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ESMA report on the Common Supervisory Action on costs and fees for investment funds

The European Securities and Markets Authority (**ESMA**), published a report on the Common Supervisory Action (CSA) on costs and fees for investment funds (the **Report**). The CSA was carried out with National Competent Authorities (**NCAs**) during 2021. The issue of costs and performance of retail investment products was identified as one of the Union Strategic Supervisory Priorities in 2020. This report will feed into that workstream.

7 MIN READ

In the Report ESMA:

- highlights the importance of supervision in ensuring investors are not charged with undue costs, considering its high impact on investors' returns
- stresses the importance of ensuring that investors are adequately compensated in all cases where they were charged with undue costs or fees, and also in cases where there were calculation errors that resulted in a financial detriment for investors
- invites NCAs to also consider enforcement actions in the cases where a significant regulatory breach was identified, particularly bearing in mind that the area of costs and fees is a priority due to the high relevance for investor protection.

Background

ESMA published a supervisory briefing (the **Supervisory Briefing**) on the supervision of costs and fees in UCITS and AIFs in June 2020. The Supervisory Briefing provided guidance to NCAs when supervising cost-related issues, including the duty of not charging undue costs to investors. It also provided market participants with indications of compliant implementation of the relevant UCITS and AIFMD provisions. The Supervisory Briefing was issued by ESMA to promote common supervisory approaches and practices across the EU/EEA.

Click here to listen to a five minute overview of the key aspects of the 2020 Supervisory Briefing or read our publication 'Undue costs - Pricing process for UCITS and AIFs' – published 12 June 2020.

The Supervisory Briefing sets out:

- a framework for assessing the concept of "undue costs"
- expectations for ManCos to develop and periodically review a structured pricing process in place
- elements that should be included in the pricing process
- expectations for the disclosure of the pricing process
- expectations for the review the pricing process by NCAs
- suggested outcomes of supervisory action in case of materialisation of undue costs charged to investors (noting that this may act as a deterrent against managers charging undue costs to investors).

In January 2021, ESMA launched the CSA on the supervision of costs and fees for UCITS across the EU/EEA. The CSA assessed the setting and reviewing of the fees, the notion of undue costs, related party transactions, quantitative findings, EPM techniques, and follow up actions. Notably, the CSA only concerned UCITS.

The CSA included UCITS management companies (**ManCo**s) employing Efficient Portfolio Management (**EPM**) techniques to assess whether they adhere to the requirements set out in the UCITS framework and ESMA Guidelines on ETFs and other UCITS issues (the **Guidelines**).

The Report notes that the UCITS Directive requires each Member State to enact rules ensuring ManCos:

- act honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market
- act with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market.

Setting and reviewing of fees

NCAs found a satisfactory level of compliance with the legislative framework with some room for improvement on the development of a structured pricing process, particularly for smaller ManCos.

Key takeaways

All ManCos should have in place a structured and formalised pricing process, in line with the characteristics of the fund(s) and the recommendations of the Supervisory Briefing regardless of the characteristics of the ManCo, including the size of AuM. While the principle of proportionality may justify less sophisticated processes from smaller entities compared to larger ones, this should not result in a situation where some smaller ManCos effectively disapply these requirements altogether.

All supervised entities should have in place policies and procedures allowing a transparent identification and quantification of all costs charged to the fund, whether those are paid to the ManCo or to third parties (such as depositary, external valuer, broker) and/or directly paid by the investors (such as entry and exit costs).

An independent analysis of the fee structures, once established is important. Concerns were flagged around compliance with delegation rules where portfolio managers (who are delegates) exercise significant influence or even decide the level of costs. An overreliance on the fee-structure provided by delegated portfolio managers should be avoided.

A review of the fund's costs and fees should occur in correlation with the general annual performance review of the fund.

The notion of undue costs

The majority of NCAs did not find funds charged investors undue costs and/or costs higher than peer funds and/or costs wrongly calculated. Eight NCAs reported that 10% funds in their sample charged undue costs, two NCAs identified between 10-20% of funds in their sample had charged undue costs, and one NCA reported more than 20% of funds in their sample had charged undue costs.

ESMA observed divergent market practices on what industry reported as “due” or “undue” costs. NCAs pointed out that the meaning of ‘undue cost’ is not defined in the UCITS Directive and Regulations and some NCAs felt that the term needed further specification to ensure greater convergence and give them more comfort to take enforcement actions.

