

Practice reference: OF-FLUX CESSIONSTEMPORAIRES-02

Management of Market Claims on securities financing transactions post-T2S

Versioning	Version	1.0
	Publication date	August 30th, 2016

I. DESCRIPTION OF THE EXISTING PRACTICE & OF THE IMPACTS

Description of the existing practice	<p>This market practice only applies to securities financing transactions over the counter not cleared by LCH SA, for which there is a title transfer, for the French ‘pensions livrées’ and for securities lending and borrowing (see below).</p> <ul style="list-style-type: none"> • Securities lending and borrowing as created on June 17th 1987 by the French legislator, is a securities financing transaction consisting in a consumer loan articles 1892 and 1904 of the French Civil code, usually a loan secured by collateralized securities and/or cash. It is a transfer of securities, notably equities, made for a certain time in exchange for collateral. • Article L211-27 of the French Monetary and Financial Code defines the French ‘pensions livrées’ as such: <i>‘A repurchase agreement is the means by which a legal entity, common fund, real-estate investment trust or securitisation common fund assigns to another legal entity, common fund, real-estate investment trust or securitisation common fund, with full title and at an agreed price, financial securities, and through which the assignor and the assignee respectively and irrevocably undertake, the former, to take back the securities, and the latter, to sell them back at an agreed price and on an agreed date.’</i> <p>Both operations result in a title transfer.</p> <p>Until the migration, Euroclear France presents a module to handle securities financing transactions, for both ‘pensions livrées’ and securities lending and borrowing. Only a limited number of operators still used it before the migration.</p> <p>This module automatically generates the far leg of the securities financing transaction with a fixed or variable rate (EONIA). This functionality also allows to</p>
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	<p>ensure the retrocession of coupons to the lender throughout the lifecycle of the contract, without further action from the parties.</p> <p>The module handles only one detection rule, whatever the type of securities.</p> <p>Outside of Euroclear’s module, instructions are input as Buy/Sell transactions or ‘cash trades’, and the market claims detection rules on these instructions through Euroclear’s SLAB module varying depending on the type of securities.</p> <ul style="list-style-type: none"> • Euroclear’s IT systems bears some limitations on the anteriority of the trade date (TD), that cannot be positioned more than 35 days ahead of the intended settlement date (ISD). • As regards market claims detection, the process is limited to 45 days after the record date (RD)
<p>Description of the T2S impact</p>	<p>The module ‘Pension Livrée’ will be decommissioned, securities financing transactions in T2S being instructed in a buy/sell mode.</p> <p>The management of market claims will no longer be automatically managed by the module, involving changes in the procedures.</p> <ul style="list-style-type: none"> • T2S does not have limitations on the anteriority of the trade date (TD), that can be positioned more than 35 days ahead of the intended settlement date (ISD). • As regards market claims detection, the process will be limited to 20 days after the record date (RD).
<p>Description of the major issue</p>	<ul style="list-style-type: none"> • In T2S, instructions on the near leg and the far leg are input in a buy/sell mode, corresponding to DVP/RVP. • The proceeds of corporate actions on stock are the ownership of the counterparty who has the securities at the CSD (Euroclear France) at the time of the record date, usually the borrower. • Market claim management rules vary depending on the nature of the securities (capital or debt) and their accounting mode (UNT, FMT). <p>These rules are detailed in the appendix to this market practice. They show the diversity of the rules and also the exceptional character of the actual detection of market claims (see appendix).</p>
<p>Description of the roles and</p>	

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responsibilities of the actors involved (OPTIONAL)	
Workflows (OPTIONAL)	
Links with other market practices	<ul style="list-style-type: none"> • MS-SETTL-CESSIONTEMP-02 • OF-FLUX-CESSIONSTEMPORAIRES-01 • MS-MATCH-CRITE-03

