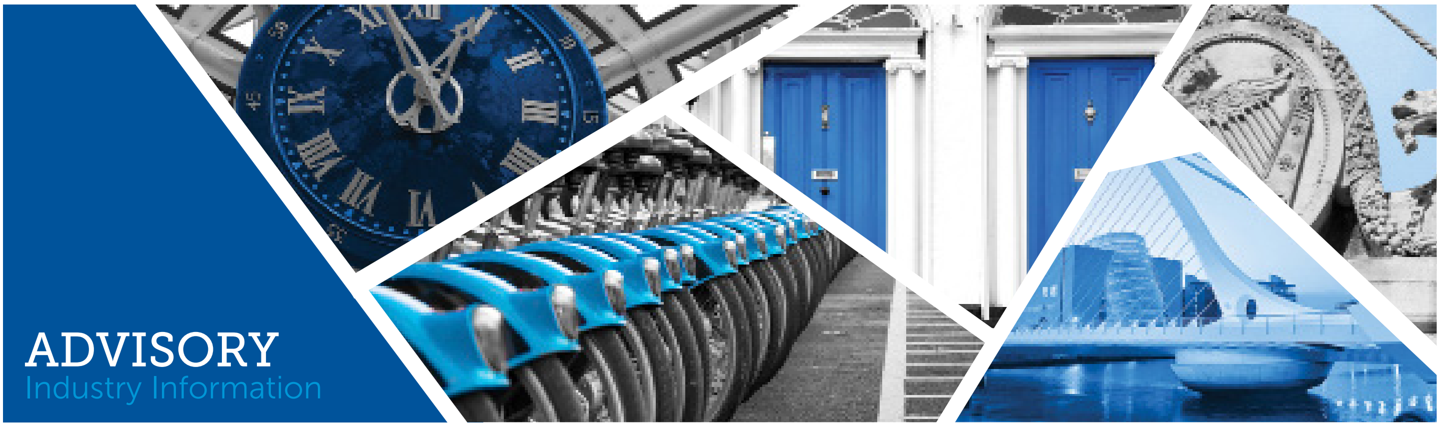

Fund Costs and Fees – ESMA's Findings from CSA

June 2022

In early January 2021, ESMA announced the launch of a common supervisory action ("CSA") with national competent authorities ("NCAs") on the supervision of costs and fees of UCITS. Our previous advisories from June 2020 and May 2021 consider the existing requirements under the UCITS and AIFMD frameworks, regulatory expectations and ESMA's supervisory briefing on the supervision of costs in UCITS and AIFs. On 31 May 2022, ESMA published its final report on this CSA (the "Report") and highlights a number of issues for UCITS management companies and self-managed funds ("Managers") to consider. This update provides an overview of the key issues highlighted in the Report, noting that it is anticipated, based on the statements in the Report that the Central Bank will issue an industry letter relating to their specific findings and expectations.

Setting and Reviewing of the Fees

The information obtained on pricing policies and processes for the setting and monitoring of fund fees and costs indicates that smaller Managers typically have less formalised pricing processes with some having no formalised pricing process in place. In addition, an over-reliance by certain Managers on delegate investment managers in terms of pricing (where such delegates either exercise significant influence over the process or even make the decisions relating to the level of costs and fees ultimately charged by a fund) and late involvement of senior management in the process including not having an active role in fee setting or challenging the output from the process were two other issues identified.

ESMA:

- expects all Managers to have a structured and formalised fees and costs pricing process in place in line with the recommendations set out in ESMA's supervisory briefing and the characteristics of the fund(s);
- highlights the importance of performing an independent analysis of fee structures once these have been established, emphasising that over-reliance on the assessment by the delegate investment manager should be avoided and that a more active role of the senior management and relevant functions/ committees as well as regular stringent controls by internal control functions should be ensured;
- states that the level of costs should be periodically reviewed and monitored in order to compare the estimated ongoing charges with the actual expenses incurred by the fund and, where possible, reduce the level of fees and ensure the viability and competitiveness of the fund over time against peer funds. In addition, ESMA notes that fund performance should be assessed on an at least annual basis and the review of costs and fees should be performed at least in the same frequency, in order to minimise the risk of undue costs being charged; and
- emphasises that the analysis regarding the sustainability of costs over time and/or the relative weight of fees on the investor's return based on the different market scenario is of paramount importance when setting the pricing structure of the fund and expects that Managers do not solely use comparisons with peer funds in order to set the pricing for a fund with each cost category to be separately assessed and determined in the best interests of the investors.

