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June 24, 2020

ESMA Supervisory Briefing on Undue Costs Charged to EU UCITS and AIFs

[32549]

June 24, 2020 TO: Global Advocacy Coordination Advisory Committee
Global Operations Advisory Committee
ICI Global EU Capital Markets Union Task Force
ICI Global Regulated Funds Committee
International Compliance Advisory Committee
International Internal Audit Advisory Committee RE: ESMA Supervisory Briefing on Undue Costs Charged to EU UCITS and AIFs

On 4 June 2020, the European Securities and Markets Authority (ESMA) published[\[1\]](#) a supervisory briefing (“the briefing”) on the supervision of costs in UCITS and Alternative Investment Funds (AIFs).[\[2\]](#) The objective of the briefing is to improve convergence across national competent authorities (NCAs) in the supervisory approach applied to undue costs.

Background

ESMA is examining the costs and performance of retail investment products, including UCITS, and has published reports on the impact of charges on returns,[\[3\]](#) the net performance of active and passive equity UCITS[\[4\]](#) and statistical reports on performance and costs in January 2019[\[5\]](#) and April 2020[\[6\]](#) in response to a request from the European Commission.[\[7\]](#) ESMA notes that UCITS Management Companies[\[8\]](#) and AIFMs[\[9\]](#) (collectively “ManCos”) are prevented from charging “undue costs” to funds and fund investors. Furthermore, Member States are required to develop conduct rules to ensure that ManCos act honestly and fairly, with due skill, care and diligence, in the best interest of the funds they manage and the integrity of the market.[\[10\]](#)

A survey undertaken by ESMA among NCAs on national approaches to the supervision of cost-related provisions and the obligation to prevent undue costs being charged to investors under the UCITS and AIFM Directives showed a lack of convergence. ESMA believes the lack of convergence in NCA approaches may result in regulatory arbitrage, hamper competition in the EU market and lead to different levels of investor protection. ESMA has developed the briefing to promote convergence by supporting NCAs in:

- Assessing the notion of undue costs; and
- Supervising the obligation to prevent undue costs being charged to investors.

Supervision of ManCos' pricing process

ESMA highlights differences in national supervisory approaches to assessing the way asset managers can charge costs – some NCAs have developed an exhaustive list of undue costs, whereas others have developed templates setting out “acceptable cost features” which are assessed during the initial authorisation of a fund.

ESMA believes that undue costs should be primarily assessed against what is in the best interest of the fund and its investors and therefore NCAs should ensure that:

- costs charged to the fund and its investors are consistent with the investment objective of the fund and do not prevent the fund to achieve this objective, particularly – but not limited to – where these costs are paid to third parties, including depositary costs; and
- the pricing process adopted by the ManCo allows a clear identification and quantification of all costs charged to the fund, 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 avoid hidden costs.

Furthermore, to support NCAs in their supervisory duties, ESMA expects NCAs to require ManCos to develop and periodically review a structured pricing process that addresses the following elements:

- whether the costs are linked to a service provided in the investor's best interest. It should therefore be assessed whether the costs are necessary for the fund to operate in line with its investment objective (e.g., the fund's investment strategy, portfolio management, transaction and settlement costs), or strictly functional to the ordinary activity of the fund or to fulfil regulatory requirements (e.g., cost of annual audit, taxes, NCA's fees);
- whether the costs are proportionate compared to market standards and to the type of service provided (e.g., by mean of a table displaying costs of funds with similar investment strategies and characteristics in order to detect outliers) particularly in the context of potential conflict of interests in the context of payments to third parties (e.g., legal or other type of professional consultancies), intragroup delegation (e.g. portfolio management, service provisions) or depositary functions;
- whether the fee structure is consistent with the characteristics of the fund (e.g., higher costs would normally be charged to funds with more complex investment strategies/type of assets; there should be a balance between the complexity of the activities performed and the costs borne by investors);
- whether the costs borne by the fund, including those paid to third parties (e.g., depositary), are sustainable taking also into account the expected net return of the fund, based also 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. To this purpose, a clear distinction between the costs charged to the fund and those paid directly to the management company and/or the depositary and/or any other third party should be made;

- 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 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;[\[11\]](#)
- whether all costs are clearly disclosed to investors in line with applicable EU rules (AIFMD, PRIIPs and UCITS[\[12\]](#)), as well as any additional rule applied at national level; and
- whether the pricing process and all charged costs are based on reliable and documented data, in order to ensure the ability of the NCA to reproduce ex post the calculations made by the management company on a single portfolio level.

