Fund cost supervision: the interplay between undue costs and transfer pricing

Costs, whether annual management fees or operating and administrative expenses, are critical to assessing the benefits of an investment fund. However, while the UCITS and AIFMD frameworks require that investors are not charged with undue cost, they do not unequivocally define this concept.



From mid-2020, regulators began providing harmonized guidance on assessing undue costs and related obligations, the latest of which was the Commission de Surveillance du Secteur Financier's (CSSF) 20 October 2022 publication (hereinafter the "Feedback Report").[1] This consisted of feedback on the European Securities and Markets Authority's (ESMA) Common Supervisory Action (CSA) about the supervision of UCITS costs and fees. The CSSF provided observations and comments regarding undue costs and addressed issues stemming from related party transactions.

This article summarizes the relevant regulatory framework and related tax/transfer pricing aspects of costs charged between related parties.

The CSSF Feedback Report

As the UCITS and AIFMD framework lacks a common definition of undue costs, the notion has been interpreted differently at the EU Member State level. The first harmonization wave came with the June 2020 ESMA Supervisory briefing, setting expectations and compliant practices for cost-related provisions of UCITS and AIFMD.[2] This document fixed criteria for management companies to assess undue costs and supervise the obligation to prevent UCITS and AIF investors being charged these costs, notably through a structured pricing process.

Soon after, ESMA and the national competent authorities (NCAs) launched a CSA in January 2021, aimed at greater convergence in the supervision of costs. A common methodology was developed to assess whether market participants effectively adhered to those rules in practice. In Luxembourg, this prompted the CSSF to create a dedicated questionnaire targeted at 36 management companies and covering a sample of 2,654 UCITS sub-funds.

In May 2022, ESMA published a detailed assessment of this exercise's findings in a Final Report.[3] It included the process of setting and reviewing fees, the notion of undue costs, the issues stemming from related party transactions and the costs related to Efficient Portfolio Management (EPM) techniques, as well as the follow-up actions envisaged by NCAs and the main lessons learned.

While the results were deemed "satisfactory", the Final Report highlighted significant shortcomings and needs for improvement in certain key areas. While it is still unclear if these findings will trigger any follow-up policy work, costs and fees are clearly a supervisory priority, given their relevance to investor protection.

The Feedback Report's concrete learning points and guidance for ensuring compliance can be summarized in five categories:
1. The pricing process must be formalized, enhanced and sufficiently independent from the portfolio manager.
2. A clear definition of undue costs can be assessed against 10 elements detailed in the ESMA 2020 Supervisory briefing.
3. Conflict of interest must be more thoroughly identified, especially regarding related party transactions, to be correctly mitigated.
4. The calculation of Ongoing Charges must be reviewed and documented to ensure it is accurate and transparent for investors.
5. Costs charged to funds must be reviewed periodically, especially for low assets under management (AuM) funds, to avoid charging much higher fees than market industry standards.

The Feedback Report requires all investment fund managers (IFMs) to perform a comprehensive compliance assessment by Q1 2023. This must include EPM activities, particularly the periodic involvement of compliance and internal audit functions, to verify they comply with applicable governance and control mechanism regulations.

Key success factors for this exercise include robust documentation and formalization, automatized and standardized approaches to enable effective supervision, and strong independence from portfolio management. Finally, IFMs with products marketed to UK retail investors should not miss the opportunity to tackle undue costs together with the UK Consumer Duty and perform a value assessment.

Related party transactions under scope and their transfer pricing implications

The CSSF devotes paragraph 2.3 of the Feedback Report to observations regarding related-party transactions to ensure that "adequate conflicts of interest policy and comprehensive conflicts of interest register are in place to ensure an effective mitigation of conflicts of interest in related-party transactions".[4]

Although the Feedback Report focuses on preventing and mitigating conflicts of interest, there are also potential transfer pricing implications stemming from these transaction types. Generally, IFMs would mainly expect scrutiny on tax matters to come from tax authorities. However, they must also closely monitor the risk of regulators challenging transfer pricing related aspects regarding intra-group arrangements, given the CSSF's growing attention on tax and transfer pricing aspects in recent circulars. For example, Circular 22/806 contains a list of aggravated tax fraud indicators for regulated IFMs, while CSSF Circular 20/744 on Outsourcing arrangements explicitly references the arm's length principle for arrangements between related parties.

Therefore, if costs are charged to the fund by a related party within the meaning of Art. 56 Luxembourg Income Tax Law (LITL), IFMs must not only assess whether the costs are "due" and in line with the Feedback Report's guidance, but also whether the fees charged are at arm's length. The latter must be assessed in light of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines), which broadly require a two-step analysis:[5]

I. Accurate delineation and recognition of the transaction

Under the Feedback Report, IFMs must assess the nature of the charges to understand whether the costs fall under the definition of undue costs. This requirement is linked with usual transfer pricing considerations for intra-group services/costs, where companies must analyze the need for a given intragroup service and if it provides the recipient with a benefit (i.e., the so-called "benefit test" under paragraph 7.6-7.11 of the OECD Guidelines).

Failing the benefit test disallows the tax deductibility of related costs, which may have different implications depending on whether the fund is tax transparent or not. The benefit test and the Feedback Report's requirements, each with their own tax and regulatory implications, clearly overlap in their goal to ensure the need, consistency and appropriateness of the costs charged.

Once the accurately delineated transaction is recognized, the transfer pricing analysis focuses on the pricing.

II. Arm's length pricing

Depending on facts and circumstances, different transfer pricing methods can be applied to price the related party transaction to ensure the "conditions in the commercial and financial relations between associated enterprises are arm's length"[6] in line with OECD Guidelines.

The most appropriate methodology largely depends on the result of a dedicated comparability and functional analysis. Generally, if independent comparable transactions can be identified, the Comparable Uncontrolled Price (CUP) method may be used. Otherwise, other methods (e.g., the "Cost Plus" method or the "Profit Split" method) can be appropriate.

Further, this assessment should be done on a case-by-case basis depending on the specific circumstances, and complemented by a benchmarking exercise for each relevant related party transaction. This process must accommodate the needs and expectations of both transfer pricing and regulatory requirements. Regarding the latter, the CSSF's Feedback Report requires costs to be "proportionate compared to market standards", which suggests similarities with the arm's length principle, as both aim to ensure the costs charged are reasonable.[7]

Having a benchmark that supports the transaction as market conforming is particularly relevant for costs charged to smaller funds. Under the Feedback Report, IFMs are required to assess the level of costs associated with their low AuM funds to ensure the fees charged are reasonable, "otherwise these costs will have to be considered as 'undue'."[8]

Conclusion

Regulatory and tax/transfer pricing aspects are becoming increasingly interconnected and complex, especially given financial regulators' growing interest in related party transactions. Therefore, IFMs must not only consider the regulatory implications of the Feedback Report, but also potential tax and transfer pricing considerations when costs are charged between related parties. Failing to do so may trigger regulatory and tax consequences that should not be overlooked.

Enrique HERCE-MARCHESI, Partner
Sergio VENTI, Partner
Serena PICARIELLO, Manager

Deloitte Luxembourg

The authors would like to thank Vanessa Leuters and Auguste Stoker for their contribution to this article.

1) CSSF, CSSF feedback report on ESMA Common Supervisory Action on the Supervision of Costs and Fees of UCITS, October 20, 2022.
2) ESMA, Supervisory briefing on the supervision of costs in UCITS and AIFs, June 4, 2020.
3) ESMA, Final Report on the 2021 CSA on costs and fees, May 31, 2022.
4) CSSF, CSSF feedback report, p. 8.
5) OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, January 20, 2022.
6) OECD, OECD Transfer Pricing Guidelines 2022, par. 2.3.
7) CSSF, CSSF feedback report, p. 8.
8) Ibid, p. 10.

LuxSE becomes first European exchange to sign Abu Dhabi Sustainable Finance Declaration

Ahead of its hosting of COP28 in December, the United Arab Emirates (UAE) zoomed in on sustainable finance and welcomed the Luxembourg Stock Exchange and other companies as new signatories to the Abu Dhabi Sustainable Finance Declaration.

from left to right: Arnaud Delestienne, Director of International Capital Markets and Member of the Executive Committee at LuxSE, Hamad Sayah Al Mazrouei, CEO of ADGM Registration Authority, Mercedes Vela Monserrate, Head of Sustainable Finance at ADGM and Carlo Houblie, Commercial Director at LuxSE © LuxSE

During the Abu Dhabi Sustainable Finance Forum hosted by Abu Dhabi Global Market on 19 January 2023, the Luxembourg Stock Exchange (LuxSE) signed the Abu Dhabi Sustainable Finance Declaration. LuxSE is the first European exchange to officially join the mission of contributing to the growth of sustainable finance and sustainable development in the region.

"Given the pioneering role that the Luxembourg Stock Exchange is playing in advancing the sustainable finance agenda, we are pleased to join forces with other leading market players and work together to increase the focus on sustainable finance in the United Arab Emirates. Climate change is a global challenge which requires a joint, global response. The transition to a low-carbon economy needs to happen everywhere, and we believe a sustainable finance market can help the United Arab Emirates in its efforts to diversify its economy and achieve its ambitious goal of net zero by 2050," said Arnaud Delestienne, Director of International Capital Markets and Member of the Executive Committee at LuxSE, who attended the Abu Dhabi Sustainable Finance Forum.

Strengthening green finance in UAE

The Abu Dhabi Sustainable Finance Declaration, launched in 2019 by the Abu Dhabi Global Market (ADGM), a leading international financial centre located in Abu Dhabi, is sponsored by the Ministry of Climate Change and Environment, the Central Bank and the Securities & Commodities Authority in Abu Dhabi.

It aims to strengthen the sustainability footprint of UAE and increase the depth and quality of green finance products in Abu Dhabi – reflecting UAE's Vision 2030 and Green Agenda. This fifth round of signatories to the Declaration brings the total number of signatories from across the globe to 117 and includes leading banks, asset managers, financial services providers and other institutions active in the field of sustainability and sustainable finance.

The global pathway to net zero

In recent years, LuxSE and its platform exclusively dedicated to sustainable finance – the Luxembourg Green Exchange (LGX) – has placed a strong, strategic emphasis on its role in helping issuers in both developed and emerging economies enter and flourish the realm of sustainable finance.

Currently displaying more than 1,500 sustainable bonds from 260 issuers in 50 countries raising a total of EUR 830 billion for sustainable development across the world, LGX helps new issuers in the process of issuing sustainable bonds through initiatives such as the LGX Academy and LGX Assistance Services.