MFSA MALTA FINANCIAL SERVICES AUTHORITY

Circular

11 April 2022

Outcome of the 2021 Common Supervisory Action ('CSA') on UCITS Costs and Fees conducted on Maltese UCITS Managers and Self-Managed UCITS Schemes

1.0 Background and Methodology

On 06 January 2021, the European Securities and Markets Authority ('**ESMA**') launched a Common Supervisory Action[1] ('**CSA**') on the supervision of costs and fees of UCITS across the European Union ('**EU**'). The purpose of this exercise was to assess the compliance of Maltese UCITS Managers and Self-Managed UCITS Schemes (henceforth referred as '**UCITS Managers**') with the relevant cost-related provisions in the UCITS framework, taking also into account the supervisory briefing on the supervision of costs[2] published by ESMA in June 2020.

The CSA also covered UCITS Managers 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[3].

The Malta Financial Services Authority (henceforth referred as **'the MFSA'** or **'the Authority'**) has participated in this CSA and shared knowledge and experiences at the level of ESMA throughout 2021.This CSA was executed on the local market in two phases. In the first phase, the MFSA gathered responses and evidence from a number of UCITS managers through a common questionnaire, whereas in the second phase, the MFSA conducted further supervisory analyses through follow up questions and thematic compliance inspections to assess whether the pricing framework of each UCITS Manager is compliant with the supervisory expectations enshrined in ESMA's supervisory briefing on the supervision of costs.

2.0 Overall compliance with supervisory expectations of Maltese UCITS Managers in relation to costs and fees

In most cases, our analysis has shown that the level of compliance with the applicable rules was overall satisfactory. However, in some cases the MFSA identified a number of common shortcomings, highlighting the need for improvements in the following key areas:

2.1. Setting and reviewing of the fee structures

It was noted that the extent to which UCITS Managers have formalised their pricing process differed across all the respondents. Smaller UCITS Managers were more commonly found to have a less formal and documented pricing process in place or had a pricing process which was not adequately documented. In some instances, smaller UCITS Managers did not have a formalised and documented pricing process at all.

[1] ESMA's announcement on the launch of a Common Supervisory Action on the Supervision of Costs and Fees
[2] ESMA's supervisory briefing on the supervision of costs
[3] ESMA Guidelines on ETFs and other UCITS issues

With regard to the initial and ongoing checks of the pricing of the UCITS, some UCITS managers do not perform reviews of the pricing methodology and mechanism except in the event of a material change in the UCITS characteristics/ad hoc events, for instance, triggered by a change of the investment strategy or change in service provider. In these cases, UCITS Managers were unable to demonstrate that formal periodic reviews took place, laying down the outcome of the review and whether this has resulted in a change in the pricing of the UCITS.

From a governance point of view, it was noted that, at times, internal control functions and independent members of the Board of Directors tended to (i) only become involved later in the pricing process; (ii) did not have an active role; or (iii) were not questioning and challenging the setup of costs and fees. In such cases, UCITS Managers were not able to demonstrate whether an independent analysis of the costs and fees structures has been performed. In addition, the Board of Directors of some UCITS Managers received low quality reports or, in rare cases, no reports at all on the pricing of the UCITS and therefore were unable to substantiate how they ensure that a fully informed decision is made in this respect.

Amongst good market practices that were identified include; the setup of a committee with its own terms of reference with members from the senior management of the UCITS manager from the portfolio management function as well as from control functions; the availability of records of periodic reviews conducted on the UCITS laying down any changes in the pricing methodology of the UCITS; minutes of periodic and ad-hoc discussions on costs and fees; and the availability of documented assessments and/or reports laying down detailed quantitative and qualitative assessments demonstrating how such factors contribute to the level of costs and fees of the UCITS.

MFSA's Comments and Expectations

All UCITS management companies should adopt and document a formal pricing policy and process allowing a transparent identification and quantification of all costs charged to the UCITS and a clear decision-making process establishing any specific tasks and responsibilities among the functions (including any outsourced function) involved in the pricing process.

