Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds

Consultation Report

OICV-IOSCO

THE BOARD OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Foreword

The Board of the International Organization of Securities Commissions (IOSCO) is consulting on a set of common international standards of best practice for the operators of Collective Investment Schemes (CIS) and regulators to consider. The report seeks to determine whether the recommendations made in the 2004 paper on *International Regulatory Standards on Fees and Expenses of Investment Funds* are still valid or might be updated or supplemented in light of market and regulatory changes.

How to Submit Comments

Comments may be submitted by one of the two following methods **on or before Wednesday 23 September**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to consultation-2015-06@iosco.org
- The subject line of your message must indicate '*Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*.'
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Paper

Send 3 copies of your paper comment letter to:

Mohamed Ben Salem
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a '*Public Comment on International Regulatory Standards on Fees and Expenses of Investment Funds.*'

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PART I INTRODUCTION AND OVERVIEW

PURPOSE OF THIS PAPER

1. Fees and expenses are important to investors in a collective investment scheme (CIS). Investors should have the appropriate information to evaluate the fees and expenses of the CIS, so cost disclosure is of key interest, as is the proper management of conflicts of interest that might otherwise misalign the interests of investors and of the CIS operator.

2. This paper follows on from the 2004 report on International Regulatory Standards on Fees and Expenses of Investment Funds,[1] which had recommended a set of common international standards of best practice for CIS operators and regulators to consider. This paper examines and re-assesses current regulatory practices concerning CIS fees and expenses, to look at whether the standards of best practice in the 2004 report are still valid or might be updated or supplemented in the light of market and regulatory changes. A complete list of recommendations and statements of practice is provided in Annex 3.

3. The 2004 report found that it was appropriate and necessary to take regulatory steps in the area of fees and expenses because of the important investor protection issues. Since the 2004 report was issued, the natural evolution of the industry has resulted in new CIS product structures, new investment strategies and changing distribution models, amongst other developments. At the same time, regulatory developments in some jurisdictions have changed the way fees and expenses are disclosed, and the effectiveness of certain disclosure models has been tested with investors.

4. IOSCO's Committee on Investment Management ('C5') has completed a second review of existing practices with respect to fund fees and expenses, to gather information about how regulatory practices have evolved in recent years. As the membership of C5 has grown since 2004, the review has been able to reflect a wider range of regulatory approaches towards markets at differing stages of maturity, as well as taking account of more recent developments in those jurisdictions that participated in the 2004 survey.

5. This paper, like the 2004 paper, looks at issues that were identified as being key across jurisdictions. Such issues concern, inter alia:

a. types of permitted fees and expenses
b. performance-related fees
c. disclosure of fees and expenses
d. transaction costs

[1] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD178.pdf.

e. hard and soft commissions on transactions

6. In preparing this consultation paper, C5 has drawn on previous IOSCO papers on the subject of fees and expenses for CIS and responses from a recent survey sent to Committee members ("the 2014 survey"),[2] as well as applicable IOSCO Principles.

SCOPE OF THIS PAPER

7. The terms 'investment fund', or 'collective investment scheme', include authorised open-ended funds like mutual funds or UCITS, as well as closed-end funds whose shares or units are traded in the securities market, unit investment trusts and contractual models. This paper is aimed at funds whose shares or units are permitted to be sold to retail investors. Funds intended for professional investors only, such as hedge funds using prime brokers or schemes investing in private equity and venture capital, are not intended to be in the scope of this paper.

8. 'Fees and expenses', as referred to in this paper, correspond to two types of costs:

a. fees paid directly by the investor out of an investment to the CIS operator, an agent or associate of the CIS operator, or the CIS itself; and

b. fees and expenses borne by the fund and deducted from its assets, which fall into four broad categories:

i. management fees corresponding to the remuneration of the management – including the financial management – of the portfolio of the fund;

ii. distribution costs of the fund, where they are allowed to be deducted from its assets or are reimbursed by the CIS operator out of its own remuneration;

iii. other operating expenses of the fund such as custody, fund accounting, or administration costs for shareholder service providers; and

iv. transaction costs associated with purchases and sales of portfolio assets, including securities lending and repo / reverse repo transactions.

9. References in this paper to (for example) disclosure to 'the CIS' should be understood to refer to a CIS which acts independently of its operator and has governance arrangements, such as a board of directors, to represent the interests of its investors.

[2] References to parts of the 2014 survey are made in each section of this paper.

APPLICATION OF THE IOSCO PRINCIPLES

10. Several of the IOSCO Objectives and Principles of Securities Regulation of June 2010 ("the Principles"[3]) may have a bearing on this subject, but Principles 24 and 26 are of particular relevance.

11. Principle 24: "The regulatory system should set standards for the eligibility, governance, organisation and operational conduct of those who wish to market or operate a collective investment scheme."

12. The methodology for assessing the level of implementation of Principle 24 considers, among other things, whether the regulatory system in each jurisdiction addresses the regulatory issues associated with fees and expenses. This is to ensure that no unauthorised charges or expenses are levied against a CIS or its investors, and that arrangements such as commission rebates, soft commissions and inducements do not conflict with the CIS operator's duty to act in the best interest of investors. So standards concerning all the key categories identified above are relevant to this principle.

13. Principle 26: "Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme."

14. The explanation of the principle states that information on fees and charges should be disclosed to both prospective and current investors in a way that enables the investors to understand their nature, structure and impact on the CIS' performance.

15. The methodology for assessing the level of implementation of Principle 26 considers, among other things, whether material matters are disclosed on a timely basis, in easy-to-understand format and language, and are kept up to date to take account of material changes affecting the CIS.

KEY DEVELOPMENTS SINCE 2004

16. Since the financial crisis, regulatory developments have aimed at achieving greater transparency in the world of investment funds as well as clearer, more focused investor disclosure. Regulatory steps to achieve this have relied on a combination of general principles, disclosure requirements, prohibition of practices and precise rules, although the combination of these has varied greatly amongst regulators depending on their regulatory framework, the structure of their national asset management landscape and their assessment of the risks and problems facing investors.

[3] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf.

17. This strengthened regulatory approach has run in parallel with significant developments in the market environment since the 2004 Report. Low interest rates have made it harder for asset managers to generate profit, while, in some jurisdictions, regulatory costs have risen considerably due to reinforced reporting requirements. Asset managers have looked to innovate, focusing on specific market segments or geographical areas in the attempt to obtain greater returns.

18. In certain markets, some active fund managers decided to launch "semi-active" funds, which are meant to offer alpha at a lower cost, while others have chosen to differentiate themselves with new products or new services to justify the level of their fees, and have invested in new alternative asset classes enabling them to deliver higher alpha. This has included demand for investment funds with high-yield, multi-asset, unconstrained and alternative strategies, as well as for exchange-traded products (ETPs) with illiquid underlying assets. It has also included an increase in index tracking and low cost products.

19. Increased investor awareness may exert downward pressure on fees, as investors learn to consider them in their investment decisions. At the same time, the rise of new technologies has created a growth of web-based portals and tools which are changing how investors receive and interact with fund information, including on fees and expenses.

20. Some jurisdictions now have more complex distribution models, which may result in more elaborate fee-sharing or retrocession arrangements and regulators in those jurisdictions have put mechanisms in place to ensure risks to investors are carefully monitored. In others, the complete separation of the costs of product manufacture and distribution has taken place in an attempt to increase transparency of costs and reduce conflicts of interest.

21. Finally, some jurisdictions have focused on increasing the alignment of interest between managers and investors, for example by creating 'skin in the game' requirements or specifying rules for remuneration policies.

22. *Question 1:*

- *Are there any other developments that C5 should take into account when formulating good practices regarding fees and expenses of CIS*?

