Final Report

On the 2021 CSA on costs and fees

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Executive Summary

Reasons for publication

In January 2021, ESMA launched a Common Supervisory Action (CSA) with National Competent Authorities (NCAs) on the supervision of costs and fees of UCITS across the EU/EEA.

The CSA's aim was to assess, foster and enforce the compliance of supervised entities with key cost-related provisions in the UCITS framework, in particular the obligation of not charging investors with undue costs. For this purpose, it was agreed to take into account the supervisory briefing on the supervision of costs published by ESMA in June 2020. Furthermore, the CSA also covered entities employing Efficient Portfolio Management (EPM) techniques to assess whether they adhere to the requirements set out in the UCITS framework and ESMA Guidelines on ETFs and other UCITS issues.

This report sets out ESMA's analysis and conclusions on the CSA exercise and present ESMA's views on the various findings, including on the process of the setting and the reviewing of fees, the notion of undue costs, the issues stemming from related party transactions and EPM techniques, as well as the follow-up actions envisaged by NCAs and the main lessons learnt.

Contents

Section I explains the background to the CSA exercise, Section II the scope of the analysis and minimum coverage thresholds. Sections III-VII set out the CSA's main findings. The follow-up actions envisaged by NCAs are included under Section VIII and the main lessons learnt in Section IX.

Next Steps

In 2020, the topic of costs and fees was also identified as a Union Strategic Supervisory Priority (USSP) given its relevance from an investor protection perspective. Based on Article 29a of the ESMA Regulation, ESMA has the obligation to discuss the relevant activities undertaken by NCAs (own initiatives and through ESMA workstreams) in the context of the identified USSPs and draw conclusions.

This work will feed into the process of drawing conclusions on the relevant USSP.

I. Background

1. The topic of costs and performance of retail investment products was identified as one of the Union Strategic Supervisory Priorities in 2020. Under this Priority, it was agreed that National Competent Authorities (NCAs) would undertake supervisory action in 2021, coordinated by ESMA, on costs and fees charged by fund managers.[1]

2. In January 2021, ESMA launched a Common Supervisory Action (CSA) with NCAs on the supervision of costs and fees of UCITS across the EU/EEA.[2]

3. The CSA's aim was to assess, foster and enforce the compliance of supervised entities with key cost-related provisions in the UCITS framework, in particular the obligation of not charging investors with undue costs. For this purpose, it was agreed to take into account the supervisory briefing on the supervision of costs published by ESMA in June 2020.[3] Furthermore, the CSA also covered entities employing Efficient Portfolio Management (EPM) techniques to assess whether they adhere to the requirements set out in the UCITS framework and ESMA Guidelines on ETFs and other UCITS issues.[4]

4. The work was done on the basis of a common methodology developed by ESMA throughout H2 2020 and was agreed in December 2020. The CSA assessment framework, including scope, coverage thresholds, methodology, supervisory expectations and timeline, therefore results from a joint effort to carry out comprehensive supervisory action in a convergent manner.

5. Throughout 2021, NCAs shared knowledge and experiences through ESMA to promote supervisory convergence in how they supervise cost-related issues, and ultimately enhance the protection of investors across the EU/EEA. In line with the CSA assessment framework, NCAs were asked to report to ESMA on the CSA results in their Member State by 31 December 2021. With the exception of one NCA, all NCAs provided ESMA with their reports[5].

6. Furthermore, following the completion of the CSA, ESMA launched a survey (the "CSA survey") addressed to NCAs in order to assess the impact of the exercise and to take stock on any type of follow-up actions envisaged/taken by NCAs.[6] The main results of the CSA survey are described throughout the following sections.

[1] ESMA identifies costs and performance and data quality as new Union Strategic Supervisory Priorities (europa.eu).
[2] ESMA launches a Common Supervisory Action with NCAs on the supervision of costs and fees of UCITS (europa.eu).
[3] esma34-39-1042_supervisory_briefing_on_the_supervision_of_costs.pdf (europa.eu).
[4] ESMA-2014-0011-01-00 EN (europa.eu).
[5] While all NCAs participated to the CSA, due to resources constraints, the HCMC Greece requested a delay of 6 months to perform the CSA and will report the results of the exercise by 30 June 2022.
[6] The following NCAs did not participate to the survey: FMA Liechtenstein and HCMC Greece.

II. Scope of the analysis and minimum coverage thresholds

7. In order to ensure supervisory convergence in relation to the sample size and thus overall coverage of the CSA across Member States, minimum coverage thresholds in terms of number of UCITS managers and Assets under Management (AuM) of UCITS managers established in each jurisdiction were agreed, including for UCITS managers employing EPM techniques.

8. It can be observed that NCAs supervising bigger markets have been closer to the minimum thresholds, whereas NCAs supervising smaller markets were able to exceed the minimum thresholds and, in some instances, even covered their whole market.

9. ESMA appreciates that the goals set in terms of the minimum coverage thresholds were almost entirely met across all EU/EEA Member States. Furthermore, many NCAs supervising smaller markets have been able to exceed the minimum expectations in terms of coverage.

10. Regarding the thresholds on EPM techniques, all NCAs that supervise in their jurisdiction UCITS managers employing EPM techniques have met the agreed minimum coverage thresholds. Naturally, in some cases, NCAs have not been able to meet this threshold in light of the lack of UCITS managers employing EPM techniques in their Member State. This was anticipated in the CSA methodology and does therefore not pose any concern in terms of the meeting the CSA objectives. Notwithstanding this, it is an interesting observation that the use of EPM techniques is rather heterogenous across EU/EEA Member States as already indicated by the 2018 ESMA Peer Review on ETFs and other UCITS issues.[7]

11. NCAs generally followed the approach set out in the CSA assessment framework in relation to the selection of the sample of UCITS managers. Accordingly, NCAs took into account the following factors: the data gathered for the purpose of the ESMA Annual Statistical Report (ASR) on Performance and Costs of Retail Investment Products in the EU ("ESMA ASR")[8]; the list of funds mentioned in the Better Finance Research Report from May 2019[9]; the risk-based criteria identified in the course of the CSA preparatory work (i.e.: preference to medium and small-sized firms and entities with a broad retail investor base, supervisory knowledge or experience indicating higher compliance risks, cross-border relevance).

