

Follow-up Report

to the Peer Review on the Guidelines on ETFs and other UCITS issues

List of Acronyms and Terms Used

BoS	Board of Supervisors
CSA	Common Supervisory Action
DerivateVO	Derivateverordnung (German Derivatives Regulation)
EPM	Efficient Portfolio Management
ESMA Q&As	Questions & Answers on the Application of the UCITS Directive (ESMA34-43-392)
ETFs	Exchange Traded Funds
EU	European Union
Guidelines	ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937)
KAGB	Kapitalanlagegesetzbuch (German Capital Investment Code)
MS	Member State
NCA	National Competent Authority
Repo	Repurchase Agreement
Reverse Repo	Reverse Repurchase Agreement
SFT	Securities financing transaction
SFTR	Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012
UCITS	Undertakings for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
UCITS Management Company	UCITS Management Companies, as defined in Article 2(1)(b) of the UCITS Directive, and self-managed investment companies that have not designated a UCITS Management Company in accordance with Chapter V of the UCITS Directive

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1 Executive Summary

1. This follow-up peer review report updates on the actions that National Competent Authorities (NCAs) took to address the issues identified in the ESMA's 2018 peer review on the Guidelines on ETFs and other UCITS issues (the Guidelines).¹
2. UCITS are a key financial product for retail investors in the EU. The UCITS framework permits the use of Efficient Portfolio Management (EPM) techniques and instruments. Investors need high-quality information to make informed decisions when investing in UCITS using EPM. ESMA issued the Guidelines to provide guidance on various UCITS topics including the use of EPM. These Guidelines were the basis of the peer review that ESMA conducted in 2018, which covered five NCAs (DE, EE, FR, IE, LU).
3. The peer review identified that some NCAs (DE, EE, LU) needed to improve their practices when supervising disclosures to investors, operational aspects of costs, fees and revenues for EPM, and collateral management issues.
4. The scope of the follow-up peer review was twofold. First, ESMA assessed whether these three NCAs (DE, EE, LU) improved their practices based on the peer review findings. Secondly, given the close link with one of the peer review topics, ESMA enquired on the supervisory work carried out by four NCAs (DE, FR, IE, LU) in relation to the attribution of revenues and costs derived from securities lending by UCITS, also in light of the findings of a Better Finance research paper published after the peer review.
5. With respect to the first point, the follow-up peer review identifies that the three NCAs (DE, EE, LU) have made progress in addressing points of partial or insufficient compliance with the Guidelines identified in the peer review. NCAs have undertaken supervisory actions (such as thematic reviews and engagement with UCITS Management Companies) and enhanced internal and external guidance on these topics.
6. With respect to the second area of focus of this follow-up peer review, the Better Finance report noted a large variation (from 51% to 95%) in the gross revenues generated by securities lending transactions that were returned to UCITS investors in some jurisdictions (DE, FR, IE, LU). This raised concerns with regards to the compliance with the Guidelines. For this reason, ESMA enquired the four NCAs on their supervisory practices and activities on the topic following this report.
7. All NCAs which supervise UCITS engaging in EPM techniques (DE, FR, IE, LU) reacted to the Better Finance paper undertaking supervisory work to check the part of revenues resulting from securities lending transactions attributed to the UCITS. The

NCA reported to ESMA that their supervisory findings were overall satisfactory in that they did not identify any / or any significant regulatory breaches.

8. All in all, ESMA positively notes that the three NCAs for which room for improvements were identified in the peer review (EE, DE, LU) have strengthened their supervisory practices. ESMA also positively notes - based on the information reported to ESMA - that the four relevant NCAs (DE, FR, IE, LU) reacted through ad hoc supervisory work following market information in the Better Finance report. NCAs should continue monitoring the effective application of the Guidelines and the effectiveness of the supervisory practices implemented.
9. At the same time, ESMA notes that there are cases where EPM costs charged to some UCITS are significantly higher in comparison to other UCITS, especially where EPM techniques are carried out by the UCITS Management Company itself or by their related parties. This is an area of concern from an investor protection perspective and NCAs should continue monitoring it.

2 Introduction

10. This report provides an update on the actions NCAs have undertaken further to the 2018 peer review report on the Guidelines.
11. Protection of investors is core to ESMA's mission. Retail investors in the EU largely use UCITS for investment. To reduce risk and costs, or to generate additional capital or income of these financial instrument, the UCITS framework permits the use of EPM techniques and instruments which, however, may increase the complexity of UCITS.
12. Investors need high quality information to make informed decisions when investing in UCITS using EPM. For this reason, ESMA issued Guidelines with the aim to protect investors by providing guidance on the information that should be communicated to investors as well as specific rules that UCITS need to apply when entering into EPM. In particular, the Guidelines provide rules on some aspects related to the use of EPM, such as transparency and disclosure rules, operational requirements, as well as rules for risk and collateral management.

¹ Guidelines came into full effect on 18 February 2014 and are available at:

https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf

The peer review report (ESMA42-111-4479) was published on 30 July 2018 and is available at:

https://www.esma.europa.eu/sites/default/files/library/esma42-111-4479_final_peer_review_report_-_guidelines_on_etfs.pdf

13. Given the importance of this topic, in 2018 ESMA carried out a peer review on NCAs' supervisory practices in consideration of the Guidelines. Peer reviews are key tools to assess and further improve the effectiveness and consistency of NCAs' supervision.
14. The peer review identified weaknesses and issued recommendations. This follow-up aims at monitoring developments and provide an update on how NCAs have taken on board the peer review's findings and recommendations.
15. The peer review report covered the following topics:
 - (i) Disclosure to end-investors of the UCITS²;
 - (ii) Internal Risk Management and Compliance with the Investment Mandate³;
 - (iii) Operational Aspects⁴; and
 - (iv) Collateral Management⁵.
16. The peer review assessed the supervisory practices of five NCAs (DE, EE, FR, IE and LU).⁶
17. The peer review report concluded that for the "Internal Risk Management and Compliance with the Investment Mandate" and "Disclosures to end-investors", NCAs' compliance with the Guidelines was mostly satisfactory, although room for improvement existed on the latter for one NCA (EE). Indeed, the peer review identified a case in which a UCITS prospectus did not contain clear information for the use of EPM, thereby impacting transparency and comparability of products for the end-investors.
18. Regarding the "Operational Aspects" and "Collateral Management", the peer review report noted that supervisory practices and arrangements in place at two NCAs (DE and LU) raised some concerns.⁷ This related to one of the fundamental Guideline expectations around "Operational aspects" which is that NCAs should check that all revenues arising from EPM, net of direct and indirect operational costs, are returned to the UCITS. NCAs should also check these costs to prevent the levy of hidden revenues to the detriment of the UCITS. In relation to "Collateral Management", Guidelines sets forth criteria for collateral management to reduce counterparty risks for the UCITS.

² In relation to Chapter X para. 25, 28, 35 and Chapter XII para. 43(e) [partly], 47, 48, of the Guidelines.

³ In relation to Chapter X para. 26, 27, 34, of the Guidelines.

⁴ In relation to Chapter X para. 29-33, of the Guidelines.

⁵ In relation to Chapter XII para. 42-44, of the Guidelines.

⁶ The peer review also assessed the UK, which was excluded from this follow up following its withdrawal from the EU.

⁷ In particular, the peer review report identified insufficient compliance in the area of 'Collateral Management' (DE and UK) and 'Operational Aspects' (UK), and partial in the area of 'Operational Aspects' (LU).

19. The peer review report made recommendations to NCAs (DE, EE, LU) to improve supervisory convergence in terms of effectiveness and consistency of supervisory practices in the areas above.

