FEATURES

Securities finance in the era of a regulatory tidal wave

In the dynamic realm of securities finance, change is the only certainty. Regulatory waves continually reshape the landscape, demanding swift adaptation from firms in the space, but what happens when there is a swell and they all arrive concurrently? This feature explores the effects of recent amendments, including the Securities Financing Transactions Regulation (SFTR), the adoption of the SEC's Rule 10c-1, and the impending T+1 regulation in the US.

By Sophia Thomson April 19, 2024 3:37 PM GMT

Looking back on the aftermath of the 2008 financial crisis, the vulnerabilities of the industry responsible for the economic downturns become glaringly apparent. Looking at the securities finance industry in particular, this revelation unearthed a stark lack of transparency and risk awareness of transactions taking place. As the players within the industry grappled with this realisation, alarm bells rang, pointing to the urgent need for regulatory measures to address the transparency deficiencies that had emerged.

These transactions, including securities lending or short selling, are known for their ability to amplify market leverage, making them attractive to investors seeking liquidity enhancements. The allure of these transactions typically over-shadowed the inherent risks that come with them, leaving investors and bond issuers caught off-guard by what ensued if transactions went south. The aftermath of the financial crisis really brought the skeletons out of the closet, sparking calls for stricter regulation to bring clarity and stability to the market.

Conversations began around the pressing need for transparency which emerged as a paramount concern for both investors and issuers. Starting chronologically, the introduction of the Securities Financing Transaction Regulation (SFTR) by the European Commission in 2015 marked a pivotal moment in addressing these concerns. SFTR's mandate, which includes detailed reporting to trade repositories and disclosure of SFT details in pre-investment documents, aimed to instil transparency and accountability throughout the securities ecosystem.

Additionally, the UK's adoption of SFTR in 2020 mirrored the European Union's directives, pushing for a unified commitment to regulatory oversight globally. With SFTR as a cornerstone, the financial landscape embarked on a journey towards greater transparency, ushering in an era where informed decision-making and prudent risk management take precedence in securities finance practices.

SFTR as a cornerstone

SFTR is essentially a rulebook designed to provide regulators with an improved view on activities happening within the securities market; with the set guidelines requiring firms to report details of securities financing transactions (SFTs) including repurchase agreements (repos), securities lending, and margin lending to trade repositories.

Commenting on the initial impact of SFTR, Darren Crowther, head of securities finance solutions at Broadridge, says: "A number of vendors provided utility services that made it easier for firms to report. There was initially a lack of clarity on how some SFTR events needed to be reported due to the complexity of flows and with differences in interpretation of certain data fields and events. However, this was cleared up, and now everyone is following the same agreed standards."

SFTR came into effect in phases, with different reporting obligations applying to different types of entities, both financial and non-financial counterparties, and transactions requiring different data points to be provided.

"Since the initial adoption of SFTR, further changes to the field definitions and event workflows have been published which have further standardised data reporting. Again, these amendments came about due to differences in opinion in initial interpretations on data fields," adds Crowther.

Additional validation rules came into force in Europe in September 2023, while the UK's variation will take effect from November 2024.

For a trader engaging in an SFT, the specific data and details of every single transaction needs to be reported to a trade repository, inclusive of any modification and even termination. The general rule is that trade activity reports need to be submitted before the end of day on T+1.

The SEC follows suit

After observing Europe's attempt at securities finance reporting regulation, the SEC then introduced its own iteration to bring transparency to the practice in the US, with Crowther noting that lessons were learnt from the European effort. "Fortunately, the guidance and framework has now been issued, and on initial review it seems a more straightforward reporting regime than SFTR," he says.

Initially, the SEC's 10c-1a rules requested for reporting deadlines within 15 minutes for new and modified trades, but following industry pushback the regulator scrapped the 15-minute window in favour of an end-of-day reporting schedule.

Crowther says: "Thankfully, that's been pushed back to something more adoptable by the market. The number of data points is smaller, and the event process is simpler, so firms can adopt this regulation that's much easier, which is good. There are suggestions of a future phase two that may add more complexity, but initially, the regulator has gone with a simpler regime."

Rule 10c-1 will require securities lenders to provide the material terms of transactions to a registered national securities association (RNSA), which would be the Financial Industry Regulatory Authority. The RNSA would then make certain information that they receive regarding those lending transactions, along with daily information pertaining to the aggregate transaction activity and distribution of loan rates for each reportable security, available to the public.

Securities lending specialist Finadium said in its coverage of the rule in October last year that it “looks to be two years out, going live in October 2025”.

