EU Securities Financing Transactions Regulation - New rules on rights of reuse of collateral
August 2015
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Financial Stability Board Recommendations
Recommendation 7: Authorities should ensure that regulations governing re-hypothecation of client assets address the following principles:

- financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary; …

*Strengthening Oversight and Regulation of Shadow Banking - Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos (August 2013)*

Recital 17 EU Securities Financing Transactions Regulation
Reuse of collateral provides liquidity and enables counterparties to reduce funding costs. However, it tends to create complex collateral chains between traditional banking and shadow banking, posing financial stability risks. The lack of transparency on the extent to which financial instruments provided as collateral have been reused and the respective risks in the case of bankruptcy can undermine confidence in counterparties and magnify risks to financial stability.

*Council paper confirming final political agreement with Parliament (26 June 2015)*
The new EU regulation on securities financing transactions (SFTR) also imposes new rules on rights of reuse of collateral

The European Parliament and the Council reached agreement on the text of the SFTR in June 2015 and it is expected that the SFTR will come into force in early 2016.

The SFTR is part of the EU initiative on “shadow banking” and introduces new rules on:
- reporting of securities financing transactions (SFTs) to trade repositories
- disclosure by collective investment undertakings of their use of SFTs and total return swaps in their prospectuses and periodic reports

The SFTR also aims to implement recommendations of the Financial Stability Board (FSB) that financial intermediaries should provide clients with disclosure on the effects of re-hypothecation of client assets.

The new EU rules will require all counterparties – not just financial intermediaries – to provide additional disclosures to the collateral provider if they receive financial instruments as collateral with a right of use or under title transfer arrangements.

The SFTR also imposes new formalities with respect to financial collateral arrangements involving rights of use or title transfer as well as requirements with respect to securities accounts.

These requirements will take effect six months after the SFTR comes into force, will have retroactive effect in relation to existing collateral arrangements and will apply extra-territorially to non-EU counterparties receiving collateral from persons in the EU.

The new rules overlap with a number of existing and planned EU and national requirements with respect to collateral arrangements, including the proposals under MiFID2 regarding the use of title transfer collateral arrangements by non-retail clients.
Article 15 SFTR
Reuse of financial instruments received under a collateral arrangement

1. Any right of counterparties to reuse financial instruments received as collateral shall be subject to at least all the following conditions:
   (a) the providing counterparty has been duly informed in writing by the receiving counterparty of the risks and consequences that may be involved in:
      (i) granting consent to a right of use of collateral provided under a security collateral arrangement in accordance with Article 5 of Directive 2002/47/EC; or
      (ii) concluding a title transfer collateral arrangement.
      In the circumstances laid down in this point, the providing counterparty shall at least be informed in writing of the risks and consequences that may arise in the event of the default of the receiving counterparty.
   (b) the providing counterparty has granted its prior express consent, as evidenced by the signature in writing or in a legally equivalent manner, of the providing counterparty to a security collateral arrangement, the terms of which provide a right of use in accordance with Article 5 of Directive 2002/47/EC, or has expressly agreed to provide collateral by way of a title transfer collateral arrangement.

2. Any exercise by counterparties of their right to reuse shall be subject to at least all the following conditions:
   (a) reuse is undertaken in accordance with the terms specified in the collateral arrangement referred to in point (b) of paragraph 1;
   (b) the financial instruments received under a collateral arrangement are transferred from the account of the providing counterparty.

By way of derogation to point (b), where a counterparty to a collateral arrangement is established in a third country and the account of the counterparty providing the collateral is maintained in and subject to the law of a third country, the reuse shall be evidenced either by a transfer from the account of the providing counterparty or by other appropriate means.

3. This Article is without prejudice to stricter sectoral legislation, in particular to Directives 2014/65/EU [MiFID2] and 2009/65/EC [UCITS], and to national law aimed at ensuring a higher level of protection of providing counterparties.

4. This Article shall not affect national law concerning the validity or effect of a transaction.

Source: Council paper confirming final political agreement with Parliament (26 June 2015) – emphasis added
Article 28 SFTR

Entry into force and application

1. This Regulation shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

2. This Regulation shall apply from the date of entry into force, with the exception of:

(c) Article 15 shall apply from [6 months after the date of entry into force].

(d) Article 15 shall apply to collateral arrangements existing at the [date of entry into force].

Recital 18 SFTR

Application of the reuse requirements should be deferred by 6 months in order to provide counterparties with sufficient time to adapt their outstanding collateral arrangements, including master agreements, and to ensure new collateral arrangements comply with this Regulation.

SFTR - next steps

Legal linguists’ review and translation into official languages

European Parliament approval in plenary (set for 27 October 2015)

Endorsement by the Council

Signature on behalf of the European Parliament and Council

Publication in the Official Journal

SFTR is likely to be in force in early 2016

SFTR does not require the adoption of any regulatory technical standards or delegated or implementing acts with respect to Article 15

Implications for Article 15

The new requirements will have retroactive effect on existing collateral arrangements

Counterparties will need to remediate existing collateral arrangements and put in place processes for new collateral arrangements by mid-2016
Scope of Article 15 SFTR

Covered transactions

Article 15 is not limited to securities financing transactions – it covers all security financial collateral and title transfer collateral arrangements.

