



Commission de Surveillance
du Secteur Financier

ESMA COMMON SUPERVISORY ACTION ON THE SUPERVISION OF COSTS AND FEES OF UCITS

CSSF FEEDBACK REPORT

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ESMA COMMON SUPERVISORY ACTION ON THE SUPERVISION OF COSTS AND FEES OF UCITS

1. Context

On 6 January 2021, the European Securities and Markets Authority (ESMA) launched a Common Supervisory Action (CSA) with national competent authorities (NCAs) on the supervision of costs and fees of UCITS across the European Union.

The aim of the CSA on costs and fees was to assess the compliance of supervised entities with the relevant cost-related provisions in the UCITS framework and the obligation of not charging investors with undue costs. It was agreed in the CSA assessment framework to notably consider the supervisory briefing¹ on the supervision of costs in UCITS and AIFs (hereafter “supervisory briefing”) published in June 2020 and the Commission Regulation (EU) No 583/2010² as regards key investor information. The supervisory briefing set common criteria to assessing the notion of “undue costs”³ and supervising the obligation to prevent undue costs being charged to investors.

The ESMA 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 (ref.: ESMA/2014/937)⁴ as detailed in Section 3 of the present report.

¹ [*ESMA 34-39-1042 supervisory briefing on the supervision of costs.pdf*](#)

² [*Commission Regulation \(EU\) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website*](#)

³ See, in particular, paragraph 19) of the supervisory briefing.

⁴ [*ESMA Guidelines on ETFs and other UCITS issues*](#)

Ensuring investor protection and greater convergence in the supervision of costs are key factors to ensure that investors' confidence in financial markets is improved. To this aim, ESMA launched the CSA with a view to assessing whether market participants adhere to those rules in practice. This was done on the basis of a common methodology developed at the level of ESMA.

The CSSF started the ESMA CSA in March 2021 by asking 36 management companies (hereafter "IFMs"), domiciled in Luxembourg and managing UCITS, to complete a dedicated questionnaire via the eDesk portal for all UCITS they managed. The final sample comprised 2,654 UCITS sub-funds, among which 147 sub-funds of foreign UCITS. The CSSF then analysed the information collected and sent its final report to ESMA at the end of December 2021.

On 31 May 2022, ESMA published the results of the CSA at EU level in [a report on the Common Supervisory Action \(CSA\)](#) on costs and fees for investment funds (hereafter "ESMA report on the CSA"). 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 setting and reviewing of fees, the notion of undue costs, the issues stemming from related party transactions and the costs related to EPM techniques as well as the follow-up actions envisaged by NCAs and the main lessons learnt.

ESMA informed in that context that the overall level of compliance with the applicable EU legislative framework was satisfactory for most IFMs, but that the exercise also showed shortcomings and the need for improvements in certain key areas.

ESMA as well reminded that the topic of costs and fees was identified as a Union Strategic Supervisory Priority (USSP) given its relevance from an investor protection perspective and that further work will be performed for promoting supervisory convergence in that area. ESMA will also consider whether the results of the CSA should lead to any follow-up policy work.

While the overall analysis of compliance for IFMs in Luxembourg is mostly consistent with the conclusions of ESMA, the objective of the present feedback report is to inform the industry about the main observations that the CSSF made in the context of its CSA supervisory work as well as about the related recommendations for improvements in view of the applicable regulatory requirements.

The CSSF is currently engaging on a bilateral basis with certain IFMs in relation to the observations made in the context of the ESMA CSA exercise, thereby asking these IFMs to implement the necessary corrective measures for the shortcomings observed.

In addition, the CSSF asks hereby all IFMs to conduct, as soon as possible and at the latest by the end of Q1/2023, a comprehensive assessment with regard to the compliance of their policy, approach and arrangements related to costs, in relation to the observations of ESMA and of the CSSF and to take, if applicable, the necessary corrective measures.

As the supervisory briefing on the supervision of costs applies both to UCITS and AIFs, the CSSF requires that the review of the pricing process is also performed by AIFMs for their AIFs under management.

