Securities Lending: Income attribution & conflicts of interests in EU retail investment funds

BETTER FINANCE

The European Federation of Investors and Financial Services Users

Fédération Européenne des Épargnants et Usagers des Services Financiers

Securities lending "*is part of the plumbing of the market. It runs smoothly in the background, so people don't usually spend too much time worrying about it. But like the plumbing in your house, when it doesn't work correctly it can quickly turn into a messy problem for everyone*"

- Opening statement of William F. Pridmore at the Securities Exchanges Commission (U.S) Roundtable on Securities Lending and Short-selling, 29-30 September 2009, https://www.sec.gov/comments/4-590/4590-17.pdf

About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

Contents

Foreword

BETTER FINANCE has been a strong proponent of fair and transparent securities lending transactions involving the assets of UCITS funds sold in EU Member States. These operations are using assets paid by – and belonging to the fund investors, can be risky and must be conducted with exemplary compliance with investor protection rules.

BETTER FINANCE stresses that all income earned from lending funds' securities must be attributed in full to the funds, less the costs necessary to undertake such operations, as required by EU rules.

Our own research in this field has revealed vastly differing "shares of the pie" returned to the beneficial owners of the funds, reason for which we have questioned whether certain fund management companies comply with the applicable law.

The first iteration of this report – in May 2019 – published the diverging shares of income attributed to the actors involved (fund, fund management company, agents -either related o rthird parties) and offered a right to reply to the management companies concerned.

This second iteration expands the analysis, from a quantitative and qualitative point of view, to better map out practices in this field and properly assess the situation in practice. We hope that, following this report, supervisory authorities and regulators will pay more attention to these operations and take action, if necessary.

The BETTER FINANCE team

BETTER FINANCE #FUNDRESEARCH

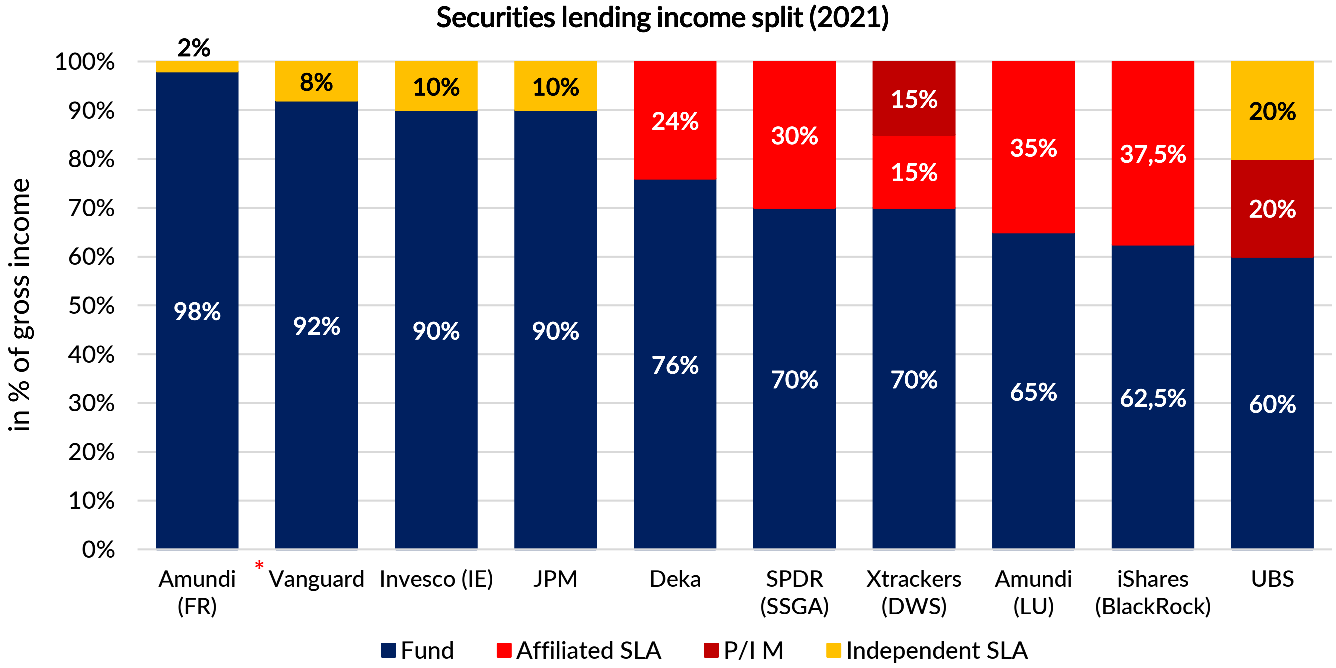
This study is part of the BETTER FINANCE #FundResearch project, an umbrella research activity aimed at providing qualitative and quantitative assessments of the EU market for "retail" investment funds, focusing on Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs). This paper looks into the practice of securities lending as an efficient portfolio management technique.

BETTER FINANCE SCIENTIFIC COUNCIL

This study has been approved by the BETTER FINANCE Scientific Council as part of the BETTER FINANCE Research Programme. The Scientific Council consists of highly skilled and experienced independent academics who help BETTER FINANCE deliver high quality research for financial services users, other stakeholders and policy makers. The Scientific Council responds to the need for more independent research in financial services to provide a sound and unbiased basis for financial policy recommendations. This is reflected in BETTER FINANCE's Scientific Council's composition, as many of its members also have extended experience in EU advisory bodies on financial services policy.

EXECUTIVE SUMMARY

SECURITIES LENDING MARKET	In 2021, the total income generated by securities lending operations globally stood at €7.8 billion, up by 21% compared to 2020. The majority of operations and lenders are outside the EU, and around 88% of securities on loan were sovereign bonds and equities.
INVESTOR PROTECTION RULES	In the EU, lenders cannot derive any profit from securities lending. All income, net of direct and indirect operational costs, must be returned to the beneficial owners. However, many asset managers distribute a large portion of revenues to affiliated parties, as agent fee, or to themselves, as other operational costs. Regarding conflicts of interests, MiFID II obliges investment services providers to respect a general duty of care and attempt to prevent or manage conflicts of interests; if the latter is not possible, such risk should be properly disclosed to investors.
ESMA ANALYSIS ON "FIXED FEE SPLIT" ARRANGEMENTS	The European Securities and Markets' Authority (ESMA) Common Supervisory Action on costs and fees (2021) found that "fixed fee split" arrangements may not be in the best interests of fund investors. Moreover, when undertaken with affiliated parties, without due consideration to comparable market prices, may lead to effectively overcharging fund investors. BETTER FINANCE agrees with the analysis and congratulates ESMA on this exercise and conclusions. We note that, in addition to ESMA's reasoning (in essence, the issue of *undue costs*), that fixed fee split arrangements contradict the ESMA Guidelines by which only direct and indirect operational costs can be deducted and "*no hidden revenue*" can be generated from securities lending.
RESEARCH FINDINGS	We observed again a high divergence in revenue split between the funds and the agent or other parties. The findings for the 2022 report are similar to the 2019 report: funds' shares range from 60% to 98% of the gross securities lending income, and operational costs (sometimes discerned between lending agent's fee and the investment manager's share) from 2% to 40%, 20 times bigger share for the latter.



Source: BETTER FINANCE own research; SLA -= securities lending agent; P/ IM = management company or investment manager/advisor; **Note*: This regards one fund only, domiciled in France (Amundi DAX UCITS ETF) and is not representative for the entire group.*

Globally, the 418 UCITS ETFs analysed generated a global gross securities lending income of €151.3 million and redistributed €97.4 million to the relevant funds. A simple extrapolation of these figures shows that, if managers would have returned at least 90% of revenues to the Funds, beneficial owners would have earned an extra €38.9 million.

Many securities lending programmes use affiliated parties to the investment manager (and the investment company), most importantly the securities lending agents.

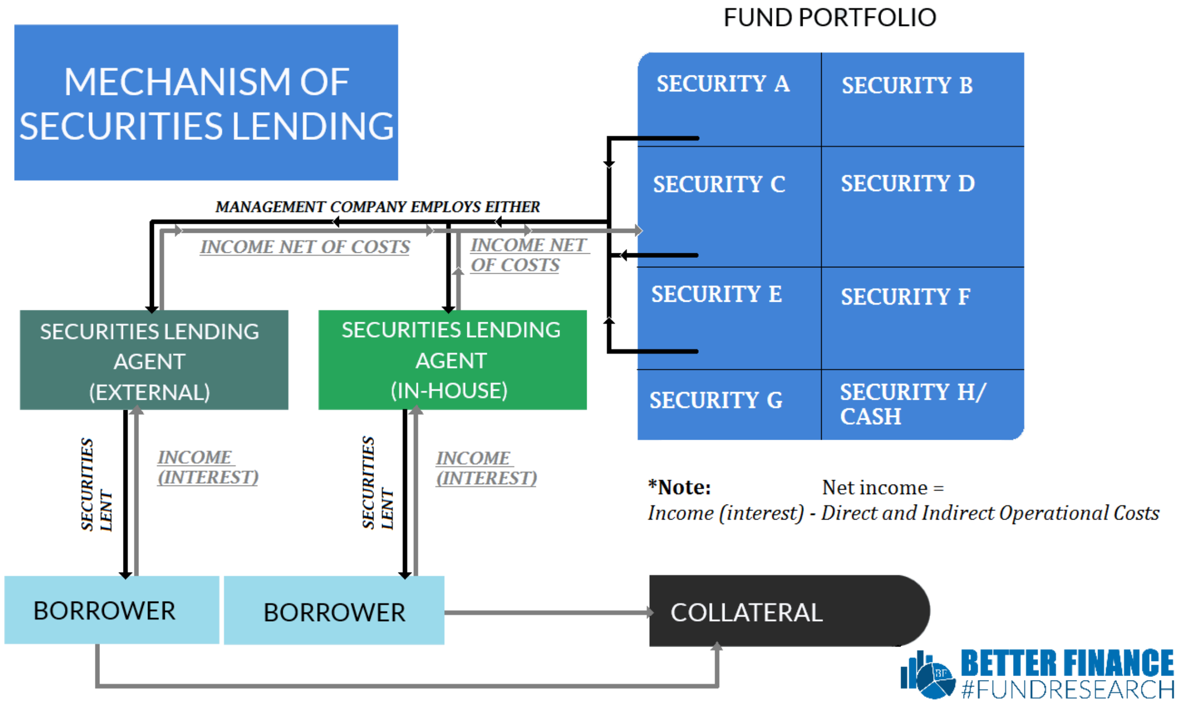
POLICY RECOMMENDATIONS

1. ESMA to clarify the "*no hidden revenue*" rule, particularly by specifying that it applies at group level (consolidated balance sheets).
2. The European Commission to clarify the rules for retail UCITS to disclose the income split in the UCITS KIID (or in the PRIIPs KID).
3. ESMA and NCAs to strengthen supervision and enforcement in this field.
4. The conflict of interests policy should justify why, if applicable, an affiliated party enhances the service to beneficial owners rather than a third-party.
5. The co-legislators should impose an upper limit of how much of the gross income can be deducted as operational costs, i.e. max. 10%. Alternatively, ESMA should investigate why some fund companies have securities lending operational costs 20 times higher than the more cost-efficient ones.
6. ESMA to clarify the obligation of asset managers to disclose the cost components of the *direct and indirect operational costs*.

SECURITIES LENDING: INCOME ATTRIBUTION & CONFLICTS OF INTERESTS IN EU RETAIL INVESTMENT FUNDS

1. INTRODUCTION

Efficient portfolio management techniques (EPMT) are transactions or contracts concluded between holders of securities – generally, asset managers – and third parties desiring to obtain a short-term profit or hedge a risk. These transactions vary from repurchase agreements (REPOs and reverse REPOs) to securities borrowing or lending. The term EPMT is most commonly used in relation to mutual investment funds. This analysis is focused on one of the simpler EPMT, securities lending, undertaken by retail UCITS.



Source: © BETTER FINANCE, 2022

In *securities lending*, the owner (such as investment funds, acting as a lenders) temporarily lends[1] a part of its holdings (securities) to a borrower, for which the borrower provides in exchange collateral and a payment (interest) for the period on loan.[2] The collateral can take the form of assets or cash. However, if cash capital is provided to the lender, in most circumstances the lender must pay back the borrower an interest rate – *rebate* – for the cash received.[3]

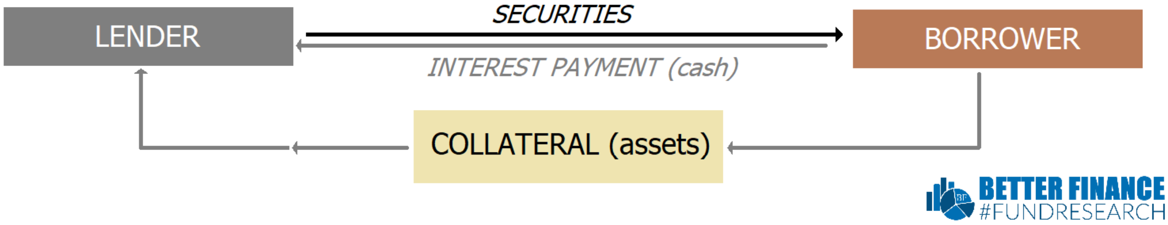
Therefore, two main types of securities lending operations occur:

[1] Although some authors argue that, in fact, the term is "misleading" since the ownership title over each security is transferred to the borrower, not lent – see Mark C. Faulkner, *An Introduction to Securities Lending: First Canadian Edition* (2006) Spitalfields Advisors Limited, p. 21, https://www.canseclend.com/wp-content/uploads/2016/02/Introduction_to_Securities_Lending_Canada.pdf; see also Viktoria Baklanova, Adam Copeland, Rebecca McCaughrin, 'Reference Guide to the U.S. Repo and Securities Lending Markets' (Staff Report no. 740, September 2015) Federal Reserve Bank of New York Staff Reports, p. 32 – 33.

[2] See also Art. 3(7) of 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, OJ L 337, 23.12.2015; For a broader definition, see IOSCO Committee on Payment and Settlement Systems, 'Securities Lending Transactions: Market Development and Implications' (July 1999) Technical Committee of the International Organisation of Securities Commissions (IOSCO), pages 5 – 6, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD96.pdf.

[3] For instance, see Adam McCullough, CFA – 'Securities Lending: An Examination of the Risks and Rewards' (December, 2018) Morningstar Manager Research, p. 3, https://www.morningstar.com/lp/securities-lending-risks-rewards.

