU.

The information to be reported to trade repositories will include at least the parties and beneficiaries, principal amount, currency, collateral details, lending fee and maturity date. Full details of the reportable data will be set out in the RTS.

The reporting obligation may be delegated to one of the counterparties, save in certain circumstances. Notably, if the counterparty subject to the reporting obligation is an AIF or a UCITS, the reporting obligation applies to the manager and cannot be delegated to the other counterparty. In practice, the reporting obligation will further expand the duties of the compliance functions, but should not cause material changes to trading practices.

Collateral documentation requirements. The collateral documentation and reuse requirements apply to all EU persons, not only regulated entities. The collateral documentation and reuse requirements will also have extraterritorial application to non-EU persons seeking to enter into, or continuing, securities financing transactions pursuant to collateral reuse arrangements with an EU person, or with an EU branch of a non-EU person.

The SFTR will impose the collateral documentation requirements on the reuse of collateral under all collateral arrangements and will apply retroactively to all collateral arrangements in place on the date the SFTR takes effect. Collateral documentation requirements are unlikely to have a significant impact on existing practices, especially in the United Kingdom, where the large prime brokers are already required to provide separate and extensive disclosure of the risks of rehypothecation.

While the SFTR will require changes to existing documentation, the changes are unlikely to be overly burdensome on the counterparties. It is likely that standard amendments to master agreements and possibly other market-standard, risk-warning language will be developed to allow for a consistent approach to meeting the SFTR requirements.

Interaction with Other EU Rules

The new rules overlap with a number of existing and planned EU and national requirements with respect to collateral arrangements, including the proposals under the revised Markets in Financial Instruments Directive regarding the use of title transfer collateral arrangements by nonretail clients.

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