Christophe Vastesaeger, senior solutions architect at SmartStream Technologies, picks up on this point, suggesting that firms need to adopt a more proactive approach by starting to make changes early and developing a comprehensive plan to tackle the complexities of the 10c-1a regulation. This involves a thorough examination of the regulation’s requirements and determining how and when they fall into its scope.
“Even if in the final publication of the rule 10c-1a, the implementation timeline is wider than expected, with the upcoming T+1 hurricane it is crucial for firms to consider their options as early as possible to cope with the rule. The rule also encourages the adoption of best practices and standards to streamline current post-trade processing,” he says.

“The only way forward for all participants in the securities ecosystem is to embrace the change in a shifting landscape. This means a transition from asking ‘why?’ towards a ‘how?’ implementing focus as if there is one certainty in the whole shifting process and that is it will be challenging with a very short timeframe to implement.”

The proposed SEC Rule 10c-1 shares similar objectives with SFTR, aiming to enhance transparency and oversight in securities lending transactions. In addition to mandating transaction reporting for supervisory and financial stability monitoring purposes, the SEC highlights the goal of reducing perceived data asymmetry between market participants.

“The US SFTR [securities finance transaction reporting] is forcing the companies within the securities ecosystem to report activity transparently and accurately,” adds Vastesaeger. “Implementation of the [US] SFTR will be challenging, however it will offer the participants in the ecosystem transparency in regard to the post-trade settlement process.”

To achieve this, the SEC proposes public disclosures of certain reported activity on an anonymised basis. This initiative seeks to promote a more level-playing field among different market users by providing access to relevant data while safeguarding individual privacy.

Embracing regulatory change through technology

If the transparency regulations weren’t enough to contend with, the securities finance market also faces an uphill battle to ready itself for T+1 in the US, with regards to method and timing around sale notifications and recall issuance. The timeline for lending and borrowing will be significantly compressed for the recalling and identifying of securities which could lead to trade breaks, while liquidity and fails increases – which will be penalised in Europe – are also a concern.

“The US move to T+1 for equities is a massive market wide undertaking. At Broadridge, we’re spending a lot of time with our clients to ensure we are jointly ready and that they understand the impact on all their upstream and downstream processes,” says Crowther. “Within the securities finance domain, T+1 is mainly impacting the recalls process as there is now a shorter timeframe between sales, recall notice and return settlement. This is driving firms to look at their operational processes. Some firms are continuing to manage processes manually and other firms have built automated processes.”

Solving these challenges comes back to changes to existing processes, technology and overall behavioural changes. Research from the ValueExchange, published in January 2024, recently depicted “increasing readiness in all areas but continuing concerns around timings for securities lending”.

When looking at the percentage of respondents planning to meet the respective market deadlines, only half said they would meet the recall booking deadline of 11:59pm ET.

“Simply hiring additional manpower to address these hurdles isn’t always best, particularly in an environment where resource optimisation and cost reduction are priorities,” says John Joseph, head of North American sales engineering at Xceptor. “Many tier one banks have actively reduced their workforce, with some even letting go of up to 20% of their employees in this climate. The answer isn’t necessarily adding more people but ensuring that there is an automated process so that when manual processes are replaced, you can ensure that there is no disruption. That’s the critical piece when you settle in T+1, or consider other SEC rules that call for transparency.”

Among the advice given by custodians and infrastructures, DTCC says “firms and their service providers should think about what changes could be made to improve their contract compare and corporate action process”, while BBH notes that “future securities lending deals should take these issues into account, with future trades in mind… additionally, custodians and other trading services providers should be given more advanced information about trades involving loaned securities, wherever possible.”

Looking into the future

The securities finance industry stands at a pivotal juncture, shaped by evolving regulations and technological advancements; and if there’s any key takeaway from all of this, it would be underscoring how crucial and fundamental it is for firms to be adaptable. Without adaptability, firms risk falling behind in a landscape where technology and transparency are becoming increasingly vital.

“In my opinion, the single most important theme for the securities finance industry is for firms to be organised in such a way across their people, processes, and technology platforms to enable them to change quickly and adapt to new technology and market opportunities,” says Crowther.

“This ability to deliver boils down to three key factors: a track record for investment in technology that enables agility, a clear understanding of the implications of entering new products or sectors, and access to expertise. The ability to manoeuvre quickly is paramount for success in the securities finance industry. This requires investment in operations and technology, coupled with a clear understanding of market trends and opportunities, to drive growth and adaptation.”

Adaptability emerges as the cornerstone for success ahead of regulatory changes, enabling firms to thrive amidst the dynamic challenges and opportunities that define the securities finance industry today and in the future.