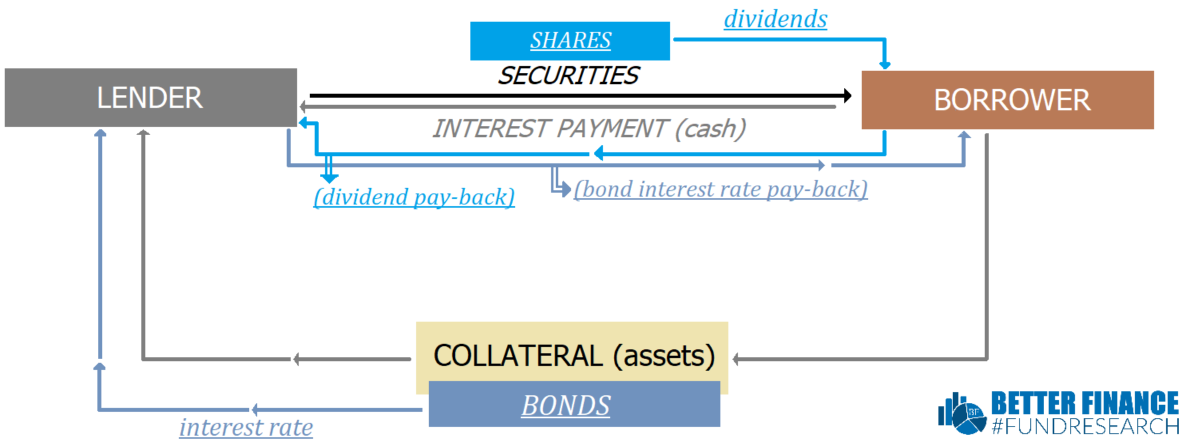
SECURITIES LENDING WITH COLLATERAL AS ASSETS



Source: BETTER FINANCE, 2022

In this case, each party must return the assets/ securities to one another at maturity. However, in most securities lending transactions, there is an actual temporary transfer of property over the securities from the lender to the borrower – for the securities on loan – and from the borrower to the lender – for the assets as collateral. Thus, each party becomes the owner of the securities or assets exchanged, with the attached obligation to return them at maturity.

SECURITIES LENDING WITH COLLATERAL AS ASSETS



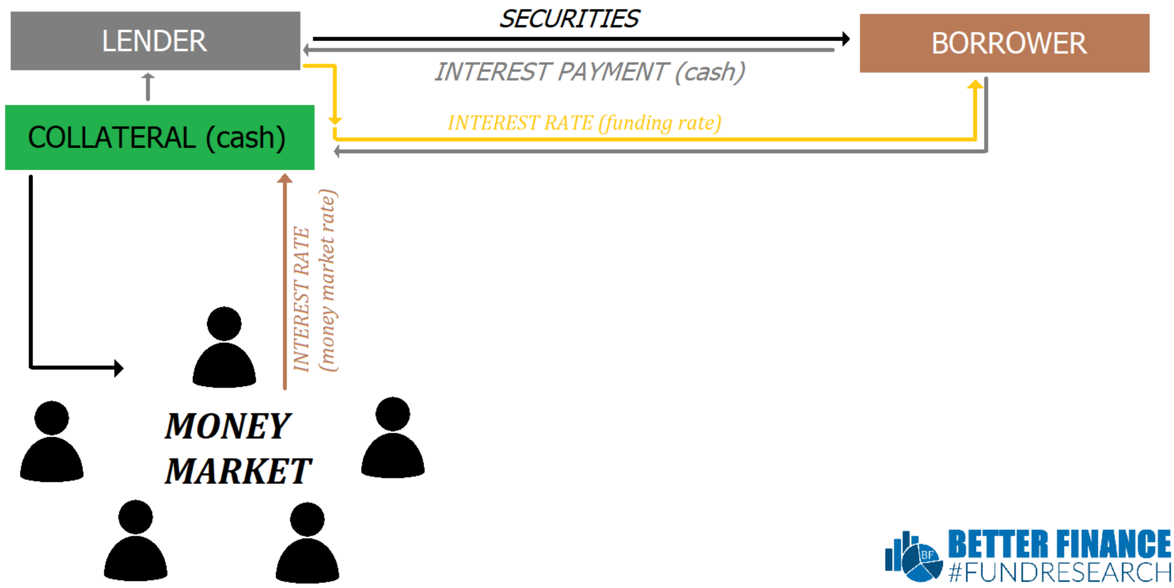
Source: © BETTER FINANCE, 2022;

The particularity of this temporary transfer of ownership is that, while the acquisitor is entitled to all proceeds or benefits attached to the securities – such as dividend payments for shares or interest rate for bonds – most transactions comprise clauses stipulating that each party must return to the other all earnings generated by the securities or assets during the lending period.

Note: If the clause stipulates that the securities are sold/bought back at maturity, then the transaction will be a different one, such as repurchase agreements or buy-sell options.

Securities lending with cash as collateral are slightly different since the temporary owner – the lender – can use it to generate income on the short-term. The additional liquidity is placed by the lender on the money market from which he will receive an interest rate (most commonly the EONIA/ESTHER rate) which will be higher than the rebate rate.

SECURITIES LENDING WITH COLLATERAL AS CASH



Source: BETTER FINANCE, 2020

Therefore, the lender will have two sources of income from the same securities lending transaction: (1) first, the lending rate (*interest payment*) received from the borrower; (2) the remaining difference between the money market rate and the funding rate resulting from the cash collateral:

$$\boldsymbol{Income = Lending\ rate + (Money\ Market\ rate - Funding\ rate)}$$

To take a simple example: Fund A lends 10 shares to institutional investor B at a lending rate of 1% of their market capitalisation value. Investor B agrees to provide a cash collateral equivalent to 105% of the market capitalisation value of the shares on loan to Fund A, but for which Investor B will require a 0.75% funding rate. Fund A reinvests the cash collateral on the money market for a 1% interest rate. Therefore, the income for Fund A will be:

$$Income = 1\%\ x\ Shares'\ Value + (1\% - 0.75\%)\ x\ cash\ collteral\ value$$

- where Fund A receives 1% interest rate from the money market on the cash collateral and pays 0.75% to Investor B as funding rate; and
- considering that the cash collateral value is equal to 105% of the value of the shares on loan, then

$$Income = 1\%\ x\ Shares'\ Value + 0.25\%\ x\ 105\%\ Shares'\ Value = 1.2625\%\ Shares'\ Value$$

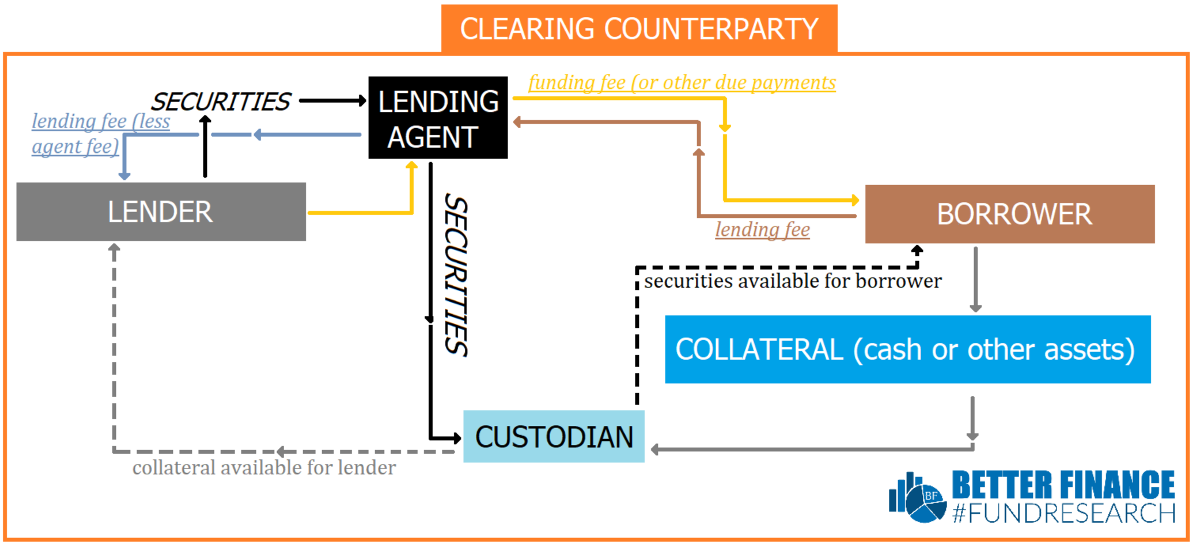
If Fund A were to lend its entire portfolio (which is much riskier), it would generate an additional yield for its investors of 1.2625% for the period on loan.

In legal terms, the securities lending transaction includes only two parties, the lender and the borrower.[4] However, most securities lending transactions include other actors, such as

[4] See, for instance, the "Global Master Securities Lending Agreement" provided by the London Stock Exchange which serves as a template or standard contract for securities lending transactions - https://www.londonstockexchange.com/traders-and-brokers/rules-regulations/formsagreements/global-lending-agreement.pdf; other similar standard drafted contracts are provided by international associations, such as the International Securities Lending Association.

- a securities lending agent (SLA), who acts on behalf of the owner (the principal) to conclude or facilitate (“*finder*”) the transaction with the borrower;
- a custodian or depositary, who is entrusted with the receipt, safekeeping and delivery of securities and assets; or
- a clearing counterparty, which is entrusted with validation of the conditions upon which the effectiveness of contractual clauses rest.

SECURITIES LENDING ACTORS



Source: BETTER FINANCE, 2020

Depending on the purpose of the securities lending transaction, some or all of the actors above may be involved with different roles.

Income from securities lending depends on the quality of lendable securities and the value of the portfolio on loan, as well as cash collateral reinvestment (if applicable). If the securities are less liquid or more difficult to find, normally the interest paid will be higher, and vice versa.[5]

Lenders will follow various strategies: some will look to maximise income and minimise the percentage of the portfolio on loan – thus, will lend more valuable securities; others will attempt to generate higher income proportionally with the volume of loaned securities. Some asset managers employ the services of Securities Lending Agents (SLAs) to undertake the lending programmes on their behalf. Some SLAs act entirely on behalf of the fund, bearing all expenses, choosing the custodian, the borrowers, determining the conditions of the programme (type of securities on loan, collateral, reinvestment techniques), and some others have more limited activities.

[5] Lewis Braham, ‘ETFs’ Hidden Source of Return: Securities Lending’ (7 April 2019, Barron’s Magazine) https://www.barrons.com/articles/etfs-hidden-source-of-returnsecurities-lending-1523054918.

2. THE SECURITIES LENDING MARKET

2.1. Overview

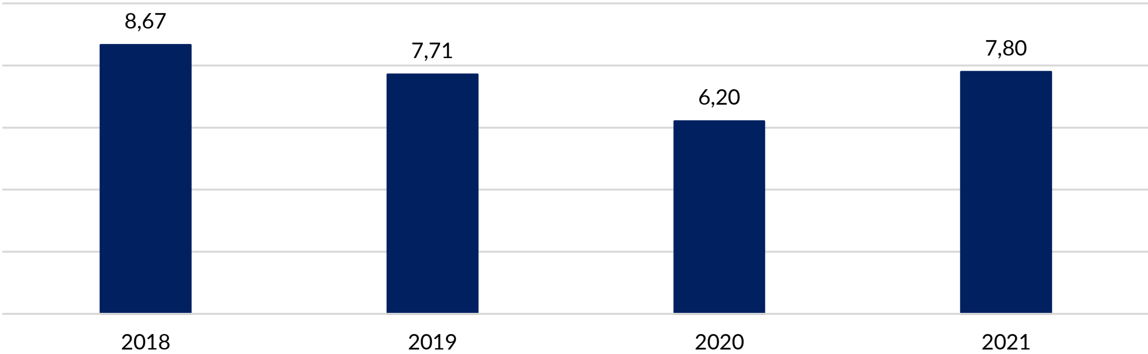
Specialised literature is rich in describing the many particular purposes for entering into a securities lending agreement, such as: to reduce a fund's tracking error to its benchmark,[6] market making,[7] cover costs or remedy short sales.[8]

Simply put, securities lending operations were categorised in the EU as *efficient portfolio management techniques* since they have the purpose of enhancing performance factors, i.e. reducing costs, increasing yield, reducing the risk ratios etc. According to research of a financial publication, the majority of transactions were done to increase return (66%) or to cover the costs (33%).[9]

Securities lending operations are mostly undertaken by passively managed or index-tracking funds – such as UCITS/AIFs or UCITS ETFs – because these investment vehicles generally hold for longer periods the portfolio, thus giving the opportunity to temporarily transfer the securities without affecting the investment strategy or their risk profile.

The global income generated by securities lending activities worldwide is showed in the graph below:

Chart 1. Global securities lending revenue (in €)



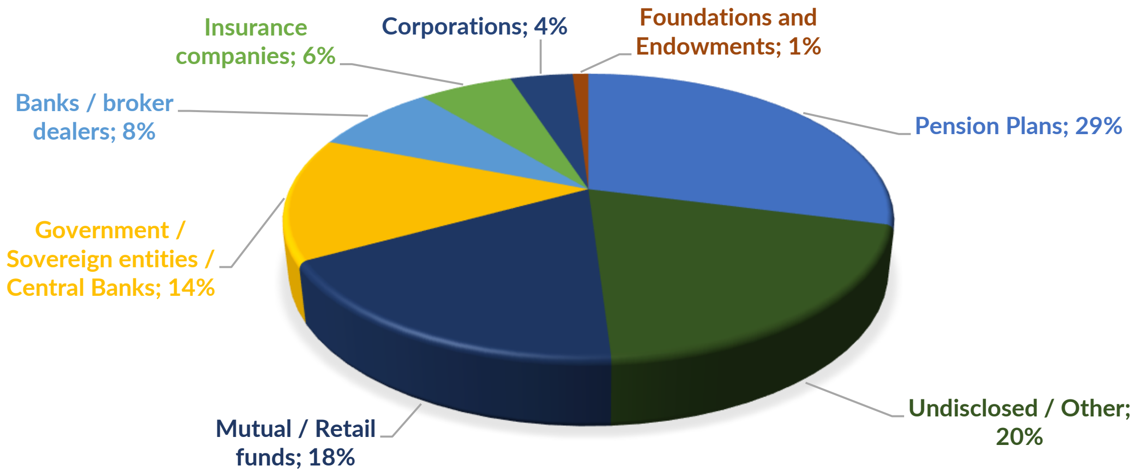
Source: Figures converted to EUR at the rate of 31 December each year as reported by the ECB, DataLend 2021[10]

Lenders usually are pension and investment funds, insurers or sovereign wealth funds due to their long-term strategies[11] and the lower trading activity or turnover. The largest disclosed lenders globally in 2019 were pension plans (29% of securities on loan), followed by retail funds (18%), and the lowest were corporations (4%) and foundations/endowments (1%).[12] In 2020 the largest lenders globally continue to be pension plans (34%), followed by government or

[6] Jesse Blocher, Robert E. Whaley, 'Passive Investing: The Role of Securities Lending' (30 January 2015) p. 5, available at https://pdfs.semanticscholar.org/4390/5c35fecce65d296a53e125e369fa7dfa19ad.pdf.
[7] International Securities Lending Association, 'Securities Lending Markets: Discussion on Latest Market Trends & Regulatory Environment (European Post Trade Forum, Brussels – 19 May 2016), available at: https://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=26948&no=3, hereinafter ISLA Presentation.
[8] Baklanova, Copeland, McCaughrin, 'Reference Guide to the U.S. Repo and Securities Lending Markets' (n 1) 22.
[9] Funds Europe issue quoting a survey done by DataLend and Funds Europe - see 'Sponsored Feature: "Many Beneficial Owners Leave Value on the Table"' (Funds Europe, October 2019), available at https://www.funds-europe.com/october-2019/sponsored-feature-many-beneficial-owners-are-leaving-value-on-the-table.
[10] See DataLend, *DataLend: Securities Lending Markets Up 21% in 2021, Generating $9.28 Billion in Revenue* (4 January 2022, datalend.com) available at: https://datalend.com/datalend-securities-lending-markets-up-21-in-2021-generating-9-28-billion-in-revenue/.
[11] International Securities Lending Association, 'Securities Lending Explained – What You Need to Know in 5 Minutes', available at https://www.isla.co.uk/.
[12] International Securities Lending Association, 'Securities Lending Market Report – 11th edition' (2019), p. 12, available at https://www.isla.co.uk/assets/smart-pdfs/isla-securities-lending-market-report/files/downloads/ISLA_SLReport_Sep2019.pdf.