That being said, the Authority is conscious of the fact that due consideration has to be made by UCTIS Managers to have processes that are proportionate considering the size, nature, scale and complexity of their activities. However, while the principle of proportionality may justify smaller entities to adopt simpler processes, this should not result in a situation in which small UCITS Managers effectively disapply these requirements in their entirety.

In this context, UCITS Managers should periodically (at least on an annual basis) review and monitor the costs and fees of each UCITS it manages, to ensure that no undue costs are being charged to the UCITS. Directors of the UCITS Manager are ultimately responsible to ensure this requirement is being met on an ongoing basis and must exercise vigilance in monitoring the costs and fees of the funds that they manage and oversee. In doing so, Directors should ensure that costs and fees remain viable and competitive over time at the fund and share class level by, for example, reducing fees where possible and passing any cost savings from economies of scale to the UCITS. The Authority also encourages efforts in having directors with adequate knowledge about issues related to UCITS costs and fees, including the types of information that they may request when they review costs and fees, and the techniques that are available to evaluate the information that they receive.

Furthermore, a more active role from independent directors, internal control functions, and relevant functions/ committees should be ensured, with a view to perform an independent analysis of the cost and fee structures of the UCITS managed by the UCITS Manager.

2.2. Formulation of the pricing of the UCITS

Delving further into the key factors that affect the setup of the pricing of a UCITS, the MFSA noted that UCITS Managers take into consideration, *inter alia*, the following quantitative and/or qualitative criteria; the risk/return profile of the fund, expected returns, investment policy, type of assets, distribution channels, the investors' expected holding period, and the level of fees charged by peer funds.

The MFSA noted that, with exception to a few UCITS Managers, the pricing tended to include a variety of factors which were aimed to align the costs with the specific characteristics, risk profile and target market of the UCITS. In some cases, UCITS Managers also took into consideration the investor's return based on different market scenarios through projections around expected returns based on historical performances and potential future market conditions. This was noted to be a good market practice and one which ensures that the sustainability of costs over time and/or the relative weight of fees on the investor's return. Nevertheless, the expected returns of the UCITS were not always being taken into consideration to ensure that the pricing of the UCITS is designed in a way to ensure sustainability of the costs over time. In such cases, UCITS managers generally resorted to comparisons with market peers having similar objectives and strategies to ensure these are in line with market standards. Although, this is a factor which should also be factored in the pricing of the UCITS, in some cases this was noted to be the main factor affecting the pricing of the UCITS and should be considered with caution.

In addition, UCITS Managers tended to also adopt an informal approach when establishing and evaluating such factors, which was often not being documented in detail within their records. Therefore, UCITS Managers were not always able to substantiate the adequacy of the formulation of the setup of costs and fees at the design stage and ongoingly through reviews of the UCITS' pricing.

MFSA's Comments and Expectations

UCITS Management Companies are encouraged to include expected returns to investors in the pricing of the UCITS, focusing on how costs and fees affect investor returns taking into account the UCITS' size, risks and volatility to ensure that fees and charges do not undermine the investor's final return.

The MFSA expects UCITS Managers to (i) carry out adequate documented assessments of the specific characteristics, risk profile and target market of the UCITS in order to set its pricing, as well as, (ii) substantiate how each cost category is linked to a service provided in the best interest of investors by *inter alia* considering whether it is necessary for operating the UCITS in line with its investment objective (e.g. the fund's investment strategy, portfolio management, transaction and settlement costs) and to costs strictly functional to the ordinary activity of the fund or to fulfil regulatory requirements (e.g. cost of annual audit, taxes, NCA's fees). UCITS Managers are expected to ongoingly assess each cost category, separately, and document discussions and/or explanations on how the pricing of each UCITS has been determined in the investor's best interest.

Furthermore, while information about costs and fees of other peer funds may be useful for UCITS Managers as an indication of its price positioning in the market, due skill and care should be taken to ensure these comparisons do not influence the pricing of the UCITS at the detriment of investors, such as initially setting prices below market prices for a short period of time to attract investors.

