

Investment funds | Supervision of costs in UCITS and AIFs

Getting Started

Here with you today



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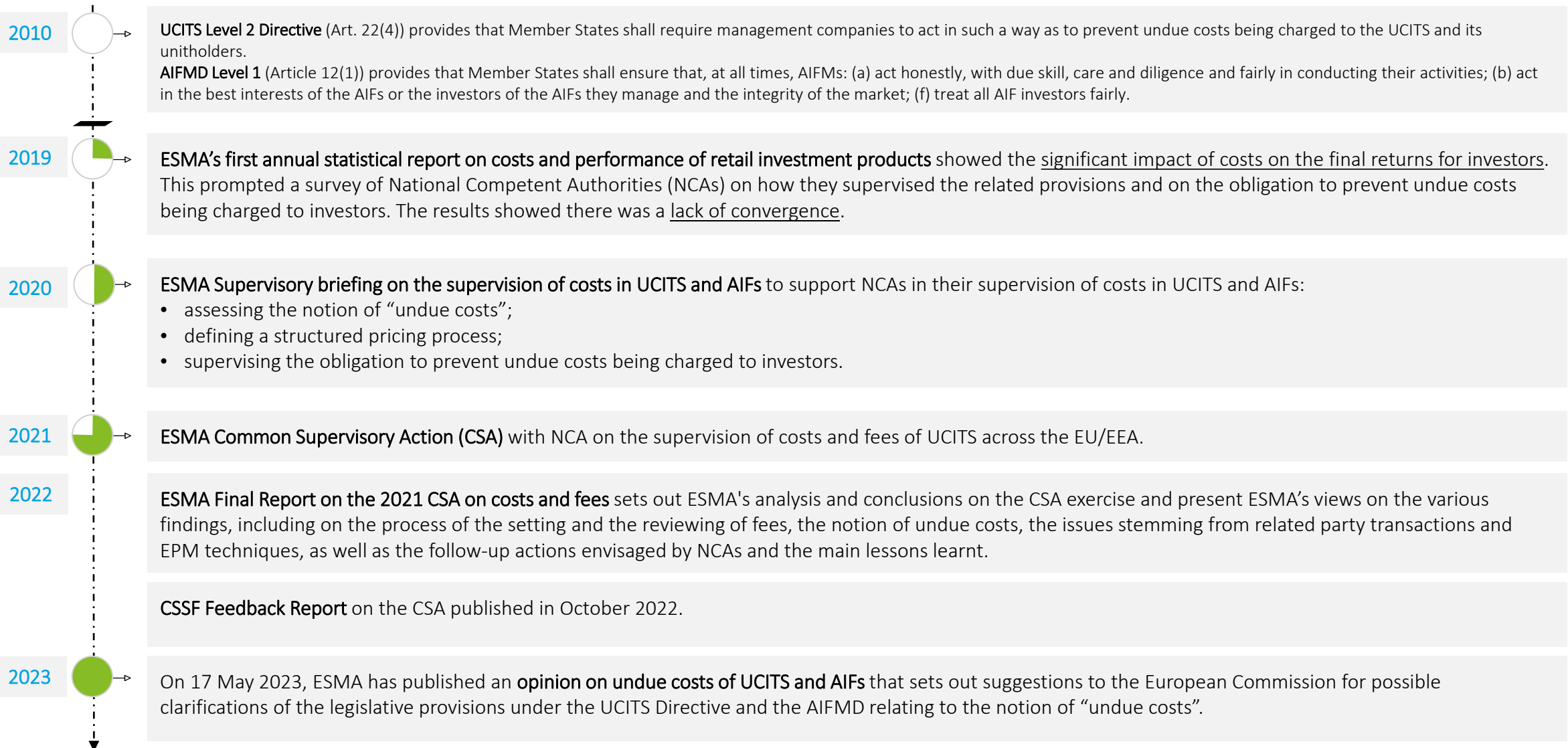
Agenda

- 1 Setting the Scene
- 2 The ESMA's Final Report on the 2021 CSA on costs and fees
- 3 2023 ESMA opinion on undue costs of UCITS and AIFs
- 4 Health Check
- 5 UK Value Assessment

Setting the Scene

Undue costs are on radar at least since 2010

In 2020 the ESMA issued guidelines relevant for all UCITS and AIFs



ESMA Supervisory briefing on the supervision of costs in UCITS and AIFs

Reminder of the 10 elements that shall compose the structured pricing process



- The ESMA defined 10 individual elements that shall typically be considered in the definition and supervision of costs in UCITS and AIFs.
- While certain elements concern all UCITS and AIFs, such as “No duplication of costs”, others impact only certain UCITS and AIFs, such as “Performance fees”.
- As long as a UCITS or an AIF is concerned by any of the elements, proper processes and documentations shall be established on the definition, implementation and supervision of those elements.

ESMA final report on the 2021 CSA on costs and fees

CSA exercise



CSA questionnaire #1

Most NCAs limited themselves to the CSA questionnaire and followed a desk-based approach
All NCAs responded to ESMA *except one*, and minimum sample coverage thresholds were (almost fully) met

CSA survey #2

CSA survey was addressed to NCAs in order to assess the impact of the exercise
All NCAs responded to ESMA *except two*

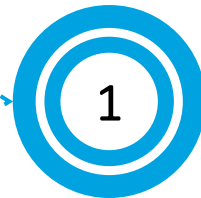
ESMA was satisfied with NCAs efforts and scope analysis



A reminder of the CSA questionnaire

Qualitative questions

Undue cost definition and controls
Fees level review and estimation
Monitoring of KIID and prospectus disclosures
Financial sustainability of the costs
Governance and procedures review



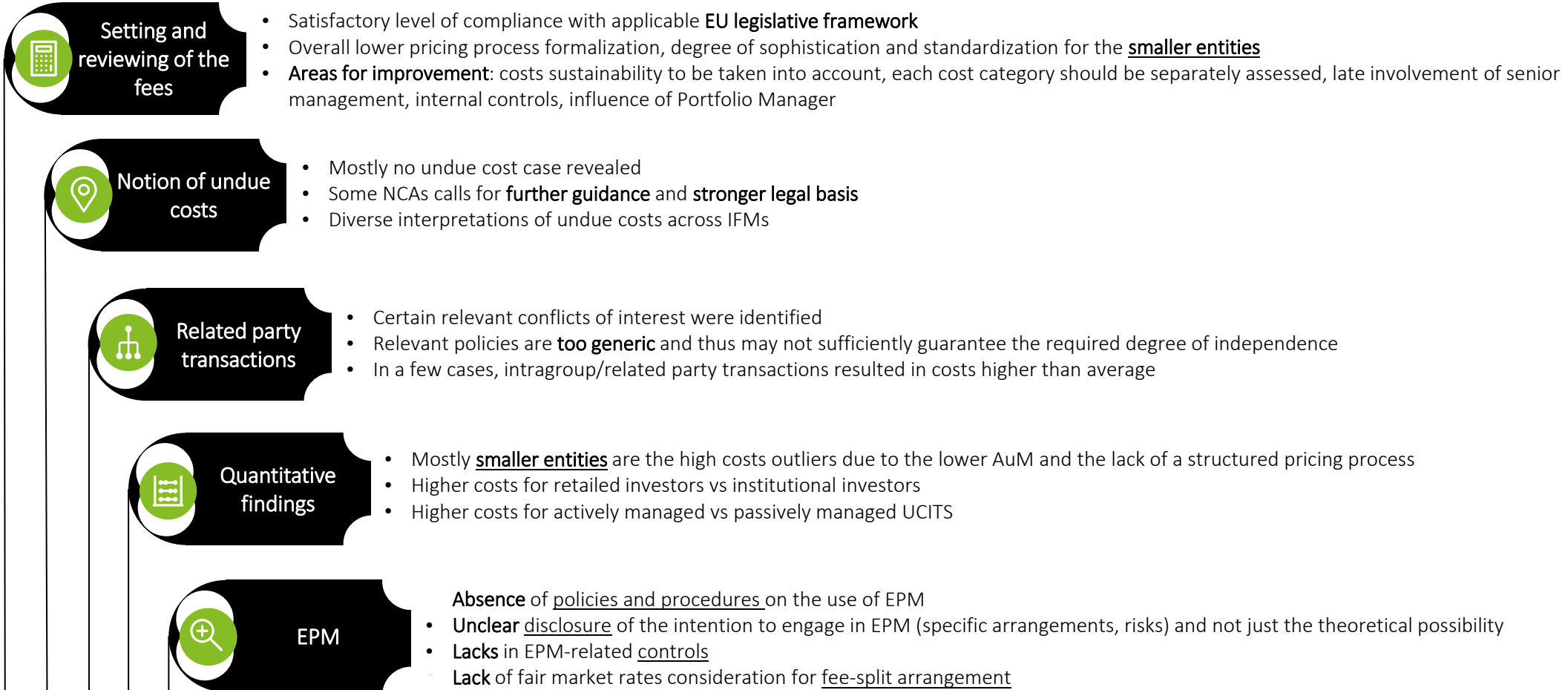
Quantitative data

Manco, Fund and Share Class definitions
Costs data at Share Class level
Historical data: returns, costs levels

The ESMA's Final Report on the 2021 CSA on costs and fees

ESMA final report on the 2021 CSA on costs and fees

Main Findings



ESMA final report on the 2021 CSA on costs and fees

Actions and Lessons



ESMA encourages NCAs to

- Perform **enhanced scrutiny** on the topic of costs and fees
- Consider **enforced actions** in the limited cases where a significant regulatory breach was identified
- Follow-up for all entities to have in place formalized and structured **pricing processes**
- Ensure that **fees are lowered**, and **investors compensated** in cases where undue costs were charged and/or costs were wrongly calculated



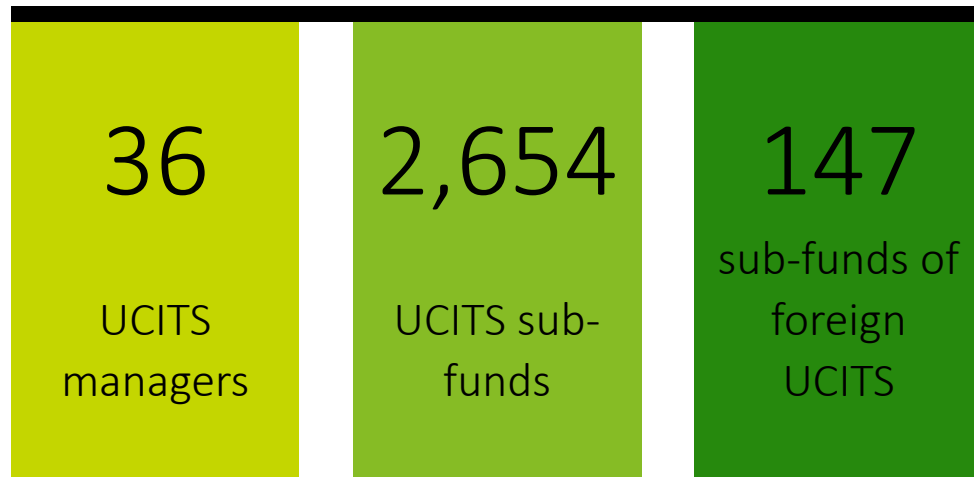
Key points for the IFMs

- The expectations set in the **supervisory briefing on the supervision of costs** shall be complied with
 - The **notion of undue** cost shall be primarily assessed against what should be considered the best interest of the investors
 - **Areas for improvement on the Pricing Process** were identified with a stronger focus on smaller funds / IFMs
- **EPM lacks** raised shall be resolved
- **Investors must be adequately compensated** if undue costs charged or calculation errors with detriment for investors

Results in Luxembourg from the 2021 CSA on costs and fees

Extracts from the CSSF Annual Report 2021

Sample composition



Results

2 cases of non-compliance:

- Article 5(b) of the CESR guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document;
- Inadequacy in the presentation of the reference value compared to the principles provided for in the document Q&A – Application of the UCITS Directive (ref. ESMA34-43-392).

Weaknesses noted:

- Pricing process lack of structure: definition of fee levels, regular review of these levels, decision-making process;
- Pricing process lack formalisation (in particular particularly for IFMs managing low AuM);
- Need to improve the procedural framework which should cover in detail all the organisational and operational arrangements linked to the use of EPM techniques and instruments.

CONCLUSION

Importance for all IFMs to implement and ensure a **structured and formalized pricing process**, in accordance with ESMA's recommendations.

Fees level must be **reviewed and controlled at least annually** taking into account the costs sustainability and impact on investor's return.

Importance of performing an **independent analysis** of the fee structures as soon as they are established.

2023 ESMA opinion on undue costs of UCITS and AIFs

2023 ESMA opinion on undue costs of UCITS and AIFs

The opinion sets out suggestions to the European Commission for possible clarifications of the legislative provisions under the UCITS Directive and the AIFMD relating to the notion of “undue costs”.

ESMA’s proposal is to take as a basis the supervisory expectations enshrined in the supervisory briefing. This would allow NCAs to build on the supervisory efforts already deployed to ensure a correct application of the briefing, without prejudice to more specific national requirements applicable to the fund or fund manager.

Key Messages

Further **specification of the notion of undue/due costs** in the [UCITS Directive](#) and [AIFMD](#) to bring clarity and a clearer legal basis.

Assessment of the **eligibility of the cost** that shall take into account:

- Annex VI Part 1.1 “List of costs” of the PRIIPs Regulation (including disclosure)
- Type of Fund, Investment Policy
- Nature and Amount
- Related party transactions

Annex VI Part 1.1 “List of costs” of the PRIIPs Regulation sets the costs into 3 categories:

- One-off costs: entry/exit cost, upfront cost
- Recurring costs: operational costs, service providers cost, transaction cost
- Incidental costs: performance fees, carried interest

Fund Managers shall **reimburse or indemnify** investors without undue delay where undue costs have been charged.

Compliance Function of the Fund Managers shall ensure that adequate **internal controls** and **reporting** to NCAs and investors of detected deficiencies.

2023 ESMA opinion on undue costs of UCITS and AIFs

AIFMD proposed additions

Art. 12

Notion of Undue Cost

4. Member States shall require AIFMs to ensure that the AIFs they manage or the investors in these AIFs are **not charged undue costs**.
5. Member States shall ensure that AIFMs assess **the eligibility of costs** by way of referring to the categories of costs set out under Annex VI Part 1.I of the Commission Delegated Regulation (EU) 2017/653, taking into account the investment policy of the AIF.
6. ESMA shall develop draft **regulatory technical standards** to:
- i. specify the circumstances in which costs should be considered as undue/not eligible, also taking into account the investment policy of the AIF, for the purpose of implementing paragraph 5; and
 - ii. specify under which conditions additional cost categories which are not included under Annex VI Part 1.I of the Commission Delegated Regulation (EU) 2017/653 are permissible.
- Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.

Pricing Process - define and monitor

7. Member States shall require AIFMs to develop and periodically **review a structured pricing process** that (i) clearly demonstrates that all charged costs are due and (ii) allocate clear responsibilities to the governing body of the AIFM for determining and reviewing the costs charged to investors.
8. Member States shall require AIFMs to ensure, as part of their pricing process, the following:
- (i) **due diligence** is performed and, upon request, made available to investors to ensure that all charged costs are equal to or better than market standards, taking into account the nature and type of the relevant service or activity;
 - (ii) in case of **related-party transactions**, conflicts of interest are appropriately identified, prevented, managed and monitored to avoid investor detriment, taking into account in particular the risk of the related party charging costs higher than market standards;
 - (iii) **costs do not exceed** the figures disclosed to investors in the pre-contractual documentation.
9. Member States shall require AIFMs **to reimburse or indemnify** investors without undue delay, where undue costs have been charged including cases where costs have been wrongly calculated to the detriment of investors.
10. Member States shall require AIFMs to ensure that their compliance function performs **ongoing monitoring and regular evaluations** of the adequacy and effectiveness of the measures, policies and procedures put in place to comply with the requirements set out in paragraphs 4 to 5 and 7 to 10 of this Article. Deficiencies detected by the compliance function and the actions taken or envisaged to address them shall be reported to the competent authority on an at least annual basis and disclosed to investors in the annual reports of the AIF.

Art. 4

“(ap) ‘**related-party transactions**’ means transactions with an investor, initiator, promoter, group entity or another entity with which AIFMs have close links or significant business relationships”

Art. 46

“(n) require the **timely reimbursement or indemnification** of investors where undue costs have been charged or costs including cases where costs have been wrongly calculated to the detriment of investors.”

2023 ESMA opinion on undue costs of UCITS and AIFs

UCITS Directive proposed additions

Notion of Undue Cost	Art. 14
Pricing Process - define and monitor	<p>3. Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unit-holders.</p> <p>4. Member States shall require management companies to assess the eligibility of costs by way of referring to <u>the categories of costs set out under Annex VI Part 1.I of the Commission Delegated Regulation (EU) 2017/653</u>, taking into account the <u>investment policy</u> of the UCITS.</p> <p>5. ESMA shall develop draft regulatory technical standards to:</p> <ul style="list-style-type: none">i. specify the circumstances in which costs should be considered as undue/not eligible, also taking into account the investment policy of the UCITS, for the purpose of implementing paragraph 4; andii. specify under which conditions NCAs may authorise on a case-by-case basis additional cost categories which are not included under Annex VI Part 1.I of the Commission Delegated Regulation (EU) 2017/653. <p>Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010.</p> <p>6. Member States shall require management companies to develop and periodically review a structured pricing process that (i) clearly demonstrates that all charged costs are due and (ii) allocates clear responsibilities to the management body of such management companies for determining and reviewing the costs charged to investors.</p> <p>7. Member States shall require management companies to ensure, as part of their pricing process, the following:</p> <ul style="list-style-type: none">(i) due diligence is performed and, upon request, made available to investors to ensure that all charged costs are equal to or better than market standards, taking into account the nature and type of the relevant service or activity;(ii) in case of related-party transactions, conflicts of interest are appropriately identified, prevented, managed and monitored to avoid investor detriment, taking into account in particular the risk of the related party charging costs higher than market standards;(iii) costs do not exceed the figures disclosed to investors in the pre-contractual documentation; <p>8. Member States shall require management companies to reimburse or indemnify investors without undue delay, where undue costs have been charged including cases where costs have been wrongly calculated to the detriment of investors.</p> <p>9. Member States shall require the compliance function to perform ongoing monitoring and regular evaluations of the adequacy and effectiveness of the measures, policies and procedures put in place to comply with the requirements set out in paragraphs 3 to 4 and 6 to 8 of this Article. Deficiencies detected by the compliance function and the actions taken or envisaged to address them shall be reported to the competent authority on at least an annual basis and disclosed to investors in the annual reports of the UCITS.</p>
Art. 2	“(u) ‘ related-party transactions ’ means transactions with an investor, initiator, promotor, group entity or another entity with which management companies have close links or significant business relationships.”
Art. 98	“(n) require the timely reimbursement or indemnification of investors where undue costs have been charged including cases where costs have been wrongly calculated to the detriment of investors.”

Health Check

ESMA Supervisory briefing on the supervision of costs in UCITS and AIFs

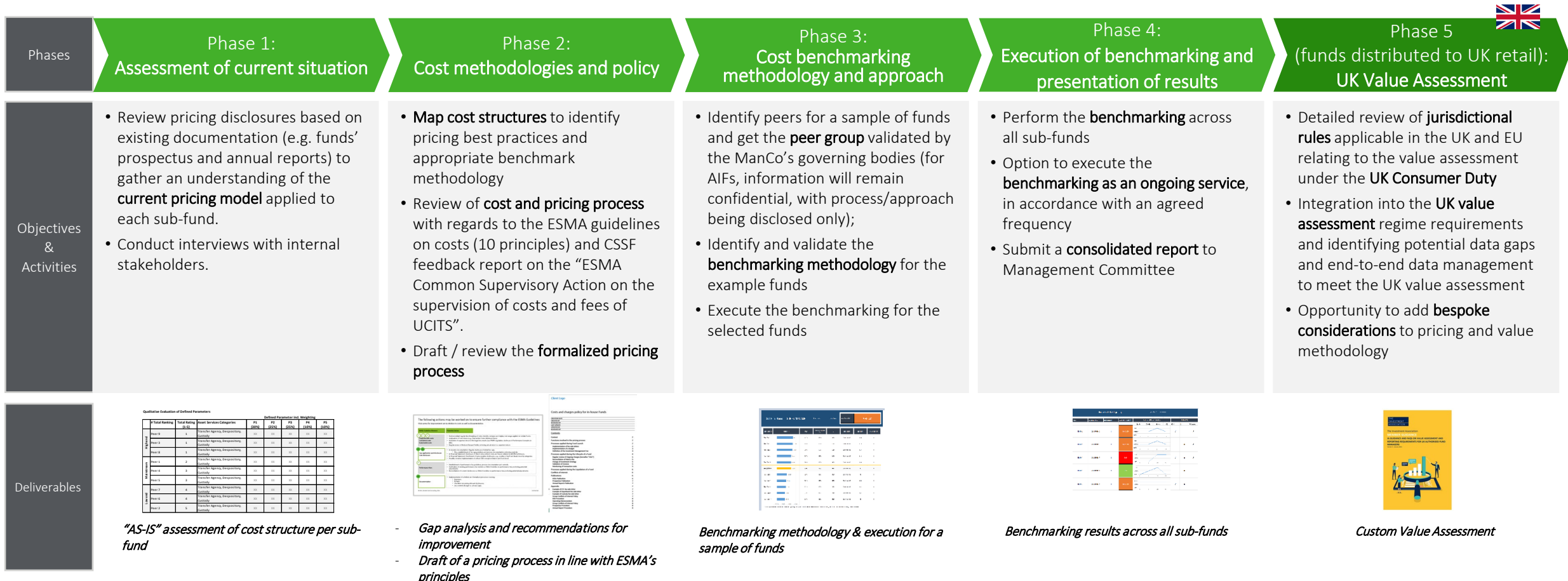
Attention points observed during the different engagements on the 10 elements highlighted by the ESMA

1 Valid costs	<ul style="list-style-type: none">➤ Lack of control on proper implementation of Fee arrangements with service providers.➤ Lack in holistic fee budget at ManCo level.➤ No regular review of budget/accruals.	6 No duplication of costs	<ul style="list-style-type: none">➤ Generally, no major cost duplication identified.
2 Proportionate costs	<ul style="list-style-type: none">➤ Lack of documentation/guidelines of costs applied to funds with similar investment strategies and characteristics.➤ Absence of Benchmarking with non-Group Funds.	7 Cap on fees application and disclosure	<ul style="list-style-type: none">➤ Fee caps are applied on certain Share Classes/Sub-Funds, but no reference is made in the Fund literature.
3 Consistent costs	<ul style="list-style-type: none">➤ Monitoring processes not properly documented.➤ Sub-funds may show increased TERs which is as such not always justifiable with the complexity of those Sub-funds.	8 Performance fees	<ul style="list-style-type: none">➤ Lack of performance fee details in the Fund literature.➤ Lack of performance fee guidelines/procedures.
4 Sustainable costs	<ul style="list-style-type: none">➤ No indicative performance is mentioned in the Sub-Funds' literature.➤ Actual Sub-Fund's performance is not consistent with the Risk and Reward Profile throughout the entire Sub-Fund range.➤ No regular review and update of the Risk and Reward Profile included in the Fund literature.	9 Costs disclosure	<ul style="list-style-type: none">➤ Disclosure around the usage of EPM techniques too generic.➤ Lack of policies and procedures around the actual use of EPM techniques.➤ Incomplete disclosure of costs arising from EPM techniques.➤ Incomplete disclosure in relation to remuneration.➤ Long list of potential costs in Funds' Prospectuses.
5 Fair treatments of investors	<ul style="list-style-type: none">➤ Invoices are split by number of Funds/Sub-Funds/Share Classes rather than by AUM.➤ Lower fees for institutional investors compared to retail investors.	10 Reliable and documented data costs	<ul style="list-style-type: none">➤ Missing documentation in relation to the overall pricing policy and/or in relation to related processes.➤ Existing documentation is not comprehensive and the formalization level is low.

Deloitte's Health Check offering for risk mitigation measures

Real added value to Management through a structured and profound approach

The **10 elements** highlighted by the ESMA should be addressed through a **structured pricing process periodically reviewed** by the Management Companies of UCITS and AIFs. As Deloitte we can support the ManCos to **develop a clear understanding of the ESMA requirements** and provide a view on market practices, supporting a **review of the fee policy and procedures** as well as the **documentation and implementation**.



