

GREAT FUND INSIGHTS

CSSF FAQ – Use of Securities Financing Transactions by UCITS (and AIFs) – three months left

On 18 December 2020, the *Commission de Surveillance du Secteur Financier (CSSF)* published a new [FAQ](#) in relation to the use by Luxembourg-domiciled UCITS of the following Securities Financing Transactions (**SFTs**): securities lending transactions, reverse repurchase agreement transactions (reverse repo) and repurchase agreement transactions (repo), as well as buy-sell back and sell-buy back transactions complying with the applicable regulation that UCITS might conclude. The objective of the FAQ is to bring further clarity concerning the use by UCITS of these SFTs, thereby taking into account the applicable regulatory framework, such as, inter alia, Regulation (EU) 2015/2365 concerning the transparency of securities financing transactions and of reuse (**SFTR**) as well as the supervisory experience gained by the CSSF in recent years.

The FAQ only applies to the SFTs mentioned above and does not cover financial derivative instruments, including total return swaps (TRS) used by UCITS for the purpose of efficient portfolio management. However, because the SFTR also sets out provisions on the use of TRS, the FAQ provides that the entities covered by the FAQ should also take into account the provisions of the FAQ for the TRS they conclude.

The FAQ is primarily aimed at Luxembourg UCITS. On the basis that the SFTR also applies to the disclosure to investors by AIFMs as laid down in Article 23 of the AIFMD, the CSSF expects that:

- Luxembourg AIFMs authorised under the AIFM Law give due consideration to the clarifications given in the FAQ for their managed AIFs.

- Non-Luxembourg AIFMs authorised under the AIFMD should consider the clarifications brought in the FAQ with regards to the Luxembourg-domiciled AIFs they manage, while those non-Luxembourg AIFMs should also give consideration to the relevant regulatory provisions and clarifications given in their respective home Member State.
- Luxembourg-domiciled regulated AIFs (Part II UCIs and SIFs) managed by a registered (sub-threshold) AIFM, as well as Luxembourg-domiciled regulated UCIs (Part II UCIs and SIFs) which do not qualify as AIFs as per Article 1(39) of the AIFM Law should also consider the clarifications of the FAQ where relevant.

The CSSF expects the disclosure clarifications given in the FAQ to be included in the prospectus for UCITS, or in the pre-contractual disclosures to investors for in scope AIFs, by **30 September 2021 at the latest**.

“In addition, IFMs have to mitigate the conflicts of interest identified and to manage those if they cannot be prevented, including by adequate disclosure of material conflicts of interest to investors by means of the UCITS prospectus.”

“The CSSF expects the risk disclosure to be sufficiently specific to each type of SFT used by the UCITS.”

Key clarifications:

1. Disclosure to investors

- Clarification on the expectations in relation to the disclosure of the intention to use SFTs: UCITS which have the intention to use SFTs should clearly refer to this fact in the prospectus for each UCITS (ie at sub-fund level for umbrella funds). The objectives of using the SFTs should be clearly explained.
- Clarification on how UCITS should disclose the risks involved by the use of SFTs in the prospectus:

The CSSF considers that the prospectus of a UCITS must provide for a risk description that adequately covers the risks linked to each individual SFT and the risks linked to collateral management. The CSSF expects the risk disclosure to be sufficiently specific to each type of SFT used by the UCITS. This risk description should cover the potential impacts these risks might have on the UCITS and its related performance. The CSSF considers that a risk description in the general part of the prospectus that covers each individual SFT that can be used by the UCITS is acceptable.

- Clarification on specific disclosures in the prospectus on gross revenues and cost/fees arising from the use of SFTs:

UCITS should disclose in the prospectus the percentage of gross revenues generated by the use of SFTs on the basis of arm's length transactions which is returned to the UCITS. In addition, the prospectus should disclose a breakdown of the overall percentage of direct and indirect operational costs/fees by service provider with an indication of the category of service provided.

- Clarification on specific disclosures in the prospectus on potential conflicts of interest arising from the use of SFTs:

Investment fund managers (IFMs) are obliged to adequately identify and disclose in the prospectus the material conflicts of interest that can potentially arise in the course of providing services and activities and whose existence may damage the interests of a UCITS. The CSSF considers that SFTs concluded with or involving related parties give rise to conflicts of interest and have to be appropriately disclosed.

2. SFT costs/fees

Operational costs/fees arising from SFTs should not include hidden revenues. Only effective costs/fees, corresponding to services rendered to the UCITS in the context of SFTs, can be charged to the UCITS. The CSSF expects UCITS IFMs to perform a comprehensive assessment of the adequacy of the operational costs/fees that are deducted from the gross revenues

arising from SFTs. In order to comply with this requirement and notably ensure that the costs/fees do not include any hidden revenue, UCITS IFMs must be able to justify, by means also of quantitative information, the relevance of the underlying cost drivers which make up the total costs/fees borne by the UCITS.

3. Conflicts of interest

The CSSF expects IFMs to proceed to a comprehensive documented assessment of the operational model (whether on a principal or model basis) and related processes underlying the SFT in order to identify and record the circumstances which constitute or may give rise to a conflict of interest entailing a material risk of damage to the interests of the UCITS.

In addition, IFMs have to mitigate the conflicts of interest identified and to manage those if they cannot be prevented, including by adequate disclosure of material conflicts of interest to investors by means of the UCITS prospectus. The CSSF finally considers that SFTs concluded with or involving related parties give rise to conflicts of interest that have to be managed accordingly.

4. Best execution

The CSSF expects IFMs to cover SFTs in their best execution policy and to have robust and comprehensive control processes in place to ensure that the UCITS obtain the best possible result as regards in particular also the securities lending revenues (lending fee) respectively the interest rates underlying repurchase agreement transactions and reverse repurchase agreement transactions, but also as regards the costs/fees charged to the UCITS when executing such transactions.

The IFMs have to perform the best execution controls either themselves or, notably in case of a portfolio delegation model, to have robust initial and ongoing due diligence/oversight in place to ensure that the best execution controls performed by the delegate are adequate.

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