PART II: FEES AND EXPENSES FOR OPERATING A CIS

TYPES OF PERMITTED FEES AND EXPENSES

23. The 2004 report (Annex 2, point 4) highlighted that some jurisdictions regulate the costs that can be charged to a CIS either directly – through a list of eligible costs – or indirectly – by forbidding some costs to be charged to CIS (e.g. start-up costs). It said any forbidden costs would be met by the CIS operator out of its revenue (management fee) and could result in a higher level of the management fee (or its local equivalent). The 2004 report did not set out any standard of practice on this subject.

24. Most jurisdictions now have rules on permitted fees. Taking investor protection into consideration, good practices could be considered to specify fees and expenses that can or cannot be deducted from CIS assets.

25. Non-exhaustive examples of such expenses might be:

a. costs associated with the formation of the CIS;
b. mergers, restructurings, or transfer from one operator to another;
c. expenses or losses resulting from the failure of the CIS operator to meet its obligations (e.g. sanctions for breaching laws or regulatory standards, interest paid on delayed settlement of payments due to investors);
d. advertising and promotional activities;
e. expenses which have not been disclosed in the legal CIS documents.

26. The following standard of good practice is proposed:

a. Regulators may decide to specify fees and expenses that cannot be deducted from the assets of a CIS. This could be in the form of guidance.

b. The scope of fees and expenses that may be deducted or those which cannot be deducted from the assets of a CIS should, in any case, at least be set out in disclosure documents available to investors before they invest and afterwards at the times mandated by regulation / legislation.

c. The CIS operator should not deduct a new type of fees from the assets of a CIS or increase the management fees unless, at a minimum, the responsible entity (e.g. board of directors, specified independent governance process, regulatory authority etc.) approves the fee. The responsible entity could consider imposing breakpoints to the CIS management fee if appropriate, given economies of scale that may occur when the CIS grows in size.

27. *Question 2:*

- *If you think defining permitted and prohibited costs is useful, should this be done by the regulatory authority or the CIS operator?*

- *What types of costs should be permitted and/or prohibited to be charged?*
- *Are there alternatives to prohibiting certain fees and expenses and if yes, what are they and why are they effective?*

REMUNERATING THE CIS OPERATOR

28. The 2004 report stated that the operator of a CIS was usually remunerated through a management fee, which was frequently asset-based, but which may also be calculated on different bases (for example a flat fee and/or a performance fee).

29. The 2014 survey shows that in all jurisdictions, the main remuneration method for the CIS operator is still the management fee. The results indicate that while principles regarding transparency and disclosure are adopted by all jurisdictions, there are several approaches to implementing principles regarding conflicts of interest.

PERFORMANCE-RELATED FEES

30. Performance-related management fees aim to reward CIS operators for the results they have achieved and can be more effective than a standard, ad valorem fee in aligning the interests of the operator and the investors. Performance fees give CIS operators a further incentive to outperform the chosen benchmark, but they create incentives for inappropriate degrees of risk-taking, even if they are properly linked to the operator's success and skill. Other problems include a risk of rewarding luck rather than management skill, or a mismatch with a chosen benchmark.

31. A few countries have forbidden the use of performance fees entirely, but the large majority of jurisdictions allow them subject to specific regulatory requirements. Those that allow them have reported that their use has generally increased in the past 20 years, though to differing degrees across different types of funds and across regions. They were originally introduced in CIS for institutional investors, but have become increasingly popular in retail CIS as well.

32. The 2004 report identified concerns about the possible incentive for the CIS operator to take more risks in the hope of increasing its performance fees, or to take risks that are inconsistent with the fund's investment objectives, or that deny investors adequate remuneration of the return from the risks taken. The 2004 report (paragraphs 24 and 25) recommended that the incentives behind a performance fee should be identified and mitigated, and that a performance fee should reward the skill exercised by the CIS operator but should not be excessive in relation to the services rendered.

Developments since 2004

33. The 2014 survey shows that the concerns mentioned in the 2004 report are still present, and may now be more prevalent as the use of performance-related fees has increased in the past ten years. All respondents have specific disclosure requirements in place, and the vast majority of them have requirements in place to mitigate the risks they pose, whether by having adopted the full recommendations from the 2004 report or by having chosen rules relevant to their market. Some jurisdictions have, for example:

a. imposed a limit on the amount that can be charged as a performance fee;
b. introduced requirements to inform the regulator if the performance fee reaches a certain limit;
c. tried to alleviate the potential problem of inequality of investors by banning methods such as the 'last in, first out'.

34. Performance fees earned should ideally be proportionate to the investment performance of the fund to ensure investors are treated fairly and should be simple to understand. For a given investor, the effective performance of their investment in a fund depends on the particular points in time when they acquire and later dispose of it. So, a performance fee should ideally be calculated separately for each investor. Where this is not practical, evidence suggests that employing the fulcrum fee as a calculation method for performance fees is fair and simple to understand for investors.[4] Banning calculation methods such as the 'last in, first out' method can also go some way to reducing the risk that one investor, or group of investors, will benefit at the expense of others.

35. Recommendations such as the adoption of a fulcrum fee model mean that a CIS operator would stand to lose money if unsuccessful. Further thought could be given to calculation methods that ensure fair outcomes for both investors and CIS operators.

36. The following standards of good practice are proposed for the use of performance fees:

1. **A regulatory regime that permits performance fees should set standards for:**
   - **their method of calculation;**
   - **the information the CIS operator should disclose to investors about their use; and**
   - **the disclosure medium to be used.**
2. **CIS operators should design calculation methods allowing for the performance fee to result in a value that is proportionate to the investment performance of the fund.**

[4] See for example "Heads we win, tails you lose: Why don't more fund managers offer symmetric performance fees?" Professor A. Clare et al, CASS Business School, November 2014 http://insight.newgatecomms.com/e895

3. **Use of the fulcrum fee method could be considered as good practice, as opposed to other types of calculations which may result in unequal treatment of investors (e.g. "last in, first out").**

4. **Performance fees should be consistent with the CIS investment objective and not create incentives to take excessive risk. To that end:**

   - **Calculation period should not be more frequent than once a year;**
   - **Where the calculation of the performance fee is based on the fulcrum fee model:**
     - **the calculation of the fee is compared to an appropriate benchmark;**
     - **the fee increases or decreases proportionately with the investment performance of the CIS over a specified period of time; and**
     - **the CIS's investment performance should be calculated on the CIS's net asset value;**
   - **Where the performance of the fund is not based on a fulcrum fee model but is measured with reference to a benchmark:**
     - **calculation of the fee is based on the same benchmark used to determine excess performance;**
     - **the excess performance is calculated net of costs.**

37. *Question 3:*

- *Which do you consider to be the most appropriate method of performance fee calculation currently employed and why? Are there methods other than a fulcrum fee or "last in, first out" that are more effective?*
- *What other requirements might curb incentives for excessive or inappropriate short-term risk-taking? Should there be specific recommendations as to how the calculation, benchmark, and target of a performance fee are disclosed? What further disclosures could be recommended?*

PART III DISCLOSING FEES AND EXPENSES

Sources of information about fees and expenses

38. Legal disclosure documents which set out key information on fees and expenses of CIS and at the same time are easy to read, can help current and prospective investors to focus on the information they deem essential. At the same time, knowing where and how to obtain further information about fees and expenses is crucial for enabling investors to make fully-informed decisions. Summary documents can refer to the places where more detailed information on fees and expenses is available, so that investors can have easy access to such information as well. Summary documents may supplement the more detailed disclosure documents but should not replace them.

39. The following standards of good practice are proposed:

a. **Current and prospective investors should be provided with easy-to-understand and summarised information on the elements of fees and expenses that are essential to make informed investment decision.**

b. **Disclosure documents that include summarised information about fees and expenses should explain clearly where and how both current and prospective investors can obtain full details about those fees and expenses.**

40. *Question 4:*

- *Do summary documents present the right amount of information about fees and expenses and in a way that is useful for investors?*

Making information accessible to investors

41. The best standard of the 2004 report set out below does not cover the jurisdictions that do not use Total Expense Ratio ('TER'). On the other hand, it is also a common approach for some jurisdictions to use a concept similar to TER. In this respect, the standard in the 2004 report that refers to disclosing the TER of the CIS could be revised as below:

- The fee table should also disclose the Total Expense Ratio ('TER') of the CIS **or a comparable calculation based on the ongoing charges it bears.**

42. *Question 5:*

- *Should regulators do more – and if so, what – to ensure disclosures to investors about fees and expenses are:*
  - *a. easier to understand?*
  - *b. more prominent?*
  - *c. more easily accessible?*
- *Is it necessary to expand the standard "Information delivered must be simple, concise and set out in clear language"? Would you find it helpful to have recommendations on (for example) the use of easy-to-read formats (font size, using tables / charts / graphs) or the use of uniform terminology?*
- *Does a standardised fee table, if applicable, provide sufficient information regarding certain fees and expenses?*
- *Are there specific sub-categories (e.g. management fee, transaction costs) that should be disclosed separately?*

Historical and forward-looking information

43. In view of the different approaches taken to the use of historical and forward-looking information, it does not seem appropriate to propose specific standards preferring the use of one to the other. On the other hand, in any case, the information should be kept up to date and disclosed adequately.

44. The following standard of good practice is proposed;

Information on fees and expenses should be kept up to date and the updating frequency should be specified in legislation/regulation.

45. *Question 6:*

- *Should there be a standard regarding the frequency of updating of fees and expenses information in disclosure documents?*
- *How often should historical information on fees and expenses be updated?*
- *In which situations (e.g. where historical information on CIS does not exist) should disclosure on an anticipated basis be obligatory?*
- *What is the most accurate or representative methodology for calculating fees and expenses on an anticipated basis (i.e. one that reduces the chance of over-estimates or under-estimates)?*
- *How should material changes to the fees and expenses of a CIS be treated in terms of historical / anticipated disclosure requirements?*
- *In cases where the information can only be provided on an anticipated basis to begin with, should the disclosure be updated later with historical information?*

Use of electronic media

46. Over the last ten years, the use of electronic media in financial services has increased rapidly, not least in the area of information disclosure (e.g. websites for the CIS or its operator, electronic disclosure systems, comparison websites, etc.). There are significant advantages to the use of electronic disclosure documents:

- widespread use of electronic media by investors may enable management companies to reach more investors than was possible through traditional channels;
- investors may have quicker access to CIS disclosure documents and the possibility of having access to all the information they need via one source;
- electronic devices make it easier for investors to search for documents and select the essential information within them; it might be possible, for example, for fees and expenses information to be tailored to an individual's intended investment amount;
- investors can simultaneously compare information about the costs of different CIS through their operators' websites or one main electronic disclosure platform;

- production and printing costs of disclosure documents are expected to decrease, which might enable certain CIS expenses to be reduced;
- it becomes easier and faster to disclose any changes made to the documents;
- investors may be able to obtain past data more easily (e.g. there might be better archiving facilities);
- reaching investors via electronic media may be more efficient than postal systems etc.

47. Taking all these advantages into consideration, the use of electronic media for disclosure of CIS fees and expenses may be recommended, although printed copies of disclosure documents should still be provided to investors upon request, and proper consideration should be given to those existing and potential investors who do not have ready access to electronic media or have difficulty in using them. As automatic use of electronic media might not always be the most appropriate way to communicate with investors, approval from the investor to use electronic media may be necessary.

48. The following standard of good practice is proposed;

Use of electronic media for disclosure of information on CIS fees and expenses should be encouraged (in appropriate circumstances) provided that:

- **updated disclosure documents can easily be obtained electronically;**
- **existing channels and printed copies of disclosure documents should continue to be available to investors upon request. These should, wherever possible, be free of charge.**

It should be ensured that sufficient and accurate information is provided to the investors who use electronic distribution channels, before they invest in CIS.

49. *Question 7:*

- *Is it desirable to add a good practice recommending the use of electronic media for fees and expenses disclosure documents? What are the reasons for your view?*
- *How can the CIS and the CIS operator ensure that electronic disclosures are received and accessed by investors?*
- *What could constitute approval from investors to receive disclosure of information through electronic media?*

PART IV TRANSACTION-BASED FEES AND EXPENSES

TRANSACTION COSTS

50. Transaction costs arise when a CIS operator carries out acquisitions and disposals of assets in the portfolio of the CIS. They are an integral feature of investment management, since any investor – not just a professional manager – has to buy and sell assets to achieve a chosen investment strategy. Explicit transaction costs (for example, transaction-related taxes and broker commission on purchases and sales of equities in most markets) can be precisely measured and reported to the CIS operator. But some transaction costs are not explicit, for example purchases and sales of bonds where the mark-up or mark-down is usually an intrinsic part of the price and is not disclosed separately by the counterparty to the CIS operator.[5]

51. The 2004 report stated that transaction costs have a direct impact on the performance of a fund, but are hard to quantify and to forecast since they depend on parameters not known in advance, such as portfolio turnover and broker commission rates. To alleviate the lack of transparency while recognising the difficulty of quantifying transaction costs, the 2004 report suggested that '*some information on transaction costs should be disclosed to investors. This information will usually be incomplete. It should however never be misleading.*'

52. The 2004 report noted that excluding transaction costs from the TER was generally accepted, since the TER (although based on data from previous periods) is frequently used as a forward-looking measure and such costs cannot be precisely forecast.[6] The report suggested that information to be disclosed in addition to the TER could include:

a. transaction costs that could be identified and quantified;
b. the percentage of transactions processed by affiliated parties;
c. the turnover rate of the portfolio, along with an explanatory note commenting on this turnover rate both in absolute and relative terms.

Developments since 2004

53. Although most jurisdictions surveyed in 2014 appear to have a common understanding of the overarching definition, some have no prescribed definition of what transaction costs are. The survey indicated, depending on jurisdictions, that transaction costs can include:

a. brokerage and exchange fees;
b. bid / offer spread costs;

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5 Much useful information about transaction costs can be found in the US SEC concept release of 2004: http://www.sec.gov/rules/concept/33-8349.htm and the joint UK Government and FCA call for evidence of 2015: http://www.fca.org.uk/your-fca/documents/discussion-papers/dp15-02

6 It is frequently the case that in an actively-managed fund, the total amount of transaction costs cannot be predicted with accuracy because of variable and unknown factors, principally the size and number of transactions that might be undertaken in a future period. This is less of an issue for passively-managed funds but there are factors, such as the need to carry out purchases and sales following the rebalancing of the index being tracked, which can make the number and size of transactions unpredictable.

c. transaction taxes such as stamp duty;
d. settlement and clearing costs;
e. market impact costs;
f. opportunity costs.

Although most jurisdictions refer to transaction costs as being "incidental", "linked to" or "in connection with" purchases and sales of assets for the portfolio of the CIS, some use stricter wording; e.g. the costs must be "necessary for" the buying and selling of assets.

54. Greater convergence on a common definition could help to make it easier to compare levels of fees and expenses in CIS established in different jurisdictions. This might help investors make better-informed choices, and would enable operators to benchmark themselves more accurately against the market as a whole. However, it may be difficult to devise a single and comprehensive definition.

55. The majority of respondents to the 2014 survey allow transaction costs to be charged directly to the assets of the CIS but have no standardised methodology for calculating their value. There was no recommendation about this in the 2004 report. However, some jurisdictions have put in place a methodology, at least for information about certain transaction costs, particularly the portfolio turnover rate.

56. Taking all the points into account, the following statements of good practice are proposed for the management of transaction costs of a CIS:

57. Regulators define what is meant by transaction costs; alternatively, the regulator or the CIS operator could specify the types of payment that cannot be charged to the assets of the fund as a transaction cost or indicate how the value and/or impact of transaction costs can be determined.

58. *Question 8:*

- *Should there be a standard definition of what transaction costs are? If so, which types of cost should be included in, or excluded from, such a definition and why?*
- *What are the most effective ways of determining the value and impact of transaction costs in a CIS?*

Issues with transaction cost transparency

59. Most regulatory regimes, with a couple of exceptions, have requirements to disclose transaction costs to investors, as recommended in the 2004 report. However, there is a lack of convergence over how and where to make these disclosures. This may result in investors being either unaware of the existence of such charges, or unable to form any reasoned view of their potential or actual impact on the performance of the fund.

60. In recent years, there has been an increased level of analysis of the effects that transaction costs can have on investment returns, especially over the long term. A number of academic studies and independent investigations have tried to quantify these effects, and some suggest that over several years, such costs can significantly erode the returns investors might have expected.[7] The difficulties that such studies face are the absence of data, and the relative lack of awareness and understanding among investors (including institutional investors) about the significance of this issue.

61. The environment of internationally low interest rates in recent years has, in some jurisdictions and for certain strategies, also drawn more attention to the levels of transaction costs in funds. [8]

62. The 2004 report sets out very high-level, general standards and the report acknowledges their limitations concerning the incompleteness of transaction cost information and the resulting partial disclosure to investors.

63. The 2014 survey indicates that most jurisdictions do not require disclosure of some types of transaction costs. For example, it may be difficult for CIS operators to obtain specific information from counterparties about implicit costs. Nonetheless, CIS documents could disclose the existence of transaction costs and explain to investors how such costs may impact performance. CIS operators could report or account for explicit costs, as recommended in the 2004 report.

64. With these considerations in mind, the following good practices are proposed for the disclosure of transaction costs of CIS:

a. Where transaction costs are deducted from the assets of the CIS, the fact that the CIS may incur certain transaction costs should be disclosed. For example, documents that contain, to the extent known, a detailed description of the CIS's fees and expenses including the types of cost that will be or may be charged as transaction costs should be provided or made available to investors before they invest. Any information provided to investors should never be misleading

b. **Where the actual amount of transaction costs is known to the CIS operator after the event, that amount (or the total of all such amounts charged in a specified period) could be disclosed to the CIS and its investors.**

65. *Question 9:*

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7 See for example "Shedding Light on "Invisible" costs: Trading Costs and Mutual Fund Performance", Edelen Roger, Evans Richard, and Kadlec Gregory, Financial Analysts Journal, Volume 69. Number 1.

8 For example see "The Arithmetic of "all-in" investment expenses, John C. Bogle, Financial Analysts Journal, Volume 70, Number 1.

- *Which costs, especially implicit costs, can be accurately quantified after the event?*
- *If they cannot be accurately measured, can they be reliably estimated instead and how useful are such estimates to investors? Could such estimates be helpful to investors in considering their investment decision making process when comparing different methodologies? What methodologies could be used?*
- *What are the challenges of disclosing transaction costs to investors?*

66. It may be difficult to estimate a CIS's future transaction costs due to a number of practical reasons.

67. *Question 10*

- *To what extent can the total amount of transaction costs be predicted for future periods? Are there standards of good practice that could be applied to such disclosures?*
- *What are the risks of using past information in this context?*

68. It is sometimes suggested that the most useful form of fees and expenses disclosure for an investor would be a single figure encompassing all charges and costs, including transaction costs. Some CIS operators have voluntarily adopted this model, enabling investors to know in advance the maximum charge they can incur by investing in that fund. However, the CIS operator must then manage the number and volume of portfolio transactions it undertakes in line with the fee and the value may be inaccurate because some costs cannot be accurately measured.

69. *Question 11*

- *What experience have CIS operators and investors had of funds which apply a single fee that includes transaction costs?*
- *Has the level of transaction costs changed as a result of introducing this model? Are there any disadvantages for investors?*

70. It also has to be considered that the absolute level of such costs over a given period might not, by itself, be a good indicator of whether or not the CIS operator had entered into transactions in the interests of investors – i.e. by investing in a timely way to secure a profit or conversely by exiting a position to avoid a loss.

71. *Question 12:*

- *What disclosure methods are appropriate for transaction costs? If disclosure is in a numeric form, what other pieces of information will help the CIS or its investors to understand the impact of these costs on investment returns?*

Question 13:

- *What is the most appropriate comparison method to ensure the transaction produced value for money?*

HARD AND SOFT COMMISSIONS ON TRANSACTIONS

72. As part of a CIS operator's fiduciary duty towards the investors in the CIS, the operator should not benefit from its position in connection with the placement and execution of fund portfolio transactions at the expense of investors. Both hard and soft commission arrangements can result in the CIS operator receiving a benefit, the only real difference being that "hard" arrangements refer to a cash amount whereas "soft" arrangements refer to benefits in kind (goods and services).

Framing hard and soft commission arrangements

73. The 2004 report highlighted that these commission arrangements might incentivise the operator to direct transactions to brokers based on criteria other than best execution services, and to increase the turnover of the fund to generate more commissions. Such incentives might not be compatible with fiduciary duty. The 2004 report recommended that transactions should always be executed on best execution principles, and hard commissions should not be a criterion in the choice of an intermediary to execute for the CIS.

74. The emphasis in many jurisdictions on requiring payments from third parties to be justified in terms of the benefit they bring to the CIS and its investors, as well as enhanced standards on obtaining best execution by reference to a range of criteria (not just market price), suggest that the use of hard commissions may have become less prevalent in recent years, at least in the more mature securities markets. Some jurisdictions do not permit them at all.

75. The standards for the treatment of hard and soft commission set out in the 2004 report are still considered to be robust and these standards have been kept largely unchanged, although some additional clarifications of the wording are proposed (shown in bold text). A new good practice is proposed:

a. Transactions should always be executed in accordance with **the principles of best execution, and the use of hard or soft commissions must not compromise this obligation.** This implies that **transactions** should be executed on market terms, where applicable. Requirements to disclose information to the regulator may assist the regulator in evaluating whether best execution principles are complied with.

b. If hard commissions **are permitted,** they should be for the exclusive benefit of the fund. This means that any hard commission should either be paid directly to the

fund or indirectly (e.g. through a reimbursement). Hard commission should not be a criterion when a **CIS** operator chooses an intermediary **to perform or arrange execution.**

c. If soft commissions are permitted, **they** should not be the sole or a primary criterion when a **CIS** operator chooses an intermediary **to perform or arrange execution.**

d. Transactions should be entered into for the benefit of the CIS and its investors and not to generate an order flow and/or dealing commission.

Soft commission arrangements – developments since 2004

76. By the time of the 2004 report, most jurisdictions had defined some specific rules relating to soft commissions. These included, variously, a requirement for soft commissions to accrue to the benefit of the holder of the CIS; a requirement for the choice of brokers to be based on the search for 'best execution services'; specific disclosure requirements; controls on the types of benefit that could be paid for with soft commissions; or a mixture of all these rules, among others.

77. IOSCO looked further into soft commission arrangements in its 2007 report.[9] That report recognised similar concerns over their use, and examined in some detail the conflicts typically present between the interests of the CIS operator and those of the CIS and its investors. It described how these arrangements may create incentives for CIS operators to direct trades based on benefits provided to the operator rather than the most favourable execution terms for the CIS.[10]

78. The 2007 report did recognise that the financing of investment research by CIS was an accepted and widely-used mechanism; and that, soft commission arrangements – notably the provision of investment research – could provide benefits to CIS investors if conflicts of interest are appropriately managed. The 2007 report did not develop general regulatory principles but suggested that these could be considered in future, especially for the limitation of goods and services payable for with soft commission, or provision of prior and periodic disclosure to investors.