II. RECOMMENDED MARKET PRACTICE

Recommended practice	<p>The management rules for market claim detection depend on the account mode of the security: unit (UNT) or nominal (FMT). The study in appendix to this market practice shows the non-systematic character of the detection of market claims, considering the date of input of the far leg and the business rule to fill the trade date (TD).</p> <p>The use of the additional matching criterion OPT-OUT would allow from an operational point of view to systematically ensure that no coupon retrocession is automatically generated by Euroclear France, neither on the near leg nor on the far leg. To this end, the additional field « Settlement Transaction Condition Indicator » should be set at 'NOMC' (No Market Claim) in the instructions between counterparties. Nonetheless, the use of such indicator, even if it ensures a single rule applicable to all counterparties, cannot be recommended for the following reasons:</p> <p style="padding-left: 40px;">A. Issue common to all types of securities financing transactions</p> <p>Two elements must be considered:</p> <ul style="list-style-type: none"> - The fiscal impact <p>These indicators having an effect on the transfer of title and thus on the party subject to taxes, their use leads to questions on the recommendation depending on the type of transactions, 'pensions livrées' or securities lending and borrowing.</p> <ul style="list-style-type: none"> - Mismatching of instructions <p>A risk of mismatching is implied by the use of this additional matching criterion that must be filled by both counterparties.</p>
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1. Fiscal impact

The use of CUM/EX and OPT-OUT indicators reverse the direction or neutralize market claims, potentially implying a lack of transparency in their detection by the IT systems of custodians.

They modify the transfer of title and thus the beneficiary of the corporate action, who could end not being the actual tax payer and lead to fiscal arbitrage, which is forbidden in France, notably in cases of coupon or dividend payments allowing for credits on taxes or on withholding tax (see appendix 2 of the market practice sheet).

To be noted that securities financing contracts under French law (notably under FBF or AFTI agreements) refer to a suspension of the transaction when this type of corporate action occurs.

This situation may lead to a responsibility of the custodian, considering they are responsible towards the tax authorities for collecting tax information and proceeds. They could notably be considered responsible, directly or indirectly, of fiscal arbitrage.

At that stage, prudence should prevail in the use of these indicators.

2. Mismatching of instructions

Market operators on 'pensions livrées' (transactions usually on securities in FMT) and on securities lending and borrowing (transactions usually on securities in UNT) do not wish to use these indicators, which could, when used in an un-harmonized way, involve delays in the matching and the settlement of instructions. It is important to remind that these indicators must be filled identically by both parties so instructions can match.

3. Analysis by type of securities financing transaction

a. 'Pensions livrées' (repurchase agreements)

Harmonization of the trade date (TD)

The AFTI market workgroup on Bonds & Collateral wishes to design a common practice for 'pensions livrées', notably a TD on the far leg set at the TD of the original contract (cf. MS-SETTL-CESSIONSTEMP-02). To be noted that the guidelines on repurchase transactions by ICMA (July 2015) can be the reference as the practice related to the crystallization of repos already refers to it for determining the appropriate rate to be applied.

Functional analysis of market claims

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	<p>The study in appendix shows that cases of market claims are less frequent on FMT securities, even as the trade date of the far leg is set at the original trade date of the contract. They in effect only concern failed instructions, where actual settlement is posterior to the intended settlement date.</p> <p>To be noted that certain repurchase transactions affect securities in UNT (equities), for which the issue of market claim is more frequent.</p> <p style="padding-left: 40px;">b. Securities lending and borrowing</p> <p>Securities lending and borrowing is already handled in buy/sell mode (over the counter). Market operators avoid to trade around corporate action periods to avoid market claims.</p> <p>It does not appear to be necessary to set the trade date of the far leg at the original trade date of the contract. Both legs are distinct, and counterparties set the trade date based on a bilateral agreement depending on market conditions.</p> <p>To avoid market claims, they can set at the same date both the trade date and the intended settlement date.</p> <p>Considering the types of securities and the market claim management rules (see appendix), any gap between the trade date and the intended settlement date can lead to market claims when a corporate action occurs during the initiation or the restitution phases.</p> <p>As is the case today, attention will be required from market operators on these operations.</p> <p>Synthesis</p> <p>Market operators must remain careful in the management of market claims as, depending on the type of operation and security, IT systems may or may not generate market claims; the most important factor being the respect of contract and tax provisions.</p> <p>As a consequence of the above mentioned analysis, the additional matching criteria (CUM/EX, OPT-OUT) should not be used, and set at blank.</p> <p>Counterparties to a securities financing transactions (client, or intermediaries) should ensure that the necessary adjustments are made, either through a market claim or bilaterally, in order to ensure that the lender gets the income as contractually agreed and under the payment conditions agreed, also taking into account the fiscal impact of the distribution.</p> <p>Market participants will need to organize the internalization of the management of market claims in relation with their clients.</p>
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Description of the roles and	
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**T2S Market Practice Adaptation Workgroup
Market Practice Sheet**



