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Regulatory Focus on Costs and Fees

June 2023

On 24 March 2023, the Central Bank of Ireland ("**Central Bank**") published a letter setting out its findings arising from the European Securities and Markets Authority ("**ESMA**") coordinated common supervisory action ("**CSA**") on costs and fees, and requiring all firms managing UCITS and AIFs to develop a plan to address any gaps in their arrangements. ESMA previously reported its high level findings from the CSA in May 2022. While the CSA focused on UCITS' managers compliance with the cost-related provisions contained in the UCITS framework – which includes a requirement that undue costs should not be charged to the UCITS and its unitholders – the Central Bank has stated that its expectations should also be considered by AIFMs with respect to costs and fees charged to AIFs.

While the CSA did not identify material undue costs being charged to UCITS, a number of deficiencies were identified with respect to fund management companies setting the costs and fee structure for investment funds. In the Central Bank's view, the identified deficiencies substantially increase the risk that investors will be subject to undue costs and may negatively impact on investment returns. The findings and expectations of the Central Bank are set out in the table below.

FINDING	EXPECTATION
Lack of policies and procedures on costs and fees: A large portion of reviewed firms failed to demonstrate that they had adequate pricing governance structures in place. The lack of detailed documented policies and procedures governing the calibration and imposition of fees creates the risk that the control environment for costs and fees is inadequate and increases the risk of investors being subjected to unnecessary costs.	Firms should have in place, structured, formalised pricing policies and procedures with clear oversight and approval from senior management allowing for transparent identification and quantification of all costs charged to the fund.

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Periodic reviews of costs fees: The majority of reviewed firms failed to provide evidence of regular reviews to UCITS costs and fees structure being carried out. In some cases, fee structures had not been reviewed since the fund's establishment.	All costs should be reviewed annually, taking account of the investment objectives and strategy of the fund, target and actual performance levels achieved and the role and obligations of service providers. Firms should ensure that costs and fees are calculated fairly and equitably, serving the best interests of investors. The review process should contain evidence of this. The competitiveness of the fund should also be reviewed to measure its ability to provide positive returns to investors.
Design and oversight of fee structure: Firms which lacked adequate policies and processes displayed an over-reliance on assessments made by delegate fund managers for calculating the pricing structure of funds, with limited firm engagement by some firms. This raises concerns around the time firms are spending setting cost and fee structures, and the firm's ability to oversee these processes. Variations in board reporting on costs and fees were also found. Reporting of fees and costs, and regular reviews of these structures is vital for the proper functioning of UCITS and is in investors' best interests.	Firms should have clear procedures and policies for design, oversight and regular review of costs and fees structures to ensure they are operating adequately and in the best interests of investors.
Effective Portfolio Management: For firms engaged in securities lending programmes, a number of these obtained notably higher revenues than others due to their security lending programmes. The majority of firms using Efficient Portfolio Management ("**EPM**") did not have formal policies and procedures in place for EPM activities. Where firms had policies and procedures in place, there was a lack of adequate detail.	All fee arrangements regarding securities lending programmes should comply with ESMA expectations and should be clearly disclosed within the fund's prospectus or supplements and policies and procedures.

Fixed Operating Expense Model: Several funds reviewed utilise a fixed operating expense model (“**FOE**”) and confirmed that they retain excess fees when a UCITS expenses are below the FOE cap. In most cases, it was found that the FOE was calibrated at such a high level, that the firm would nearly always receive additional income from the decision to implement a FOE, in some cases this figure reached 0.15% NAV.	Where the FOE model is used to provide investor protection and certainty regarding fees, investors should be aware of all expenses and the model should be calibrated to minimise any differential and ensure undue costs are not placed on investors. The FOE models should be reviewed within the annual costs and fees review.
Non-discretionary Investment Advisor Charge: In several firms, the non-discretionary investment advisor retained a greater fee than the delegate investment manager. This raises concerns around cases where an investment advisor is appointed to a fund and is acting with more control and influence than is suitable.	The role performed by the investment advisor is non-discretionary and adjunct to the role of the investment manager. Firms should ensure appropriate fee arrangements are in place.

The Central Bank’s letter requires fund management companies to conduct a gap analysis of the findings and expectations and, where appropriate, put a plan in place by the end of Q3 2023.

EU Developments

The Commission’s Retail Investment Strategy, published on 24 May 2023, is aimed at ensuring that retail investors can take full advantage of capital markets and that they are supported by rules that are coherent across all relevant legal instruments. It includes proposals to ensure that investment products offer retail investors value for money and provisions relating to increased transparency in relation to costs.

Following on from ESMA’s CSA on costs and fees in investment funds and its opinion to the Commission on undue costs, the draft directive would require fund managers to prevent undue costs from being charged to investment funds and their investors. AIFMs and UCITS management companies would be required to establish a sound pricing process which should identify, analyse and review the costs charged directly or indirectly to investment funds or their investors. Costs would be considered to be due if they comply with

UCITS' and AIFs' pre-contractual documents, are necessary to their functioning and are borne by investors in a fair way. Management companies would be required to compensate investors where undue costs have been charged, including where costs have been miscalculated to the detriment of investors and would be required to report such incidents to regulators, auditors and depositaries.

Value for money assessments have been part of the regulatory landscape in the UK since 2019, where there have been some implementation challenges. Reviews of the assessments conducted by the Financial Conduct Authority ("**FCA**") have found that most authorised fund managers failed to meet the FCA's standards in carrying out the assessment and that there was a lack of rigour from fund managers when assessing value in their funds. Managers should be able to draw on their experience complying with the UK requirements in complying with the new rules under the Retail Investment Strategy and it is to be hoped that there will not be significant divergence between the UK and EU approaches with regard to the detailed requirements applicable to these value assessments.

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