ICMA
International Capital Market Association

Are you obliged to report under SFTR?

A checklist for non-European firms

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Introduction

SFTR is the **Securities Financing Transactions Regulation** of the EU. Among other things, it requires anybody within its scope to report:

- the conclusion, amendment and termination of every securities financing transaction (SFT);
- the details of each transaction and any changes; and
- the re-use of collateral

The reporting requirements started to apply on 13 July 2020, initially to sell-side firms, CCPs and CSDs and as of 12 October 2020 also to buy-side firms. Non-financial counterparties will have to start reporting in January 2021.[1]

Reports of transactions must be made to an authorized or recognized trade repository by T+1 and reports of collateral by S+1. SFTs include repurchase transactions and secured loans called repos, buy/sell-backs, securities lending and borrowing, commodities lending and borrowing, and margin lending. What this means is further explained in questions 3-6 below.

The "conclusion" of an SFT is taken to be the execution of a transaction, in other words, the creation of a contract by or on behalf of a principal. Some SFTs are executed by agents on behalf of principals. Agents have no reporting obligation. However, the task of reporting (but not the regulatory responsibility) can be delegated to an agent, either the executing agent or a third-party service-provider.

In the case of funds which are authorized or recognized in the EU as UCITS or Alternative Investment Funds (AIF), the regulatory reporting responsibility is delegated to the managers, who cannot contract out of this responsibility (mandatory delegation). In the case of a small EU non-financial entity transacting an SFT with an EU financial entity, there is mandatory delegation to the latter.

SFTR specifies that the reporting obligations apply to any financial or non-financial SFT counterparty that is either **established in the EU** or established in a third country, if the SFT is **concluded in the course of the operations of an EU branch** of that counterparty. The first two questions below explain in more detail what this means. Please note that the same reporting requirements apply in the UK post-Brexit. **The answers below should therefore be read accordingly for firms established or located in the UK**. In January 2021, after the end of the transition period, firms in scope of UK SFTR will report to a UK-authorised trade repository.

Further SFTR information and resources from icmagroup.org

Q1 Are you "established" in the EU?

Under SFTR Article 3(5), "established" means:

a. *if the counterparty is a natural person, where it has its head office;*

b. *if the counterparty is a legal person, where it has its registered office;*

c. *if the counterparty has, under its national law, no registered office, where it has its head office;*

If you are established within the jurisdiction of an EU member, you will have to report any SFTs which you have concluded as a principal, whether or not you have done so from within or from without the territory of a member of the EU.

You will therefore be subject to SFTR if you are a branch of an EU entity operating outside the EU, eg the Toronto branch of a bank incorporated in the Netherlands. And, of course, you will be subject to SFTR if you are a subsidiary incorporated in the EU.

1 Please note that this requirement only applies in the EU. Under the UK version of SFTR, the reporting obligations will not apply to non-financial counterparties, as the UK Government has clarified.

Q2 Are you located in the EU?

You may be subject to SFTR if you are a branch operating in the EU of an entity established outside the EU - so-called "third-country" branches, eg the Frankfurt branch of a bank incorporated in Singapore). There has been some confusion as to whether and when third-country branches are subject to SFTR but the final position of the regulator is that such branches fall outside the scope of SFTR if the transactions with which they have been involved (in any capacity, eg sales) are booked with the parent entity. It is up to parties to interpret the meaning of "booking" but it would seem to mean the allocation of risk.

In the case of investment funds authorized or recognized in the EU as Alternative Investment Funds (AIF), regulators have clarified that the location of the AIF itself determines whether the entity is in scope for SFTR reporting, not the location of the respective investment manager (AIFM).

Exclusions:

- Branches of non-EU legal entities involved in the transaction of SFTs which are booked with their non-EU parents.
- Managers (AIFM) established in the EU of AIFs located outside the EU.

Q3 Do you transact repos?

You may be subject to SFTR if you transact repos. Repos include:

- **"repurchase transactions"** or the same or similar transactions under other names (eg "classic repos");
- **"buy/sell-backs"** or the same or similar transactions under other names (eg "simultaneas", "PCT", "recompras", etc);[2] and
- transactions called "repos" but collateralized by a security interest such as a pledge rather than by the transfer of legal title to the "collateral" (eg Chinese "pledged repos").

Repos can be collateralized by securities, other financial instruments or commodities.

Exclusions

- Commodity repos do not have to be reported if they have commercial and non-financing objectives, in other words, if they are for industrial and operational purposes. Industrial purposes include "transportation and capacity needs". Operational purposes include:
  - Gas storage in line with "market practice" or to "industry standards" and including a sale and repurchase obligation.[3]
  - Transactions whereby the "quantity or characteristics" of the commodity to be repurchased are materially different to the commodity sold.
- Repos do not have to be reported if the counterparty is the ECB or an EU central bank (known collectively as members of the European System of Central Banks (ESCB)).

2 The definitions of repurchase transaction and buy/sell-back in SFTR are misleading. Among other things, SFTR defines a buy/sell-back as an undocumented SFT but the reporting requirements recognize that they are often documented. In practice, parties should report documented repos as repurchase transactions or buy/sell-backs on the basis of their own classification.