2.3. Conflicts of Interests

Whilst most UCITS Managers implemented a general conflict of interest policy outlining how conflicts of interests are identified and prevented, it was noted that the policy did not always include specific internal controls to ensure the mitigation of conflicts of interest, including those arising from inducements, such as commissions and third-party payments.

With regards to UCITS Managers forming part of a group, the MFSA noted that in these cases there was a general lack of assessment being carried out to determine whether there are any circumstances which may give rise to a conflict of interest resulting from the structure and business activities of other members of the group. One example of a conflict of interest, in a group context, includes a conflict arising as a result of using a Group entity/related party as a service provider, particularly when the UCITS Manager is encouraged to use group entities when this may not be the best choice for the funds and may not be in the best interests of investors (e.g. in terms of quality and/or price).

In general, in case a conflict is identified, UCITS Managers appeared to adopt the practice of having conflicting board members abstain from taking decisions in areas where the conflict has been identified. That being said, UCITS Managers should bear in mind that this practice is not adequate for each and every situation, particularly for the purpose of mitigating conflicts from affiliations with other entities such as a parent Company, where a conflict generally affects all the business rather than an individual member of the Company.

MFSA's Comments and Expectations

The Authority emphasizes the role of independent board members, with independence generally defined relative to the operational structure of the Company or to the fund sponsor and other service providers. Independent directors play a critical role in overseeing conflicts of interest between the UCITS funds and the Company as well as with other service providers.

UCITS Managers should aim to have adequate controls, in particular in the context of all types of cost and charges paid or received to/from Group/related entities, by additional reviews and oversight of the independent director(s). The UCITS Manager should be able to demonstrate how it ensures on an ongoing basis, at least annually, that all costs and fees paid are reasonable and competitive when compared to market standards. The Authority expects UCITS Managers to keep adequate records of any relevant assessments and evaluations in this context.

In case of the existence of conflicts of interest, the UCITS Manager should explain in detail how it ensures that the risk of damage to investors' interests will be prevented and employ effective mitigating measures and carry out diligent assessments and evaluations (e.g. independent research on prices and services offered by other competitors) to ensure fair treatment of investors and that no undue costs/fees are paid despite any potential conflicts of interest.

3.0 Common findings in relation to the costs and fees requirements concerning Efficient Portfolio Management ("EPM") techniques

The CSA revealed that the EPM techniques used by UCITS Managers mainly focused on risk reduction (FX hedging, forwards, futures, swaps, etc.), as opposed to EPM techniques focusing on profit generation (securities lending, reverse purchase etc.).

UCITS Managers employing EPM techniques were asked to provide the Authority with their internal policies and procedures in place in this context. Further to the Authority's review, it was noted that most UCITS Mangers did not have dedicated policies and procedures laying down details of their EPM techniques and how risks arising from such transactions are managed. Instead, there was a tendency among the participants to place reliance on risk disclosures on EPM techniques included in the UCITS' prospectus.

Most UCITS Managers also informed the Authority that they applied best execution controls in relation to EPM transactions. However, further to a review conducted on the Best Execution Policies received during the course of the CSA, the MFSA noted that such documents did not have specific controls governing EPM transactions.

Further to the above, the MFSA carried out an assessment on the disclosures made within the UCITS' prospectus in relation to EPM techniques. This assessment revealed that most UCITS managers could have better explained their use of EPM techniques, particularly since the UCITS' prospectus contained generic language which does not confirm nor reject that the UCITS is or will engage in EPM transactions. The assessment also pointed out a general lack of detailed information in EPM related disclosure regarding areas such as risks, conflicts of interest and impact of EPM Techniques on the performance of the UCITS.

MFSA's Comments and Expectations

The MFSA reminds UCITS managers that in accordance with Article 11 of the Eligible Assets Directive, UCITS employing efficient portfolio management techniques should make sure that the risks arising from these activities are adequately captured by the risk management process of the UCITS.

In this context, UCITS Managers are expected to include, within their risk management policies and procedures, more detail on the use of EPM techniques and the way in which these facilitate Efficient Portfolio Management or contribute to a reduction of risks. In addition, the Authority expects that policies and procedures on EPM techniques clearly outlining which types of instruments are/will be utilised for this purpose, also providing examples.

