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EU proposal to bring transparency to SFTs | Reporting to trade repositories - the story continues

Firms that engage in securities lending and repos, referred to as securities financing transactions (SFTs), will face EMIR-like reporting requirements and stricter rules on rehypothecation under a proposal published today by the European Commission. Investment funds will also be subject to increased disclosure requirements. The proposal is designed to enhance transparency and forms part of a wider package of reforms to address the risks posed by shadow banking. It has been published alongside a proposal on structural reform for banks, reflecting concerns from the Commission that structural separation measures might lead to banks shifting parts of their activity into the less-regulated shadow banking sector.

The proposal is the latest in a long line of regulatory initiatives seeking to increase transparency and reaffirms trade repositories as an important part of the market infrastructure. Firms that are getting to grips with European Market Infrastructure Regulation (EMIR) reporting requirements will have a sense of déjà vu and will need to consider the new challenge of SFT reporting. However, it seems that the Commission has learned some lessons from EMIR, by clarifying how the rules apply to branches in and outside the EU and where liability lies under delegated reporting.

**Key proposals**

**Scope**

Under the proposals, the Regulation will apply to all counterparties engaging in SFTs and rehypothecation (i.e. the use of client or counterparty assets provided as collateral). Investment funds as defined in the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and the Alternative Investment Fund Managers Directive (AIFMD) will be subject to additional disclosure requirements.

**Reporting to trade repositories**

Intended to draw on existing infrastructure and processes already being developed as part of EMIR implementation, counterparties will be required to report SFT transactions to trade repositories on a T+1 basis. Some historical trades will also be captured. While the exact detail, format and frequency of reports will be developed by the European Securities and Markets Authority (ESMA), reported information will include the parties to the SFT, the collateral used, the repo rate or lending fee, whether the trade has been rehypothecated, the
haircut and relevant dates. Reporting could be delegated. Regulators and the market have been surprised by the hesitancy of firms to offer a delegated reporting service to help their clients meet the EMIR reporting requirements. However, specifying that any enforcement action would fall on the counterparty as opposed to a firm that undertakes delegated reporting may lead to a different outcome for SFTs.

**Transparency requirements for investment funds**

In order to increase investor awareness of the risks associated with SFTs, management companies of UCITS, UCITS investment companies and AIFMs will need to disclose additional information to investors about their use of SFTs, as well as other financing structures, over and above current requirements under the AIFMD and the UCITS Directive. The mechanism for investor disclosure is via the prospectus or other pre-investment documentation and within annual reports. This will require a wholesale repapering of prospectus documentation and is likely to drive up the complexity of annual reports.

**Rehypothecation**

While it provides liquidity and can reduce funding costs, the Commission is concerned that the practice of rehypothecation can create complex collateral chains between the traditional and shadow banking sectors. Stricter rules on rehypothecation seek to address some of these concerns, setting out that counterparties that receive financial instruments as collateral will only be permitted to rehypothecate them with the express consent of the providing counterparty, once they have been informed of the inherent risks, and only after the collateral has been transferred to the counterparty’s account.

**What’s next?**

The proposed Regulation will pass to the European Parliament and Council for negotiation and adoption. Progress is likely to be relatively slow in the short term due to the existing pipeline of initiatives and European Parliament elections in May. The implementation timeline is difficult to predict at this stage, but entry into force before 2015 would be ambitious. The reporting requirements would apply 18 months after entry into force and the investment fund disclosure requirements would apply six months after entry into force.

While we need to wait for the full story on SFT regulatory reform to become clear, firms need to keep this initiative well and truly on their radar, including monitoring work at the international level expected later this year.

We trust this information is of assistance and remain at your disposal for any further questions.

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