LEGAL OPINION

SFTR and « re-use »

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Like other international authorities such as the Financial Stability Board* , the European Commission raised the issue of the involvement of various unregulated operators in the development of the global financial crisis of 2008, in the context of financing economic operators (commercial or industrial companies), as well as banking or financial industry operators.

Certain transactions conducted by those operators attracted particular attention for having played a central role in the excessive indebtedness within the financial sector. A certain number of transactions were identified, such as temporary transfers of securities (delivered repos or securities lending), for which transparency rules have been proposed in a draft regulation dated January 29th, 2014 (the SFTR Proposal)**. Beyond this, re-uses of securities given as guarantee by the beneficiaries of such guarantees drew particular attention of the European authorities. The Commission and the European Central Bank (ECB) pointed out the fact that this practice, which has the effect of generating dynamic chains of collateral where the same security is lent several times, contributes to increase the leverage's level and strengthens the pro-cyclic nature of the financial sector. As a result the financial sector becomes vulnerable to «runs» and to unpredictable and sudden movements of leverage's reduction. These authorities stressed that the lack of transparency of these operations, which makes it difficult to identify the property rights («who owns what?»), the monitoring of risks concentration and the identification of the counterparties («who is exposed to who?»).***

The authorities emphasized the consequences of the use by creditors of the assets granted as security for the purposes of reducing financing costs. Such reallocation creates complex chains which have the effect of causing uncertainty as to the risks undertaken by each operator of those chains, in particular the risks undertaken by the original debtor.

** Global shadow banking monitoring report 2013, 14 November 2013.*

*** Proposal for a regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions (2014/0017 (COD)).*

**** Communication of the Commission to the Council and the European Parliament COM(2013) 614 final and ECB, SRC/2014/38 May 28th 2014).*

The bankruptcy of Lehman Brothers has highlighted issues in identifying (i) what rights (in particular right of use) have been recognized to certain creditors benefiting from guarantees on financial instruments, (ii) whether those rights had been exercised or not and (iii) who, at the end, was the owner of these financial instruments encumbered with such right.*

Under French law (as in many civil law jurisdictions within the European Union which have adopted a conception of the property inherited from Roman law), the issue of the re-use of the securities transferred by way of security by the beneficiary of the security is a particularly sensitive issue, and French securities law is not fashioned in a way that fits properly with the right of use provided under the Directive on financial collateral arrangements.

French securities law is based on two fundamental principles:

• he registration in an account constitutes the financial security (thus, it is not a mere proof of ownership),

• the securities account holder has a right of ownership of the securities credited to his account.

As a result :

• on the one hand, a financial security cannot be credited simultaneously to two securities accounts and,

• on the other hand, while the owner of a securities account may dispose without restriction of the securities credited to the securities account, he cannot dispose of securities which are not credited to his account since he does not own them.

The «re-use» of the securities by the beneficiary of the guarantee does not raise any issues where the ownership of the securities has been transferred as collateral**. Strictly speaking, it is not a 're-use' but merely the exercise, by the beneficiary of the guarantee, of his ownership's rights on the securities. In practice, the security is debited from the account of the guarantor, then credited on the account of the beneficiary who, as owner of the security, may in turn dispose of it, provided that he returns to the guarantor an equivalent security on the agreed term. The system is perfectly secure, legal effects are known, and the identification of the owner of the security results from the location of that security.

The situation is different where the beneficiary has only a pledge over the securities. The Directive on financial collateral arrangements (so-called «collateral») recognises, in favor of the beneficiary, a right of re-use of the pledged securities, which is legally unknown of French law and of most of the civil law jurisdictions and which is, in practice, difficult to implement.

** Refer to recital 27 of the SFTR Proposal.*

*** Nor does it cause more difficulties when it comes to the right of the borrower of the titles or the beneficiary of a delivered repo, holders of an ownership right on the securities delivered on the execution of the contract.*

Legally, the use could only be a «re-pledging» since the beneficiary of the guarantee may not have more rights than he is entitled to. The practice did not follow this path. It has bypassed the difficulty by using securities lending: the guarantor lends securities to the beneficiary of the pledge, the loan transfers the ownership of the securities to the beneficiary who can then freely use them ; the lender/pledgor account is debited and correlatively, the borrower/beneficiary's account is credited.

In this context, the HCJP has analyzed with particular attention Article 15 of the draft SFTR Regulation which refers to the conditions of exercise by a creditor of the right to use the securities which were transferred as guarantee.

Article 15.1 of the SFTR Proposal provides that the right of «re-hypothecation»* of financial instruments may be granted if (i) the counterparty providing the guarantee (in fact, the assets constituting the guarantee) has been informed of the risks arising from the granting of such right of «re-hypothecation» and (ii) this counterparty gave a prior express consent by signature to such right recognised in favor of the beneficiary of the «re-hypothecation» right. Moreover, Article 15.2 provides that the effective exercise of the right of «re-hypothecation» is subject to the dual condition of: (i) compliance with the agreement entered into on that particular issue and (ii) the credit of the financial instruments to the account of the beneficiary of the guarantee. Finally, Article 15.3 indicates that the provisions governing the «re-hypothecation» do not affect the European sectorial rules which may be more stringent on such possibility (for example by prohibiting it), explicitly mentioning the UCITS and AIFM directives.

