

**FEES AND COMMISSIONS WITHIN THE  
CIS AND ASSET MANAGEMENT SECTOR:  
SUMMARY OF ANSWERS TO QUESTIONNAIRE**



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# **FEES AND COMMISSIONS WITHIN THE CIS AND ASSET MANAGEMENT SECTOR: SUMMARY OF ANSWERS TO QUESTIONNAIRE**

## **Introduction**

This report presents an examination of the standards and practices among the jurisdictions of the members of the Technical Committee Standing Committee on Investment Management ('SC5') on the subject of fees and commissions in Collective Investment Schemes ('fees and commissions'). This report also describes key issues arising out of this examination.

This project was accepted by the Technical Committee at its meeting in October 2001. A project specification was discussed at the SC5 meetings of July and October 2001 and a questionnaire was circulated to SC5 members in spring 2002.

This report builds on the answers to this questionnaire. It provides a mapping of the standards and practices among SC5 members as of July 2002.<sup>1</sup>

## **Summary**

This report has three sections:

- (1) What are the current regulatory approaches on the subject of fees and commissions? How and to what extent is the information on fees and commissions disclosed to the investor?
- (2) What are the specific issues arising from:
  - a. performance fees
  - b. fees in funds of funds
  - c. transaction costs
  - d. multi-class funds
- (3) Soft commissions and fee-sharing agreements (including distribution costs).

## **1. The disclosure of fees and commissions to the investor**

### ***1.1. Current regulatory approaches***

All jurisdictions acknowledge the importance of fees and commissions and the necessity to regulate this area:

- fees and commissions have a direct impact on the performance of a Collective Investment Scheme ('CIS')
- the level of fees and commissions is an important consideration when making an investment decision

Regulatory approaches derive from these two facts and are structured around the following principles:

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<sup>1</sup> Answers for Mexico were updated following changes in their regulation at the beginning of 2003.

- an investor must have access to relevant information on fees and commissions:
  - this relevant information should be available both to investors considering investing in a CIS and to investors who have invested in this CIS.
  - it should enable the investor to understand the cost structure of the CIS and to make comparisons with other CISs.
- the regulator should take steps to ensure that the above principles are implemented. In taking these steps, the regulator should consider the following issues:
  - disclosure requirements of a CIS towards the investor, taking into account the risk of overwhelming the investor with information
  - methods of calculation of fees and commissions to ensure that these methods reflect the true cost structure of the CIS and enable comparisons between CIS
  - homogenization of the presentation of fees and commissions between CIS to make comparisons easier
- as a rule, the regulator does not aim at controlling the level of fees and commissions:
  - It rather aims at having a competitive and informed market, which will then ensure that the fees and commissions are coherent with the type and quality of services provided.
  - However, differences in the structure of the asset management industry may lead some jurisdictions to define ceilings for certain types of fees (Ireland, Spain, United States), to require that warnings on the level of fees and commissions be inserted in documents describing CIS (France, Hong Kong, Jersey, Portugal) or to encourage CIS to lower their fees when they consider that their level is inappropriate (Luxembourg).
  - The enforcement of best execution principles by regulators may lead them to exercise *de facto* some control on the level of fees and commissions linked to transaction costs since best execution principles require that fees on transactions be coherent with market prices.

Country	Control of the level of fees and commissions			
	No, generally	No, but warning in the prospectus	ceilings for certain types of fees	comments
Australia	x			Current proposals for standardized disclosure; fund calculator in development.
Brazil	x			Comparative tables on the CVM web site
Canada	x			possible disclosure of higher than usual fees
France		x		No, possible warning
Germany	x			
Hong Kong		x		No, possible warning
Ireland			x	Yes, for the redemption charge in retail CIS (max 3%) No otherwise
Italy	x			No
Japan	x			No
Jersey		x		
Luxembourg	x			No, possible discussion
Mexico	x			
Netherlands	x			No
Portugal		x		No, possible warning (not used)
Spain			x	Yes, precise ceilings
Sweden	x			No
Switzerland	x			No
UK	x			No, comparative tables
US	x		(x)	No, emphasis on the role of CIS directors, but limits on sales loads and distribution fees.

Depending on the structure of their industry, jurisdictions may have specific areas of concerns. These areas are examined in parts 2 and 3 of this report.

