

# Alert

## The SFT Regulation Comes into Effect on 12 January 2016

12 January 2016

### Background and Timing

Regulation (EU) 2015/2365 on Transparency of Securities Financing Transactions and of Reuse (the 'SFT Regulation') has been published in the EU *Official Journal* and applies from 12 January 2016. As an EU regulation, it applies directly in each EU Member State without the need for local implementing legislation.

### Scope

The SFT Regulation applies to securities financing transactions ('SFTs') and total return swaps ('TRSs'). An SFT, for these purposes, includes repo transactions, securities or commodities lending or borrowing, buy-sell back or sell-buy back transactions, and margin lending.

This *Alert* describes the provisions of the SFT Regulation that will be of particular relevance to alternative investment fund managers ('AIFMs') established in the EU, management companies of Undertakings for Collective Investment in Transferable Securities ('UCITS'), and firms that provide investment management services to alternative investment funds ('AIFs') and UCITS on a delegated basis (collectively, 'fund managers').

### Record Keeping

Article 4(4) of the SFT Regulation requires fund managers to keep a record of all SFTs entered into for their funds. The record-keeping requirements apply in respect of the conclusion, modification and termination of an SFT with effect from 12 January 2016. Fund managers should note that records must be kept for at least five years after an SFT transaction is terminated.

### Initial Investor Disclosure Obligations

Article 14 of the SFT Regulation sets out certain disclosure requirements in relation to SFTs and TRSs to be included in 'pre-contractual documents', defined as prior investor disclosures under Article 23(1) and (3) of the Alternative Investment Fund Managers Directive ('AIFMD'), and the UCITS prospectus. The rationale for requiring these additional disclosures is to ensure that investors in AIFs and UCITS understand and appreciate the inherent risks of SFTs and TRSs before they invest. The reference to Article 23 of AIFMD indicates that these disclosure obligations will apply only in respect of EU AIFs or those non-EU AIFs that are marketed to EU investors. The prior disclosure obligations will apply to all UCITS funds.

Funds launched on or after 12 January 2016 will be subject to these disclosure requirements (if applicable) with immediate effect or from the date when the AIFM makes a marketing notification.

Funds launched prior to the entry into force of the SFT Regulation will have until 13 July 2017 to comply with the new disclosure obligations.

Section B of the Annex to the SFT Regulation contains a detailed list of information to be disclosed, including:

- General description of the SFT and TRS used and the rationale for their use;
- Overall data for each type of SFT and total return swap, such as the type of assets that can be subject to them, and the maximum and expected proportion of the fund's assets under management that will be subject to them;
- Selection criteria for SFT and TRS counterparties (including legal status, country of origin and minimum credit rating);
- Description of acceptable collateral with regard to asset types, issuer, maturity, liquidity, diversification and correlation policies;
- Collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margin is used;
- Description of risks linked to SFTs and total return swaps and collateral management, including matters such as operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from the right of reuse of collateral;
- Description of how assets subject to SFT and TRS, and collateral received are safe-kept (e.g. with fund custodian);
- Description of any restrictions (regulatory or self-imposed) on the right of reuse of collateral; and
- Policy on the sharing of any return generated by SFTs and TRSs, including proportion of revenue paid to the fund, and costs and fees assigned to the manager and third parties (e.g. lending agent).

Article 14(3) empowers the European Securities and Markets Authority ('ESMA') to develop technical standards specifying the content of these disclosures in order to reflect any evolving market practices and to ensure uniform disclosure of data by fund managers. It is not clear when, if at all, such technical standards may be produced by ESMA.

Fund managers should consider whether the description of the investment policy, risk factors, custody arrangements and the fund's counterparties in the existing fund offer documentation include sufficient detail to address the new obligations and should prepare additional disclosures, as appropriate. It is not currently clear whether any changes to the above information could simply be disclosed to investors as an update to the fund offer documentation, or whether these changes would also need to be notified to the regulator, as in the case of the AIFMD leverage limits disclosure, for example.

### **Periodic Investor Disclosure Obligations**

The following information, specified in Section A of the Annex to the SFT Regulation, will need to be included in the AIF annual reports and UCITS half-yearly and annual reports published after 13 January 2017:

- Global data: (1) the amount of securities and commodities on loan as a proportion of total lendable assets; and (2) the amount of assets engaged in each type of SFT and TRS expressed both as an absolute amount and as a proportion of the fund's assets under management;
- Concentration data: (1) 10 largest collateral providers across all SFTs and TRSs (with a breakdown of volumes of the collateral received per provider); (2) top 10 counterparties for each type of SFT and TRS separately (name of counterparty and gross volume of outstanding transactions);
- Aggregate transaction data for each type of SFT and TRS separately broken down by: (1) type and quality of collateral; (2) maturity tenor; (3) currency; (4) maturity tenor of the SFTs and TRSs; (5) country where the counterparty is established; and (6) settlement and clearing (e.g. central counterparty cleared or bilateral).
- Data on reuse of collateral: (1) share of collateral received that is reused compared with the maximum limits specified in the initial disclosure made to investors; and (2) cash collateral reinvestment returns to the fund;
- Safekeeping of collateral received as part of SFTs and TRSs (e.g. with the fund custodian);
- Safekeeping of collateral granted as part of SFTs and TRSs (e.g. how the assets pledged as collateral will be treated by the prime broker or another counterparty); and
- Data on return and cost for each type of SFT and TRS.

As with the initial disclosure obligations above, ESMA may, in time, develop regulatory technical standards with further detail of the content of such reports. When preparing such regulatory technical standards, ESMA will be required to take account of the administrative burdens and the specific characteristics of the different types of SFT and TRS.

### Transaction Reporting

The SFT Regulation imposes an obligation to report SFTs to trade repositories and specifies that, in the case of AIFs and UCITS, the obligation to report falls on the manager (rather than on the fund, as the counterparty to an SFT). Fund managers will be able to delegate reporting to their counterparties.

Details of the information reported will be specified in the regulatory technical standards ('Reporting RTS') to be developed by ESMA in cooperation with the European Systemic Risk Board by 12 January 2017. The reporting start dates for each category of counterparty specified in the SFT Regulation will be dependent upon the date of the entry into force of the delegated act adopting the Reporting RTS. Fund managers will be subject to reporting 18 months following the entry into force of that delegated act.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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