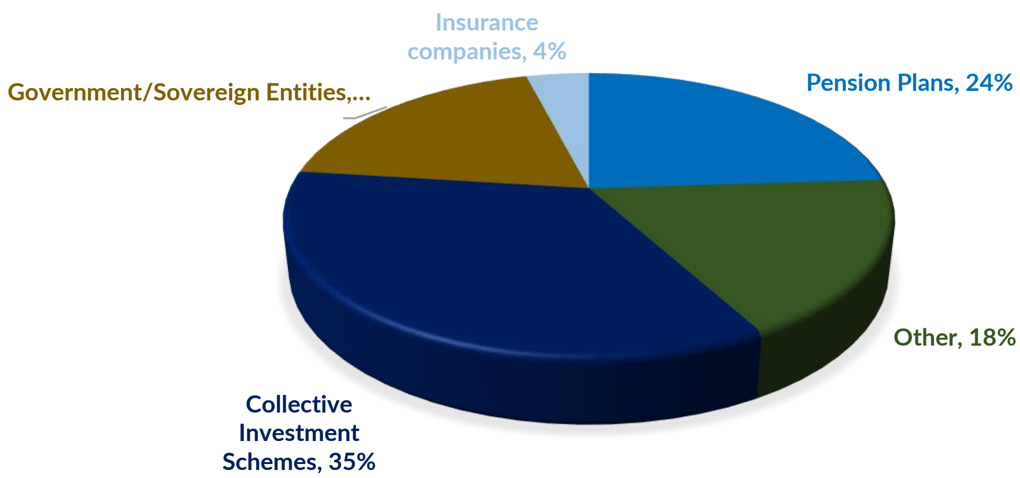
sovereign wealth funds (29%) and collective investment vehicles (such as UCITS, with 22%).[13] By the end of 2020, the landscape had changed, with the largest lenders being collective investment vehicles (35% of total securities on-loan), followed by pension plans (25%) and sovereign entities (21%).[14]

CHART 2. LENDERS BY INSTITUTIONAL SECTOR - 2019



Source: ISLA Annual Report 2019

CHART 3. LENDERS BY INSTITUTIONAL SECTOR - MAY 2021



Source: ISLA Securities Lending Market Report May 2021

In terms of domicile, US lenders had the lion's share globally (55%) in 2018,[15] while EU-domiciled lenders held a third of the world share and were in minority even within the EU market, representing 40% of lenders.[16]

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[13] International Securities Lending Association, 'Securities Lending Market Report – 13th edition' (August 2020), p. 13, available at https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report-august-2020/.

[14] International Securities Lending Association, 'Securities Lending Market Report – 14th edition' (February 2021), p. 14, available at https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report-march-2021/files/downloads/ISLA_SLReport_Feb2021_final.pdf.

[15] United States Financial Stability Oversight Council, *2018 Annual Report*, pages 45-46, hereinafter FSOC 2018 AR; United States Financial Stability Oversight Council, *2019 Annual Report*, pages 55-56, hereinafter FSOC 2018 AR.

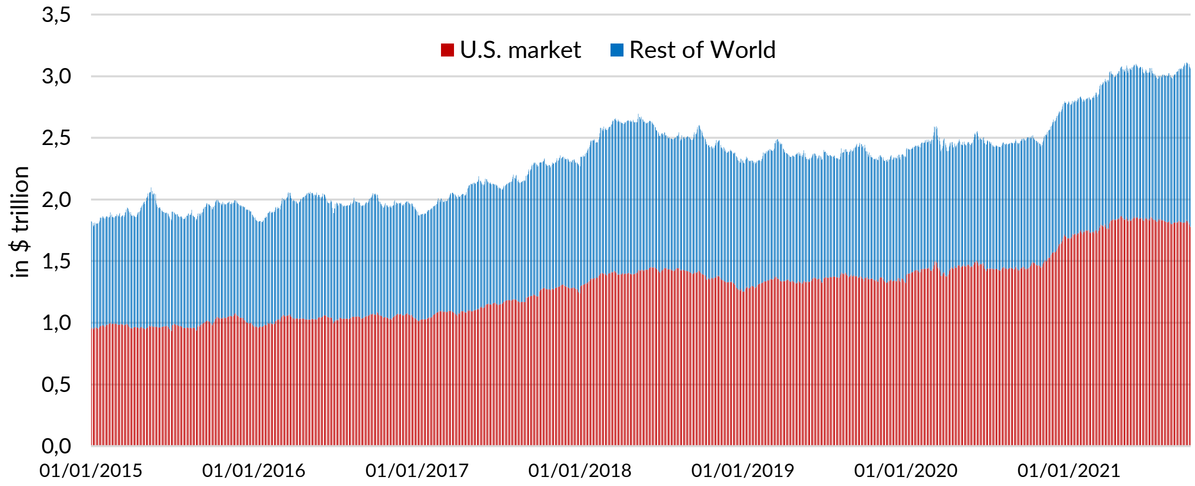
[16] Owen Walker, 'New Rules Will Shine Light On Securities Lending' (FT.com, 28 July 2018) available at https://www.ft.com/content/caf0541a-90ec-11e8-bb8f-a6a2f7bca546.

Securities lending can be done by active managers as well. However, most active managers wish to maintain their flexibility to buy and sell the holdings at any time, so they will either not lend or ask higher lending rates, which are unattractive for borrowers.

Securities lending agents can be asset managers (investment firms), credit institutions (such as banks) or actors specialised in securities lending. Borrowers can be any other market participant, but are usually banks, companies or prime brokers.[17]

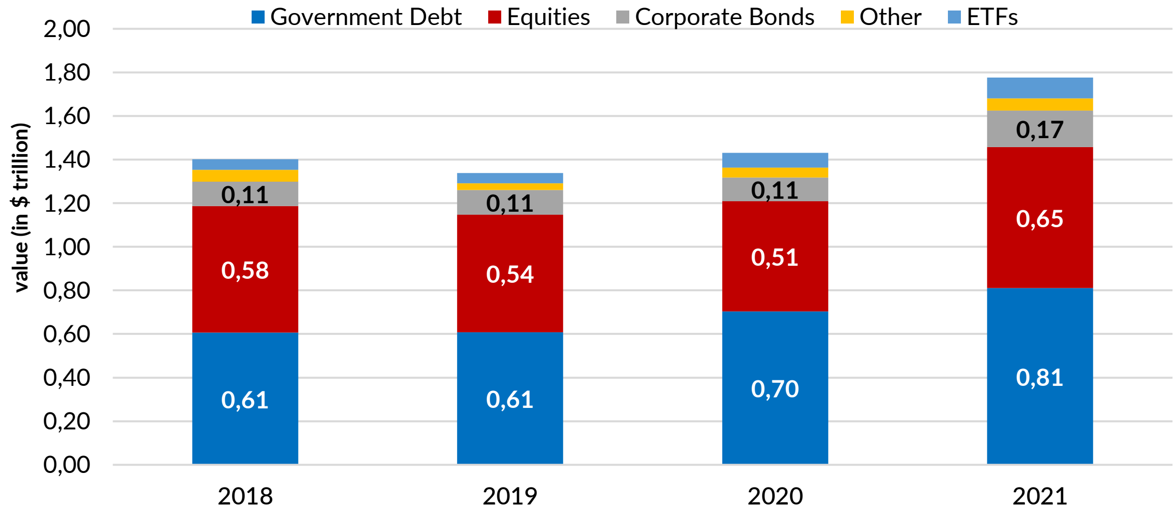
In terms of size, the securities lending market has halved in 2008 – 2010 compared to the pre-crisis period but is showing signs of picking up again. The total estimated value worldwide stood at €2.236 trillion ($2.6 trillion) in 2018[18] and slightly decreased by September 2019 to €2.208 trillion ($2.4 trillion)[19] and re-increased to €2.63 trillion ($3.06) by the end of September 2021.

Chart 4. Value of securities on loan - U.S. Market vs Rest of World



Source: US Financial Stability Oversight Council, Annual Report 2020

Chart 5. Securities lending value by assets on-loan, worldwide



Source: FSOC AR 2018, 2019, 2020, 2021

[17] See Faulkner, *An Introduction to Securities Lending: First Canadian Edition* (n 1), 31 *et seq*; see also ISLA Presentation (n 5), page 6.

[18] FSOC 2018 AR (n 11), pages 45-46; original figures are in US dollars ($) and have been converted EUR € using ECB Statistical Warehouse Data rates https://sdw.ecb.europa.eu/curConverter.do on the day indicated in the data source, hereinafter.

[19] FSOC 2019 AR (n 11), pages 55-56; original figures are in US dollars ($) and have been converted EUR € using ECB Statistical Warehouse Data rates https://sdw.ecb.europa.eu/curConverter.do on the day indicated in the data source, hereinafter FSOC 2019 AR.

Worldwide, between 2018 and 2021 (September-September) the majority of assets on loan were sovereign bonds (46%) and equities (36%). In the EU, 55% of transactions concerned sovereign bonds and 42% equities in 2018,[20] although the vast majority €8.7 billion ($10 billion) securities lending revenue[21] was generated by equity-loans and just a small portion from corporate and Government bonds.[22]

As regards income for beneficial owners, a study into the US securities lending marketplace shows that, among the top 10 ETF providers that use such EPMTs, lending fees managed to offset between 7% - 65% of the management fees on a 5-year average between 2013-2017.[23] How does this translate in layman terms?

Example box

Assume the value of a fund is €10,000 and the management fee is 2% annually of that value. This means that beneficial owners will pay 2% x €10,000 = €200 as management fees. If the management company lends 10% of the fund's portfolio (= 10% x €10,000 = €1,000 worth of securities) for a lending fee of 5% of the securities on loan, it will gain an income from securities lending of €50.

Item	Securities Lending	in %	in €
1	Fund value	-	€ 10,000
2	Management fee *as % of fund value*	2%	€ 200
3	Portfolio on loan *as % of fund value*	10%	€ 1,000
4	Lending fee *as % of portfolio on loan*	5%	€ 50
5	Operational costs *as % of lending fee*	15%	€ 7.50
6	Net income *as difference between (4) and (5)*		€ 42.50
7	Management fee offset *net income as % of (2)*	21%	€ 42.50

Since the management company must pay operational costs of 15% of the lending fee, the net income for the fund out of this securities lending transaction will be €50 – €7.5 = €42.5

If the net income is deducted from the management fee, it means that the securities lending transaction offset 21% of the annual management fee.

Source: BETTER FINANCE own research

However, securities lending income can only offset fees if either:

- the management fee is a fixed amount; or
- if the management fee crystallises before the term of the lending agreement.

Otherwise, the income from securities lending will translate into additional yield for the fund (increase of the AuM). Therefore, the actual management fee will be higher.

[20] Minutes of the Securities Lending Committee of the Bank of England (29 May 2019) available at https://www.bankofengland.co.uk/-/media/boe/files/minutes/2019/securities-lending-committee-may-2019.

[21] Joe Parsons, 'Revenues From Securities Lending Touch $10 billion In 2018' (GlobalCustodian.com, 3 January 2019) available at https://www.globalcustodian.com/revenues-securities-lending-touch-10-billion-2018/.

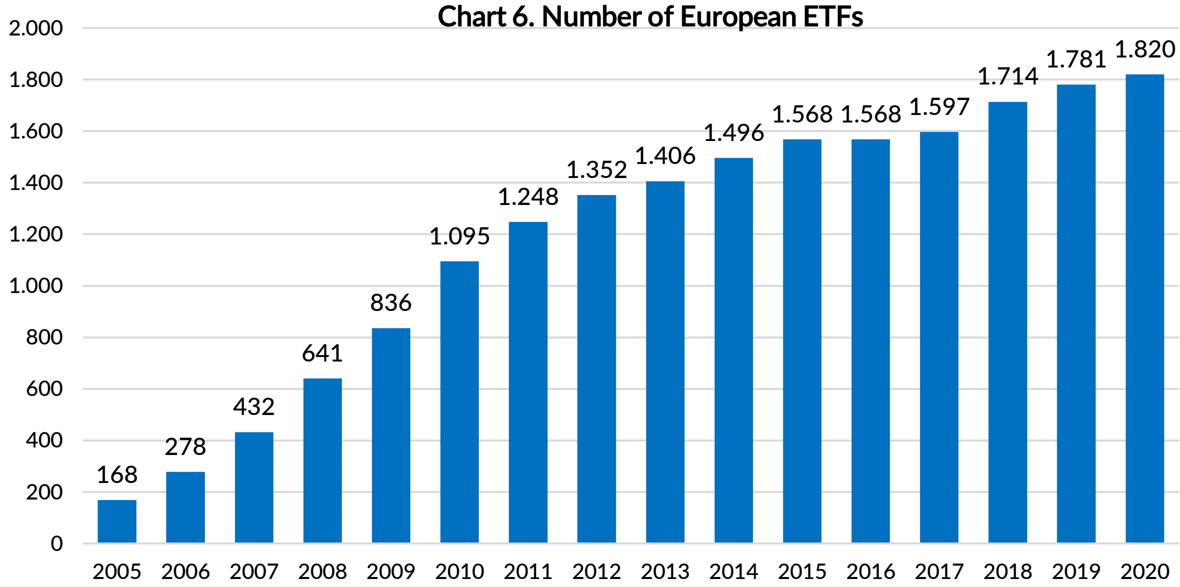
[22] Walker, 'New Rules Will Shine On Securities Lending' (n 12).

[23] Adam McCullough, CFA – 'Securities Lending: An Examination of the Risks and Rewards' (December, 2018) Morningstar Manager Research, p. 10, Exhibit 6, https://www.morningstar.com/lp/securities-lending-risks-rewards.

2.2. The ETF market

In the EU, the ETF market has been on the rise as more and more institutional and “retail” investors see value in buying this kind of funds, especially since the majority of them are low-cost, index-tracking investment vehicles – a viable alternative for actively managed funds.

