

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Circular to the Financial Services Industry on the Securities Financing Transactions Regulation N° 2015/2365 ('SFTR' or 'the Regulation')

Requirements affecting, inter alia, Managers of UCITS and AIFs

[1.0] Introduction - The Securities Financing Transactions Regulation

The SFTR was published in the Official Journal of the European Union on 23 December 2015 and came into force on 12 January 2016. Upon the coming into force of the Regulation, only a limited number of obligations became applicable, with the other obligations being periodically phased-in. The SFTR is directly applicable in all EU member states and member states do not need to adopt national rules to give effect to its requirements.

The SFTR requires the European Securities and Markets Authority ('ESMA') to develop detailed rules on reporting to trade repositories through regulatory technical standards ('RTS') and implementing technical standards ('ITS').

On the other hand, ESMA's empowerment to draft RTS relating to transparency of UCITS and AIFs in periodical reports and pre-contractual documents, is optional.

[2.0] What are Securities Financing Transactions?

Securities financing transactions ('SFTs') are transactions whereby securities are used to borrow cash, or vice versa. In each SFT, ownership of the securities provisionally changes in return for cash, and similarly the cash temporarily changes ownership. At the end of an SFT, the change of ownership for the securities and for the cash reverts to its original owner, and both counterparties get back what they possessed prior to the SFT. In this regard, SFTs act like collateralised loans.

The SFTR defines SFTs as:

- Repurchase transactions for securities, commodities and guaranteed rights
- Lending and borrowing transactions on securities and commodities
- Buy-sell backs and sell-buy backs of securities, commodities and guaranteed rights
- Margin lending transactions – extending credit in connection with the purchase, sale, carrying or trading of securities – but not other loans secured by collateral in the form of securities

The recitals to the SFTR indicate that SFTs include 'liquidity swaps' and 'collateral swaps' where they are not derivative contracts as defined in EMIR¹. SFTs under the SFTR do not include any derivatives contract as defined in EMIR.

[3.0] Requirements under the SFTR

The main aim of the SFTR is to increase the transparency of SFT markets, which are not currently covered through other European regulations. The SFTR covers three key requirements: collateral reuse obligations, disclosure requirements and transaction reporting requirements.

[3.1] Reuse of Collateral

All counterparties (including non-financial counterparties) will have the right to reuse financial instruments received as collateral under a security or title transfer collateral arrangement, provided that the conditions imposed by the SFTR on the right to reuse financial instruments provided as collateral are satisfied. The requirements relating to the reuse of collateral have become applicable from 13 July 2016.

[3.2] Disclosure Requirements for UCITS and AIFs

The SFTR requires managers of UCITS and managers of AIFs (AIFMs) that are authorised in the EU, to make detailed disclosure of their funds' use of SFTs and total return swaps through:

- a. Pre-contract disclosure: disclosure of the information set out in Section B of the Annex to the SFTR in the prospectus required under the UCITS Directive or the pre-contractual documents required under the AIFMD. These requirements are applicable from 13 July 2017 for collective investment undertakings constituted before the date of coming into force of the SFTR (12 January 2016). For collective investment undertakings constituted after the date of coming into force of the SFTR, this requirement is applicable from the date of their constitution.
- b. Periodic reports: disclosure of the information set out in Section A of the Annex to the SFTR in the six monthly and annual reports required under the UCITS Directive or the annual report required under the AIFMD. These requirements have become applicable from 13 January 2017.

[2.2.1] Disclosure Requirements – Pre-contractual Documents

Article 14 of the SFTR requires UCITS management companies and AIFMs authorised under the AIFMD to specify in their pre-contractual documents the Securities Financing Transactions

¹ Regulation (EU) N° 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories

(‘SFTs’) and total return swaps they are authorised to use and to include a clear statement that those transactions and instruments are used.

Therefore, according to the SFTR, a collective investment undertaking’s investment policy with respect to SFTs and total return swaps should be clearly disclosed in the pre-contractual documents, such as the prospectus for UCITS and the pre-contractual disclosure to investors for AIFs. This should ensure that investors understand and appreciate the inherent risks before they decide to invest in a particular UCITS or AIF.

In terms of Section B of the Annex to the SFTR, the following information shall be included in the UCITS Prospectus and AIF disclosure to investors:

- General description of the SFTs and total return swaps used by the collective investment undertaking and the rationale for their use;
- Overall data to be reported for each type of SFTs and total return swaps;
- Types of assets that can be subject to them;
- Maximum proportion of Assets Under Management (‘AUM’) that can be subject to them;
- Expected proportion of AUM that will be subject to each of them;
- Criteria used to select counterparties (including legal status, country of origin, minimum credit rating);
- Acceptable collateral: description of acceptable collateral with regard to asset types, issuer, maturity, liquidity as well as the collateral diversification and correlation policies;
- Collateral valuation: description of the collateral valuation methodology used and its rationale, and whether daily mark-to-market and daily variation margins are used;
- Risk management: description of the risks linked to SFTs and total return swaps as well as risks linked to collateral management, such as operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from its reuse;
- Specification of how assets subject to SFTs and total return swaps and collateral received are safe-kept (e.g. with fund custodian);
- Specification of any restrictions (regulatory or self-imposed) on reuse of collateral;
- Policy on sharing of return generated by SFTs and total return swaps: description of the proportions of the revenue generated by SFTs and total return swaps that is returned to the collective investment undertaking, and of the costs and fees assigned to the manager or third parties (e.g. the agent lender). The prospectus or disclosure to investors shall also indicate if these are related parties to the manager.

The Authority would like to clarify that an authorised fund manager of a UCITS scheme or a non-UCITS retail scheme that does not use SFTs or total return swaps is not required to include the abovementioned information in the prospectus or other pre-sale documents.

[2.2.2] Disclosure Requirements – Periodic Reporting

Article 13 of the SFTR also requires UCITS management companies and AIFMs authorised under the AIFMD to inform investors, in the annual and half-yearly reports for UCITS and in the annual report for AIFs, about the use they make of SFTs and total return swaps.

Kindly note that an authorised fund manager of a qualified investor scheme that has not used SFTs or total return swaps during the relevant annual accounting period is not required to include the information required by Article 13 of the SFTR, in its reports.

Therefore, a scheme which does not use SFTs and total return swaps, and which is not required to disclose its use of SFTs in its pre-contractual documents as required by Article 14 of the SFTR, need not make the disclosure required under Article 13 of the SFTR.

Similarly, if a scheme normally uses SFTs and total return swaps and has made a disclosure to this effect in its pre-contractual document in accordance with Article 14 of the SFTR, a disclosure under Article 13 would not be required if for that particular reportable period their SFTs would be nil.

The Authority requires the SFTR report (when required) to be inserted into the UCITS and AIFs audited financial statements. The information which shall be provided in the UCITS half-yearly and annual reports and the AIF's annual report is contained in Section A of the Annex to the SFTR.

[3.3] Transaction Reporting

The Regulation will require both parties to a trade (whether they are financial or non-financial counterparties) to report new, modified or terminated SFTs to a registered or recognized trade repository by T+1 and must maintain records of SFTs for at least five years following the termination of the transaction.

Contacts

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