It is wider than the Financial Collateral Directive (FCD) – it applies even if the arrangement does not secure “relevant financial obligations”.

But it only applies to the reuse of financial instruments (not cash).

Covered counterparties

The obligations apply to a “counterparty” that receives collateral with a right of reuse, possibly including from an individual (Article 3(1)(7)).

Counterparties are “undertakings” established in the EU or third countries - not only regulated firms (wider than FSB Recommendation 7).

The obligations do not apply to members of ESCB, EU public bodies charged with or intervening in the management of the public debt or BIS:

- Commission can adopt delegated acts to cover e.g. non-EU central banks.
- Counterparties receiving collateral from exempt entities must still comply with Article 15 (contrast Article 2(2) and 2(2a) SFTR).

Extra-territorial impact

Requirements apply where counterparty engaging in reuse of collateral is:

- Established in the EU (including where acting through non-EU branches); or
- Established in a third country and is receiving collateral:
  - through a branch in the EU; or
  - from an EU counterparty (or an EU branch of a third country entity).

SFTR Recitals

(17b) Although the scope of the rules concerning reuse is wider than the one of the Directive 2002/47/EC [FCD], this Regulation does not amend the scope of Directive 2002/47/EC but rather should be read in addition to Directive 2002/47/EC. …

(18a) In order to promote international consistency of terminology, this Regulation employs the term “reuse” due to the FSB Recommendations. This should however not lead to inconsistency within Union acquis, in particular it should be without prejudice to the use of the term “reuse” employed in Directives 2009/65/EC [UCITS] and 2011/61/EU [AIFMD].

Article 3(1) SFTR

(7) “reuse” means the use by a receiving counterparty, in its own name and on its own account or on the account of another counterparty, including any natural person, of financial instruments received under a collateral arrangement. Such use includes transfer of title or exercise of a right of use in accordance with Article 5 of Directive 2002/47/EC [FCD] but does not include the liquidation of the financial instrument in the event of default of the providing counterparty;

(7a) “title transfer collateral arrangement” means a title transfer financial collateral arrangement as defined in point (b) of Article 2(1) of Directive 2002/47/EC concluded between counterparties to secure any obligation.

(7b) “security collateral arrangement” means a security financial collateral arrangement as defined in point (c) of Article 2(1) of Directive 2002/47/EC concluded between counterparties to secure any obligation.

(8) “collateral arrangement” means title transfer collateral arrangement and security collateral arrangement.

(9) “financial instruments” means financial instruments as defined in point (15) of Article 4(1) of Directive 2014/65/EU10 [MiFID2];
Article 32(7) MiFID implementing directive
7. An investment firm, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved.

CASS 9.3.1R
(1) A firm must ensure that every prime brokerage agreement that includes its right to use safe custody assets for its own account includes a disclosure annex.
(2) A firm must ensure that the disclosure annex sets out a summary of the key provisions within the prime brokerage agreement permitting the use of safe custody assets, including:
(a) the contractual limit, if any, on the safe custody assets which a prime brokerage firm is permitted to use;
(b) all related contractual definitions upon which that limit is based;
(c) a list of numbered references to the provisions within that prime brokerage agreement which permit the firm to use the safe custody assets; and
(d) a statement of the key risks to that client’s safe custody assets if they are used by the firm, including but not limited to the risks to the safe custody assets on the failure of the firm.
(3) A firm must ensure that it sends to the client in question an updated disclosure annex if the terms of the prime brokerage agreement are amended after completion of that agreement such that the original disclosure annex no longer accurately records the key provisions of the amended agreement.

Information obligation
Article 15 imposes a new requirement to inform the collateral provider of “the risks and consequences” of granting consent to a right of use or entering into a title transfer collateral arrangement

Compare Article 32(7) MiFID implementing directive (retail clients), CASS 9.3.1R (prime brokerage) and proposed standards under MiFID2 for title transfer collateral agreements with non-retail clients (see below)
- The SFTR obligations also apply to clients and counterparties receiving collateral from regulated firms
- Mutual disclosure may be required for two-way collateral agreements

Counterparties may choose to provide information by:
- specific disclosures in new master agreements/credit support documents or
- cross-agreement disclosure through one-way notices or terms of business (in particular when remediating for existing collateral arrangements)

Execution obligation
Requires “prior express consent” of counterparty, “evidenced by signature or equivalent” to a security financial collateral agreement including rights of reuse

Requires “express agreement” of counterparty to provide collateral by way of title transfer

Compare Article 3 FCD: validity etc. “not dependent on a formal act” where “the financial collateral arrangement can be evidenced in writing or in a legally equivalent manner”

This should not require additional steps for counterparties using signed market standard securities financing/credit support documentation
Reuse conditions

Compliance with agreement

Reuse must be undertaken in accordance with the terms specified in the collateral arrangement

This should not require additional implementation steps by firms

Securities accounts

Reuse is also subject to condition that the “financial instruments received under a collateral arrangement are transferred from the account of the providing counterparty” except where:

