

Supervisory briefing

On the supervision of costs in UCITS and AIFs



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1. Executive Summary

Reasons for publication

Article 22(4) of Commission Directive 2010/43/EU (UCITS Level 2 Directive) provides that Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unitholders.

Article 17(2) of Commission Delegated Regulation (EU) No 231/2013 (AIFMD Level 2 Regulation) provides that AIFMs shall ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs.

ESMA has developed this supervisory briefing to promote convergence on the supervision of costs in UCITS and AIFs.

This briefing is expected to be considered by National Competent Authorities (NCAs) when supervising cost-related issues, including the duty of not charging undue costs to investors. It can also give market participants indications of compliant implementation of the aforementioned UCITS and AIFMD provisions.

This document is issued under Article 29(2) of the ESMA Regulation.¹

¹ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC. In particular, Article 29(2) of ESMA Regulation states that “the Authority may, as appropriate, develop new practical instruments and convergence tools to promote common supervisory approaches and practices.”

2. Introduction and background

1. ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices.
2. This supervisory briefing is designed to provide guidance to National Competent Authorities (NCAs) as regards the supervision of how costs are charged to investors by UCITS and/or AIFs and their managers. It is also meant to give market participants indications of NCAs' expectations and compliant practices regarding the cost-related provisions of the UCITS and AIFMD frameworks.
3. Article 22(4) of the UCITS Level 2 Directive provides that Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unitholders. Based on Article 14(1)(a) and (b) of Directive 2009/65/EC (UCITS Level 1 Directive), each Member State shall draw up rules of conduct to ensure that a management company: (a) acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market; (b) acts with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market.
4. Article 17(2) of the AIFMD Level 2 Regulation provides that AIFMs shall ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs. Furthermore, Article 12(1) of Directive 2011/61/EU (AIFMD Level 1) provides that Member States shall ensure that, at all times, AIFMs: (a) act honestly, with due skill, care and diligence and fairly in conducting their activities; (b) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market; (f) treat all AIF investors fairly.
5. In July 2019 ESMA launched a survey (ESMA survey) among NCAs on national approaches to the supervision of the cost-related provisions under the UCITS and AIFMD frameworks.
6. This initiative was prompted by ESMA's first annual statistical report on costs and performance of retail investment products, which showed the significant impact of costs on the final returns for investors.²
7. The ESMA survey focused on how NCAs supervise the relevant cost-related provisions in the UCITS and AIFMD frameworks and on the obligation to prevent undue costs being charged to investors.³

² https://www.esma.europa.eu/sites/default/files/library/esma50-165-731-asr-performance_and_costs_of_retail_investments_products_in_the_eu.pdf See also the last iteration of the report available at https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf

³ Under the UCITS and the AIFMD frameworks, there are specific provisions related to the duty to act in the best interest of investors and the costs charged to investors by investment funds and their managers. Those are:

8. The analysis of the responses to the ESMA survey showed that there is a lack of convergence on the way the notion of “undue costs” is interpreted across the EU and on the supervisory approach to the cost-related provisions. Furthermore, all responding NCAs considered the concept of “undue cost” as a transversal one and equally applicable to both UCITS and AIFs.
9. ESMA deems that the lack of convergence on this topic leaves room for regulatory arbitrage and risks of hampering the competition in the EU market. Furthermore, it may lead to different level of investor protection depending on where a fund is domiciled.
10. Therefore, it is important to set out a common framework for NCAs to consider in their supervisory activity when assessing the level of funds’ costs, having regard to the management company’s operational framework. This supervisory briefing is designed to help supervisors make the aforementioned assessment.
11. To promote convergence in relation to the supervision of costs in UCITS and AIFs, ESMA has developed the criteria set out in this briefing to support NCAs in:
 - a) assessing the notion of “undue costs”;
 - b) supervising the obligation to prevent undue costs being charged to investors.
12. In this briefing ESMA has adopted an approach to take into consideration the general characteristics of the different costs which are charged to investors in UCITS and AIFs and the supervision of those costs.
13. This supervisory briefing is issued under Article 29(2) of the ESMA Regulation which enables ESMA to develop new practical instruments and convergence tools such as supervisory briefings. The purpose of these tools is to promote common supervisory approaches and practices. The content of this supervisory briefing is not subject to any ‘comply or explain’ mechanism for NCAs and is non-binding.
14. The next sections of this document are organised as follows: section 3 includes (a) indicators which should allow NCAs to identify costs that should be considered as “undue” to investors and (b) examples of such costs; section 4 includes elements to be taken into account by NCAs for the purpose of their supervision of the duty to prevent undue costs being charged to investors.

