Matheson

ESMA Statement On Phase 1 Reporting Under SFTR

Counterparties to a repurchase transaction, a securities or commodities lending or borrowing transaction, a buy-sell back or sell-buy back transaction or a margin lending transaction (a securities financing transaction, or "**SFT**") must ensure the necessary systems are in place for future compliance with the Securities Financing Transactions Regulation ((EU) 2015/2365) ("**SFTR**"), which aims to increase transparency in respect of securities financing markets. Obligations under SFTR start to come into force from 13 April 2020.

Although lessons have been learned by the industry and regulators from the implementation of similar reporting obligations in the past such as EMIR, SFTR goes further than previous regulations in terms of the extensive range of reference data required to be reported.

COVID-19 Statement

As a result of the COVID-19 pandemic, ESMA issued a Public Statement to ensure coordinated supervisory actions on the application of SFTR. ESMA expects competent authorities not to prioritise their supervisory actions towards entities subject to SFT reporting obligations as of 13 April 2020 until 13 July 2020. ESMA also expects trade repositories to be registered sufficiently ahead of the next phase of the reporting regime, namely 13 July 2020. On 26 March 2020 ESMA issued a revised Public Statement clarifying that this expectation on competent authorities also applies to SFTs concluded between 13 April 2020 and 13 July 2020 and SFTs subject to backloading under SFTR. ESMA also expects trade repositories to be registered sufficiently ahead of the next phase of the reporting regime, namely 13 July 2020.

Background – Obligations Under SFTR

Under SFTR, the requirement on financial counterparties ("**FCs**") and non-financial counterparties ("**NFCs**") to report details of an SFT is being implemented in stages depending on the status of the relevant counterparty, with phase 1 in respect of banks and investment firms originally applying from April. The obligation will then successively be extended in respect of central counterparties and central securities depositories from July 2020 (phase 2); remaining FCs (including insurance or reinsurance firms, UCITS, AIFs and pension schemes) and third country entities from October 2020 (phase 3); and NFCs from January 2021 (phase 4).

Where an FC enters into an SFT with an NFC that is considered a small or medium sized entity (an "**SME NFC-**") for accounting purposes, the FC will be responsible for reporting the trade details for both parties. As the reporting obligation on NFCs under SFTR is not due to come into force until January 11 2021, however, the FC will not be required to report on behalf of an SME NFC- before then. If an SFT is between an FC and an NFC (excluding an SME NFC-), both counterparties are mandatorily obliged to report, but it is possible for the NFC to delegate reporting to its FC counterparty.

SFTR reporting applies extraterritorially in two situations: (i) when a non-EU branch of an EU entity enters into an SFT and (ii) when an EU branch of a third-country entity enters into an SFT.

The International Capital Markets Association ("**ICMA**") anticipates that once the phase 1 implementation goes live in April, banks' resources may be stretched trying to sort out any issues with their own reporting procedures and may be less able to assist phase 3 clients with their preparations. ahead of the phase 3 implementation deadline in October. It is therefore important for such phase 3 entities (including investment funds) to begin thinking about compliance with the reporting obligation sooner rather than later.

ICMA recommends that market participants involve their legal teams as well as their operational teams in implementing reporting procedures, in order to ensure that the procedures put in place at an operational level properly reflect the contractual structure of the relevant trades and comply with the requirements of SFTR.

Guidance

Level 3 guidance was published by the European Securities and Markets Authority ("**ESMA**") in January 2020. ESMA may issue Q&A addressing other questions after the phase 1 implementation date in April.

ICMA published its best practices guide (the "ICMA Guide"), with a view to setting out common best practice in the repo industry and to thereby:

- ensure that trades are reported in the same way by both counterparties (minimising the number of reporting mismatches);
- serve as a point of reference for ops teams, and assist in resolving disputes about how trades should be reported; and
- assist less experienced market participants in complying with the reporting requirements.

The contents of the ICMA Guide are not definitive, but may be updated and revised in future based on industry experience and dialogue with regulators. There are still a number of outstanding questions not addressed in the guidance, and ICMA continue to liaise with ESMA and the national competent authorities ("**NCAs**") about these.

Specific Issues

a) Collateral

The trade report in relation to SFTs set out in the Annex to the SFTR technical standards (Commission Delegated Regulation (EU) 2019/356) not only contains fields for the amount of collateral being provided, but also the quality of the collateral, information on the issuer of the collateral if securities are used and details on the reuse of such collateral. In accordance with Article 4 of the SFTR RTS, it is the counterparty receiving the collateral that is expected to complete the relevant fields of the trade report relating to collateral reuse.

The extensive collateral reporting requirements under SFTR arose due to a concern that collateral is often used multiple times resulting in 'complex collateral chains', posing a risk to financial stability. By increasing transparency, it is hoped that this risk can be mitigated and confidence of counterparties to trades can be increased, especially in instances of bankruptcy.

b) Unique Transaction Identifiers ("UTIs")

One key operational issue that still needs to be resolved is how UTIs will be generated and shared in an efficient manner. Agreeing on a standard approach is likely to be very important to ensuring a smooth implementation of the reporting obligation.

c) Legal Entity Identifiers ("LEIs")

There are questions around how to report trades where the underlying instrument has no ISIN, or the underlying issuer has no LEI. ESMA has stated that, as a temporary measure, it will allow trade reports which do not include an LEI for the underlying issuer, only where the underlying issuer is a third-country issuer and has no LEI. This measure will remain in place until 13 April 2021.

d) International Securities Identification Numbers ("ISIN")

ESMA has granted no such relief in respect of underlying securities which do not have an ISIN. As such, market participants will need to be pro-active in ensuring that any securities underlying their repo trades have ISINs in advance of the relevant reporting implementation deadline.

e) Back-reporting

SFTR includes a 190 day grace period for back-reporting in-scope trades outstanding on the relevant phase-in date. The best practice as recommended by ICMA is to avail of the 190 day grace period set out in SFTR. A minority of market participants have stated that they would prefer to back-report trades on the date of the relevant implementation phase (effectively foregoing the 190 day grace period). This is permissible, but such market participants should agree this approach with their counterparties to ensure that such trades are reported in a uniform manner and there are no mismatches.

f) Existing Trades

ICMA's position is that partially closing a trade is effectively a modification of an existing trade, rather than a new trade, and therefore does not require a new UTI.

Re-allocating a trade to a new counterparty would constitute a new trade and would need to be reported as such, with a new UTI.

Conclusion

As noted above, it is vital that parties prepare well in advance to meet their obligations, noting carefully the timeframe applicable to their market sector.

For further information, please contact Christian Donagh, Richard Kelly or your usual Matheson contact.