## 1.2. *Current practices*

- **Means of information.** In all jurisdictions, the prospectus – or its local equivalent – is the primary means for the disclosure of fees and commissions to the prospective investor.
  - All jurisdictions require additional information to be disclosed in other regulatory documents such as the statement of additional information, the incorporation document or the periodic reports.
  - However, many jurisdictions note that many investors apparently seldom use these additional documents.
- **Kind of information.** All jurisdictions require maximum, prospective figures to be disclosed, except for transaction costs since these cannot be forecasted. All jurisdictions also require some information on actual charges and expenses since these may differ significantly from the prospective figures.
  - The information on effective figures is most often found in periodic reports (usually the annual report). Given the above remark on the use of periodic reports by investors, this limits the effectiveness of the disclosure.

- Some jurisdictions require some effective figures to be disclosed in the prospectus (Canada, Sweden, and United States).
- **Level of detail.** Jurisdictions seek to find an equilibrium between the level of detail required and the necessity to have simple, comparable information.
  - some jurisdictions have chosen to focus on delivering to the investor all the information needed to take the decision and to follow the investment. Those jurisdictions require a high level of detail in the different regulatory documents.
  - some jurisdictions have chosen to focus on having an easy-to-read prospectus. This has led them to require a lower level of detail and to focus on the information which they deem essential for the investor.
  - the United States has adopted an intermediate approach by requiring that comprehensive information be disclosed in the prospectus and that further information be disclosed in an additional document to the prospectus, the Statement of Additional Information.
  - some jurisdictions allow an all-in fee to be charged to the CIS by the management company, who then pays the different creditors of the CIS. No details on the fee structure are then available in the prospectus.
- **Structure of the information.** There are important variations in the structure of the information delivered to the investor.
  - All jurisdictions expect the information to be structured around the main cost areas (for example, subscription fee, redemption fee, management fee, and other fees). In general, this structure distinguishes between costs borne by the CIS and costs borne by the investors. The level of detail required and the types of costs that have to be individually identified depend on the jurisdiction.
  - Two jurisdictions have introduced standardized fee tables (Canada, United States).
  - Six jurisdictions have formally adopted a concept of Total Expense Ratio ('TER') (Canada, Japan, Mexico, Spain, Sweden, and United States). Switzerland will shortly require the publication of a TER from all domestic and foreign CIS. Four jurisdictions use equivalent concepts, either a "management fee" or an "all-in fee" encompassing all fees charged to the CIS or two separate fees which add to a TER (France, Italy, Switzerland, and United Kingdom).
  - To enable the investor to better understand the real impact of costs on shareholder's/unit holder's investment, four jurisdictions require CIS to illustrate this impact through an example (Canada, Sweden, United Kingdom, and United States).

Country	Use of Total Expenditure Ratio			
	Yes	equivalent concept	No	Comment
Australia			x	No (but funds may use the OMC or the MER)
Brazil			x	
Canada	x			Yes (MER)
France		x		use an equivalent concept (management expenses include all expenses except transaction costs)
Germany			x	No, but recommended by the BVI (business association of the German fund industry) in the recently issued self-regulation “BVI-Rules of Conduct”
Hong Kong			x	
Ireland			x	
Italy		x		use an equivalent concept (management expenses include all expenses except transaction costs)
Japan	x			
Jersey			x	
Luxembourg			x	
Mexico	x			disclosed on a monthly basis
Netherlands			x	No, but recommended
Portugal			x	
Spain	x			Yes, in the financial report
Sweden	x			Yes, Total cost ratio in the annual report
Switzerland		x	x	Some funds use the TER, others an “all-in” fee.
UK		x		No, but equivalent in two separate figures. TER widely used
US	x			Yes, generally includes all expenses incurred by CIS except transaction costs of securities transactions.

- **Excluded costs.** Some jurisdictions regulate the types of costs that can or cannot be charged to a fund:
  - 7 jurisdictions do not have any specific regulations regarding this issue though there may exist requirements on how fees may be charged to the CIS (as is the case in the US for distribution fees)
  - 3 jurisdictions explicitly prohibit some specific costs being charged to the fund.
  - 8 jurisdictions have a list of authorized costs that may be charged to a CIS. All other fees must be paid by the management company out of its management fee.

