DECEMBER 2019

REVIEW OF SPOT INSPECTIONS

SECURITIES FINANCING TRANSACTIONS BY ASSET

amf-france.org

INTRODUCTION

As part of its Supervision#2022 strategy, the AMF is conducting short thematic inspections called "SPOT" (Supervision des Pratiques Opérationnelle et Thématique - operational and thematic supervision of practices) and disclosing the information derived from these operations. This document is a review of SPOT inspections on securities financing transactions ("SFTs"), with regard to organisation, implementation by the funds, related controls and information provided to investors by the asset management companies ("AMCs").

The choice of this subject reflects both (i) the coming into effect of European Regulation 2015/2365 (hereafter the "**SFTR**") from 12 January 2016,[1] and (ii) past or current inspections which raised various issues, moreover (see below).

This note aims to provide an overview of the "SFT" SPOT inspections and shed light on AMCs' practices in this area, the difficulties they face and ways of providing support.

This document is neither a position nor a recommendation and may not introduce elements of policy.

1 INSPECTION SCOPE AND PROCEDURE

The first Recital of the SFTR states that the global financial crisis of 2007-2008 highlighted the need to improve transparency and monitoring not only in the traditional banking sector, but also in areas where bank-like credit intermediation known as 'shadow banking' takes place; SFTs are an illustration of this. During this financial crisis, they were a source of contagion and identified as being procyclical.

The SFTR, published in December 2015, is therefore a response to this need to enhance the transparency of SFTs so as to enable the regulatory and supervisory authorities, as well as investors, to correctly evaluate and monitor the risks entailed by these transactions and the level of interlinking in the financial system. It established three new types of obligations for UCITS and AIFs:

- an obligation to report SFTs to trade repositories (from 12 October 2020);
- an obligation to publish additional information on the use of SFTs in the prospectuses and annual reports of UCITS and AIFs and in half-year reports for UCITS (from 13 January 2017 for regular reports and from 13 July 2017 for precontractual documents);
- a framework for the re-use of financial instruments deposited as collateral (from 13 July 2016).

Since this coming into effect and prior to 2018, the AMF Inspections Directorate conducted several conventional inspections of AMCs focusing especially on SFTs. These transactions can be either carried out directly by the AMC, or delegated to another AMC, or entrusted to a service provider who may or may not interpose his own account (service provider acting as principal or as agent).[2]

The inspections mainly raised issues of (i) sharing of remuneration between the service provider and the fund, (ii) investor information on potential conflicts of interest, notably in the context of group relations, and (iii) best execution.

In light of these observations, it was considered appropriate to make the SFT theme a priority for supervision in 2018 and, as a consequence, to continue deploying this theme within the framework of conventional inspections but also to use the SPOT inspection format, in order to:

- fine tune the understanding of the framework of use of SFTs, and in particular the various schemes involving outside service providers;

[1] A peer review was initiated in November 2017 by the European Securities and Markets Authority (hereafter "**ESMA**") on effective portfolio management techniques, the results of which were published on 30 July 2018, with a glowing report for the AMF.

[2] For improved clarity the terminology used by the Enforcement Committee in its decision of 25 September 2019 has been used.

- monitor allowance for the specific features of these transactions in risk management and conflicts of interest management systems;
- verify compliance with the obligations established by the SFTR regarding transparency.

These inspections on the AMCs' SFTs, carried out in 2018, were performed jointly in five AMCs. The verifications covered the period 2015-2017 and made it possible to examine:

- ☐ the best execution or best selection system;
- ☐ the conflicts of interest management system;
- ☐ the risk and collateral management system;
- ☐ the remuneration and the impact of the assets deposited as collateral on the level of remuneration practised
- ☐ compliance with obligations regarding information and transparency with respect to the holders.

They gave rise to follow-up letters containing requests to remedy the nonconformities identified.

This note aims to provide an overview of the "SFT" SPOT inspections and shed light on AMCs' practices in this area, the difficulties they face and possible ways of providing support.

Important note
SFTs aim to improve funds' performance in variable proportions after remuneration, where applicable, of the AMC, the depository and the service provider (generally a few basis points).

Generally, when they are executed against a cash collateral, temporary securities purchase transactions can represent an alternative to short-term cash investment instruments. These transactions are generally performed by the AMCs themselves.

Given the small amount of income that they produce, these transactions are sensitive to their regulatory environment and in particular to its cost, in a context of more stringent obligations regarding prior and periodic information, reporting obligations (trade repositories, counterparties in the event of re-use of the securities) and the calling into question of the transactions on dividends, which are the most lucrative (see below). When an AMC uses a service provider, it often chooses the depository of its funds to capitalise on the sharing of legacy information systems.

In this review the AMF adopts a pragmatic approach enabling the funds to benefit from additional remuneration while ensuring investor protection.

SUMMARY OF THE MAIN FINDINGS OF THE INSPECTIONS

☐ **Findings regarding compliance with the regulations**
■ **Good practices** and **bad practices**
↗ **Recap of the applicable regulations**

REGARDING THE ORGANISATION AND OPERATING PROCEDURES FOR SECURITIES FINANCING TRANSACTIONS

☐ Findings

Of the AMCs inspected, two perform their SFTs themselves (via their fund managers or special teams), while three others use one or more service providers acting as principal for all or part of their transactions.

SFTs are organised around agreements defining the rights and obligations of the counterparties and, where applicable, relations with the service provider (in particular the eligible securities, conclusion of the transactions, the sale and resale of securities, margin calls and management, the cancellation of transactions and their remuneration, etc.).

However, a special feature of one AMC is that it performs some of its transactions with a bank in its group, although this business relationship has not been covered by contractual arrangements.

On 25 September 2019, the AMF Enforcement Committee reiterated with respect to an ISP to which the execution of SFTs had been entrusted on behalf of funds (transactions performed by interposing its own account between the funds and the counterparty) that: "*the execution, by an investment service provider, of own-account transactions with clients entails, with respect to said clients, the same effects as the provision of the third-party order execution service and entails, consequently, the application to the service provider in question of the conduct of business rules laid down by the aforementioned directive of 10 August 2006*". As a consequence, when the service provider is an ISP, it is bound by the best execution obligations arising from the MiFID Directive and the asset management company which has entrusted its SFTs is bound by an obligation of best selection and control.

The task force noted, in the contractual documentation binding the inspected AMCs to their ISP, the absence of details regarding the information provided by the latter to enable them to ensure best selection.

In one case, the service provider is a US entity (and not an ISP subject to best execution obligations). And yet, the AMC has not verified whether this service provider has "*order execution mechanisms that enable the asset management companies to comply with their obligations under the terms of this Article when they transmit orders to that entity for execution*" (IV of Article 321-114 of the AMF GR for UCITS; see also Article 28 of Delegated Regulation (EU) No. 231/2013 for AIFs – "*The AIFM shall only enter into arrangements for execution where such arrangements are consistent with the obligations laid down in this Article.*").

Note that Position-Recommendation 2012-19 ("**Guide for drawing up the programme of activity of asset management companies"**) stipulates that "*the asset management company shall describe in its programme of activity (…) the selection process for providers, the legal classification of the service provided by the provider as well as the means for exchanging information between the asset management company and the selected provider*". Said Position-Recommendation 2012-19 thus distinguishes between "*delegated investment management*" and the everyday instructions given to a service provider to execute/transmit SFTs on account of the AMC acting in the name and on behalf of the funds.

Recap of the applicable regulations and AMF action

- It is important to stress the need for contractual arrangements for SFTs,[3] and in particular verification of the conditions enabling the AMC to fulfil its best execution/best selection obligations, especially when it uses a service provider who is not an ISP.[4]
- To support AMCs better in their thinking on SFTs, the AMF is considering supplementing the Guide for drawing up the programme of activity (Position-Recommendation 2012-19) in order to illustrate the formal requirements of exchanges between AMCs and service providers as required in this Position-Recommendation with regard to the defined service. In particular, the content of the AMC's everyday instructions to the service provider must enable the AMC to prevent any risk of infringement of the fund's investment constraints and the regulations (AMCs must, in particular, apply the new Article 119 bis A of the Code Général des Impôts (French General Tax Code) which came into effect on 1 July 2019 designed to prevent taking advantage of a difference of tax treatment of dividend detachments between securities lenders and borrowers: see below).

Best practice

- When selecting a service provider, the use of a regulated ISP in the EU providing an investment service for the execution of SFTs is a good practice insofar as the latter is required to implement conflicts of interest management and best execution policies, and the relevant controls, in a standardised framework and under the supervision of a regulatory authority.

Bad practice

- It is bad practice not to identify in the contractual documentation binding the AMC and the service provider (i) the obligations and means of the service provider for verifying best execution in the event that said service provider is not a regulated ISP in the EU, and (ii) the level of information that the service provider must provide to enable the AMC to check this service (also see below regarding the best execution system).

REGARDING CONFLICTS OF INTEREST IDENTIFICATION AND MANAGEMENT

☐ **Findings**

The five AMCs inspected have a conflicts of interest procedure and register. However, these documents do not mention SFTs, even though these lead to potential conflicts of interest. In particular, a conflict of interest can exist between two funds holding the same securities (allocation of loans between the funds or allocation of the collateral). Moreover, the fact that, for part of their transactions, two AMCs use companies belonging to their groups also represents a situation of potential conflict of interest.

The AMCs using a service provider (acting as agent or principal) highlighted the fact that the latter uses an algorithm allowing a proportional allocation of securities based on their holdings in the funds. A service provider acting as principal has also established an algorithm that can be used to match the transaction executed by the fund with the "back to back" transaction that it executes for hedging with a market counterparty.

Recap of the applicable regulations

- An AMC which uses service providers for the execution of SFTs must ensure conflicts of interest management within the framework of fund management in relation with the organisation that it has chosen.[5]

[3] Provisions of Articles R. 214-18 and R. 214-32-27 of the Monetary and Financial Code.

[4] IV of Article 321-114 of the AMF GR (UCITS) and Article 28 of Delegated Regulation (EU) No. 231/2013 (AIFs).

[5] Article L. 533-10 I 3° of the Monetary and Financial Code.

Best practice

↗ We should stress the good practice consisting of employing a service provider who uses an algorithm allowing a proportional allocation of securities based on their holdings in the funds. Likewise, an agreement between the AMC and its service provider on the algorithm for allocation of securities loans among funds by the AMC should allow management of potential conflicts of interest between funds.

Comment: These practices are also virtuous regarding best execution (see below).

