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Central Bank Industry Letter on Fund Costs and Fees

March 2023

On 24 March 2023, the Central Bank of Ireland (the "Central Bank") published its industry letter (the "Industry Letter") setting out its own findings and expectations following its review of the costs and fees charged to UCITS as part of ESMA's Common Supervisory Action on costs and fees (the "CSA'). The purpose of the CSA was to assess UCITS Managers compliance with the relevant cost-related provisions contained in the UCITS framework. While the scope of the CSA did not include a review of AIFMs, the Central Bank expects that the findings and actions of this review be considered also by AIFMs with respect to cost and fees charged to AIFs.

The Industry Letter comes in the wake of increased regulatory focus on costs and fees of UCITS and AIFs in recent years as highlighted in our previous series of advisories:

Fund Costs and Fees – ESMA's Findings from CSA

Ireland Update: Funds Costs & Fees – Regulatory Spotlight

Supervision of costs in UCITS and AIFs

The CSA consisted of three distinct phases comprising the issuance of a qualitative and quantitative questionnaire to UCITS management companies ("UCITS Mancos"), a desk based review and virtual inspection calls. The Central Bank required a sample of 59 UCITS Mancos 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 UCITS Mancos through virtual inspection calls.

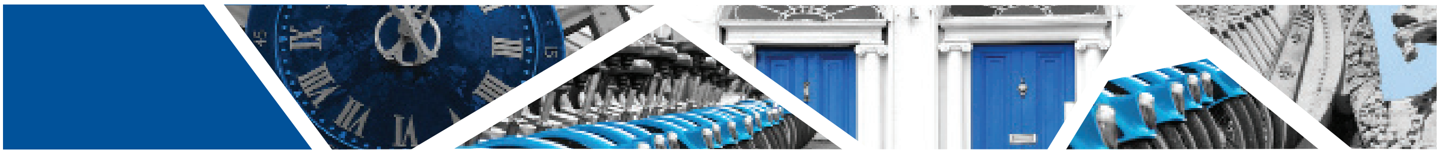
The Central Bank has not identified examples of material undue costs charged to UCITS, however a number of deficiencies were evident in the cost and fee structure set by fund management companies ("FMCs") for investment funds.

The key findings detailed in the Industry Letter focus on six distinct areas:

1) Lack of policies and procedures on costs and fees

A significant majority of UCITS Mancos reviewed 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.

Key Expectation: All FMCs should 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 UCITS Mancos reviewed failed to evidence that regular reviews were conducted of their costs and fees structure. In some instances, fee structures were established prior to the fund being launched and were not reviewed during the lifetime of the fund.

Key Expectations: 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. Periodic independent reviews of cost and fee structures should also be performed to ensure that these structures continue to offer investors a return commensurate with the risk profile of the fund.

3) Design and oversight of fee structure

Where the UCITS Mancos did not have documented pricing policies and processes in place, there was an over-reliance by UCITS Mancos on the assessments made by delegate investment managers for determining the pricing structure of the funds, with limited engagement in the process by some UCITS Mancos.

Key Expectation: Clear policies and procedures are required 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 (“EPM”)

A number of UCITS Mancos engaged in securities lending programmes retained significantly more revenue (between 30-40%) than their peers from their securities lending programmes. In addition, a significant majority of UCITS Mancos utilising EPM did not have formalised policies and procedures in place covering EPM activities, or where they were in place, there was a general lack of sufficient detail. There was a lack of evidence that UCITS Mancos undertook regular reviews of the fees applicable to securities lending arrangements on a planned and systematic basis.

Key Expectations: All fee arrangements with respect to securities lending programmes should be compliant with ESMA’s Guidelines on ETFs and other UCITS issues and be clearly disclosed within the fund prospectus or supplements as well as being captured in the FMC’s policies and procedures. Fee arrangements relating to all EPM activities should be reviewed as part of the FMC’s annual costs and fees review.

FMCs should undertake a review of EPM disclosures within fund documentation to ensure these clearly describe the EPM strategy, the risks involved and the fee structure relating to the specific EPM techniques, which the fund is utilising.

5) Fixed Operating Expense (“FOE”) Models

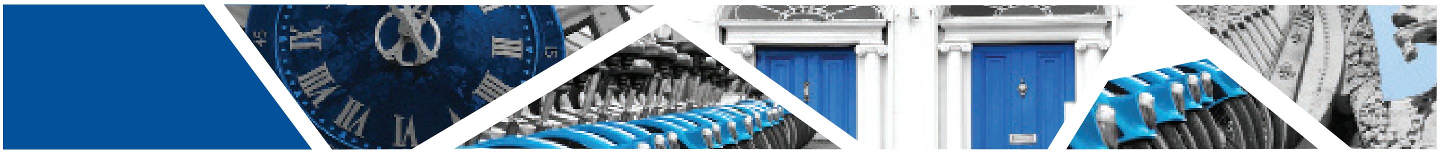
Where a FOE rate covered all of the running costs of a fund was provided for a majority of UCITS Mancos were in receipt of additional income from their decision to implement a FOE.

Key Expectations: Where a FOE model is 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. FMCs should undertake a review of FOE models as part of the annual costs and fees review.

6) Non-discretionary Investment Advisors

The practice of a non-discretionary investment advisor being paid a greater fee than the delegated investment manager raised supervisory 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.

Key Expectation: 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. FMCs should ensure that the fee arrangements for non-discretionary advisors are appropriate for the services provided.



Next Steps

The Industry Letter includes a requirement for all FMCs managing both UCITS and AIFs to put a plan in place by the end of Q3 2023 to address any gaps in their arrangements as against the Central Bank's expectations. Accordingly, it would be prudent for all FMCs to now commence a review of their processes in place in respect of fund costs and fees, ensuring that the costs and fees are calculated in a fair and equitable manner, serving the best interests of investors both at fund launch stage and during the life of each fund. These processes should be supported by clearly documented policies and procedures; detailed disclosure in fund documentation and underpinned with clear oversight and approval from senior management.

FMCs already having a fund costs policy may need to consider enhancements to comply with the Central Bank's expectations in respect of the issues identified in the Industry Letter. We have been assisting clients in reviewing these processes and advising on the types of enhancements that should be considered.

Key Contacts

If you have any queries on the content of this advisory and/or the impact that it may have on you and your business, please speak to your usual contact in Walkers or connect with:

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