



ESMA OPINION ON UNDUE COSTS CSSF SAQ AND HOW THEY RESULT IN ADDITIONAL DOCUMENTATION REQUIREMENTS FOR AIFMS

On 17 May 2023, ESMA published its Opinion on undue costs of UCITS and AIFs (the “Opinion”). The Opinion is the result of a common supervisory action (CSA) with national competent authorities (NCAs) launched by ESMA in January 2021. According to ESMA, the CSA identified divergent market practices as to what the industry reported as due or undue costs. In 2023, market participants were required for the first time to submit the self-assessment questionnaire (“SAQ”) in accordance with CSSF circular 21/790. The SAQ will become a yearly part of the ever-increasing reporting obligations for investment fund managers. In the following paragraphs we will focus on the meaning and impact of the Opinion and we will briefly outline the impact it already had and will most likely continue to have on the SAQ. As a summary:

Executive Summary

- Article 17(2) of the Level 2 Regulation requires AIFMs to ensure that investors are not charged undue costs.
- Currently, there is no clear definition of what constitutes undue costs charged to an AIF.
- ESMA’s Opinion intends to clarify the term undue costs.
- The list of costs contained in Annex VI of the PRIIPs Regulation may not simply be used as a model for “due costs” for all AIFs managed by an AIFM.
- **According to ESMA, AIFMs must develop a pricing process in relation to the costs charged to AIFs that not only takes into account the investment policy and complexity of each AIF but also defines the responsibilities within the governing body of an AIFM.**
- Fees and costs that are or may be charged to an AIF must be disclosed in the AIF’s pre-contractual documentation, not only by type and nature but also by

(maximum) amounts.

- Violations are to be reported to the NCAs and the investors.
- ESMA considers this responsibility to fall on the compliance function of an AIFM.
- The SAQ (Self-Assessment Questionnaire) requires AIFMs to report annually on compliance with these requirements.

Legal Background

Article 12(1) of Directive 2011/61/EU on Alternative Investment Fund Managers (“AIFMD”) provides that Member States must ensure that, at all times, AIFMs: (a) act honestly, with due skill, care and diligence and fairly in conducting their activities; (b) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market; (f) treat all AIF investors fairly.

Article 17(2) of Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (“Level 2 Regulation”) specifies further that AIFMs must ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs.

However, to date, neither the Level 2 Regulation nor the AIFMD itself or any other regulatory statement at EU level specifies what the term “undue costs” actually means.

The Opinion

In the Opinion, ESMA sets out its views on how to clarify the notion of undue costs under [the UCITS Directive] and the AIFMD. It argues that the topic has high investor protection relevance, and if left unaddressed, it leaves room for regulatory arbitrage and could have a negative impact on competition in the EU market. The Opinion sets out suggestions to the European Commission for possible clarifications of the legislative provisions under the UCITS Directive and the AIFMD relating to the notion of undue costs.

In particular, it refers to the “list of costs” (the “List”) as specified in the PRIIPs Regulation. ESMA points out that this list, which is indeed quite extensive and detailed,

should generally be considered exhaustive. Only under certain conditions should NCAs be permitted to authorize on a case-by-case basis additional cost categories which are not already included in the List. However, given that the List is rather broad and does not consider different types of investment funds, ESMA proposes to obtain a mandate for regulatory technical standards (“RTS”) specifying the circumstances in which the costs included in the List should be considered as undue/not eligible, also taking into account the investment policy of investment funds. In other words, AIFMs may not simply rely on the costs and fees specified in the List to determine whether an AIF can be charged a fee or cost.

ESMA sees this check against the List as an “eligibility test”. This can be considered the first step in the analysis of costs charged to an AIF. To complicate matters further, ESMA points out that a fee or cost that meets the requirements of the eligibility test may still have to be considered as being “undue” in terms of its quantum. Therefore, the Opinion proposes to require AIFMs to develop and periodically review a structured pricing process that (i) clearly demonstrates that all charged costs are due and (ii) allocates clear responsibilities to the governing body of the AIFM for determining and reviewing the costs charged to investors.

Finally, such costs and fees must be disclosed to investors in the pre-contractual documentation of an AIF. Consequently, AIFMs will have to anticipate not only the type and nature of costs and fees that will or may be charged to an AIF when setting up an AIF but also their respective (maximum) amounts.