Follow-up process

20. This follow-up aims to check the progress made by three NCAs (DE, EE, LU) in those areas where the peer review identified insufficient or partial compliance as listed above. It also considers the supervisory work carried out by four NCAs (DE, FR, IE, LU) in relation to the attribution of revenues and costs derived from securities lending by UCITS, taking also into account the findings of a report⁸ by Better Finance issued in May 2019 (as it relates in part to the “Operational Aspects” covered by the peer review). As a result, two additional NCAs (FR and IE) were included in the scope of this follow-up, despite the peer review had identified no shortcomings in this area. The ESMA’s Board of Supervisors agreed on conducting this follow-up in the ESMA 2021-2022 Peer Review Work Plan.
21. ESMA carried out the assessment through a desk-based information gathering to determine progress in addressing the weaknesses identified in the peer review and how the NCAs addressed the issues identified in the Better Finance report. ESMA’s analysis did not cover the actual supervisory files produced by the NCAs nor exchanges between the NCAs and the supervised firms. The analysis therefore relies and is based on the descriptions provided by NCAs on supervisory practices and their practical implementation.
22. The work was launched through letters by ESMA’s Chair addressed to those NCAs for which findings have been identified in the peer review report⁹ or to those which supervise UCITS engaging in EPM techniques, also considering the findings of the Better Finance report published after the peer review, namely:
 - a) DE for the areas of ‘Operational Aspects’, ‘Collateral Management’ and regarding the findings in the Better Finance report;
 - b) LU for the area of ‘Operational Aspects’ and regarding the findings in the Better Finance report;
 - c) EE for the area of ‘Rules on Disclosure to end-investors of the UCITS’;
 - d) FR and IE regarding the findings in the Better Finance report.

⁸ [Research Paper on Efficient Portfolio Management Techniques: Attribution of profits derived from Securities Lending by UCITS Exchange-Traded Funds](#)

⁹ As indicated above, a consequence of the withdrawal of the UK from the EU, the UK is considered out of scope.

Table 1 – Country codes and acronyms of Competent Authorities covered in the ESMA follow-up.

Country Code	Country	Competent Authority	Acronym
DE	Germany	Bundesanstalt für Finanzdienstleistungsaufsicht	BaFin
EE	Estonia	Finantsinspektsioon	EFSA
FR	France	Autorité des Marchés Financiers	AMF
IE	Ireland	Central Bank of Ireland	CBOI
LU	Luxembourg	Commission de Surveillance du Secteur Financier	CSSF

3 Overview of follow up assessment

23. The following section presents the overview of the follow up assessment per NCA.

3.1 Germany

24. The peer review report identified insufficient compliance with regard to two assessment areas, namely: (i) operational aspects; and (ii) collateral management. For operational aspects, the peer review noted that DE had: (i) not sufficiently formalised and documented approaches on revenues, fees and costs of EPM; and (ii) an insufficient threshold-based approach on minimum net revenue to be returned to the UCITS, with no additional review or challenge of UCITS Management Companies. Regarding collateral management, the peer review report identified exemptions for organised securities lending schemes from a subset of collateral management requirements set out in the Guidelines.

25. In addition, the Better Finance report suggested that market participants in Germany use some revenue sharing models for securities lending transactions which might raise concerns as to their compliance with the Guidelines. Therefore, ESMA also sought clarification on whether these findings were investigated.

3.1.1 NCA Response

Operational aspects

26. **No sufficiently formalised and documented approach on revenues, fees and costs of EPM:** During the peer review period, DE did not have sufficient internal or external guidance to assess UCITS Management Companies' set-up regarding fees, costs and revenues.
27. DE indicated in its response to ESMA that, following the peer review, it revised its rules and guidance. Supervisory processes have been revised and documented in the process manual and model documents, which are regularly revised, and are used for supervisory checks.
28. Model documents provide applicants and established UCITS with minimum standards to comply with and include 'Model for cost clauses of open-ended public investment funds'¹⁰ (model cost clauses) and other documents¹¹. DE indicated that it assesses whether costs are due or undue by referring to the expectations set out in the model cost clauses.
29. UCITS Management Companies established in Germany are allowed to deduct a fee (for the initiation, preparation and execution of securities lending transactions) that is at a fair market rate and in any case limited to one-third of the gross revenues generated by these transactions. All direct and indirect costs clauses are a mandatory part of the fund's investment terms and conditions. DE carries out supervisory checks as detailed in the below section.
30. **Insufficient threshold-based approach on the minimum net revenue to be returned to the UCITS with additional review or challenge of UCITS Management Companies:** the findings in the peer review especially related to the model cost clauses which stipulated that only 51% of the *net* revenues, generated by securities lending transactions, had to be returned to the investment fund. As a result, DE allowed UCITS Management Companies to deduct up to 49% of the *net* revenues (generated through EPM transactions) without further reviewing and challenging them on the fee structure (and the risk of levy of hidden revenues to the detriment of the UCITS, especially given the deductions on a net basis).
31. DE indicated that, following the peer review, it revised its rules in relation to the threshold approach. Now, UCITS Management Companies are only allowed to deduct a fair market rate fee for the initiation, preparation and execution of securities lending transactions, limited to one-third of the gross revenues generated by these transactions. Moreover, the German Investment Code¹² was amended to provide that the revenue from securities

¹⁰ The document refers to the "Model for cost clauses of open public investment funds (excluding special real estate funds)". Following the peer review, DE has updated the section related to the "Securities lending transactions and securities repurchase agreements".

¹¹ These include 'Model investment terms and conditions' and 'Model administrative acts'.

¹² Kapitalanlagegesetzbuch or KAGB

lending transactions shall accrue to the domestic UCITS¹³. The amendment has entered into force on 2 August 2021.

32. Furthermore, DE noted that, notwithstanding the limitation of the fees to a maximum of one-third, the rate charged has to be in line with a fair market rate. In DE's view, this ensures that the UCITS Management Company (or the securities lending agent that performs EPM) does not collect revenues as a lump sum without a specific merit.
33. DE also indicated that it performs supervisory reviews and challenges UCITS Management Companies.
34. In particular, DE assesses and approves UCITS cost clauses at initial authorisation stage (i.e., new fund issue) and in the event of amendments. DE refuses its approval in case of undue costs, i.e., costs that do not comply with the model cost clauses in terms of transparency and proportionality. DE does not make price specifications and would only investigate the costs level in exceptional cases (e.g., if exceptionally high or in case of a significant deviation from fair market rate). Whenever costs are noticeably different from other UCITS, DE has established an internal task force (composed of experts on cost-related issues) which discusses cases in the authorisation phase. DE indicated that this aims to achieve a harmonised approach.
35. With regard to ongoing supervision, DE indicated that the external auditor of the UCITS performs controls as to whether the UCITS Management Company has complied with the costs' provisions of the investment terms and conditions. The annual audit also considers the management of conflicts of interest and delegation. In case of findings, DE investigates further and may conduct special audits. DE also follows up on complaints from investors and information from whistle-blowers. Furthermore, DE holds periodic supervisory meetings with UCITS Management Companies.

Collateral management

36. **The exemption for 'Organised securities lending schemes' from a subset of collateral management requirements:** In relation to the insufficient compliance in the area of 'Collateral Management' identified in the peer review report, organised securities lending schemes were by law excluded from some collateral management requirements.¹⁴ These exemptions had their legal basis in the national regulations.¹⁵

¹³ Cfr. sec. 200 para. 1 of the KAGB.

The full text of the sec. 200 KAGB is available at: https://www.gesetze-im-internet.de/kagb/_200.html

¹⁴ The peer review report indicated that, in Germany, UCITS using 'organised securities lending systems' were by law exempt from some of the collateral management requirements set out in the assessed Guidelines, provided that the '*interests of investors are safeguarded*'. The potential exemptions in particular related to para. 43 d), e) and h) as well as para. 46 of the Guidelines. Such partial exemption had been granted to the securities lending program of Clearstream Banking.

¹⁵ In particular sec. 202 KAGB which is available at: https://www.gesetze-im-internet.de/kagb/_202.html and sec. 27 of the German Derivatives Regulation (DerivateVO) which is available at: http://www.gesetze-im-internet.de/derivatev_2013/_27.html

37. DE indicated that following the peer review, the legislator has removed the specific exemption in relation to organised securities lending schemes such as central securities depositories. These changes entered into force on 2 August 2021. As a result, DE indicated that there are no more exemptions from European requirements under German law.¹⁶

Better Finance report

38. The Better Finance report mentioned three German ETFs managed by a UCITS Management Company (operating in Germany) which deducted up to 49% from the revenue generated by securities lending transactions.
39. DE explained that they approached the relevant UCITS Management Company and requested a detailed statement on how the costs for securities lending transactions were calculated and how the amounts paid for these transactions were justified.
40. As reported by DE, the issues are considered to be resolved. DE reported that changes had been made in accordance with the model cost clauses, and to the permissible activities laid down in the relevant terms and conditions.

3.1.2 Analysis

Operational aspects

41. ESMA notes that DE has taken actions to follow up on the findings in the 2018 peer review.
42. **The formalisation and documentation of the approach on revenues, fees and costs of EPM:** DE has established that costs should be related to the initiation, preparation and execution of securities lending transactions and securities repurchase transactions. In addition, as established in model cost clauses, the fee should be in line with fair market rates. DE has indicated that it has revised its supervisory processes and model documents that it uses to perform checks and controls. Documents such as the 'Model cost clauses', the 'Model Investment Terms and Conditions' and the 'Model Administrative Acts' formalise DE's approach. DE has indicated that all processes are documented in the process manual. As all these documents form the basis for supervisory processes and provide the minimum standards to be met in relation to costs and fees of EPM, DE has therefore improved its approach since the peer review, including the relevant formalisation and documentation.

¹⁶ The exemption has been removed in the current version of the sec. 202 KAGB.

43. **The threshold-based approach on minimum net revenue to be returned to the UCITS and additional reviews or challenge of UCITS Management Companies:** Following the peer review, DE changed the former policy approach that was allowing UCITS Management Companies to deduct up to 49% of the *net* revenues.
44. DE changed this approach and now challenges UCITS Management Companies where needed. Currently, UCITS Management Companies may deduct a fee limited to one-third of the *gross* revenues for carrying out securities lending and securities repurchase activities (on behalf of the UCITS). This implies that at least two-thirds of the gross revenues generated must be returned to the UCITS (and its investors). The change of the DE approach and the removal of the possibility for UCITS Management Companies to deduct up to 49% of the net revenues is an improvement for investors.
45. Furthermore, the rule in the model cost clauses stipulates that the costs and fees charged to the UCITS (by UCITS Management Companies) must relate to the initiation, preparation and execution of securities lending and securities repurchase transactions, and be in line with fair market rates. To verify that the costs are compliant with the model cost clauses, DE indicated that it reviews any cost clauses and refuses its approval in case of undue costs. This can be considered positively as DE reviews and challenges UCITS Management Companies and, where needed, refuses the authorisation.
46. To check that costs are at fair market rate, DE has established an internal task force to discuss specific cases where costs are exceptionally high or in case of a significant deviation from fair market rate. While this approach can be positively considered as it seeks to ensure that EPM-related costs and fees borne by investors are in line with fair market rates, DE should systematically challenge UCITS Management Companies on the costs set-up.
47. ESMA also positively notes that DE foresees specific controls in its ongoing supervision by external auditors. It is indeed important that costs are not assessed only at authorisation stage but are also monitored throughout the fund's life. ESMA also positively notes that critical cases identified by the auditors are further investigated by the NCA. Finally, ESMA considers it positively that DE takes into account any complaints from investors as well as information from whistle-blowers, in order to consider further supervisory work including special audits. However, as already noted in other peer reviews, DE approach appears rather reactive in its own ongoing supervisory controls, which could limit its ability to directly identify cases that deserve increased supervisory attention, in addition to

those identified by auditors. While the annual audits can provide a useful source of information to be used in an NCA's supervision, activities performed by the firm's external auditor cannot substituted supervisory activities performed by DE staff.¹⁷

Collateral management

48. **The exemption for organised securities lending schemes from a subset of collateral management requirements:** While the Guidelines do not contain any exemption, the German regulatory framework used to provide for an exemption when securities lending activity was engaged in through a securities lending program of a central securities depository. It is positively noted that the legislator has now removed the exemption.

Better Finance report

49. ESMA takes note of DE's engagement with the Management Company following the Better Finance report. Although ESMA did not receive details of the specific supervisory controls performed by DE, ESMA notes that, in DE's view, the Management Company involved provided an acceptable justification for the level of revenue returned to funds.

Recommendations

50. ESMA positively notes that DE undertook important steps to review, clarify, formalise and document existing requirements and supervisory controls in the area of "Operational Aspects" to address issues of insufficient compliance identified in the peer review. ESMA recommends that DE continues to (i) monitor the implementation of the revised guidance and supervisory practices, (ii) keep track of and build on market information (including research such as the Better Finance report), and (iii) investigate potential cases of high EPM costs and contraventions of the Guidelines, taking stringent supervisory and enforcement action where needed.
51. With specific regard to the controls introduced, ESMA recommends that DE conducts controls to ensure that the cost set-up of UCITS is in line with fair market rates in all cases, in a systematic manner and not only in exceptional cases.
52. While the annual controls performed by external auditors can provide a useful support to NCAs' supervision, ESMA also recommends that DE strengthens its own ongoing supervisory practices in order to be able to directly identify cases that deserve increased supervisory attention, in addition to those identified by auditors.

¹⁷ It is also worth recalling that findings in relation to DE's own supervisory capacity and activities in addition to the external auditors, were also raised in past peer reviews, notably: (i) Peer review into supervisory actions aiming at enhancing the quality of data reported under EMIR; (ii) Peer Review on the collection and use of STORs and (iii) Peer review on supervision of cross border activities of investment firms

3.2 Estonia

53. The peer review report identified partial compliance in the area of “Disclosure to end-investors of the UCITS”. It identified issues with the NCAs’ supervisory practices in relation to comprehensibility and substance of disclosures for investors. Notably, the peer review identified that disclosures by a UCITS Management Company employing EPM did not put investors in a position to make an informed decision regarding the intended EPM engagement by the UCITS.

3.2.1 Response

Disclosure to end-investors

54. EE informed ESMA that it raised the issue of end-investors’ disclosure in the prospectus with the UCITS Management Company concerned by the finding in the peer review report.
55. EE also indicated that the UCITS Management Company assured that it had never used EPM techniques before, nor was it planning to do so in the near future. If the UCITS Management Company decided to start using EPM in the future, it would have to update the fund's prospectus¹⁸ and to notify EE providing an assessment of the impact of such change on the fund and its investors.
56. EE reported that as the UCITS Management Company must inform them in advance before starting to use EPM, it would use this notification to adjust its supervisory approach on the UCITS Management Company as appropriate (i.e., the review of the prospectus). Moreover, in the case of material amendments to the prospectus, the UCITS Management Company must ensure that at the request of the unit-holders, a unit can be redeemed without any redemption fee within at least one month before the amendments enter into force.
57. EE noted that the UCITS market in Estonia is small and has contracted. In particular, during the peer review process in January 2018, there were 10 active UCITS. Currently, this number has reduced to seven, of which two are currently in the process of a cross-border merger and only one UCITS, with a total net asset of 41,9 million Euro (representing approximately 0,8% of the domestic market), may employ EPM techniques.
58. Furthermore, EE mentioned that it checked the use of EPM techniques by market participants during the 2021 ESMA Common Supervisory Action on costs and fees,¹⁹ (there-

¹⁸ As stipulated in §78(1) of the Estonian Investment Funds Act.

¹⁹ <https://www.esma.europa.eu/press-news/esma-news/esma-reports-supervision-costs-and-fees-in-investment-funds>

after, the CSA). In this context, EE observed that neither the above-mentioned Management Company nor any other UCITS Management Company in Estonia employed EPM techniques.

3.2.2 Analysis

59. The peer review noted that EE permitted disclosures that would likely confuse investors regarding the intended EPM engagement by the UCITS.
60. ESMA notes that the NCA has taken action to follow up on the specific peer review findings, requesting information to the Management Company on its actual use of EPM techniques. The company informed EE that it did not and will not use EPM techniques and EE noted that it will adapt its supervisory screening should it be informed of UCITS using such techniques in the future (noting that there is a mandatory prior notification). At the same time, ESMA notes that the prospectus in question, which is still publicly available, has not been amended in respect to the relevant wording identified in the peer review. The prospectus still includes confusing disclosure which does not enable investors to make an informed investment decision regarding the intended EPM engagement by the UCITS.
61. ESMA positively notes that EE undertook supervisory activity to check the use of such techniques by other companies through the CSA.