12. NCAs highlighted the challenges posed by the Covid-19 pandemic in performing the tasks related to the CSA exercise. For this reason, most NCAs chose a desk-based approach and only conducted on-site inspections if necessary. While there

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[7] https://www.esma.europa.eu/sites/default/files/library/esma42-111-4479_final_peer_review_report_-_guidelines_on_etfs.pdf
[8] Available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-1106-asr-performance_and_costs.pdf
[9] Available at: https://betterfinance.eu/wp-content/uploads/BETTER-FINANCE-Research-Paper-Securities-Lending-11062019.pdf

was the possibility for NCAs to complement the CSA questionnaire with further questions, taking into account the applicable requirements at national level, the majority of NCAs did not ask for any additional questions and only followed up with management companies after the analysis of the responses received under specific circumstances (e.g.: in case of unclear/ambiguous answers, after the detection of outliers, supervisory findings that required follow-up actions etc).

13. ESMA welcomes the efforts made by NCAs in meeting the minimum coverage thresholds and in selecting a diversified sample of entities in the scope of the CSA exercise, taking into account the criteria identified in the course of the CSA preparatory work.

14. ESMA also values the NCA efforts made in conducting the supervisory work despite the challenging environment caused by the Covid-19 pandemic.

III. Setting and reviewing of the fees

15. The CSA methodology covered a number of provisions, including in relation to the disclosure requirements as well as the UCITS rules which provide 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.

16. The UCITS Directive requires each Member State to draw up rules of conduct to ensure that a management company: (a) acts 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.

17. ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices. To this goal, ESMA published in June 2020 a supervisory briefing on the supervision of costs in UCITS and AIFs providing guidance to NCAs as regards the supervision of how costs are charged to investors by UCITS and/or AIFs and their managers. While the supervisory briefing is addressed at NCAs, it (indirectly) serves as a source of guidance for market participants on supervisory expectations and compliant practices regarding the cost-related provisions of the UCITS and AIFMD frameworks. The supervisory briefing was taken into account in the development of the CSA methodology. In this context, NCAs were asked, inter alia, to assess and report on how UCITS management companies formulate the pricing process, in line with the ESMA supervisory briefing on the supervision of costs.

18. The 2021 CSA also covered cost-related provisions set out in the UCITS KIID Regulation aimed at ensuring a clear disclosure to investors.

19. Broadly, NCAs reported a satisfactory level of compliance of supervised entities with regard to the applicable EU legislative framework. However, several NCAs

highlighted that there is room for improvement regarding the development of a structured pricing process.

20. In this context, the majority of NCAs reported that smaller entities have in place less formalised pricing processes compared to entities managing larger amounts of AuM. In some instances, smaller entities did not have a formalised pricing process at all. The degree of sophistication of the pricing process as well as its standardisation also varies based on the size of AuM, showing a lower level of quality for small-sized firms, for which a documented periodic review of the fee structure is less frequent and/or could not be demonstrated.

21. The results of the analysis show that while larger managers demonstrated to have good structures in place, including committees with members from the UCITS manager as well as the portfolio manager, in some instances, small UCITS managers appeared not to have strong pricing process structures in place and over-rely on portfolio managers for the pricing of the fund. Furthermore, senior management tended to only become involved late in the process and did not have an active role in the price setting and challenging of the output. Equally, there was often room for improvement with respect to the role and activities of internal control functions.

22. The outcome of the CSA exercise shows that, in some instances, portfolio managers (i.e. delegates) exercise significant influence or even decide over the level of costs and fees ultimately charged by the fund. This raises questions concerning compliance with the delegation rules. While delegate portfolio managers will naturally have an important impact on certain costs and fees, this should not result in a situation where the authorised UCITS manager does no longer perform sufficient controls and take its own decisions on the adequacy of the overall level of costs and fees.

23. A few NCAs reported that in their jurisdiction the management companies in scope of the CSA exercise take into account, inter alia, the sustainability of costs over time and/or the relative weight of fees on the investor’s return based on the different market scenario when setting the pricing structure of the fund.

ESMA views

I. ESMA would like to stress the importance for *all* UCITS managers to have in place a structured and formalised pricing process, in line with the characteristics of the fund(s) and the recommendations enshrined in the supervisory briefing on the supervision of costs and regardless of the characteristics of the management company, including the size of AuM. The supervisory briefing was published in June 2020 and, by now, NCAs should expect that all supervised entities have in place policies and procedures allowing a transparent identification and quantification of all costs charged to the fund, whether those are paid to the management company or to third parties (e.g.: depositary, external valuer, broker) and/or directly paid by the investors (e.g.: entry and exit costs), in order to avoid hidden costs and a level of costs which is consistent with the investment objective of the fund and the risk/return profile of the investor.

II. ESMA highlights the importance of performing an independent analysis of the fee structures once those have been established. It should be avoided to over-rely on the assessment made by the delegate portfolio manager. Moreover, a more active role of the senior management and relevant functions/ committees as well as regular stringent controls by internal control functions should be ensured. The level of costs should be periodically reviewed and monitored in order to compare the estimated ongoing charges with the actual expenses incurred by the fund and, where possible, reduce the level of fees and ensure the viability and competitiveness of the fund over time against peer funds. Fund performances should be assessed on an at least annual basis and the review of costs and fees should therefore be performed at least in the same frequency, in order to minimise the risk of undue costs being charged.

III. ESMA reiterates that the analysis regarding the sustainability of costs over time and/or the relative weight of fees on the investor's return based on the different market scenario is of paramount importance when setting the pricing structure of the fund as set out in the ESMA supervisory briefing on the supervision of costs. ESMA therefore sees this as an important practice since, ultimately, costs cannot be disentangled from the expected return for the investor, which is the ultimate goal of the investment itself. Comparison with peer funds should not solely be used by management companies in order to set the pricing of the fund, but each cost category should be separately assessed and determined in the investor's best interest.