- a counterparty to a collateral arrangement is established in a third country and
- the account of the counterparty providing the collateral is maintained in and subject to the law of a third country,

the reuse shall be evidenced either by a transfer from the account of the providing counterparty or by other appropriate means

Firms holding financial instruments in custody for clients which are reused under a collateral agreement should ensure that the reuse is reflected in the client’s securities account

- Clients’ accounts should distinguish between securities held in custody and those to which client has a contractual right of return of equivalent securities
- Compare Article 43(2)(b) MiFID implementing directive regarding the content of the annual financial statement sent to clients of investment firms and banks holding client financial instruments

Recital (17a) SFTR

In order to increase transparency of reuse, minimum information requirements should be imposed. Reuse should take place only with the express knowledge and consent of the providing counterparty. Therefore, the exercise of reuse should be reflected in its securities account of the providing counterparty, unless this account is governed by the law of a third country which might provide for other appropriate means to reflect the reuse.

Article 43 MiFID implementing directive

The statement of client assets ... shall include the following information:

(a) details of all the financial instruments or funds held by the investment firm for the client at the end of the period covered by the statement;

(b) the extent to which any client financial instruments or client funds have been the subject of securities financing transactions;

(c) the extent of any benefit that has accrued to the client by virtue of participation in any securities financing transactions, and the basis on which that benefit has accrued.
**Sanctions**

**Member states must give competent authorities the power to impose effective, proportionate and dissuasive administrative sanctions and other administrative measures for breach of Article 15, including:**

- maximum administrative pecuniary sanctions of at least €15m or 10% of consolidated turnover (legal persons) or €5m (individuals)
- penalties and temporary bans for management and other individuals responsible for breach by a legal person
- Cease and desist orders, public censure, suspension or withdrawal of authorisation

**Member states may provide for criminal sanctions instead of or additional to administrative sanctions**

**Member states must notify rules on sanctions to Commission and ESMA within 18 months of SFTR coming into force**

**Impact on validity and civil liability**

**Article 15(4) suggests that transactions that are otherwise valid under national law may not be affected by contraventions of Article 15 but:**

- ECJ case law envisages the possibility of civil liability for breach of a directly applicable EU regulation (Muñoz v Frumar)
- Article 20(5) is explicit that contraventions of the reporting requirements under SFTR do not affect the validity of a transaction or give rise to civil liability
Governance arrangements concerning the safeguarding of client assets

1. Investment firms shall appoint a single officer of sufficient skill and authority with specific responsibility for matters relating to the firm’s compliance with its obligations regarding the safeguarding of client instruments and funds.

2. In accordance with the MiFID proportionality principle, investment firms shall decide where it is appropriate for the officer appointed under (1) to be dedicated solely to this task, or to have additional responsibilities.

Inappropriate use of title transfer collateral arrangements (TTCAs) for non-retail clients

3. Article 16(10) of MiFID II prohibits firms from concluding TTCAs with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations. For non-retail clients, investment firms shall not conclude TTCAs without proper consideration.

4. TTCAs are not appropriate where:
   i. there is only a very weak connection between the client’s obligation to the firm and the use of TTCAs, including where the likelihood of a liability arising is low or negligible;
   ii. the amount of client funds or financial instruments subject to TTCAs far exceeds the client’s obligation, or is even unlimited if the client has any obligation at all to the firm;
   iii. firms insist that all clients’ assets must be subject to TTCAs, without considering what obligation each client has to the firm.

5. Investment firms shall consider and be able to demonstrate that they have properly considered the use of TTCA in the context of the relationship between the client’s obligation to the firm and the client assets subjected to TTCA by the firm.

6. Where using TTCAs, investment firms shall highlight to clients the risks involved and the effect of any TTCA on the client’s assets.

Securities financing transactions and TTCAs

7. While some transactions permitted under Article 19 of the MiFID Implementing Directive may require the transfer of title, it shall not be possible to make use of Article 19 to effect arrangements that are prohibited under Article 16(10) of MiFID II.

Securities financing transactions and collateralisation

8. Investment firms shall adopt specific arrangements for retail and non-retail clients to ensure that the borrower of client assets provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of client assets.

Source: ESMA Technical Advice (December 2014), p. 75
Glossary

AIFMD: the EU Alternative Investment Managers Directive
BIS: the Bank for International Settlements
Commission: the European Commission
Council: the Council of the EU
ECJ: the European Court of Justice
ESMA: the European Securities Markets Authority
EU: the European Union
FCD: the EU Financial Collateral Directive
FSB: the Financial Stability Board
MiFID: the EU Markets in Financial Instruments Directive
MiFID2/MiFIR: the new EU directive and regulation replacing MiFID
Parliament: the European Parliament
SFT: securities financing transaction (which, under SFTR, includes corresponding commodities transactions)
SFTR: the recently agreed EU regulation on securities financing transactions
TTCA: title transfer collateral arrangements
UCITS directive: the EU directive on undertakings for collective investment in securities
SFTR - New rules on rights of reuse of collateral

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