Supervising the obligation to prevent undue costs being charged to investors

ESMA has set out its expectation that NCAs incorporate the review of ManCo's pricing processes into their supervisory activity. ESMA expects NCAs to review the processes leading to costs being charged/charged to investors through a case-by-case analysis during one or more of the following stages/supervisory actions, as appropriate:

- fund's authorisation stage;
- off-site supervision;
- on-site inspections;
- approval of material changes to the fund (which would require the NCA's approval and prior information to investors, as well as the possibility to the investor to redeem at no additional charges);
- thematic reviews; and
- assessment of investors complaints.

ESMA has also set out its expectation that NCAs' supervisory activity should cover the following aspects:

- cost disclosure and transparency:
 - the existence, nature and amount of the costs/fees are clearly disclosed to investors in a manner that is comprehensive, accurate and understandable; and
 - the charged costs are consistent with funds' rules, documentation, offering documents. Information should be consistent across offering documents and marketing material, while the latter may not be reviewed by NCAs.
- business conduct, strategic risk and reputational risk.

To ensure that fee or commission payments to service providers do not impair compliance with the ManCo's duty to act in the best interest of investors, ESMA considers that NCAs should monitor the pricing process developed by ManCos to ensure that this contains the

following elements:

- clearly sets out responsibilities among the management bodies of the firm in determining and reviewing the costs charged to investors;
- in case of the existence of conflicts of interest, it ensures that the risk of damage to investors' interest will be prevented; and
- is clearly documented and periodically reviewed.

Where NCAs identify from their supervisory work that ManCos have charged undue costs to investors, ESMA considers that NCAs should assess the need for the following actions to be taken by the ManCo:

- investor compensation to be paid, where allowed under the national provisions;
- reduction of fees; and
- review of disclosure documents.

ESMA also believes that NCAs should consider the communication of good and poor practices to market/stakeholders/press, which should assist in acting as a deterrent against managers charging undue costs to investors.

Next Steps

ESMA will closely cooperate with NCAs to promote the application of the supervisory briefing and will take stock of the level of convergence reached across the EU in 2021.

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endnotes

[1] ESMA Press Release: ESMA Promotes Convergence in the Supervision of Costs in UCITS and AIFs, 4 June 2020, *available from* <https://www.esma.europa.eu/press-news/esma-news/esma-promotes-convergence-in-supervision-costs-in-ucits-and-aifs>

[2] Supervisory Briefing: On the supervision of costs in UCITS and AIFs, dated 4 June 2020, *available from* https://www.esma.europa.eu/sites/default/files/library/esma34-39-1042_supervisory_briefing_on_the_supervision_of_costs.pdf

[3] The impact of charges on mutual fund returns, ESMA Report on Trends, Risk and Vulnerabilities, No. 2, 2017, *available from* https://www.esma.europa.eu/sites/default/files/library/esma50-165-422_trv_-_vulnerabilities_-_investor_protection_corrected.pdf

[4] Net Performance of active and passive equity UCITS, ESMA Report on Trends, Risk and Vulnerabilities, No. 2, 2019, *available*

from https://www.esma.europa.eu/sites/default/files/library/esma_50-165-883_report_on_trends_risks_and_vulnerabilities_no.2_2019.pdf#page=59

[5] See Memorandum No. 31641, RE: ESMA Report on the Performance and Costs of EU Retail Investment Products, dated 5 March 2019, *available from* https://www.ici.org/my_ici/memorandum/memo31641

[6] ESMA Annual Statistical Report: Performance and Costs of Retail Investment Products in the EU 2020, 6 April 2020, *available from* https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf

[7] In 2017, the Commission issued a request to the European Supervisory Authorities to report on the cost and past performance of investment products, *available from* https://ec.europa.eu/info/sites/info/files/171013-request-to-esas-to-report_en.pdf

[8] See Article 22(4), Commission Directive 2010/43/EU implementing Directive 2009/65/EC as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company, *available from* <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32010L0043>

[9] See Article 17(2), Commission Delegated Regulation 231/2013 supplementing Directive 2011/61/EU with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision, *available from* <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:EN:PDF>

[10] See Article 14(1), UCITS Directive 2009/65/EC and Article 12(1), AIFM Directive 2011/61/EU

[11] ESMA Final Report: Guidelines on performance fees in UCITS and certain types of AIFs, 3 April 2020, *available from* https://www.esma.europa.eu/sites/default/files/library/esma_34-39-968_final_report_guidelines_on_performance_fees.pdf

[12] ESMA draws particular attention to its UCITS Q&A on Benchmark Disclosure, *available from* <https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits>