

ADVICE TO ESMA

Securities lending: SMSG advice to ESMA in anticipation of a peer-review of UCITS Guidelines compliance.

I. Executive summary

Securities lending is what the UCITS directive and the UCITS eligible assets directive call an efficient portfolio management technique.

This technique is widely used by many market participants. Lenders are mostly institutional investors in securities, such as pension plans, insurance companies, and collective investment schemes (UCITS).

Within the framework of the control of the operations of UCITS, ESMA included in its “Guidelines for competent authorities and UCITS management companies” a chapter on the use of “Efficient Portfolio Management Techniques” by UCITS. This chapter contains eleven paragraphs numbered from 25 to 35 identifying appropriate techniques for UCITS.

In addition ESMA published in April 2016 a Guidelines compliance table showing that all European countries comply or intend to comply with these Guidelines.

II. Background

1. The SMSG understands that ESMA intends to carry out a peer review of compliance with these Guidelines in the second part of this year, and in order to assist this effort we have identified below the issues which the SMSG considers should be the priority focus of this thematic review on securities lending practices by UCITS.
2. The SMSG considers that the focus of ESMA’s assessment of compliance should lie on the following guidelines:

III. Under Section X:

3. Guideline 27 recalls that these operations must not result in a change of the declared investment objective of the UCITS objective or add substantial supplementary risks in comparison to the original risk policy as described in its sales documents.

4. In order to maintain an adequate level of protection for the investor, it is essential to verify how the competent authorities ensure compliance with the guideline, and that there is appropriate convergence at the EU level.
5. Guideline 29: “All the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS.” We note that ESMA has provided further interpretative guidance on this issue in its UCITS Q&A updated in April 2016. It would seem appropriate for ESMA to further evaluate the level of supervisory convergence with respect to the enforcement of this guideline, and where possible facilitate a common definition of such direct and indirect costs.
6. Guideline 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.” This guideline is explicitly covered by the ISLA Master Agreement on Securities Lending, although we note that some securities lending may take place outside of such a framework. Accordingly, we consider it important that ESMA ascertains how NCAs ensure that this guideline is complied with.
7. Guideline 43, subparagraph (e) offers detailed guidance with respect to collateral diversification. We consider that in the context of its work on supervisory convergence, ESMA should ascertain whether there are any inconsistencies in national interpretation which should be remedied.
8. Finally, in the context of its work on supervisory convergence, ESMA should ascertain whether national interpretations of disclosure requirements are acting as a barrier to entry to securities lending by UCITS.
9. In its review of the Guidelines and in discussions with securities lenders and borrowers, SMSG has also identified that certain aspects of the Guidelines as currently drafted may be contributing to a competitive disadvantage for UCITS which are engaging in securities lending. While these aspects relate more to interpretive concerns than to supervisory convergence *per se*, we have identified them below as they may be contributing to a disadvantage for UCITS investors.
10. Guideline 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”. This guideline specifies that the transactions referred to are de facto and de jure in accordance with guidelines 31 and 32. As some market participants consider that this safe-harbor in the guideline may deter UCITS from entering into securities lending transactions of this type of more than 7 days, it would be helpful that ESMA should provide clarity of its position with respect to longer-dated lending arrangements. This concern is particularly relevant insofar as the market for longer-dated securities lending has evolved significantly in recent years as a result of greater demand for stable lending over the 30-day term.
11. Guideline 43, subparagraph (g) offers guidance with respect to title transfer arrangements; however this has led to uncertainty among market participants as to the nature of “other types of collateral arrangements” which would be suitable. In particular we note recent developments in securities lending via security pledge rather than title transfer. As some security borrowers might have a preference for pledge structures, an absence of guidance with respect to use of pledge structures may be resulting in UCITS investors being disadvantaged in their securities lending activity. Additional ESMA guidance on the use of pledge structures by UCITS could also facilitate UCITS participation in CCP-cleared securities lending.

Adopted on 12 June 2017

[signed]

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Chair

Securities and Markets Stakeholder Group