## March 2023

# Dear Chair Letter on undue costs and fees

# **Background**

As readers will be aware there has been significant regulatory focus on fees for a number of years. Notably, in 2020, ESMA issued a <u>Supervisory Briefing on fees and costs in June 2020</u>, with the aim of promoting convergence on the supervision of costs in UCITS and AIFs. This led to a common supervisory action (the **CSA**) during 2021, which was carried out by national competent authorities (**NCAs**, including the Central Bank of Ireland). The CSA led to the publication of an <u>ESMA report in May 2022</u>, which concluded that "in order to promote retail participation in the fund market, continued supervisory attention is needed on the topic of costs and fees in investment funds."

Demonstrating the continued focus on this area, and arising from the CSA, the Central Bank has now issued a "Dear Chair" letter to the chairs of Irish regulated UCITS management companies and alternative investment fund managers (together ManCos) (the Dear Chair Letter).

#### **Key Findings**

The Dear Chair Letter recognises six key findings/supervisory expectations:

## 1 Lack of policies and procedures

A "significant majority" of firms reviewed by the Central Bank did not have appropriate pricing policies and procedures in place. The Central Bank expects all ManCos to have formalised pricing policies and procedures in place to allow for the transparent identification and quantification of all costs charged to the fund.

#### 2 Periodic review

The Central Bank's expectation is that all costs, both new and existing, are reviewed on an annual basis taking into account the investment objective and strategy of the relevant For further information on any of the issues discussed in this article please contact:



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fund(s), the target and actual level of performance achieved, and the role and responsibilities of service providers.

## 3 Design and oversight of fee structure

The Central Bank's analysis found an over-reliance on delegate investment managers determining fee structures, which the Central Bank indicated raised concerns about the lack of importance that some ManCos apply to setting cost and fee structures, and the ability of these ManCos to oversee the pricing process.

## 4 Efficient Portfolio Management (**EPM**)

With regard to EPM techniques, the Central Bank's analysis showed that "a significant majority of firms utilising EPM did not have formalised policies and procedures in place covering EPM activities." The Central Bank also identified, for ManCos engaged in securities lending, that a number of them retained significantly more revenue than their peers from their securities lending programmes.

## 5 Fixed Operating Expense Models

With regard to "Fixed Operating Expenses" fee structures (whereby a "catch-all" fee is paid to the ManCo, which then pays the fees of other service providers), the Central Bank noted the practice of ManCos retaining excess amounts once all fees had been paid. The Dear Chair Letter notes that "investors should be fully aware of all expenses and the model should be calibrated so that any differential is minimised and that undue costs are not charged to investors." The Central Bank also noted that "this will be an area of focus for the Central Bank in future supervisory engagements."

## 6 Non-discretionary Investment Advisor charges

The Central Bank has noted instances where non-discretionary investment advisors are paid higher fees than the discretionary investment managers that appoint them. The Dear Chair Letter states that "this practice raises concerns as to whether (i) the investment advisor is in fact the de facto discretionary investment manager and (ii) the negotiated fee is in the best interests of the investors." The Central Bank has indicated that this leads to concerns that an investment advisor may be appointed to a fund and that investment advisor is acting with more influence and control than is appropriate.

## **Action required**

The Dear Chair Letter requires ManCos to conduct a gap analysis of the findings and expectations outlined in the Dear Chair Letter and, where appropriate, put a plan in place by the end of Q3 2023 to address any gaps identified. The Dear Chair Letter confirms that while the scope of the CSA did not include a review of AIFMs, it expects AIFMs consider the findings and actions of this review with respect to cost and fees charged to AIFs.

Should you have any queries or require any assistance in complying with the CSA (including the preparation/update of the necessary policies referenced above), please do not hesitate to get in touch with your regular Dillon Eustace contact.

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