REGARDING THE RISK MANAGEMENT SYSTEM

☐ **Findings**

All the AMCs inspected have a risk management procedure providing, where applicable, for the unwinding of SFTs. This procedure is partial in one case because it does not completely cover the transactions executed with the group. Furthermore, all the AMCs inspected have established a satisfactory collateral exchange system. The quality of the control systems examined should be emphasised. In one case, however, regarding transactions with the group, the collateral is not adjusted during the life of the transactions according to changes in the market value of the securities posted as collateral.

In one case, the level-two controls were not tracked. The task force also noted that one AMC verified, within the framework of its level-two control, the sharing of remuneration between service provider and AMC and that it had noted some errors which had been able to be corrected.

Bad practice

↗ Not establishing a control on compliance with the contractual sharing of remuneration among the funds, the service provider and the AMC[6] is bad practice.

REGARDING THE BEST EXECUTION AND BEST SELECTION SYSTEM

☐ **Findings**

The five AMCs inspected by the AMF have all established procedures to organise the execution of their transactions or best selection of the service providers to whom are entrusted the orders based on their investment management decisions. For four out of five AMCs, however, these procedures do not mention the securities financing activity although its specific features would justify special supervisory measures. For the fifth one, it was not highly operational.

➢ **More specifically, regarding control of the remuneration for these transactions (interest)**

For its repo transactions, one AMC relied on competitive tendering by counterparties, which was not very effective because it laid down no requirements regarding the quality of the counterparties to be asked to bid. In practice, the same single counterparty replied, of the three asked to bid. This AMC's system has been adapted as a consequence.

The inspection task force also observed that the three AMCs entrusting the execution of their transactions fully or partly to a service provider did not receive from the latter clear information enabling them to assess the conditions in which their SFTs were executed, nor the rate of utilisation of the securities eligible for a loan.

➢ **Regarding cost control for these transactions**

The costs consist mainly of the remuneration of the service provider and the depository. However, these various remunerations are neither examined nor justified by the AMC.

[6] Articles 321-23 IV, 321-31 I, 321-80 and 321-81 of the AMF General Regulation (UCITS) and Articles 61.2 and 57.1 (c) 41 and 45 of Delegated Regulation 231/2013 for AIFs.

Recap of the applicable regulations and AMF action

- It is important to remember (i) the need to ensure that the best execution policies and the procedures include SFTs,[7] and (ii) the need to perform level-two controls[8] relating to best execution or best selection covering the securities financing activity.
- The AMF will consider enriching its position-recommendations in order to guide AMCs with regard to best execution for SFTs, which have numerous special features and which require large and costly operational resources of the service providers. The importance of collateral management in assessing execution or the quality of reporting will be specified in particular.

Bad practices

- It is important to note the bad practices which consist, for an AMC, in not enquiring, especially before signing the service provider's contract, about (i) the procedures for price formation, (ii) the procedures for allocation of transactions among the service provider's clients, (iii) the potential existence of a matching mechanism in the event of interposition of the service provider's own account making it possible to establish a correspondence between its transactions and those of its service provider which placed market counterparties in competition, and (iv) the quality of the reports that will be provided by the service provider, who may, if he is of high quality, consolidate control of best execution.

REGARDING INFORMATION AND TRANSPARENCY WITH RESPECT TO UNITHOLDERS

☐ Findings

The inspection task force noted good information of the unitholders in the prospectuses and annual reports of the funds, except for one AMC for which this information was missing from the annual reports of two funds. Also, two AMCs did not publish in their annual reports the information required by the annex to the SFTR regarding the absence of re-use of collateral.

Recap of the applicable regulations

- It is important to remember the obligation of mentioning in the prospectuses and annual reports of the funds (and in the half-year reports in the case of UCITS) the information mentioned in the annex to the SFTR, including on the re-use of collateral.[9]

[7] Article L. 533-22-2-2 of the Monetary and Financial Code: "*In the context of collective investment management, asset management companies shall take all reasonable measures to achieve, at order execution, the best possible result taking into account the price, cost, speed, likelihood of execution and settlement, size, nature of the order, or any other considerations related to execution of the order.*"

[8] Articles 321-23 IV and 321-31 I of the AMF General Regulation (UCITS) and Articles 61.2 and 57.1 (c) of Delegated Regulation (EU) No. 231/2013 (AIFs).

[9] Annex (sections A and B) of the SFTR.

DETAILED NOTE

2 RECAP OF THE REGULATIONS APPLICABLE TO SECURITIES FINANCING TRANSACTIONS

SFTs are techniques and instruments that can be used for the purpose of effective portfolio management (cf. definition below). Article R. 214-18 of the Monetary and Financial Code[10] (UCITS) transposed Article 51 of the UCITS Directive (2009/65/EC) and Article 11 of the directive on eligible assets (2007/16/EC) discusses those techniques. It mainly covers temporary securities purchase and sale transactions, which should be used to reduce the risks or costs of UCITS or to generate extra income. Regarding AIFs, similar provisions are provided for in Article R. 214-32-27 of the Monetary and Financial Code.

In December 2012, the professional obligations of AMCs relating to the use of SFTs were specified with the application of the ESMA guidelines on effective portfolio management techniques for UCITS.[11] The AMF applies all these guidelines (cf. AMF Position 2013-06 on listed funds and other UCITS-related issues). These guidelines specify numerous principles mainly with regard to income sharing, risk management and information to be disclosed to unitholders.

Finally, the 2015 SFTR regulation strengthened AMC's obligations of information with regard to unitholders of the UCITS and AIFs that they manage. This regulation broadens the scope of the transactions involved. Accordingly, all "*securities financing*" transactions are now covered, whether they be repos (repurchase agreements and reverse repos) or securities lending and borrowing, for which Article 3 of the regulation specified the definitions. Likewise, the provisions of the SFTR apply to UCITS and AIFs.

