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Briefing note February 2014

The EU regulation on reporting and transparency of securities financing transactions – another piece in the jigsaw of shadow banking regulation

On 29 January 2014, the European Commission issued a proposed regulation on reporting and transparency of securities financing transactions (SFTs).

The proposed regulation will apply to counterparties to securities financing transactions - both financial and non-financial - and parties to rehypothecation arrangements. Under the proposal, all SFTs must be reported to a trade repository, managers of UCITS and AIFs have additional investor disclosure obligations and written consent must be obtained prior to any transaction which involves 'rehypothecation' of assets.

This is the latest in a package of measures instituted by the Commission to reduce risks in the shadow banking sector and was issued alongside the proposal for structural reform of the EU banking sector in the wake of the Liikanen report, the rationale being to prevent banks affected by the structural reform proposals shifting parts of their activity to the shadow banking sector.

The date when the proposed regulation might come into force is unknown at present. The next step is for the Parliament and the Council of the European Union to agree the text of the regulation. As European elections are scheduled for May 2014, it is unlikely that much progress will be made on this proposal until late this year or early 2015.

Securities financing transactions and shadow banking

Despite their acknowledged benefits (including providing additional market liquidity and facilitating the funding of market participants and central banks) SFTs are considered by regulatory authorities to be a significant feature of the shadow banking sector and potential sources of risk to financial stability. In their view, SFTs can lead to credit creation, with maturity and liquidity transformation; rehypothecation of collateral, which they believe often involve long transaction chains, can lead to the build-up of hidden leverage and interconnectedness between the banking and the shadow banking system. For these reasons, SFTs have been a focus of both the Financial Stability Board (FSB) and the European Commission in their attempts to mitigate shadow banking risks. In August 2013, the FSB issued a policy framework for addressing shadow banking risks in securities lending and repos which consisted of 11 recommendations. The proposed

Key Features of the Regulation

- All SFTs to be reported to a central repository
- Detailed reporting on SFT activity by investment funds (including UCITS and AIFs)
- Prior risk disclosure and express written consent required before any rehypothecation of assets

"...Securities financing transactions are integral to the efficient functioning of banks... Increased reporting and transparency is designed to assist regulators detect attempts to circumvent the proposed new rules on bank structures by shifting activities perceived by regulators to be too risky out of the spotlight..."

regulation is in line with four of these, being those that relate to transparency in the SFT market, disclosure to investors and rehypothecation. The European Commission too identified improving transparency in the securities financing markets as one of their main priorities in its September 2013 Communication on shadow banking. The proposed regulation on SFTs is the means by which the Commission intends to address those concerns in the European Union and would put the EU ahead of other jurisdictions in implementing the FSB's recommendations.

Main elements of the proposal

The proposed regulation suggests improving transparency is a necessary first step in understanding the risk and magnitude of the securities financing market, providing regulators with the information they need in order to develop policy in this area and define parameters for utilising the 'policy tools' already identified by the FSB for use in this market. The focus is on three main areas:

- Highly granular and frequent reporting of securities financing transactions to trade repositories
- Enhanced disclosure to fund investors of the use of securities financing transactions
- Imposing rules on rehypothecation, increasing the disclosure to clients and counterparties.

Reporting to trade repositories

The proposed reporting obligation is broad. Any EU financial and non-financial entity would be required to report to a trade repository details of its securities financing transactions. This would include banks, broker-dealers, funds, insurance companies, pension funds and other financial companies, as well as non-financial companies. However, EU central banks, the Bank for International Settlements and 'public bodies managing public debt' would be exempt. The reporting obligation would apply to all SFTs concluded after the date the Regulation comes into force, as well as those which are outstanding at that date.

SFTs include repos, reverse repos, securities lending and borrowing transactions, buy-sell backs and sell-buy backs and other financing structures with equivalent economic effect. This means that derivative transactions, such as total return swaps, liquidity swaps and collateral swaps would also be subject to the reporting obligation, so there would be some overlap with the EMIR reporting regime.

A number of European supervisory bodies and regulators would have access to the data, including ESMA, ECB, ESRB, EBA, EIOPA as well as national authorities. The intention is

What are Securities Financing Transactions?

- Securities lending and borrowing transactions
- Repos, reverse repos
- Buy/sell backs and sell/buy backs
- Any transaction having an equivalent economic effect

Who will be affected?

- Parties to securities financing transactions or financing structures with equivalent economic effect
- UCITS managers and investment companies
- AIFMs
- Parties to rehypothecation arrangements

"…There is some overlap with derivative reporting under EMIR as financing transactions with 'equivalent economic effect' as repos are caught…"

"...Coming as it does in the wake of EMIR, the SFT Reporting regime is another example where reporting requirements apply to all market participants, not just intermediaries. We are witnessing increasing direct regulation of end-users, which marks a sea change in regulatory approach..."

that supervisors would have the means to monitor the market, gain a better understanding of its intricacies and intervene if necessary should any risks to financial stability arise.

The proposed SFT reporting regime is based on that for derivatives under EMIR. ESMA would supervise the reporting framework and develop technical standards in areas such as reporting procedures, access to data and registration procedures for trade repositories.

It is significant that the EMIR reporting regime has been chosen as the blueprint for SFT reporting. EMIR reporting has been highly controversial in many respects, not least that it requires both parties to the trade to report and is therefore more onerous than the US regime under Dodd-Frank. Consequently, there is potential for a repeat of the same problems that have confronted the derivatives market - for example in relation to timing, content and the considerable administrative costs to end-users in establishing a reporting infrastructure.

Disclosure to fund investors

The proposed regulation contains specific disclosure requirements for UCITS management companies and investment funds and Alternative Investment Fund Managers (AIFMs) and in this respect supplements the provisions of the UCITS Directive and the AIFMD. SFTs are widely used by investment funds e.g. lending portfolio securities to generate a return or using repos to raise cash for additional investments. Aspects of this activity have raised concerns on the part of the European authorities e.g. that investors bear counterparty and liquidity risk on an SFT but only receive part of the additional earnings (as typically only part of the lending fee on the securities lending transaction is passed to investors). The European Commission fears a misalignment of the interests of investors and fund managers. The proposed solution is to mandate disclosure of sufficient information to enable investors to assess thoroughly the risks and returns of their investment.

The proposal envisages additional detailed disclosures in fund annual (and, for UCITS, half-yearly) reports and in prospectuses or offer documents. For example, initial disclosures would include information on limits on the maximum amount of assets under management that can be subject to SFTs, counterparty and collateral criteria, valuation methodologies, risk management and policy on sharing of returns. Ongoing disclosures would include detailed quantitative breakdowns of total activity, concentration data and transaction data and data on re-use and rehypothecation.

Rehypothecation

Rehypothecation is defined in the proposed Regulation as 'the use by a receiving counterparty of financial instruments received as collateral in its own name and for its own account or for the account of another counterparty'. The FAQs issued alongside the proposed Regulation specify that the rules would cover any collateral arrangement under the Financial Collateral Directive i.e. both title transfer and security interest collateral arrangements. Financial collateral arrangements are used widely in the financial markets e.g. in derivatives, repos, securities lending, margin lending, prime brokerage arrangements and structured finance transactions.

The proposed Regulation would introduce four specific rules on rehypothecation:

- The client or counterparty must give prior consent to its assets being rehypothecated
- The risks of hypothecation must be made clear; the 'providing counterparty' (collateral giver) must be informed in writing of the risks of rehypothecation, especially in the event of a default by the 'receiving counterparty' (collateral taker)
- There must a written agreement
- The financial instruments received as collateral must be transferred to an account opened in the name of the 'receiving counterparty'

These new rules are explicitly stated to be subject to the stricter rules in the UCITS Directive and the AIFMD.

The scope of the new rules is broad. They will impact many financial companies (e.g. banks, broker-dealers, prime brokers) who use, for their own purposes, financial instruments that have been provided to them by clients as collateral.

EU central banks and the Bank for International Settlements would be exempt from these restrictions but there is no immediate exemption for non-EU central banks, multilateral development banks, central counterparties or other entities (although the Commission could extend the exemption to cover additional classes of entity). There is no proposal to exempt existing contracts from these restrictions and so there would be a potentially significant retroactive impact on existing arrangements, even if they have been priced on the basis that rehypothecation is permitted.

Third country issues

In common with other recent regulations (e.g. EMIR, AIFMD, MiFID II), aspects of the proposed Regulation would have extra-territorial effect:

- Non-EU branches of EU entities would be fully subject to the reporting requirements and the restrictions on rehypothecation (regardless of potentially conflicting or duplicative local privacy or other laws)
- Non-EU trade repositories could be used to report SFTs as long as they are 'recognised' by ESMA

"…There are some useful transitional provisions for SFT reporting and disclosure to funds investors, although the rehypothecation requirements would have immediate effect…"

- SFT data could be shared with non-EU regulatory authorities subject to regulatory co-operation agreements or, for countries with their own derivatives repositories, treaties on mutual sharing of information being established
- Non-EU entities would be subject to the reporting obligations for SFTs concluded in the course of the operations of an EU branch. Non-EU entities would also be subject to the restrictions on rehypothecation if:
  - the rehypothecation is effected in the course of the operations of an EU branch of the non-EU entity or
  - an EU entity (or the EU branch of another non-EU entity) is the provider of the collateral, even if the transaction takes place wholly outside the EU (e.g. where the EU collateral provider is acting through a non-EU branch)

Administrative sanctions

National authorities would need to set the sanctions for breaches of the SFT reporting obligation and the rehypothecation provisions. A minimum set of measures are set out in the proposed regulation, including withdrawal of authorisation, public warnings, dismissal of management, restitution of profits gained from breaches of the regulation and administrative fines. Individual member states would be able to impose stricter standards, which might include criminal sanctions. However, breach of the SFT reporting obligation would not affect the validity or enforceability of the transaction or give rise to compensation rights. There is no equivalent protection for rehypothecation rights where the required disclosures and consents have not been made or obtained.

Contravention of the transparency requirements for UCITS and AIFs will be subject to the sanctions and other measures established in accordance with the UCITS Directive and the AIFMD. The regulation would also require regulators to take measures to facilitate 'whistleblowing' on breaches of the reporting and rehypothecation rules.

Entry into force and transitional provisions

The new rules are proposed to be implemented by way of a Regulation, directly applicable in all Member States, which would come into force 20 days after publication in the Official Journal of the European Union. The obligation to report SFTs to trade repositories would apply 18 months after the Regulation comes into force and the obligations to make disclosures to fund investors would apply 6 months after the Regulation comes into force. But the restrictions on rehypothecation would take immediate effect without any exceptions for existing contractual arrangements.

Review

A review would take place three years after the Regulation comes into force on the effectiveness and efficiency of the Regulation.

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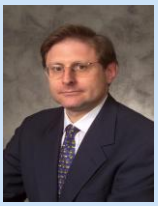

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