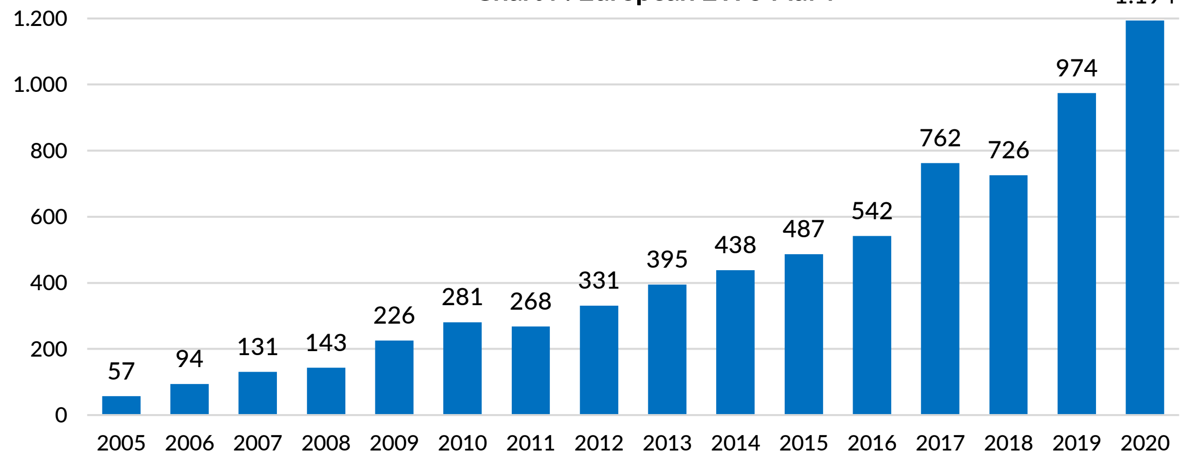
Chart 6. Number of European ETFs



Source: Statista 2022 (https://www.statista.com/statistics/1199446/number-etfs-europe/)

The number of exchange-traded funds (ETFs) listed in Europe has grown considerably over the past 16 years, reaching 1,820 by the end of 2020. In terms of size (assets under management – AuM), the growth trend was discontinued in 2011 and 2018, but also saw significant spikes in 2017 (+40% vs 2016) and in 2020 (+22.58% vs 2019). In 2020, the value of money invested in ETFs in Europe grew much stronger than the number of listed ETFs (+23% vs 2.2%), which could be attributed to capital market returns (*returns on investments*), but most probably due to considerable inflows (new investors buying ETFs) sparked by the global health pandemic.

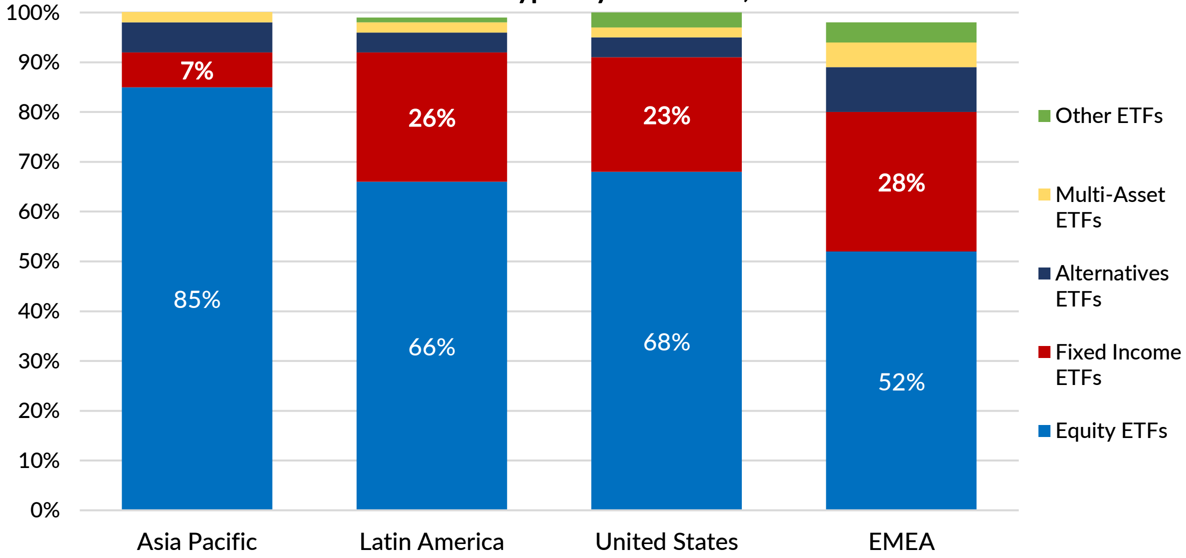
Chart 7. European ETFs' AuM



Source: Statista, 2021 (https://www.statista.com/statistics/1199455/aum-etfs-europe/)

In terms of the assets invested in, by far the leading class with ETFs worldwide (and in Europe) are equities:

Chart 8. ETF types by asset class, 2020



Source: Statista; EMEA stands for Europe, Middle East and Africa;

According to research done by PwC, the most tracked equity indices by EU-domiciled ETFs were the S&P 500, followed by MSCI World, MSCI Emerging Markets, Stoxx Europe 50 and EURO Stoxx 50; the largest domiciles for ETFs are by a wide margin Ireland and Luxembourg: these are the jurisdictions where most ETFs are domiciled for cross-border distribution.[24]

The ten largest ETF providers in the EU (20% of the total number) managed €606 billion at the end of 2018, representing 93% of the market.[25] In terms of cross-border distribution, by the second half of 2021, the top 6 ETF providers in the EU distributed these funds in at least 20 other jurisdictions in the EU.[26] In the first half of 2019, the ETF marketplace[27] reached a value of net assets of €759.7 billion of AuM, or 8.6% of the total European market for investment funds.

The major "players" maintained their share of the pie: by AuM, the ten largest ETF providers held a 92.3% share of the market (€701 billion) and continued to be heavily inclined in favour of BlackRock, which has been leading by a wide margin for several years in a row.

Based on the calculations of the source,[28] BlackRock's flagship *iShares* UCITS ETFs alone account for 44.6% of the total AuM, or €339 billion at the end of 2019's first quarter. The next in line, DWS's Xtrackers UCITS ETFs manage four times less, i.e. around €84 billion (11%). However, it seems that the composition of the top 10 changed slightly:

- 2018 stats indicated (alphabetically) Amundi, iShares, Commerzbank, Deka, Invesco, Lyxor, SPDR, UBS, Vanguard and Xtrackers as the largest, while
- 2019 figures show that German providers (Commerzbank and Deka) lost their top positions in favour of WisdomTree and BNP Paribas, although the difference may stem from the type and coverage of the data.

[24] PwC, *European ETF Listing and Distribution* (October 2021) Global Fund Distribution & Market Research Centre, available at: https://www.pwc.lu/en/asset-management/docs/pwc-european-etf-listing-distribution.pdf, p. 4, hereinafter "PwC report".
[25] Ridhima Sharma, 'Review of the European ETF Market, April 2018' (2018) InvestEurope, https://www.investmenteurope.net/investmenteurope/opinion/3710324/review-european-etf-market-april-2018.
[26] PwC report, p. 5.
[27] Hortense Bioy, Jose Garcia-Zarate, Kenneth Lamont, Dimitar Bodzhiev, Helaine Kang, '*A Guided Tour of the European ETF Marketplace*' Morningstar Manager Research EMEA (24 April 2019), available at http://media.morningstar.com/uk/media/etf/A_Guided_Tour_of_the_European_ETF_Marketplace.pdf.
[28] Ibid; the statistics presented under this sub-section quote the same source:

Categorised by asset class, the three largest ETF ranked (2019 data):

- *equities*: BlackRock 42.5%, Xtrackers 11.7%, Lyxor 9%;
- *bonds*: BlackRock 63%, Xtrackers 8.5%, Lyxor 6.2%;
  except for
- *commodities*: WisdomTree 28%, DeutscheBörse 13.7%, Swisscanto 13%, BlackRock 11.7% etc.

Nevertheless, the evolution of the ETF marketplace is remarkable: in 10 years it grew almost four times and is expected to reach €2 trillion in the next four years. For these reasons and considering that the "usual suspects" for securities lending are index-tracking UCITS ETFs,[29] we focus in this paper on ETFs that track mainstream market indices (such as MSCI Europe). More details about the fund selection criteria and final fund sample are given under Sections 4 (*Methodology*) and 5 (*Analysis*) below.

3. *INVESTOR PROTECTION – RULES AND LIMITS FOR SECURITIES LENDING*

When securities lending concerns retail investment products – such as retail UCITS – the asset manager must observe several investor protection rules regarding the (i) conduct of business and (ii) reporting requirements.

3.1. Attribution of income and conduct of business

The European Securities and Markets Authority (ESMA) has developed guidelines on transparency and conduct of business rules for UCITS and UCITS ETFs regarding efficient portfolio management techniques (EPMTs).[30] Although these guidelines are not directly applicable for market participants (*soft law*), national competent authorities (NCAs) can transpose and enforce them.[31] By April 2016, 27 of the 28 EU Member States had transposed these guidelines into national law.[32] The provisions therein are described below.

First, all EPMTs must be conducted in the best interest of the fund.[33] Both the lender and the securities lending agent have a duty of care towards beneficial owners to enter and conduct such arrangements when and as it best serves the interests of the beneficial owners, which in our analysis are individual, non-professional ("retail") investors.

> *25. (…) The use of these techniques and instruments should be in line with the best interests of the UCITS.*

This requirement complements the provisions of MiFID II prescribing a "duty of care" for financial services providers. According to Article 24(1) MiFID II:

> *Member States shall require that, when providing investment services* […] *an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.*

[29] Securities lending is possible with any type of fund, not only index-tracker ETFs; however, these are the most prone to employ such techniques given that the portfolio composition is very much likely to stay the same for long periods of time (sometimes, even years), whereas active fund managers may need to buy and sell securities in order to generate excess return to the benchmark; in addition, index-tracking ETFs that use a *synthetic replication* method (i.e. swapping the returns of the fund's holdings with the returns of securities that constitute the benchmark) are less likely to use securities lending operations since the revenue must be ceased to the swap counterparty.

[30] European Securities and Markets Authority (ESMA) Guidelines for competent authorities and UCITS management companies: Guidelines on ETFs and other UCITS issues, of 18/12/2012 (ESMA/2012/832EN) and 01.08.2014 (ESMA/2014/937EN), hereinafter *the Guidelines*.

[31] According to Article 16 of Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OJ L 331, 15.12.2010, p. 84–119 (hereinafter ESMA Regulation).

[32] ESMA, '*Guidelines Compliance Table: Guidelines on ETFs and other UCITS issues (ESMA/2014/937)*', ESMA2016/602, 12/04/2016.

[33] Para 25 of the Guidelines (n 27).

In terms of results, the Guidelines do not prescribe the purposes to be achieved through securities lending, but only those *that should be avoided*. Therefore, EPMTs should not:

> *a) result in a change of the declared investment objective of the UCITS; or*
> *b) add substantial supplementary risks in comparison to the original risk policy as described in its sales documents.*[34]

In addition, whatever the desired result, securities lending agreements cannot generate surplus income for the management company. The Guidelines require:

> *29. **All the revenues** arising from efficient portfolio management techniques, net of direct and indirect operational costs, **should be returned to the UCITS**.*[35]

Moreover, concerning the operational costs that can be deducted from the lending income, the Guidelines state that:

> *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.*[36]

The management company can benefit only indirectly from EPMT through an increase of the AuM, which can lead to an increase of the monetary value of the management fees. Otherwise, the management company cannot derive any income from a securities lending transaction.

There are several consequences derived from the above rules:

- the management company cannot retain a share of the income;
- the management company cannot deduct operational costs it incurred itself;
- the management company must exercise due diligence and prudence in choosing both the borrower, the quality of collateral, the lending fee and the agent;
- using or reinvesting the collateral (in particular relevant for cash) should not increase the overall risk profile of the fund;
- the management company must avoid conflicts of interests in the securities lending process;
- the management company must pay attention to the level of fees it pays to third parties as operational costs.

Concerning all adjacent income resulting from a securities lending transaction (such as cash collateral re-investment interest), we believe it falls under the same rules prescribed by paragraphs 28 and 29 of the Guidelines. Therefore:

- the management company cannot withhold or deduct charges from the interest rate received from the cash or non-cash collateral;
- the management company should avoid conflicts of interests and exercise prudence from depositing or re-investing the collateral;
- the management company must avoid excessive fees paid to third-parties.

As our desk research shows, many large asset managers re-invest the cash collateral not directly on the money market, but through money market funds (managed by affiliates). The money market fund naturally generates a yield, but also charges a management fee. Therefore,

[34] Para 27 of the Guidelines (n 19).
[35] Para 29 of the Guidelines (n 19), emphasis added.
[36] Emphasis added.

if the net return of the fund is lower than the rebate rate to be paid to the borrower, then the beneficial owners will lose capital.

Moreover, whereas direct investment in the money market exposes to counterparty default risk, re-investments through money market funds expose to loss of capital risk, which has more detrimental effects for beneficial owners than the former.

3.2. Reporting obligations

The Securities Financing Transactions Regulation (SFTR)

The EU adopted a new regulation on transparency and reporting by financial institutions on securities financing transactions (SFTs, such as securities lending, repos, buy-sell backs etc).[37] It sets new rules on the disclosure requirements on:

- pre-contractually: for UCITS, the types of SFTs a financial institution can enter into – in the Prospectus, including:

  *Policy on sharing of return generated by SFTs and total return swaps: **description of the proportions of the revenue generated** by SFTs and total return swaps **that is returned to the collective investment undertaking**, **and of the costs and fees assigned to the manager or third parties** (e.g. the agent lender). The prospectus or disclosure to investors shall also indicate if these are related parties to the manager*.[38]

- execution phase: for UCITS, all information, including returns and costs, from SFTs – in the half-annual and annual reports.[39]

Unfortunately, not only the SFTR does not contain any conduct of business rules concerning SFTs, but it seems to reinforce the idea that the asset manager can deduct directly revenue from SFTs, which would run against:

- the ESMA Guidelines (paragraph 29);
- MiFID II rules, in particular:
  - to provide fair, clear, and not misleading information;
  - to act in the best interest of the investor.

Nevertheless, the provisions of paragraphs 28 and 29 of the ESMA Guidelines will still be applicable after the entry into force of the SFTR (which are only reporting requirements), i.e. for funds (UCITS) as of 19 October 2020.[40]

ESMA Guidelines

The ESMA Guidelines require management companies to include details related to efficient portfolio management techniques only in the Prospectus and Annual Reports (paras 28 and 35).

According to paragraphs 25 and 28 (precited above), the Prospectus must disclose:

- *UCITS should inform investors clearly in the prospectus* [...] *a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest* [...];[41]
- *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*[42] and

[37] See Art. 3(11) SFTR.
[38] Last paragraph of Section B of the Annex of the SFTR, emphasis added.
[39] Art. 13 SFTR.
[40] See ESMA webpage 'SFTR Reporting' https://www.esma.europa.eu/policy-activities/post-trading/sftr-reporting, accessed 9 January 2020.
[41] Para 25 of the Guidelines.
[42] Paragraph 28 of the Guidelines.

- *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*.[43]

In the execution phase, pursuant to paragraph 35(f), the annual reports must disclose, among others:

- *the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred.*

Fortunately, these Guidelines have been transposed into national law of EU Member States, so they have a legally binding force on UCITS management companies. However, further clarifications are still needed in order to avoid regulatory arbitrage and different standards of investor protection.

KIID Regulation

Both the ESMA Guidelines and the SFTR require disclosure in the pre-contractual phase only in the Prospectus (for UCITS), but do not make any mention regarding the key (investor) information document(s) – KIID for UCITS and KID for PRIIPs.

