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# ESMA issues guidance on 'undue cost' requirement for UCITS and AIFs

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#### INTRODUCTION

On 4 June 2020, ESMA published a Supervisory Briefing with non-binding guidance for national regulators (NCAs) supervising UCITS managers and AIFMs' compliance with the obligation not to charge undue costs to investors. The Supervisory Briefing forms part of ESMA's response to the issues identified in its 2019 and 2020 Annual Reports on performance and EU retail fund costs, including the disproportionately negative impact of ongoing costs on fund performance and returns for retail investors. While fee compression has been the dominant trend over recent years, with the exponential rise of lower cost, mass market passive products and growing disintermediation of distribution, ESMA clearly sees a need for further intervention to accelerate progress. The themes and expectations around robust cost control in this Supervisory Briefing share some overlap with the value for money outcomes which were a prominent feature in the FCA's Asset Management Review.

Althoughaddressed to NCAs, we would recommend that managers of UCITS and AIFs pay close attention to the clear articulation of supervisory expectations, which we anticipate will feature in the Central Bank's engagement on new and existing fund products. An early and proactive approach is recommended so that Boards and fund management companies are well positioned.

#### PRICING PROCESS

In its Supervisory Briefing, ESMA tells NCAs to supervise compliance with the obligation not to charge undue costs by requiring management companies to develop clear and well-documented pricing processes that set out who is responsible for determining and reviewing costs, how conflicts of interest will be managed in the best interest of investors, and which address the following detailed elements:

### Investors' Best Interests

Costs should either be
(i) necessary to achieve
the objective of the fund
e.g. strategy, portfolio
management, transaction
and settlement costs; or (ii)
functional to the activities of
the fund or to fulfil regulatory
requirements e.g. audit, tax
and NCA fees.

## Market Standards

Costs should be proportionate when compared to the market standard and the type of service being provided particularly in the context of payments to third parties which may present conflicts of interest (e.g.: legal or other type of professional consultancies), intragroup delegation (e.g. portfolio management, service provisions) or depositary functions.

## Complexity of Fund Strategy

There should a balance between the complexity of the activities performed and the costs borne by investors e.g. higher costs would normally be charged to funds with more complex investment strategies/ asset types.

#### **No Duplication**

Costs should be clearly categorised and accounted for to avoid fees of the same type being included in two different cost categories.

## **Equal Treatment of Investors**

Costs should not materially prejudice the interests of any class of shareholders or investors with the exception of non-retail AIFs who disclose preferential treatment in their constitutional or offering

## Sustainability

Costs, including depositary's fees should be sustainable taking account of the expected net return of the fund, its risk profile and investment strategy.

### **Fee Caps**

Any cap on fees must be clearly disclosed to investors e.g. expressed as % of NAV

#### **Performance Fees**

If charged, the performance fee model and its disclosure should comply with ESMA Guidelines on performance fees.

### Disclosure

Fee disclosure must be in line with governing rules.

### **Pricing Data**

Pricing must be based on reliable and documented data which allows for ex-post reproduction at portfolio level.

#### **NEXT STEPS**

The Supervisory Briefing recommends that NCAs review the pricing processes of management companies on a case-by-case basis:

- · at fund authorisation stage;
- · through off-site supervision;
- · during on-site inspections;
- at post-authorisation approval of material changes to the fund;
- · during thematic inspections; or
- · when assessing investor complaints.

UCITS managers and AIFMs should adopt, or review existing, pricing processes and procedures to ensure implementation and documentation of a pricing process which takes account of the recommended elements discussed above and further detailed in ESMA's Supervisory Briefing.

#### **CONTACT US**

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