Responsibility of the AIFM

ESMA clarifies – and this is already evident from Article 12(1) of the AIFMD and Article 17(2) of the Level 2 Regulation – that it is the responsibility of the AIFM to ensure that no undue costs are charged to an AIF. In case of a violation of Article 17(2) of the Level 2 Regulation as specified in an AIFM’s pricing process and its pre-contractual documentation, ESMA states that the AIFM’s compliance function has a reporting

obligation to the competent NCA and the investors of an affected AIF. In ESMA's opinion, even a negligent infringement of these obligations should be sanctioned with a fine.

Objective of the Opinion

ESMA's explicit aim is to clarify the term due/undue costs for UCITS and AIFs, have AIFMs establish a coordinated pricing process for the AIFs they manage and thereby to provide NCAs with a stronger legal basis to take supervisory and enforcement actions. As a result, we may expect some level of interest by NCAs to investigate this matter and ensure that AIFMs (i) have a documented approach as to how to assess whether costs charged to an AIF are "due" or not and (ii) document this policy in relevant cases.

The SAQs (Self-Assessment Questionnaires)

This can already be seen in the SAQs. Here, the CSSF asks the AIFM inter alia whether all costs and fees charged at the level of a SPV controlled by the AIFs during the year have been adequately disclosed in the pre-contractual documentation. Furthermore, the CSSF explicitly requests information on whether the carried interest/performance fee paid to an investment adviser is higher than the fee(s) paid to the portfolio manager. It seems appropriate to refer to ESMA's Final Report on Guidelines on Sound Remuneration Policies under the UCITS Directive and the AIFMD (the "Remuneration Guidelines"). In the Remuneration Guidelines ESMA requires AIFM to ensure- and document accordingly - that entities to which any investment management activities have been delegated are subject to regulatory requirements on remuneration that are equally as effective as those applicable under these Remuneration Guidelines. As most of you know and learned from painful experience this year, the SAQ is an extensive spreadsheet requiring AIFMs to report in detail on their AIF's compliance with regulatory and contractual obligations, risk management practices, governance structures and procedures, approval, review and application of compliance policies, due diligence procedures, etc. This will now be done an-

nually and will be part of the audit starting next year. Unfortunately, we can already expect the questions to change for 2023. However, we believe that it makes sense to try to anticipate as many of these requirements as possible and implement them in the daily life of an AIFM and boards. Some of the items can be “easily” covered by incorporating existing policies and procedures into AIFM and board meetings and minutes. Others can be addressed by including them in AIF’s pre-contractual documentation.

Our solution

While the Opinion and the SAQs still leave something to be desired in terms of clarity and examples, we believe that it is better to have a documented, practical approach as to how an AIFM ensures that no undue costs are charged to its AIF and how “due” costs are communicated to potential investors than to have nothing to show for. Should the legislator and/or the NCA provide more details at a later stage, the existing policies and workflows can be amended accordingly. The same applies to the reporting obligations under the SAQs.

Please bear in mind that Article 12(1) of the AIFMD and the more relevant Article 17(2) of the Level 2 Regulation already apply to AIFMs. As an AIFM, you must address this issue on an ongoing basis. Otherwise, you could be subject to complaints from your NCA and/or your investors. Waiting for more information and clarifications from legislators and/or ESMA does not release you from the obligation to comply with AIFMD and Level 2 Regulation requirements.

We at AIQUNITED are happy to assist you on all questions related to this topic. Please do not hesitate to contact us:

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[1] <https://www.esma.europa.eu/document/opinion-undue-costs-ucits-and-aifs>

[2] <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02011L0061-20210802>

[3] <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0231>

[4] Please refer to the Opinion, page 6, items 7 & 8.

[5] As always, AIQUNITED will focus on issues related to the AIFMD in this newsletter.

[6] Opinion, page 7, item 12.

[7] Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) No 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R0653>.

[8] Opinion, page 8, items 19 & 22b.

[9] Opinion, page 8, item 22a.

[10] Opinion, page 10, item 23.

[11] Opinion, page 13, proposal to amend Article 12 of the AIFMD.

[12] Opinion, see e.g. page 7, fn. 8; the same applies to UCITS management companies. For the avoidance of doubt, these requirements are already in place and apply to any type of SPV owned by an AIF as well. It is not limited to the level of the AIF.

[13] Opinion, page 11, item 26.

[14] Opinion, page 11, item 28.

[15] https://www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd.pdf

[16] Please refer in particular to point 16 of the Remuneration Guidelines.

Get in touch with us.

We are happy to be at your disposal for a personal consultation.



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