79. In the EU, the recent revision of the Markets in Financial Instruments Directive (MiFID II) will introduce new requirements from January 2017 in relation to the types of goods and services that EU-regulated investment firms providing the service of individual portfolio management or investment advisers can receive. The details have still to be finalised, but ESMA has suggested to the European Commission that this proposed framework could be extended to managers of collective investment undertakings (i.e.

9 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD255.pdf

10 For example, cheaper execution options such as electronic communications networks do not provide softed goods and services that the operator would otherwise have to pay for itself.

alternative investment fund managers and UCITS management companies) with a view to ensuring a level playing field among all types of asset managers in the EU.[11]

80. Possible conflicts of interest in the use of soft commissions were highlighted again in responses to the 2014 survey. Some jurisdictions noted the risks of the CIS operator compromising its fiduciary obligations by trading the CIS' portfolio simply in an effort to earn these commissions. They explained how the CIS operator may also use brokers on the basis of the research and additional brokerage services provided, rather than only on the quality of their execution services. One jurisdiction noted concerns over the use of brokers belonging to the same group as the CIS operator or management company. Another drew on its recent supervisory work which found evidence of investment managers that lacked adequate controls and oversight of the amounts of dealing commissions spent on behalf of clients, putting at risk their ability to assess best execution and ensure they are acting in the best interest of their clients.

81. Although the 2014 survey revealed that the regulatory regimes for soft commission arrangements remain diverse across jurisdictions and are not expected to evolve in the near term, the developments in the EU could have a significant impact on the global industry, particularly on the financing of investment research.

Managing the conflicts of interest effectively

82. It is evident that a number of jurisdictions have taken steps since 2004 to ensure soft commission arrangements are regulated in the interests of the CIS and its investors. Although there are differing views about whether soft commissions actually benefit investors, it seems that – in the absence of alternative market mechanisms for certain goods and services to be priced and distributed – softing may be the only practical way to recompense the providers of those goods and services in those markets. CIS operators and other asset managers (the "buy side") have responsibility for deciding how their clients' money is spent, but the way that some market counterparties of CIS operators (the "sell side") structure their business models can make it difficult for the

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[11] MiFID II stipulates that in order to prevent conflicts of interest, investment firms will no longer be able to accept and retain fees, commissions or any monetary or non-monetary benefits from a third party unless they can be considered "minor non-monetary benefits". ESMA has provided the Commission with a technical advice on this topic (among others) in which it suggests an exhaustive list of acceptable benefits. From ESMA's technical advice published on 19 December 2014 : "*Article 24(7)(b) and 24(8) of MiFID II state that when an investment firm provides investment advice on an independent basis or portfolio management, it shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients. Minor non-monetary benefits that are capable of enhancing the quality of service provided to a client and are of a scale and nature such that they could not be judged to impair compliance with the investment firm's duty to act in the best interest of the client should be clearly disclosed and are excluded from this provision.*"

In addition, ESMA suggests a strict framework to be complied with for investment research not to be considered as an inducement and therefore to be authorised. It is proposed that either investment firms pay directly out of their own balance sheet for the research used (which they can choose to reflect through an increase in management fees) or they can make payments through a distinct research payment account subject to specific detailed requirements, including the definition *ex ante* of a research budget, the absence of a link between the defined budget and the transactions volume, the client's consent, and ex post disclosure.

buy side to manage effectively some of the conflicts of interest it faces around the use of dealing commission.

83. Jurisdictions that permit soft commission arrangements can limit the potential conflicts of interest identified above, by setting standards for the buy side, the sell side or both. Where a jurisdiction places standards on the CIS operator as to what goods or services are permitted to be obtained under soft commission (or equivalent) arrangements, a CIS operator should have procedures to allow them to determine and demonstrate compliance with such requirements. A CIS operator should also be able to justify how such goods and services contribute to their investment decisions on behalf of the CIS.

84. Therefore, a possible approach is to specify types of goods and services that should not be paid for with dealing commission. These could include items such as certain IT services and equipment, or travel, accommodation and entertainment provided to directors and employees of the operator or an associated company or person.

85. Another possible (or additional) approach is to define what can properly be paid for in this way, which avoids uncertainty about whether certain services and arrangements are acceptable or not. A positive list could cause CIS operators to consider even more carefully which providers they enter into agreements with and for which goods and services. Regulators might seek to reinforce this approach by indicating (for example) what types of investment research and research-related services they consider acceptable, or the criteria that a CIS operator should apply to determine whether investment research is an eligible service under the appropriate regulation.

86. Even if restrictions apply to the types of goods and services that may be softed, the CIS operator may face conflicts of interest over the specific arrangements in place with the provider. Operators should be able to identify the situations that typically arise and to develop policies and procedures for managing them in the interests of the CIS and its investors. For example, the operator should consider its fiduciary obligations to the CIS and its investors when it:

a. arranges for a transaction to be executed by an associated company;

b. receives softed goods and services for which it can negotiate an explicit price;

c. receives softed goods and services for which there is no explicit market price; or

d. receives a bundle of softed goods and services, only some of which can be demonstrated to benefit the CIS and its investors.

87. A CIS operator can also demonstrate that it has identified and addressed conflicts of interest by keeping a record of all soft commission arrangements it enters into and of all goods and services it receives that are paid for in this way.

88. Where commission-sharing agreements are permitted that facilitate payment to other brokers or independent providers of investment research that benefits the CIS, they may help to manage conflicts of interest by reducing incentives for fund managers to accept bundled goods and services that add no value for the CIS and investors.

89. Taking account of all these points, the following standards of good practice are proposed for the use of soft commission arrangements relating to CIS and the management of conflicts of interest:

a. Rules, guidance or a regulatory code specify a non-exhaustive list of the types of goods and services that should not be paid for with dealing commission, or a list of the types of goods and services that may legitimately be paid for with soft commission.

b. The CIS operator takes steps to satisfy itself that the receipt of such goods and services does not impair its duty to act in the best interests of the CIS and its investors.

c. CIS operators have policies and procedures in place for overseeing the use of soft commission arrangements and addressing potential conflicts of interest.

90. *Question 14:*

- *What are the most effective ways of mitigating conflicts of interest relating to soft commission arrangements?*
- *Do lists of forbidden or permitted goods and services give enough certainty to CIS operators and investors about what can be paid for in this way?*
- *What other steps might regulators and/or CIS operators take, to enable goods and services provided by the sell side to be paid for in an efficient way that does not adversely affect the interests of CIS investors?*

Disclosure of hard and soft commission arrangements

91. The 2004 report suggested that disclosure should enable investors to assess the scope of soft commissions and how they will benefit others, but did not set out any detailed standards to achieve this aim. A number of different regulatory approaches have emerged, including prior disclosure to prospective investors in a fund and ongoing periodic disclosure to the CIS and/or existing investors.

92. Prior disclosure can make investors aware in a general way of the practices of the CIS operator, and of what measures are in place to ensure these practices are adequately controlled. Ongoing ex-post disclosure may describe what commission has been paid and which goods and services supplied. The nature of the disclosure will depend on the governance of the CIS, which is outside the scope of this paper; if the CIS has a board

of directors, for example, it may be more appropriate for details of softed goods and services to be presented to them rather than the individual investors.

93. Such details might include, for example:

a. details of the types of goods and services paid for with soft commission;

b. the names of brokers or other counterparties receiving commission, including if applicable any parties paid under commission-sharing agreements;

c. the total value of soft commissions paid out over a specified period;

d. an itemised breakdown of the total payments to each broker or counterparty;

e. a calculation or reasonable estimate of the value of goods and services paid for with soft commission; or

f. an analysis of the conflicts of interest related to these soft commissions, and how they might affect the duty of the firm to act in the best interest of its clients.

