Commission de Surveillance du Secteur Financier

CSSF Thematic Review

Efficient Portfolio Management by UCITS – Revenues & Costs/Fees

RESULTS

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1. Context

At the end of 2019, the CSSF launched a thematic review on the use by UCITS of efficient portfolio management techniques (EPM) and more particularly securities lending as well as repurchase agreement and reverse repurchase agreement transactions (hereafter "EPM techniques").

The review was focused on the regulatory provisions on revenues and costs / fees arising from these EPM techniques as laid down in the ESMA document "Guidelines on ETFs and other UCITS issues" (ref.: ESMA/2014/937EN, dated 1 August 2014, hereafter "the Guidelines") which has been implemented in the Luxembourg regulation by means of Circular CSSF 14/592 as well as the related controls in place at the level of the management companies. It followed also the conclusions mentioned in the ESMA report "Final Report Peer review on the Guidelines on ETFs and other UCITS issues (ref: ESMA42-111-4479)" of 30 July 2018.

More specifically, the review has been carried out on a representative sample of fifty UCITS management companies (hereafter "IFMs"), domiciled in Luxembourg and other European countries, managing Luxembourg-domiciled UCITS that use securities lending, repurchase agreement (repo) and reverse repurchase agreement transactions (reverse repo)[1].

The questionnaire used by the CSSF in that context covered various questions relating, among others, to aspects such as the model used by the IFMs for the EPM techniques (principal or agent model), the policy regarding operational costs, taxation, disclosure, investment restriction controls, conflicts of interest and best execution controls.

[1] *The sample of IFMs included in the scope of the thematic review covered more than 99% of the volume of securities lending, repurchase agreement and reverse repurchase agreement transactions reported to the CSSF in the context of the UCITS Risk Reporting. It should be noted that securities lending and reverse repurchase agreement transactions are the main techniques used by IFMs. Repurchase agreement transactions are only used to a very limited extent.*

The main observations made by the CSSF in that context together with the related recommendations and improvements are set out hereafter. The CSSF is currently engaging on a bilateral basis with IFMs in relation to the observations made.

The CSSF invites all IFMs using EPM techniques to conduct a thorough assessment with regard to the compliance of their set-ups with regard to these observations and to take the necessary corrective measures if necessary.

Finally, the CSSF will publish additional guidance on the EPM techniques by means of an FAQ covering the Guidelines and related provisions from the EU Regulation on transparency of securities financing transactions and of reuse (SFTR).

2. Observations

2.1 EPM disclosure

Paragraph 28 of the Guidelines mentions that "*The UCITS should disclose in the prospectus the <u>policy regarding direct and indirect operational costs/fees</u> arising from efficient portfolio management techniques that may be deducted from the revenue delivered to the UCITS. These costs and fees should not include hidden revenue. The UCITS should disclose the <u>identity of the entity(ies) to which the direct and indirect costs and fees are paid</u> and indicate if these are related parties to the UCITS management company or the depositary*". (emphasis added)

In addition, the ESMA document "Questions & Answers - Application of the UCITS Directive" (hereafter "ESMA Q&A") mentions in its answer 4c under section III relating to the Guidelines that "*UCITS management companies may disclose this information <u>in the prospectus of the UCITS or in the annual report of the UCITS</u>.*" (emphasis added).

Paragraph 29 of the Guidelines further mentions "*All the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS*".

The CSSF noted that the identity of the entity(ies) to which the direct and indirect operational costs / fees are paid is disclosed by most IFMs in the prospectus and in the annual report. For some IFMs the information is disclosed in one of the two documents. In addition, some IFMs disclose as well the information in other documents like the semi-annual report for instance.

While the information on the identity of the concerned entity(ies) to which the direct and indirect operational costs are paid has to be disclosed, as a minimum, in either the prospectus or the annual report, the CSSF recommends to disclose this important information in both documents for informing investors in a comprehensive manner.

The CSSF noted as well that some IFMs did not have controls in place to ensure that any related parties to the IFM of the UCITS or the depositary are duly disclosed in the prospectus or the annual report. In addition, some IFMs did not confirm that those controls were performed at their level.

The CSSF reminds IFMs to control, in accordance with the applicable regulation, the compliance of the UCITS they manage with the applicable disclosure requirements, including the disclosure requirements on EPM techniques.

In relation to the information disclosed in the prospectus with regard to the policy regarding direct and indirect operational costs/fees arising from EPM techniques, the CSSF noted that some IFMs disclose only a general sentence similar to the text of paragraph 29 of the Guidelines, sometimes supplemented with additional "specific" disclosure on the direct and indirect costs supported.

The CSSF considers that the prospectus should disclose the percentage of gross revenues generated by the use of EPMs on the basis of arm's length transactions which is returned to the UCITS (e.g. x% of the gross revenue[2] goes to the UCITS).

[2] *By reference to a 100% gross revenue figure that does not consider any direct and indirect operational costs.*

In addition, the prospectus should disclose a breakdown of the overall percentage[3] 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).