Recommendations

62. ESMA maintains the peer review recommendation to improve comprehensibility and substance of disclosures in the prospectus identified in the peer review, so as to avoid the inclusion of confusing wording.
63. Investors should be clearly informed of the intended engagement in EPM - by the UCITS Management Company - without it being left as a mere possibility or option of the UCITS. EE should ensure to adequately challenge UCITS Management Companies with a view to avoid the currently unclear wording.
64. ESMA understand that EE identified that currently no UCITS Management Companies employs EPM techniques. Should this be the case in the future, EE should ensure that its supervisory practices allow to systematically, timely and thoroughly scrutinise prospectus disclosures to promote that investors receive clear and comprehensive information.

3.3 France

65. The peer review report did not note any areas of insufficient or partial compliance in relation to FR. However, in light of the information included in the Better Finance report, ESMA used the opportunity of this follow-up to ask clarifications about FR's practices concerning the supervision of EPM techniques.
66. In particular, ESMA sought clarification from FR on two aspects: (i) whether the use of revenue sharing models in relation to EPM is permitted in France; and (ii) whether FR investigated the allegations made in the Better Finance report concerning the securities lending practices of certain UCITS established in France.

3.3.1 NCA Response

Whether the use of revenue sharing models in relation to EPM is permitted in France

67. Revenue sharing is permitted in France to the extent that UCITS Management Companies can define in the fund prospectus a maximum proportion of cost to be deducted from the revenues generated by the use of EPM techniques.
68. **Type of national rules or guidance that are in place:** FR explained that it has a domestic framework in place for UCITS. FR has integrated ESMA's Guidelines into its own guidance²⁰. Additionally, French law provides a regulatory framework for best execution of transactions and selection of counterparties (Best Selection²¹) and a policy on conflicts of interests (Conflicts of interests²²) to promote that the level of the revenue is appropriate.
69. **Whether there are minimum thresholds that must be met and whether these apply on a net or gross basis:** FR informed ESMA that it has not prescribed any such thresholds.
70. **Supervisory checks and controls that FR performs to prevent the levy of hidden revenues and to ensure that the UCITS and its investors receive all revenues from EPM activities, net of direct and indirect operational costs:** FR informed ESMA that, during the authorisation process, it carries out controls on the use of EPM techniques

²⁰ Available at: <https://www.amf-france.org/en/regulation/policy/doc-2013-06>

²¹ In accordance with Article L. 533-22-2-2 of the French Monetary and Financial Code the Management Company shall ensure best execution of Security Financing Transactions (SFTs) or best selection of the service provider to which it entrusts the SFTs. Article L533-22-2-2 is available at: https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000035015622/2022-11-23

²² In accordance with Article L533-10 I 3° which is available at: https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000043706970

aiming at verifying that all revenues, net of direct and indirect operational costs, arising from EPM should be returned to the funds.

71. In case of revenue sharing, UCITS Management Companies should disclose in the funds' prospectus the maximum proportion of cost to be deducted from the revenues (generated by the use of EPM techniques). FR indicated that it systematically reviews EPM-related disclosures.
72. Additionally, FR indicated that UCITS Management Companies are required to be able: (i) to justify that costs are compliant with ESMA's Guidelines and are actually/effectively borne by intermediaries; as well as (ii) to demonstrate that the level of costs deducted from revenues is in line with fair market rates. In this last regard, FR noted that in the French market, most UCITS Management Companies return to the fund around 60-65% of the revenues generated from the EPM activities. FR also indicated that it is starting to develop a more analytical approach to further assess revenues and operational costs from EPM.
73. FR informed ESMA that it has carried out supervisory work regarding the Guidelines after the publication of the peer review report. FR undertook a thematic on-site inspection on the application of the Guidelines (report²³ published in December 2019). Moreover, FR imposed a sanction in September 2019 in relation to hidden revenue from EPM techniques.²⁴
74. FR also participated to the 2021 CSA on costs and fees performing a thematic on-site and off-site supervisory work with dedicated questions on the use of EPM. FR undertook follow-up work e.g., asking companies to formalise EPM procedures, to improve disclosures on this topic and asking clarification on the due diligence done under the French rules on Best Selection. No hidden revenues were found as part of the CSA work.

Whether FR investigated the allegations made in the Better Finance report concerning the securities lending practices of UCITS established in France

75. FR reported that, following the Better Finance report, it undertook supervisory activities to analyse if the relevant (two) Management Companies, that managed UCITS ETFs covered in the report, were in compliance with the relevant legislation and guidelines.
76. In one case, FR reviewed (i) the procedures related to EPM, (ii) the types of revenues generated by EPM and their allocation, and (iii) the legal documentation of the French funds with the highest volume of EPM trades to check EPM related disclosures. Addi-

²³ Report available at: [Summary of SPOT inspections on securities financing transactions by asset \(amf-france.org\)](https://www.amf-france.org)

²⁴ Decision n°12 (25 September 2019) by AMF Commission Des Sanctions, available at: <https://www.amf-france.org/sites/default/files/2020-02/decision-de-la-commission-des-sanctions-du-25-septembre-2019-a-legard-des-societes-x-natixis-asset-management-finance-et-natixis-investment-managers-international.pdf>

tionally, FR interviewed the UCITS Management Company's representatives to understand the EPM fee scheme. Based on this review, FR did not find any breach of the Guidelines.

77. In the other case, FR carried out an onsite inspection looking into the best selection and execution obligations in relation to the management of the ETF and more specifically the EPM transactions and the revenue split. FR did not identify significant breaches of the Guidelines and issued a follow-up letter leading to a complete review of the relevant procedures and an independent audit of different thematic including EPM in the ETF. Moreover, FR noted that one Management Company decided to stop using EPM techniques for its ETFs due to the complexity and reporting burden, on the one hand, and the low added value provided to the fund, on the other hand.
78. FR also indicated that EPM techniques are currently used by a limited number of Management Companies - especially given the small number of French UCITS ETFs. Based on FR's observations, EPM techniques usage is also decreasing because it is less and less profitable: the costs of implementation are high and fixed while the revenues decreased significantly due to higher competition and (until recently) lower interest rates.
79. Regarding the appropriate level of cost, FR considers that the comparison performed in the Better Finance report did not include all qualitative elements that would enable to set a maximum proportion of the revenue that could be shared. The Better Finance report mentioned one Management Company that returned a very high level of revenue to the UCITS and its investors (95%). According to FR, this practice is indeed beneficial to the investors, while it also pointed out that it should be kept in mind that this was a large Management Company focusing on passive funds. FR noted that different factors may influence the level of costs. Larger Management Companies can split fixed costs on a wider basis, compared to smaller Management Companies. Most of the Management Companies included in the CSA analysis used intragroup or internal teams to execute EPM transactions. Very few Management Companies use external/independent entities for the execution of EPM transactions. The level of costs is one the elements considered in the selection process together with other factors such as operational feasibility, efficiency, better execution and cash remuneration conditions. In the case of smaller Management Companies, it is not always economically beneficial to have an internal team to execute EPM transactions, therefore they make lesser use of EPM techniques.