Country	Regulation of the costs that can be charged to a CIS			
	A – No	B – prohibited costs	C – authorized costs	Comments
Australia	x			Must be set out in the CIS constitution and management company's right to payment or indemnification is only available in relation to the proper performance of its duties.
Brazil			x	
Canada		x		A CIS may not pay compensation to distributors (commissions or sales incentives) or costs related to its initial start-up directly.
France	x (SICAV)		x (common funds)	For common funds, only the management fee, the audit fee and transaction costs may be charged to the fund.
Germany			x	agreement with the industry on a list of authorized costs, integrated in the sample fund rules as a standard provision
Hong Kong		x		Prohibited costs for CIS: - commission payable to sales agents arising out of any dealing in units/shares of the CIS; - expenses arising out of any advertising or promotional activities in connection with the CIS; - expenses which are not ordinarily paid from the property of the CIS authorized in Hong Kong; and - expenses which have not been disclosed in the constitutive documents.
Italy			x	authorized costs : management fees, performance fees, transaction costs, fiscal costs, legal costs, other administrative costs
Japan	x			
Luxembourg	x			
Mexico	x			(under new regulations)
Netherlands	x			
Portugal			x	authorized costs : management fees, depositary fees, transaction costs, audit costs, supervision fees, taxes
Spain			x	authorized costs : depositary and management fees, expenses which are originated by a mandatory duty for the ongoing fund
Switzerland			x	agreement with the industry on a list of authorized costs
UK		x (ICVCs)	x (Unit trusts)	prohibited costs for ICVCs : performance fees and payments for the promotion and acquisition of shares authorized costs for Unit trusts : managers' periodic charge, trustee expenses, brokers commission, interest on permitted borrowings, cost of unit holders meetings, audit fee, regulatory fees, taxes and a few very minor specific items
US	x			but there may be requirements that, among other things, essentially impose limits on certain expenses or on how fees may be charged to the CIS (distribution fees/Rule 12b-1, excessive management fee)
A – no specific regulation B – list of prohibited costs C – list of authorized costs				

## 2. Regulatory approach to specific fees and commissions

### 2.1. *Performance fees*

- **Definition.** A performance fee is a variable management fee linked to the “performance<sup>2</sup>” of a CIS. A performance fee can for example be based on a share of the capital gains or the capital appreciation of the CIS’s funds or any portion of the CIS’s funds as compared to an appropriate index of securities or other measure of investment performance. It is charged to the CIS by the management company. It aims at creating an incentive for the management company to optimize the performance of the CIS.
- **Use of performance fees.** In a vast majority of jurisdictions, performance fees are allowed but are subject to regulation.
  - All jurisdictions except the United Kingdom permit some form of performance fees. The United Kingdom is currently considering whether to permit performance fees.
  - Among the 18 jurisdictions that allow performance fees, five do not have restrictions or rules on the use of these fees (Australia, Japan, Mexico, Netherlands, and Portugal). In the remaining 13 jurisdictions, restrictions and rules relate to the types of CIS that may use performance fees (restriction to qualified investors), the definition of an appropriate benchmark, the method of calculation of the fee, the disclosure in the prospectus of that benchmark or of the method of calculation of the performance fee, and the frequency of payment of that fee.

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<sup>2</sup> The “performance” of a CIS should be understood in a very wide scope here. It includes capital appreciation as well as any income linked to the CIS’s assets (e.g. dividends).



Performance fees						
Country	Accepted ?			Appropriate Benchmark	Minimum Period	Other
	Yes	Yes, with restrictions or rules	No			
Australia	x					
Brazil		Only for qualified investors + rules		Yes	6 month (on the NAV)	High on high
Canada		Rules		Yes	Annual	Fee payable only if fund outperforms benchmark; Cumulative losses against the benchmark (in prior periods) will reduce any outperformance (in future periods).
France		Rules		Yes	Annual (on the NAV)	Limit of 30 % of the excess performance (compared to the benchmark)
Germany		Rules				on a case by case basis disclosure of the calculation method in the prospectus
Hong Kong		Rules			Annual	High on high Disclosure of the calculation basis and payment frequency in the prospectus
Ireland		Rules				High watermark
Italy		Rules		Yes		only if CIS performance positive during the period
Japan	x					
Jersey		x				generally not allowed for normal retail funds
Luxembourg		Rules		Yes		
Mexico	x					disclosure of the benchmark in the prospectus
Netherlands	x					disclose calculation method in the prospectus
Portugal	x			Yes		Management fee cap
Spain		Rules			Annual (on the NAV)	
Sweden		Rules in practice		Yes		
Switzerland		Rules		Yes		High watermark
UK			x			
US		generally only fulcrum fees are allowed		Yes	see next column	Fulcrum fee The calculation period must be sufficiently long to provide a reasonable basis for evaluating the performance (customarily, one year)

- **Issues.** A number of issues have been identified by jurisdictions regarding performance fees:
  - **Risk taking.** Because of the performance fee, there is a risk of creating an incentive for the management company to take higher risks than necessary in the hope of increasing its performance fee. Jurisdictions have taken this risk into account by requiring that a significant part of the fund's performance remain in the fund (France, Portugal), by requiring that the fee be a fulcrum fee<sup>3</sup> (United States) or by requiring that cumulative gains be offset in some way by cumulative losses (Brazil, Canada, Hong Kong, Ireland, Switzerland).
  - **Calculation method.** Most jurisdictions consider that a performance fee should be paid only when the performance of the CIS is truly above standard expectations. This general consideration has led jurisdictions to define precise rules on the calculation method of the performance fee:
    - Nine jurisdictions require that the benchmark used to calculate the fee be appropriate. This requirement most often translates into the use of a public index.
    - Six jurisdictions require a minimum period for the payment of the fee. This period is usually annual.
    - Most jurisdictions require that cumulative gains be offset by cumulative losses. This can be achieved, for example, through the use of a high-on-high<sup>4</sup> or a high-watermark.<sup>5</sup>
- **Equality of investors.** For the purpose of the calculation of the performance fee, the performance of the CIS should theoretically be calculated for each individual investor, based on his date of entry in the fund. The practical implementation of this principle is complex since it would require the CIS to keep track of the dates of entry of all investors and to make a different calculation for each investor. Some jurisdictions therefore resort to the following alternative solution: the CIS must accrue the performance fee at each date of calculation of the NAV. This solution guarantees a satisfactory though not absolute level of equality between investors: it doesn't take into account the fact that investors that enter the fund may "benefit" from accrued performance fees (if the NAV of the fund subsequently decreases, part of the decrease will be offset by the decrease in accrued performance fees which were deducted from the assets of the fund before the investor entered the fund).

## 2.2. *Funds of Funds*

- **Issue.** Funds of funds invest a significant part of their assets in other funds. This results in the overlaying of two cost structures, the cost structure of the original fund

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<sup>3</sup> When a fulcrum fee is used the level of the fee increases or decreases proportionately with the investment performance of the CIS over a specified period of time. If a fund underperforms the index or benchmark during a period, the manager will not earn a performance fee for that period and its base fee will be reduced to reflect the relative underperformance.

<sup>4</sup> When a high-on-high method is used to calculate a performance fee, the performance fee may be charged only if the unit value of the fund exceeds the unit value on which the performance fee was last calculated and paid.

<sup>5</sup> When a high-watermark method is used to calculate a performance fee, the performance fee may be charged only if the unit value of the fund exceeds the highest unit value attained in the past.

and the cost structure of the underlying funds. This in turn raises the question of the information to the investor on the existence of two layers of fees:

Country	Transparency of fees in funds of funds					
	A	B	C	D	E	Comments
Australia	x					
Brazil			x	x		Over 30 %, : disclosure in the periodic report
Canada					x	Separate TER in the prospectus and in the periodic report
France			x	x		Over 50 % : disclosure in the prospectus and in the periodic report
Germany		x				in the prospectus + no fees if underlying fund belongs to the same financial group
Hong Kong				x		in the prospectus + subscription fee of underlying funds be waived if the underlying funds and the fund of funds are managed by the same management company or connected persons
Ireland		x		x		in the prospectus
Italy		x				Warning in the prospectus
Jersey	x					close review to ensure no double charging will take place
Luxembourg				x		
Mexico						No fund of funds at this time
Netherlands				x	x	Recommendation only, no specific additional rules for funds of funds
Portugal				x	x	D : in the fund rules, E: in the simplified prospectus
Spain		x	x	x		Over 50 %, in the prospectus (management and depositary fees)
Sweden	x					
Switzerland		x	x			Over 50 %, warning in the prospectus
UK	x					No rules
US				x		Explanatory disclosure may include TER
A. no specific rules B. warning notice C. specific requirements above a given threshold D. disclose information on the fee structure of underlying funds E. synthetic TER (either exact or approximate)						

- a. **Current rules and practices.** Only four jurisdictions (Australia, Jersey, Sweden, and United Kingdom) do not have any specific rules regarding the disclosure of fees and commissions in funds of funds. One jurisdiction (U.S.) has specific rules relating to the top-tier fund and follows a case by case approach with respect to disclosure of bottom-tier fees. All other jurisdictions have specific rules:

- o Two main approaches can be identified:
  - setting a threshold regarding the ratio of assets investing in funds above which specific rules apply (Brazil, France, Spain, Switzerland). This threshold varies from 30 to 50%. Some jurisdictions have pointed out that this may lead funds to voluntarily stay just below that threshold.

- requiring or recommending that a synthetic TER encompassing fees of the original fund and of the underlying funds be calculated (Canada, Netherlands, and Portugal).
- A majority of jurisdictions (nine) require funds of funds to disclose information on the cost structure of the underlying funds. The information required varies between jurisdictions.
- One jurisdiction (Italy) only requires that a specific warning on the double cost structure be included in the prospectus.
- **The case of funds investing in underlying funds within the same financial group.** Six jurisdictions restrict the kind of fees that can be charged to a fund that invests in underlying funds managed by the same company or an affiliated party (Hong Kong, Ireland, Spain, Sweden, Switzerland, and United Kingdom). These rules mostly require that no subscription fee be charged. One jurisdiction (U.S.) restricts the aggregate sales loads and distribution expenses that may be borne by the top-tier fund shareholder<sup>6</sup>. One jurisdiction requires that trailer fees (subscription fees) be waived entirely (Switzerland).

### **2.3. Transaction costs**

- **Definition.** Transaction costs are costs incurred by a CIS in connection with transactions on its portfolio. Transaction costs can be split between:
  - brokerage fees
  - taxes and linked charges
  - the market impact of the transaction. This market impact corresponds to the fact that the transaction will be processed at a price which may be impacted by the transaction itself (especially for assets with a low liquidity).
- **Issues.** The disclosure of transaction costs raises two main issues:
  - transaction costs cannot be forecasted since they depend on unknown parameters (turnover of the portfolio, commissions charged by the broker)
  - some financial instruments (bonds, commercial paper, derivatives) are negotiated without explicitly identifying underlying transaction costs. Transaction costs therefore cannot always be identified.

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<sup>6</sup> U.S. law also limits sales charges for (1) certain unaffiliated fund of funds structures (see exemption in Section 12(d)(1)(F) of the Investment Company Act for funds and their affiliates that acquire more than 3% of a CIS – that section limits sales loads to 1.5%) and (2) unaffiliated fund of funds that obtain exemptive relief to exceed the limits of section 12(d) must comply with a condition that imposes certain limits established by the NASD.

Country	Disclosure of transaction costs						Comments
	specific rules ?		what rules ?				
	Yes	No	A	B	C	D	
Australia		x					
Brazil	x		x				In the semi-annual report
Canada	x		x	x	x	x	In the prospectus (selection of brokers), report (amount of commissions)
France		x					
Germany	x		x				a list of sales and purchases of the securities and of transactions in financial instruments has to be published in the annual report
Hong Kong	x					x	In the annual report
Ireland		x					
Italy	x		x				In the annual report
Japan		x					
Jersey		x					
Luxembourg		x					
Mexico		x					
Netherlands		x					
Portugal	x		x	x			In the yearly and half yearly report turnover rate : only the numerator is disclosed
Spain		x					
Sweden	x		x			x	In the prospectus and in the annual report
Switzerland		x					
UK		x					
US	x		x	x	x	x	In the SAI (amount of commissions + affiliated) + mark up and mark down
A. disclose those transaction costs that can be identified B. disclose the turnover rate of the portfolio C. disclose the criteria used to select intermediaries D. disclose the amount of broker fees paid to affiliated brokers							

- **Current rules and practices.** Eight jurisdictions have specific rules regarding the disclosure of transaction costs (Brazil, Canada, Germany, Hong Kong, Italy, Portugal, Sweden, and United States).
  - All these jurisdictions (except Hong Kong<sup>77</sup>) require that transaction costs, meaning those transaction costs that can be identified, be disclosed to the investor. Most of these jurisdictions use the periodic reports (usually the annual report) as the choice means of disclosure of this information. Two jurisdictions require that this information be disclosed in the prospectus (Sweden – on top of the disclosure in the annual report) or in the Statement of Additional Information (United States – information on the last three fiscal years)
  - Two jurisdictions have additional requirements regarding the disclosure of the criteria used to select brokers (Canada, United States)

<sup>77</sup> The HKSFC requires transaction costs paid to affiliated brokers be disclosed in the annual report.

- Three jurisdictions have additional requirements regarding the disclosure of the turnover rate of the portfolio (Canada, Portugal, United States)
- **The case of commissions paid to affiliated brokers.** Transactions using brokers affiliated to the management company may result in a conflict of interest and a breach in the segregation of duties between the broker and the asset manager. This in turn may result in the CIS paying excessive transaction costs in relation to the level of execution provided. Jurisdictions usually have a general rule which says that brokers should be chosen so as to ensure "best execution" of the transactions. On top of this general rule, four jurisdictions require that the amount of commissions paid to affiliated brokers be disclosed in the annual report or the statement of additional information (Canada, Hong Kong, Sweden, and United States). The United States also limit the amount of brokerage commission that can be received by an affiliated broker for effecting transactions for a CIS.

#### **2.4. *Multi-class funds***

- **Definition.** Multi-class funds are funds that have different classes of shares or units. These classes of shares often have different levels of fees and are marketed to different types of investors.
- **Issue.** Multi-class funds are a possible answer to the necessity to take into account the different requirements (especially in the fee structure) of different types of investors. However, they may raise questions regarding equality of treatment of investors since different types of investors will then be charged different levels of fees. Regulators therefore need to define rules to ensure that the use of different classes of shares will not result in breach of equality of treatment.

Country	Different classes of shares or units		
	?		Comments
	Yes	No	
Australia	x		disclosure
Brazil		x	
Canada	x		disclosure
France		x	
Germany	x		disclosure
Hong Kong	x		disclosure
Ireland	x		disclosure
Italy	x		disclosure
Japan		x	
Jersey	x		
Luxembourg	x		disclosure
Mexico	x		disclosure
Netherlands	x		
Portugal		x	
Spain		x	
Sweden		x	
Switzerland	x		disclosure
UK	x		Yes for ICVCs + disclosure (no for Unit Trusts)
US	x		disclosure

- **Current rules and practices.** A majority of countries permit multi-class funds.
  - all those countries have disclosure requirements regarding the existence of different classes of shares or units.
  - in most cases, these different classes of shares or units aim to take into account the different cost structures (especially as far as distribution costs are concerned) of different types of investors.
  - some countries require that objective criteria be set (like a minimum amount of subscription) to justify the different classes of shares or units.