2. Observations

2.1 Pricing process

Paragraphs 18 and 19 of the supervisory briefing set out the principles of the notion of undue costs and the characteristics of a structured pricing process. The following points are particularly noteworthy:

*“18. b) **the pricing process adopted by the management company allows a clear 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.*

*19. In order to allow NCAs to appropriately supervise that investors are not charged with undue costs, NCAs are expected to require that management companies **develop and periodically review a structured pricing process...**”.*

In relation to these requirements, the CSSF observed several weaknesses regarding the pricing process.

First, in terms of procedure's documentation and decisions' formalisation. Some entities have a less formalised process and do not necessarily have automatised and standardised approaches. The CSSF noted that smaller entities have in place less formalised pricing processes compared to entities with larger amounts of assets under management (hereafter "AuM").

While larger IFMs demonstrated to have better pricing process in place in line with Paragraph 18 and 19 of the supervisory briefing, including committees with members from the IFMs as well as the portfolio manager, in some instances, small IFMs overrely on portfolio managers for the pricing of the fund.

The CSSF also observed a certain disparity concerning the degree of sophistication of the pricing process as well as its standardisation. IFMs sometimes refer to existing procedures which cover more general (in the sense of "high-level") processes (for example "Control and Supervisory Function", "Product Governance" or "KIID Production") and which are not specifically dedicated to fees set-up and review. These procedures also sometimes refer to other documents existing at fund administration agent level.

In addition, poor processes and inconsistent analysis were detected in a few cases: absence of periodic review of the fee structure, insufficient frequency of this periodic review, lack of review of the level of fees in light of the performance of the fund.

On that basis, the CSSF expects all IFMs, regardless of their size, in accordance with the applicable regulation and in line with the ESMA report on the CSA, to:

- define and implement a structured and formalised pricing process, bearing in mind the characteristics of their fund(s) and the recommendations enshrined in the supervisory briefing;
- perform an independent (i.e. from the portfolio manager) analysis of the fee structures once those have been established. It should be avoided to over rely on the assessment made by the portfolio manager and a more active role of the senior management, internal control functions, and relevant functions/ committees should be ensured;

- periodically review the level of cost, **at least on an annual basis**, and monitor it in order to compare the estimated ongoing charges with the actual expenses incurred by the fund and, where possible, reduce the level of fees;
- ensure the viability and competitiveness of the fund over time by taking due care of the sustainability of the costs over time (not only considered ex ante, but also based on the actual ex post investment performance) and ensure an appropriate level of fees in the best interest of investors.

2.2 The notion of undue costs

Article 25(4) of the CSSF Regulation 10-4¹ requires IFMs to act in such a way as to prevent undue costs being charged to the UCITS and its unitholders.

Additionally, the supervisory briefing sets common criteria for assessing the notion of “undue costs” and supervising the obligation to prevent undue costs being charged to investors. In this context, the notion of undue costs can be assessed on the basis of the principles set out in paragraphs 18 and 19 of the supervisory briefing and notably the costs charged to the fund or its unit holders should :

- **be consistent** with the investment objective of the fund and do not prevent the fund to achieve this objective;
- **be linked to a service** provided in the **investor’s best interest**;
- **be proportionate** compared to market standards and to the type of service provided;
- **be consistent** with the characteristics of the fund;
- **be sustainable** taking into account the expected net return of the fund, based also on its risk profile and investment strategy;
- ensure investors’ **equal treatment**;

¹ CSSF Regulation 10-4 transposing Commission Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company as amended by CSSF Regulation No 22-05 of 27 July 2022 amending CSSF Regulation No 10-4 of 20 December 2010 (Mém. A 2022, No 405)

- **not be of material prejudice** to the interests of any class of unitholders or potential unitholders;
- **not be duplicated** (e.g.: the same type of fee is not included in two different cost categories);
- be properly **separated** and accounted for;
- **be clearly disclosed** to investors.

The CSSF reminds IFMS that the pricing process to be defined and implemented must take these criteria into account in order to assess whether costs are appropriate.

2.3 Related party transactions

Chapter III of the CSSF Regulation 10-4 concerning conflicts of interest specifies the provisions that IFMs have to comply with in application of Article 109 (1) (b) and Article 111 (d) of the Law of 17 December 2010.

Furthermore, Articles 18 to 23 of the CSSF Regulation 10-4 require IFMs, amongst others, to have a conflicts of interest policy, to keep and regularly update a record of the types of activities subject to a conflict of interest and to manage the activities giving rise to detrimental conflicts of interest.