- Directive 2009/65/EC: Article 14(1), Article 25, Article 77, Article 78, Schedule B;
- Commission Directive 2010/43/EU: Article 22;
- Directive 2011/61/EU: Article 12, Article 23;
- Commission Delegated Regulation (EU) No 231/2013: Article 17.

3. Supervision of the pricing process of the management company

15. Different supervisory approaches to assessing the way asset managers can charge costs are in place at national level. Some NCAs set out a closed list of costs; they would consider as “undue” all costs which are not included in those lists. The availability in the national framework of a closed list of costs may be beneficial in the sense that it provides legal certainty on the admissible cost categories.
16. Other NCAs developed specific templates setting out acceptable cost features to be compiled by management companies at the fund’s authorisation stage. Any costs other than those specified in the template should be justified by the management company to the NCA. The availability of such a template also represents a tool to provide more clarity on which costs could be charged to investors and those for which further assessment could be required by the NCA.
17. Without prejudice to these different national requirements to be applied by management companies, it is important to set out a framework which ensures that national supervisory approaches are in line with some common principles followed by NCAs across the EU.
18. The notion of undue cost should be primarily assessed against what should be considered the best interest of the fund or its unit holders. To this end, it should be ensured that:
 - a) the costs charged to the fund or its unit holders 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;
 - b) the pricing process adopted by the management company 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.
19. In order to allow NCAs to appropriately supervise that investors are not charged with undue costs, NCAs are expected to require that management companies develop and periodically review a structured **pricing process** addressing the following elements:
 - a) 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);

- b) 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;
- c) 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);
- d) 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;
- e) 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;
- f) 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;
- g) 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);

- h) 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 fees⁴;
- i) whether all costs are clearly disclosed to investors in line with applicable EU rules (AIFMD, PRIIPs and UCITS⁵), as well as any additional rule applied at national level;
- j) 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.

4. Supervising the obligation to prevent undue costs being charged to investors

20. In order to ensure that undue costs are not charged to investors, NCAs are expected to incorporate the review of management companies' pricing processes in their supervisory activity at different stages.

21. NCAs should 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:

- a) fund's authorisation stage;
- b) off-site supervision;
- c) on-site inspections;
- d) 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);
- e) thematic reviews;
- f) assessment of investors complaints.

22. In their supervisory activity, NCAs' should ensure to cover the following aspects:

- a) cost disclosure and transparency

⁴ See the relevant final report on Guidelines on performance fees in UCITS and certain types of AIFs (ESMA34-39-968), available here: https://www.esma.europa.eu/sites/default/files/library/esma_34-39-968_final_report_guidelines_on_performance_fees.pdf

⁵ This includes in particular the UCITS Q&As on benchmark disclosure: <https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarifybenchmark-disclosure-obligations-ucits>

a.1) the existence, nature and amount of the costs/fees are clearly disclosed to investors in a manner that is comprehensive, accurate and understandable;

a.2) 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.

b) business conduct, strategic risk and reputational risk.

23. NCAs should supervise that the payment of any fee or commission is aimed at remunerating a service provided to the fund/its investors and does not impair compliance with the management company's duty to act in the best interests of the unit-holders. To this end, NCAs should monitor that the management company develops a pricing process that:

a) clearly sets out responsibilities among the management bodies of the firm in determining and reviewing the costs charged to investors;

b) in case of the existence of conflicts of interest, it ensures that the risk of damage to investors' interest will be prevented;

c) is clearly documented and periodically reviewed.

24. NCAs should supervise that within the pricing process developed by the management company, the elements referred to by paragraph 19) of Section 3) are addressed.

25. The outcome of the supervisory action in case of materialisation of undue costs charged to investors is expected to include an assessment of the possibility to request the following actions:

a) investor compensation, where allowed under the national provisions;

b) reduction of fees;

c) review of disclosure documents;

d) communication of good and poor practices by NCAs to market/stakeholders/press, which should assist in acting as a deterrent against managers charging undue costs to investors.