94. Taking account of all these points, the following standards of good practice are proposed for the disclosure of dealing commission arrangements (including hard commission payments) relating to CIS:

a. A CIS operator that uses hard or soft commission arrangements should disclose, in documents to be provided or made available to investors before they invest and that contain, to the extent known, a detailed description of fees and expenses payable, at least:
- **the existence of such arrangements;**
- **the types of goods and services that may be acquired through soft commission arrangements;**
- **the measures that may, if required, be taken to manage the conflicts of interests related to these soft commissions.**

b. A CIS operator that uses hard or soft commission arrangements should periodically disclose adequate information to the CIS and/or its investors about the amount of transactions and related commissions that have been paid as a result of executing transactions and receiving research services.

95. *Question 15:*

- *What types of disclosure concerning hard and soft commission arrangements are most useful to the board of directors of a CIS, and/or investors in a CIS?*

PART V OTHER ISSUES

FUNDS THAT INVEST IN OTHER VEHICLES (INCLUDING FUNDS OF FUNDS)

96. A fund may invest through one or more vehicles to gain exposure to the assets required to help achieve its investment objectives. Investing through vehicles, such as other funds, trusts or partnership may impose additional costs, which may affect an investor's investment return.

97. The 2004 report recommended that information on fees and expenses should enable investors to understand that if there is a double fee structure, it will impact the performance of the fund. It appears only the disclosure measures have been followed across a wide range of jurisdictions, with varying levels of disclosure expected.

98. It is important that the costs of a CIS investing in other vehicles are disclosed so that investors are aware of the total cost of investing through the CIS. The manager of the fund may not always have full knowledge of the indirect costs, in particular when investing through a multi-layered arrangement. In this case, if the manager can reasonably estimate the indirect costs, they may wish to include this estimation when calculating the overall costs of the fund.

99. The following good practice is proposed as an addition to the 2004 recommendations:

- **When a CIS invests in other vehicles, the management fees of the CIS and any underlying CIS (including any management fees paid to affiliates) should be disclosed to investors.**

100. *Question 16:*

- *Are current disclosure requirements about fees and expenses, for funds investing in other vehicles, appropriate to assist investors in making an informed decision?*
- *Are disclosure requirements about fees and expenses enough to manage potential conflicts of interest arising from investment in other vehicles? What other requirements might help to mitigate those conflicts of interest?*

MULTI-CLASS CIS

101. The 2014 survey shows most jurisdictions that have multi-class CIS require information regarding fees and expenses of multi-class funds to be presented separately. Given the wide adoption of standards requiring disclosure of fees and expenses, **there does not appear to be a strong need for enhanced or additional good practice in this area**.

CHANGES IN THE MAIN CHARACTERISTICS OF A CIS

102. The 2004 report recommended a prominent statement to be inserted in documents stating that, following significant changes to the main characteristics of the fund, information based on historical data may not be relevant for investors considering investing in the fund; or to define precise additional requirements to deal with such

cases. It also recommended that current investors in the fund should be able to redeem their investment free of charge and/or to vote against the authorisation of changes. The requirements by which the fund has to abide should be defined for the start-up period of the fund.

103. While there appears to be general convergence around the principle of providing disclosure of changes, some jurisdictions have not adopted either recommendation about treatment of investors who object, although regulators would always take investor protection into account before authorising a change in the main characteristics of a CIS. It might be desirable to enhance standards of good practice in this area. As such, we propose to add the following good practice:

- **Investors should be allowed a period of time (which should preferably be determined by the regulatory authority) between the issuance of the notice to investors about the changes and the changes coming into force**

104. *Question 17:*

a. Are you aware of problems in identifying what constitutes a change in the main characteristics of a CIS in relation to fees and expenses?

b. Should there be more specific standards of good practice concerning disclosure of changes, e.g. a minimum period of prior notice, and the ability of investors to respond to such changes? Please give examples of appropriate measures, if possible indicating the likely costs they would involve.

LEVELS OF FEES AND EXPENSES

105. The 2004 report stated that regulators do not dictate the level of fees and expenses because the focus has been to promote competitive and informed markets, which will ensure fees and expenses are understood in the context of the type and quality of service provided. The majority of respondents in 2014 kept to this line, although some had set ceilings for certain types of funds and some had set an overall upper limit.

106. No new good practices seem to be required in this area, but IOSCO would welcome opinions on this matter.

GENERAL QUESTIONS REGARDING GOOD PRACTICE STANDARDS

107. *Question 18:*

- *Which other areas of the 2004 report, if any, do you believe should be updated and/or amended? Please provide any suggested changes to specific standards of*

good practice or definitions of key terms set out in Annex A, including drafting proposals and rationale.

108. *Question 19:*

- *Does the report cover all of the key issues on standards regarding fees and expenses of CIS?*
- *Are standards needed to address any additional issues? Please provide a summary of the issue and suggest wording for the proposed standards.*

ANNEX 1

GLOSSARY OF TERMS

The following definitions have been devised for the purpose of this paper only. They do not necessarily correspond to the definitions used in the laws and regulations of any jurisdiction that is a member of C5.

'Transaction costs' are costs incurred by a fund in connection with the acquisition or disposal of assets of the portfolio. An exact inclusive list varies amongst regulators. Acquisition and disposal may be understood to include "temporary" transactions such as stocklending or repo / reverse repo.

'Fulcrum fee' is a type of performance fee. When a fulcrum fee is used the level of the fee increases or decreases proportionately with the investment performance of the fund over a specified period of time in relation to the investment record of an appropriate securities index. This means that a fulcrum fee can be negative, and thus deducted from the basic fee charged by the fund operator to the investment fund.[12]

'Hard commissions' are fee-sharing agreements between a CIS operator and a broker in which the broker agrees to split with the operator the dealing commission paid by the CIS to the broker for processing transactions for the fund.

'Soft commissions' (or 'soft dollar benefits') are certain economic benefits – goods or services – that a CIS operator may receive in connection with the payment of dealing commissions by the CIS on transactions involving its portfolio securities. They exclude the transactional costs linked to execution (i.e. the pure cost of buying and selling securities) but they are typically obtained from, or through the agency of, the broker.

'Soft commission-sharing agreements' are agreements between a CIS operator and a broker that allow the CIS operator, when paying commission to the broker, to separate payment for execution from payment for other 'softed' goods and services that benefit the CIS. The broker will facilitate instructions from the CIS operator to re-direct some or all of the non-execution-related part of the payment to third parties to recompense them for goods and services they have provided.

A 'performance-related fee' is a variable management fee linked to the performance of a CIS portfolio, and usually payable in addition to a basic fee (generally asset-based). The fee is paid by the CIS to the CIS operator. Its aim is to align the economic interests of the CIS

[12] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD178.pdf

operator and the investors in the CIS, thus creating an incentive for the CIS operator to optimise investment performance. The 'performance' of a CIS should be understood in a very wide scope here, to include capital appreciation as well as any income linked to the CIS's assets (e.g. dividends).

'Prospectus' includes any offering document having a similar purpose.

ANNEX 2

CONSOLIDATED LIST OF CONSULTATION QUESTIONS

Question 1:

- *Are there any other developments that C5 should take into account when formulating good practices regarding fees and expenses of CIS*?