92% of the IFMs in the scope of the ESMA CSA sample have identified related party transactions. The CSSF observed in the context of its CSA work that the identification of diverse situations of conflict of interest were not properly performed for few IFMs as their conflicts of interest register and/or their conflicts of interest policy do not adequately refer to these situations.

On that basis, the CSSF asks IFMs to ensure that adequate conflicts of interest policy and comprehensive conflicts of interest register are in place to ensure an effective mitigation of conflicts of interest in related-party transactions.

Please also refer to paragraph 3.2.3 for additional details regarding conflicts of interest's findings in relation to EPM.

2.4 Quantitative findings: costs categories and costs of smaller funds

2.4.1 Types of charges included in the ongoing charges figures in the KIID

Point 5 of the CESR Guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document (CESR/10-674)¹ mentions the charges and payments that shall not form part of the amount to be disclosed as ongoing charges in the KIID.

In reviewing the breakdown of the different types of charges included in the ongoing charges figures calculated in the fund's sample, the CSSF identified breaches of this point of the CESR Guidelines. More particularly, the CSSF observed cases where IFMs had wrongly included performance fees or interest on borrowings in the amount to be disclosed as ongoing charges.

These above identified vulnerabilities showed that, when getting more into the detail of the different types of charges included in the ongoing charges figures, the practices observed at the level of the industry participants may present room for improvement.

On that basis, the CSSF reminds IFMs to develop and implement a documented internal approach for the definition of what charges and payments shall or shall not form part of the amount to be disclosed as ongoing charges in the KIID for supporting the disclosure in the KIID.

2.4.2 Costs of smaller funds

In the CSA exercise, the CSSF has compiled the averages of ongoing charges level for 2020 by type of strategy. From these averages, the CSSF compared the level of ongoing charges between funds having a common strategy (peer funds) and has detected potential outliers, i.e. funds charging fees much higher than their peers.

¹ [METHODOLOGY FOR CALCULATION OF THE ONGOING CHARGES FIGURE IN THE KEY INVESTOR INFORMATION DOCUMENT](#)

The main reason for a high level of ongoing charges provided by outliers' IFMs is the low amount of assets under management and the newly launched fund which lead to the observation that almost half of the high ongoing charges observation are due to a low level of AuM. The CSSF has noted that fixed costs undeniably generate a high percentage in comparison to a low amount of assets under management.

The CSSF is currently carrying out the necessary analysis to assess this situation and will inform in due time the industry about the main observations and conclusions that will be drawn.

Pending these conclusions, the CSSF wishes to draw the attention of IFMs to the fact that these situations of high costs concerning funds with low AUM must not persist for long periods, otherwise these costs will have to be considered as "undue".

As of now, the CSSF asks all IFMs to assess the current and foreseeable level of costs associated with their low AuM funds in order to ensure that no undue costs are charged to investors. The CSSF also require IFMs to verify the viability of these funds in terms of their ability to provide a positive return to their investors and the viability of the costs borne by these funds.

3. Use of EPM techniques by UCITS

3.1 Context

The CSSF performed at the end of 2019 a thematic review on the use of Efficient Portfolio Management techniques (EPM) by Luxembourg UCITS and more particularly securities lending transactions as well as (reverse) repurchase agreement transactions.

The following 2 documents were [published](#) as a result on 18 December 2020:

- a report "*CSSF Thematic Review – Efficient Portfolio Management by UCITS – Revenues & Costs/Fees*" which presents the main observations made by the CSSF, together with the related recommendations; and

- an FAQ “CSSF FAQ - *Use of Securities Financing Transactions by UCITS*” (the “CSSF FAQ”) in relation to the use by Luxembourg UCITS of securities lending transactions and (reverse) repurchase agreement transactions and whose objective was to provide clarifications concerning the use by UCITS of these Securities Financing Transactions (SFTs).

The ESMA Common Supervisory Action on the supervision of costs and fees of UCITS (the “ESMA CSA”) covered 36 IFMs domiciled in Luxembourg, among which 10 IFMs employing EPM techniques were selected to contribute to the EPM part of the CSA.

