ESMA clarifies expectations on securities lending for retail clients

ESMA has published a Statement setting out its concerns around investor protection in relation to securities lending for retail clients.

25 July 2023

On 12 July 2023, ESMA published a Public Statement, on the risks to retail clients arising out of securities lending (the Statement).

The Statement

- sets out the applicable requirements under MiFID II;
- highlights ESMA's investor protection concerns related to securities lending;
- outlines the obligations of firms engaging in this practice; and
- makes clear ESMA's expectations for firms' compliance with the relevant MiFID II requirements in particular that:
  - revenues from securities lending should directly accrue to the retail client (net of a normal compensation for the firm's services); and
  - express prior consent from retail clients should not be sought by way of the firm's general terms and conditions.

What happens next?

ESMA will continue to monitor this area and makes clear that "if needed", it will issue further technical advice to the European Commission on the topic.

What does the Statement say?

Securities financing transactions (SFTs) may bring extra returns on financial instruments, but they also bring additional risks (such as counterparty and collateral shortfall risk) and are difficult for the average retail client to understand. Because of this, MiFID II imposes strict requirements on the use of client financial instruments.

The Statement

- reminds firms that engage in SFTs in relation to retail client financial instruments about a number of important MiFID II investor protection requirements which apply; and
- illustrates ESMA's expectations as to how these requirements should be applied in practice.
Taking these in turn:

(a) MiFID II investor protection requirements which apply to securities lending

Measures a firm takes to safeguard client ownership rights will not apply to financial instruments used in SFTs. This means that an investor who lends their financial instruments will incur a loss if a borrower fails to return the instrument and the collateral is insufficient to cover its loss.

As a result, MiFID II imposes strict rules on client consent, provision of collateral and information disclosure when it comes to securities lending.

At the same time, Article 24(1) of MiFID II applies more generally and requires firms to act honestly, fairly and professionally in line with a client's best interests.

(i) Safeguarding of client assets

Under MiFID II, a firm must make adequate arrangements to safeguard the ownership rights of clients and prevent the use of a client's financial instruments on own account unless the firm has the client's express prior written consent. The use of the client financial instruments should be restricted to the specified terms to which the client consents.

(ii) Written agreement and provision of information

Firms entering into SFTs in relation to client financial instruments must provide adequate information to the client both before and afterwards:

- 'in good time' before entering into an SFT in relation to a client's financial instruments, the firm must provide the client with clear, full and accurate information (in a durable medium) about the firm's obligations and responsibilities with respect to the use of those financial instruments, including information on the risks involved;
- the written client agreement must include the terms on which SFTs involving client financial instruments will generate a return for the client; and
- periodic statements on retail client assets held by firms should include individualised information on how far retail client financial instruments have been the subject of SFTs, the benefit that the retail client has enjoyed as a result of participation in any SFTs and the basis on which that benefit has accrued.

(b) Practical application of MiFID II requirements in respect of retail client financial instruments

The Statement also highlights certain adverse practices to illustrate ESMA's expectations on how the relevant MiFID II securities lending requirements should be applied in relation to retail clients.
(i) **Revenues from securities lending should directly accrue to the retail client, net of a normal compensation for the firm's services**

Some firms which engage in SFTs in relation to retail client financial instruments retain revenues which arise from the activity. This means that the client incurs greater risk as his or her financial instruments are lent out without gaining the benefit of the additional returns.

In ESMA's view, where a firm generate additional revenues in this way, it may not be acting fairly and professionally in accordance with the best interests of its retail clients as required under MiFID II.

ESMA expects that any revenue arising from securities lending and other SFTs should accrue directly to the retail client whose financial instruments are being lent out.

ESMA accepts that the firm may charge a normal compensation (i.e. direct and indirect operational costs and a fair and proportionate fee) for its services but the amount of normal compensation deducted from the revenues that arise from securities lending "should be included in any costs and charges information provided to the client whose financial instruments are lent out".

(ii) **Express prior consent should not be sought by way of the firm's general terms and conditions**

Some firms request a client's consent for securities lending as part of their general terms and conditions.

In ESMA's view, this should not be considered as fulfilling the requirement to obtain express prior consent evidenced in writing as the client will not have been made sufficiently aware that he or she is consenting to the firm using his or her financial instruments.

The requirement to obtain a client's express prior consent to SFTs, should mean firms giving specific prominence to a request for the client's consent, for example by having a separate record of the client's specific consent for SFTs or by including an additional step in the client's onboarding process, requesting his or her prior express consent.

The Statement makes clear ESMA's view that express prior consent should "not take the form of a pre-ticked box or any other method of passive consent".

In addition, firms should provide clients with adequate information on the risks involved, in good time before requesting their consent - this will ensure that the client is aware of the risks of SFTs when express prior consent is given.

**Sign up** to get the latest legal know-how delivered straight to your inbox.

This document (and any information accessed through links in this document) is provided for information purposes only and does not constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action as a result of the contents of this document.