Key takeaways

ESMA emphasized the importance of ensuring compliance with the Supervisory Briefing.

In particular, the notion of undue cost should be primarily assessed against what should be considered the best interest of the fund and its investors, bearing in mind the applicable rules at national level.

Related party transactions

Several NCAs reported that ManCos identified conflicts of interest regarding related party transactions.

NCAs reported that ManCos often implemented general policies outlining the measures aiming to verify the required degree of independence between the different parties. Some of these general measures included 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. However, beyond these general measures, NCAs did not report more specific or concrete measures implemented by relevant managers to ensure an effective mitigation of conflicts of interest in related-party transactions.

In some cases of dual-hatting of board members, they had to abstain from voting on certain issues posing potential or actual conflicts or be counterbalanced by independent board members. ESMA noted that this measure does not necessarily address all conflicts of interest risks that arise in related-party transactions. Especially where payments are made to the parent undertaking or other group entities where fund managers might have generally less incentives to ensure that the costs/fees paid are in fact competitive and in line with fair market prices.

Key takeaways

ESMA highlighted the potential for intragroup/related-party transactions resulting in higher costs and/or costs higher than average. We can expect this to be an area of focus.

Quantitative findings

NCAs assessed the level of ongoing charges imposed so as to detect potential outliers. Some NCAs reported that smaller entities constituted the majority of outliers. This was the result of smaller entities having a smaller amount of AuM and higher fixed costs.

This finding is also confirmed by ESMA's annual statistical report 2022 on the performance and costs of EU retail investment products which highlights that "across time horizons and asset classes, larger funds have lower costs than smaller funds. Over one and five year time periods, on average, the top 25% of funds in terms of AuM, were approximately 20% cheaper than the bottom 25% of funds. The "main drivers are economies of scale and the reduced relevance of fixed costs over total assets".

Key takeaways

ESMA asks NCAs to specifically address the topic of costs of smaller funds/ManCos, where the risk of investors being charged with undue costs appears to be higher due to the lack of a structured pricing process.

