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Central Bank's Dear CEO Letter Highlights Areas of Concern on How Fund Managers Calculate Costs and Fees

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On 24 March, the Central Bank of Ireland (the Central Bank) issued a “Dear Chair” letter (the Letter) following its review in 2021 of the costs and fees charged to undertakings for collective investment in transferable securities (UCITS) as part of the European Securities and Markets Authority’s (ESMA) Common Supervisory Action (the CSA).

The Letter, which is addressed to Irish UCITS fund management companies (FMCs), sets out the Central Bank’s main findings from the 2021 review and its expectations on the actions to be taken by FMCs to address the deficiencies identified. Despite the focus being on UCITS FMCs, the Central Bank specifically emphasized that it will expect its findings and actions to be considered by Irish alternative investment fund managers (AIFMs) with reference to alternative investment funds under management.

Background to The Letter

The CSA was launched by ESMA with national competent authorities in 2021. The aim of the CSA was to assess compliance with the cost-related provisions of the UCITS framework and the requirement that investors not be charged undue costs. The CSA also covered the use of efficient portfolio management (EPM) techniques to assess whether they adhere to the requirements set out in the UCITS framework and the ESMA *Guidelines on ETFs and other UCITS issues*.

The CSA was conducted through the issuance of qualitative and quantitative questionnaires to FMCs, a desk based review and virtual inspection calls.

The Central Banks' Findings

The CSA did not identify material levels of undue costs being charged by UCITS but it found deficiencies in FMCs’ setting the costs and fee structures for UCITS.

The Central Bank noted that the majority of FMCs reviewed failed to show they had sufficient pricing governance structures in place. The Central Bank commented on the absence of detailed documented policies and procedures governing the calibration and imposition of costs and fees, noting that it creates the risk that the control environment is ineffective and adds to the risk that undue costs are to be met by investors.

The Letter also stated that the majority of FMCs failed to evidence of any regular reviews of UCITS' costs and fees. The Central Bank noted that, in some cases, fee structures were established before a fund launch and not revisited during the fund's lifetime.

The Central Bank further stated that where FMCs lacked documented pricing policies and processes, too much reliance was placed on assessments made by investment managers in determining funds' pricing structures with insufficient engagement from the FMCs.

In relation to the issue of EPM techniques, the Central Bank made reference to the requirement in ESMA's *Guidelines on ETFs and other UCITS* that "all revenue…[from EPM techniques]…net of direct and indirect operational costs, should be returned to the UCITS". The Letter stated that the Central Bank's review found that many firms were retaining significantly more revenue (30% to 40%) than their peers from their securities lending arrangements (SLAs).

The Central Bank found that, for the majority of FMCs using EPM, there were no formalized policies and procedures in place covering such activities and, in cases where policies existed, they were insufficiently detailed. In addition, the Central Bank identified that regular, planned, systematic reviews of the fees relating to SLAs were lacking.

For funds using fixed operating expense (FOE) models, the Central Bank stated that a number of FMCs confirmed to them in the course of their review that they retain any excess fees when the expenses of the UCITS fall below the FOE cap. The Central Bank found however that the majority of such FOEs were so high that FMCs would be in receipt of additional income due to the decision to implement the FOE.

Finally, in respect of nondiscretionary investment advisors, the Central Bank found that there were instances where a nondiscretionary investment advisor was paid more than the fund's investment manager. The Central Bank expressed concerns that this might suggest that the advisor was in fact the de facto discretionary investment manager or playing an outsized role and that the fee was not in investors' best interests.

The Central Bank's Expectations

Regularly reviewed, clearly designed policies and procedures on costs and fees

The Central Bank stated that when setting the cost and fee structure, FMCs must have regard to the requirement that investors be treated fairly and that actions be in their best interests. The Central Bank expects this process to be supported by clearly designed and documented policies and procedures with clear oversight and approval at senior management level, allowing for the transparent identification and quantification of all costs and fees charged to a fund.

All costs and fees charges and their calculation methodologies must be reviewed at least annually and that review in turn should be documented. It should assess whether the costs and fees charged to investors remain appropriate taking into account various factors including the fund's strategy, performance, the responsibilities of service providers, and the viability and competitiveness of the fund. Specifically, the Central Bank expects the board of an FMC to reflect on whether the UCITS has delivered its objective and remains a suitable investment for its investors. Throughout the life of funds, the Central Bank expects FMCs to ensure that costs and fees are calculated fairly and equitably, serving investors' best interests.

EPM and SLA fee requirements

The Central Bank stated that all fee arrangements relating to SLAs must comply with ESMA's *Guidelines on ETFs and other UCITS*, be clearly disclosed in the UCITS offering documents, and be captured in the FMCs policies and procedures.

EPM disclosures in offering documents need to describe the EPM strategy, risks, and the fee structure relating to the specific EPM techniques that the fund is using. The costs and fees themselves should be reviewed as part of the annual review set out above.

Fixed operating expense models

The Central Bank stated that where an FOE model is to be used, investors should be made fully aware of all expenses and the model should be designed in such a way as to minimise any differential so that investors are not charged undue costs. Again, any such policy should be reviewed annually. The Central Bank mentioned that there will be future supervisory engagement in this area.

High fees to investment advisors

The Central Bank stated that FMCs need to ensure that fee arrangements are appropriate for the services provided and, in the context of investment advisors, this is a nondiscretionary service and an adjunct to the role of the investment manager.

Next Steps

The Letter stated that the oversight and calibration of costs and fees need to be made a priority for UCITS and requires that boards of FMCs consider and discuss the contents of the Letter and take the necessary action to address any deficiencies in their practices without delay. Specifically, the Central Bank requires that all FMCs and AIFMs conduct a gap analysis of the requirements of the Letter as against their present practices and put a plan in place by the end of the third quarter of this year to address any gaps.

As such, FMCs and AIFMs need to immediately begin this analysis and consider what steps and changes are needed to meet the Central Bank's expectations.

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