IV. ESMA encourages NCAs to follow-up on the outcome of the CSA exercise to ensure that all entities covered in the sample have in place formalised and structured pricing processes and ensure compliance with the relevant regulatory framework and supervisory expectations enshrined in the supervisory briefing, bearing in mind the characteristics of the fund(s). While the principle of proportionality may justify expecting less sophisticated processes from smaller entities compared to larger ones, this should not result in a situation where some smaller UCITS managers effectively disapply these requirements altogether.

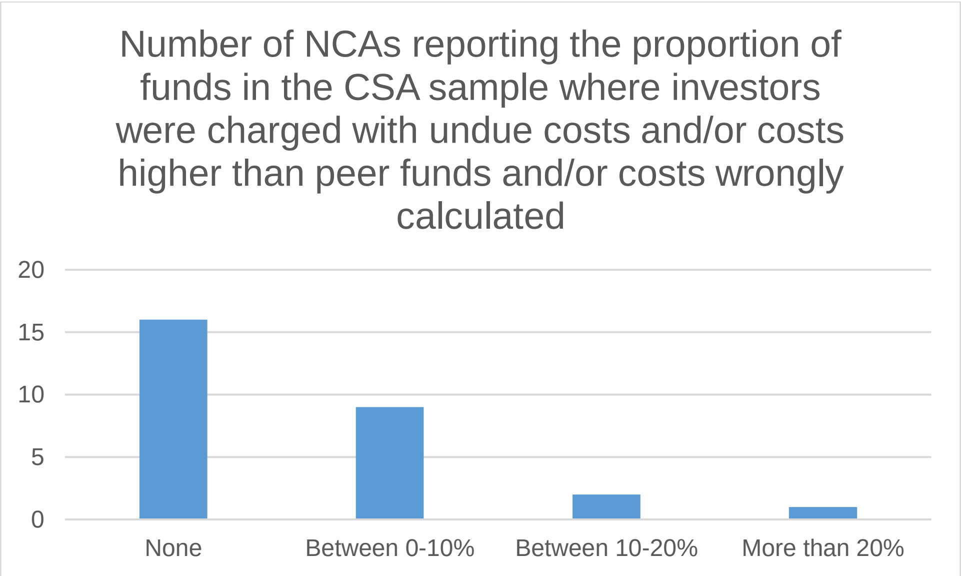
IV. The notion of undue costs

24. In the context of the CSA exercise, NCAs were asked to report, inter alia, on: 1) the most common approaches for UCITS managers to prevent that investors are charged with undue costs and, where present, provide list of costs that they consider as "undue" and as "due"; 2) what UCITS managers take into account when setting the pricing level of the fund.

25. NCAs highlighted the subjectivity of the notion of “undue cost” due to the lack of definition in the Level 1/Level 2. However, they reported that the supervisory briefing on the supervision costs provided useful indications on the cases where a cost should be considered as due/undue and the categories of costs identified by fund managers largely corresponded to the macro categories included in the supervisory briefing. Some NCAs called for further guidance and/or stronger legal basis on the topic in order to further harmonise the notion of what should be considered as an undue cost among Member States.

26. The outcome of the CSA survey shows that the majority of NCAs did not find funds in their national CSA sample that charged investors undue costs and/or costs higher than peer funds and/or costs wrongly calculated. Eight NCAs reported a percentage of 10% of the funds in the CSA sample (i.e. number of funds/total number of funds in the sample) which fell into that category, two NCAs between 10-20% and only one NCA more than 20%.

Table 1



27. In some instances, ESMA observed divergent market practices on what industry reported as “due” or “undue” costs. In this context, some NCAs mentioned that the notion of “undue costs” would require further specification to ensure greater

convergence and give them more comfort to take enforcement actions against relevant market participants.

ESMA views

V. ESMA would like to draw NCAs' attention to the importance of ensuring that market participants comply with the supervisory expectations enshrined in the supervisory briefing on the supervision of costs and how the notion of undue cost should be primarily assessed against what should be considered the best interest of the fund and its investors, bearing in mind the applicable rules at national level (e.g.: closed-ended list of costs that can/cannot be charged). The supervisory briefing sets out a framework which ensures that national supervisory approaches are in line with some common principles followed by NCAs across the EU, without prejudice to these different national requirements to be applied by management companies.

V. Related party transactions

28. Several NCAs reported that UCITS managers covered in the CSA sample identified relevant conflicts of interest in this context, in particular in cases of related-party transactions.

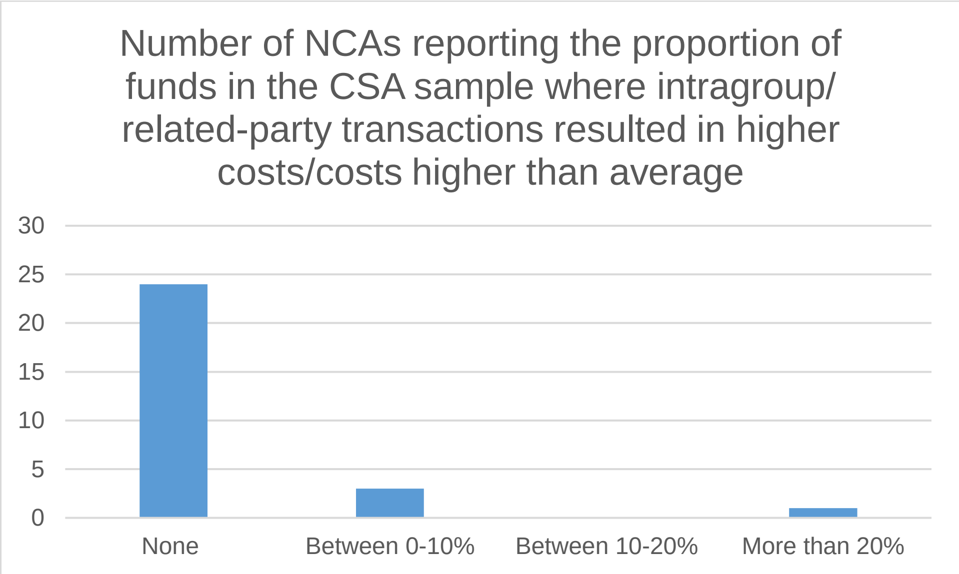
29. Many NCAs reported that UCITS managers often implemented general policies outlining the measures aiming to verify the required degree of independence between the different parties. Some of these general measures included monitoring relevant cases in the conflicts of interest log, educating employees on the code of conduct and disclosing conflicts of interest in the fund prospectus. However, beyond these general measures, NCAs did not report more specific or concrete measures implemented by relevant managers to ensure an effective mitigation of conflicts of interest in related-party transactions.

