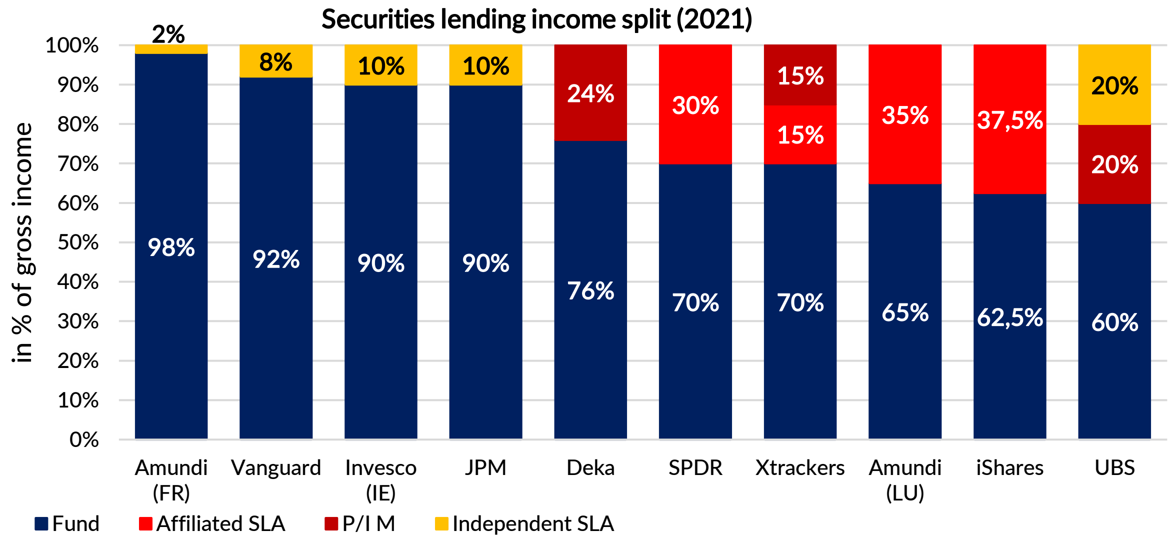
BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

PRESS RELEASE

ESMA Report Confirms BETTER FINANCE Findings of Investor Detriment through "Fixed Fee Splits" in Securities Lending

10 June 2022 – A report published on Tuesday 31 May 2022 by the European Securities and Markets Authority (ESMA), confirms BETTER FINANCE's findings that fund managers often don't seem to act in the best interest of fund investors when it comes to securities lending.

Three years after its first report,[1] BETTER FINANCE expanded on its research into securities lending[2] to once more find that fund managers' "*fee split*"[3] arrangements, particularly with in-house agents, vary considerably and may be contrary to ESMA's Guidelines.[4] Such practices could lead to investor detriment and actually constitute a breach of the generally duty of care[5] towards "retail" fund investors.



<u>*Source*</u>: BETTER FINANCE report (2022); *SLA = securities lending agent;* P/I M = portfolio / investment manager; <u>***Note***</u>*: The Amundi fund domiciled in France (Amundi DAX UCITS ETF) regards just one fund and is not representative of the entire group.*

EU "soft"[6] law stipulates that securities lending income, net of direct and indirect operational costs,[7] must be returned to the funds' beneficial owners.[8] The key provision is that these operational costs cannot include "*hidden revenues*", reason for which BETTER FINANCE questions why some asset managers can pay as little as 2% of gross income, while others deduct up to 40%.

Most providers covered by the BETTER FINANCE research use "*fixed fee split*" arrangements, through which the practice of splitting the income into net securities lending income and operational costs is established as a policy, rather than calculated on a case-by-case basis. Moreover, some providers do

[1] See BETTER FINANCE, *Efficient Portfolio Management Techniques: Attribution of Income Derived from Securities Lending by EU Equity UCITS ETFs* (2019), available at: https://betterfinance.eu/publication/fund-research-efficient-portfolio-management-techniques-attribution-of-profits-derived-from-securities-lending-by-ucits-exchange-traded-funds/.
[2] The practice of lending a stock, bond or other financial instrument in exchange for interest, with our focus on EU equity UCITS exchange-traded funds (ETFs).
[3] Term used by ESMA but in fact it refers to the divide between direct and indirect operational costs and net income for the Fund, see ESMA Common Supervisory Exercise on Costs and Fees (31 May 2022) ESMA34-45-1673, p. 13, available at: https://www.esma.europa.eu/sites/default/files/library/esma34-45-1673_final_report_on_the_2021_csa_on_costs_and_fees.pdf.
[4] European Securities and Markets Authority, *Guidelines on ETFs and other UCITS issues* (Guidelines for competent authorities and UCITS management companies, 1 August 2014) ESMA/2014/937EN, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-0011-01-00_en_0.pdf.
[5] According to MiFID [Art. 24(1)], and the UCITS V Directive [Art. 14(1)(a)], fund managers have the obligation to "*act fairly, honestly, and professionally in accordance with the best interests of clients*".
[6] This is because ESMA's Guidelines and Recommendations are not directly enforceable and must be transposed into national law by national competent authorities, or otherwise explain why not (*comply or explain principle*).
[7] Which cannot include "hidden revenues" for asset managers.
[8] ESMA Guidelines on ETFs and other UCITS issues, para 28.

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not adequately disclose this revenue split to investors in the fund documentation, notably the Key Investor Information Document (KIID).

ESMA came to similar conclusions and raised serious concerns for national competent authorities.[9] UCITS managers in ESMA's sample deduct as much as 50% from the gross income and have inadequate disclosures in their fund documentation. Most importantly, ESMA highlighted the widespread practice of establishing a "*fixed fee split*" policy "*without due consideration*" of wether such arrangements are in the best interest of investors. Furthermore, it noted that such policies "*particularly where* [they are] *done with related parties*" creates a risk *"of investors being effectively overcharged*".

BETTER FINANCE concurs and casts doubt on whether fund managers act in the best interest of investors, with providers potentially overcharging investors by using affiliated (in-house) agents instead of searching the market for better rates.

To address the situation and ensure that the revenue from securities lending is returned to the beneficial fund owners, BETTER FINANCE recommends:

- imposing a maximum threshold of 10% of the income that can be deducted as operational costs
- clarifying disclosure obligations on securities lending to investors
- transforming ESMA's Guidelines regarding securities lending revenues into enforceable, Level 2, measures

➔ BETTER FINANCE Research Report 2022: "Securities Lending: Income Attribution & Conflicts of Interests in EU Retail Investment Funds"

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[9] ESMA Common Supervisory Exercise on Costs and Fees (31 May 2022) ESMA34-45-1673, p. 13-16, available at: https://www.esma.europa.eu/sites/default/files/library/esma34-45-1673_final_report_on_the_2021_csa_on_costs_and_fees.pdf.