The objective of the ESMA CSA work on EPM was to assess whether the IFMs complied with the requirements of the UCITS framework and the ESMA Guidelines on ETFs and other UCITS issues (ref.: ESMA/2014/937EN dated 1 August 2014).

The present section informs the industry about the main observations that the CSSF made in the context of the ESMA CSA supervisory work on EPM as well as about the related recommendations for improvements in view of the applicable regulatory requirements.

These observations shall be read together with the conclusions drawn by ESMA and set out in the ESMA report “[Final Report – On the 2021 CSA on costs and fees](#)” as a result of the supervisory work performed across the EU/EEA. The ESMA conclusions on EPM techniques (as referred to in section VII “EPM techniques” of the ESMA report) are consistent on some aspects with the observations made by the CSSF at a local level.

The CSSF is currently engaging on a bilateral basis with IFMs in relation to the observations made in the context of the ESMA CSA exercise, thereby asking these managers to implement the necessary corrective measures for the shortcomings observed.

In addition, the CSSF asks hereby all IFMs to conduct, **at the latest by the end of Q1/2023**, a comprehensive assessment with regard to the compliance of the set-up of their EPM activities in relation to the observations made by ESMA and the CSSF and to take, if applicable, the necessary corrective measures.

3.2 Observations

3.2.1 *Internal policies and procedures on EPM*

Article 109 (1) (a) of the Law of 17 December 2010 relating to undertakings for collective investment (the “Law of 17 December 2010”), as further supplemented by Article 5 (1) (a), (b) and (d) of CSSF Regulation 10-4 and Section 5.5.4 of Circular CSSF 18/698, requires notably that every UCITS manager must establish a precise and clear manual of procedures which describes more specifically its internal functioning, the allocation of tasks amongst its staff and the reporting lines. This manual of procedures must be available at the registered office of the IFMs, accessible to its staff and kept up-to-date considering the evolution of the activity.

The CSSF observed in the ESMA CSA that most IFMs had documented policies and procedures in place - with a varying level of granularity – governing the use of EPM techniques.

Generally speaking, these policies and procedures, which have to cover the organisational and operational arrangements in relation to the EPM techniques employed, need however to be enhanced by addressing in particular in a detailed manner the following aspects:

- a definition of the EPM techniques used, thereby considering that the UCITS regulatory framework does not limit techniques and instruments relating to transferable securities and money market instruments to the sole SFT transactions, as referred to above, and that in particular also financial derivative instruments (for instance options, futures, swaps) can be used under the EPM framework if they comply with the related regulatory provisions;
- the specific roles and services provided by the third parties involved in the EPM techniques operated on behalf of the UCITS managed to which direct and indirect operational costs / fees are paid;
- the controls in place at the level of the IFMs to ensure that all the revenues arising from the EPM techniques, net of direct and indirect operational costs, are returned to the UCITS and to enable them by that mean to justify the operational costs deducted from the gross revenues earned on EPM transactions.

3.2.2 Operational costs controls

The ESMA Guidelines on ETFs and other UCITS issues, implemented in the Luxembourg regulation by means of Circular CSSF 14/592, mention in the paragraphs 28 and 29:

*"The UCITS should disclose in the prospectus the policy regarding **direct and indirect operational costs/fees arising from efficient portfolio management techniques** that may be deducted from the revenue delivered to the UCITS. These costs and fees should **not include hidden revenue.**"* and *"**All the revenues** arising from efficient portfolio management techniques, **net of direct and indirect operational costs, should be returned to the UCITS**".* (emphasis added)

Moreover, the CSSF clarifies in point 2.1. of the CSSF FAQ:

*"Operational costs / fees arising from SFTs do not include hidden revenues. **Only effective costs / fees, corresponding to services rendered to the UCITS in the context of SFTs, can be charged to the UCITS.** (...)*

*The CSSF expects UCITS IFMs to perform a comprehensive assessment of the adequacy of the operational costs / fees that are deducted from the gross revenues arising from SFTs. In order to comply with the present requirement and notably ensure that the costs / fees do not include any hidden revenue, **UCITS IFMs must be able to justify, by means also of quantitative information, the relevance of the underlying cost drivers which make up the total costs / fees borne by the UCITS.***

*In a general manner, UCITS have to be able **to justify the ratio of gross revenues to direct and indirect operational costs / fees** arising per SFT and **to provide corresponding documentary evidence of the underlying rationale**".* (emphasis added)

The CSSF observed in the ESMA CSA a certain disparity concerning the fixed fee splits operated for the securities lending transactions, with practices observed ranging from a 40%/60% fee split to an 8%/92% split (i.e. the first figure refers to the costs / fees deducted from the gross revenue, while the second figure relates to the proportion of the gross revenue that is returned to the UCITS).