30. Some NCAs mentioned that in the case of dual-hatting of board members, they had to abstain from voting on certain issues posing potential or actual conflicts or be counterbalanced by independent board members. While this measure is certainly welcome, it does not necessarily address all conflicts of interest risks that arise in related-party transactions, especially where payments are made to the parent undertaking or other group entities where fund managers might have generally less incentives to ensure that the costs/fees paid are in fact competitive and in line with fair market prices.

31. Interestingly, the results of the CSA survey show that only three NCAs observed a proportion between 0-10% of the funds in the CSA sample (i.e. number of

funds/total number of funds in the sample) where intragroup/related-party transactions resulted in higher costs/costs higher than average. In one jurisdiction this percentage was higher than 20%; all other NCAs did not report any case.

Table 2



ESMA views

VI. ESMA would like to draw NCAs' attention to the potential for intragroup/related-party transactions resulting in higher costs and/or costs higher than average as this is a topic of high importance from an investor protection perspective.

VI. Quantitative findings

32. NCAs were asked to perform an assessment regarding the level of ongoing charges figure and detect potential outliers, i.e. funds charging fees higher than their peers.

33. On the assessment regarding the detection of potential outliers, some NCAs reported that smaller entities constituted the largest part of the outliers identified. This was mainly due to the smaller amount of AuM and the higher impact of fixed costs. One NCA put in relation the Net Profit/AuM of the manager to the Total Fees/AuM figure: the outcome of the analysis showed that UCITS managers with lower net profits tend to charge, on average, higher fees and, conversely,

managers benefiting from economies of scale will tend to pass this benefit to the funds by setting lower prices.

34. These findings, if read in conjunction with the observed deficiencies/lack of formalised policies and procedures regarding the setting of the fees, highlight a potential risk of smaller UCITS managers setting higher fees compared to peer funds and/or having less structured pricing processes in place which could in turn potentially penalise the investors of the relevant funds.

35. While recognising that the different size of the investments/portfolio and possible economies of scale may have an impact on the level of costs for small and mid-sized entities, ESMA notes that retail investors should have access to the same level of protection, regardless of the size of the NAV of the fund or AuM of the manager. This finding is also confirmed by the ESMA 2022 ASR, which highlights that "across time horizons and asset classes, larger funds have lower costs than smaller funds. Over one-year and five-year horizons, on average, the top-25% funds, in terms of size, were around 20% cheaper than the bottom-25% funds across the asset classes considered". In this context, the report also confirms that the "main drivers are economies of scale and the reduced relevance of fixed costs over total assets".

36. The size of the investment also has an impact on the costs paid by retail investors, which are higher than those paid by institutional investors. This finding, also confirmed by the 2021 ESMA ASR, is also largely attributed by the economies of scale that fund managers gain on the larger amounts invested by institutional investors.

37. Higher fees are also attributed to actively managed UCITS compared to passively managed UCITS invested in the same asset class, as also confirmed by the findings of the 2021 ESMA ASR.[10] Overall, funds with lower SRRI and funds invested in bond and money market asset classes have lower fees than funds with higher SRRI and other asset classes across both management types. This is

ESMA views

VII. ESMA invites NCAs to specifically address the topic of costs of smaller funds/managers, where the risk of investors being charged with undue costs appears to be higher due to the lack of a structured pricing process. ESMA holds that such analysis is of paramount importance in order to provide retail investors exposed to such funds/managers with an adequate level of protection and ensure the viability of relevant retail investment products in terms of being capable to providing a positive return to their investors.

[10] . See, in particular, esma_50-165-1710_asr_performance_and_costs_of_eu_retail_investment_products.pdf (europa.eu), p. 18.

consistent to one of the findings of the ESMA ASR which shows that "*consistently across asset classes, higher risk classes correspond to higher performances and higher costs, and retail investors are subject to higher costs compared to institutional investors*".[11]

VII. EPM techniques

38. NCAs were asked to investigate and report on the practices of UCITS managers using EPM techniques.

39. The most common EPM techniques used by UCITS managers are securities lending, (reverse) repurchase agreements and buy-sell/sell-buy back transactions.

40. A number of NCAs reported that the majority of UCITS managers were unable to provide the requested copies evidencing that their internal policies and procedures on EPM ensure compliance with the applicable regulatory requirements. This issue was not observed by one NCA that conducted a thematic review on EPM techniques in 2019 and therefore already performed some comprehensive supervisory work in this area prior to the launch of the CSA.

41. Some NCAs also identified that the funds' prospectus was not always tailored to the specific UCITS as it stated that the fund may engage in certain transactions but did not state that it intends, does or will engage in those transactions.

42. Many NCAs also highlighted the lack of detailed information in the EPM-related disclosures regarding areas such as risks, conflicts of interest, impact on the performance of the UCITS and fee/revenue splits. Another problem that NCAs have mentioned is the use of generic language by UCITS managers on what EPM techniques they use and for what reasons. Moreover, some NCAs reported that most UCITS managers could have better explained their use of EPM techniques because the funds' prospectus was not always tailored to the specific UCITS. Instead, NCAs observed many cases where the same information was used across the UCITS managers' or even the group's fund range without sufficient regard to the specificities of the individual fund and EPM arrangement.

