ESMA Supervisory briefing – application examples on the preparation of guidelines for management companies concerning the pricing process

A) Requirements of the ESMA Supervisory briefing

In the pricing process, to preclude hidden costs, management companies must identify and quantify all costs charged to the fund regardless of the party to which they are ultimately credited.

In the pricing process, management companies shall assess, inter alia, whether:

a) the costs charged for the service are in line with the investors' best interests. Firms must assess whether the costs are necessary for example to execute the investment policy or comply with regulatory requirements.
b) the costs are proportionate with market standards and funds with a comparable investment strategy
c) the cost structure is consistent with the investment strategy (more complex strategies involve higher costs than simpler ones)
d) the costs are reasonable with a view to the expected net return of the fund as well as its risk profile and investment strategy
e) pricing across the unitholders is equitable
f) the costs are clearly broken down into costs paid by the management company and costs charged to the UCITS, so that they are not charged twice
g) a maximum has been set for the various costs (such as subscription and redemption fees) and stated to the investors in clear terms
h) the fee model concerning performance fees, if any, is compliant with the ESMA Guidelines on performance fees (ESMA34-39-992) and stated to investors in line with the Guidelines.
i) all costs are disclosed to investors in line with EU regulation (AIFMD, PRIIPS and UCITS) and any national requirements
j) the pricing process and costs charged to the fund are based on reliable and documented data, allowing the supervisor to recalculate afterwards the costs charged to the fund.

B. Application examples

1) Clear pricing models, no undue costs charged to investors

Based on the sample reviewed, the pricing and fee models applied by the firms are not generally complex, but they can be considered clear and transparent. Performance-based fee models may make the pricing models more difficult for the target groups using the funds concerned. However, the use of performance fees is not very common. These were found in funds managed by two management companies within the sample, one of which had discontinued the use of performance fees during the review period.

No outright misconduct, such as fees charged twice, was identified in the sample. However, the methodologies of the thematic review were insufficient to examine all payments or cash flows referred to in the responses, such as arrangements related to kickbacks.

> *Application example 1: For example, excessive trading and the resulting costs may constitute undue costs.*

> *Application example 2: Regulation on inducements and the management of conflicts of interests should be considered in any kickback arrangements.*

2) Pricing is based on market factors – Assessment of investors' interests does not play a key role

The review of the funds' cost level demonstrates that, as a rule, pricing by management companies is based on competitive and market conditions as well as the amount of costs resulting from the management of the fund.

Some of the firms also review costs from the investors' perspective, but this is not the primary starting point for determining the final cost level. The pricing processes do not include, for example, an evaluation or specification of maximum fees and costs in proportion to the fund's expected returns, when considered as a whole in advance.

Neither do the firms present, in the context of the product governance procedure or definition of the customer target group, any other quantitative limits in addition to the maximum levels, as to how high the costs may be relative to expected return.

> *Application example 3: In establishing costs and fees, it would be warranted that the firms would consider the investors' interests from the perspective of the acceptable proportion of costs and fees out of total return.*

> *Application example 4: The consideration of investors' interests should take place at the level of an individual fund or share class to ensure that each individual fund or share class offered to an investor would be reasonable from the investors' point of view and consistent with the investors' interests. All unitholders should participate in the costs of a fund. A fund shall not include share classes whose holders are not charged fees at all.*

3) Documentation of the pricing processes is flawed

The FIN-FSA was unable to ascertain that the firms comply with the guidance provided in the Supervisory briefing, due to shortcomings in the documentation provided by the firms. Some of the firms had considered questions related to fund pricing in processes and documents required by other regulation, such as requirements concerning product governance procedures.

> *Application example 5: As part of the pricing process, firms should also provide the rationale underlying the cost and fee structures as well as the amounts established. Through describing the rationale, it can be ensured that all pertinent factors, including the investors' interests, are considered in setting costs and fees, and assessing them on a regular basis.*

4) Information in key investor information documents was found appropriate

Information required in the key investor information document on the fund's activeness and benchmark, among other things, was mainly presented well. Furthermore, all KIIDs included the required description of the fund's degree of freedom from the benchmark. Individual shortcomings of a more minor nature were identified in the presentation of past performance.

5) Shortcomings in the documentation of the process for the calculation of ongoing charges

Not all firms were able to specify, with the required level of precision, the items constituting the fund's total costs (the ongoing charges figure). Neither were they able to present their internal process guidelines for the determination of ongoing charges, which demonstrates room for improvement in this respect.

> *<u>Application example 6:</u> The calculation of ongoing charges of the funds should be documented in a manner allowing the supervisor to verify, where necessary, which items comprise the ongoing charges figure.*

6) Costs and fee level across different fund categories are consistent

The average ongoing charges of the funds included in the sample, broken down by fund category and risk-reward ratio, were generally consistent. Funds involving higher risk, such as equity funds investing in small companies, charged higher costs than funds in lower risk categories.

The main justification for the level of ongoing charges was the activeness of the fund, i.e. the amount of active risk. The responses were at a general level and did not assess the significance of activeness on a fund-specific basis in more detail or report related key figures.

7) Some funds had a relatively high level of fees; fees in general are slightly declining

The level of costs of Finnish funds has been declining in recent years[1]. Some of the funds in the sample stood out with relatively high ongoing charges (approximately 30–80% higher than funds in the peer group). The ongoing charges of the abovementioned funds ranged from 1.5% to 2.6%[2]. The majority of these funds were funds investing globally in equities or both equities and fixed income through other funds.

8) No significant deficiencies were found in arrangements related to the use of effective portfolio management techniques (EPM).

Firms applying EPM (for example share lending) must consider, among other things, what techniques may be used by UCITS and under what conditions, and what

[1] Average ongoing charges of Finnish UCITS and non-UCITS funds, according to Investment Research Finland: 1.4% (2017), 1.32% (2018), 1.29% (2019) and 1.27% (2020).
[2] Asset-weighted average of the share classes in the survey.

information must be provided to investors on the use of such techniques. Income derived from the use of such techniques must be credited to the fund.

Application example 7: Management companies' internal processes and guidelines must indicate how the arrangements required by regulation are carried out. Furthermore, investor information (including fund rules) must only indicate the EPM techniques actually used by the UCITS instead of listing all techniques that may possibly be applied in the future.