3.3.2 Analysis

Whether the use of revenue sharing models in relation to EPM is permitted in France

80. **Type of national rules or guidance that are in place:** ESMA notes that FR transposed ESMA's Guidelines into its own guidance which is complemented by measures in French law relating to Best Selection and Conflicts of Interest.
81. Based on the information provided, the set of national rules and guidance in place regarding the revenue sharing models for EPM techniques appears to reflect relevant ESMA Guidelines, promoting stakeholders' awareness of the funds' obligations in this area.
82. **Whether there are any minimum thresholds that must be met and whether these apply on a net or gross basis:** ESMA notes that FR has not prescribed any minimum thresholds that must be met.
83. **Supervisory checks and controls that FR performs to prevent the levy of hidden revenues and to ensure that the UCITS and its investors receive all revenues from EPM activities, net of direct and indirect operational costs:** ESMA notes that FR allows UCITS Management Companies to define a maximum proportion of cost to be deducted from the revenue generated by EPM techniques that is subject to upfront disclosure of this information in the fund's prospectus.
84. ESMA also notes that FR requires Management Companies to be able to justify costs. Amongst others, costs should be in line with fair market rates.
85. ESMA takes note that the FR has started to develop a further analytical approach on EPM revenues and operating costs with the aim to further identify the costs incurred and the allocation to the UCITS.
86. ESMA positively notes that following the publication of the peer review, FR undertook a thematic on-site inspection and participated to the 2021 CSA, with dedicated controls on the use of EPM. ESMA notes the added value of undertaking thematic reviews on important topics such as EPM in addition to day-to-day supervision of UCITS Management Companies. Furthermore, FR engaged in follow-up actions after the CSA, requiring Management Companies to take remedial action, so as to further improve standards regarding EPM in the French market, thereby promoting better outcomes for investors.
87. ESMA also positively notes that FR made use of all its supervisory tools, including taking an enforcement action in relation to a case of hidden revenue from EPM techniques.

Whether FR investigated the allegations made in the Better Finance report concerning the securities lending practices of UCITS established in France

88. ESMA takes note of the engagement by FR with relevant Management Companies following the Better Finance report. While no significant breaches were found, FR issued where needed a follow up letter to review the process of Management Companies with

particular reference to best selection and execution procedures. This can be positively considered as it aims to improve Management Companies practices and to ensure the execution of EPM transactions in the best interests of investors.

89. ESMA notes that the Better Finance report mentions one Management Company returning 95%²⁵ of revenue from securities lending to funds, whereas other Management Companies included in the analysis and operating in FR, returned around 60-65% of the revenue to the funds. The difference is quite large, even when considering qualitative elements and the scale/size of the Management Company. This continues deserving close supervisory attention on the practices followed by Management Companies, to ensure that there are no hidden revenues and assess possible room for reducing costs charged to the UCITS.
90. FR noted in its analysis that most of the Management Companies use intragroup or internal teams to execute EPM transactions. While this approach is adopted in consideration of different elements, not limited solely to the cost level, it is important to maintain close supervisory attention on the management of conflict of interests within the Management Companies and related parties, so as to ensure that EPM are executed in the best interest of investor and no inflated costs are charged to the fund.

Recommendations

91. ESMA recommends that FR continues to (i) monitor the adequacy and implementation of its supervisory practices, (ii) keep track of and build on market information (including research such as the Better Finance report), and (iii) investigate cases of high EPM costs and contraventions of the Guidelines, taking stringent supervisory action where needed.²⁶ This holds especially true with respect to cases that indicate higher costs in comparison with the market rate. This is also of particular importance in cases where UCITS Management Companies use related parties to perform EPM given the potential conflicts of interest.

3.4 Ireland

92. The peer review report did not identify areas of insufficient or partial compliance in relation to IE. However, in light of the information included in the Better Finance report, ESMA used the opportunity of this peer review follow-up work to ask clarifications about IE practices concerning the supervision of EPM techniques.

²⁵ The case of Management Company returning more than 90% of revenues is not unique in the EU UCITS market as shown in a publication of Better Finance in 2022. The report is available at: [Securities-Lending-Income-Attribution-Conflicts-of-Interest-in-EU-Retail-Investment-Funds-2022.pdf](https://www.betterfinance.eu/Securities-Lending-Income-Attribution-Conflicts-of-Interest-in-EU-Retail-Investment-Funds-2022.pdf) ([betterfinance.eu](https://www.betterfinance.eu))

²⁶ Including the further analytical approach once implemented.

93. In particular, ESMA sought clarification on two aspects: (i) whether the use of revenue sharing models in relation to EPM is permitted in Ireland (and if so to receive details on regulatory and supervisory aspects); and (ii) whether IE investigated the allegations made in the Better Finance report concerning the securities lending practices of certain UCITS established in Ireland.

3.4.1 NCA Response

Whether the use of revenue sharing models in relation to EPM is permitted in Ireland

94. IE reported that, in Ireland, the practice of revenue sharing with respect to securities lending is used by some Management Companies and is not explicitly prohibited.
95. **Type of national rules or guidance that are in place:** IE explained that there is a domestic framework in place for UCITS in Ireland. This domestic framework comprises of the Irish UCITS regulations (which transposes the EU UCITS Regulation)²⁷, the Central Banks UCITS Regulations²⁸ and Central Bank guidance²⁹, including the Central Bank UCITS Q&As³⁰. IE has also integrated the ESMA Guidelines on ETFs and other UCITS issues into its domestic framework.
96. IE informed ESMA that the Central Banks UCITS Regulations capture both ESMA Guideline 28 (which requires the UCITS to disclose in the prospectus its policy regarding direct and indirect operational costs/fees arising from EPM techniques that may be deducted from the revenue delivered to the UCITS)³¹ and ESMA Guideline 29 (which requires that all revenue arising from EPM techniques, net of direct and indirect operational costs, should be returned to the UCITS)³².
97. Additionally, as per the Irish UCITS Regulations, the depositary must report in the annual financial statements whether the UCITS has been managed in accordance with the Regulations (which include the rules regarding EPM techniques). IE expects depositaries to verify compliance with investment and borrowing restrictions set out in the Central Banks' UCITS Regulations or imposed through the constitutional documentation of the UCITS. Depositaries must also verify that fees charged to the UCITS are a category of fees which may be charged under the constitutional documentation. The depositary does not carry

²⁷ S.I. No. 352 of 2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (as amended) which transpose the UCITS legislation.

Available at: <https://www.irishstatutebook.ie/eli/2011/si/352/made/en/print>

²⁸ S.I. No. 230/2019 - Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019.

Available at: <https://www.irishstatutebook.ie/eli/2019/si/230/made/en/print>

²⁹ Available at: <https://www.centralbank.ie/regulation/industry-market-sectors/funds/ucits/guidance>

³⁰ Available at: <https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/ucits/guidance/ucits-qa-36th-edition.pdf>

³¹ Cfr Regulation 46 (1) (c) of the Central Bank UCITS Regulations.

³² Cfr Regulation 23 (2) of the Central Banks UCITS Regulations.

out an assessment with regard to quantum of fees and IE notes that this is not a regulatory requirement.

98. Furthermore, UCITS Management Companies in Ireland have a legal obligation to notify and report to IE any breach of the Central Banks UCITS Regulations or the IE's requirements that are applicable to the relevant UCITS or the Management Company.
99. **Whether there are any minimum thresholds to be met and whether these apply on a net or gross basis:** IE informed ESMA that it has not prescribed any such thresholds.
100. **Supervisory checks and controls that IE performs to prevent the levy of hidden revenues and to ensure that the UCITS and its investors receive all revenues from EPM activities, net of direct and indirect operational costs:** IE informed ESMA that supervisory checks and controls take place at two stages of the supervisory lifecycle, namely at authorisation and supervision. IE requires to ensure that all revenues arising from EPM, net of direct and indirect operational costs, are returned to the UCITS.
101. During the authorisation stage, IE reviews: (i) general information on the EPM techniques and instruments to be utilised; (ii) a detailed description of the inherent risks including counterparty risk and potential conflicts of interest; (iii) information on the collateral policy; and (iv) disclosures of the policy to be applied in the case of the direct and indirect operational costs/fees arising from EPM that may be deducted from the revenue delivered to the UCITS and the identity of the entity/entities to which the direct and indirect costs and fees are paid.
102. During ongoing supervision, IE engages in targeted activities, such as deep dive on selected funds and thematic reviews. On the latter, during its participation to the CSA on costs and fees, IE conducted a desk-based review of 59 UCITS Management Companies and an inspection call with all of those who stated they utilised EPM techniques. Out of the 59 UCITS Management Companies, 15 utilised EPM and 11 of them engaged in securities lending programmes. IE informed that, as part of this work, it issued Risk Mitigation Programmes (which require specific remedial action based on the supervisory findings) regarding the level of fees retained. In particular, with the aim to reduce costs levels and ensure a higher percentage of revenues returned to investors, IE requested two UCITS Management Companies to carry out a full review of their securities lending fee arrangements.
103. In addition, as part of its ongoing supervision, IE supervisors would receive regulatory, depositary and statutory audit reports in case of breaches, errors, or changes. If an EPM-related issue or breach is identified in these reports, IE investigates and engages with the funds/fund service providers concerned to understand the issue and consider appropriate next steps. This would include, where needed, an investigation to understand how the breach arose, how long the breach continued for, how it was identified, whether the

breach has been rectified, whether compensation has been due to unitholders and the need for issue of a risk mitigation programme. Where it is determined appropriate the matter can be referred to the IE's Enforcement Division.