43. Regarding securities lending arrangements, several NCAs reported of cases where UCITS managers use fee splits without due consideration to assessing that both EPM revenues generated, and the amount of revenue deducted by the securities lending agent are in line with the fair market rates and therefore in the best interest of investors (often referred to as "fixed fee splits"). This is relevant in particular in situations where fund managers engage in arrangements with securities lending agents within their own group (related-party transactions) to deduct a fixed amount of the EPM revenue generated without due consideration

[11] *Ibidem*, p. 16.

to whether both (1) the revenue generated, and (2) the portion of the revenue retained by the group securities lending agent is indeed competitive and in line with fair market rates. Moreover, these types of fee split arrangements are often not (peer) reviewed and adjusted on a regular basis to reflect the evolution of the market conditions and prices but fixed in the sense that they might risk remaining at a consistently high level, despite competitors offering the same services with a similar level of quality and at a better rate. Hence, fixed fee split arrangements, in particular where this is done with related parties raises risks of investors being effectively overcharged.

44. A few NCAs reported that the majority or even all of the entities investigated during the CSA used fixed fee split arrangements, whereas in most other Member States this was only detected in isolated cases or not detected at all. However, the feedback received from some NCAs indicates that there are still some uncertainties on the notion of “fixed fee splits” and what type of fee arrangements could be reconciled with the ESMA Guidelines on ETFs and other UCITS issues.

45. The percentage retained by the securities lending agents in the CSA sample ranged from 50% on the high end of the scale to 10% on the low end. In this context, one NCA reported that outliers on fee splits concerning securities lending generally settle on the high end rather than the low end, with a few entities having implemented a fee split around 90% of the gross revenues being returned to the UCITS fund, while 10% go to the securities lending agent.

46. Many UCITS managers only return between 50% to 65% of the gross revenues to the fund and its investors. This is in line with the findings made in the Better Finance Research Paper which indicated large divergence concerning the percentage of revenue forwarded to investors and questioned the reasons for this. In this context, some NCAs have expressed the view that there would be merit in specifying the ESMA Guidelines on ETFs and other UCITS issues to ensure a greater level of supervisory convergence on the issue of fee splits.

47. Concerning reverse repurchase transactions, NCAs reported that a fixed split is generally not applied, as operational costs are already included in the repo rate applied to the transaction.

48. Although most NCAs reported that UCITS managers often did not perform a documented assessment to justify the costs deducted from the gross revenue earned on EPM techniques, UCITS managers still claimed that the total fees charged are in line with peers and market standards. In addition, those UCITS managers who did review their securities lending structures often did not make a clear distinction between indirect and direct costs.

49. In several Member States the majority of UCITS managers had conducted peer review assessments on the reasonability of the fee split compared to market standards. In contrast, one NCA reported that the vast majority of UCITS managers

in its jurisdiction did not perform such assessments. Nevertheless, UCITS managers still claimed that fees and revenues are in line with market standards as these are informally discussed and reviewed with the service lending agent on an annual basis.

50. NCAs also reported that most UCITS managers have implemented conflicts of interest policies. However, these do not always cover the employment of EPM techniques specifically.

51. Some NCAs reported that many UCITS managers do not have procedures in place for internal control and governance mechanisms with respect to EPM. However, many UCITS managers have a form of oversight in place for EPM techniques whereby senior management receives regular reports (monthly/bi-monthly/quarterly) on reviews and reconciliations performed by their delegates.

ESMA views

VIII. ESMA is of the view that the absence of any policies and procedures on the use of EPM constitutes a breach of regulatory obligations to have adequate policies and procedures in place on risk and portfolio management and would like to invite the relevant NCAs in those cases to consider taking stricter follow-up measures including enforcement actions, where appropriate.

IX. ESMA would like to stress that the indication of a mere theoretical possibility of using EPM is not in line with the ESMA Guidelines on ETFs and other UCITS issues where such indication is not complemented and specified with the clear disclosure of the additional information required by the ESMA Guidelines (counterparty risk, conflict of interest, impact on performance). This is because the ESMA Guidelines require the clear disclosure of the intention to engage in EPM and not just the theoretical possibility. It is important to ensure that UCITS managers do not engage in EPM techniques without clearly and comprehensively disclosing the specific arrangements and risks faced by investors as required under the ESMA Guidelines. Equally, incomplete or boilerplate disclosures that do not clearly inform investors of the specific arrangements and risks of the individual case cannot ensure compliance with the ESMA Guidelines on ETFs and other UCITS issues. ESMA would therefore invite the relevant NCAs in those cases to consider taking stricter follow-up measures including enforcement actions, where appropriate.

X. In light of the divergent market practices and doubts expressed by some NCAs, ESMA is of the view that the issue of fee-split arrangement merits further investigations and analysis.

XI. ESMA is concerned about the aforementioned adverse findings reported by a number of NCAs regarding the lack of EPM-related checks and controls performed by many UCITS managers. ESMA would therefore invite the relevant NCAs in those cases to consider taking stricter follow-up measures including enforcement actions, where appropriate.

VIII. Follow-up actions envisaged by NCAs

52. NCAs were asked to report on the follow-up actions that they plan on taking following the CSA exercise.

53. The majority of NCAs noted that they did not identify any regulatory breaches but rather discovered some deficiencies in the way UCITS managers applied relevant provisions and/or identified that certain aspects of the governance arrangements relating to costs and fees that did not meet the supervisory expectations set out in the ESMA supervisory briefing on the supervision of costs. These NCAs stated that identifying regulatory breaches proved to be challenging given the lack of specificity in the Level 1/Level 2 requirements on the topic of costs and fees and the fact that the supervisory briefing constitutes guidance rather than regulatory provisions.

54. Very few NCAs reported of regulatory breaches which were already addressed by imposing administrative measures. In one case, the breach related to a case of a fund having a share in another fund managed by the same management company which charged investors the management fees of both funds. This type of practice was already detected in previous investigations. Other NCAs indicated that the final decision on the types of follow-up actions on the identified shortcomings has not yet been taken.