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responsibilities of the actors involved (OPTIONAL)	
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Workflows (OPTIONAL)	
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III. IMPLEMENTATION

Implementation timeline	Before the migration to T2S	Upon go live on T2S	After the migration to T2S
	<input type="checkbox"/> Date: _____	<input checked="" type="checkbox"/> Date: 12/09/2016	<input type="checkbox"/> Date: _____

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APPENDIX 1 – Functional study on eligibility to market claims

This appendix details rules applicable to securities financing transactions and their operational consequences in terms of market claims as proposed in Euroclear France's DSD. Securities financing transactions imply a transfer of title:

- A loan of securities is a contractualized transaction whereby a party will transfer to the other securities over a certain period of time, with an interest rate agreed between the parties. The borrower of the securities is supposed to deliver collateral in securities or cash to the lender, and is also supposed to pay the interest rate, for the use of the securities.
 - o The lender is always entitled to the income, based on the provisions of the contract, with the exception of voting rights, in the form of a compensation (manufactured dividend) or a sharing according to AFTI rules, "hors 1987".
- In France, Article L211-27 of the Monetary and Financial Code specifies that "A repurchase agreement is the means by which a legal entity, common fund, real-estate investment trust or securitisation common fund assigns to another legal entity, common fund, real-estate investment trust or securitisation common fund, with full title and at an agreed price, financial securities, and through which the assignor and the assignee respectively and irrevocably undertake, the former, to take back the securities, and the latter, to sell them back at an agreed price and on an agreed date."
 - o For Repos: when a coupon is paid during the term of the loan, it belongs to the borrower of the securities due to the transfer of title. Nonetheless, it is due to be immediately paid to the lender of the securities upon maturity of the contract.

The operational analysis below has shown a number of situations, leading to questions on the possible non-systematic application of market claims.

Examples below correspond to far leg instructions of securities financing transactions.

In certain cases, the application of a market claim would involve a bilateral retrocession in favor of the lender to cancel an erroneous effect of the market claim.

Symmetrically, the same market claim rules would also apply to the near legs of the transaction.

Examples of impacts of market claims on the far leg of a securities financing transaction:

- a) **Rule (1) for the detection on capital securities in UNIT and Rule (2) for the detection on debt securities in UNIT with (Ex Date = Payment Date):**
 - i) TD before ExD (Ex-date) and ASD (Actual settlement date) after RD => (market claim for allocating the proceeds to the lender)

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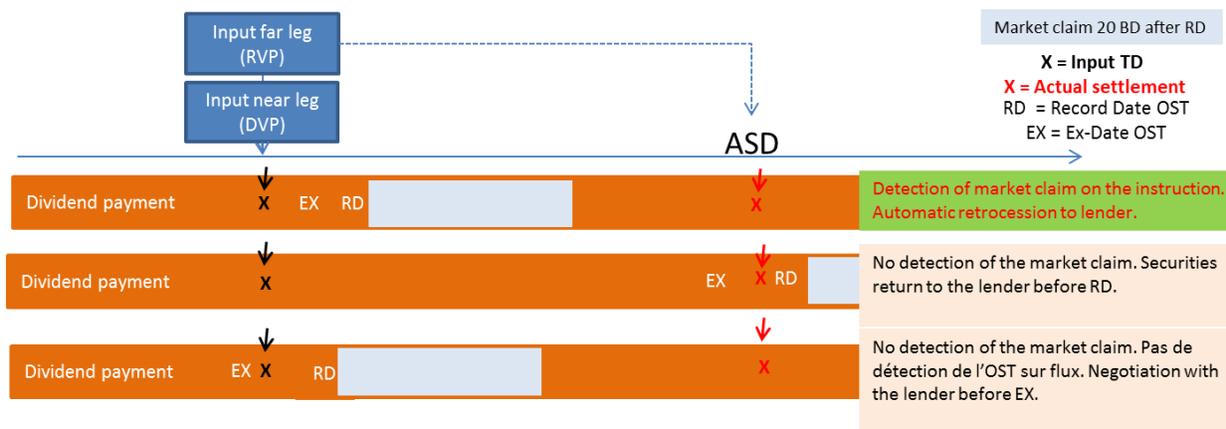
- ii) TD after ExD eand ASD before RD => (market claim with allocation of the proceeds to the borrower. To be retroceded bilaterally to the lender).
- iii) Rules applicable to instructions pending and/or failed (*)

b) Rule (3) for detection on debt securities in FMT :

- i) If the intended settlement date (ISD) occurs before or on the RD,) and if the ASD occurs after the RD => (market claim for allocation of the proceeds to the lender)
 - ii) The Trade date is not considered in the detection rules
 - iii) Rules applying to failed instructions failed only (*)
- (*) Notion of Pending vs Failed instructions for the purpose of this market practice:
Pending instructions are instructions awaiting for settlement, whether the ISD is before or after the RD. On the contrary, a failed instruction is a more restrictive notion, as the ISD is anterior to the RD, the ASD being posterior to the RD.

The way market claims must be handled also depends on the timing of the input and matching of the far leg in the settlement system.

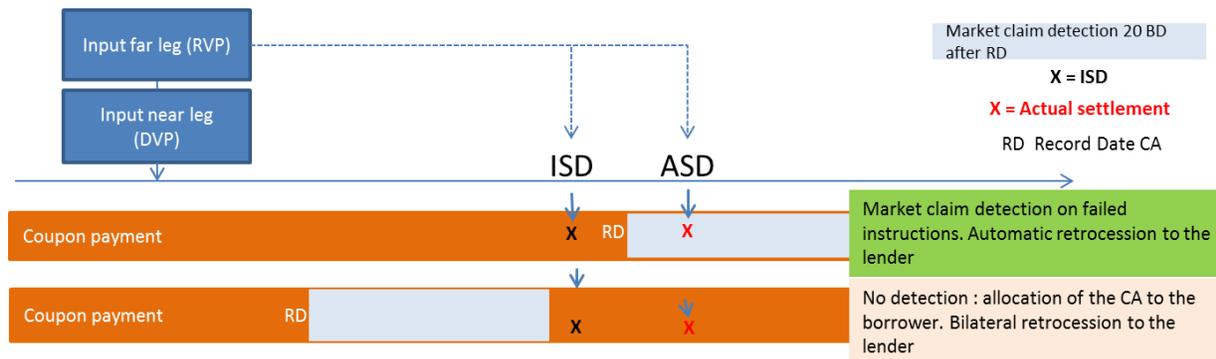
- a) If the Input / Matching of the far leg happens at the time of the initiation of the securities financing transaction, the detection of market claims is ensured during the whole term of the contract, until its maturity.
 - i) This solution is viable:
 - (1) For securities financing transactions with a fixed rate or a 0-rate.
 - (2) For securities in UNT, where the TD is a criterion for detecting market claims. The TD of the far leg being equal to the TD of the near leg. (Cf. MS-SETTL-PENSION-02, Cf.Rues (1) et (2)).
 - (3) Illustration (non exhaustive)



The detection of market claims during the contract, ie the time span between TD and the ASD of the far leg

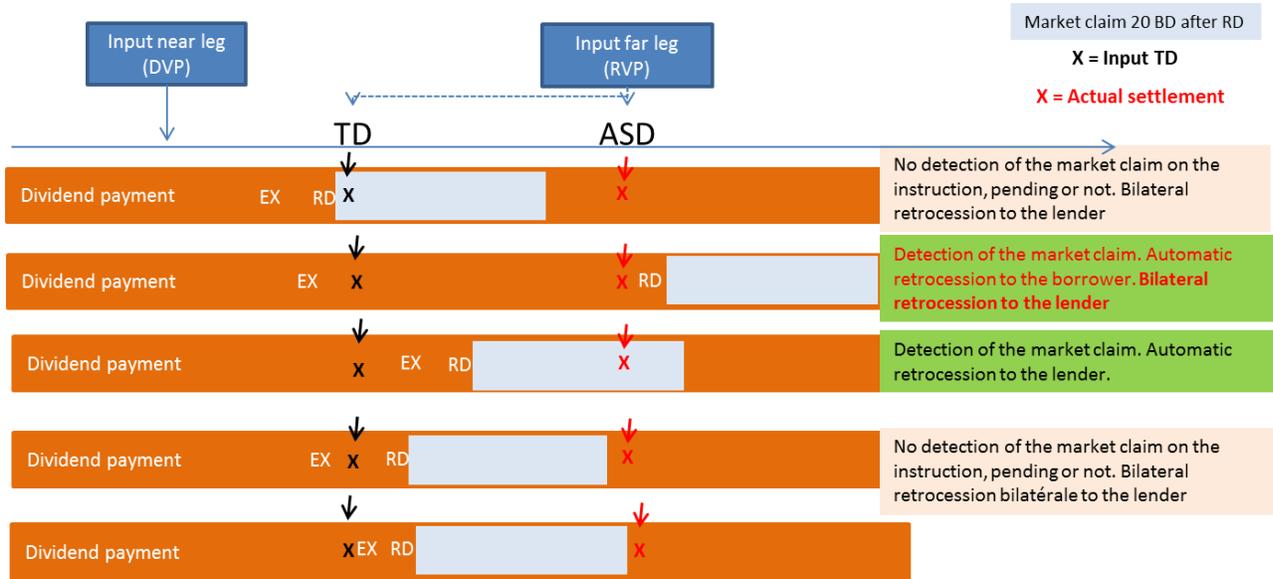
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- i) This solution is not efficient:
- (1) For securities financing transactions with a variable rate involving instructing the far leg at the maturity of the contract because of constraints related to the calculation of the remuneration.
 - (2) For securities in FMT. Detection rules do not rely on the TD. In this situation, even when both the near leg and the far leg are input at the same time, only the intended and actual settlement dates (ISD/ASD) are efficient to ensure the detection. *Cf. Rule (3).*
 - (3) All corporate actions occurring before the retrocession are not detected and will require a bilateral retrocession (most frequent case).
 - (4) Illustration (non exhaustive)



