



CSSF FAQ – Use of Securities Financing Transactions by UCITS



Commission de Surveillance
du Secteur Financier

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CSSF FAQ – Use of Securities Financing Transactions by UCITS

CONTEXT

The present document¹ refers to a list of questions & answers (FAQ) in relation to the use by Luxembourg domiciled UCITS of the following Securities Financing Transactions²:

- securities lending transactions;
- reverse repurchase agreement transactions (reverse repo) and repurchase agreement transactions (repo)³.

The objective of the present FAQ is to bring further clarity to the following topics concerning the use by UCITS of these SFTs, thereby taking into account the applicable regulatory framework as well as the supervisory experience gained by the CSSF over the last years:

- disclosure to investors;
- revenues and costs / fees;
- conflicts of interest;
- best execution.

SFTs AND APPLICABLE REGULATORY FRAMEWORK

Securities lending transactions as well as repurchase agreement transactions and reverse repurchase agreement transactions (hereafter “SFTs”) can, in accordance with article 42(2) of the Law of 17 December 2010 (hereafter the “2010 Law”) on techniques and instruments relating to transferable securities and money market instruments, only be used by UCITS for the purpose of efficient portfolio management.

The use of these SFTs by UCITS is also governed by the EU Regulation on transparency of securities financing transactions and of reuse (SFTR) where notably, in accordance with article 3(11) of that Regulation, securities lending transactions, repurchase agreement transactions⁴ and reverse repurchase agreement transactions are falling in the scope of the definition of a “securities financing transaction” (SFT).

¹ The CSSF has conducted a Thematic Review on Efficient Portfolio Management – Revenues & Costs/Fees in 2020. The resulting CSSF report should be read in conjunction with the present FAQ.

² It should be noted that securities lending and reverse repurchase agreement transactions are the main SFTs used by Luxembourg domiciled UCITS. Repurchase agreement transactions are only used to a limited extent.

³ The FAQ also applies to buy-sell back and sell-buy back transactions complying with the applicable regulation that UCITS might conclude.

⁴ The definition of SFT includes also buy-sell back and sell-buy back transactions.

On that basis, the use of the SFTs by UCITS is more specifically governed by the following regulatory provisions:

- article 11 (“Techniques and instruments for the purpose of efficient portfolio management”) of the Grand-Ducal Regulation of 8 February 2008 as regards the clarification on certain definitions;
- point 24 (“Article 11 – Techniques and instruments for the purpose of efficient portfolio management”) of the CESR guidelines concerning eligible assets for investment by UCITS;
- Sections X (“Efficient portfolio management techniques”) and XII (“Management of collateral for OTC financial derivative transactions and efficient portfolio management techniques”) of the ESMA Guidelines on ETFs and other UCITS issues (Ref. ESMA/2014/937EN) (the “Guidelines”) as implemented in Luxembourg Regulation by means of Circular CSSF 14/592⁵;
- Regulation (EU) 2015/2365 concerning the transparency of securities financing transactions and of reuse (“SFTR”).

In this context, the CSSF is mindful that the UCITS regulatory framework does not limit techniques and instruments relating to transferable securities and money market instruments to the sole SFTs as referred to above and that in particular also financial derivative instruments (for instance options, futures, swaps) can be used under the EPM provisions if they comply with the related provisions.

The CSSF also recognizes that the SFTR, as regards the prospectus transparency requirements applicable to UCITS, covers both the above mentioned SFTs and total return swaps (TRS) that UCITS might conclude (if these TRS comply with all applicable UCITS rules).

However, the present FAQ does *not* intend to deal with financial derivative instruments (inclusive of TRS) used by UCITS in the context of efficient portfolio management.

The SFTR also applies to the disclosure to investors by AIFMs as laid down in article 23 of the alternative investment fund managers Directive (AIFMD).

On that basis, the CSSF expects Luxembourg alternative investment fund managers authorised under the Law of 12 July 2013 on alternative investment fund managers (AIFM Law) for their managed AIFs to give due consideration to the clarifications given in this FAQ.

⁵ In this context, the CSSF would like to specify that the Guidelines prevail over Circulars CSSF 08/356 and CSSF 11/512 in case of discrepancies.

The CSSF also draws the attention of non-Luxembourg alternative investment fund managers authorised under the AIFMD to the clarifications brought in this FAQ with regards to the Luxembourg-domiciled AIFs they manage, while those IFMs should give consideration to the relevant regulatory provisions and clarifications given in their respective home Member State.

Similarly, the CSSF expects Luxembourg-domiciled regulated AIFs (UCI Part II and SIFs) managed by a registered AIFM as well as Luxembourg-domiciled regulated UCIs (UCI Part II and SIFs) which do not qualify as AIFs as per article 1(39) of the AIFM Law to also consider the clarifications of this FAQ where relevant.