55. The majority of NCAs highlighted that they have followed up/are going to follow up on the CSA's main findings by means of bilateral exchanges with the fund managers in order to ensure that the identified mitigating actions have been correctly put in place and deficiencies have been effectively remediated. Many NCAs highlighted that, in some cases, in light of the applicable regulatory framework, they do not have sufficient legal basis to escalate their interventions in case of adverse findings that do not constitute a clear-cut breach of a regulatory provision.

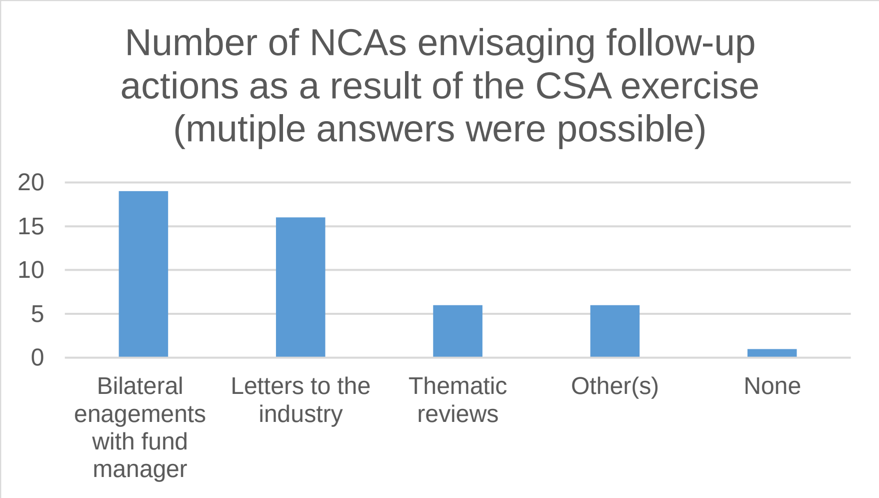
56. Many NCAs plan to issue a public report/industry letter on the outcome of the CSA exercise aimed at identifying best market practices. In addition, some NCAs have sent letters to UCITS managers to provide individual feedback, while others issued or plan to issue industry letters to provide more general feedback.

57. A few NCAs highlighted that the results of the CSA will play an essential role in ongoing and upcoming on-site inspections, and one NCA explicitly mentioned that it would continue monitoring the ongoing charges ratio through monthly reporting. Another NCA considers a revision of national legislation as an additional measure to complement the obligation to maintain decision-making procedures for the pricing framework and adequate and orderly records of their business.

58. The CSA survey provided an overview of the envisaged follow-up NCA actions which confirms that bilateral engagement with fund managers is the preferred tool

used by NCAs to address the adverse findings identified in the course of the exercise, followed by letters to the industry and thematic reviews. Among the other tools, NCAs also envisage to follow-up with on-site inspections, additional investigations, and other corrective measures.

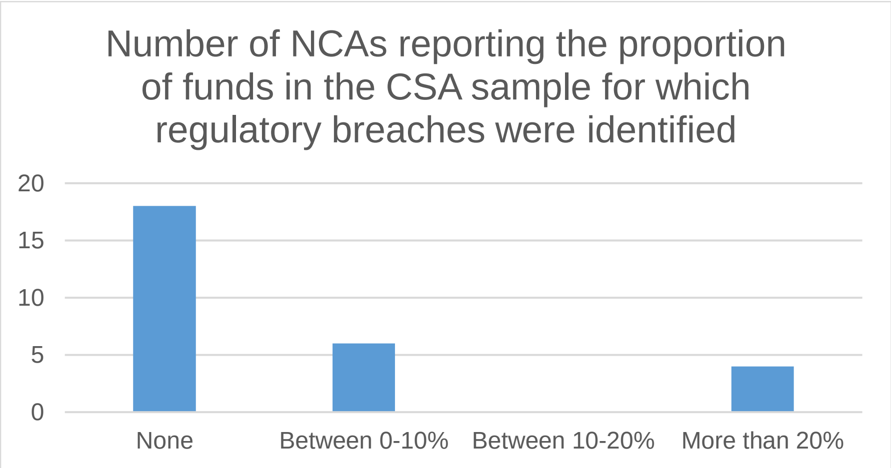
Table 3



59. Overall, only a low number of regulatory breaches were identified by NCAs in the course of the CSA. However, in most cases of identified breaches, NCAs do not plan to take any follow-up actions in the form of using their enforcement powers, e.g. to impose sanctions.

60. Six NCAs reported that the proportion of the fund managers in the CSA sample (i.e. number of fund managers/total number of fund managers in the sample) that have committed regulatory breaches was between 0 and 10% and four NCAs reported a percentage higher than 20%.

Table 4



61. The above results are confirmed by the fact that 25 NCAs are not planning to refer any case to enforcement and for 17 of them the reason was that no regulatory breach was detected. Five NCAs confirmed that the detected regulatory breach(es) can be better solved through escalated supervisory measures, others that the finding was minor or already remediated.