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The Notion of Undue Costs

Feedback from NCAs highlighted that as there is no definition of "undue costs" in the relevant legislation, there is a degree of subjectivity relating to this term and that further consideration should be given to additional guidance or a legislative basis to harmonise the notion of undue costs across EU member states.

It is acknowledged that ESMA's supervisory briefing provided useful indications on the cases where a cost should be considered as due/undue. ESMA emphasises the importance of ensuring that Managers comply with the supervisory expectations enshrined in the supervisory briefing and how the notion of undue cost should be primarily assessed against what should be considered as being in the best interest of the fund and its investors. ESMA re-iterates that Managers should be expected to have policies and procedures that satisfy the expectations set out in the supervisory briefing.

Related Party Transactions

While findings note that Managers often implement general policies outlining the measures aiming to verify the required degree of independence between the different parties, with some of these general measures including monitoring relevant cases in the conflicts of interest log, educating employees on the code of conduct and disclosing conflicts of interest in the fund prospectus, Managers generally do not typically have more specific or concrete measures in place to ensure the effective mitigation of conflicts of interest in related party transactions.

ESMA notes the potential for intragroup/related party transactions to result in higher costs and/or costs higher than average being charged and states that this is an important matter from an investor protection perspective.

Quantitative Findings

An assessment of the level of the ongoing charges figure that identified outliers was performed with the outcome of an analysis of the net profit/AuM of the Manager to the total fees/AuM showing that Managers with lower net profits tend to charge, on average, higher fees and conversely, Managers benefiting from economies of scale will tend to pass the benefit to the funds by setting lower prices.

ESMA expects NCAs to take action to specifically address the issue of costs for smaller Managers and funds, where the risk of investors being charged with undue costs appears to be higher due to the lack of a structured pricing process.

EPM Techniques

The findings from the CSA identified that the most common efficient portfolio management ("EPM") techniques used by Managers are securities lending, (reverse) repurchase agreements and buy-sell/sell-buy back transactions. It was noted that;

1. some Managers were unable to provide the requested copies evidencing that their internal policies and procedures on EPM ensure compliance with the applicable regulatory requirements;
2. funds' prospectuses are not always tailored to the specific UCITS as while they stated that a fund may engage in certain transactions they did not always state that the Manager intends, does or will engage in those transactions on behalf of the fund;
3. there is generally a lack of detailed information in the EPM-related disclosures regarding areas such as risks, conflicts of interest, impact on the performance of the UCITS and fee/revenue splits
4. generic language is used by Managers in respect of the EPM techniques they use and for what reasons;
5. in relation to securities lending arrangements, some Managers use fee splits without 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. ESMA notes that the issues of fee split arrangements merits further analysis;
6. while most Managers have implemented conflicts of interest policies, these do not always specifically cover EPM techniques; and
7. some Managers do not have procedures in place for internal control and governance mechanisms with respect to EPM although Managers typically do have a form of oversight in place for EPM techniques whereby senior management receives regular reports on

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ESMA states that the absence of any policies and procedures on the use of EPM constitutes a breach of regulatory obligations to have adequate policies and procedures in place on risk and portfolio management and expects NCAs to consider strict follow-up measures where such policies and procedures are not in place and also where there is a lack of EPM-related checks and controls in place.

ESMA emphasises the importance of ensuring that Managers do not engage in EPM techniques without clearly and comprehensively disclosing the specific arrangements and risks faced by investors as required under the ESMA's guidelines on ETFs and other UCITS issues. In addition ESMA notes that incomplete or boilerplate disclosures that do not clearly inform investors of the specific arrangements and risks cannot be compliant with these guidelines.

Next Steps

It is anticipated that the Central Bank will issue feedback on its findings in the near future and that action may need to be taken by Managers to ensure that their processes relating to fund costs and fees and, where relevant, EPM techniques comply with the Central Bank's expectations. In advance of the publication of this feedback and/or guidance it would be prudent to review the Report and consider whether any enhancements may need to be made to the policies, processes and procedures in place in respect of the issues identified in the Report.

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