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ESMA reports on regulatory supervision of costs and fees in UCITS

Background

In 2020 the topic of fund fees and costs was recognised as a priority item to be addressed by national competent authorities (**NCAs**, including the Central Bank of Ireland). In June of that year, the European Securities and Markets Authority (**ESMA**) issued a supervisory briefing on the subject of undue costs (the **Supervisory Briefing**). This led to a common supervisory action on costs and fees in UCITS, which was carried out by ESMA alongside NCAs during the course of 2021.

ESMA has now published a report on this common supervisory action on costs and fees (the **CSA Report**), concluding 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.*"

The CSA Report

The CSA Report presents the main results of the common supervisory action (noting that there is room for improvement on the application of the Supervisory Briefing) as follows:

- The CSA Report notes that, given that the Supervisory Briefing was published two years ago, at this stage all supervised entities should have in place policies and procedures allowing a transparent identification and quantification of all costs charged to the fund. This should apply both at the time of establishment and on an ongoing basis (including at least an annual review).

  In this regard, the CSA Report highlights a distinction between management companies based on their size (i.e. assets under management (**AuM**) and notes that:

Key Points to Note:

- **UCITS managers (including smaller managers) should have policies and procedures in place regarding fee structures and the ongoing monitoring of same.**
- **ESMA highlighted instances where delegates exercise significant influence over costs charged by funds.**
- **Continued Central Bank focus in this area, including at the authorisation stage for new UCITS.**

Smaller entities have in place less formalised pricing processes compared to entities managing larger AuM. In some instances, smaller entities did not have a formalised pricing process at all. The degree of sophistication of the pricing process as well as its standardisation also varies based on the size of AuM, showing a lower level of quality for small-sized firms, for which a documented periodic review of the fee structure is less frequent and/or could not be demonstrated.

- ESMA has expressed its concern regarding compliance with delegation rules, specifically the role played by investment managers – which are, after all, delegates of the relevant funds and their managers – where they exercise significant influence over, or even decide the level of, costs charged by the fund.

- ESMA has noted that, while undue costs should not be charged to funds, the level of fees and charges should be sustainable over time.

- The CSA Report sets out divergent market practices across the EU in the interpretation of what costs are validly "due", as opposed to "undue" costs. In this regard, ESMA has reiterated the guidance set out in the Supervisory Briefing that "*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*." ESMA also pointed to the framework and principles set out in the Supervisory Briefing.

- The CSA Report draws attention to the potential for intragroup/related-party transactions, which could result in higher costs. In this regard, ESMA has noted that there should be adequate policies and procedures in place to mitigate such conflicts, including Board members abstaining from voting on issues where they may have a potential conflict of interest.

- ESMA has reiterated an issue raised in its Guidelines on ETFs and other UCITS issues (the **ESMA Guidelines**), which was originally published in 2014. It has noted that "*it is important to ensure that UCITS managers do not engage in efficient portfolio management (**EPM**) techniques without clearly and comprehensively disclosing the specific arrangements and risks faced by investors as required under the ESMA Guidelines.*"

- Regarding securities lending arrangements, the CSA Report sets out that there are instances in several jurisdictions of UCITS managers using fee splits without due consideration of either the EPM revenues generated, or the amount of revenue deducted by the securities lending agent, to ensure that they are in line with fair market rates and therefore in the best interest of investors. This is particularly important where the securities lending agent may be part of the manager's group.

- On the topic of investor compensation, the CSA Report highlights 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 calculation errors result in a financial detriment for investors.

Next steps

ESMA has asked NCAs, including the Central Bank, to report back on their proposed follow-up actions to address the issues that have been identified, noting that ESMA has also suggested that, in certain cases, where significant regulatory breach was identified, NCAs should consider enforcement actions. On this basis, we would expect the Central Bank to continue its focus on costs and fees, in line with ESMA recommendations.

It is likely that the Central Bank will continue its ongoing engagement with UCITS managers in this area, which could potentially result in Risk Mitigation Programmes being issued where appropriate and for the Central Bank to issue a letter to industry in due course. In addition, it is likely that there will be an increased focus on costs and fees as part of the authorisation/approval process for new UCITS.

How Dillon Eustace can assist

If you have any queries with regard to the CSA Report, or in relation to any aspect of this client update, please liaise with your usual contact at Dillon Eustace.

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