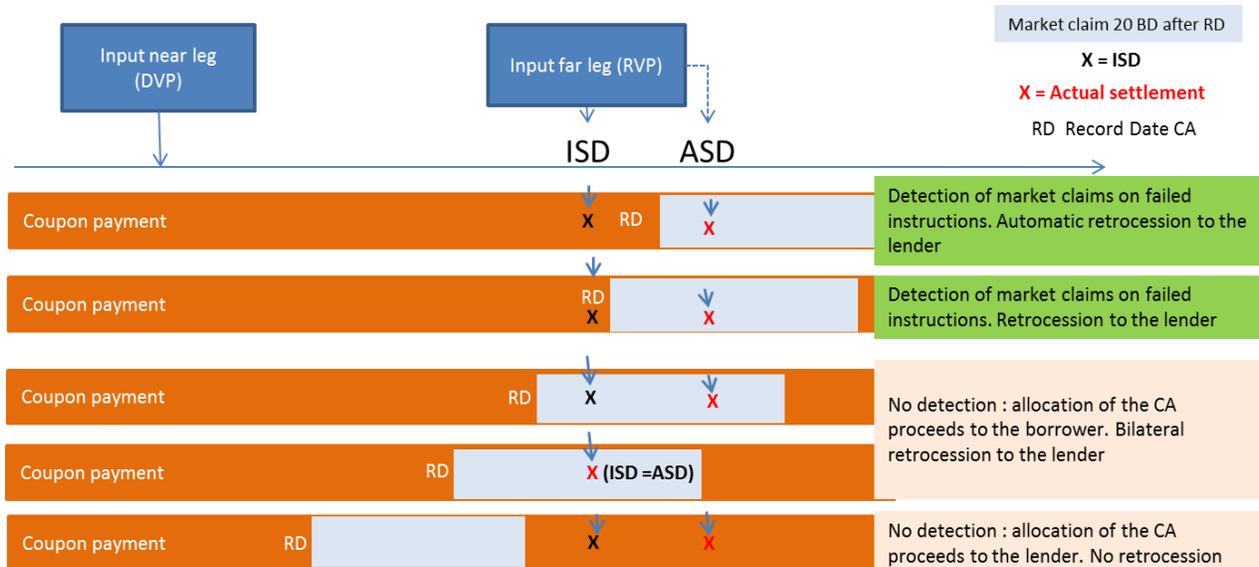
- a) If both legs are input separately, involving an input of the far leg at the maturity of the contract, market claim detection rules are constrained by the 20-day limit after the RD of the CA, whatever the anteriority of the TD.
- i) Behavior of **Rules (1) and (2)** for capital securities in UNT.
- (1) The market claim detection is subject to specific conditions and not systematic. All CA occurring before the retrocession, with a TD and ASD not meeting detection rules, are not detected and will require bilateral retrocession (most frequent case).
 - (2) The behavior is more or less the same for securities corresponding to **rule (2)** for which the sequence of dates is different (Ex-Date = Payment-Date)
 - (3) Illustration (non exhaustive)

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i) Behavior of **Rules (3)** for debt securities in FMT.

- (1) Detection rules consider the conditions related to the RD, the anteriority of the ISD and the posteriority of the ASD. All market claims occurring before the intended settlement date of the far leg are excluded from the detection. Bilateral retrocessions will be required (most frequent case).
- (2) Illustration (non exhaustive)



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Synthesis:

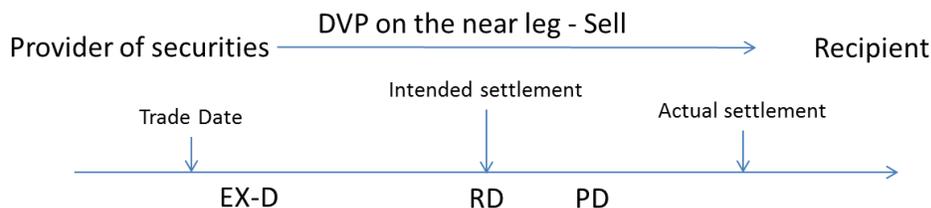
RULES	REPOS	SECURITIES LENDING
<p>Rule (1) for detection on capital securities in UNT andet Rule (2) for detection on debt securities in UNT with (Ex-Date = Payment-Date) :</p> <ul style="list-style-type: none"> i) TD before ExD (Ex-date) and ASD after RD ii) TD after ExD and ASD before RD iii) Rules applicable to instructions pending and/or failed (*) 	<p>Securities of Rule (2)</p>	<p>Securities of Rule (1) and (2)</p>
<p>Rule (3) for detection on desbt securities in FMT :</p> <ul style="list-style-type: none"> i) If ISD is before or equal to the RD and if the ASD is after RD ii) Trade date not considered by detection rules iii) Rules applying to failed instructions only (*) 	<p>Securities of Rule (3)</p>	<p>Rarely used for this type of operation</p>