Table 5

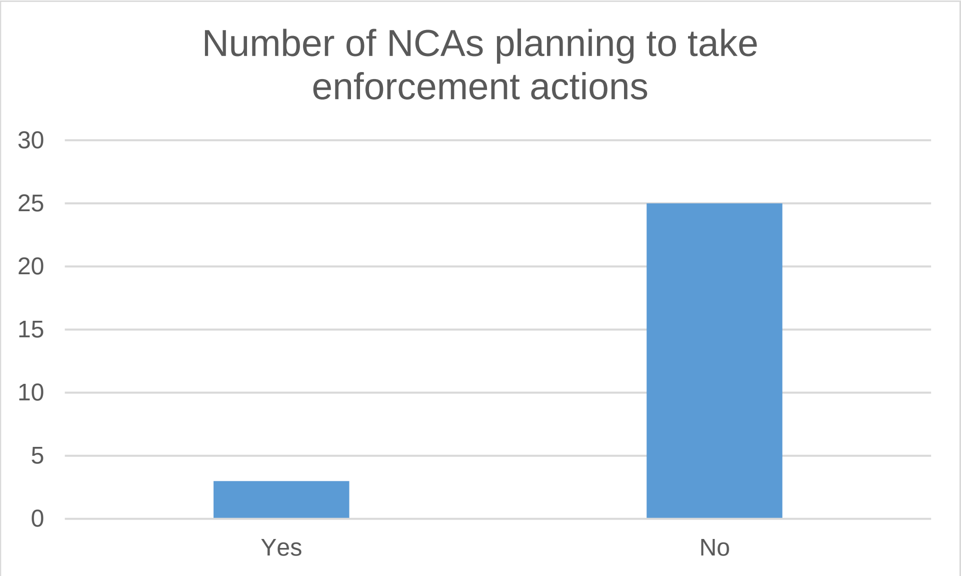
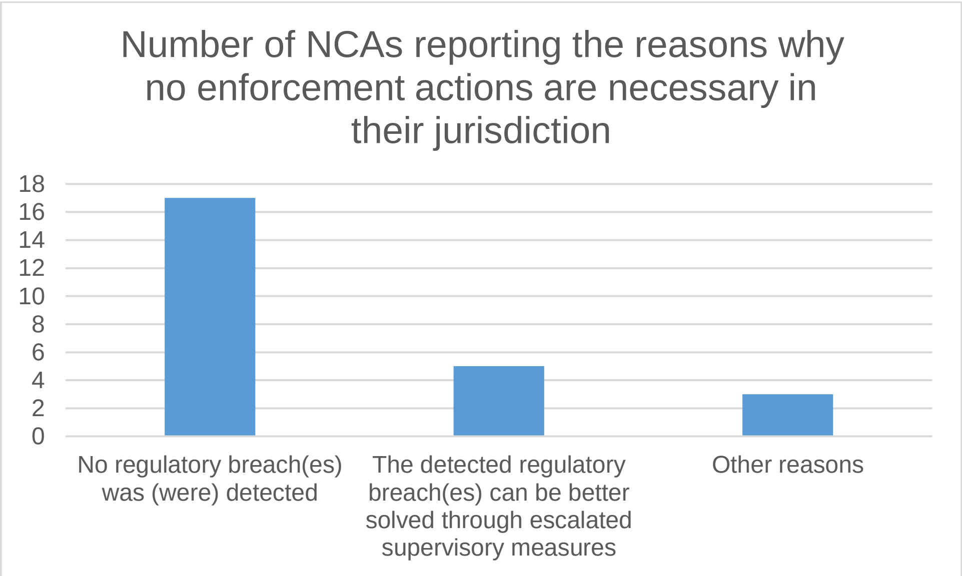


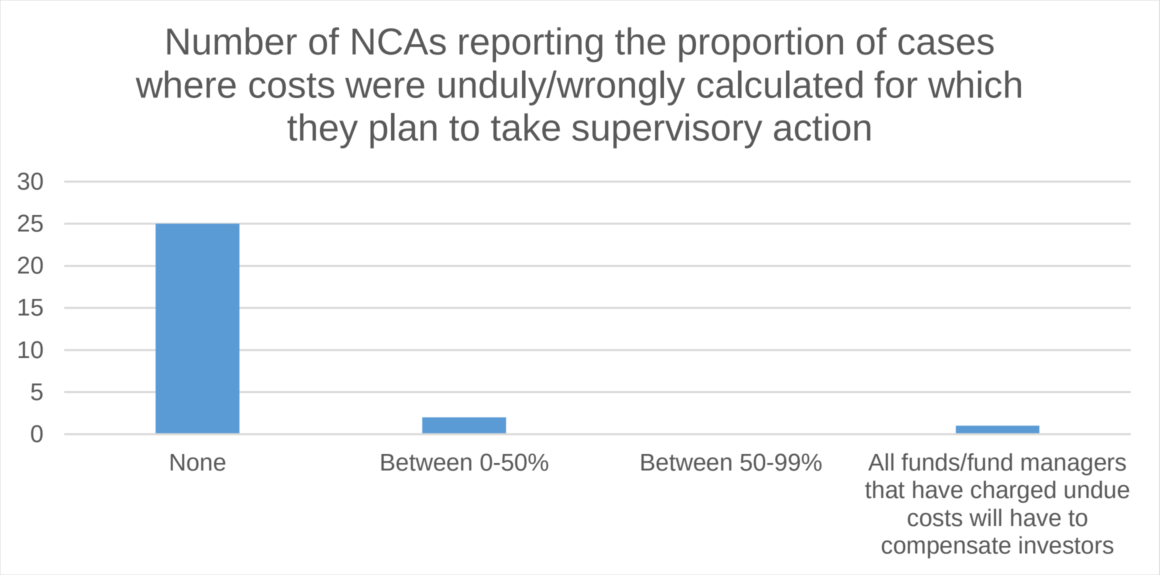
Table 6



62. On the topic of investor compensation, the results of the CSA survey show that only in one jurisdiction all funds/fund managers that have charged undue costs will have to compensate investors. In this jurisdiction the errors of calculations of costs and fees outlined as part of the CSA were all remediated via compensation to the

relevant share classes and reissuance of the correct NAV within a timely manner with no financial losses suffered by investors. Two NCAs are envisaging investor compensation in 50% of the cases where undue costs were charged. All other NCAs are not planning to take supervisory action to ensure investor compensation. This result raises concerns for ESMA considering that 11 NCAs reported cases where undue costs and/or costs higher than peer funds and/or costs wrongly calculated were charged to investors.

Table 7



ESMA views

XII. ESMA acknowledges NCAs' general preference to use escalated supervisory measures instead of taking stricter enforcement measures.25 However, ESMA would like to invite NCAs to seize the opportunity of the CSA to also consider enforcement actions in the limited cases where a significant regulatory breach was identified, particularly bearing in mind that the area of costs and fees is a priority area/USSP and given its high investor protection relevance.