UCITS managers are also expected to cover EPM techniques in their best execution policy and to have sufficiently robust and comprehensive processes in place to ensure that the UCITS obtains the best possible result, in particular to any interest rates, FX Forward legs etc. underlying EPM transactions. Processes should also be in place to ensure any costs / fees charged to the UCITS when executing such transactions is made on the basis of an arm's length transaction and in line with market prices.

With respect to EPM disclosures, a statement merely suggesting that the UCITS may engage in certain transactions is insufficient and is not considered in line with the ESMA guidelines on ETFs and other UCITS issues, which requires clear disclosure of the *intention* to engage in EPM.

Similarly, generic language and descriptions that are not adapted to each individual UCITS and specific EPM techniques should be reviewed and amended in such a way to enable investors' understanding of all the risks and rewards of the UCITS emanating from EPM transactions. In this respect, UCTIS Managers should aim to provide retail investors with comprehensive and tailored descriptions of *inter alia* (i) the EPM instruments/strategies used by the specific UCITS, including any risks arising from using such techniques and the impact on the performance of the fund should such risks materialise; (ii) any relevant counterparties and service providers used when carrying out EPM transactions (iii) conflicts of interests arising from EPM techniques concluded with or involving related parties, including the name of the entity/entities thereof; and (iv) the proportion/percentage of gross revenues generated by the use of EPM techniques which is returned to the UCITS.

4.0 Other common findings in the context of fees and costs

4.1. Ongoing charges

Some of the responses provided indicated some very few instances where UCITS managers were not always aware of the circumstances triggering the need to (i) report an estimated figure of ongoing charges in the UCITS Key Investor Information Document ("KIID) (ii) make available a revised KIID when the ongoing charge figure disclosed in the KIID is no longer reliable.

The MFSA Officials also carried out a review of a sample of calculations of the 'ongoing charge' figure performed by the Fund Administrators of the UCITS. In some cases, it was noted that the performance fee was erroneously also being included in the calculation of the ongoing charge figure. Although, this affected the ongoing charge figure disclosed within the KIIDs, the Authority noted that this error did not have any negative repercussions on the amount paid by the UCITS and the investors.

Furthermore, whilst most UCITS Managers reviewed the amount of charges during NAV checks, there was a general lack of internal written procedures and checks to ensure the calculation is in accordance with the methodology prescribed in the CESR's Guidelines issued on 1st July 2010 on the methodology for calculation of the ongoing charges figure in the KIID[4] (henceforth referred as '**the CESR's Guidelines**').

MFSA's Comments and Expectations

According to Article 10(2)(b) of the UCITS KIID Regulation, the UCITS Manager shall present a single figure in relation to ongoing charges representing all annual charges and other payments taken from the assets of the UCITS over the defined period and based on the figures for the preceding year.

When the UCITS Manager cannot comply with requirements set out in Article 10(2)(b) of the KIID Regulation, the ongoing charge figure should be based on a reasonable estimate in accordance with Article 13 of the UCITS KIID Regulation (in case of a new UCITS) and 24(2)(b) of the KIID Regulation (in case of material changes to the charging structure). For the sake of clarity, an estimate is to be used in case, all or part, of the ongoing charge figure cannot be measured based on previous year's figures. Some examples of estimates used by UCITS Managers were based on

[4] CESR's Guidelines on the methodology for calculation of the ongoing charges figure in the KIID

(i) fees and costs from existing funds/share classes having the same or similar strategies and objectives (ii) expected model portfolios of assets and anticipated activity of the UCITS (iii) predictable fixed costs and/or variable costs, such as annual audit fees, management fee, depositary fees etc. A disclaimer should be included to explain the methodology used to arrive at the estimated charge.

The UCITS Manager should review the ongoing charge figure at least annually and shall ensure that all the costs included in the ongoing charge figure, as disclosed in the KIID, is in, all respects, a reflection of the current charging structure of the fund. Should a review of the KIIDs be carried out prior to or following any changes in the charging structure a revised version should be made available promptly to investors in accordance with Article 23(1) of the KIID Regulation.