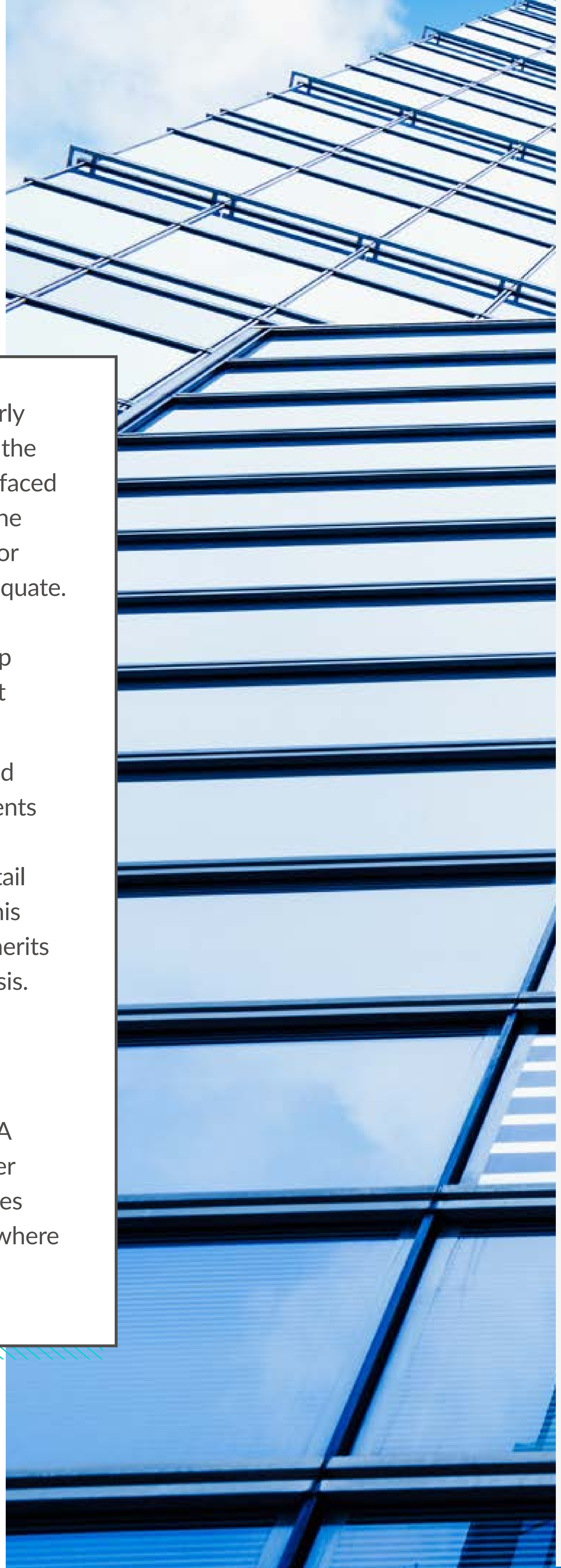
EPM Techniques

NCAS were asked to assess the application of EPM techniques by ManCos. Some ManCos were unable to provide evidence of internal policies and procedures regarding EPM. Many NCAs found inadequate disclosure of EPM techniques in regulatory documents.

The most common EPM techniques used by ManCos are securities lending, (reverse) repurchase agreements and buy-sell/sell-buy back transactions.

Key takeaways

- In ESMA's view, 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. ESMA invites relevant NCAs to consider taking stricter follow-up measures including enforcement actions, where appropriate.
- The CSA found instances of inadequate disclosures as required under the Guidelines. The indication of a mere theoretical possibility of using EPM is inadequate where it is not complemented and specified with the clear disclosure of the additional information required by the Guidelines (counterparty risk, conflict of interest, impact on performance). This is because the Guidelines require the clear disclosure of the intention to engage in EPM and not just the theoretical possibility. It is important to ensure that ManCos do not engage in EPM techniques without clearly and comprehensively disclosing the specific arrangements and risks faced by investors as required under the Guidelines. Equally, incomplete or boilerplate disclosures are inadequate. ESMA invites relevant NCAs to consider taking stricter follow-up measures including enforcement actions, where appropriate.
- ESMA found that the widespread use of fixed fee splits arrangements for securities lending continues, with unfavourable results for retail investors. ESMA believes that this issue of fee-split arrangement merits further investigations and analysis.
- ESMA is concerned about the reports of a lack of EPM-related checks and controls performed by many UCITS managers. ESMA invites relevant NCAs to consider taking stricter follow-up measures including enforcement actions, where appropriate.



Follow-up actions envisaged by NCAs

The majority of NCAs reported that they did not identify any regulatory breaches but rather observed some operational deficiencies. Moreover, NCAs found that identifying regulatory breaches was difficult due to the lack of specificity in the UCITS Directive and Regulations relating to costs and fees.

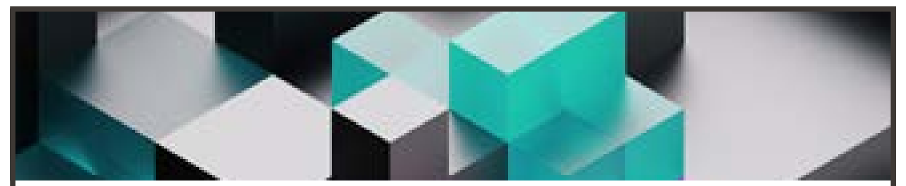
Bilateral engagement with fund managers is the preferred tool used by NCAs to address the adverse findings identified in the CSA, followed by letters to the industry and thematic reviews. NCAs also envisage follow-up with on-site inspections, additional investigations, and other corrective measures.

ESMA invites NCAs to consider enforcement actions were applicable, in lieu of using escalating supervisory measures.

ESMA emphasised the importance of ensuring investors are adequately compensated in all cases where undue charges have occurred.

Main lessons learned by NCAs and ESMA from the CSA

- Control of the cost/fee structure of the fund at the funds' authorisation stage is important
- ESMA encourages all NCAs to perform enhanced scrutiny on costs and fees to ensure investor protection
- ESMA considers that investors should be adequately compensated in all cases where undue costs and fees are charged, and also in cases where there were calculation errors that resulted in a financial detriment for investors



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Resources

- Report on the Common Supervisory Action (CSA) — READ MORE
- Undue costs - Pricing process for UCITS and AIFs — READ MORE
- Supervisory briefing — READ MORE
- ESMA Guidelines on ETFs and other UCITS issues — READ MORE
- Annual statistical report 2022 — READ MORE
- Guidelines — READ MORE
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