Finally, having regard to the fact that the SFTR also sets forth provisions on the use of TRS, the entities as covered by the FAQ should also take into account the provisions of the present FAQ for the TRS they conclude.

The CSSF expects the disclosure clarifications given by means of the present FAQ to be included in the prospectus, respectively in the disclosure to investors, by **30 September 2021** at the latest.

FREQUENTLY ASKED QUESTIONS

1. Chapter I – Disclosure to investors

1.1 Point 25 of Section X of the Guidelines requires UCITS to inform investors in the prospectus clearly of its intention to use SFTs.

Article 14(1) of SFTR requires the UCITS prospectus to include a clear statement with regard to the SFTs used. Article 14(2) with Section B of the Annex of the SFTR requires amongst others for a general description of these SFTs used, for the rationale of their use and for overall data (expected and maximum proportions) to be reported for each type of SFT.

What are the expectations in relation to the disclosure of this information in the UCITS prospectus?

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UCITS which have the intention to use SFTs should clearly refer to this fact in the prospectus for *each* UCITS (i.e. at sub-fund level for umbrella funds).

This disclosure should include a description of all the following elements in the prospectus:

- (i) a general description of the SFTs;
- (ii) the precise conditions under which those SFTs will be used;

Examples where such disclosure is required include the confirmation whether these SFTs will be used on a continuous or temporary basis or if the use will be dependent on market conditions. If their use is conditional to certain elements like, for instance, market conditions, the UCITS should provide a clear description of the circumstances under which it intends to have recourse to those techniques and instruments.

(iii) the rationale/objectives and impact of using those SFTs, including if relevant the contribution to the investment strategy.

The objectives of using the SFTs should be clearly explained. For instance, SFTs could be used to generate additional capital or income through the transaction itself or through the reinvestment of the cash collateral. In this context, please note that UCITS which reinvest cash collateral must ensure that they comply with all applicable UCITS provisions.

In line with SFTR, UCITS should also disclose the expected and maximum proportion of AUM that can subject to SFTs.

Those proportions should be defined in a manner to adequately reflect their effective use by the UCITS, in line with the investment objective and policy of each UCITS.

More particularly, the disclosure of the expected and maximum proportion should for instance observe the following:

- the range should not be unduly large; as an example , an expected proportion of the AUM for a given SFT of 0%-100% cannot in principle be considered to be compliant with this requirement;
- the disclosure of a maximum amount of AUM of 100% for a given SFT, which is very unlikely to occur based on the CSSF experience, can only be accepted if specifically requested and duly justified;
- in case a UCITS does not intend to use a given SFT (respectively a UCITS that did no use this SFT in the past and does not intend to use it in the near future), the prospectus should clearly state this fact.

Finally, the CSSF acknowledges that the disclosure points as above can be presented in different manners in the UCITS prospectus, i.e., in terms of the articulation between the general and specific parts (i.e. sub-fund level for umbrella funds).

Hence, irrespective of the manner in which a UCITS chooses to present the above information, the CSSF considers that compliance with the present requirements is only met if all the above disclosure points are adequately addressed in the UCITS prospectus in a way as described above.

1.2 How should UCITS disclose the risks involved by the use of the SFTs in the prospectus, in line with the requirements of point 25 of Section X of the Guidelines and the information required under Article 14(2) and Section B of the Annex of SFTR?

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The CSSF considers that the prospectus of a UCITS must provide for a risk description that adequately covers the risks linked to each individual SFT and the risks linked to collateral management, thereby covering at a minimum operational, liquidity, counterparty, custody and legal risks and, where applicable, the risks arising from its reuse. In case the SFTs expose the UCITS to other risks, these should be dealt with in this description. The CSSF expects the risk disclosure to be sufficiently specific to each type of SFT used by the UCITS.

This risk description should inform on the potential impacts these risks might have on the UCITS and its related performance.

The CSSF considers that a risk description in the general part of the prospectus that covers each individual SFT that can be used by the UCITS is acceptable.

1.3 What should UCITS specifically disclose in the prospectus on gross revenues and costs/fees arising from the use of SFTs as per point 28 of Section X of the Guidelines and Article 14(2) with Section B of the Annex of the SFTR on the policy on sharing of return generated by SFTs?

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UCITS should disclose in the prospectus the percentage of *gross revenues* generated by the use of SFTs on the basis of arm's length transactions which is returned to the UCITS (e.g. x% of the gross revenue goes to the UCITS). More particularly, the percentage represents the part of the gross revenue, after deduction of the direct and indirect operational costs / fees, returned to the UCITS.