Furthermore, the CESR's Guidelines identifies which items should be included and excluded from the ongoing charges figure. The UCITS Manager should aim to review the ongoing charge methodology adopted by the Fund Administrator to ensure that the calculation of the ongoing charges figure is compliant with the above-mentioned Guidelines. Such a review is expected to be included as part of the compliance checks conducted by the Compliance Officer of the UCITS Manager as part of any periodic checks carried out on the Administrator.

4.2. Disclosure within the UCITS KIID

4.2.1. Performance fees

Following a sample review of UCITS KIIDs, the MFSA noted that, in some instances, the UCITS KIID only included the percentage basis of the performance fee and appeared to have omitted the performance fee charged during the previous financial year (as a percentage of NAV).

MFSAs Comments and Expectations

According to Article 12 of the UCITS KIID Regulation, the UCITS Manager is required "*to disclose performance fees in accordance with Article 10(2)(c)*[5]*. The amount of the performance fee charged during the UCITS' last financial year shall be included as a percentage figure*". The ESMA Guidelines on performance fees[6] further states that the percentage of the performance fees should be based on the share class NAV.

The performance fee which has been deducted from the fund for the past financial year must be stated as a percentage in the table within the 'Charges' section of the UCITS KIID, whereas the basis on which the charge is calculated can be included as shown in the following example. If the fund does not charge any performance fee, "none" or "not applicable during the period (NA)" should be stated in the table instead.

The following is an example of how (i) the performance fee charged during the previous year and (ii) the basis on which the performance fee is calculated and when charges apply, should be disclosed in the 'Charges Section' of the UCITS KIID in accordance with Article 10(2)(c) and Annex II of the KIID Regulation.

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[5] Article 10(2)(c) requires that *"the table shall list and explain any charges taken from the UCITS under certain specific conditions, the basis on which the charge is calculated, and when the charge applies."*
[6] ESMA Guidelines on performance fees

Charges taken from the fund under certain specific conditions	
Performance fee	20% a year of any net returns the fund achieves in excess of the benchmark, the [insert name of benchmark] In 2021 the fund charged a performance fee of 1.89%

5.0 Benchmarks

The Authority reviewed the use of Benchmarks by UCITS funds, as part of the discussions held at ESMA level in relation to the CSA. Further to a review of a sample of the latest UCITS KIIDs it transpired that disclosures relating to the use of benchmarks were not updated in accordance with the revised UCITS Q&A issued by ESMA on 29 March 2019[7] ("**the UCITS Q&A**"). For example, the MFSA Officials noted that the description contained in the 'Objectives and Investment policy' section of the KIID were not always covering the essential features of the UCITS as indicated in Question 8 of the UCITS Q&A, including whether the UCITS is actively or passively managed and whether this approach includes or implies a reference to a benchmark and if so, which benchmark is the UCITS tracking or in reference to which it is being managed.

MFSA's Comments and Expectations

UCITS Managers are expected to carry out a review of their UCITS KIIDs with the revised UCITS Q&A, unless this has already been conducted. In case the KIIDs have not been updated to address ESMA's revised UCITS Q&A, UCITS Managers should make any changes to the KIID in order to incorporate this additional guidance as soon as practicable.

6.0 Conclusion

The CSA has served as an important tool to assess compliance and the adequacy of the fees charged as well as to remind the industry on the importance of costs and fees, especially to identify and oversee certain inherent risks and implement robust controls to prevent undue/excessive fees.

The Authority shall continue its supervisory work in the area of costs and fees in future supervisory interactions to assess the level of compliance of UCITS Managers with the applicable requirements and guidelines, particularly to assess whether the indicated shortcomings and guidance provided in this Circular, have led to an increase in the robustness of internal controls of UCITS Managers. The Authority does not exclude the possibility of taking appropriate regulatory action in case of any significant lack of progress by UCITS Managers to have in place adequate controls and governance arrangements in this area.

7.0 Contacts

Any queries in relation to this Circular are to be addressed to funds@mfsa.mt

[7] ESMA UCITS Q&A