### 3. Soft commissions and fee-sharing agreements

#### 3.1. *Soft commissions*

- **Definition.** Soft commissions (or soft dollar benefits) correspond to any economic benefit, other than clearing and execution services, that an asset manager receives in connection with the CIS's payment of commissions on transactions that involve the CIS's portfolio securities. Soft commissions are typically obtained from, or through, the executing broker.
- **Issues.** Soft commissions should not be a criterion by which a management company chooses an intermediary. This choice should be primarily based on the search for "best execution" services. It follows that a broker that provides soft dollar benefits may be chosen only if that broker can provide best execution that is equal to or better than other brokers.
- **Current rules and practices.** Only two jurisdictions prohibit soft commissions (Brazil, Mexico). All other jurisdictions have defined specific rules.
  - Ten jurisdictions require that soft commissions should accrue to the benefit of the holder of the CIS (Canada, France, Germany, Hong Kong, Italy, Japan, Luxembourg, Spain, Sweden, and Switzerland). For two of these jurisdictions, it is the sole rule as far as soft commissions are concerned (France, Spain).
  - Six jurisdictions specifically require that the choice of brokers should be based on the search for "best execution" services (Canada, Germany, Hong Kong, Ireland, Italy, United States)
  - Thirteen jurisdictions have disclosure requirements, either in the prospectus (Hong Kong, Ireland, Italy, Jersey, Luxembourg, Netherlands, Portugal, Sweden) or in a document linked to the prospectus (Canada in the annual information form, United States in the Statement of Additional Information) and/or in a periodic document (Hong-Kong, Ireland, Japan, Jersey, Luxembourg, Netherlands, Portugal). Australia requires disclosure of soft commissions in a Product Disclosure Statement and (for some products) in periodic documents to the extent that the acceptance of soft commissions by the management company will or may bear directly or indirectly on the cost of the financial product or the return to the product holder.
  - Six jurisdictions impose controls on the nature of the soft commissions. This can be achieved by giving a list of authorized soft commissions (Hong-Kong, United Kingdom) by defining what is not permitted (Luxembourg) or by having more general requirements (directly related to order execution and to investment decision making: Canada – benefits must assist in the provision of investment services to the CIS: Ireland, United States - research related<sup>8</sup>)

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<sup>8</sup> The U.S. SEC interprets the phrase "research" to include any product or service that provides lawful and appropriate assistance to an investment adviser in the performance of its investment decision-making responsibilities. In many cases, a "research" product or service may also serve functions that are not related to making investment decisions, for example, a computer that is used both for research and administrative functions. When a product has such a "mixed use" (i.e., it has a secondary use other than research), a CIS's investment adviser must allocate the cost of the item according to its use. The percentage of the service or the specific component that provides research may be paid for in soft dollars, the rest must be paid for by the CIS's investment adviser with its own money.



Country	Soft commissions					
	Not prohibited ?		Requirements			
	No	Yes (prohibited)	Disclosure (A)	best execution (B)	benefit to the holder (C)	restrictions (D)
Australia	x		in Product Disclosure Statement			
Brazil		x				
Canada	x		Annual report	x	x	directly related to order execution and to investment decision making
France	x				x	
Germany	x			x	x	Self-regulation by the BVI-Rules of Conduct
Hong Kong	x		Prospectus Annual report	x	x	list of authorized soft commissions
Ireland	x		Prospectus Periodic reports	x		benefits must assist in the provision of investment services to the CIS
Italy	x		Prospectus	x	x	
Japan	x (does not exist)		Registration report		x	
Jersey	x		Prospectus Annual accounts			
Luxembourg	x		Prospectus Periodic report		x	what is not authorized is defined
Mexico		x				
Netherlands	x		Prospectus Periodic report			
Portugal	x		in the prospectus and in the fund rules			
Spain	x				x	
Sweden	x		Prospectus		x	General requisition
Switzerland	x				x	Written definition of the policy
UK	x					list of authorized soft commissions
US	x		SAI + clients	x		soft commissions must be research related or used to offset the CIS's expenses
A. Disclosure requirements B. The choice of brokers should be primarily based on the search of "best execution" C. Soft commissions should benefit to the holder of the fund D. Restrictions on the types of soft commissions that are authorized						

### **3.2. Fee-sharing agreements on transaction costs**

- **Definition.** A fee-sharing agreement is an agreement between a CIS's management company and a broker in which the broker agrees to split with the management company the transactions fees paid by the CIS to the broker for processing transactions for the CIS.
- **Issue.** Such agreements have a high risk of creating conflicts of interest since:
  - the choice of the broker by the management company could be based on the existence of a fee-sharing agreement and not on “best execution” criteria.
  - it could create an incentive for the management company to increase the level of transactions on the portfolio.

They also result in a lack of transparency towards the investor: the fees paid may be an undisclosed compensation to the investment advisor not taken into account in the TER.