The main documents applicable to AMCs regarding securities financing transactions are as follows.

✓ **Regarding best selection/execution:**

a) **Article L. 533-22-2-2 of the Monetary and Financial Code**;
b) **Articles 27 and 28 of Delegated Regulation (EU) No. 231/2013 of 19 December 2012 for AIF management**;
c) **Articles 321-110 to 321-115 of the AMF General Regulation for UCITS management;**
d) **Recital 103 of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016.**

✓ **Regarding the implementation of a conflict of interest policy:**

e) **Article L. 533-10 I 3° of the Monetary and Financial Code**;
f) **Articles 30, 31, and 33 to 36 of Delegated Regulation (EU) No. 231/2013 of 19 December 2012 for AIF management**;
g) **Articles 318-13 (AIF) and 321-46 and 321-48 to 321-51 (UCITS) of the AMF General Regulation.**

[10] *"I. – An UCITS may use the techniques and instruments concerning eligible financial securities and money market instruments, and in particular repo transactions and transactions similar to temporary securities purchase and sale transactions, provided that said techniques and said instruments are used for the purpose of effective portfolio management. These techniques and instruments must in no case lead the UCITS to deviate from its investment objectives as set out in the fund's regulations, in the articles of association of the SICAV, or in the prospectus of the UCITS.*
II. – The techniques and instruments referred to in I shall meet the following criteria:
1° They shall be economically appropriate, in the sense that their use is profitable;
2° They are used in order to achieve one or more of the following objectives: a) Risk mitigation; b) Cost cutting; c) Creation of additional capital or income for the UCITS;
3° The risks they entail are taken into consideration appropriately in the UCITS' risk management process (…)".

[11] *ESMA/2014/937, "Guidelines for competent authorities and UCITS management companies – Guidelines on ETFs and other UCITS issues", 01/08/2014. These obligations do not apply to AIFs.*

✓ **Regarding the retention of records for a period of at least five years after the termination of operations:**

h) **Article 4.4 of Regulation (EU) No. 2015/2365 of 25 November 2015 (the "SFTR")**;

✓ **Regarding transparency with respect to unitholders in the funds' prospectuses and annual reports (and in the half-year reports in the case of UCITS):**

i) **Articles 13 and 14, and Annex to the SFTR**;

✓ **Regarding the re-use of assets received as collateral - excluding cash:**

j) **Article 15 of the SFTR**;

✓ **Regarding risk and collateral management arising from securities financing transactions**

k) **Articles 318-38 et seq. (AIFs), and 321-76 et seq. of the AMF General Regulation (UCITS);**

l) **Articles 38 et seq. of Delegated Regulation (EU) No. 231/2013 (AIFs);**

m) **Paragraphs 18, 26 and 33 to 39 of AMF Position-Recommendation No. 2013-06 adopted pursuant to Articles L. 214-23, R. 214-15 to R. 214-19 and D. 214-22-1 of the Monetary and Financial Code)**;

✓ **Regarding the costs, charges and remuneration related to securities financing transactions:**

n) **Paragraphs 20 and 21 of AMF Position-Recommendation No. 2013-06**;

✓ **Regarding the automatic recall of securities lent/sold as collateral:**

o) **Articles R. 214-18 III and R. 214-32-27 III of the Monetary and Financial Code**.

✓ **Regarding the programme of activity of AMCs:**

p) Position-Recommendation 2012-19 ("**Guide for drawing up the programme of activity of asset management companies**") adopted pursuant to Articles 316-3, 316-4, 317-1 to 317-5, 317-7, 318-1, 318-62, 321-2, 321-3, 321-9, 321-10, 321-13, 321-15, 321-23, 321-93 to 321-97 and 321-157 of the AMF General Regulation and Article 32 (1) of Commission Delegated Regulation (EU) No. 2017/565 of 25 April 2016.

I. TYPES OF SECURITIES FINANCING TRANSACTIONS

1. General overview

Basically, securities lending transactions can be divided into two main categories:

- "*bulk*" or "*General Collateral*" transactions (hereafter "GC"): these correspond to mass transactions, not very profitable individually (interest of less than 15 bps), which cover various needs of market counterparties (e.g. need of securities in order to transfer them as collateral to counterparties);
- "*specific*" securities transactions: these are securities transactions for which there is a strong market demand at a given point in time (related to an arbitrage possibility requiring sale of the security), or a market participant shorting a security (e.g. *fail coverage*[12] transactions). The number of these transactions is generally small but the remuneration can be very high.

All the AMCs performing securities lending transactions are concerned by the two types of transaction.

Given borrowers' different needs, this over-the-counter market sees the coexistence of price disparities (prices being valid for a given quantity depending on demand). The price also depends on the desired quality and type of collateral (security or cash collateral).[13] **This market functioning highlights the importance of the best execution obligations. Accordingly, the quality of service of the person in charge of SFTs (see below) can be analysed notably in light of:**

[12] In the event of a difficulty in delivering a security on the market for a market participant (due, for example, to a time lag between receiving and delivery of their transactions), the latter may borrow a security to avoid penalties for failure to deliver securities.

[13] In particular, a "security" collateral will translate into lower remuneration (to reflect the cost of borrowing the securities deposited as collateral).