Question 2:

- *If you think defining permitted and prohibited costs is useful, should this be done by the regulatory authority or the CIS operator?*
- *What types of costs should be permitted and/or prohibited to be charged?*
- *Are there alternatives to prohibiting certain fees and expenses and if yes, what are they are why are they effective?*

Question 3:

- *Which do you consider to be the most appropriate method of performance fee calculation currently employed and why? Are there methods other than a fulcrum fee or "last in, first out" that are more effective?*
- *What other requirements might curb incentives for excessive or inappropriate short-term risk-taking? Should there be specific recommendations as to how the calculation, benchmark, and target of a performance fee are disclosed? What further disclosures could be recommended?*

Question 4:

- *Do summary documents present the right amount of information about fees and expenses and in a way that is useful for investors?*

Question 5:

- *Should regulators do more – and if so, what – to make disclosures to investors about fees and expenses:*
  - *easier to understand?*
  - *more prominent?*
  - *more easily accessible?*
- *Is it necessary to expand the standard "Information delivered must be simple, concise and set out in clear language"? Would you find it helpful to have recommendations on (for example) the use of easy-to-read formats (font size, using tables / charts / graphs) or the use of uniform terminology?*

- *Does a standardised fee table, if applicable, provide sufficient information regarding certain fees and expenses?*
- *Are there specific sub-categories (e.g. management fee, transaction costs) that should be disclosed separately?*

Question 6:

- *Should there be a standard regarding the frequency of updating of fees and expenses information in disclosure documents?*
- *How often should historical information on fees and expenses be updated?*
- *In which situations (e.g. where historical information on CIS does not exist) should disclosure on an anticipated basis be obligatory?*
- *What is the most accurate or representative methodology for calculating fees and expenses on an anticipated basis (i.e. one that reduces the chance of over-estimates or under-estimates)?*
- *How should material changes to the fees and expenses of a CIS be treated in terms of historical / anticipated disclosure requirements?*
- *In cases where the information can only be provided on an anticipated basis to begin with, should the disclosure be updated later with historical information?*

Question 7:

- *Is it desirable to add a standard recommending the use of electronic media for fees and expenses disclosure documents? What are the reasons for your view?*
- *How can the CIS and the CIS operator ensure that electronic disclosures are received and accessed by investors?*
- *What could constitute approval from investors?*

Question 8:

- *Should there be a standard definition of what transaction costs are? If so, which types of cost should be included in, or excluded from, such a definition and why?*
- *What are the most effective ways of determining the value and impact of transaction costs in a CIS?*

Question 9:

- *Which costs, especially implicit costs, can be accurately quantified after the event?*
- *If they cannot be accurately measured, can they be reliably estimated instead and how useful are such estimates to investors? Could such estimates be helpful to*

investors in considering their investment decision making process when comparing different methodologies? What methodologies could be used?

- *What are the challenges of disclosing transaction costs to investors?*

Question 10

- *To what extent can the total amount of transaction costs be predicted for future periods? Are there standards of good practice that could be applied to such disclosures? What are the risks of using past information in this context?*

Question 11

- *What experience have CIS operators and investors had of funds which apply a single fee that includes transaction costs? Has the level of transaction costs changed as a result of introducing this model? Are there any disadvantages for investors?*

Question 12:

- *What disclosure methods are appropriate for transaction costs? If disclosure is in a numeric form, what other pieces of information will help the CIS or its investors to understand the impact of these costs on investment returns?*

Question 13:

- *What is the most appropriate comparison method to ensure the transaction produced value for money?*

Question 14:

- *What are the most effective ways of mitigating conflicts of interest relating to soft commission arrangements?*
- *Do lists of forbidden or permitted goods and services give enough certainty to CIS operators and investors about what can be paid for in this way?*
- *What other steps might regulators and/or CIS operators take, to enable goods and services provided by the sell side to be paid for in an efficient way that does not adversely affect the interests of CIS investors?*

Question 15:

- *What types of disclosure concerning hard and soft commission arrangements are most useful to the board of directors of a CIS, and/or investors in a CIS?*

Question 16:

- *Are current disclosure requirements about fees and expenses, for funds investing in other vehicles, appropriate to assist investors in making an informed decision?*
- *Are disclosure requirements about fees and expenses enough to manage potential conflicts of interest arising from investment in other vehicles? What other requirements might help to mitigate those conflicts of interest?*

Question 17:

- *Are you aware of problems in identifying what constitutes a change in the main characteristics of a CIS in relation to fees and expenses?*
- *Should there be more specific standards of good practice concerning disclosure of changes, e.g. a minimum period of prior notice, and the ability of investors to respond to such changes? Please give examples of appropriate measures, if possible indicating the likely costs they would involve.*

Question 18:

- *Which other areas of the 2004 report, if any, do you believe should be updated and/or amended? Please provide any suggested changes to specific standards of good practice or definitions of key terms set out in Annex A, including drafting proposals and rationale.*

Question 19:

- *Does the report cover all of the key issues on standards regarding fees and expenses of CIS? Are standards needed to address any additional issues? Please provide a summary of the issue and suggest wording for the proposed standards.*

ANNEX 3

STATEMENTS OF GOOD PRACTICES RELATING TO FEES AND EXPENSES OF CIS from the 2015 report

1. Regulators may decide to specify fees and expenses that cannot be deducted from the assets of a CIS. This could be in the form of guidance.

2. The scope of fees and expenses that may be deducted or those which cannot be deducted from the assets of a CIS should, in any case, at least be set out in disclosure documents available to investors before they invest and afterwards at the times mandated by regulation / legislation.

3. The CIS operator should not deduct a new type of fees from the assets of a CIS or increase the management fees unless, at a minimum, the responsible entity (e.g. board of directors, specified independent governance process, regulatory authority etc.) approves the fee. The responsible entity could consider imposing breakpoints to the CIS management fee if appropriate, given economies of scale that may occur when the CIS grows in size.

Performance fees

1. a regulatory regime that permits performance fees to set standards for:
    a. their method of calculation;
    b. the information the CIS operator should disclose to investors about their use; and
    c. the disclosure medium to be used.
2. Performance fees should be consistent with the CIS investment objective and not create incentives to take excessive risk . To that end, it could be considered good practice for CIS operators to enter into performance fee arrangements in which:
    a. Calculation period should not be more frequent than once a year;
    b. Where the calculation of the performance fee is based on the fulcrum fee model:
        i. the calculation of the fee is compared to an appropriate benchmark;
        ii. the fee increases or decreases proportionately with the investment performance of the CIS over a specified period of time; and
        iii. the CIS's investment performance should be calculated on the CIS's net asset value;
    c. Where the performance of the fund is not based on a fulcrum fee model but is measured with reference to a benchmark:
        i. calculation of the fee is based on the same benchmark used to determine excess performance;
        ii. the excess performance is calculated net of costs.

Sources of information about fees and expenses

1. Current and prospective investors should be provided with easy-to-understand and summarised information on the elements of fees and expenses that are essential to make informed investment decision.

2. Disclosure documents that include summarised information about fees and expenses should explain clearly where and how both current and prospective investors can obtain full details about those fees and expenses**.**

Historical and forward looking information

1. Information on fees and expenses should be kept up to date and updating frequency should be specified in legislation/regulation.

Use of electronic media

1. Use of electronic media for disclosure of information on CIS fees and expenses should be encouraged (in appropriate circumstances) provided that:
    - updated disclosure documents can easily be obtained electronically;
    - existing channels and printed copies of disclosure documents should continue to be available to investors upon request. These should, wherever possible, be free of charge.
2. It should be ensured that sufficient and accurate information is provided to the investors who use electronic distribution channels, before they invest in CIS**.**

Transaction costs

The following statements of good practice are proposed for the management of transaction costs of a CIS:

1. Regulators define what is meant by transaction costs; alternatively, the regulator or the CIS operator could specify the types of payment that cannot be charged to the assets of the fund as a transaction cost or indicate how the value and/or impact of transaction costs can be determined.

2. Where transaction costs are deducted from the assets of the CIS, the fact that the CIS may incur certain transaction costs should be disclosed. For example, documents that contain, to the extent known, a detailed description of the CIS's fees and expenses including the types of cost that will be or may be charged as transaction costs should be provided or made available to investors before they invest. Any information provided to investors should never be misleading.