BETTER FINANCE believes it derives from the wording of Article 7(2)d of the KIID Regulation[44] that securities lending transactions, as asset management techniques, should be disclosed in Section 1 of the fund's KIID. In particular, the provision reads:

> *2. The description referred to in paragraph 1 shall include the following information, so long as it is relevant:*[...]
> *(d) where specific asset management techniques are used, which may include hedging, arbitrage or leverage, an explanation in simple terms of the factors that are expected to determine the performance of the UCITS;*

Neither ESMA nor EU law provide a definition for specific asset management techniques or for efficient portfolio management techniques, rather several examples for the latter. However, we believe that the broad category of Article 7(2)d of the KIID Regulation encompasses EPMT. Therefore, in order to explain "*the factors that are expected to determine the performance of the UCITS*" in the KIID, the UCITS Management Company should clearly mention if such techniques are employed and the split of revenue.

3.3. Conflicts of interests

One important aspect we observed when writing the first report – and analysed in more detail in the current – is the closed circle of actors from the same financial group in securities lending transactions. Large ETF providers in the EU select affiliated intermediaries, custodians and counterparties (borrowers) for securities lending agreements, creating "in-house" streams of income, cheap leases and reinvestments. This generates a risk of a potential conflict of interests to the detriment of beneficial owners and may, in theory, potentially lead to a breach of fiduciary duties.

Analysing the EU applicable law in this field – Article 23 of MiFID II on conflicts of interests – we observed that there are few limitations for financial services providers in this regard. Moreover, those limitations which are in place are not strong enough to properly prevent the risk of a conflict of interests with beneficial owners.

[43] Ibid.

[44] Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website, OJ L 176, 10.7.2010, p. 1–15.

In our view, the biggest issue is the lack of an explicit definition for "conflict of interest" in MiFID II, allowing many real cases to escape regulation. Indeed, Article 24(9) does regulate inducements and conditions the provision thereof on two cumulative criteria:

> *a.* [...] *to enhance the quality of the relevant service to the client;* and
> *b.* [to] *not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its clients.*

Nevertheless, to the extent that any of the actors involved in the securities lending transaction are not paid or do not receive any other non-monetary remuneration for undertaking its role, this provision will not be incident.

A discussion can be made regarding the definition of conflicts of interests. It could be inferred by logic that a conflict of interests arises when there is an incentive (natural/economic or contractual) interfering with the ability of the financial intermediary to act and take decisions catering the best interests of the client. However, the question is whether we can assume, *iuris tantum* (relative) or *iuris et de jure* (absolute), cases where conflicts of interest arise or whether we should condition conflicts of interests on an actual damage to beneficial owners' rights and legitimate interests?

According to Article 23(1) MiFID, financial services providers must identify conflicts of interest and take <u>all appropriate steps</u> to prevent or manage those whose existence may damage the interests of clients.

Pursuant to paragraph (2), when <u>all the appropriate steps</u> taken by financial services providers are insufficient to ensure "*with reasonable confidence, that risks of damage to client interests will be prevented*", MiFID II requires disclosure of the source and nature of conflicts of interest to clients and what steps are taken to "*mitigate those risks*". Therefore, MiFID II creates a regulatory loophole which may allow circumvention of the investor protection regime by requiring providers to either:

- prevent and manage conflicts of interests;
  or, if the above fails,
- disclose the risk thereof.

It is true that *disclosure* is a measure of last resort, and providers must demonstrate that others were insufficient.[45] However, the clear legislative inconsistency is that financial services providers on the one hand are <u>obliged</u> to act in the best interest of clients while undertaking their activity and on the other hand they are relieved from this obligation by merely disclosing the risk of potential damage to client interests.[46]

In our view, the rule of *disclosure* as a last resort measure is an unjustified regulatory shift of burden from financial services providers to the individual, non-professional client since:

- in all the funds we have researched, these policies are standard clauses in the investment contract, which the retail investor cannot negotiate or exert influence over, but only adheres to;
- even to identify these risks of "potential" conflicts of interests takes specialised knowledge and tens of hours of research in the thousand pages Prospectuses and Annual Reports.

Moreover, MiFID II should at least have provided that the *disclosure rule* represents a measure of last resort instead of implying a sort of passport for the provider to ignore interest of its

[45] Cf. Article 34(4) Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 87/1, 31.3.2017, hereinafter MiFID II DA.
[46] Cf. Article 24(1) MiFID II.

clients and to avoid liability. In fact, if the interest in conflict concretely affects the interest of the clients and causes a prejudice, it should directly engage the liability of the provider for breach of the fiduciary duty.

At Level 2, the MiFID II Delegated Act[47] requires providers to establish, in writing, a conflict of interests policy[48] that sets out the measures taken to ensure that supervision, control, remuneration or exercising influence over the persons giving rise to the conflict of interests is avoided and "*ensure the requisite degree of independence*".[49]

In our view, the issue is both of wording and of substance.

First, a "*requisite degree*" does not say anything as a criterion and can be very widely interpreted. Second, conceptually, risks of and actual conflicts of interests are avoided or removed, not prevented or managed, and the "*requisite degree of independence*" is anyway not pivotal to eliminating harm to investors. This is because conflicts of interests result from a natural tendency to act against the best interests of the clients. The measures required by Article 34 MiFID II DA should not aim at creating a "*degree of independence*", but to actually ensuring that the incentive interfering with the duty of care [Art. 23(1)] does not exist.

For this reason, as we explain in the analysis below, conflicts of interest cannot be factored only in remuneration policies, as in most cases they arise from qualitative considerations. If the mandate to an affiliated actor in the SLT causes unnecessary additional risks, then EU law should be much stronger in sanctioning these situations.

Conversely, there may be instances where a situation giving rise to conflicts of interests does not create damage for clients, e.g. the custodian in a securities lending arrangement is affiliated with the lender. Whereas the lender may be naturally incentivised to maximise income for the custodian, the element of trust in safekeeping assets may trump the remuneration element and be in the advantage of the beneficial owners. However, if the depositary or clearing house is affiliated with the SLA or borrower, then this could have detrimental effects for beneficial owners since the depositary may "oversee" certain best execution elements, such as the daily mark-to-marketing.

In our view, the determination of conflicts of interests rests on:

a) ascertaining whether the provider has <u>a distinct interest</u> that is aligned or overlaps with the interest of the financial group, globally considered; and
b) whether mandating an affiliated actor represents an <u>avoidable</u> or even <u>detrimental additional cost</u> or <u>risk</u> that results in a damage for fund's subscribers.

Concerning the first criterion (a), the externalization of such activity to affiliated "*third parties*" certainly represents a case where there is a natural incentive to act against the best interests of clients, thus breaching the duty of care. The duty of care, among others, involves the obligation of managing assets in a prudent manner, to minimize costs and maximize profits.

Concerning the second criterion (b), two hypotheses can be further distinguished. Since the risk could be avoided or could prove detrimental, hence there is no materiality or certainty about it, MiFID II could offer the possibility for financial intermediaries to justify that the benefits for clients trump the potential risks. Therefore, if the company identifies an avoidable or potentially detrimental cost or risk for beneficial owners, the only hypothesis in which the originating cause could be maintained is if there is a justification report showing the advantages thereof.

[47] One of the Level 2 implementing acts for MiFID II is the MiFID II DA (n 33 above).
[48] Article 34(1) MiFID II DA.
[49] Paragraphs (2) and (3) of Article 34 MiFID II DA.

For this reason, what Article 23 MiFID II and Article 34 MiFID II DA should have required instead is a justification as to why maintaining an arrangement that gives rise to a conflict of interests better serves the interests of clients.

The last question is whether the damage has to be proved on all cases or whether a relative assumption is reversed, meaning that damage is presumed and is subject to contrary evidence by the financial intermediary that has to prove that it did not occur.

In the *policy recommendations* section of this Report, BETTER FINANCE put forward proposals to ensure that a proper investor protection regime is established in order to actually prevent conflicts of interests and best serve the needs of beneficial owners. To this end, MiFID II should lay down explicit provisions that frame the necessary and sufficient conditions for a conflict of interest to rise. However, the analysis is not that simple.

Empirical examples of a risk of conflicts of interests in securities lending
Affiliated counterparty Some management or investment management companies select as counterparty (borrower) in a securities lending agreement that is affiliated (owned or part of the same group). In this hypothesis, the lender may naturally be incentivised to not challenge the counterparty and seek the best remuneration. As such, we believe that such a conflict of interests cannot be prevented or managed.
Affiliated reinvestment vehicles If cash collateral is reinvested in a money market vehicle (fund) owned by an affiliated party, it may potentially reduce fee competition and/or breach the rule of ensuring that the cash collateral is reinvested in suitably safe vehicles.

Source: BETTER FINANCE own research

An analysis of the research findings with regards to conflicts of interests is provided under section 5 below.

3.4. Enforcement activities

In May 2022, ESMA published the results of a Common Supervisory Action (CSA) on the supervision of costs and fees of UCITS across the EU and European Economic Area (EEA).[50] According to ESMA's report, "*the CSA's aim was to assess, foster and enforce the compliance of supervised entities with key cost-related provisions in the UCITS framework*", focusing on due costs, related party transactions, and efficient portfolio management techniques (EPMT).

While CSAs are meant to ensure supervisory coordination between the 30 national competent authorities at EU/EEA level, it is unlikely that the conclusions put forward by ESMA (*calls for enforcement*) will be materialised. This is because some NCAs pointed out to ESMA the lack of a "*sufficient legal basis to escalate their interventions in case of adverse findings that do not constitute clear-cut breaches of a regulatory provision*".[51]

The ESMA CSA put forward four alarming findings:

- issues with disclosures (on efficient portfolio management techniques) in fund documentation;
- widespread use of "fee split" arrangements;
- some investment managers return as little as 50% of the gross securities lending income to fund beneficial owners; and

[50] European Securities and Markets Authority, *Final Report on the 2021 CSA on Costs and Fees* (31 May 2022), ESMA34-45-1673, 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; hereinafter "ESMA CSA 2021 on Costs and Fees".

[51] ESMA CSA 2021 on Costs and Fees, p. 17.

- many national competent authorities (NCAs) cannot escalate supervisory intervention further than bilateral exchanges with fund managers due to an insufficient legal basis, which is probably the case for securities lending as well.

BETTER FINANCE agrees with ESMA's findings that the wording used in fund documentation (KIID, Prospectus) to describe securities lending arrangements and their use is quite often vague and without a clear justification as to why such techniques would be used (albeit not the purpose of this analysis).

At the same time, in terms of "fee split" arrangements, ESMA's view is that these may not be established with due consideration to "*assessing that both EPM revenues generated, and the amount of revenue deducted by the securities lending agent are in line with the fair market rates and therefore in the best interest of investors*". Moreover, fee split arrangements entered with an in-house (affiliated) securities lending agent is further worrying as the income deducted under operational costs may not be "*competitive and in line with fair market rates*". In this sense, ESMA concludes that "*fixed fee split arrangements, in particular where this is done with related parties raises risks of investors being effectively overcharged*".

BETTER FINANCE firmly agrees and congratulates ESMA on this analysis as it singles out the main issue observed both in the 2019 report and this edition as well: fee split arrangements may breach the general duty of care (Art. 24(1) MiFID II – Art. 14(1)(a) UCITS V Directive) obliging UCITS managers to act in the best interests of fund beneficial owners.

As ESMA found, such arrangements raise the question of undue costs, or otherwise "*investors being effectively overcharged*", which is contrary to Art. 22(4) of the Commission Delegated Regulation 2010/43/EU:

> "*Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unit-holders*".

We wish to highlight that, while the ESMA rationale still stands perfectly valid, there is an additional legal basis to potentially claim that managers breach investor protection rules when entering fixed fee split arrangements with third-parties, particularly with affiliated entities: the rule in the ESMA Guidelines on Efficient Portfolio Management Techniques specifying that "*no hidden revenue*" can be derived from securities lending should be understood as referring not only to the UCITS or investment manager, but also to the related entities. In other words, the emphasis should be at group level, reason for which – in our view – such arrangements by default can breach the ESMA rule on no hidden revenue.

The culprit is that neither the Commission Delegated Regulation (level 2), nor the UCITS Directive of MiFID II (level 1) specify what "undue" costs are, thus the provision being virtually unenforceable. The ESMA supervisory briefing on costs in UCITS and AIFs does set out a mechanism that should be followed by national supervisors to assess whether costs are due or not.[52] Most notably, ESMA laid down a list of 10 elements to be considered by asset managers when establishing the pricing process. As these considerations are applicable *mutatis mutandis* to securities lending as well, we focus on two elements relevant for our analysis of operational costs:

I. Costs need to be linked to a service provided in the best interest of clients; in this sense, ESMA clarifies that costs charged must either be

[52] European Securities and Markets Authority, *Supervisory Briefing on the Supervision of Costs in UCITS and AIFs* (4 June 2020) ESMA34-39-1042, available at: https://www.esma.europa.eu/sites/default/files/library/esma34-39-1042_supervisory_briefing_on_the_supervision_of_costs.pdf.

- *"necessary for the fund to operate in line with its investment objective"*, or
- *"strictly functional to the ordinary activity of the fund or to fulfil regulatory requirements"*.

II. Costs need to be proportionate compared to market standards and the service provided, in particular when costs are deducted to pay affiliated parties or otherwise entities with which conflicts of interests may arise.

For the second criterion, we wish to highlight that using affiliated parties (or in-house lending agents) does not fit the criterion of "market standard" as these are not independent and there may be no challenge or negotiation as regards prices. On the contrary, intra-group managers will be economically incentivised to accept preferential prices charged by lending agents, which as we can observe in our sample are at least twice that of independent agents.

Thus, in our view, it cannot be argued that fees paid to affiliated or non-independent parties fall under the category of "comparable market standards".

4. METHODOLOGY

This report looks at securities lending practices by EU UCITS[53] ETFs[54] from the largest providers on the European market. The research team analysed the largest ETF providers (by Assets under Management) and compiled a fund database for analysis. The following asset managers have been eligible[55] for the analysis and included in the final fund sample (in alphabetic order, by provider): Amundi, BlackRock (*iShares*), Deka, DWS (*Xtrackers*), Invesco, JPMorgan, State Street (*SPDR*), UBS and Vanguard. Compared to the 2019 report, Fidelity, Lyxor and Commerzbank ETFs reported that the funds have no longer entered securities lending programmes in the last reported financial year.

Compared to the 2019 report,[56] this iteration of the securities lending research focuses also on global figures. That is to say, instead of analysing only a few individual ETFs from each provider, we analysed also the global securities lending figures by the investment company under which the ETFs are registered (as sub-Funds).

All data comes from the three reporting documents prescribed by the UCITS V Directive:

- the Key Investor Information Document (KIID);
- the Prospectus; and
- the Annual Report (or semi-Annual Report), and (if applicable)
- supplements to Prospectuses, securities lending policy documents, or other relevant documents.

In consideration of Art. 23(3) KIID Regulation,[57] all KIIDs are the versions updated for 2022. For the Prospectus and Annual Reports, the research team used the latest available versions – where the research team could not find the Annual Report ended in 2021, we used the figures from the semi-Annual Reports (marked accordingly). The purpose of the analysis is not *per se*

[53] Undertakings for the Collective Investment in Transferable Securities, regulated by Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, p. 32–96.

[54] Exchange-Traded Funds.

[55] Eligibility criteria are: to provide UCITS ETFs, to be distributed in the EU and to not exclude securities lending transactions as part of the investment strategies.

[56] BETTER FINANCE, 'Efficient Portfolio Management Techniques : Attribution of Income Derived from Securities Lending by UCITS Exchange-Traded Funds' (May 2019) https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-Research-Paper-Securities-Lending-11062019.pdf.

[57] Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website, OJ L 176, 10.7.2010, p. 1–15.

to obtain all figures, but to have a computation basis to check whether the income split policy matches the absolute amounts disbursed to the parties involved.

The following table provides definitions for the main indicators used in the analysis:

Indicator	Definition
Affiliated party	Party that is fully or partially owned or that is part of the same group as the lender, or not.
AuM	Total value of the portfolio according to the Annual Report (generally, expressed as NAV), referred to as either "*total securities portfolio*" or "*net assets attributable to shareholders*";
Domicile (of the fund)	Country where the UCITS or fund is registered according to the ISIN code.
Securities Lending Agent (SLA)	Party to or intermediary in the securities lending agreement designated to act on behalf of the lender and to provide services (all or in part) to facilitate the transaction or act on behalf of the lender.
SL	Securities lending
SLI	Securities lending income
gSLI	Gross securities lending income
nSLI	Net securities lending income
Investment company	Refers to the undertaking for collective investment (as legal form) under which the fund or sub-fund operates; when a "-" symbol appears, it means that the fund/trust is the investment company.

Source: BETTER FINANCE own composition

5. ANALYSIS

This follow-up on the first report on securities lending looks through at global securities lending figures for all investment companies (hereinafter ICs) managing the ETFs (usually as sub-Funds) from the largest ETF providers in the EU. The research focuses on the conditions and criteria of securities lending, describing the share of income, and information about the actors involved (management company, securities lending agent, counterparties). This iteration of the report also looks at the relationships between the lender and the other parties involved from a conflicts of interest point of view.

Data sample: our data sample comprises 17 umbrella funds (investment companies) and 5 standalone UCITS ETFs from the 10 largest ETF providers in the EU,[58] totalling 810 UCITS ETFs, of which 418 (52%) have entered into securities lending programmes in the financial years ending in 2020 or 2021 (depending on the availability of Annual Reports).

Domiciles: more than half of these ETFs (63%) are registered in the largest ETF domicile, Ireland, and supervised by the Central Bank of Ireland; another 36% are domiciled in Luxembourg and supervised by the CSSF; to analyse if there are differences due to the home Member State (regulatory arbitrage or gold plating), the research team included also 4 UCITS ETFs from Germany and 1 in France, although these are very difficult to find due to the very large number and variety of IE-domiciled funds that are distributed across the EU.

Looking at the number of ETFs in each umbrella fund undertaking securities lending agreements, we found the following:

Investment company	Dom.	# ETFs	% of total ETFs	Gross income*	Net income	Fund share (%)
Amundi Index Solutions	LU	121	32%	€8,497,543	€5,475,911	65%
Amundi ETF DAX UCITS ETF	FR	1	100%	€54,424	€53,441	98.2%

[58] Based on our desk research, Invesco, Commerzbank, WisdomTree and BNPP Easy ETFs did not enter securities lending transactions in the last reported financial years.

Invesco Markets II plc (2020)	IE	30	53%	€1,396,646	€1,256,981	90%
iShares I plc	IE	39	87%	€51,064,000	€31,915,000	62.5%
iShares II plc	IE	49	61%	€22,395,200	€13,997,000	62.5%
iShares III plc	IE	37	70%	€4,180,800	€2,613,000	62.5%
iShares IV plc	IE	68	59%	€8,664,000	€5,415,000	62.5%
iShares V plc	IE	37	59%	€6,486,480	€4,054,050	62.5%
iShares VI plc	IE	28	54%	€3,701,920	€2,313,700	62.5%
iShares VII plc	IE	32	69%	€13,924,800	€8,703,000	62.5%
UBS (LU) Fund Solutions	LU	58	36%	€12,731,278	€7,638,767	60%
UBS ETF plc (IE) SAR2021	IE	27	48%	€265,188	€159,113	60%
Vanguard Funds plc (IE)	IE	33	55%	€5,647,816	€5,210,118	92%
Deka ETFs (2020)	DE	4	100%	€259,934	€197,119	76%
Lyxor Multi Units (LU)	*LU*					*min. 65%*
SSGA SPDR ETF Europe II	IE	46	48%	€1,698,234	€1,188,764	70%
JPM ETFs	IE	20	20%	€531.72	€478.55	90%
Xtrackers	LU	78	47%	€7,594,856	€5,316,399	70%
Xtrackers II	LU	39	38%	€591,071	€413,750	70%
Xtrackers (SAR2021)	IE	63	43%	€2,098,256	€1,468,779	70%
Totals		810	418	€151,252,978	€97,930,371	

Source: BETTER FINANCE own composition; all figures in another currency have been converted to EUR (€) according to the date of the Annual Reports; figures underlined mean that they are not disclosed in fund documentation and the research team calculated them based on the income split policy available in the Prospectus and Annual Report; where "(SAR2021)" is indicated next to the name of the fund, it means that absolute figures are derived from the semi-Annual Report of 2021 because the latest annual report available was for 2020; Lyxor Multi Units discloses in the Prospectus a securities lending and income split policy, but the research team could not find any fund that used such technique in 2021 – as such, we kept it in the table for information purposes;

The research team observed two types of ETFs (and umbrella funds, or investment companies):

- those that only marginally enter securities lending programmes; as such, the latter lend a small share of the portfolio and, thus, earn a consequently marginal income: from €53,441 (Amundi ETF DAX) or €479 (JPMorgan ETFs);
- those that engage much more assets in securities lending and have significant income: by far the largest net fund income from securities lending in the financial years ended in 2021 was earned by iShares umbrella funds (I, II, and VII) totalling €87,384,000 gross income (calculated), of which €76,898,498.27 was returned to the fund investors and €46,139,098.93 was deducted as the securities lending agent's fees. In total, for the reporting year ended in 2021 (at different dates), we calculated that the seven Irish-domiciled umbrella funds earned a gross securities lending income of €110,417,220, to which the 189 ETF sub-funds were distributed a total €69,010,750 and €41,406,450 to the securities lending agent.

Note: for the Deka funds, the research team used the Annual Reports for 2020 instead of the semi-annual reports for the first half of 2021 because the funds probably did not pay yet the operational costs for securities lending, reason for which the difference between the gross and net income at that point was 0. For the Invesco funds, the research team could not find Annual or Semi-Annual Reports ending in 2021, so we used the Annual Report ending 31/12/2020.

The majority of *gross* incomes and agent fees are calculated by BETTER FINANCE based on the fixed split policy since we did not find proper disclosure in the annual reports for most umbrella funds.

The second largest earnings came from the UBS umbrella fund, domiciled in Luxembourg, which earned net €7,638,767, from which we calculated a gross income of €12,731,278 and the difference being equally split between the investment manager and agent, €2,546,256 each.

Most investment companies only disclose (under various headings) the "securities lending income", leaving it to a retail investor to investigate whether it is a gross or a net figure by reading the notes to the financial statements. Further, a retail investor must read the Prospectus and the relevant paragraphs in the Annual Report to find out that, in almost all cases, the income split is standardised through the securities lending policy.In addition, the figures presented in the table above are converted to EUR (€) at the rate reported by the European Central Bank for the date of the annual report as the reporting occurs in the currency of each sub-fund. In summary, the UCITS and umbrella funds in our data sample earned from securities lending programmes (in 2020 or 2021, depending on the availability of Annual Reports):

- Gross income: €151,252,978
- Net income: €97,930,371 and
- Operational costs (divided or not between two actors): €53,322,607.

Extrapolating the figures, the research team attempted to calculate how much money would EU investors make extra if the income split was at least 90:10 and we obtained a figure of additional €38,868,852 from the 418 UCITS ETFs in the sample.

5.1. Income split (in %)

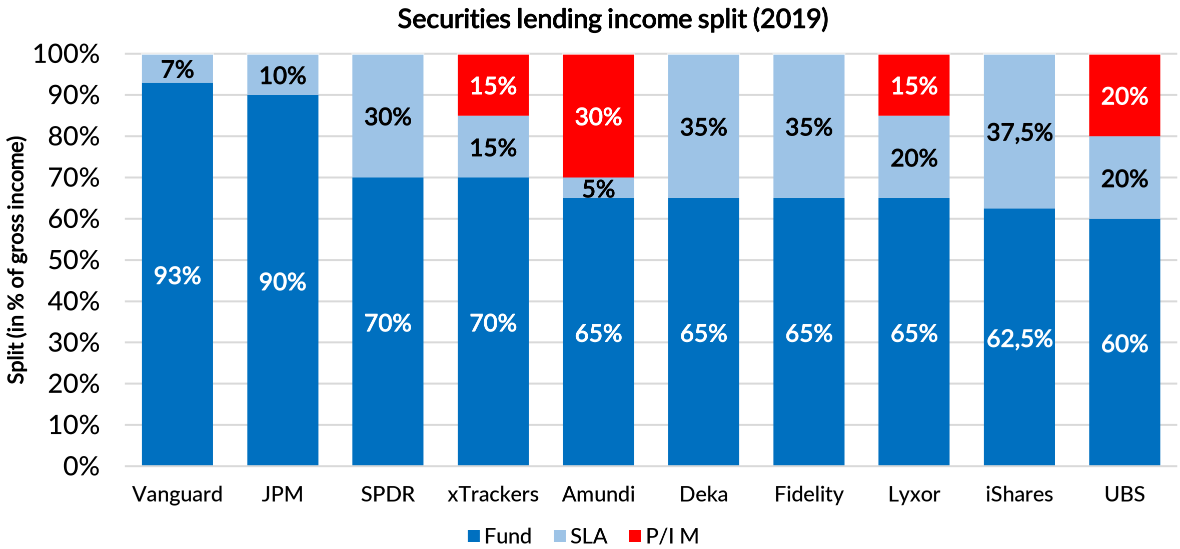
With a few exceptions, we found that most ETF providers employ a fixed gross income split in the securities lending programmes – described in the Prospectus and in the Annual Report – between the fund and the other parties involved. Generally, we observed two types of splits:

- one where the gross income is divided between the SLA and the fund; and
- one where the gross income is divided between operational costs, further split to the lending agent and another party, and the net income for the fund.

The predominant model is the first one, and usually the securities lending policy (described in the Prospectus and/or in the Annual Report) specifies that the SLA will bear all direct and indirect operational costs related to the securities lending programme. In the 2019 report we found:

- the funds in scope of the analysis receive between 60% and 93% of gross securities lending income (gSLI);
- the lending agents receive between 7% and 37.5% of gSLI, and
- the third parties (where applicable) receive between 15% and 30% of gSLI.

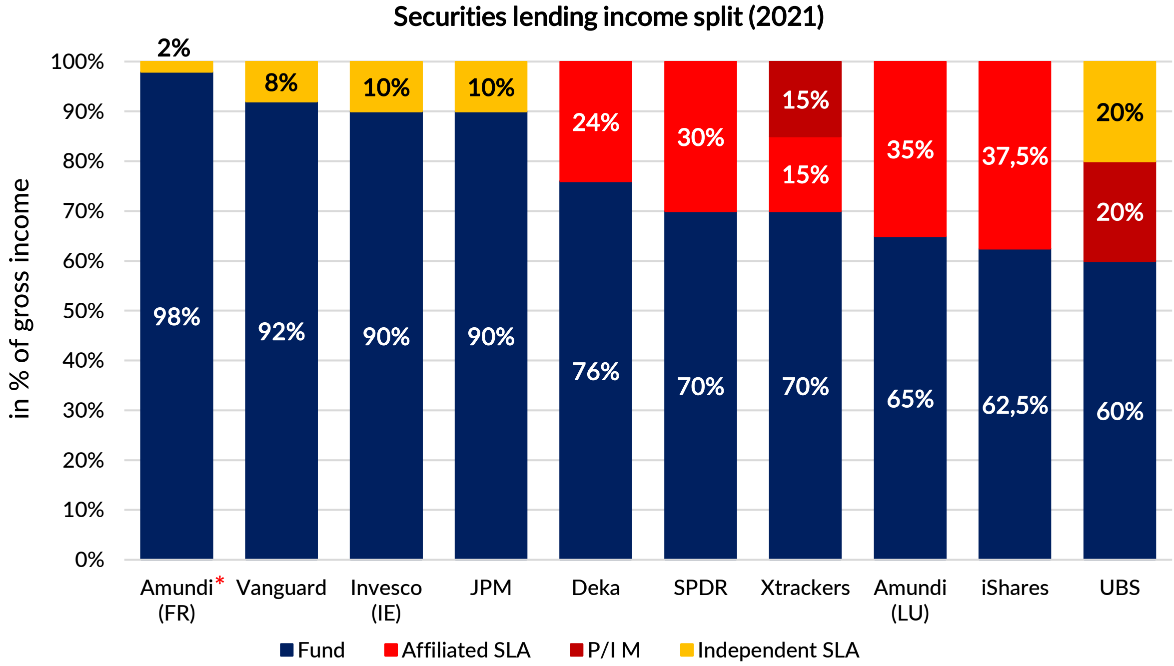
The bar chart below reiterates the findings from the 2019 report:



Source: BETTER FINANCE own research; SLA = securities lending agent; P/I M = portfolio/investment manager, or other names under which the manager of the fund come across;

For the 2021 reporting period, we found slight changes in the securities lending policies, but the overal picture tends to be consistent with the 2019 report:

- the funds in scope of the analysis receive between 60% and 98% of gross securities lending income (gSLI);
- the lending agents receive between 2% and 37.5% of gSLI, and
- the third parties (where applicable) receive between 15% and 24% of gSLI.



Source: BETTER FINANCE own research; SLA -= securities lending agent; P/ IM = management company or investment manager/advisor; **Note*: *This regards one fund only, domiciled in France (Amundi DAX UCITS ETF) and is not representative for the entire group.*

The vast majority (7 out of 9) providers have established the income split between the fund and other actors through the securities lending policy (Prospectus), thus the calculations are the same regardless of the fund. We have found only two exceptions to the fee split arrangements established as a policy (Xtrackers DAX and DAX income where the fund earned 90% of income).

For the two other (Vanguard, Deka, Invesco), we have observed that the asset manager only deducts the costs charged by the agent – differing from one fund to another – and the net revenues are returned to the beneficial owners, thus not having a pre-set split. Deka implements a policy by which no more than a third of the gross income can be deducted as operational costs, which is in line with the 2019 BaFin rules on the topic.

5.2. Income split (in €)

While the revenue split is easier to compare expressed in percentage (%) terms of the gross income, the amounts in absolute terms (€) present more difficulties since these are dependent on the value of securities lent and their quality and liquidity. At the same time, given that the market fluctuates, the values are reported at different times throughout 2021.

The revenues in absolute figures vary widely between the investment companies mainly due to the amount of the portfolio on loan and number of ETFs engaged in such programmes. Based on the information available, in the total 21 investment companies analysed, 39 UCITS ETFs generated €66.1 million in gross terms, and returned to beneficial owners €42.3 million, the difference of €23.8 million being deducted as direct or indirect operational costs.

The table below lists the amounts in monetary terms returned to the fund, to the management company (if applicable) and to the agent (if any).

UCITS ETF	Company	Gross income	Fund income	P/I M income	Agent income
Amundi Index MSCI Europe UCITS ETF	Amundi Index Solutions	€ 1,344,309.09	€ 873,468.09	-	€ 489,941.25
Amundi Euro Stoxx 50 UCITS ETF	Amundi Index Solutions	€ 712,186.93	€ 462,899.98	-	€ 213,674.52
Amundi CAC40 UCITS ETF	Amundi Index Solutions	€ 370,287.74	€ 240,602.04	-	€ 96,000.66
Amundi Index S&P 500 ESG	Amundi Index Solutions	€ 25,757.66	€ 16,763.81	-	€ 7,709.02
Amundi DAX UCITS ETF	-	€ 54,424.08	€ 53,441.20	-	€ 632.38
Invesco MDAX UCITS ETF (2020)	Invesco Markets II plc	€198,690	€174,560	-	€24,130
Invesco US Treasury Bonds 7-10y UCITS ETF (2020)	Invesco Markets II plc	€1,045,744.02	€941,201.37	-	€104,542.65
iShares Core FTSE 100 UCITS ETF	iShares plc I	€ 995,200	€ 622,000	-	€ 373,200
iShares € HY Corp Bds UCITS ETF	iShares plc I	€ 15,243,200	€ 9,527,000	-	€ 5,716,200
iShares Core MSCI Europe UCITS ETF	iShares plc II	€ 2,227,200	€ 1,392,000	-	€ 835,200
iShares Core UK Gilts UCITS ETF	iShares plc II	€ 460,800	€ 288,000	-	€ 172,800
iShares Core € Gov Bonds UCITS ETF	iShares plc III	€ 28,884,800	€ 18,053,000	-	€ 10,831,800
iShares Core MSCI Europe UCITS ETF	iShares plc III	€ 1,702,400	€ 1,064,000	-	€ 638,400
iShares Europe Val Factor UCITS ETF	iShares plc IV	€ 576,000	€ 360,000	-	€ 216,000
iShares MSCI World Mom F UCITS ETF	iShares plc IV	€ 302,400	€ 189,000	-	€ 113,400
iShares EM Dividend UCITS ETF	iShares plc V	€ 681,472	€ 425,920	-	€ 255,552
iShares MSCI ACWI UCITS ETF	iShares plc V	€ 1,013,760	€ 633,600	-	€ 380,160
iShares MSCI Eur MC UCITS ETF	iShares plc VI	€ 51,200	€ 32,000	-	€ 19,200
iShares Edg MSCI Eur Min Vol U ETF	iShares plc VI	€ 2,374,500	€ 1,484,062	-	€ 890,437
iShares Core Euro STOXX 50 UCITS ETF	iShares plc VII	€ 452,800	€ 283,000	-	€ 169,800
iShares Core S&P 500 UCITS ETF	iShares plc VII	€ 2,541,820	€ 1,588,638	-	€ 953,183
Deka MSCI Europe UCITS ETF (2020)	-	€ 133,650	€ 100,810	-	€ 32,840
Deka MSCI USA UCITS ETF (2020)	-	€ 8,625	€ 6,584	-	€ 2,041
Deka MSCI World UCITS ETF (2020)	-	€ 38,493	€ 29,283	-	€ 9,210
Deka Euro STOXX 50 UCITS ETF (2020)	-	€ 79,167	€ 60,443	-	€ 18,724
Lyxor EuroStoxx Banks UCITS ETF	-	*min. 65%*	-	*max. 20%*	*max. 15%*
Lyxor JPX-Nikkei 400 UCITS ETF	-	*min. 65%*	-	*max. 20%*	*max. 15%*
JPM BB US Equity UCITS ETF	JPMorgan ETFs (IE)	€ 31	€ 29	-	€ 3
JPM Global Equity MFac UCITS ETF	JPMorgan ETFs (IE)	€ 455	€ 410	-	€ 45
SPRD MSCI Europe UCITS ETF	*€ 150,547.14*	€ 105,383.00	-	€ 45,164.14	*€ 150,547.14*
SPDR MSCI Europe SC UCITS ETF	*€ 335,538.57*	€ 234,877.00	-	€100,661.57	*€ 335,538.57*
Vanguard FTSE 250 UCITS ETF	Vanguard Funds	€ 2,134,236	€ 1,960,755	-	€ 173,481
Vanguard S&P 500 UCITS ETF	Vanguard Funds	€ 246,033	€ 230,070	-	€ 15,963
UBS S&P 500 UCITS ETF (SAR2021)	UBS IRL ETF	€ 18,543	€ 11,151	€ 3,696	€ 3,696
UBS MSCI USA UCITS ETF (SAR2021)	UBS IRL ETF	€ 70,127	€ 42,071	€ 14,028	€ 14,028
UBS MSCI Europe UCITS ETF	UBS (LU) Fund Solutions	€ 131,510	€ 78,908	€ 26,300	€ 26,300
UBS MSCI EMU UCITS ETF	UBS (LU) Fund Solutions	€ 916,700	€ 550,016	€ 183,340	€ 183,340
Xtrackers S&P 500 UCITS ETF	Xtrackers (IE)	€ 7,782	€ 5,447	€ 1,167	€ 1,167
Xtrackers MSCI World UCITS ETF	Xtrackers (IE)	€ 528,895	€ 370,227	€ 79,334	€ 79,334
Xtrackers MSCI Europe UCITS ETF	Xtrackers (LU)	€ 696,460	€ 487,522	€ 104,469	€ 104,469
Xtrackers Euro STOXX 50 UCITS ETF	Xtrackers (LU)	€ 302,913	€ 212,039	€ 45,437	€ 45,437
Xtrackers Eurozone Gov Bds UCITS ETF	Xtrackers II (LU)	€ 209,464	€ 146,625	€ 62,839	€ 62,839
Xtrackers Germ Gov Bds UCITS ETF	Xtrackers II (LU)	€ 53,873	€ 37,711	€ 16,162	€ 16,162

Source: BETTER FINANCE own composition based on prospectuses (figures in other currencies are converted into EUR on the rate of the date of the prospectus); for iShares, some of the *figures* are deducted, see 5.3 below; for Deka ETFs, the Annual Reports disclose only the operational costs, which we assumed are given to the SLA; for x-Trackers, two ETFs (DAX UCITS ETF and DAX Income UCITS ETF) receive 90% of the income; P/I M = portfolio or investment manager;

The research team took two example UCITS ETFs for each investment company (umbrella fund). We also attempted to gather UCITS ETFs from more than the two traditional fund domiciles in the EU (IE and LU), in particular from the same providers to observe whether disclosure or conduct of business rules are different due to different regulatory or supervisory standards. For this reason, where available, we have included also individual ETFs (standalone undertakings) to make the analysis more robust.

Out of the 41 UCITS ETFs analysed (table above), only 6 providers out of 9 properly disclose all figures related to securities lending, such as gross income, net fund income (and the relative value) as well as the payables (costs), in monetary and relative terms.

As presented below, 6 providers (Amundi, BlackRock, Deka, DWS, Lyxor, and SSGA) use an affiliated party as securities lending agent. In broader terms, we relay below a few other adjacent findings of the report:

Provider	BDI	CCR	SLA aff.	KIID disclosure
Amundi	No	Allowed	Yes	Partial
BlackRock	Yes	Not allowed	Yes	Full
Deka	No	Allowed	Yes	No
DWS	Yes	Allowed	Yes	Full
Invesco	Yes	Allowed	No	No
JPM	No	Allowed	No	Partial
Lyxor	-	*Allowed*	*Yes*	-
SSGA	No	Allowed	Yes	Partial
UBS	Yes	Allowed	No	No
Vanguard	No	Allowed	No	Partial

Source: BETTER FINANCE own composition based on fund documentation; BDI = *borrower default indemnity*; CCR = *cash collateral reinvestment*; SLA aff.= *securities lending agent affiliation with the investment manager and/ or management company*; n/a = not applicable.

With two exceptions, all providers allow cash collateral to be reinvested, although non-cash (securities) must be safekept by the depositary. In terms of disclosure in the KIID, most asset managers include partial information on whether the fund does or can enter securities lending agreements or on the income split. Only two (BlackRock and DWS) prominently indicate it, while DWS has already included in the 2022 KIIDs an additional line for *securities lending costs* (see below), as well as dedicating a website page to this topic.

Relating to credit risk arising from securities lending transactions, four providers have arrangements in place to cover the losses resulted from the borrower defaulting on the obligation to return the securities in full or in time and the collateral not sufficing for the shortfall.

ESG: Throughout the research, the BETTER FINANCE team observed that several ETF managers do not allow ESG-factored ETFs to enter into securities lending agreements; one (Invesco) justified that it would not be able to exercise voting rights while the stocks are on loan; however, as this aspect was not part of the research focus, BETTER FINANCE will return on the topic for a more ample analysis.

5.3. Results – qualitative analysis

The qualitative analysis gives a bit of insight into the securities lending policies and how these are disclosed in the regulatory reporting documents of the funds and investment companies in question, i.e. KIID, Prospectus and Annual Report. We found value in this *qualitative* side of the analysis since it uncovers both some questionable (such as not disclosing who or on what grounds acts as an agent) and good practices (such as the borrower indemnity default).

Amundi: The research team analysed two investment companies from Amundi. One is a variable capital company (SICAV) registered in Luxembourg, comprising 121 index-tracking UCITS ETFs, and one is a stand-alone UCITS registered in France.

That ETF tracks the German large cap index (DAX) and is managed by Amundi AM (FR), part of the Amundi Group.

According to the securities lending policy, the costs are borne by the fund and paid to the *securities lending agent*,[59] Amundi Intermédiation (FR), affiliated to the management company and shall not exceed 50% of the gross income (p. 22 Prospectus). Both the management company and the agent are part of the Amundi Group.

The investment company, Amundi Index Solutions, groups 95 sub-funds (UCITS ETFs), of which the research team chose four examples to analyse: the MSCI Europe tracker, the Euro STOXX 50, CAC 40 and S&P 500 ESG trackers. To begin with, we observed a difference in reporting, as the Luxembourg-domiciled UCITS ETFs all mention in the KIID the fact that "*Sub-Fund may also enter into securities lending operations*", while the FR-domicile did not.

The Prospectus (January 2022) specifies that operational costs for securities financing transactions (incl. securities lending) may not exceed 35%, out of which 5% are paid to CACEIS Bank (affiliated) acting as collateral agent.

In terms of good practices, one aspect stood out for Amundi: in line with the SFTR reporting requirements, and keeping in mind the abovementioned issue, the research team found Amundi's reporting template the easiest to understand and follow compared to all other 11 formats (sometimes, the reporting format changes from one domicile to another).

Invesco: This UCITS ETF provider has registered two umbrella funds in the EU (Ireland), Invesco Markets plc and Invesco Markets II plc. While both Prospectuses specify that the sub-funds may enter into transactions for efficient portfolio management (including securities lending), the Annual Report (ended 30 November 2020) of Invesco Markets plc specified that, accurate as at the date of the Annual Report, the UCITS ETFs did not enter such arrangements.

We noted a positive practice in relation to the Invesco Markets II plc documentation: a justification that the fees paid to the securities lending agent will be benchmarked at the "*normal commercial rates*" (same for BlackRock's iShares). The Prospectus specifies (p. 98) that the direct and indirect operational costs, which do not include hidden revenues:

> "*shall include fees and expenses payable to* (…) *securities lending agents engaged by the Company from time to time. Such fees and expenses* (…) *will be at normal commercial rates together with VAT, if any, thereon, will be borne by the Company or the Fund in respect of which the relevant party has been engaged*".

The securities lending agent is an unaffiliated party (Bank of New York Mellon) and provides a borrower default indemnity for counterparty risk. The Annual Report specifies the value of securities on loan, the value of collateral (in absolute and relative terms), the net income and the securities lending agent fee. However, we found it misleading that the agent fees are reported in USD, whereas the income and fee calculation for certain funds is done in other currencies (€ or £).

The company provides a securities lending document where ample details on how the agreements will be entered to and function, what parties will be involved etc., on the website of the sub-funds.

[59] The Prospectus does not spell out "securities lending agent", but only the responsibilities that Amundi Intermediation was entrusted to undertake for securities lending for the Fund. Since these attributions are similar to what securities lending agents provide, we assumed it acts as securities lending agent.

Unfortunately, at the time of writing of this report (ending June 2022), we could not find on the provider's website, nor on other websites through desk research, Annual or Semi-Annual Reports ending in 2021. Thus, the research team used the Annual Report ending 31/12/2020.

iShares: The primary finding concerning iShares funds is the inconsistency between the website, KIIDs (the IE-domiciled ones), the Prospectus and Annual Report, regarding the *securities lending policy*. Whereas the first three sources of information mention a clear, fixed split of income from securities lending transactions – the fund will receive 62.5% and the SLA 37.5% - the Annual report only discloses the minimum/maximum: the fund will receive at least 62.5% and the SLA no more than 37.5%.

"*The Funds which undertake securities lending transactions receive at least 62.5%, while the Securities Lending Agent receives up to 37.5% of such income, with all operational costs borne out of the Securities Lending Agent's share. Income earned during the financial year by the Funds from securities lending transactions is disclosed in the income statement*" – p. 149, emphasis added, Notes to the Financial Statements no. 15; in some cases, also the AR notes that the limits are fixed.

The issue with securities lending reporting is that the Annual Reports do not mention how much did the securities lending agent actually receive from the gross income; we can thus deduct, based on the information available, what the gross income and SLA income figures would be. This in some cases is quite misleading as the Annual Reports (iShares II plc,) suggest that all details (gross income, SLA fee, net income) will be reported, whereas this is not the case:

> "*Full financial details of the amounts earned and expenses incurred with respect to securities lending for the Funds of the Company, including fees paid, will be included in the Company's annual reports and audited financial statements and semi-annual reports and unaudited financial statements. The Manager will, at least annually, review the securities lending arrangements and associated costs*". – p. 122 (iShares II plc Prospectus); emphasis added.

However, a feature standing out as good practice is that BlackRock Inc., the holding company of the SICAVs, investment managers and SLAs, provides a borrower default indemnity, which covers the risks of securities lending for the beneficial owners.

Deka: Following the entry into force of the BaFin rule[60] on the maximum splits of income between the fund and counterparties, Deka ETFs have reduced the share for the SLA from 35% to around 24% for all funds analysed in this report, as follows:

Fund name	Previous splits	Fund net income (%)	SLA income (%)
Deka MSCI Europe UCITS ETF	Fund: 65% SLA: 35%	71.49%	28.51%
Deka EuroSTOXX 50 UCITS ETF		71.14%	28.86%
Deka MSCI USA UCITS ETF		71.10%	28.90%
Deka MSCI World UCITS ETF		75%	25%

Source: ETFs' Annual and semi-Annual Reports

[60] Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Kostenklauseln offener Publikumsinvestmetvermögen, I.1.b): "*Die Gesellschaft erhält für die Anbahnung, Vorbereitung und Durchführung vonWertpapierdarlehensgeschäften und Wertpapierpensionsgeschäften für Rechnung des Sondervermögens eine marktübliche Vergütung in Höhe vonmaximal einem Drittel der Bruttoerträge aus diesen Geschäften. Die im Zusammenhang mit der Vorbereitung und Durchführung von solchenGeschäften entstandenen Kosten einschließlich der an Dritte zu zahlendenVergütungen trägt die Gesellschaft*" ("*For the initiation, preparation and execution of securities lending transactions and securities repurchase transactions for the account of the Fund, the Company receives a standard market reimbursement of up to one third of the gross proceeds from these transactions. The costs incurred in connection with the preparation and execution of such transactions, including the fees payable to third parties, are borne by the Company*").

In addition, Deka GmbH is one of the few that discloses the income split in monetary and relative terms, as well as the gross income, which makes it easier for the reader to understand the distribution structure and makes the policy more transparent.

Lyxor ETFs: Most Lyxor funds have not entered anymore securities lending programmes in the last financial year, thus we could only find three UCITS ETFs from the umbrella fund domiciled in Luxembourg (Lyxor Multi Units SICAV LU). We found no outstanding issues with the securities lending policy of Lyxor: the income split is established through the Prospectus and disclosed in the Annual Report – the management company can receive a maximum 20% of the gross income and the securities lending agent, affiliated party with the management company, can receive a maximum 15% of the gross income. Thus, the net income for the funds could be a minimum 65%.

JPM ETFs: In addition to last year's report, JP Morgan Asset Management UCITS ETFs have started to enter more broadly securities lending programmes in the last reporting year (ended 2021) – as in the Annual Report for 2018 the research team could find only one such ETF. Out of the 20 ETFs registered under the Luxembourgish umbrella fund (JPM ETF), only 4 have entered into securities lending agreements and have generated a gross €532 income, split 90% to the funds (€479) and 10% for the securities lending agent (€53).

However, two aspects stand out: first, it is one of the three providers that do not employ the services of affiliated parties in SL (the SLA is Brown Brothers Harriman & Co. (third-party).

Second, it is the third-best performer in terms of income split: following Amundi (FR) and Vanguard, the SL policy of JPM is that all costs incurred by the management company for costs arising from SL are "waived" in favour of the fund, only deducting 10% for the SLA and returning 90% to the funds concerned. According to the Annual Report (p. 100):

> "*The management company waives the incremental income received from the portion of income generated from the securities lending program, for its oversight of the program; hence, 90% of any incremental income earned from the securities lending is accrued to the applicable Sub-Fund, whilst the remaining 10% income is paid to the securities lending agent which arranges the transaction*".

SPDR: We have found two umbrella funds of SSGA, but only one which has funds that enter into securities lending agreements (SPDR ETF Europe II), which totals 46 ETFs, of which half entered into securities lending agreement by the end of March 2021. The entity uses State Street Bank as securities lending agent, an entity affiliated with the investment manager and the depositary.

SPDR have a fixed income split policy by which the fund is attributed 70% of the revenues and the lending agent received 30%. Based on the notes to the financial statements on securities lending, we observed that SPDR ETFs only marginally used securities lending transactions, while a small value of outstanding securities on loan at the end of the financial year, the entity earning a total of €883,761.10 distributed across the 22 ETFs involved.

Vanguard: In line with the findings of the 2019 report, Vanguard is the provider that attributes the second largest portion of the SLI to the sub-funds concerned, i.e. 92% on average. We have calculated the income split for all 18 UCITS ETFs authorised under the Vanguard Funds (plc, IE) company and observed that the funds' income share ranges between 91% and 95%.

This is because, alongside Deka ETFs and Amundi (FR), Vanguard does not have a fixed income split policy implemented, reason for which we believe that the costs for the securities lending agent vary by 4 p.p. depending on the types of securities and maturity tenor involved.

Additionally, Vanguard is also one of the three (next to JPM and UBS) that does not employ the services of affiliated parties for securities lending. The agent is also Brown Brothers Harriman & Co., which is a third party to Vanguard Inc., and neither are any of the counterparties involved in the programme affiliated with Vanguard.

However, we observed an issue: in terms of pre-contractual disclosure for – at least – retail investors, Vanguard UCITS ETFs do not disclose that the funds may enter into securities lending. Concerning counterparty risk, Vanguard does not offer a default indemnity, relying on the quality and marking to market of the collateral received, and does not explicitly prohibit the reinvestment of cash collateral.

Moreover, Vanguard is among the providers (in this data sample) that clearly and fully discloses the securities lending elements and cost components in the Annual Report, making it fairly easy to understand for the non-professional savvy investor. This should not be interpreted that other providers are in breach of the reporting obligations (i.e. under SFTR), but that Vanguard gives more detail and makes it easier to understand.

UBS: we found two umbrella funds with UCITS ETFs that enter SL programs, registered in Ireland and in Luxembourg. Although we found no differences in terms of conditions for securities lending, conduct of business or operational aspects between the two companies, UBS remains the providers which distributed most of the gSLI to the management company and the agent.

According to the latest available prospectus, UBS Asset Management Switzerland AG is attributed 20% of the gross income for covering “due diligence” costs in relation to securities lending, without further specifying in what these consist of; by way of deduction, one of the “due diligence” activities undertaken by the portfolio manager is selecting, together with the agent, the counterparties to the SL programs. The rest 20% are returned to the SLA, a non-affiliated party to the portfolio manager. This makes UBS the least generous fund company in sharing the gross income derived from securities lending with their beneficial owners.

Xtrackers – the three Xtrackers investment companies, of which two are domiciled in Luxembourg (Xtrackers I and II) and one in Ireland, disclose the same securities lending policy, which is available on the website. The document is made easy to understand and explains that 70% of the revenues will be returned to the fund,[61] implying that the rest will be kept by the SLA, Deutsche Bank AG, affiliated with the management company and part of Deutsche Bank Group.

Xtrackers’ SL policy also offers a borrower default indemnity to all sub-funds engaging in securities lending, although it is disclosed in the policy document that this indemnity may not fully cover the losses. However, analysing the regulatory reporting documents, it was unclear for the research team why the Annual Report makes a difference in wording between the direct/indirect operational costs deducted from the SLI to cover expenses and fees to parties involved and the fact that those parties can receive a fee (AR, note 8, p. 415). A simple interpretation would lead to the finding that Xtrackers deducts from the funds’ revenues also the fees for the parties involved, meaning that the investment company also earns a revenue from SL, which is prohibited.

Moreover, we found an unclear or perhaps even misleading statement in the Prospectus, according to which:

[61] Except for Xtrackers DAX UCITS ETF and Xtrackers DAX Income UCITS ETF, which will receive 90%.

"*To the extent the Sub-Fund undertakes securities lending to reduce costs, the Sub-Fund will be allocated 85 percent of the associated revenue generated of which it will receive 70 percent with the remaining 15 percent. being received by the Sub-Portfolio Manager on instruction of the Sub-Fund. The outstanding 15 percent will be allocated to the Securities Lending Agent*" – p. 93.

In our view, it is confusing at least, if not misleading, to disclose that the sub-funds will receive 85% of the gross SLI, of which 15% is allocated to the sub-portfolio manager and another 15% to the SLA – thus we question whether the rule of no hidden revenue is observed in this hypothesis.

"*Unless otherwise specified in the relevant Product Annex and to the extent a Sub-Fund undertakes Securities Lending Transactions, the Securities Lending Agent, as the case may be, and/or the relevant Investment Manager and/or Sub-Portfolio Manager shall receive a fee for the services provided in this respect*" – p. 26 Prospectus.

Moreover, the Prospectus leaves unanswered the question of what the income split will be for all circumstances where the sub-fund undertake SL for other reasons than to reduce costs?

5.4. Conflicts of interests

Fund management companies have a fiduciary duty towards beneficial owners to act honestly, fairly and professionally in their best interest – in accordance with Art. 24(1) MiFID II and pursuant to ESMA Guidelines, para. 25. This includes the obligation to avoid paying unjustified or excessive fees and to challenge the providers and counterparties in obtaining the best return on behalf of the Fund.

One empirical finding of this research is that the majority of asset managers (7 of 9) contract the services of affiliated companies for at least one function of the securities lending agreement – most commonly, the agent.

Amundi: For the DAX UCITS ETF, the Prospectus discloses that "*Such transactions carried out by Amundi Intermédiation, a company that is part of the same group as the Management Company, creates a potential conflict of interest*" (p. 22) – therefore, in light of the MiFID II framework, should a retail investor deduct that the potential conflicts of interest could not be managed or excluded, thus the investment company chose to disclose the risk?

In relation to the Amundi Index Solutions IC, the Prospectus mentions that the counterparties[62] are Amundi Intermediation and CACEIS bank, which are part – together with the management company – of the same financial conglomerate. In terms of the largest counterparties' disclosure (ac. Section A of the Annex to the SFTR), the research team found no affiliated counterparties for securities lending for any of the ETFs involved.

Deka: According to the Annual Reports of the four Deka UCITS ETFs domiciled in Germany, the securities lending agent is DekaBank, an affiliated party of the UCITS manager and investment manager.

Invesco: We did not observe any source of potential conflicts of interests in relation to Invesco funds as the securities lending agent (Bank of New York Mellon) is an independent third-party of the UCITS manager and investment manager.

[62] According to Article 3(7) of the SFTR Regulation, a "counterparty" is the entity transferring or borrowing securities or commodities for the purpose of securities financing transactions; thus, the counterparty can be understood as the securities lending agent as well under the new regulation.

iShares: although the Prospectus discloses the risk of a conflict of interest due to the affiliation of the different actors involved in the management or transactions in which the funds enter, we have a big question mark in relation to securities lending: the investment manager and the securities lending agent are the same for all seven iShares umbrella funds, i.e. BlackRock Advisors (UK).

Neither the Annual Report, nor the Prospectus, disclose the risk of a conflict of interest arising from the fact that the investment manager, promoter and lending agent for the seven entities is the same company, BlackRock Advisors (UK), although the Prospectus contains a large Conflicts of Interests policy description.

In relation to the largest borrowers, our research shows that none of the top ten largest counterparties to any of the iShares ETFs are related to BlackRock Advisors (UK) or BlackRock Inc (USA).

Lyxor: The lending agent of Lyxor UCITS ETFs would be (by policy) Societe Generale, to whom the investment manager is affiliated. However, since neither funds have entered securities lending agreements in 2021, this fund is analysed for comparison purposes only.

SSGA: SPDR ETFs are part of a securities lending agreement between the investment manager and the lending agent, both part of State Street Corporation. In relation to conflicts of interest, the Prospectus makes a very important specification for the subject debates, which have not found in other disclosure documents for other ETFs:

> "*There is no assurance that the rates at which the Company pays fees or expenses to the Investment Manager or its affiliates, or the terms on which it enters into transactions with the Investment Manager or its affiliates or on which it invests in any such other investment vehicles will be the most favourable available in the market generally or as favourable as the rates the Investment Manager makes available to other clients. There will be no independent oversight of fees or expenses paid to, or services provided by, those entities. Because of its financial interest, the Investment Manager may have an incentive to enter into transactions or arrangements on behalf of the Company with itself or its affiliates in circumstances where it might not have done so in the absence of that interest. Transactions and services with or through the Investment Manager or its affiliates will, however, be effected in accordance with the applicable regulatory requirements.*" – emphasis added.

JPM: We found no potential risk of conflicts of interest with JP Morgan ETFs as both the securities lending agent and the largest borrowers are not part of the same financial group as the investment manager or the management company.

UBS: UBS discloses that UBS AG, the investment manager, receives 20% of the gross income, the same as the lending agent – State Street GmbH – for "due diligence", although this is not properly disclosed. We did not find any affiliated counterparties (to the investment manager or the lending agent) in the latest annual reports.

Vanguard: We found no potential risk of conflicts of interest with Vanguard ETFs as both the securities lending agent and the largest borrowers are not part of the same financial group as the investment manager or the management company.

Xtrackers: they use DWS UK Ltd as sub-portfolio manager, affiliated to the investment manager (DWS Investments GmbH) and the management company of the SICAV through a common holding (Deutsche Bank AG) which receives 15% of the securities lending income. However, it is not specified, and very unclear, why and for what DWS UK received 15% of SLI

(AR, p. 415 and 444). In addition, Xtrackers MSCI Europe UCITS ETF and Xtrackers STOXX Europe 600 UCITS ETF had the largest counterparties in the SLT DB AG London, and Xtrackers MSCI Europe Small Cap UCITS ETF had the fifth largest counterparty DB AG London. In total, these three ETFs loaned ca. €82.6 million worth of securities to DB AG London, while the first two loaned almost half of the SLT to this affiliated counterparty. However, we found no correlation between the SLI and the SoL.

Finally, the list of approved borrowers for Xtrackers mentions Deutsche Bank AG and its affiliates, including DB Securities Inc.

This research paper is not exhaustive and does not determine, nor claim, whether these UCITS management companies, investment managers, or other parties involved, comply or not with the legal provisions applicable by virtue of EU law. The sole purpose of this paper is to provide an analysis and policy recommendations "through the eyes of a retail investor" about the disclosure, accessibility of information, and practices surrounding securities lending for a selected sample of UCITS ETFs traded in the EU.

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6. POLICY RECOMMENDATIONS

Observing that not much has improved since BETTER FINANCE's first iteration of the securities lending report, nor with the upcoming entry into force of the SFTR reporting, we put forward several policy recommendations to better align the interests of beneficial owners (individual investors) with those of asset managers and lending agents.

1 *ESMA to clarify the "no hidden revenue" rule.*

We believe that the rule on *no hidden revenues* is too vague and leaves too much room for interpretation and divergent practices. ESMA must amend its Guidelines and clearly indicate:

- what constitutes an eligible direct or indirect operational cost,
- who is not allowed to derive *hidden revenue* and
- whether a "margin of profit" is considered or not as operational cost.

2 *The European Commission to clarify the rules for retail UCITS to disclose the income split in the UCITS KIID (or in the PRIIPs KID).*

We have observed a good practice with a few asset managers, clearly disclosing the income split shares or the securities lending costs. The European Commission should amend the KIID Regulation to specify that, when a fund enters a securities lending programme, it must prominently disclose either the costs for investors or the income split.

3 *ESMA and NCAs to strengthen supervision and enforcement in this field.*

Although the global income figures are not that high compared to the AuM of the ETFs involved, the value of the portfolios on loan are significant in most cases. ESMA should better coordinate with national competent authorities and pay more attention to these practices, especially with large actors, to ensure that the few operational and conduct of business rules are respected.

4 *The conflict of interest policy should justify why, if applicable, an affiliated party enhances the service to beneficial owners rather than a third-party.*

The vast majority of asset managers use affiliated parties for securities lending services or as counterparties: while this does not necessarily imply a conflict of interest, is raises the risk. Instead of simply disclosing this situation, asset managers should be required to justify why it is in the interest of fund investors to use affiliated actors.

5 *The co-legislators should follow the BaFin approach and impose an upper limit of how much of the gross income can be deducted as operational costs, i.e. max. 10%.*

The German financial supervisory authority, BaFin, has led the way with an example of strengthening the rules on securities lending and requires asset managers to return at least 2/3 of income to the fund. However, we believe that ESMA should impose an upper limit of 10% of the income that can be deducted as operational costs.

Alternatively, ESMA should investigate why certain fund companies' securities lending operations would cost up to 20 times more compared to gross income than the best in class.

6 *ESMA to clarify the obligation of asset managers to disclose the cost components of the direct and indirect operational costs.*

In many instances, the Annual Reports only disclose the securities lending income (without specifying if it's gross or net), and the Prospectuses the share split policy. ESMA should clarify that asset managers must clearly disclose all revenue components of securities lending, i.e. the gross figures, the net income returned to the fund, and the amounts (either in monetary or absolute terms) deducted for operational costs, clearly indicating what those consist of.