- **the amount of remuneration paid by the service provider (or the market counterparty if different from the service provider) to the fund given the market opportunities and the AMC's requirements in terms of collateral (cash or securities, credit quality), and the creditworthiness of the authorised counterparties;**
- **the rate of utilisation of the securities;**
- **the quality of collateral management systems.**

Regarding repos, this is a market which is similar to an investment in the money market: the institution which does a reverse repurchase agreement looks for investing the capital that it hands over in exchange for the securities posted as collateral. This capital is remunerated at a rate indexed to the Eonia or Euribor plus or minus a margin.

The AMC may delegate the SFT activity or manage these transactions directly. In the latter case, for the execution of its investment management decisions the transactions can be either executed directly by the AMC or entrusted to a service provider. In practice, the following systems are observed:
- AMC which itself executes the orders on SFTs based on its investment management decisions: the transactions are concluded with market counterparties or entities belonging to the same group as the AMC. The task force found one case in which the AMC uses a service provider who proposes opportunities for transactions in emerging markets which the AMC may decide to act on or not;
- AMC which uses a service provider for execution of its orders: The legal framework governing this relationship may be very different. For example, the service provider may be:
  - a "pure" financial intermediary who acts as "agent": he selects market counterparties who will enter into transactions with funds without interposing their own account;
  - a financial intermediary interposing his own account who acts as "principal": the establishment of a relationship with market counterparties entails the interposition of the lender service provider's own account.

Whether they be a "pure" financial intermediary acting as agent or an intermediary interposing their own account acting as principal, the service provider is subject, vis-à-vis its client, to the conduct of business rules arising from the MiFID Directive whenever it is an ISP. In particular:
- The service provider operates, not on its own initiative and in its interest alone, but as an intermediary called on by the AMC acting in the name and on behalf of funds to enable them to enter into SFTs, as shown by the contractual framework outlined in the box below and the practical procedures (master agreements, standing instructions, sending of lendable bases);
- Recital 103 of Commission Delegated Regulation (EU) No. 2017/565 of 25 April 2016 provides that "*Proprietary trading with clients by an investment firm should be assimilated to the execution of clients' orders and therefore be subject to the requirements provided for by the 2014/65/EU Directive and this Regulation, in particular the requirements of the best execution obligations*";
- In its decision of 25 September 2019, the Enforcement Committee considers that the execution of own-account transactions with clients "*entails, with respect to said clients, the same effects as the provision of the third-party order execution service and entails, consequently, the application to the service provider in question of the conduct of business rules of said investment service.*"
- In the same decision, the Enforcement Committee considers that "*the activity performed by [x] as agent, which involves receiving instructions for lending or repoing the financial securities of funds and passing them on to various bank counterparties authorised to provide the third-party order execution service comes under 1 of Article D.321-1 of the Monetary and Financial Code* (third-party order receipt and transmission service)".

Of the AMCs inspected, three use one or more service providers for all or part of their transactions. In particular, one AMC uses two service providers, one of which is not a European Union ISP (US entity regulated by the laws of the State of Vermont, which cannot be considered as an ISP within the meaning of the MiFID Directive).

One AMC inspected has no legal framework for transactions carried out with its group.[14]

[14] **Which was analysed as not complying with the provisions of Articles R. 214-18 and R. 214-32-27 of the Monetary and Financial Code.**

Bad practice

- A bad practice that was noted involves not specifying in the legal documentation binding the AMC and the service provider (i) the obligations and ressources of the service provider for verifying best execution in the event that said service provider is not an ISP, and (ii) the level of information that the service provider must provide to enable the AMC to check this service (also see below regarding the best execution system).

Best practice

- The use of a regulated ISP in the EU providing an investment service for the execution of SFTs is a good practice insofar as the latter is required to implement conflicts of interest management and best execution policies, and the relevant controls, in a standardized framework and under the supervision of a regulatory authority.

Legal framework of securities lending and borrowing transactions

SFTs are governed by master agreements:[15]

- mainly under English law: Global Master Repurchase Agreement ("GMRA") for repo transactions, Global Master Securities Lending Agreement ("GMSLA") for securities lending, and European Master Agreement ("EMA") for both repos and securities lending (but also derivatives);
- under French law between service providers governed by French law and/or funds governed by French law (e.g.: FBF master agreement concerning repo transactions – latest version dated July 2007).

These various agreements/accords consist of three types of documents:

- A master agreement defining the rights and obligations of the parties: in particular the eligible securities, conclusion of the transactions, the sale and resale of securities, margin calls and their management, the cancellation of transactions (events of default), and the calculation and payment of the balance at cancellation;
- A schedule amending/supplementing the master agreement, and stipulating the applicable administrative and financial parameters: calculation agent, additional events of default, eligible assets as collateral, frequency of margin calls, etc.;
- A confirmation for each transaction concluded, summarising its criteria (securities involved, maturity date, price, etc.).

These master agreements are supplemented by a standing instruction which provides that the AMC shall send its lendable base to its service provider. In light of this standing instruction, the sending of the lendable base by the AMC is equivalent to a "*contract offer*", with the acceptance of said offer by the service provider resulting in the implementation of securities lending transactions insofar as the service provider is able to do so given the opportunities available in the market.

2. Programme of activity of the AMCs

[16]Note that Position-Recommendation 2012-19 ("**Guide for drawing up the programme of activity of asset management companies**") stipulates that "*the asset management company shall describe in its programme of activity, in addition to the points mentioned above, the selection process for providers, the legal classification of the service provided by the provider as well as the means for exchanging information between the asset management company and the selected provider*". However, a single AMC provided a very brief description of its SFT activities.