XIII. ESMA stresses the importance of ensuring that investors are adequately compensated in all cases where they were charged with undue costs/fees or there were calculation errors that resulted in a financial detriment for investors.

[25] See, for instance, the 2019 and 2020 UCITS sanctions reports available at esma34-45-934_2019_ucits_sanctions_report.pdf (europa.eu) and esma34-45-1269_2020_ucits_sanctions_report.pdf (europa.eu).

IX. Main lessons learnt from the CSA

63. NCAs were also asked to report on the main lessons learnt from the CSA.

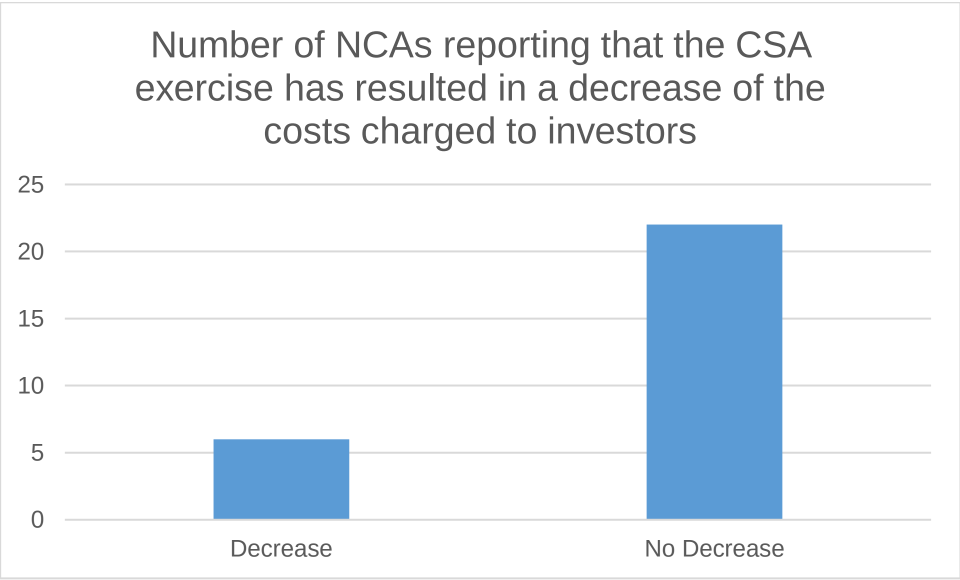
64. Broadly, NCAs welcomed the CSA as a useful exercise to take stock of the industry practices and level of compliance concerning the topic of costs and fees.

65. One NCA reported that as the results of this CSA have been shared by the supervision team with the authorisation team, the latter will perform an enhanced scrutiny of certain general issues and risks identified in the context of the CSA in future authorisation cases. In particular, where the cost/fee structure in place requires further analysis, the team assessing the application at the authorisation stage may now request model portfolio information, evidence of stress testing and information on any scenario that has been underestimated.

66. One NCA confirmed that thanks to the CSA two managers lowered the management fee of their funds and, the average ongoing charges for the SRRI 3 and 4 category lowered, respectively, for 50 and 20 basis points following the CSA exercise.

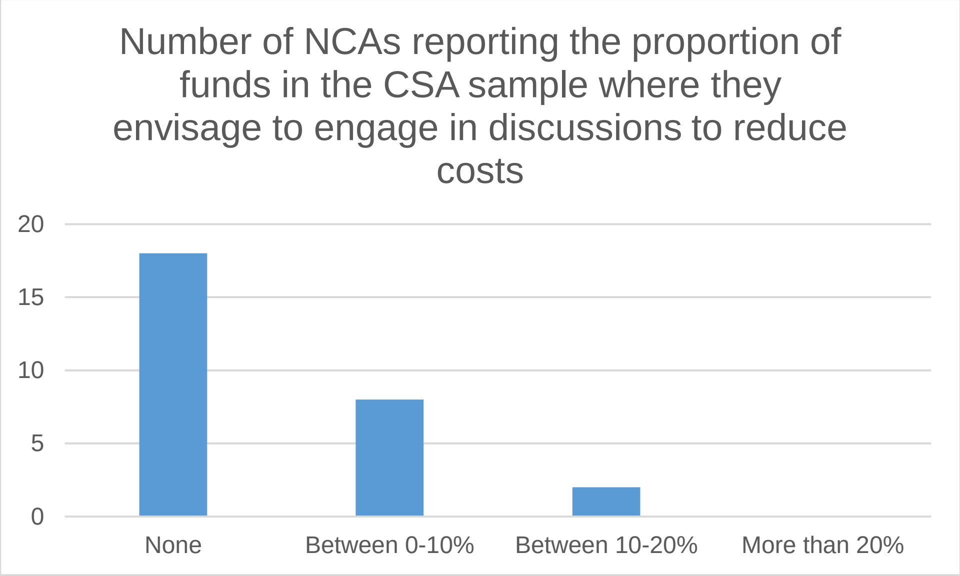
67. The outcome of the CSA survey shows that, for the moment, only six NCAs have reported a decrease of the charged costs as a result of the CSA exercise.

Table 8



68. Linked to the above, it is interesting to notice that the majority of NCAs reported that they do not envisage to engage in discussions to reduce the costs charged by the funds in the CSA sample. Eight NCAs plan to follow-up with a proportion of funds (i.e. number of funds/total number of funds in the sample) between 0-10% and only two NCAs reported a percentage between 10 and 20%.

Table 9



ESMA views

XIV. ESMA believes that the control of the cost/fee structure of the fund at funds' authorisation stage is a positive development. ESMA would encourage all NCAs to perform enhanced scrutiny on the topic of costs and fees as part of NCAs' gatekeeping role with a view to addressing the important investor protection risks in this area in a more timely and effective manner.

XV. ESMA considers that lowering the management fee of the fund as a result of the CSA exercise is a positive and concrete outcome for investors. ESMA would encourage other NCAs to follow this path and ensure that fees are lowered, and investors compensated in cases where undue costs were charged and/or costs were wrongly calculated.