This Article, and the amendments recently proposed by members of the European Parliament, which tend in particular to the removal of Article 15.2, raise the following comments with regards to the consequences under French law and under the European legislation.

1° The scope of Article 15 of the draft of Regulation

The SFTR Regulation's draft deals with operations of «re-hypothecation», such term being defined under Article 3.7 as «the use of financial instruments by a counterparty which receives them as guarantee, in its own name and for its own account or on behalf of another counterparty.»

This approach differs from:

• the Directive on financial collateral arrangements (Art. 2), which refers to the «right of use», being defined as «the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial»;

** The french version of the SFTR Proposal uses the expression «réaffectation».*

• the FSB, followed by the European Central Bank, which distinguishes the notion of «re-hypothecation» and «re-use» in the following terms: «Re-use is defined broadly as any use of securities delivered in one transaction in order to collateralise another transaction, thereby encompassing the concept of Re-hypothecation». «Re-hypothecation is defined more narrowly as re-use of clients assets». Re-hypothecation primarily occurs in the prime-brokerage business, where broker-dealers use client assets, mostly obtained from hedge funds in the form of a pledge in margin lending activities, for their own purposes.»

Therefore, the HCJP questions the scope of the draft Regulation. Does it aim to govern all temporary transfers of securities or only financial guarantees (the title of Article 15 «Rehypothecation of financial instruments received as collateral» seems to lead to the second interpretation)? All financial guarantees or only those which do not transfer ownership of the securities to the beneficiary of the guarantee?

The report of Mr. Renato Sorù to the European Parliament (2014/0017 (COD) suggests to substitute to «rehypothecation» the notion of «re-use» as defined by the FSB *(««re-use» «means any use of securities delivered in one transaction in order to collateralise another transaction»)*, thus embracing only financial guarantees, but at the same time all categories of financial guarantees, whether or not they lead to transfer of ownership of securities given as collateral.

The HCJP questions the extent of the scope and the conditions provided in the SFTR Regulation draft.

The question at stake is whether this reallocation would only apply to transactions with no transfer of ownership of financial instruments which are under the "control" of a counterparty, that is not, by definition, the owner (as a creditor benefiting from a pledge would be). This would limit the application of rules regarding reallocation mainly to financial instruments encumbered with a security interest*.

As of today, there are ongoing debates on whether these rules should not be extended to all financial guarantees arrangements with or without transfer of ownership, in order to provide better guidance on the use of financial instruments subjects of a financial guarantee.

Such approach is confusing since a full ownership transfer, even taken as guarantee, entails necessarily the transfer of the right to use and dispose of the thing for which ownership has been transferred. The effect of the transfer of ownership would be weakened, or even questioned if this right was subject to additional information or to compliance with certain rules which are incompatible with the concept of ownership (defined as the right to enjoy and dispose of things in an absolute manner).

As the French system is based on the concept of ownership of financial instruments, such confusion would be detrimental to the protection of investors.

** A security on a financial instrument could be defined as a privilege granted to a creditor without him being the owner of the financial instrument. On the contrary, a guarantee could be defined as the transfer of full ownership of the financial instruments as collateral. During the French transposition of the Directive 2002/47 on financial guarantees contracts, this double wording «security» and «guarantee» has been used, particularly for limiting the faculty of utilization or disposition to the securities only (cf. article L. 211-38 III of the French Monetary and Financial Code).*

2° The exercise of the right to re-use of the beneficiary of the guarantee is subject to the transfer of the securities to the credit of his account

Article 15 of the SFTR Regulation draft subordinates the exercise of the right of «rehypothecation» to the inscription to the credit of financial instruments to the account of the beneficiary of the guarantee: «financial instruments received as collateral are transferred to an account opened on the name of the counterparty that receives them».

This proposal leads to the subject the right of use of the securities to their ownership, even for a moment of reason, by the beneficiary of the guarantee.

The amendment suggested by the rapporteur R. Sorù completes the proposal by stating that: «the financial instruments received as collateral are transferred from the account of the providing counterparty to a separate account opened in the name of or held by the receiving counterparty ». Thus, it fully secures the operation by preventing the security given in guarantee from appearing both in the account of the guarantor and that of the beneficiary.

This proposal has the advantage of safety and simplicity since it constitutes an obstacle to the inflation of securities and allows a prompt identification of the holders of rights in securities granted as collateral and the nature of their rights.

3° The scope of the limitation of the re-use by Article 15 of the SFTR proposal

The directive MiFID II, as already provided under MiFID I, allows any intermediary to be given a right of use of the securities owned by its clients with their express consent (Article 16.8). However it prohibits the creation of a guarantee with full ownership transfer by a non-professional client in favor of its service provider (Article 16.10). It would be appropriate that such a prohibition of use be provided in the event of recourse to re-use granted by the guarantor of a security without transfer of ownership, in order to avoid any circumvention of the rules set forth in MiFID II.

It would also be appropriate to make sure that those rules would be consistent with the Collateral directive, since the Collateral directive provides the possibility for the guarantor of a financial collateral arrangement to grant a right to re-use (if the guaranteed obligations were entered into between regulated entities).

The Chairman, Michel PRADA