Excerpt from Position-Recommendation 2012-19

[15] *In accordance with Articles R.214-18 and R.214-32-27 of the Monetary and Financial Code.*

[16] Adopted pursuant to Articles 316-3, 316-4, 317-1 to 317-5, 317-7, 318-1, 318-62, 321-2, 321-3, 321-9, 321-10, 321-13, 321-15, 321-23, 321-93 to 321-97 and 321-157 of the AMF General Regulation and Article 32 (1) of Commission Delegated Regulation (EU) No. 2017/565 of 25 April 2016.

- *Temporary acquisitions and temporary disposal of securities by the provider carried out on the instructions of the asset management company.*

The asset management company may entrust an external provider with operations of temporary acquisition and temporary disposal of securities without being subject to the financial management delegation regime[17] when this third party is acting on the basis of specific instructions.

To be able to manage the risks associated with the temporary acquisition and temporary disposal of securities, the asset management company must put in place an appropriate system of risk management and require the service provider to provide detailed daily reports on the activities it has been assigned. As an example, the intermediary shall inform the asset management company about the level of remuneration obtained from the securities compared to the market price.

The asset management company must have processes in place to allow:

- orders to be sent daily to the intermediary identifying precisely, for each collective investment under its management, the securities that it wishes to lend;
- restrictions to be sent to the intermediary that the asset management company wishes to attach to the lending transaction each time a change is to be applied (securities provided to or received from third parties as a collateral or by third parties as a guarantee against the operations executed, requirements of overcollateralisation, list of eligible compensatory measures or validation of the list drawn up by the external provider);
- to be able, at any moment, to recall the securities that were subject to the lending transaction.

However, when the temporary acquisitions or temporary disposal of securities are not tracked by the asset management company, and when a general and permanent instruction is given allowing the intermediary the total freedom to assess the securities to be lent in the coming weeks and to decide on the conditions of the operation, the delegated financial management regime shall apply.
The asset management company should ensure that the conditions regarding the governance and management of conflicts of interest that the provider contract may present are respected.

[17] This analysis has no bearing on the potential qualification of the execution of orders as an intermediary investment service activity under Article L. 321-1 2. of the Monetary and Financial Code.

The task force noted that the daily instruction was generic and almost automatic, summarising all the lender funds but without specifying, for example, the securities to be excluded (e.g. in the dividends season).

Now, this instruction is important to prevent any risk of non-compliance (e.g. failure to comply with funds' investment constraints). Regarding a potential non-compliance risk, we should mention securities lending and borrowing in the dividend season (so-called "cumcum/cumex" transactions). The number of securities lent during this period has increased sharply, mainly because of the derived resident/non-resident tax benefit.

This issue was the subject of an amendment in the 2019 Budget Act (Article 36). Carried over to the Code Général des Impôts (French General Tax Code),[17] this amendment aims to prevent profiting from a difference of tax

[17] According to Article 119 bis of the French General Tax Code "*Art. 119 bis A. - 1. Shall be deemed to constitute distributed income subject to the withholding tax provided for in 2 of Article 119 bis any payment, within the limits of the amount corresponding to distribution of the revenues from units or shares mentioned in b, made, in whatsoever form and by whatsoever means, by a person who is established or has his (her) tax residence in France, for the benefit, directly or indirectly, of a person who is not established or does not have his (her) tax residence in France, when all the following conditions are met:*
"a) The payment is made in the form of a temporary sale or any transaction giving entitlement to or making it mandatory to return or resell said units or shares or rights concerning said securities;
"b) The transaction mentioned in a is performed during a period of less than forty-five days including the date on which the right to a distribution of revenues from shares, partnership shares or similar income mentioned in Articles 108 to 117 bis is acquired. "2. Withholding tax is due upon issue of the payment mentioned in 1 and shall be paid by the person who makes said payment.
"3. When the beneficiary of the payment mentioned in 1 provides proof that this payment corresponds to a transaction of which the main purpose and effect is other than to avoid the application of a withholding tax or to obtain the award of a tax benefit, paragraph 1 is not applicable. The beneficiary can in that case obtain reimbursement of the definitively unjustified withholding tax from the tax department of his (her) place of residence or head office.
"4. The person who issues the payment mentioned in 1 shall forward to the tax authorities, at their request and in an electronic format, the amount, date, issuer of the units or shares covered by the transaction mentioned in b of said paragraph 1, and recipient of the payment."
II. - Title I comes into effect on 1 July 2019."

treatment of dividend detachments between securities lenders and borrowers. This provision, which has been in effect since 1 July 2019, could significantly alter the conditions of supply and demand for securities lending and borrowing during the dividend season. Greater attention paid by AMCs in determining the lendable base of the funds they manage therefore appears decisive during such dividend seasons.

II. COMPLIANCE WITH BEST EXECUTION OR BEST SELECTION

In accordance with Article L. 533-22-2-2 of the Monetary and Financial Code[18] "*I.-In the context of collective investment management, asset management companies shall take all reasonable measures to achieve, at order execution, the best possible result taking into account the price, cost, speed, likelihood of execution and settlement, size, nature of the order, or any other considerations related to execution of the order (…)".*

The AMC shall ensure best execution of SFTs or best selection of the service provider to which it entrusts the SFTs. The task force verified:[19]

(i) the existence and publication of the best execution policy:
(ii) the existence of a procedure relating to order execution or the selection of service providers explicitly mentioning the securities financing activity;
(iii) the performance of tracked regular controls, permanent and periodic.