2.2 Conflicts of interest

The thematic review showed that the conflicts of interest policy of IFMs cover EPM techniques. In relation to the list of conflicts of interest identified by the IFMs in relation to the EPM techniques as well as the related management by the IFMs, the review showed that some IFMs have robust processes and controls in place. This is, for instance, the case for conflicts of interest arising from EPM techniques concluded with or involving related parties (notably also as these activities result in additional revenues for the Group) where these IFMs did refer to specific control frameworks (e.g. mapping of EPM related conflicts of interest, fee benchmarking, counterparty acceptance/review) as well as to comprehensive disclosure in the prospectus of the UCITS. However, the survey also showed that for most IFMs such processes and controls do not appear to be in place based on the answers provided.

Chapter III of CSSF Regulation N° 10-4 (transposing the Commission Directive 2010/43/EU of 1 July 2010) concerning conflicts of interest specifies the provisions with which IFMs have to comply in application of Article 109, paragraph (1), point b) and Article 111, point d) of the Law of 17 December 2010 relating to undertakings for collective investment (hereafter "2010 Law").

Furthermore, Articles 18 to 23 of the CSSF Regulation N° 10-4 require management companies among other to have a conflicts of interest policy, to keep and regularly update a record of the types of activities subject to a conflict of interest and to manage the activities giving rise to detrimental conflicts of interest.

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

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Article 20 stresses notably that the conflicts of interest policy of a management company <u>which is part of a group</u> shall also take into account any circumstances of which the company is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

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 EPM techniques 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 EPM techniques concluded with or involving related parties give rise to conflicts of interest that have to be managed accordingly.

2.3 Best execution controls

The CSSF noted that most IFMs informed about best execution controls in place concerning EPM techniques. However, the CSSF noted also that some IFMs do not control that the generated gross revenue is in line with the market conditions (i.e. that the effective gross revenue is coming from arm's length transactions) independently of the counterparty to the transaction (i.e. linked to the group or not). With regards to the entities in charge of these best execution controls, most IFMs informed that they are not performed directly by the IFMs. In addition, the thematic review also showed that some IFMs do not have in place a best execution policy that governs EPM techniques.

The CSSF reminds in this context Article 111 points a) and b) of the 2010 Law that sets forth notably that management companies shall act in the best interests of the UCITS they manage.

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.

In this context, the CSSF expects IFMs to cover EPM techniques 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.

2.4 EPM costs / fees

The CSSF noted that some IFMs do not periodically control that the different costs/fees charged to the UCITS funds correspond to the effective costs/fees of the services provided by the different parties involved in the EPM techniques. In addition, some IFMs indicated that the periodical controls are delegated to the principal/agent or to another party.

The CSSF noted as well that the costs/fees charged to the UCITS correspond generally to the following categories of cost drivers based on the answers provided by IFMs: equipment, human resources, transaction costs, trading platform, Information Technology, legal, compliance, risk controls, collateral management, oversight, reporting.

For the securities lending transactions, respectively the reverse repo transactions, the CSSF could observe that for the fifty IFMs surveyed, on average, around 75%, respectively 100%, of the gross revenue[4] arising from these transactions, is returned to the UCITS.

[4] The figure corresponds to an arithmetic average based on the number provided by each IFM and does thus not consider the volume of securities lending transactions concluded by the IFMs subject to the survey.

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Finally, the CSSF observed that only some IFMs proceed to a comprehensive assessment of the operational costs/fees arising from the EPM techniques in order to ensure that all revenues, net of direct and indirect operational costs/fees, are returned to the UCITS. Some IFMs limit themselves to ensure that the charged operational costs/fees are in line with market standards and have therefore not a full understanding of the underlying cost drivers paid to each entity making up the total costs/fees.

The CSSF reminds IFMs to consider paragraphs 28 and 29 of the Guidelines that require "*These costs and fees should <u>not include hidden revenue</u>*" and "*<u>All the revenues</u> arising from efficient portfolio management techniques, <u>net of direct and indirect operational costs</u>, should be returned to the UCITS*". (emphasis added)

To comply with the above requirements, and notably to ensure that the costs/fees do not include any hidden revenue, the CSSF considers that IFMs have to perform a comprehensive assessment of the adequacy of the operational costs/fees that are deducted from the gross revenues arising from EPM techniques and that 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.

2.5 Investment restriction controls

Article 43 (1) of the 2010 Law mentions notably "*A UCITS may not invest more than 20% of its assets in deposits made with the same body*".

The ESMA Q&A further clarifies in its answer 6m under section III relating to the Guidelines that "(...) *the reinvested cash collateral should be taken into account for the calculation of the investment restrictions applicable to UCITS. For example, this means that if a UCITS has already placed 10% of its assets on deposits with a given issuer, it should not reinvest cash collateral for more than 10% of its assets in deposits with the same issuer in order to comply with the 20% limit of Article 52(1)(b) of the UCITS Directive.*

In addition, the reinvested cash collateral has to comply with the diversification requirement laid down in paragraph 44 of the ESMA guidelines on ETFs and other UCITS issues".

In this context, the CSSF noted that some IFMs answered that they do not consider the reinvested cash collateral in the calculation of the above mentioned investment restriction. Based on further exchanges with these IFMs, it appeared for those IFMs that, in practice, collateral was primarily received as non-cash assets and that on that basis they answered negatively to the related question.

The CSSF wants to clarify that the reinvested cash collateral placed on deposit with a credit institution has to be taken into account in the 20% deposit limit laid down in the UCITS regulation.

In addition, the reinvestment of the cash collateral in other eligible reinvestments (e.g. high-quality quality government bonds) has also to be taken into account in the relevant diversification requirements laid down in the UCITS regulation.

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