

ESMA Supervisory Briefing on UCITS and AIF Costs

Introduction

In June 2020, ESMA published its '*Supervisory Briefing on the supervision of costs in UCITS and AIFs*'. The briefing is designed to provide National Competent Authorities ("NCAs") such as the Central Bank of Ireland ("CBI") with guidance in respect of the supervision of how costs are charged to investors by UCITS and AIFs. Experts in the industry have commented that the European authorities have been inspired by the Financial Conduct Authority's recent work on value for money in the UK.

Background

In July 2019, ESMA launched a survey among NCAs on national approaches to the supervision of the cost-related provisions under the UCITS and AIFMD frameworks. The survey focused on how NCAs supervise the frameworks and the obligation to prevent undue costs being charged to investors. The analysis of the responses to the survey showed that there is a lack of convergence in the way "undue costs" is interpreted across the EU and on the supervisory approach to the cost-related provisions.

ESMA deemed that the lack of convergence on this topic left room for regulatory arbitrage and presented the risk of 'hampering competition in the EU market'. It was also concerned that there may be differing levels of investor protection depending on where a fund is domiciled. To promote convergence, the supervisory briefing note developed specific criteria to support NCAs in:

- assessing the notion of "undue costs"
- supervising the obligation to prevent undue costs being charged to investors

Supervision of the Pricing Process

As noted, different supervisory approaches to assessing the way asset managers can charge costs are in place at national level. Some NCAs set out a list of costs and consider as "undue" all costs which are not included in those lists. Other NCAs developed specific templates setting out acceptable cost features to be complied with. Any costs other than those specified in the template should be justified to the NCA.

ESMA states within the briefing paper that the notion of undue costs should be primarily assessed against what would be considered in the best interests of the fund or its unit holders. To this end, it should be ensured that:

- the costs charged are consistent with the investment objective of the relevant fund and do not prevent the fund achieving this objective, particularly – but not limited to – where these costs are paid to third parties, including depositary costs;
- the pricing process adopted allows a clear identification and quantification of all costs charged whether those are paid to the management company or to third parties (e.g. depositary, external valuer, broker) and/or directly paid by the investors (e.g. entry and exit costs).

In order to allow NCAs to appropriately supervise undue costs, NCAs are expected to require that funds/management companies develop and periodically review a structured pricing process which addresses a number of elements/factors.

These elements/factors include:

- whether the costs are linked to a service provided in the investor's best interest;
- whether the costs are proportionate compared to market standards and to the type of service provided (e.g. by means of a table displaying costs of funds with similar investment strategies and characteristics in order to detect outliers);
- whether the fee structure is consistent with the characteristics of the relevant fund;
- whether the costs borne by the fund, including those paid to third parties are sustainable taking into account the expected net return of the fund based on its risk profile and investment strategy;

- whether the costs ensure investors' equal treatment and are not of material prejudice to the interests of any class of unitholders or potential unitholders, except for AIFs not distributed to retail investors disclosing a preferential treatment in their rules or instruments of incorporation where such a preferential treatment is allowed under the applicable legislation;
- whether there is no duplication of costs (e.g. the same type of fee is not included in two different cost categories) and costs are properly separated and accounted for;
- whether a cap on fees (e.g. subscription/redemption fees), if any, is applied and clearly disclosed to investors (e.g. expressed as a percentage of the NAV);
- in the case of UCITS and relevant AIFs, if the fund charges performance fees, whether the performance fee model and its disclosure is compliant with the ESMA Guidelines on performance fees;
- whether all costs are clearly disclosed to investors in line with applicable EU rules (AIFMD, PRIIPs and UCITS), as well as any additional rules applied at national level.

Preventing Undue Costs Being Charged to Investors

In order to ensure that undue costs are not charged to investors NCAs are expected to incorporate the review of funds'/management companies' pricing processes in their supervisory activity at different stages.

NCAs should review the processes leading to costs being charged during one or more of the following stages/supervisory actions, as appropriate:

- At a fund's authorisation stage;
- Via off-site supervision and on-site inspections;
- At the stage where approval of material changes to the fund is required;
- During thematic reviews/inspections;
- When assessment of investor complaints is required.

During these reviews, NCAs should review cost disclosures and transparency in addition to business conduct, strategic risk and reputational risk.

The outcome of the supervisory action where undue costs have been charged to investors is expected to include an assessment of the possibility to request the following actions:

- investor compensation (where allowed under the national provisions);
- reduction of fees;
- review of disclosure documents;
- communication of good and poor practices by NCAs to the market/stakeholders/the press which should assist in acting as a deterrent against future managers charging undue costs to investors.

Next steps

While the briefing is non-binding, we expect that the CBI will fully comply with the relevant requirements and funds'/management companies should take the necessary measures to put in place a pricing process that complies with the requirements outlined above. ESMA is expected to review the implementation of the briefing in 2021.

KB Associates Services

KB Associates provides a range of services to investment funds including:

- The provision of UCITS management company/AIFM services
- The provision of designated persons to perform UCITS business plan/AIFMD programme of activity functions.
- The provision of operational and compliance services to both UCITS and AIFMD compliant structures.

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