Whether IE investigated the allegations made in the Better Finance report, concerning the securities lending practices of UCITS established in Ireland

104. IE reported that, following the Better Finance report, it undertook an investigation to analyse if some of the relevant Management Companies based in Ireland, who managed UCITS ETFs covered in the report, were in compliance with the relevant legislation and guidelines.
105. IE wrote to the top ten Irish Management Companies in Ireland requesting them to confirm their compliance with ESMA Guideline 29³³ and to provide evidence of how they comply including a breakdown of the relevant fees and operational costs for 2018/2019. These letters to the top ten Irish Management Companies covered 94% (in terms of number of funds) of all the Irish UCITS ETFs.
106. Four of the ten Management Companies confirmed that they engaged in securities lending. The level of revenue returned to funds managed by those four firms varied from 60% to 90%. IE engaged with those Management Companies to understand the rationale for the breakdown of revenue returned to the funds, the costs charged by the securities lending agents and the factors which influenced the level of securities lending fees. Management Companies noted some of the factors driving the costs include scale of the securities lending programmes, due diligence costs, operational costs and appointment of more than one securities lending agent.
107. As part of this work, IE stated that it reviewed all additional information provided including quantitative information relating to revenues and costs and was satisfied that the Management Companies in scope provided acceptable justifications and that further investigations were not required at the time.

3.4.2 Analysis

108. **Type of national rules or guidance that are in place:** based on the information provided, the set of national rules and guidance in place regarding the revenue sharing models for EPM techniques appears to reflect relevant ESMA Guidelines, which promoting stakeholders' awareness of the obligations in this area.
109. **Whether there are any minimum thresholds to be met and whether these apply on a net or gross basis:** ESMA notes the IE has not prescribed any minimum thresholds.

³³ As indicated above, this Guideline requires that all revenues arising from EPM, net of direct and indirect operational costs, should be returned to the UCITS.

110. **Supervisory checks and controls that IE performs to prevent the levy of hidden revenues and to ensure that the UCITS and its investors receive all revenues from EPM activities, net of direct and indirect operational costs:** ESMA notes IE's controls at authorisation stage - such as reviewing how the Management Company will undertake EPM techniques - as they aim to identify possible issues before the firm is authorised and before its entry into the supervisory perimeter. ESMA notes that, amongst others, IE's supervisors review general information on the EPM techniques, disclosure of the policy to be applied in the case of the direct and indirect operational costs/fees arising from EPM, and potential conflicts of interest. The latter is particularly important to assess whether the Management Company has effective arrangements to manage conflicts of interest and to allow the NCA to be aware and supervise them.
111. ESMA also notes that in its ongoing supervision of securities lending fee arrangements, IE conducts deep dive fund reviews and thematic reviews, including through the 2021 ESMA CSA on costs and fees. This can be positively considered to earn a fuller understanding of fund practices, perform transversal assessments and engage in follow-up actions (risk mitigation programmes) as needed. ESMA positively notes in particular that IE engaged in follow-up actions after the CSA, requiring Management Companies to take remedial action, so as to further improve standards regarding EPM in the Irish market, thereby promoting better outcomes for investors. In particular, IE requested two UCITS Management Companies to carry out a full review of their securities lending fee arrangements with the aim to reduce costs levels for investors.
112. IE expects depositaries to verify compliance of fees charged to the UCITS to ensure they are a category of fees which may be charged to the UCITS under the constitutional documentation. This involves an assessment of fees paid out of the UCITS' assets and analysing whether the ability to pay them is provided for in the UCITS' constitutional document and is disclosed in advance to investors through prospectus documentation. This is an important check on costs charged to the UCITS.
113. However, as depositaries conduct controls which are limited to eligibility of costs and their consistency with constitutional documents and prospectus disclosure, IE should also conduct controls on costs levels to verify whether they are in line with fair market rates and reasonable. These controls would aim to ensure that UCITS and their investors are not overcharged without objective reasons and, when necessary, challenge UCITS Management Companies on the costs set-up.
114. IE supervisors receive and control regulatory, depositary and statutory audit reports where needed, also liaising with the relevant funds/fund service providers, on a reactive basis, to investigate issues relating to securities lending arrangements. While this is an appropriate response to compliance problems that may arise, IE should conduct such controls in a proactive manner. These could be conducted with the aim to assess risks to investors' interest by checking costs set ups and driving factors – including scale of

the securities lending programmes, due diligence costs, operational costs and other factors impacting on costs. ESMA positively notes that IE conducted thematic reviews. However, while ESMA recognises and supports the use of this important supervisory tool, IE should use a more systematic approach with regard to reviewing costs, fees and revenues relating to EPM.

Whether IE investigated the allegations made in the Better Finance report concerning the securities lending practices of UCITS established in Ireland

115. ESMA takes note of the engagement by IE in 2020 following the Better Finance report and that, in IE's view, the relevant Management Companies provided acceptable justifications for the level of revenue returned to the relevant UCITS and their investors. Following the supervisory work as part of the 2021 CSA on Costs and Fees, IE issued risk mitigation programmes to two Management Companies asking to carry out a full review of their securities lending fee arrangements, with the aim to reduce costs levels for investors. This can be positively considered as aiming at protecting investors' interest and achieving a better result for them.
116. While the risk mitigation programmes may still need to be reflected into Management Companies practices, ESMA notes that the revenue returned to the funds by the UCITS Management Companies engaging in securities lending varied from 60% to 90%. The variability of the fees deducted by Management Companies is quite large, especially where UCITS Management Companies use related parties to perform EPM. As a result, some UCITS are charged with higher level of fees and some UCITS investors may receive lower returns than others. This continues deserving close supervisory attention on the practices followed by Management Companies, to ensure that there are no hidden revenues and assess possible room for reducing costs charged to the UCITS.

Recommendations

117. ESMA recommends that IE continues to (i) monitor the adequacy and implementation of its supervisory practices, (ii) keep track of and build on market information (including research such as the Better Finance report), and (iii) investigate cases of high EPM costs and contraventions of the Guidelines, taking stringent supervisory action where needed. This holds especially true in regard of UCITS Management Companies and UCITS that show higher costs and high variability of fees in comparison with market rate, and where UCITS Management Companies use related parties to perform EPM.
118. With the aim to reduce costs levels for investors, ESMA recommends IE to continue monitoring UCITS costs setups, including requesting, when needed, the review of securities lending fee arrangements to ensure that the cost set-up of UCITS is in line with fair market rates.

3.5 Luxembourg

119. The peer review report identified partial compliance in the area of Operational Aspects. In particular it identified that LU had: (i) not sufficiently formalised and documented approaches on revenues, fees and costs of EPM; and (ii) an insufficient threshold-based approach on minimum gross revenue to be returned to the UCITS, with reviews occurring only when the operational set-up of the UCITS stood out as noticeably different from other UCITS.
120. In addition, the Better Finance report suggested that market participants in Luxembourg use revenue sharing models for securities lending transactions. As part of the follow-up peer review exercise, ESMA sought clarification from LU to ascertain whether it investigated the Better Finance report findings in relation to UCITS and UCITS Management Companies established in Luxembourg and what was the outcome of such investigations.

