Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

T +353 (0)1 224 6000

Bosca PO 559
Baile Átha Cliath 1

PO Box 559
Dublin 1

www.centralbank.ie

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Re: 2021 Common Supervisory Action on the supervision of Costs and Fees of UCITS

Dear Chair,

In 2021, the Central Bank of Ireland ('the Central Bank') undertook a review of the costs and fees charged to UCITS as part of the European Securities and Markets Authority's (ESMA's) Common Supervisory Action ('CSA').[1] The scope of the CSA was to assess UCITS Managers'[2] ('hereinafter referred to as 'firms') compliance with the relevant cost-related provisions contained in the UCITS framework. The Irish UCITS Regulations[3] provides that firms act in such a way as to prevent undue costs[4] being charged to the UCITS and its unitholders. The purpose of this letter is to highlight the main findings of the inspection, set out the Central Bank's expectations and to identify the key actions to be taken by all firms to mitigate these issues. While the scope of the CSA did not include a review of AIFMs; it is the expectation of the Central Bank that the findings and actions of this review are also considered by AIFMs with respect to cost and fees charged to AIFs.

Each National Competent Authority ('NCA') examined whether firms, when charging costs to the fund/unitholders:

- Comply with the cost-related disclosure provisions set out in UCITS legislation in practice;
- Act honestly and fairly in conducting their business activities and do so with due skill, care and diligence and in the best interests of their underlying investors; and

[1] Press Release - ESMA launches a Common Supervisory Action with NCAs on the supervision of costs and fees of UCITS.
[2] UCITS Management Companies and Self-Managed Investment Companies (SMICs)
[3] See Schedule 5 (Conduct requirements applicable to Management Companies) of the S.I. No. 352/2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (Irish UCITS Regulations)
[4] As outlined in the ESMA Supervisory Briefing

- Do not charge investors with undue costs.

The CSA consisted of three distinct phases comprising the issuance of a qualitative and quantitative questionnaire to firms, a desk based review and virtual inspection calls. In order to satisfy the prescribed ESMA sample thresholds for this review, the Central Bank required a sample of 59 firms to complete the qualitative and quantitative questionnaires. Each submission was subject to an in-depth desk-based supervisory review. Following the desk based review supervisors engaged directly with 40% of the firms through virtual inspection calls. We would like to thank firms for the strong level of engagement and collaboration during the CSA.

Findings

While this CSA did not identify material undue costs being charged to UCITS, a number of deficiencies were demonstrated by fund management companies in setting the cost and fee structure for investment funds. These deficiencies substantially increase the risk that investors will be subject to undue costs and may negatively impact on investment returns.

When setting the cost and fee structure, the firm must have regard to its obligation[5] to act in the best interests of investors and to treat investors fairly. This process must be supported by clearly documented policies and procedures with clear oversight and approval from senior management.

The costs and fees charged and the methodology for calculating these fees should be reviewed at least on an annual basis. The review should be documented and assess, inter alia, whether the costs and fees charged to investors remains appropriate taking into account the investment objective and strategy of the fund, the target and actual level of performance achieved as well as the role and responsibilities of service providers. The board should consider if the UCITS has delivered its stated objective and remains a viable and suitable investment for investors.

In light of the deficiencies found and their relevance to investor protection, the oversight and calibration of costs and fees should be made a priority for UCITS. The content of this letter should be discussed and considered by the Board and appropriate action should be taken without delay.

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[5] See Schedule 5 (Conduct requirements applicable to Management Companies) of the S.I. No. 352/2011 - European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2011 (Irish UCITS Regulations)

These findings should be considered in conjunction with ESMA's final report[6] on the CSA, which was published on 31 May 2022.

Key Findings and Supervisory Expectations

1) Lack of policies and procedures on costs and fees

A significant majority of firms reviewed as part of this CSA sample failed to demonstrate that they have sufficient pricing governance structures in place. The absence of detailed documented policies and procedures to govern the calibration and imposition of costs and fees gives rise to the risk that the control environment for costs and fees is ineffective and increases the potential for undue costs to be imposed on investors.

The Central Bank's expectation is that all firms have structured, formalised pricing policies and procedures in place with clear oversight and approval from senior management that allows for the transparent identification and quantification of all costs charged to the fund.

2) Periodic reviews of costs and fees

A majority of firms reviewed failed to evidence that regular reviews of their UCITS' costs and fees structure were conducted. In some instances, fee structures were established prior to the fund being launched and were not reviewed during the lifetime of the fund.

The Central Bank's expectation is that all costs, both new and existing, are reviewed on an annual basis taking into account the investment objective and strategy of the fund, the target and actual level of performance achieved and the role and responsibilities of service providers. Throughout the life of the fund, firms should ensure that the costs and fees are calculated in a fair and equitable manner, serving the best interests of investors. This should be evidenced as part of the review process. In addition, the viability and competitiveness of the fund should be considered as part of this review in terms of the UCITS being capable of providing a positive return to investors. As highlighted in the ESMA report[7], periodic independent reviews of cost and fee structures should also be performed to ensure that they continue to offer investors a return commensurate with the risk profile of the fund.

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[6] ESMA's Final Report on the CSA on Costs and Fees
[7] ESMA's Final Report on the CSA on Costs and Fees

3) Design and oversight of fee structure

Our analysis shows that in the majority of cases where firms did not have documented pricing policies and processes in place, there was an over-reliance by firms on the assessments made by delegate investment managers for determining the pricing structure of the funds, with limited engagement in the process by some firms. This raises concerns about the lack of importance that some firms are applying to setting the cost and fee structures, and the firm's ability to oversee the pricing process. Variations in the frequency and detail of board reporting on costs and fees were also identified. The reporting of UCITS costs and fees, and the regular review of these charges by firms is essential for the proper functioning of UCITS and is in the best interests of investors.

The Central Bank requires firms to have clear policies and procedures for the design, oversight and regular review of the costs and fees structures to ensure they are operating effectively and in the best interests of investors.

4) Efficient Portfolio Management

'*ESMA's Guidelines on ETFs and other UCITS' states* that *"all the revenue streams arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS"*. From the sample of firms in scope for this CSA who engaged in securities lending programmes, our analysis identified a number of firms who retained significantly more revenue (between 30-40%) than their peers from their securities lending programmes.

In addition, our analysis demonstrated that a significant majority of firms utilising Efficient Portfolio Management (EPM) did not have formalised policies and procedures in place covering EPM activities. For those firms that did have policies and procedures in place there was a general lack of sufficient detail. The information contained within the fund documentation was not sufficiently detailed to cover the associated requirements and risks for UCITS utilising specific EPM techniques. In the majority of cases, there was a lack of evidence that firms undertook regular reviews of the fees applicable to securities lending arrangements on a planned and systematic basis.

The Central Bank expects that all fee arrangements with respect to securities lending programmes are compliant with ESMA's expectations[8] and are clearly disclosed within the fund prospectus or supplements as well as being captured in the policies and procedures of the firm. EPM disclosures within fund documentation should clearly describe the EPM strategy, the risks involved and the fee structure relating to the specific EPM techniques, which the fund is utilising. It is the expectation of the Central Bank that fee arrangements relating to all EPM activities should be reviewed as part of the annual costs and fees review.

5) Fixed Operating Expense Models

A Fixed Operating Expense ('FOE') is a practice whereby a fixed rate is proposed by a fund management company to cover all of the running costs of a fund. A number of firms in our CSA sample utilise FOE models and confirmed to supervisors that they retain any excess fees when the expenses of the UCITS are below the FOE model cap. However, in the majority of cases, the FOE was calibrated at such a high level that the firm would have, in almost all circumstances, been in receipt of additional income from the decision to implement a Fixed Operating Expense - in some cases earning additional revenues in excess of 0.15% of the NAV.

The Central Bank expects that where a FOE model is being used for the purposes of providing investors with protection and certainty with respect to the fees being incurred, those investors should be fully aware of all expenses and the model should be calibrated so that any differential is minimised and that undue costs are not charged to investors. It is the expectation of the Central Bank that FOE models should be reviewed as part of the annual costs and fees review. This will be an area of focus for the Central Bank in future supervisory engagements.

6) Non-discretionary Investment Advisor Charge

Supervisors identified a number of firms where the non-discretionary investment advisor was being paid a greater fee than the delegated investment manager. This practice raises concerns as to whether (i) the investment advisor is in fact the de facto discretionary investment manager and (ii) the negotiated fee is in the best interests of the investors. In circumstances like this, it would lead to supervisory concerns on the outsized role the investment advisor is playing in the day to day running of the Firm. As outlined in the Securities Markets Risk Outlook Report 2022[9], the concerns

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[8] ESMA's Guidelines on ETFs and other UCITS
[9] Securities Markets Risk Outlook Report 2022

of the Central Bank in this regard relate specifically to cases where an investment advisor is appointed to a fund and that investment advisor is acting with more influence and control than is appropriate.

The Central Bank expects that the role performed by the investment advisor is non-discretionary in nature and an adjunct to the role performed by the investment manager. With respect to the fees paid to non-discretionary advisors, firms should ensure that the fee arrangements are appropriate for the services provided.

Action required

Firms should ensure that the costs and fees are calculated, on an ongoing basis, in a fair and equitable manner and serving the best interests of investors. In order to address the concerns raised in the findings of the review, the Central Bank requires that all firms managing both UCITS and AIFs conduct a gap analysis of the findings and expectations outlined above and, where appropriate, put a plan in place by the end of Q3 2023 to address any gaps identified.

In circumstances of non-compliance by any firm with respect to any requirements relevant to the matters raised in this letter, the Central Bank may, in the course of future supervisory engagement, or when exercising its supervisory and/or enforcement powers in respect of such non-compliance, have regard to the consideration given by a firm to the matters raised in this letter. The findings from this review will inform future policy development and enhancements to the current regulatory framework for the supervision of costs and fees.

Should you have any queries regarding the content of this letter, please contact CommonSupervisoryAction@centralbank.ie .

Yours sincerely

D.Rossi

Darragh Rossi
Head of Funds Supervision Division