3. Where the actual amount of transaction costs is known to the CIS operator after the event, that amount (or the total of all such amounts charged in a specified period) could be disclosed to the CIS and its investors.

Hard and soft commissions

1. Transactions should always be executed in accordance with the principles of best execution, and the use of hard or soft commissions must not compromise this obligation. This implies that transactions should be executed on market terms, where applicable. Requirements to disclose information to the regulator may assist the regulator in evaluating whether best execution principles are complied with.
2. If hard commissions are permitted, they should be for the exclusive benefit of the fund. This means that any hard commission should either be paid directly to the fund or indirectly (e.g. through a reimbursement). Hard commission should not be a criterion when a CIS operator chooses an intermediary to perform or arrange execution.
3. If soft commissions are permitted, they should not be the sole or a primary criterion when a CIS operator chooses an intermediary to perform or arrange execution.
4. Transactions should be entered into for the benefit of the CIS and its investors and not to generate an order flow and/or dealing commission.
    a. Rules, guidance or a regulatory code specify a non-exhaustive list of the types of goods and services that should not be paid for with dealing commission, or a list of the types of goods and services that may legitimately be paid for with soft commission.
    b. The CIS operator takes steps to satisfy itself that the receipt of such goods and services does not impair its duty to act in the best interests of the CIS and its investors.
    c. CIS operators have policies and procedures in place for overseeing the use of soft commission arrangements and addressing potential conflicts of interest
5. A CIS operator that uses hard or soft commission arrangements should disclose, in any documents to be provided or made available to investors before they invest and that may contain a description of fees and expenses payable, at least:

- the existence of such arrangements;
- the types of goods and services that may be acquired through soft commission arrangements;
- The measures that may, if required, be taken to manage the conflicts of interests related to these oft commissions.

6. A CIS operator that uses hard or soft commission arrangements should periodically disclose adequate information to the CIS and/or its investors about the amount of transactions and related commissions that have been paid as a result of executing transactions and receiving research services.

Funds That Invest In Other Vehicles (Including Funds of Funds)

1. When a CIS invests in other vehicles, the management fees of the CIS and any underlying CIS (including any management fees paid to affiliates) should be disclosed to investors.

Changes in the main characteristics of the CIS

1. As far as current investors are concerned, requirements should aim at ensuring that the investor is aware of changes to fees and expenses that have occurred and, if these changes of costs concern management fees are significant appropriate regulation may consist of one or more of the following:

    - allowing investors a period of time (which should be determined by the regulatory authority) before the changes come into force with the notice made to investors about the changes.

ANNEX 4: Principles in the Final report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds – November 2004.[13]

Disclosure of fees and expenses to the investor

1. Information on fees and expenses should be disclosed in a way that allows investors to make informed decisions about whether they wish to invest in a fund and thereby accept a particular level of costs.
2. Information on fees and expenses should be disclosed to both prospective and current investors.
3. The information should enable investors to understand what fees and expenses are charged.
4. Information delivered must be simple, concise and set out in clear language. It should avoid overloading investors with details which are not relevant for them.
5. Information should be delivered using a standardized fee table. This fee table should distinguish between fees paid directly by the investor out of his or her investment in the fund, and expenses that are deducted from the fund's assets. The fee table should also disclose the Total Expense Ratio ('TER') of the fund.
6. Information delivered must not be misleading.
7. Fee information disclosed should be aimed at enabling investors to understand the

impact of fees and expenses on the performance of the fund. The information should describe the cost structure (e.g. the management fee, operational costs such as custody fees) of the fund.

8. The information should describe the fees and expenses actually paid on a historical basis, and may also describe the fees and expenses likely to be paid on an anticipated basis.
9. Information on fees and expenses should enable investors to compare costs between funds.
    a. Information on fees and expenses should disclose the Total Expense Ratio of the fund. This TER should be disclosed in a standardized way, standardized fee table or financial highlights.

[13] Please refer to the full report for explanations and guidance on these high-level principles.

Conditions of remuneration of the fund operator

1. The conditions of remuneration of the fund operator should comply with three main principles:

   - transparency, enunciated in paragraph 13,
   - prevention of conflicts of interest, as conditions of remuneration of fund operators should not create an incentive to behave contrary to the interest of the investor,
   - fairness of competition; disclosure requirements (should prevent any distortion among operators).

Performance fees

1. A performance fee should not create an incentive for the fund operator to take excessive risks in the hope of increasing its performance fee.
2. A performance fee should be consistent with the fund's investment objectives and should not create an incentive for the operator to take excessive risks and should not deny investors an adequate remuneration of the return from the risks taken on their behalf and previously accepted.
3. The calculation of a performance fee should be verifiable. It should not be possible to manipulate.

   - The following items should be unambiguously determined:

     • how the performance of the fund will be assessed (over what timeframe including or excluding subscription/redemption fees, etc.),

     • what benchmark reference that the performance will be compared to. This reference must be verifiable and provided by an independent party,16

     • what the calculation formula will be (including the description of th methods used to offset gains with past losses, if applicable).
4. A performance fee should not result in a breach of the principle of equality of investors.
5. Investors should be adequately informed of the existence of the performance fee and of its potential impact on the return that they will get on their investment.

Transaction costs

1. Some information on transaction costs should be disclosed to investors. This information will usually be incomplete. It should however never be misleading.

Hard and soft commissions on transactions

1. Regulators also agree that soft commissions may create conflicts of interest for fund operators. Regulation should therefore seek to ensure that those conflicts are either eliminated or managed in the investors' best interests;

2. Transactions should always be executed in accordance with best execution principles. This implies that they be executed on market terms.

- If hard commissions are not prohibited, hard commissions should not be a criterion when a Fund operator chooses an intermediary. If soft commissions are permitted, the soft commissions should not be the sole or primary criteria when a Fund operator chooses an intermediary. The current trend among regulators is to consider as an acceptable practice the fact that a Fund operator chooses an intermediary that provides soft commissions as long as the broker can provide execution services that are equal to or better than other brokers.
- Requirements to disclose information to the regulator may assist the regulator in evaluating whether best execution principles are complied with.

3. If permitted, hard commissions should be for the exclusive benefit of the fund. This means that any hard commissions should either be paid directly to the fund or indirectly (e.g., through a reimbursement).

Funds that invest in other funds (including funds of funds)

1. Information on fees and expenses should enable investors to understand that if there is a double fee structure, it will impact the performance of the fund.
2. Conflicts of interest that arise because of the investment in other funds should be minimized.
   - If permitted, fee-sharing agreements should benefit exclusively the top-tier fund. They should not benefit the Fund operator, be it directly or through a third party.
   - if the top-tier fund invests in funds managed by affiliated parties, this should be disclosed to investors and subscription/redemption fees should be waived (except for those fees that go to the fund to cover the costs linked to the subscription/redemption24).
   - if the bottom-tier fund is a multiclass fund (see below paragraph 44), the top-tier fund should invest in the class with the lowest fee structure among the comparable classes in which it wishes to invest.

Multiclass funds

1. The existence of different share classes should not result in a breach of equality of investors who invest or have invested in the same share class. The investors in the same class should bear the same fees and expenses that are reflected in the TER for the class. Those fees and expenses should not be waived for only certain shareholders within a class. Differences in fee and expenses shall be based on objective criteria disclosed in the fund prospectus (e.g. the amount of subscription).

2. No advantage should be provided to a share class that would result in a prejudice to another share class or to the fund.

Changes in a fund's operating conditions

1. As far as current investors are concerned, requirements should aim at ensuring that the investor is aware of changes to fees and expenses that have occurred and, if these changes of costs concern management fees are significant appropriate regulation may consist of one or more of the following:
   - allowing an investor to redeem his investment free of charge, or
   - allowing fund investors to vote against the authorization of changes.

2. Requirements should also be defined for the start up period of funds.