3.5.1 NCA Response

121. **The formalisation and documentation of the approach on revenues, fees and costs of EPM:** LU indicated in the response to ESMA that it developed additional internal and external supervisory guidance, namely: (i) additional external supervisory guidance on the “Use of Securities Financing Transactions by UCITS”; and (ii) internal supervisory practices and guidance on revenues, costs and fees for EPM.

(i) Additional external supervisory guidance on the “Use of Securities Financing Transactions by UCITS”

122. At the end of 2019, LU carried out a thematic review on the use of EPM by Luxembourg domiciled UCITS (managed by Management Companies domiciled in Luxembourg and other European countries). Based on this work³⁴, LU published additional guidance on the “Use of Securities Financing Transactions (SFTs) by UCITS” in the form of a FAQ (SFT FAQ)³⁵.
123. The SFT FAQ clarifies the expectations arising from the use of SFTs³⁶ by UCITS Management Companies when performing EPM. More specifically, the SFT FAQ specifies: (i) the information that LU expects UCITS prospectuses to disclose on gross revenues and costs/fees arising from the use of SFTs³⁷; (ii) requirements on direct and indirect

³⁴ See published report on 18 December 2020 with the result of the exercise: https://www.cssf.lu/wp-content/uploads/Rapport_thematique_EPM_Final_181220.pdf

³⁵ The SFT FAQ is available at: https://www.cssf.lu/wp-content/uploads/FAQ_EPM_181220.pdf

³⁶ SFT refers to a repurchase transaction (including repurchase agreement and reverse repurchase agreement transaction), a securities or commodities lending and securities or commodities borrowing, a buy-sell back transaction or sell-buy back transaction, a margin lending transaction. SFTs are regulated by SFTR Regulation (EU) 2015/2365 on transparency of securities financing transactions and of reuse.

³⁷ Question 1.3. of the SFT FAQ.

operational costs and fees arising from SFTs³⁸; and (iii) the information that LU expects UCITS prospectuses to disclose on conflicts of interest arising from the use of SFTs (in that section, LU mentions notably that it considers that SFTs concluded with or involving related parties give rise to conflicts of interest that have to be appropriately disclosed³⁹).

124. In the context of the SFT FAQ, LU also:

- a) reminds the general rule to be observed in relation to “hidden revenues”;
- b) sets forth a list of eligible cost drivers that can arise from the use of SFTs, thereby clarifying that cost drivers may relate to components such as: equipment, human resources, transaction costs, trading platform, IT, legal, compliance, risk controls, collateral management, oversight and reporting;
- c) requires UCITS Management Companies to perform a comprehensive assessment of the adequacy of the operational costs and fees that are deducted from the gross revenues arising from SFTs; and
- d) requires UCITS Management Companies to be able to justify the relevance of the underlying cost drivers which make up the total costs and fees borne by the UCITS also by means of quantitative information and backed by documentary evidence.

125. LU indicated that to check the implementation of the FAQ, it requested UCITS Management Companies to update prospectuses of UCITS adopting EPM techniques with necessary additional information by 30 September 2021, and to receive such prospectus updates. LU has reviewed the updated documentation and, when needed, asked for enhancements.

(ii) Development of internal supervisory practices and guidance on revenues, costs and fees for EPM

126. LU indicated that in July 2021, it further specified and strengthened its internal procedures and guidelines on the supervision of EPM activities. In particular, LU further specified the authorisation process detailing the reviews/checks to be performed by the UCITS authorisation department, during the initial approval and subsequent amendments of UCITS prospectuses, in relation to EPM activities. This included specific controls on revenues and costs/fees arising from the use of EPM, to verify that:

- a) the prospectus mentions the proportion of gross revenues (before any deduction) that is returned to the UCITS; and
- b) the costs/fees put forward in the prospectus are reasonable by reviewing the nature, the proportion and checking the plausibility of the costs/fees indicated.

³⁸ Question 1.4. of the SFT FAQ.

³⁹ Question 3.1. of the SFT FAQ.

127. UCITS Management Companies are required to be able to justify: (i) the relevance of the costs/fees borne by the UCITS, also by means of quantitative information; and (ii) the relationship between gross revenues and (direct and indirect) operational costs/fees arising from the use of EPM and to provide corresponding documentary evidence of the underlying rationale to LU.
128. **The threshold-based approach on minimum gross revenue to be returned to the UCITS and the occurrence of the reviews only when the operational set-up of the UCITS stands out as noticeably different:** The peer review report indicated that LU interacted with applicants and conducted reviews only when the operational set-up of the UCITS stood out as noticeably different from other UCITS. LU used to apply a threshold of 51% to be returned to the UCITS on the basis of the gross revenue. This internal policy and the threshold served as a backstop of minimal revenues to be returned to the UCITS.
129. LU indicated that following the peer review and its thematic review mentioned above, it updated its supervisory practices and reflected them in revised procedures. In particular:
- a) If the prospectus indicates that less than 75% of the gross revenue is returned to the UCITS, supervisors (i) inform the UCITS Management Company/UCITS, that the proportion is not in line with the levels observed by LU at industry level;⁴⁰ and (ii) ask the UCITS Management Company/UCITS to justify the level of operational costs/fees applied.
 - b) If between 75% and 100% of gross revenues generated from securities lending transactions are returned to the UCITS the prospectus should indicate the proportion of gross revenues (before any deduction) that accrues to the UCITS. Revenue sharing based on net revenues is not accepted (i.e., the prospectus must disclose a breakdown of operational costs/fees based on the gross revenue and not the net revenue). A UCITS Management Company should carry out a full assessment of the adequacy of the operational costs/fees which are deducted from the gross revenues from the SFTs. Supervisors perform critical assessment that the costs/fees put forward in the prospectus are reasonable (review of the nature, proportion and plausibility of the costs/fees).
 - c) Where 100% of the gross revenue is returned to the UCITS, supervisors also challenge the UCITS Management Company/UCITS as regards the operational set-up and the related costs/fees, assessing the services delivered by the delegate/EPM service providers involved in the value chain of EPM techniques, and the related fees paid to these delegates/service providers in order to avoid that any hidden revenues are paid. Supervisors question the UCITS to understand whether the service providers are working without remuneration (free of charge) as free services would

⁴⁰ By reference to the Thematic Review Report and the SFT FAQ.

be uncommon and it would be important to assess whether they receive a remuneration in any form and if so, how.

130. In addition, LU introduced a checklist with a dedicated section concerning EPM activities, in case of a launch of a new (sub-)fund or a modification of a sub-fund.

Better Finance report

131. LU confirmed that it investigated the findings of the Better Finance report. Notably, it included three (out of four) UCITS Management Companies mentioned in the Better Finance report in its 2020 thematic review mentioned above, and in the 2021 CSA on costs and fees. The fourth UCITS Management Company stopped engaging in EPM techniques on behalf of the UCITS referred to in the Better Finance report.
132. According to LU, all UCITS Management Companies provided documented analysis (with varying levels of granularity) to justify the costs/fees deducted from the gross revenue earned on EPM techniques (cost drivers analysis, peer review, qualitative assessment). Furthermore, these UCITS Management Companies perform one or more of the following controls:
- a) an assessment of the adequacy of the underlying operational cost drivers making up the total costs/fees paid to each party involved in EPM activities (e.g., lending agent, UCITS Management Company);
 - b) a comparison of costs/fees applied to the UCITS (managed by the UCITS Management Company itself) with UCITS managed by other UCITS Management Companies;⁴¹
 - c) a review of the respective lending agent considering elements such as the ability of the agent to generate extra revenues, the counterparty risks, the operational risks, the capacity to lend securities, the capacity to avoid default or the fluidity of the daily operational exchanges.
133. More specifically, UCITS Management Companies provided LU with one or more of the following analyses:
- a) assessments (backed by quantitative information) that could justify the operational costs/fees deducted from the gross revenues from SFTs;

⁴¹ This comparison is based on information disclosed in the annual reports and prospectuses of UCITS or based on information from third party data providers (e.g., IHS Markit).