In addition, the prospectus should disclose a breakdown of the overall percentage⁶ of direct and indirect operational costs/fees by service provider with an indication of the category of service provided (e.g. y% of the gross revenue paid to entity A in relation to agent lending services).

⁶ The gross revenue returned to the UCITS represents 100% minus the overall percentage of direct and indirect operational costs/fees.

For instance, in case of a lending agent set-up with a related party, the CSSF considers the following disclosure to meet the present requirements:

"A [Investment Fund Manager] has appointed company B as securities lending agent for the UCITS funds that engage in securities lending. The UCITS funds pay X % of the gross revenues generated from securities lending activities as costs / fees to the lending agent and retain (100-X)% of the gross revenues generated from securities lending activities. All costs / fees of running the programme are paid from the lending agent's portion of the gross income (X%). This includes all direct and indirect costs / fees generated by the securities lending activities. A is a related party to B."

1.4 What should UCITS specifically disclose in the prospectus on potential conflicts of interest arising from the use of SFTs as per point 25 of Section X of the Guidelines?

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Investment fund managers (IFMs) are obliged to adequately identify and disclose in the prospectus the material conflicts of interest that can potentially arise in the course of providing services and activities and whose existence may damage the interests of a UCITS.

The CSSF considers that STFs concluded with or involving related parties give rise to conflicts of interest and have to be appropriately disclosed. For instance, the fact that the UCITS managed by an IFM would enter into a securities lending agency agreement with a related Group entity for the processing of securities lending transactions would expose the IFM to a conflict of interest because such a set-up would result in additional remuneration for the Group to which the IFM belongs.

2. Chapter II – SFT costs / fees

2.1 What should UCITS comply with in terms of the requirements on direct and indirect operational costs / fees arising from SFTs as per points 28 and 29 of Section X of the Guidelines and related provisions on the policy on sharing of returns on SFTs under Article 14 of SFTR with Section B of the Annex?

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Operational costs / fees arising from SFTs do not include hidden revenues. Only effective costs / fees, corresponding to services rendered to the UCITS in the context of SFTs, can be charged to the UCITS.

In this context, IFMs should have a full understanding of the underlying operational cost drivers making up the total costs / fees paid to each entity and that are deducted from the gross revenue arising from SFTs.

Those cost drivers could, for instance, relate to the following components: equipment, human resources, transaction costs, trading platform, Information Technology, legal, compliance, risk controls, collateral management, oversight and reporting.

The CSSF expects UCITS IFMs to perform a comprehensive assessment of the adequacy of the operational costs / fees that are deducted from the gross revenues arising from SFTs. In order to comply with the present requirement and notably ensure that the costs / fees do not include any hidden revenue, UCITS IFMs must be able to justify, by means also of quantitative information, the relevance of the underlying cost drivers which make up the total costs / fees borne by the UCITS.

In a general manner, UCITS have to be able to justify the ratio of gross revenues to direct and indirect operational costs / fees arising per SFT and to provide corresponding documentary evidence of the underlying rationale.

3. Chapter III – Conflicts of interest and best execution

3.1 Chapter III of CSSF Regulation 10-04 sets forth provisions that IFMs need to comply with in terms of conflicts of interest.

How do the provisions apply in the context of the use of the SFTs?

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The CSSF expects IFMs to proceed to a comprehensive documented assessment of the operational model (whether on a principal or model basis) and related processes underlying the SFT in order to identify and record the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the UCITS.

In addition, IFMs have to mitigate the conflicts of interest identified and to manage those if they cannot be prevented, including by adequate disclosure of material conflicts of interest to investors by means of the UCITS prospectus. The CSSF finally considers that SFTs concluded with or involving related parties give rise to conflicts of interest that have to be managed accordingly.

3.2 Chapter III of CSSF Regulation N° 10-4 sets forth provisions that IFMs need to comply with in terms of best execution.

In particular, Articles 28 to 30 of the CSSF Regulation N° 10-4 further specify these provisions in relation to best execution by requiring notably from IFMs to take all reasonable steps to obtain the best possible result for the UCITS, taking into account price, costs, speed, likelihood of execution and settlement, order size and nature, or any other consideration relevant to the execution of the order.

How do those provisions apply in the context of the use of the SFTs?

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The CSSF expects IFMs to cover SFTs in their best execution policy and to have robust and comprehensive control processes in place to ensure that the UCITS obtain the best possible result as regards in particular also the securities lending revenues (lending fee) respectively the interest rates underlying repurchase agreement transactions and reverse repurchase agreement transactions, but also as regards the costs / fees charged to the UCITS when executing such transactions.

The IFMs have to perform the best execution controls either themselves or, notably in case of a portfolio delegation model, to have robust initial and on-going due diligence/oversight in place to ensure that the best execution controls performed by the delegate are adequate.



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