3 Note also that a repo against gas may also be reportable under SFTR by T+1 and, at the same time, under EU REMIT regulation by T+30.

Q4 Do you transact securities lending or borrowing?

You may be subject to SFTR if you transact securities lending and borrowing. This is the temporary transfer to another party of securities including the right to dispose of those securities. Temporary means the agreement is either (1) for a fixed term agreed by the parties or (2) is open-ended and allows either party to terminate the "loan" by giving due notice. As part of the loan agreement, the borrower of the securities or other financial instruments is obliged to return the same or similar ("equivalent") assets. Securities loans can be uncollateralized but are usually collateralized by:

- securities or other financial instruments to which legal title is transferred;
- cash; or
- a security interest such as a pledge.

Exclusions

Securities lending and borrowing with a member of the ESCB (as explained under Q1).

Q5 Do you transact commodities lending or borrowing?

You may be subject to SFTR if you transact commodities lending and borrowing. This is the temporary transfer to another party of a commodity and the right to dispose of that commodity, either (1) for a fixed period agreed by you and the other party or (2) subject to either party terminating the "loan" by giving due notice. As part of the loan agreement, the borrower of the commodities is obliged to return the same or similar ("equivalent") assets.

Commodities loans are usually collateralized by:

- securities or other financial instruments to which legal title is transferred;
- cash; or
- a security interest such as a pledge.

Exclusions

Commodity securities lending and borrowing for operational and industrial purposes falls outside SFTR (as explained under Q1).

Q6 Do you engage in margin lending?

You may be subject to SFTR if you are involved in margin lending. This is defined as "transactions in which an institution extends credit in connection with the purchase, sale, carrying or trading of securities" but "does not include other loans that are secured by collateral in the form of securities". Collateralization is by a pledge of the borrower's securities. Margin lending essentially covers only "cash lending from prime brokers to their clients against collateral as part of a prime brokerage agreement".[4 5] However, this is a very broad definition and has had to be narrowed.

Exclusions

- Margin lending to retail and private clients, including *"Lombard loans and other forms of private banking"* to high net-worth individuals or *"legal structures built to optimize their investments"* but excluding autonomous trusts.[6 7]
- The wholesale financing of non-financial entities, not to make a profit on the securities, but *"where all or part of the proceeds of the loan is used to acquire shares in companies, or refinance previous loans made for those purposes"*, for example, in mergers and acquisitions, corporate restructuring, investing in infrastructure and other forms of syndicated corporate lending.[8] Reference is also made to the "financing of shares in unlisted companies in the context of privately negotiated transactions (infrastructure transactions, financing for the purchase of a group of subsidiaries, intra-group reorganization activities)" as well as the syndicated loans and other corporate loans used for the "financing of shares in listed companies in the context of public transactions (mergers and acquisitions)" and other corporate actions such as "joint ventures, spin-offs and carve-outs, divestiture, reduction of capital, share buy-backs", where the purchase or sale of securities, in contrast to an SFT, is "to gain or reduce ownership of a business" for "a (non-financial) commercial purpose" and seeking to "directly influence the decision-making of the issuer of the security".
- The use by custodians of liens to secure their daylight exposure through "intraday credit/overdraft facilities" that are sometimes offered as part of the "fails-curing" programmes to clients arising from settlement.

4 A 'prime broker' is defined as *"a credit institution, a regulated investment firm or another entity subject to prudential regulation and ongoing supervision, offering services to professional investors primarily to finance or execute transactions in financial instruments as counterparty and which may also provide other services such as clearing and settlement of trades, custodial services, securities lending, customised technology and operational support facilities"*.

5 Prime brokerage margin lending is described as taking place *"on a portfolio basis, against a pool of collateral, by (re)using assets in the client's margin account as collateral. Clients may deposit or draw cash in different currencies from their account, implying that prime brokers may have simultaneous cash credits and debits with each client on their balance sheet. Margin lending is synonym of net cash debit in base currency, i.e. when the sum of cash debits and credits converted into the main currency of dealings with each client falls below zero. Margin loans may be extended and paid back several times per day, as real-time cash balances switch from positive to negative as a result of other prime brokerage services, such as securities dealing on behalf of clients. Therefore, margin lending is different from other SFTs, as there is no transaction settlement or central clearing. Every day, clients receive information from their prime broker(s) about their exposures, short market value, estimated collateral re-use, margin requirements and margin financing, on a net position basis."*

6 Such lending is seen as typified by a lack of the master agreements associated with SFTs and governed by instead by general consumer credit law. It is believed to be used typically for payments unrelated to the initial investments, including consumption, and of much longer duration than most SFTs.

7 In an autonomous trust, the trustors may be personally liable for some debts incurred by the trustees on behalf of the trust.

8 ESMA's Final Report implies the wholesale exclusion of non-financial entities. It says that SFTR applies only to *"prime brokerage margin lending, i.e. cash lending from prime brokers to their clients against collateral as part of a prime brokerage agreement"* (para.186), *"whereby a financial entity (usually an investment fund) borrows money from a prime broker…as part of a prime brokerage agreement, with some or all of the assets and collateral received from other transactions held by the prime broker used as collateral to secure the margin loan and the short market value"* (para.299).

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