ESMA
European Securities and Markets Authority

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Public Statement

Highlighting the risks of securities lending in relation to retail client financial instruments and clarifying certain important MiFID II investor protection requirements

Certain firms in the EU engage in securities lending and other securities financing transactions (SFTs)[1] in relation to retail client financial instruments. While SFTs may bring the benefit of generating extra returns on financial instruments, SFTs are also a risky and complex practice that is difficult to understand for the average retail client. MiFID II[2] therefore imposes strict requirements regulating the use of client financial instruments.

ESMA addresses this statement to firms and highlights the retail investor protection concerns relating to SFTs. Moreover, ESMA wishes to remind firms engaging in SFTs in relation to retail client financial instruments about certain important applicable MiFID II investor protection requirements.[3] Lastly, some practices related to securities lending are described to illustrate ESMA's expectations about the practical application of the relevant MiFID II requirements, including the expectation that revenues arising from SFTs should accrue to the client.

Securities lending: risks and certain important requirements

From the perspective of the investor, SFTs may bring the benefit of generating extra return on his or her financial instruments, where these are lent out. However, they also bring additional risks, such as counterparty and collateral shortfall risk. In addition, measures taken by the firm to safeguard the client's ownership rights will not apply to financial instruments used in securities financing transactions (SFTs) such as securities lending. Simply put, the investor lending out his or her financial instruments will incur a loss if the external borrower is not able to return the borrowed financial instrument and if the value of the collateral is insufficient to cover the loss of the financial instrument that is lent out and the investment firm is unable to compensate for the loss.

Therefore, MiFID II imposes strict rules on securities lending, in the area of client consent, provision of collateral and information disclosure. Moreover, the general requirement of Article 24(1) of MiFID II applies, requiring firms to act honestly, fairly and professionally in accordance with their clients' best interests. While securities lending is also possible for retail clients, the

[1] As defined in Article 2(4) of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016.
[2] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014.
[3] Please note that this statement does not cover all applicable investor protection requirements in relation to SFTs.

bar in terms of investor protection is higher when a firm uses retail client financial instruments, as further specified in the next section of this statement.

Safeguarding of client assets. According to Article 16(8) of MiFID II, a firm is required to make adequate arrangements to safeguard the ownership rights of clients and to prevent the use of a client's financial instruments on own account except with the client's express consent. Article 5 of the MiFID II Delegated Directive[4] further specifies the requirements for firms that enter into SFTs in relation to client financial instruments:

- A client should give his or her prior express consent on the use of his or her financial instruments on specified terms, evidenced in writing, through signature or equivalent;

- The use of the client financial instruments should be restricted to the specified terms to which the client consents;

- Firms shall adopt specific arrangements to ensure that the borrower of client financial instruments provides appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance with the value of the client financial instruments.

Written agreement and provision of information. Firms that enter into SFTs in relation to client financial instruments are required to provide adequate information to the client on an ex-ante and ex-post basis:

- In good time before entering into SFTs in relation to client financial instruments, or otherwise using such instruments for own or another client's account, firms must provide the client in a durable medium with clear, full and accurate information on the obligations and responsibilities of the firm with respect to the use of those financial instruments, including the terms for restitutions, and the risks involved (Article 49(7) of the MiFID II Delegated Regulation[5]).

- In the written client agreement, firms shall include the terms on which SFTs involving client financial instruments will generate a return for the client (Article 58(c) of the MiFID II Delegated Regulation).

- In the periodic statements on retail client assets held by firms, firms should include individualised information on the extent to which any retail client financial instruments have been the subject of SFTs, the extent of any benefit that has accrued to the retail client by virtue of participation in any SFTs, and the basis on which that benefit has accrued (Article 63(2)(b) and (c) of the MiFID II Delegated Regulation).

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[4] Commission Delegated Directive (EU) 2017/593 of 7 April 2016.
[5] Commission Delegated Regulation (EU) 2017/565 of 25 April 2016.

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Practical application of certain important MiFID II requirements to securities lending in respect of retail client financial instruments

To illustrate ESMA's expectations on the practical application of the relevant MiFID II requirements in relation to retail clients, ESMA highlights some adverse practices of securities lending hereafter.

Revenues from securities lending should directly accrue to the retail client, net of a normal compensation for the firm's services

ESMA is aware that some firms engaging in SFTs in relation to retail client financial instruments retain revenues arising from this activity. In such cases, the additional returns from securities lending do not accrue to the client, while the client does incur the higher risk due to lending out his or her financial instruments. Some firms using securities lending in this way argue that the practice still benefits their clients because it enables lowering trading commissions charged to clients.

In ESMA's view, a firm using retail client financial instruments to generate additional revenues for the firm may not be acting fairly and professionally in accordance with the best interests of its retail clients, in accordance with MiFID II. Securities lending is a highly complex practice that exposes retail clients to significant additional risks; ESMA therefore expects that any revenue arising from securities lending and other SFTs, save for a normal compensation for the firm's services (i.e. direct and indirect operational costs and a fair and proportionate fee), accrues directly to the retail client whose financial instruments are being lent out. ESMA stresses that the amount of normal compensation deducted from the revenues arising from securities lending should be included in any costs and charges information provided to the client whose financial instruments are being, or have been, lent out.

The prospect of any indirect 'benefit', such as lower trading commissions, may not justify exposing a retail client to the risks of securities lending. Furthermore, such an indirect 'benefit', if any, would not necessarily and proportionately accrue to all retail clients exposed to the risks arising from the lending of their securities, but to retail clients exhibiting more active trading behaviour.

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

ESMA is aware that some firms request a client's consent for securities lending as part of agreeing to their general terms and conditions. This way, by agreeing to the general terms and conditions, the client also gives his or her consent to lending out his or her financial instruments.

In ESMA's view, requesting a client's consent to SFTs as part of the written agreement setting out the general rights and obligations of the parties should not be considered as fulfilling the requirement to obtain express prior consent evidenced in writing, through signature or

equivalent, irrespective of whether the firm states that the client does so.[6] In ESMA's view, a client has not been made sufficiently aware of consenting to the firm using his or her financial instruments if the clause on the client's consent is included in a document containing broader information, without giving specific prominence to such a clause.

According to ESMA, the requirement to obtain a client's express prior consent to SFTs, as a separate requirement from the obligation to record rights and obligations of the parties in a basic written agreement, should mean that a firm should give specific prominence to requesting such consent from clients, for example by having a separate record of the client's specific consent for SFTs. In an online environment, a client's express prior consent could for instance be requested by adding an additional and distinct step in the client's onboarding process on requesting his or her prior express consent. For the avoidance of doubt, this express prior consent shall not take the form of a pre-ticked box or any other method of passive consent.

To ensure that clients are aware of the risks of SFTs when providing their express prior consent, firms should, in good time before requesting this consent, provide clients with adequate information on the risks involved. For example, in the additional and distinct step in the client's onboarding process, information can be provided on the risks involved, before requesting the client's express prior consent.

[6] For example, the fact that the firm states that the client 'expressly consents to the firm using his or her financial instruments', does not amount to requesting a client's express prior consent if such a statement is included in a general document detailing all client's rights and obligations.