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Regulatory Focus on Fund Charges

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The fund management industry has become increasingly cost sensitive in recent years. While much of this has been driven by competitive pressures, the power of significant allocator investors and investor appetite for index products, other factors including investor education and regulatory oversight, or related concerns have also been factors. The latter seems poised to assume central stage as the European Securities and Markets Authority (ESMA), the European super-regulator, has identified costs as one of its priority areas of focus for 2021 and it is currently orchestrating a pan-EU action by local regulatory authorities to focus on “undue” costs.

Background

ESMA published its first annual statistical report on costs and performance for retail products in early 2019¹. This highlighted the significant impact of fees on performance, particularly for retail fund products. This prompted ESMA to undertake a survey among National Competent Authorities across the EU (“NCAs”), the local regulators in each member state (“Member State”) of the European Union (“EU”), on approaches to the supervision of cost-related provisions, noting that the legislation underpinning both UCITS and alternative investment funds contain relevant legislative provisions.

The results revealed diverse interpretations of the concept of “undue costs” between NCAs as well as related supervisory procedures. ESMA identified this as creating potential for regulatory arbitrage and deficiencies in appropriate investor protection across the EU and accordingly determined that there was a need for a common framework for NCAs to use to consider issues pertaining to fund costs as well as related supervision and enforcement.

A briefing (the “ESMA Briefing”) was issued under Article 29(2) of the ESMA Regulation which enables ESMA to develop new practical

instruments to assist in driving convergence among Member States in June 2020².

ESMA subsequently cited costs and fees charged by fund managers as one of the two supervisory priorities to be addressed for 2021 under their discretion to identify key market risks impacting Member States³. The reason for selecting this topic as a focus for priority attention is cited to be its key role in investor protection since unfair or disproportionate costs and fees can cause significant investor detriment. Regulatory arbitrage is also a concern as it negatively impacts the competitive landscape.

As a result ESMA announced⁴ it was launching a “common supervisory action” (“CSA”) with the NCAs early in 2021 to assess the compliance of supervised entities with the cost-related provisions in the UCITS framework and in particular the obligation to ensure funds were not paying undue charges.

Legal Basis

A key driver behind EMSA’s actions in this regard has been the fact that the existing product level financial services legislation, being the UCITS Directive and Alternative Investment Fund Managers Directive (“AIFMD”), already address the fundamental issues identified.

For example, Article 22(4) of Commission Directive 2010/43/EU (UCITS Level 2 Directive)

¹ Available at: [esma50-165-731-asr-performance and costs of retail investments products in the eu.pdf \(europa.eu\)](https://www.esma.europa.eu/press-news/esma-press-releases/esma50-165-731-asr-performance-and-costs-of-retail-investments-products-in-the-eu.pdf)

² “Supervisory Briefing on the Supervision of costs in UCITs and AIFs” 4 June 2020 ESMA34-39-1042

³ See Press Release: “ESMA Identifies Costs and Performance Data Quality as New Union Strategic Supervisory Priorities”, 13 November 2020

⁴ See Press Release “ESMA launches a Common Supervisory Action with NCAs on the Supervision of Costs and Fees of UCITS”, 6 January 2021

provides that Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its Unitholders. The ESMA Briefing further notes that Article 14(1)(a) and (b) of Directive 2009/65/EC (the UCITS Level I Directive) provides for Member States to draw up rules of conduct to ensure management companies (a) act honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market; (b) acts with due skill, care and diligence in the best interests of the UCITS it manages and the integrity of the market.

Similarly, in relation to the AIFMD, Article 17(2) of Commission Delegated Regulation (EU) No 231/2013 (AIFMD Level 2 Regulation) provides that AIFMs shall ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs.

Furthermore Article 12(1) of Directive 2011/61/EU (AIFMD Level 1) provides that Member States shall ensure that, at all times, AIFMs (a) act honestly, with due skill, care and diligence and fairly in conducting their activities; (b) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market (c) treat all AIF investors fairly.

The ESMA Briefing is non-binding on NSAs but seeks to assist them by setting out a common framework for their consideration and principles to be applied when conducting supervisory authority in the context of assessing fund costs, which as noted above are already subject to existing legal requirements. This framework can be used to assist in determining if specific costs ought to be considered “undue” for the purposes of applicable legislation in the context of specific funds. This is particularly useful given that the term is not defined in such legislation.

Analysis and Indicators

The ESMA Briefing clarifies that the primary principle to be applied in considering the notion of undue costs is that these should be assessed

against what should be considered in the best interests of the fund or its unitholders.

Accordingly, the costs charged should: (a) be consistent with the investment objective of a fund and not prevent it from achieving this objective, particularly where those costs are paid to third party service providers to the fund, and (b) be clearly identifiable and quantifiable.

To facilitate effective supervision that undue costs are not being charged, management companies are to be expected to develop and periodically review a structured pricing process addressing key elements:

- (a) Whether costs are linked to a service necessary for the fund to operate in line with its investment objective or ordinary activity;
- (b) Whether such costs are proportionate to market standards and the types of services provided (interestingly legal costs are specifically mentioned in this regard);
- (c) Whether the fee structure is consistent with the characteristics of the fund;
- (d) The sustainability of costs;
- (e) Whether costs ensure equal treatment of investors (except where specifically permitted);
- (f) The absence of duplication of costs;
- (g) The application and disclosure of fee caps;
- (h) Compliance of performance fees with applicable guidance and rules as well as disclosures;
 - (i) The disclosure of all costs; and
 - (j) The reliability of the data.

Clearly therefore the question as to whether fees are “undue” will be entirely fund specific and needs to be assessed on the merits of individual cases. It is also evident that the response to any analysis of this question with respect to any given fund could change over time.

Supervisory Actions

NCA's are now expected to incorporate a review of compliance with the relevant requirements at different stages — including not only during the fund authorisation process, but during periodic inspections, upon approval of material changes, thematic reviews and when undertaking an assessment of investor complaints.

Key aspects of the focus of the review should include disclosure and transparency relating to fees and ensuring that fees are aimed at remunerating services incurred by the fund without impairing compliance with the duty to act in the best interests of investors. Primary aspects of the latter include the development of a pricing policy that sets out responsibility for reviewing costs charged and preventing negative impacts due to conflicts of interest.

Where undue costs are identified it is to be expected that remedial action may include investor compensation, reduction of fees, review of disclosures and public disclosures of the identification of poor practices, including in the press to act as a deterrent.

Current Position

Throughout 2021, NCA's are sharing knowledge and experiences co-ordinated through ESMA to ensure EU supervisory convergence regarding cost-related issues as part of the CSA. This is being undertaken on the basis of the common methodology developed by ESMA. Certain NCA's have announced measures they are undertaking as part of this CSA, e.g. the CSSF in Luxembourg⁵ and given that this CSA is one of two stated ESMA priorities for 2021, it is to be expected that significant progress will be achieved and applied on a general basis across UCITS over the course of this year.

Other Relevant Initiatives

Other Relevant Initiatives

As mentioned at the outset of this article, regulatory pressures on costs have been evident for some time in the funds' context. Performance fees in particular have already been a focus at the EU level⁶. However, there have also been various examples of actions being undertaken at the Member State level by NSAs such as the Central Bank of Ireland⁷ or the "value for money" focus of the Financial Conduct Authority in the UK. Many US managers will also be familiar with the provisions under Section 36(B) of the 1940 Act to ensure excessive fees are not paid to investment managers.

Recommendations

Given the current status of the CSA, it is to be recommended that management companies and fund boards ensure that an analysis is undertaken using the framework set out in the ESMA Briefing and steps are taken to address any potential deficiencies. It is clearly preferable to take the initiative in identifying and tackling any issues in this regard rather than waiting until an NSA such as the Central Bank or CSSF undertakes such analysis and potentially commences action on foot of this, which could potentially include not only instructions to pay investor compensation but also public censure.

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⁵ [Launch of the ESMA Common Supervisory Action on the supervision of costs and fees of UCITS – CSSF](#)

⁶ See for example "Guidelines on performance fees in UCITS and certain types of AIFs" [esma_34-39-968_final_report_guidelines_on_performance_fees.pdf \(europa.eu\)](#)

⁷ See for example: [Central Bank to launch fund fee probe \(irishtimes.com\)](#)

About the Author



His expertise primarily involves advising on the structuring, establishment and operation of investment funds in Ireland, including UCITS and Alternative Investment Funds, for international distribution. He also advises on issues affecting clients throughout the financial sector, including with regard to AML, MiFID, crypto-currencies, emoney and payment systems, data protection (including GDPR), distance selling and internet-based products and investments. His international funds experience covers a number of key global fund centres and he has previously worked in the funds practice of a leading Cayman Islands firm as well as for a global custodian based in Luxembourg. Mark was elected to the Global Board of the Alternative Investment Management Association (AIMA) in 2020.

A frequently published author and speaker with regard to issues relating to the financial services industry he is recommended as a leading investment funds lawyer by The Legal 500 and Chambers & Partners (Europe and Global). Previous editions of Chambers Global noted that “he garners significant praise for launching UCITS funds and ICAVs, as well as handling the relevant regulatory issues with clients describing him as “terrific: he is responsive, almost always available and knowledgeable.” And reported

Mark is from Clontarf in Dublin and was educated at Belvedere College S.J., University College Dublin and the Law Society of Ireland.

He trained and qualified as a solicitor in a leading Dublin law firm, where he specialised in the investment funds area and has over fifteen years related experience.

Prior to joining Clerkin Lynch as Head of Asset Management and Funds. Mark was a financial services partner in an international law firm.

that clients stated “the amount of attention he gave us was outstanding,” praising his “knowledge of how to get the deal done, and his great end product.” He is recognised as a “notable practitioner” by IFLR1000, the guide to the world’s leading financial law firms. He was previously named as ‘Investment Fund Formation Lawyer of the Year in Ireland’ in the CIM Global Awards and Investment Management lawyer of the year in Ireland by the Lawyer International ‘s Legal 100 awards.

In addition to his Irish legal qualifications, Mark has also been admitted to the roll of solicitors in England and Wales and qualified as an attorney at law in the Cayman Islands. He currently only practices Irish law.

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