

ESMA Promotes Convergence in the Supervision of Costs

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UCITS and AIFs may need to put in place a detailed, documented pricing process, if national regulators implement a recent ESMA supervisory briefing on the supervision of costs.

On 4 June 2020, the European Securities and Markets Authority (“ESMA”) published a **supervisory briefing** on the supervision by national competent authorities (“NCAs”) of costs applicable to UCITS and AIFs. The initiative was prompted by ESMA’s first annual statistical report in January 2019 on costs and performance of retail investment products, which showed the significant impact of costs on the final returns for investors. Following the publication of this report, ESMA began working with the NCAs to assess the different national approaches to the supervision of the cost-related provisions set out in Level 2 measures under the UCITS Directive and the AIFMD. ESMA found that there has been a lack of convergence in the way that the concept of “undue costs” is interpreted across the EU and in the supervisory approach to cost-related provisions.

ESMA states that this lack of supervisory convergence gives rise to the risk of different investor protection levels depending on where a fund is domiciled. ESMA has therefore developed criteria to support NCAs in: (a) assessing the notion of undue costs; and (b) supervising the obligation to prevent undue costs being charged. It is also intended to provide market participants with indications of NCAs’ expectations and compliant practices regarding the cost-related provisions of the UCITS and AIFMD frameworks.

Identifying Undue Costs

Section 3 of the briefing addresses indicators which should allow NCAs to identify costs that should be considered “undue” to investors and recommends that management companies should develop and maintain a pricing process.

Pricing Process

- Management companies should develop and periodically review a documented, structured pricing process, which should address whether:
 - the costs are linked to a service provided in the investors’ best interests. It should be assessed whether the costs are: (a) necessary for the fund to operate in line with its investment objective (eg, the fund’s investment strategy, portfolio management, transaction and settlement costs); or (b) strictly functional to the ordinary activity of the fund or to fulfil regulatory requirements (eg, cost of annual audit, taxes, NCA’s fees);
 - the costs are proportionate compared to market standards and to the type of service provided. The briefing suggests that this could be done by means of a table displaying costs of funds with similar investment strategies and characteristics in order to detect outliers;
 - the fee structure is consistent with the characteristics of the fund;
 - the costs borne by the fund are sustainable taking into account the expected net return of the fund, based on its risk profile and investment strategy;
 - the costs ensure investors’ equal treatment (except where AIFs not distributed to retail investors disclose preferential treatment in fund documentation where such preferential treatment is permitted under relevant legislation);
 - there is no duplication of costs and costs are properly separated and accounted for;
 - a cap on fees is applied and clearly disclosed;
 - where a performance fee is charged, the performance fee model and its disclosure is compliant with ESMA’s **Guidelines** on Performance Fees;
 - all costs are clearly disclosed in accordance with applicable EU and national rules; and
 - the pricing process and all charged costs are based on reliable and documented data, to ensure that NCAs can reproduce ex post the calculations made by the management company on a single portfolio level.
- The notion of undue costs should be primarily assessed against what should be considered the best interest of the fund or its investors.
- The costs charged to the fund or its investors should be consistent with the investment objective of the fund and should not prevent the fund achieving this objective.
- The pricing process adopted by the management company should allow a clear identification and quantification of all costs charged to the fund, whether those are paid to the management company or to third parties and / or directly by the investors in order to avoid hidden costs.
- The pricing policy should clearly set out responsibilities among the management bodies of the firm in determining and reviewing the costs charged to investors.

Supervising the Obligation to Prevent Undue Costs being Charged

Section 4 of the briefing addresses the elements to be taken into account by NCAs in supervising the duty to prevent undue costs being charged to investors. This section states that NCAs should review the pricing processes through a case-by-case analysis during one or more of the following stages: authorisation stage; off-site inspection; on-site inspection; approval of material changes to the fund; thematic reviews; and assessment of investors’ complaints.

In the event that undue costs are identified by NCAs, the supervisory briefing suggests that NCAs may request investor compensation, reduction of fees, review of disclosure documents and communication of good and poor practices.

Next Steps

The briefing is not subject to any “comply or explain” mechanism (such as that which applies in respect of ESMA guidelines) and is stated to be non-binding. We understand that the Central Bank is considering whether any amendments are required to its existing requirements in order to implement the recommendations in the supervisory briefing. ESMA will closely cooperate with NCAs to promote the application of the supervisory briefing and will take stock of the level of convergence reached in 2021.

The publication of the supervisory briefing, and also the publication of ESMA’s annual statistical reports on performance and costs in retail investment products, suggest that fund managers can expect increased regulatory focus on costs over the coming months.

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