EU SFTR Investor Transparency and Disclosure Requirements: Implications for Investment Fund Managers

The EU Securities Financing Transactions Regulation (the SFTR) came into force on January 12, 2016. In this Update we focus on the implications for investment fund managers, as regards additional investor disclosure and transparency reporting requirements, some of which may apply now. There are other disclosure requirements between counterparties in relation to reuse of financial instruments received under certain contracts common in the financial markets. Such requirements will be the subject of another Update.

Background

The SFTR forms part of the broader drive at EU level to provide greater transparency on activities broadly categorized as “shadow banking.” The proposal giving rise to the SFTR was first adopted in January 2014 but can be traced back to the EU action plan on shadow banking published in September 2013. The SFTR’s main purported function is to shine a torch on certain types of transactions which EU policy makers believe may pose a high level of systemic risk. Specifically, the SFTR sets out requirements to achieve additional market transparency on various types of “securities financing transactions” (SFTs) including securities and commodities lending, margin lending and repos. In addition, total return swaps (TRS) are caught by certain disclosure requirements. As noted above, the SFTR also sets out specific disclosure and consent requirements in relation to the reuse of non-cash collateral (e.g. bonds). This increased transparency is intended to promote more effective market supervision and enable regulators and investors alike to identify and mitigate related risks.

Scope Affecting Investment Fund Managers

When Do the SFTR Requirements Apply?

The SFTR will be implemented in a staged manner in the period from January 12, 2016 to early 2019.

Certain aspects of the SFTR require further detailed rules to be published by the European Securities and Markets Authority (ESMA) in the form of regulatory technical standards (RTS) and implementing technical standards (together, so-called Level 2 measures). On March 11, 2016, ESMA issued its first consultation on its proposed trade reporting RTS (the Trade Reporting RTS Consultation), with final rules estimated to be issued in January 2017. Like all EU regulations (as opposed to EU directives), the SFTR is directly applicable and is not required to be transposed into the local law of each EU member state.
Which Types of Investment Fund Are in Scope of the Investor Disclosure Requirements?

Certain types of investment funds are caught by the SFTR, these are:

- alternative investment funds (AIFs) managed by alternative investment fund managers (AIFMs) authorized or registered in accordance with the Alternative Investment Fund Managers Directive (the AIFMD); and
- UCITS or, where relevant, their management companies.

Are Non-EU Investment Fund Managers Caught by the Investor Disclosure Requirements Described in This Update?

Non-EU AIFMs and their AIFs should not be directly caught by the SFTR disclosure requirements described in this Update. This is due to the fact that in order to be caught within scope, an AIFM would need to be authorized or registered under the AIFMD. For the time being only EU AIFMs are capable of being “authorized” or “registered” under the AIFMD. Absent any further guidance from the European Commission or ESMA to the contrary and despite the fact the language of the SFTR is not entirely clear, it is generally considered that these particular disclosure requirements of the SFTR do not apply to AIFs managed by non-EU AIFMs who have taken steps to comply with individual EU member state private placement marketing regimes pursuant to Article 42 of the AIFMD.

However in the context of UCITS that appoint non-EU investment sub-advisors, it is possible that, although such sub-advisors are not directly in scope under SFTR, the UCITS (or its management company) will in practice seek to require its non-EU sub-advisors to provide information to facilitate the disclosure of the necessary information to investors. Accordingly, non-EU sub-advisors who are currently involved in a UCITS platform structure may wish to consider engaging with the UCITS (or its management company) early on to understand what may be required of them in this regard.

Disclosure and Transparency Requirements for Investment Fund Managers

For fund managers that are within scope, the main SFTR transparency and disclosure requirements are as follows:

- **Now**: pre-contractual disclosure requirements in respect of SFTs and TRS apply pursuant to Article 14 and Section B of the Annex to the SFTR in respect of every fund which is a UCITS or an AIF formed after January 12, 2016 and which is managed by an authorized or registered AIFM.

- **January 2017**: periodic reporting requirements commence for in-scope investment funds, pursuant to Article 13 and Section A of the Annex to the SFTR. UCITS are required to include the relevant information in

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1 An AIF is any kind of investment fund that is not a UCITS. This would include (i) private funds such as hedge funds and private equity funds, including where such funds are formed outside of the EU irrespective of whether such funds are marketed in the EU, and (ii) mutual funds that are not UCITS, such as U.S. registered investment companies.

2 AIFs with non-EU AIFMs may well be subject to disclosure requirements between counterparties in relation to reuse of financial instruments. Such requirements will be the subject of another Update.

3 At some point in the future, provided certain provisions of the AIFMD are activated by the Commission, certain non-EU AIFMs will be able to apply to become fully authorized under the AIFMD. At that point, such non-EU AIFMs will become subject to the SFTR requirements.
their semi-annual and annual reports, whilst in-scope AIFMs are required to include such information in their annual reports.

- **July 2017**: pre-contractual disclosure requirements in respect of SFTs and TRS apply pursuant to Article 14 and Section B of the Annex to the SFTR in respect of every fund which is a UCITS or an AIF formed before January 12, 2016 which is managed by an authorized or registered AIFM.

It is worth noting that the disclosure requirements imposed by Article 14 and Section B of the Annex to the SFTR are intended to be included by UCITS in their prospectuses, and by in-scope AIFMs as part of the pre-investment disclosures required under Article 23 of the AIFMD. In the latter case, this would seem to give AIFMs the latitude to make the required disclosures outside of the main offering documentation, if they so wished.

A copy of the Annex which sets out the information required to be disclosed under the disclosure requirements referred to above, is appended to this update for reference. The information required under Section A of the Annex is particularly granular and likely to require considerable time and effort to compile and report. The disclosure requirements of Section B of the Annex are more generic and should in practice be somewhat easier to comply with.

The disclosure requirements under Article 14 and Section B of the Annex appear to afford AIFMs the ability to adopt a fairly flexible form of high level disclosure wording, bearing in mind that the main purpose of the disclosure is to “ensure that investors understand and appreciate the inherent risks before they decide to invest in a particular UCITS or AIF” (Recital 20 to the SFTR). This is also on the basis that investors will receive more granular information via the transparency requirement under Article 14.

Note that ESMA has the right, although no obligation, to issue Level 2 measures in relation to the application of both Sections A and B of the Annex. In the Trade Reporting RTS Consultation, ESMA has indicated that for the time being it is not intending to issue any such additional Level 2 measures.

**Looking Ahead**

Shadow banking remains a central focus for EU financial services policy makers, and the SFTR may be regarded as a step towards an emerging regulatory framework for enhanced transparency and risk mitigation in this area. For the time being, investment fund managers should be aware of the key phases of the SFTR’s implementation and understand the key requirements, some of which may require significant planning.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work, or

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ANNEX

Section A – Information to Be Provided in the UCITS Half-Yearly and Annual Reports and the AIF’s Annual Report

Global Data:
- the amount of securities and commodities on loan as a proportion of total lendable assets defined as excluding cash and cash equivalents; and
- the amount of assets engaged in each type of SFTs and TRS expressed as an absolute amount (in the collective investment undertaking’s currency) and as a proportion of the collective investment undertaking’s assets under management (AUM).

Concentration Data:
- ten largest collateral issuers across all SFTs and TRS (break down of volumes of the collateral securities and commodities received per issuer’s name); and
- top 10 counterparties of each type of SFTs and TRS separately (name of counterparty and gross volume of outstanding transactions).

Aggregate Transaction Data for Each Type of SFTs and TRS Separately to Be Broken Down According to the Below Categories:
- type and quality of collateral;
- maturity tenor of the collateral broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open maturity;
- currency of the collateral;
- maturity tenor of the SFTs and TRS broken down in the following maturity buckets: less than one day, one day to one week, one week to one month, one to three months, three months to one year, above one year, open transactions;
- country in which the counterparties are established; and
- settlement and clearing (e.g.: tri-party, Central Counterparty, bilateral).

Data on Reuse of Collateral:
- share of collateral received that is reused, compared to the maximum amount specified in the prospectus or in the disclosure to investors; and
- cash collateral reinvestment returns to the collective investment undertaking.
Safekeeping of Collateral Received by the Collective Investment Undertaking as Part of SFTs and TRS:
- number and names of custodians and the amount of collateral assets safe-kept by each of the custodians.

Safekeeping of Collateral Granted by the Collective Investment Undertaking as Part of SFTs and TRS:
- the proportion of collateral held in segregated accounts or in pooled accounts, or in any other accounts.

Data on Return and Cost for Each Type of SFTs and TRS:
- broken down between the collective investment undertaking, the manager of the collective investment undertaking and third parties (e.g. agent lender) in absolute terms and as a percentage of overall returns generated by that type of SFTs and TRS.

Section B – Information to Be Included in the UCITS Prospectus and AIF Disclosure to Investors:
- general description of the SFTs and TRS used by the collective investment undertaking and the rationale for their use;
- overall data to be reported for each type of SFTs and TRS:
  - types of assets that can be subject to them;
  - maximum proportion of AUM that can be subject to them; and
  - 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 TRS 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 TRS and collateral received are safe-kept (e.g. with fund custodian);
- specification of any restrictions (regulatory or self-imposed) on reuse of collateral; and
- policy on sharing of return generated by SFTs and TRS: description of the proportions of the revenue generated by SFTs and TRS 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.
Sidley Investment Funds Practice

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (i.e., mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds and their boards, as well as investment advisers to funds and other investment products and accounts, under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, commodities, funds and advisers, including the Dodd-Frank Act, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 120 lawyers in New York, Chicago, London, Hong Kong, Singapore, Shanghai, Tokyo, Los Angeles and San Francisco.

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