At the same time, the CSSF noted that IFMs generally have to enhance the level of granularity of the specific documented assessment / analysis for justifying the operational costs deducted from the gross revenue earned on EPM techniques. Furthermore, upon request by the CSSF, some IFMs could not provide sufficient quantitative information to justify the relevance of the underlying cost drivers which make up the total costs / fees borne by the UCITS and thus the fee split level operated.

Based on these observations, the CSSF asks IFMs to enhance the control framework (including also the related materialisation / documentation of these controls) around the operational costs / fees deducted from the gross revenues arising from EPM techniques by:

- (i) enhancing the best execution controls in relation to EPM techniques covering these transactions specifically in the best execution policy and by ensuring that the UCITS obtain the best possible result as regards not only the revenues generated by the EPM techniques (e.g. securities lending fee), but also the costs / fees charged to the UCITS when employing such transactions;
- (ii) to develop the depth of the controls in regard to the operational costs deducted from the gross revenue, thereby also critically assessing the operational costs charged by the third parties involved in the performance of EPM activities for the UCITS and making use of quantitative information when performing such controls.

IFMs have to adhere in that context strictly to the guidance given by the CSSF in the above mentioned CSSF FAQ.

3.2.3 Conflicts of interest management

As mentioned above in section 2.3 of this report, Chapter III of the CSSF Regulation 10-4 specifies the provisions that IFMs have to comply with in relation to conflicts of interest.

Furthermore, Article 20 stresses notably that the conflicts of interest policy of an IFM which is part of a group shall also take into account any circumstances of which the company is or should be aware which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group.

In accordance with point 3.1. of the CSSF FAQ, IFMs have *"to proceed to a **comprehensive documented assessment of the operational model** and related processes underlying the use of the SFT in order to **identify and record the circumstances which constitute or may give rise to a conflict of interest** entailing a material risk of damage to the interests of the UCITS."* and *"to **mitigate the conflicts of interest identified** and to **manage** those if they cannot be prevented, including by **adequate disclosure** of material conflicts of interest to investors by means of the UCITS prospectus. The CSSF finally considers that SFTs concluded with involving related parties give rise to conflicts of interest that have to be managed accordingly."*

In the context of the ESMA CSA, the CSSF observed that most of the IFMs assessed operate the EPM techniques with a securities lending agent that is part of the same group.

While these IFMs have established a conflicts of interest policy with related procedures, the CSSF noted that these documents were general and did not specifically cover the employment of EPM techniques. Furthermore, the conflicts of interest register did not always identify, in a precise manner, the specific conflicts of interest related to the EPM activities and the specific measures implemented for mitigating such conflicts of interest.

Following from above, the CSSF asks IFMs to cover adequately, in compliance with the above-mentioned applicable regulation and guidance, the conflicts of interests arising from the use of EPM techniques.

3.2.4 Governance and control mechanisms around the use of EPM techniques

The CSSF noted in the ESMA CSA that for most IFMs a recent review of their policies and procedures on EPM related costs and fees, involving their senior management, was performed.

However, the CSSF observed in that context that the materialisation (including versioning, date of review/validation) as well as the depth of these reviews must in most cases be improved.

Furthermore, the CSSF identified shortcomings in the procedural and control framework in place at IFMs concerning EPM techniques, as evidenced by the list of observations set out in the present document, which were previously not detected by the compliance or internal audit functions in their monitoring / review activities.

On that basis, the CSSF asks IFMs, in accordance with Article 11 (1) and (2) and Article 12 (2) of the CSSF Regulation 10-4, to provide for an adequate and periodic involvement of the compliance and internal audit functions for verifying the compliance of the activities concerning the EPM techniques with the applicable regulation.



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