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APPENDIX 2 – IMPACT OF INDICATORS ON THE TRANSFER OF TITLE

A - REPO on securities in FMT (fixed-income)

○ Negotiation and settlement of the near leg



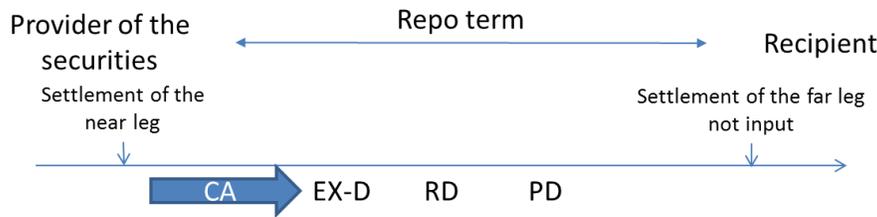
In this situation, the recipient should have had the position at the RD in order to receive the proceeds from the corporate action on stock.

CA on Stock	After the RD, the provider is still owner of the securities as the operation has not settled. The provider receives the interests on PD.
Market claim	After the RD, the CSD triggers the market claim in favor of the recipient in order to regularize the CA on PD.
Fiscal situation of the provider	Le provider can ask for the retrocession of the coupon in the form of a compensation.
Fiscal situation of the recipient	The Market Claim automatically generated by the CSD, is a retrocession of the coupon and not a compensation (to be confirmed). The coupon paid is taxable in regular conditions

In the absence of a Market Claim automatically generated by the CSD with a use of the OPT6OUT indicator, counterparties would have made a bilateral retrocession of the coupon paid on stock in the form of a compensation, with booking of the coupon at the provider.

○ During the term of the repo

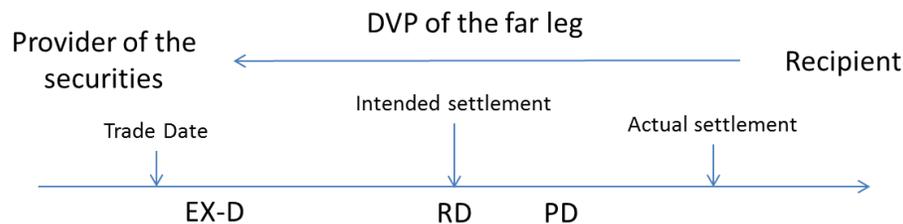
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In this situation, the recipient has the position at the RD in order to receive the proceeds of the CA on stock

CA on stock	He recipient is owner of the securities
Market claim	No market claim is detected by the CSD. The regularization must be carried out bilaterally.
Fiscal situation of the provider	The payment by the recipient must be considered as a retrocession of the coupon in the form of a compensation.
Fiscal situation of the recipient	The coupon paid is taxable in regular conditions.

o *Negotiation and settlement of the far leg of the repo*



In this situation, the provider should have had the position at the RD to receive the proceeds of the CA on stock.

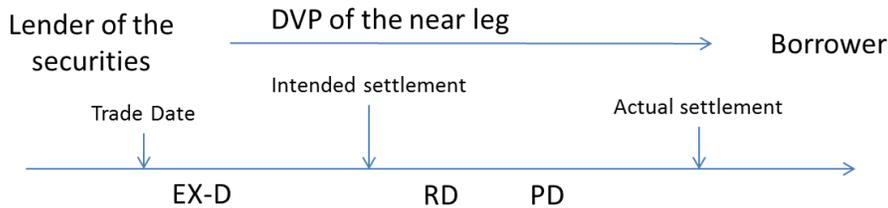
CA on stock	After the RD, the recipient is still owner of the securities as the operation has not settled, and he receives the proceeds on PD.
Market claim	After the RD, the CDS triggers a market claim in favor of the provider in order to regularize the CA at PD.
Fiscal situation of the provider	The Market Claim automatically generated by the CSD, is considered as a retrocession of the coupon and not as a compensation. The provider must pay the tax.