- **Current rules and practices.** Ten jurisdictions have consequently forbidden fee-sharing agreements on transaction costs. (Brazil, France, Germany, Hong Kong, Ireland, Mexico, Spain, Sweden, Switzerland, United Kingdom). The remaining six have different approaches to the question:
  - Such practices do not exist in Japan
  - One jurisdiction does not currently have any specific rules but is considering defining such rules (Luxembourg).
  - One jurisdiction currently has general disclosure requirements but is considering requiring that all benefits go to the CIS (Portugal)
  - Two jurisdictions have specific disclosure requirements: in the prospectus and in the annual report (Netherlands) or in the annual accounts and in the annual report (Jersey).
  - One jurisdiction prohibits fee-sharing agreements on transaction costs unless the full amount shared is used to offset the CIS's advisory fee or other CIS expense (United States).
  - France has prohibited fee-sharing agreements on transaction costs but has tolerated fee-sharing agreements between the depositary and the management company for the transactions on the portfolio of the CIS. This has lead to an increase in such fee-sharing agreements, even if their impact on the gross revenue of management companies remains marginal.

Country	Fee-sharing agreements		
	Not prohibited ?		Specific rules
	No	Yes (prohibited)	
Australia	x		disclosure in a Product Disclosure Statement and (for some products) in periodic documents
Brazil		x	
Canada	x <sup>9</sup>		treated the same as soft commissions. Disclosure in the annual information form (prospectus document)  must benefit the CIS must be directly related to order execution and investment decision making
France		x	Possibly a direct commissions on transactions
Germany		x	But considerations to allow fee-sharing agreements, if they benefit the CIS and if they are disclosed in the prospectus and the yearly report
Hong Kong		x	
Ireland		x	
Italy	x		General rules
Japan	x (does not exist)		disclosure in the registration report
Jersey	x		Disclosure in the annual accounts and in the annual report
Luxembourg	x		
Mexico		x	
Netherlands	x		disclosure in the prospectus and the annual report
Portugal	x		disclosure in the prospectus and in the fund rules
Spain		x	
Sweden		x	
Switzerland		x	
UK		x	
US		(x)	Except if benefits to the CIS disclosure in SAI

### 3.3. Fee-sharing agreements in funds of funds

- Definition.** Fee-sharing agreements in funds of funds can benefit either the fund itself, or to its management company. In the first case, the underlying fund may waive part of the subscription/redemption fees and/or management fees paid by the CIS. In the second case, a fee-sharing agreement may be concluded between a management company and an underlying fund. According to this agreement, if a CIS of the management company invests in the fund, part of the fees charged to the CIS (either directly – subscription/redemption fees- or indirectly – management fees etc) because of this investment will be paid by the management company of the underlying fund to the management company of the CIS.

<sup>9</sup> although not aware of how widespread this practice is

- **Issue.** The latter type of agreement has a high risk of creating conflicts of interest since it may become a criterion for the choice of underlying funds. The management company may then not be acting for the benefit of the holders of the CIS. It may also impair the transparency of the remuneration of the management company.

Country	Fee-sharing agreements in funds of funds that benefit to the management company of the fund		
	Not prohibited ?		Additional information
	No	Yes (prohibited)	
Australia	x		
Brazil	x		
Canada		x	
France	x		
Germany		x	
Hong Kong		x	
Ireland		x	
Italy	x		disclosure in the prospectus
Jersey	x		disclosure in the annual accounts and in the annual report
Luxembourg		x	
Mexico		x	No
Netherlands	x		disclosure in the annual report if substantial
Portugal	x		disclosure in the prospectus and in the fund rules
Spain		x	No
Sweden	x		Yes
Switzerland	x		disclosure
UK		x	No
US		x	No

- **Current rules and practices.** Nine jurisdictions forbid fee-sharing agreements in funds of funds. It is interesting to note that out of these nine jurisdictions, seven also forbid fee-sharing agreements on transaction costs (Germany, Hong Kong, Ireland, Mexico, Spain, United Kingdom, United States – if they benefit the management company), the other two being Canada and Luxembourg. Four of the eleven jurisdictions that forbid fee-sharing agreements on transaction costs do not forbid fee-sharing agreements in funds of funds (Brazil, France, Sweden, and Switzerland).
- It can be noted that forbidding fee-sharing agreements in funds of funds does not imply that the fund of funds doesn't have the possibility of negotiating fees of the underlying funds. However, it means that the CIS must be the exclusive beneficiary of any rebate.

## **Conclusion**

This report indicates that jurisdictions apply a range of regulatory tools (prohibitions; ceilings; specific or general disclosure requirements) to fees and commissions charged to CIS investors. SC5 is currently working on some possible best practices with respect to the regulation of fees and commissions charged to CIS investors, and expects to publish a consultation document on this topic in the near future.