(i) Regarding the best execution policy

The AMCs all have best execution policies, but these do not specifically concern the SFT activity, and this is not consistent with the provisions of Article L. 533-22-2-2 of the Monetary and Financial Code.

(ii) Regarding procedures

The five AMCs inspected have all established procedures to organise the execution of their transactions or best selection of the service providers to whom are entrusted the orders based on their investment management decisions. **For four out of five AMCs, however, these procedures do not mention the securities financing activity although its specific features would justify special supervisory measures, and this is not consistent with the aforementioned provisions of Article L. 533-22-2-2 of the Monetary and Financial Code**. Moreover, for the fifth AMC, the procedure is not very precise in that it lays down no conditions for the counterparties to be questioned, meaning that the verification of best execution is ineffective. Precisely, this AMC itself executes the orders based on its investment decisions. Its procedure provides that at least three counterparties should be questioned in order to ensure best execution. The test conducted by the task force shows that the AMC's dealer

[18] "*I.-In the context of collective investment management, asset management companies shall take all reasonable measures to achieve, at order execution, the best possible result taking into account the price, cost, speed, likelihood of execution and settlement, size, nature of the order, or any other considerations related to execution of the order.*
II.-Asset management companies shall establish and implement effective measures, and notably an order execution policy, to comply with the requirements of I above.
III.-The order execution policy shall include, with regard to each category of instruments, information on the various systems in which the asset management company executes orders and the factors influencing the choice of execution system. It shall at least include systems which enable the asset management company to achieve, in most cases, the best possible result for order execution. Asset management companies shall provide appropriate information to the shareholders or unitholders of collective investment products regarding their order execution policy.
When the order execution policy provides that orders can be executed outside of a trading venue, the asset management company shall inform in particular the shareholders or unitholders in the collective investments of this possibility.
IV.-The General Regulation of the Autorité des Marchés Financiers specifies the conditions of application of this article, adapting them depending on whether asset management companies execute the orders or transmit or issue them without themselves executing them.
V.-Asset management companies shall adopt and apply procedures ensuring the swift and fair execution of orders on account of the collective investment products that they manage compared with orders on account of the individual portfolios that they manage and orders on their own account.
The AMF General Regulation specifies the conditions of application of the order processing rules applicable to asset management companies."

[19] See box above regarding the applicable documents.

indeed questions the three counterparties. In practice, for overnight reverse repo transactions, the AMC's dealer did not always wait for their replies, because one and the same counterparty was interested in concluding the transactions according to the AMC.

(iii) Regarding controls

In one case where the AMC uses a third party, the service provider is a US entity (and not a European Union ISP subject to best execution obligations resulting from the MiFID Directive). And yet, the AMC has not verified whether this service provider had "*order execution mechanisms that enable the asset management companies to comply with their obligations under the terms of this Article when they transmit orders to that entity for execution*" (IV of Article 321-114 of the AMF GR for UCITS; see also Article 28 of Delegated Regulation (EU) No. 231/2013 for AIFs – "*The AIFM shall only enter into arrangements for execution where such arrangements are consistent with the obligations laid down in this Article.*").

The control systems are of prime importance, especially for AMCs which rely on their service provider to ensure best selection. However, the level-two controls designed to ensure best execution or best selection are not completely satisfactory for four of the five AMCs, either because these controls are not tracked sufficiently, or because they do not specifically include SFTs in their scope, and this is not consistent with the aforementioned provisions of Article L. 533-22-2-2 of the Monetary and Financial Code.

The inspection task force also observed that the three AMCs using a service provider for all or part of their SFTs do not receive from the latter sufficient information to enable them to assess the conditions in which their SFTs were executed. In particular, these reports are not sufficiently clear.

For example, based on the monthly reports sent by the service providers, the AMCs in question are not able to carry out the best selection control. The concepts appearing in these reports are neither sufficiently explicit nor, as a consequence, sufficiently well understood by the AMCs (for example: the concept of *peer group* used in the reports, and the price and utilisation rate statistics reported). One AMC spoke of difficulties in obtaining more detailed reports from its service provider.

The AMCs which operate via service providers perform no other due diligence to assess price quality (e.g. request for justification on a sample of transactions, comparison with an external database, etc.) apart from analysis of the service providers' reports. Accordingly, the reports are of crucial importance since they should enable the AMCs to assess best execution. However, the AMCs lay down no conditions regarding these reports.

Bad practices

- It is important to note the bad practices which consist, for an AMC, in not enquiring, especially before signing the contract with the service provider, about (i) the procedures for price formation, (ii) the procedures for allocation of transactions among the service provider's clients, (iii) the potential existence of a matching mechanism in the event of interposition of the service provider's own account making it possible to establish a correspondence between its transactions and those of its service provider which placed market counterparties in competition, and (iv) the quality of the reports that will be provided by the service provider and on which the AMC may base its control of best execution.

III. CONFLICT OF INTEREST MANAGEMENT

SFTs can generate conflicts of interest, notably when:

1. the securities to be lent are owned by several funds managed by the same AMC and therefore the allocation of the loans or collateral among the funds should be determined (especially when the conditions of remuneration of the service provider and the AMC are different depending on the funds); and
2. when the counterparty to the transaction is a company related to the AMC.

