

Investment funds | Undue Cost and UK Value Assessment for Luxembourg UCITS/AIF

Getting Started

Here with you today



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Agenda

- 1 ESMA Undue Costs
- 2 UK View: OFR & Value Assessment
- 3 Health Check
- 4 Q&A

ESMA Undue Costs

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.

2023 ESMA Opinion on Undue Costs of UCITS and AIFs

ESMA sets out suggestions for possible clarifications of the legislative provisions under UCITS D and the AIFMD relating to the notion of “undue costs”

ESMA Opinion – Key Messages

- Further **specification of the notion of undue/due costs** in the **UCITS Directive** and **AIFMD** to bring clarity and a more precise legal basis.
- Assessment of the **eligibility of the cost** that shall take into account:
 - Annex VI Part 1.I “List of costs” of the PRIIPs Regulation (including disclosure)
 - Type of fund, investment policy
 - Nature and amount
 - Related party transactions
- **Annex VI Part 1.I “List of costs” of the PRIIPs Regulation** classifies the costs to be disclosed 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 adequate **internal controls** and **reporting** to NCAs and investors of detected deficiencies.

ESMA Opinion – Proposed Additions to UCITS D and AIFMD

The regulations, regarding the assessment of undue costs and the development of regulatory standards of AIFMD and UCITS Directive, are **analogous but tailored to the different investment structures**.

Notion of Undue Cost

AIMD
Art.12

UCITS D
Art.14

- **Prevent excessive/ undue costs** to be charged.
- **Evaluate costs** using specified categories from **Annex VI Part 1**, considering the AIF’s / UCITS’ investment strategy.
- **ESMA will create RTS to identify excessive or ineligible costs** based on AIF/UCITS investment policies and allow additional cost categories.

Pricing Process – define & monitor

Management companies in Member States must:

- Develop and regularly review a **clear pricing process** ensuring legitimacy of charged costs and assigning responsibilities to their management body.
- **Guarantee** through this process that **charged costs are at or better than market standards**, considering service nature, and manage conflicts of interest in related-party transactions.
- **Ensure charged costs align with disclosed figures** and promptly reimburse investors for undue charges or miscalculations.
- **Maintain ongoing monitoring by the compliance function** and report deficiencies and actions taken to the competent authority annually, disclosed in UCITS' annual reports.

Redefinition of concepts

AIFMD
Art.4 & 46

UCITS D
Art.2 & 98

- **Related-party transactions** means transactions with an investor, initiator, promoter, group entity or another entity with which management companies / AIFMs have close links or significant business relationships.
- 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.

Retail Investment Strategy - Value for Money

Several value and cost related elements of the Retail Investment Strategy Omnibus Directive have generally been accepted by the Council



European Parliament's position

European Council's position

Benchmarks

- 1 ESMA and EIOPA would develop Union supervisory benchmarks that are **integrated in the manufacturer's and distributor's product governance process.**
- 2 The benchmark data shall be made public.
- 3 Access to the **data will be at cost.**
- 4 Overall, the product governance process is to be strengthened with a peer group.

- 1 ESMA and EIOPA would develop Union supervisory benchmarks that **would be used as a supervisory tool only**, which would be developed in a way that helps national competent authorities detect investment products that fail to offer value for money
- 2 The benchmark data shall only be made public after a test demonstrating their relevance
- 3 Access to the **data will be at cost.**
- 4 Overall, the product governance process is to be strengthened with a peer group.
- 5 **Opt-in for manufacturers/distributors** to use benchmarks instead of peer groups, once benchmarks are published.
- 6 Manufacturers and distributors would compare their investment products to a peer group of other similar investment products in the EU to establish whether the investment product offers value for money.
- 7 There will be **an IBIP exemption from applying** EU benchmarks where the national benchmark system is **in place before 1 July 2024.**
 - Members allowed to decide to continue to use those national benchmarks but only in relation to insurance-based investment products.

Undue costs

- 1 Manufacturers and distributors are obliged to determine whether costs related to financial products are justified and proportionate with regard to their performance, other benefits and characteristics, their objectives and, if relevant, their strategy based on an annual (at a minimum) value-assessment conducted primarily by the manufacturer.
- 2 If undue costs have been charged, including where costs have been miscalculated to the detriment of investors, investors should be compensated.

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Operational consideration for undue costs regulation implementation

Path towards proper pricing governance and process

Fund managers need to implement proper pricing governance and framework and periodically verify that fees charged to the funds are in line with market practice



Pricing framework

- **Pricing policy** based on a **risk-based** approach depending on party involved / fee charged
- **Pricing governance** and **pricing grid** definition
- **Fee/cost monitoring** process
- **Escalation** process



Fee mapping

Fee mapping covering:

- **Identification** of all fees directly / indirectly charged to investors
- **Fee levy and level** identification
- Mapping of source of data
- **Control** (duplication) and **classification** (nature, counterparty, budgeted vs. actual)



Ongoing monitoring and justification

- **Information assessment** and **performance of cost controls**
- **Ensure alignment of fees charged to the funds/SPVs with market price** (e.g. via fee benchmarking)
- **Ensure sustainability of fee structure vs. expected return** of product
- **LP communication** and justification

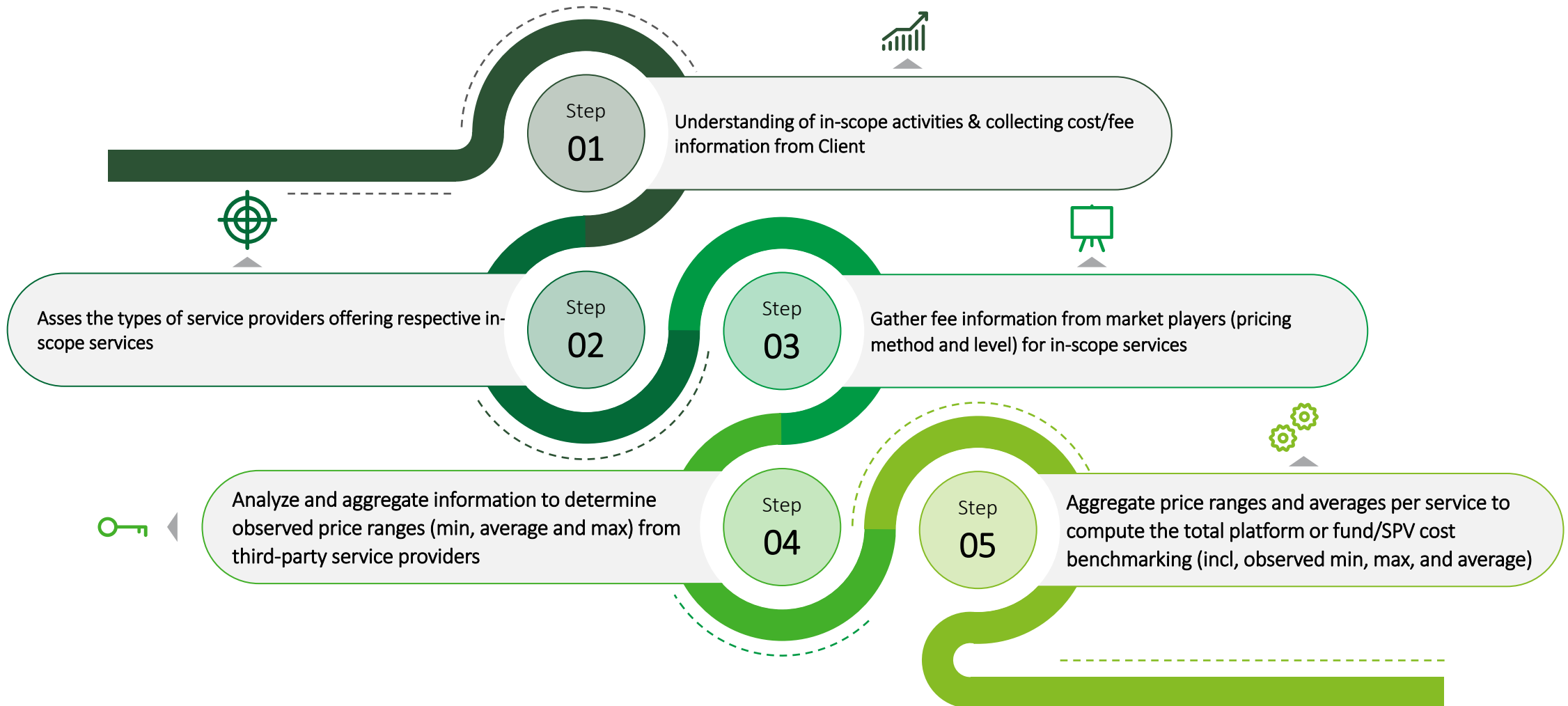
Observed challenges and pitfalls when revisiting cost allocation strategy

Cost allocation model shall clearly consider legal and regulatory constraints, operational implementation of each possible model and support the justification of the level of fees recharged

	Contractual and regulatory restrictions	Pricing model implementation	Pricing level justification
Observed challenges	<ul style="list-style-type: none">• LPA may restrict the scope of activities to be recharged by the manager on top of management fees• The issue shall be anticipated but might require investor (and/or LPAC) approval where the LPA's language does not permit it• Regulatory frameworks, while generally not defining permissible scope of recharged activities, do require control and governance framework, investor transparency and economic justification of the model	<ul style="list-style-type: none">• Different pricing models (e.g. bps on AuM, flat annual fee, event-triggered fee, fully charged costs plus margin, hourly rates, etc.) are observed on the market, with generally a mixed model approach• Each model requires the right infrastructure to efficiently track relevant metrics and produce invoicing and reporting and define the right level of granularity of metrics / pricing units• Ensure alignment of implemented pricing strategy over time considering the evolution of market prices and models	<ul style="list-style-type: none">• Recharging internal costs shall not be considered excessive or unjustified remuneration• Different benchmarking approaches may be selected with most data points not being publicly available in the Alternative space
Solutions	<ul style="list-style-type: none">• LPA analysis• For existing programs, potential commercial discussions and legal approval by existing investors• Adequate governance and control framework in place	<ul style="list-style-type: none">• Consider pricing models based on existing data sources, IT tools and cultural preference of the organization• Analyze potential pricing models by nature of activity and/or by business lines	<ul style="list-style-type: none">• Set clear rules (incl. limits) to the amount that can be recharged• Periodically benchmark fees being recharged to a specific program to demonstrate that the level of fees is in line with limits and market practice / prices

Deloitte's proven method for executing costs/fees benchmarks

Our approach for conducting benchmarks remains constant whether it is done at platform, fund or SPV level



UK View: OFR & Value Assessment

Overseas Funds Regime ('OFR') – Timeline and Impact

In July 2024, FCA published its final rules for OFR (PS24/7); overseas fund operators are required to apply in designated landing slots specified by the FCA

What is the OFR?

- The new recognition regime will replace the Temporary Marketing Permissions Regime (TMPR) to **allow overseas funds to be marketed to UK retail investors** where the HM Treasury (HMT) has recognised the jurisdiction equivalent.
- So far, the **HMT has granted equivalence for EEA UCITS funds**, so the scope of OFR only applied to these funds. It may be extended to other schemes in the future.

What firms are impacted?

- **EEA UCITS and the management companies** of such funds that currently market to UK investors or plan to do so
- **Distributors of EEA UCITS** marketed to UK investors
- Investment advisers
- Firms approving financial promotions on behalf of EEA UCITS
- Firms providing facilities to UK investors in EEA UCITS



Over 8,000 EEA UCITS funds are marketed into the UK under the current TMPR regime

Application Timeline

September 2024

Landing slot for new (i.e. non-TMPR) schemes

October 2024

Landing slot for standalone TMPR schemes

November 2024-2026

Landing slots for TMPR umbrella schemes in alphabetical order of fund operator from November onwards

Landing slots will be in a 3-month window assigned by the FCA, who will respond with a decision within 2 months.

OFR – Key Challenges and Next Steps

Unlike the previous EU passporting regime, OFR recognition requires substantial time and effort, with a detailed and lengthy application process beyond a regulatory notification regime

Manufacturers of EEA UCITS



The requirement to notify the FCA of fund changes has been amended from 30 days in advance to 'as soon as reasonably practical'.



The FCA has confirmed that whilst applications are at umbrella level, it has the ability not to recognise all of the sub funds if they do not meet the OFR requirements.



The FCA's powers to refuse recognition, revocation and public censure remain given the focus on UK customers' best interests.



Strategic consideration required for the launching of new sub-funds – Firms may add newly authorised sub-funds to the umbrella up to 2 weeks prior the opening of the allocated landing slot or must wait until the umbrella has been recognised by the FCA.



The UK Government intends to consult on applying the UK's Sustainability Disclosure Requirements (SDR) and labelling regime to OFR funds.

Downward Distribution Impact



Whilst the HMT's equivalence determination has not imposed the requirement for overseas funds to produce a UK-style value assessment, some UK distributors may potentially expect this in order to meet their own obligations under the Consumer Duty.



Where funds choose not to become recognised under the OFR, UK distributors may potentially impose restrictions on top-ups by existing UK investors.



EEA funds not recognised under OFR may potentially find that their existing UK customers divest e.g. if the fund loses its ISA eligibility.



UK distributors may not always have ready access to OFR recognition data to validate a fund's recognition status, meaning additional engagement with UK distribution network will be required.

Leveraging Equivalence



Overseas firms looking to apply for recognition under the OFR will need to consider the **wider impact of UK distribution as part of the business strategies** and the extent their funds align with fair value requirements, so they don't fall short of the UK's standards.

- **Fair value** – The FCA will assess whether overseas funds represent 'fair value' to UK investors. UK distributors may potentially also request additional qualitative information and collateral to satisfy their own obligations.
- **Look for outliers** – Firms should consider any outliers in their fund range and how they demonstrate fair value of costs and fees.
- **Leveraging the EU undue costs regime** – Firms should consider their current undue cost frameworks and the extent to which fair value standards are can be demonstrated. To future proof these frameworks, firms should consider how UK expectations could be incorporated.

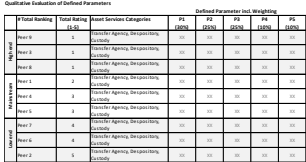
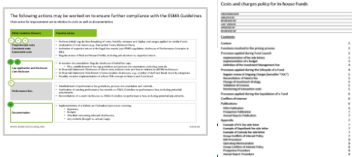


Health Check

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**.

Phases	Assessment of current situation	Cost methodologies and policy	Cost benchmarking methodology and approach	UK Value Assessment (funds distributed to UK retail)
Objectives & Activities	<ul style="list-style-type: none">Review pricing disclosures based on existing documentation (e.g. funds' prospectus and annual reports) to gather an understanding of the current pricing model applied to each sub-fund.Conduct interviews with internal stakeholders.	<ul style="list-style-type: none">Map cost structures to identify pricing best practices and appropriate benchmark methodology.Review of cost and pricing process with regards to the ESMA guidelines on costs (10 principles) and CSSF feedback report on the "ESMA Common Supervisory Action on the supervision of costs and fees of UCITS".Draft / review the formalized pricing process.	<ul style="list-style-type: none">Identify peers for funds and get the peer group validated by the ManCo's governing bodies.Identify and validate the benchmarking methodology for funds.Execute benchmarking for funds.	<ul style="list-style-type: none">Detailed review of jurisdictional rules applicable in the UK and EU relating to the value assessment under the UK Consumer Duty.Integration into the UK value assessment regime requirements and identifying potential data gaps and end-to-end data management to meet the UK value assessment.Opportunity to add bespoke considerations to pricing and value methodology.

Deliverables	<div></div> <p><i>"AS-IS" assessment of cost structure per sub-fund</i></p>	<div></div> <ul style="list-style-type: none">Gap analysis and recommendations for improvementDraft of a pricing process in line with ESMA's principles	<div></div> <p><i>Benchmarking methodology & execution for a sample of funds</i></p>	<div></div> <p><i>Custom Value Assessment</i></p>
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[Find out more](#)

[The UK Consumer Duty Value Assessment Vs EU Undue Costs Rules... finding the leverage](#)

Questions?

Next Link'n Learn webinar

Date: 16/11/2024

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





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