In the absence of a Market Claim automatically generated by the CSD with the use of the OPT6OUT indicator, counterparties would have made contacts in order to retrocede the coupon in the form of a compensation, the coupon being booked at the recipient.

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B – Securities lending on securities in UNT (Equities like)

○ Negotiation and settlement of the near leg of the operation



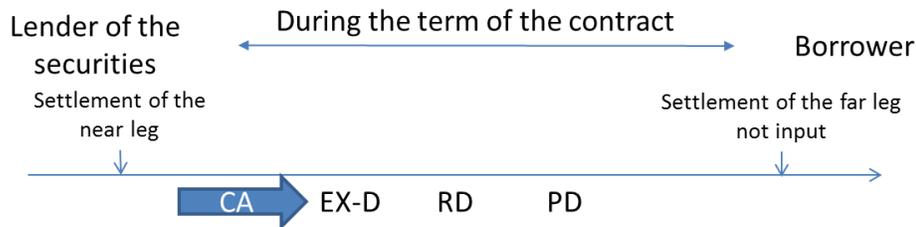
In this situation, the borrower should have had the position at the RD in order to receive the proceeds of the CA on stock.

CA on stock	The lender has sold coupon attached. After the RD, he is still owner of the securities as the operation has not settled. He receives the payment on PD.
Market claim	After the RD, the CSD triggers a market claim in favor of the borrower in order to regularize the CA on PD.
Fiscal situation of the Lender	The lender can reclaim all or part of the dividend in the form of a compensation.
Fiscal situation of the Borrower	The Market Claim automatically generated by the CSD is a retrocession of the dividend and does not constitute a compensation. The dividend paid is taxable in regular conditions.

In the absence of Market Claim automatically generated by the CSD with the use of the OPT-OUT indicator, the lender would have received the dividend and would have been subject to taxes in regular conditions.

○ During the term of the securities lending contract

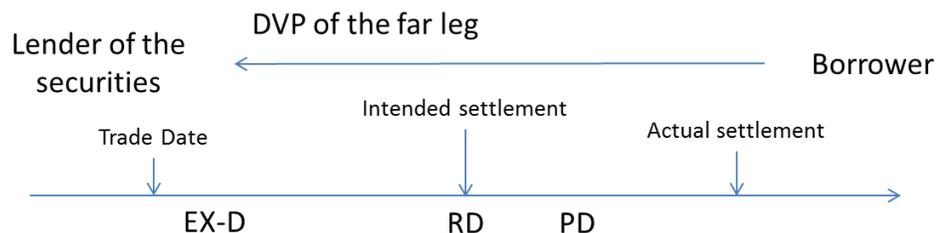
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In this situation the borrower is in position at the RD to receive the proceeds of the CA on stock.

CA on stock	At the RD, the borrower is owner of the securities
Market claim	No market claim is detected by the CSD. The regularization must be carried out bilaterally.
Fiscal situation of the Lender	The payment by the borrower to the lender must be considered as a retrocession of the dividend in the form of a compensation.
Fiscal situation of the Borrower	The dividend paid is taxable in regular conditions.

o Negotiation and settlement of the far leg



In this configuration the lender should have had the position at the RD in order to receive the proceeds of the CA on stock.

CA on stock	After the RD, the borrower is still owner of the securities as the operation has not settled and he receives the dividend on PD.
Market claim	After the RD, the CSD triggers a market claim in favor of the lender in order to regularize the CA on PD
Fiscal situation of the Lender	The Market Claim automatically generated by the CSD is a retrocession of the dividend and does not constitute a compensation. The dividend paid must be taxed in regular conditions.

In the absence of a Market Claim automatically generated by the CSD and with the use of the OPT6OUT indicator, counterparties would have made a retrocession of the dividend payment in the form of a compensation, the booking having occurred at the borrower.