The five AMCs inspected have a conflicts of interest procedure and register. However, none of these procedures mentions SFTs. The potential conflicts of interest specific to this activity have therefore not been identified.

To manage the first case, the AMCs should[20] implement clear allocation rules *ex ante*, or make sure that the service provider which they use for these transactions has established them. If the service provider has obligations with regard to conflicts of interest management related to its activities, the AMC is responsible for managing conflicts of interest as manager of the fund. It is also responsible for the information that it reports to the funds' unitholders.

Best practice

↗ We should stress the good practice consisting of employing a service provider who uses an algorithm allowing a proportional allocation of securities based on their holdings in the funds. Likewise, an agreement between the AMC and its service provider on the algorithm for allocation of securities loans among funds by the AMC is also an effective measure to manage potential conflicts of interest.

IV. RISK AND COLLATERAL MANAGEMENT

1. Existence of a procedure and implementation of controls

All the AMCs inspected have dedicated procedures governing SFTs. Pre- and post-trade daily controls are indeed conducted in accordance with these procedures, consisting notably of verification of compliance with the statutory and regulatory constraints applicable to funds having to handle the SFT in question.

Moreover, the contractual systems of the five AMCs provide the funds that they manage with the capability for unwinding the SFTs concluded at any time.

[20] According to **Article L 533-10, I of the Monetary and Financial Code**: "*Asset management companies must: (…) 3. Take all reasonable measures to ensure that conflicts of interest do not harm the interests of their clients. These conflicts of interest are those which arise between, on the one hand, the asset management companies themselves, the persons placed under their authority or acting on their behalf or any other person directly or indirectly linked to them through a controlling relationship and, on the other hand, their clients, or between two clients, in the provision of any investment service or related service or combination of such services. When these measures are not sufficient to guarantee, with reasonable certainty, that the risk of harming clients' interests will be avoided, the asset management companies shall clearly inform the clients of the general nature or source of these conflicts of interests, before acting on their behalf*". **According to Article 321-51 of the AMF GR (with regard to UCITS)**: "*Where the organisational or administrative arrangements made by the asset management company for the management of conflicts of interest are not sufficient to ensure with reasonable confidence that the risk of damage to the interests of the UCITS or of its unitholders or shareholders will be prevented, the senior management or other competent internal body of the asset management company shall be promptly informed in order for them to take any necessary decision to ensure that in all cases the asset management company acts in the best interests of the UCITS and of its unitholders or shareholders. Unitholders or shareholders in the UCITS shall be informed, on a durable medium, of the reasons for the decision taken by the asset management company.*". According to **Article 318-13 of the AMF GR** (**with regard to AIFs**): "*II. - Where organisational arrangements made by an asset management company to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of unitholders or shareholders will be prevented, the asset management company shall clearly disclose the general nature or sources of conflicts of interest to such holders before undertaking business on their behalf, and develop appropriate policies and procedures.*".

2. Existence of a collateral exchange system

For the five AMCs, the collateral exchange mechanisms are effective, apart from the absence of collateral adjustment in one case, for transactions handled with an entity of the group to which the AMC belongs.

The type of collateral posted and the credit quality are disparate. In one case, the greater flexibility left by the counterparty to its service provider regarding the type of collateral posted goes hand-in-hand with an increase in the remuneration of financing transactions, but also over-collateralisation.

The re-use of the assets posted as collateral, excluding cash, is prohibited by the AMCs.

V. REMUNERATION AND IMPACT OF ASSETS DEPOSITED AS COLLATERAL ON THE REMUNERATION PRACTISED

The remuneration related to SFTs depends on the assets posted as collateral.

The remuneration of SFTs is generally in a range of between 2 and 5 bps for the lender funds. One of the two AMCs executing their SFTs themselves leaves the funds all the remuneration for these transactions, while the other one receives 33%. Regarding the AMCs using a lending service provider, the conditions of sharing also differ, with the portion attributable to the funds ranging between 60% and 90%.

Regarding controls, only one of the five AMCs (more precisely the level-one middle office and level-two internal control) verifies the correct sharing and payment of fees.

Bad practice

↗ Not establishing a control on compliance with the contractual sharing of remuneration among the funds, the service provider and the AMC (errors were noted by the AMC which established such a control) is bad practice.

VI. COMPLIANCE WITH INFORMATION AND TRANSPARENCY OBLIGATIONS

The SFTR requires the keeping of a record of all SFTs concluded or amended or which have been terminated for a minimum period of five years after termination of the transaction. The inspection task force noted that this requirement was complied with by the five AMCs.

Moreover, sections A and B of the Annex to the SFTR describe in detail the information to be published in the prospectus, on the one hand, and in the annual report of the funds, as well as in the half-year report of UCITS, on the other hand. For UCITS and AIFs formed prior to 12 January 2016, the AMCs had until 13 July 2017 at the latest (prospectus) and 13 January 2017 (annual report for AIFs and UCITS and half-year report for UCITS) to apply and comply with the provisions regarding information to be disclosed to holders.[21] Funds formed after 12 January 2016 had to comply with the provisions immediately.
Most of the points listed in these annexes have been replicated correctly by the inspected AMCs in their documentation.

Recap of the applicable regulations

↗ It is important to remember the obligation of mentioning in the prospectuses and annual reports of the funds in question (and in the half-year reports in the case of UCITS) the information mentioned in the annex to the SFTR.

[21] *Article 33 of the SFTR.*