UK Value Assessment

UK's approach to "Value for Money"

A comparison of both regimes – same goal, different approach



Supervision of costs

- Focus on **pricing process'** assessment based on the level of the fund
- **Regular assessment** with close involvement of staff across the firm
- **No (public) reporting** required
- 3 elements to assess:
 - Cost (notion "undue cost")
 - Net return of the fund
 - Quality of service



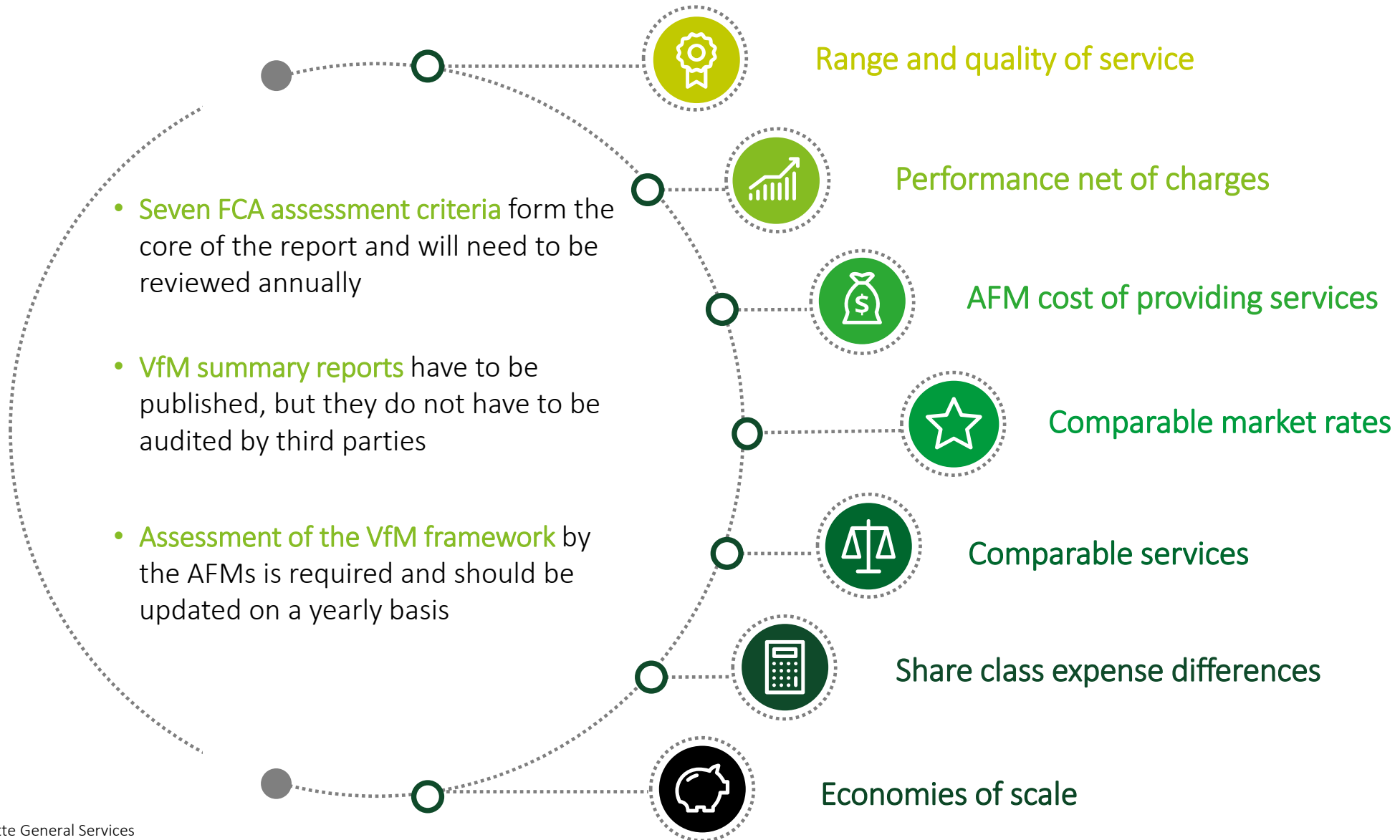
Value for Money

- Focus on **governance process'** assessment based on the level of the fund and its fund manager
- **Regular assessment** with close involvement of staff across the firm
- **Report** about assessment results to be published
- 3 elements to assess:
 - Cost
 - Performance against objective
 - Quality of service

best interest of the fund and its investors

Criteria to assess Value for Money

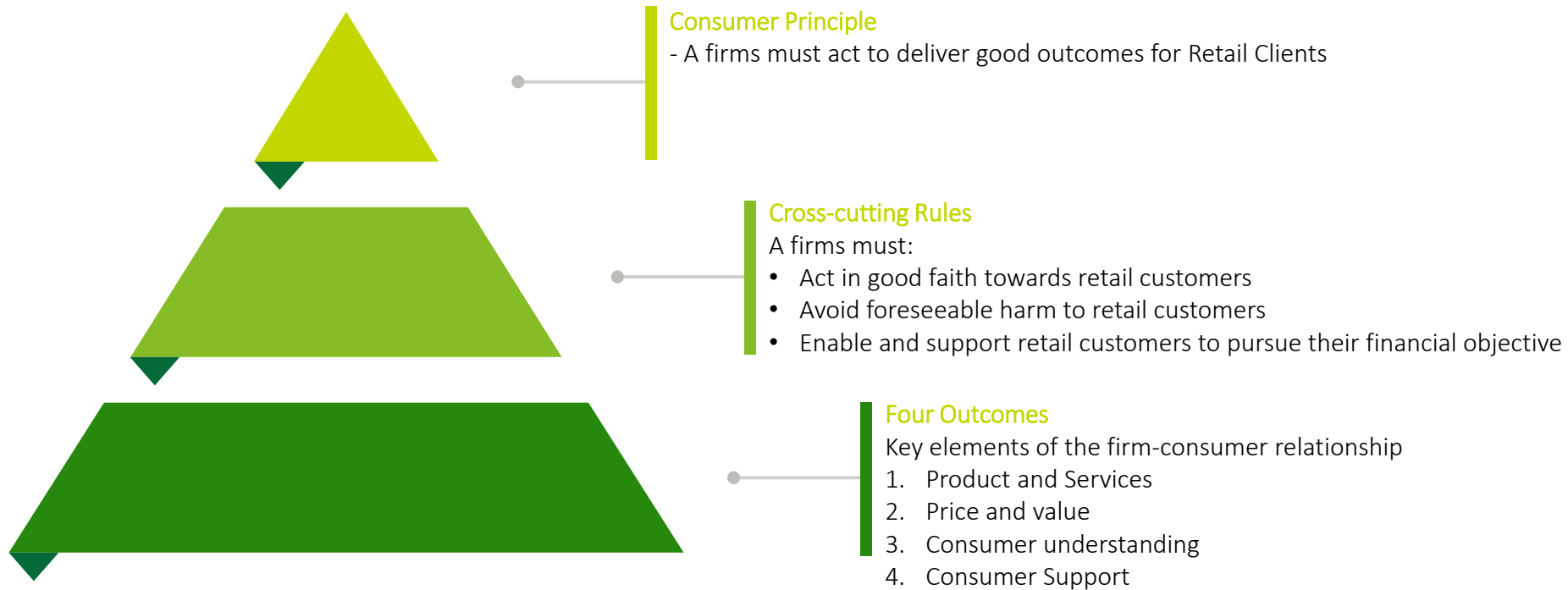
FCA has defined 7 quantitative and qualitative self-assessment criteria



UK Value Assessment Report

FCA Consumer Duty – Impact for Luxembourg domiciled funds

UK distributors of non-UK products and services must take all reasonable steps to understand the product or service, the target market it would serve and the value it provides in order to ensure it will be distributed appropriately



Appendix

ESMA Supervisory briefing on the supervision of costs in UCITS and AIFs

Management Companies of UCITS AND AIFs should develop and periodically review a structured pricing process addressing **10 elements** highlighted by ESMA

1 Valid costs
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);

2 Proportionate costs
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;

3 Consistent costs
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);

4 Sustainable costs
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;

5 Fair treatments of investors
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;

6 No duplication of costs
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;

7 Cap on fees application and disclosure
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);

8 Performance fees
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 fees;

9 Costs disclosure
whether all costs are clearly disclosed to investors in line with applicable EU rules (AIFMD, PRIIPs and UCITS), as well as any additional rule applied at national level;

10 Reliable and documented data costs
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.

Questions?

Next Link'n Learn webinar

Date: 18/10/2023

**Topic: Banking | Distributed
Ledger Technology, Tokenization
and Digital Assets**





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