- b) benchmarking process concerning (i) the revenue split applied in the different securities lending programs and (ii) the performance achieved by the different securities lending agent, with the support of external data provider;
 - c) assessment to identify and document all the costs drivers in relation to the securities lending activity;
 - d) quantitative information justifying the costs deducted from the gross revenue and agreed in the dedicated fee sharing agreements;
 - e) specific qualitative analysis with the securities lending agent to ensure that the cost percentage taken is adequate, thereby considering also different aspects such as counterparty quality and securities lending performance achieved;
 - f) quantitative comparison with peers through information available in prospectuses and annual reports; use of market data that exhibits trends in securities lending and rates of utilisation and returns in global markets; and / or
 - g) reassessment of processes and the value contribution in the securities lending process, the number and quality of resources engaged directly and indirectly in securities lending activities, as well as the technical infrastructure supporting the activity.
134. LU noted that UCITS Managers explained higher operational costs also in that they select the security lending agent not only in relation to its costs, but also in view of elements such as its revenue generation capacity, counterparty credit quality, efficiency of operational processes and exchanges (e.g., collateral reports).
135. Where LU found UCITS Management Companies unable to justify clearly the costs charged for the specific services provided, it proceeded to further investigations. LU followed up and challenged the concerned UCITS Management Companies and conducted internal assessment work.

3.5.2 Analysis

136. ESMA notes that LU has taken actions to follow up on the findings in the peer review.
137. **The formalisation and documentation of the approach on revenues, fees and costs of EPM:** ESMA positively notes that after the peer review, LU has conducted a dedicated thematic review. As the review identified, amongst others, that some Management Companies charged operational costs/fees in line with fair market rates but without a full understanding of the underlying cost drivers paid to each entity, LU clarified supervisory expectations through external guidance, supporting UCITS Management Companies in understanding their obligations when performing EPM.

138. ESMA positively notes that the SFT FAQ requires that the prospectus presents a breakdown of the overall percentage of direct and indirect fees/costs between the delegate/EPM service providers with an indication of the type of service provided. This enhances the possibility for the investors to have a fuller understanding of the cost that the UCITS will incur.
139. In addition, LU has further developed (and formalised) its supervisory approach on revenues, fees and costs of EPM by developing additional internal controls to assess the nature, proportion and plausibility of the costs/fees. LU has further specified costs by identifying some of the costs drivers that may be allowed and related controls. ESMA positively notes that these improvements set the basis for more systematic, consistent controls across supervisors and challenge to the UCITS Management Companies.
140. **The threshold-based approach on minimum gross revenue to be returned to the UCITS and the occurrence of the reviews only when the operational set-up of the UCITS stands out as noticeably different:** To address the peer review findings in relation to the insufficient threshold-based approach and the rather exceptional nature of reviews, LU has introduced more detailed supervisory checks to challenge UCITS Management Companies. Such checks - further supported by relevant documentation and checklists - depend on the different revenue sharing thresholds and are intended to challenge the operational set-up of the UCITS. Also, LU establishes that revenue sharing based on net revenues is not acceptable. ESMA positively notes these improvements as they set forth the basis to carry out supervisory assessment in a more thorough, systematic and consistent manner.

Better Finance report

141. ESMA takes note of the actions that LU undertook following the publication of the Better Finance report, including assessing relevant Management Companies based in Luxembourg covered in the report through the thematic review and the CSA on costs and fees.
142. ESMA also notes that LU has requested relevant UCITS Management Companies to provide extensive analysis to justify the costs/fees through different means, such as cost drivers analysis, peer review, qualitative assessment. ESMA positively notes that by doing so LU investigated the specific cases to better understand the costs incurred by the UCITS using different approaches.
143. ESMA also positively notes that when the UCITS Management Companies were unable to justify clearly the costs charged for the specific services provided, LU proceeded to further investigations, thereby following up on potential supervisory concerns.

Recommendations

144. ESMA positively notes that LU has taken action to improve its supervisory practices, to provide internal and external guidance to address issues of partial compliance identified in the peer review.
145. ESMA recommends that LU continues to (i) monitor the implementation of the revised guidance and supervisory practices, and (ii) keep track of and build on market information (including research such as the Better Finance report), and (iii) investigate cases of high EPM costs and contraventions of the Guidelines, taking stringent supervisory and enforcement action where needed. This is especially true in cases where UCITS Management Companies use related parties to perform EPM, given the potential conflicts of interest. In these situations, supervisory checks and detailed cost analyses are indeed crucial to prevent market practices that may negatively impact investors.

Annex – Extract of the Guidelines on ETFs and other UCITS issues

Guidelines for the Operational Aspects - Chapter X para. 29 - 33

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

30. A UCITS should ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.

31. A UCITS that enters into a reverse repurchase agreement should ensure that it is able at any time to recall the full amount of cash or to terminate the reverse repurchase agreement on either an accrued basis or a mark-to-market basis. When the cash is recallable at any time on a mark-to-market basis, the mark-to-market value of the reverse repurchase agreement should be used for the calculation of the net asset value of the UCITS.

32. A UCITS that enters into a repurchase agreement should ensure that it is able at any time to recall any securities subject to the repurchase agreement or to terminate the repurchase agreement into which it has entered.

33. Fixed-term repurchase and reverse repurchase agreements that do not exceed seven days should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS.

Guidelines for the Disclosure to end-investors of the UCITS Chapter X para. 25, 28, 35; Chapter XII para. 43(e) [partly], 47, 48

25. A UCITS should inform investors clearly in the prospectus of its intention to use the techniques and instruments referred to in Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments should be in line with the best interests of the UCITS

28. The UCITS should disclose in the prospectus the policy regarding direct and indirect operational costs/fees 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 identity of the entity(ies) to which the direct and indirect costs and fees are paid and indicate if these are related parties to the UCITS management company or the depositary.

35. The UCITS' annual report should also contain details of the following: c) the exposure obtained through efficient portfolio management techniques; d) the identity of the counterparty(ies) to these efficient portfolio management techniques; e) the type and amount of collateral received by the UCITS to reduce counterparty exposure; and f) the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred.

43. Where a UCITS enters into OTC financial derivative transactions and efficient portfolio management techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times: [...]

e) Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this subparagraph, a UCITS may be fully collateralised in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' net asset value. UCITS that intend to be fully collateralised in securities issued

or guaranteed by a Member State should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral for more than 20% of their net asset value.

47. The prospectus should also clearly inform investors of the collateral policy of the UCITS. This should include permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, re-investment policy (including the risks arising from the re-investment policy).

48. The UCITS' annual report should contain details of the following in the context of OTC financial derivative transactions and efficient portfolio management techniques:

- a. where collateral received from an issuer has exceeded 20% of the NAV of the UCITS, the identity of that issuer; and
- b. whether the UCITS has been fully collateralised in securities issued or guaranteed by a Member State.

Guidelines for the Collateral Management - Chapter XII para. 42-44

42. All assets received by UCITS in the context of efficient portfolio management techniques should be considered as collateral for the purpose of these guidelines and should comply with the criteria laid down in paragraph 43 below.

43. Where a UCITS enters into OTC financial derivative transactions and efficient portfolio management techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times:

- a) Liquidity – any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the provisions of Article 56 of the UCITS Directive.

b) Valuation – collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.

c) Issuer credit quality – collateral received should be of high quality.

d) Correlation – the collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty.

e) Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value. When a UCITS is exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer. By way of derogation from this subparagraph, a UCITS may be fully collateralised in different transferable securities and money market instruments issued or guaranteed by a Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong. Such a UCITS should receive securities from at least six different issues, but securities from any single issue should not account for more than 30% of the UCITS' net asset value. UCITS that intend to be fully collateralised in securities issued or guaranteed by a Member State should disclose this fact in the prospectus of the UCITS. UCITS should also identify the Member States, local authorities, or public international bodies issuing or guaranteeing securities which they are able to accept as collateral for more than 20% of their net asset value.

f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.

g) Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.

h) Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

i) Non-cash collateral received should not be sold, re-invested or pledged

j) Cash collateral received should only be: - placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive; - invested in high-quality government bonds; - used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis; - invested in short-term money market funds as defined in the Guidelines on a Common Definition of European Money Market Funds.

44. Re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral.