

## Regulators next hit: Securities Financing Transactions Regulation

Mar 22 2018 [Marco Iezzi and Paul Gronau](#)



No sooner has the market digested the [Markets in Financial Instruments Directive](#) (MiFID II) than it finds itself having to deal with the next regulatory implementation requirement in the form of the [Securities Financing Transactions Regulation](#) (SFTR).



Few assets or types of business have escaped regulatory scrutiny in recent years. Reporting requirements have increased enormously, whether it is the obligation to register under the [European Market Infrastructure Regulation](#) (EMIR) or under [Article 26](#) of the Markets in Financial Instruments Regulation (MiFIR).

These reporting obligations, alongside other investor protection issues, which have gained additional importance under MiFID II in particular, are intended to increase transparency in the market, reduce market abuse and provide the investor with all the information he needs.

The intention behind these regulations is certainly praiseworthy, but whether the flood of regulation actually achieves its goals remains to be seen. Most market participants have to overcome enormous hurdles even to achieve minimum "compliance" with the regulatory requirements.

### Securities Financing Transactions Regulation

Until recently, securities financing transactions had escaped regulatory scrutiny but the [SFTR](#) now closes this gap. The regulation strengthens the transparency of certain activities in the financial markets, such as the use of securities financing transactions and the re-use of collateral, to enable the identification and control of the corresponding risks.

The SFTR applies to counterparties to a securities financing transaction established in the European Union, including all its branches, irrespective of their location; or established in a third country where the securities financing transaction is closed in the context of the activities of a branch in the EU of such counterparties.

Furthermore, management companies of undertakings for collective investment in transferable securities (UCITS), managers of alternative investment funds (AIFM) and counterparties that engage in the re-use of collateral are affected.

Not all the details for the implementation have yet been clarified (the release of the final regulatory technical standards announced for the end of 2017 is still pending), but early involvement with SFTR is nevertheless advisable.

The regulation is based on three pillars:

- Transaction reporting requirements for counterparties to SFTs to report all SFTs to central trade repositories.
- Client disclosure requirements for investment funds to disclose the use of SFTs to investors in their regular reports and pre-contractual documents.
- Minimum transparency conditions for the reuse of collateral received in a SFT (rehypothecation), such as the disclosure of the resulting risks and consequences as well as prior consent by the counterparty providing collateral.

The SFTR sets EU rules on the reporting of details of SFTs to trade repositories and information on SFTs and total return swaps to investors in UCITS, as well as minimum transparency requirements on the re-use of collateral by the involved parties.

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Securities financing transactions within the meaning of the SFTR are considered to be the following transactions:

- Lendings in: securities and commodities.
- "Buy-sell back transactions" or "sell-buy back transactions": securities, commodities and guaranteed rights relating to title to securities or commodities.
- Repurchase transaction (repos) for: securities, commodities and guaranteed rights relating to title to securities or commodities.
- Margin lending transactions (a transaction in which a counterparty extends credit in connection with the purchase, sale, carrying or trading of securities, but not including other loans that are secured by collateral in the form of securities).

#### Reporting of securities financing transactions

As already mentioned, the regulation is based on three pillars: the first, and certainly the most important, pillar in terms of implementation is the reporting of securities financing transactions under [art 4](#) of the SFTR.

Under this article, EU securities transaction counterparties are required to enter the details of any securities financing transaction they have concluded and any modification or termination of such transactions into a centralised database — an approved trade repository — registered with the European Securities and Markets Authority (ESMA).

The new registration requirement specifies 153 —partly new —reporting fields.

The reporting must be carried out no later than the working day following the conclusion, modification or termination of the transaction.

The obligation for the counterparties to record closed-end securities financing transactions concluded, amended or terminated after the end of the transaction is at least five years.

The full transparency which regulators have striven so hard to achieve for investors is enshrined in arts [13 and 14](#) of the SFTR.

#### Investor protection

Like most recent regulations, the SFTR claims to be particularly focused on investor protection. To ensure investors are aware of the risks associated with the use of securities financing transactions and total return swaps, managers of collective investment undertakings must report in detail on the extent to which they rely on them in periodic reports.

The investment policy of a collective investment undertaking in relation to SFTs and total return swaps should be clearly disclosed in the pre-contractual documentation.

The transparency of the re-use of collateral is regulated in [art 15](#) of the SFTR.

To increase transparency on the extent to which financial instruments used as collateral have been re-used, and in relation to the associated risks in the event of insolvency, the SFTR has introduced minimum requirements. A reuse of collateral should only take place:

- with explicit knowledge of the possible risks and consequences;
- with the prior approval of the guaranteeing counterparty; and
- the transfer of collateral should be done from the account of the collateral counterparty.

#### Other topics covered in the SFTR

The SFTR also deals with the following topics, which are not discussed further in this article:

- Cooperation between competent authorities.
- A requirement for the competent authorities and ESMA to cooperate closely and exchange information to identify and remedy, in particular, violations of the regulation.
- Relations with non-EU countries.

The SFTR delegates powers to the European Commission to assess non-EU country rules for recognition of trade repositories from these non-EU countries and to avoid any duplication or inconsistency in the requirements.

#### Impact of the provisions on financial institutions

Firms should not just regard the SFTR as yet another regulatory measure that needs to be implemented; it will have a whole range of regulatory implications. Firms will of course have learned lessons from the implementation of earlier regulations and will be able to apply existing best practice approaches, particularly in terms of extended regulatory reporting.

The sheer volume of different regulations introduced in recent years, all with their own specific requirements, has led to a fragmented and in many cases decentralised back-office structure within financial services firms.

Implementing SFTR requirements, and the expected EMIR refit provisions, will require financial institutions to re-think their back-office workflows. The regulation introduces new data requirements and a whole range of additional day-to-day business tasks.

Most market participants will be unable to deal with the more onerous workload by simply increasing staff numbers; rather, they will need to redesign existing workflows and their organisational structures.

Line managers will also have to deal with the conflict of interests between regulatory compliance and the need to make a profit. Smaller institutions in particular will be unable to maintain a dedicated regulatory task force, and so most of the day-to-day tasks will have to be covered by the business line once the implementation programme has been successfully completed.

The demand for monitoring capabilities has also grown with each new regulation, and as a result the back office has become responsible for the operational regulatory compliance.

Back-office managers might do well to use the SFTR provisions as a starting point for re-designing their workflows. In most financial institutions, there is a boundary between the day-to-day operational business that generates revenue and the new processes which are the result of regulatory implementation efforts, and so any new organisational set-up will need embrace as the need to juggle sometimes conflicting demands.

While analysing the SFTR implementation requirements, line managers should think a step ahead and incorporate likely future tasks into their day-to-day activities. Regulatory reporting duties have a considerable impact on day-to-day back-office routines and it may be possible to draw synergies, particularly since many of the reporting requirements under MiFIR, EMIR, and SFTR involve similar tasks.

It may therefore be useful to merge those reporting streams into a single centralised reporting unit. This should significantly reduce the resources that need to be devoted to implementation.

Firms can also increase efficiency by harmonising their IT landscape and using technology to manage certain tasks, such as generating reports, record retention and supplying certain identifiers, e.g., legal entity identifiers (LEIs), international securities identification numbers (ISINs). Line managers should take care to ensure that the project management approaches used to implement SFTR requirements are aligned with the structural and organisational set-up of their back offices.

At first sight, the SFTR requirements may not seem overly demanding, but one of the main lessons to be learned from the past is that often it can be the smallest provisions that generate the most work. Financial institutions should hesitate no longer, and start their implementations projects "asapissimo".



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