Financial Conduct Authority

August 2025 update:
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Thematic Review TR14/7

Clarity of fund charges

May 2014

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1. Executive summary

Overview

In this paper, we present the findings from our clarity of fund charges project and remind firms of the current regulatory framework. It is important that investors look at charges, as well as considering the risks of the fund and the fund manager's ability to deliver growth.

There are two main messages from our work:

1. Using the annual management charge (AMC) in some marketing material and the ongoing charges figure (OCF) in other documents may confuse investors and hinder their ability to compare charges.

2. Using the OCF consistently in all marketing material for UCITS funds[1] is likely to help investors understand and compare charges.

Firms must put consumers at the heart of their business model. That means it is important to make comparing costs as easy as possible. As part of the overall relationship between firms and consumers, firms need to manage the costs with as much tenacity as they produce returns, and make the costs they charge clear.

Background

The FCA Investment Management Strategy is focused on asset managers' role as agents, making decisions on behalf of customers. Our work has sought to understand how firms discharge their responsibilities as agents in ensuring charges are clear to investors. Our assessment was based on existing rules that firms should appropriately represent the interests of investors[2], manage conflicts of interest between the firm and investors[3] and ensure that communications are clear, fair and not misleading.[4]

What we did

Our assessment focused on UK firms operating funds that were sold to UK retail investors. Eleven firms of different sizes and business models (mainstream asset managers, banks, insurers, wealth managers) were used as our sample. They generally had a significant UK retail exposure

1 Authorised funds subject to the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive.
2 Principle for businesses 6
3 Principle for businesses 8
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relative to their size and we focused on actively managed funds. Our firm sample covered 29% of the UK retail market by assets under management, equivalent to £131bn.

Findings

1. Seven firms used the AMC as the headline charge figure on marketing material, which did not provide investors with a clear, combined figure for charges.
2. Seven firms did not fully consider investors and had charging structures and information that were likely to be less than clear to investors.
3. Six firms made charging structures more complex by using administration charges that did not correspond to specific administration costs or adding performance fees.
4. Three firms had unclear descriptions of administration charges.

Our expectations

1. Firms have a duty to act in the best interest of investors. This means all firms must ensure their charges are clear to investors, particularly retail investors, so they know what they are paying for and can compare funds.
2. Communications with retail customers should be fair, clear and not misleading[5] for both UCITS and non-UCITS funds.
3. For UCITS funds, information on charges in marketing material (including websites) must be presented to investors in a way that is consistent with the key investor information document (KIID).[6] This means using the OCF as the headline charges figure.
4. Platforms, advisers and other intermediaries should also use the OCF as the headline charges figure for UCITS funds.
5. Descriptions of charges in the prospectus should explain clearly how the charges work.[7]

5 COBS 4.2.1R (1) A firm must ensure that a communication or a financial promotion is fair, clear and not misleading.

6 COBS 4.13.2R(1) A firm must ensure that a marketing communication that comprises an invitation to purchase units in a UCITS scheme or EEA UCITS scheme and that contains specific information about the scheme:
(a) makes no statement that contradicts or diminishes the significance of the information contained in the prospectus and the key investor information document or EEA key investor information document for the scheme.

7 COLL 4.2.4R (1) The authorised fund manager:
(a) must ensure that the prospectus of the authorised fund does not contain any untrue or misleading statement or omit any matter required by the rules in this sourcebook to be included in it.

Next steps

We have given detailed feedback to the firms visited and, where it appears firms may not have complied with relevant principles or rules, we have asked them to justify their approach and, where appropriate, required them to take remedial action.

All authorised fund managers should consider the findings in this paper and review their arrangements accordingly. The senior managers of the authorised fund manager, and the wider group if appropriate, should satisfy themselves that their firm's practices in relation to the clarity of charge information and fund governance are appropriate.

2. Our findings in more detail

It is important for investors to understand and compare charges because they contribute to fund returns, along with performance and the level of risk. This project focused on the clarity of charges.

Information provided to retail investors on charges may be spread across multiple documents and may refer to different charge figures (e.g. AMC, total expense ratio (TER), OCF), so investors may not be clear on which charges to compare between funds or the level of cost associated with investing in a particular fund. Being able to clearly compare charges across funds may improve efficiency in the retail market. We therefore looked at charging structures and the communication of charges.

Charging structures

The AMC is widely quoted in marketing literature and is deducted directly from investors' funds. This charge goes to the asset manager to cover ongoing management. It is taken to pay for the cost of the manager's investment management services, such as research analysis and portfolio management.

However, running a fund requires many activities in addition to this, such as keeping a register of investors, calculating the price of the fund's units or shares, and keeping the fund's assets safe. Each of these activities can be charged separately to funds. This can result in a complex charging structure. Initial charges and performance fees add to the complexity of charging structures and retail investors may not be able to estimate the potential cost of a performance fee.

We found that the number of parties involved in running a fund contributed to all firms in our sample using complex charging structures. However, some minimised the complexity by not using initial charges or performance fees.

A minority of firms could not provide a clear rationale for their charging structures, particularly performance fees, indicating insufficient consideration of investors when designing charging structures.

Communication of charges information

Communications with retail customers should be fair, clear and not misleading for both UCITS and non-UCITS funds. Descriptions of charges in the prospectus should explain clearly how the charges work. Rules for UCITS funds specify that marketing material must not contradict or diminish information contained in the KIID, the key disclosure document for UCITS funds.

Using the AMC as the headline charge figure on marketing material does not provide investors with a clear, combined figure for charges as it excludes additional charges and expenses that are taken from funds. Additional ongoing charges can add significant amounts to the cost of a fund and we saw some small funds with charges of up to 0.9% in addition to the AMC. Using the AMC could therefore result in retail investors finding it difficult to accurately compare charges and potentially underestimating the cost of some funds.

The OCF represents the ongoing costs to the funds, which includes the AMC and other charges for services such as keeping a register of investors, calculating the price of the fund's units or shares and keeping the fund's assets safe. The OCF must be displayed in the KIID.

If charges information for UCITS funds is provided in marketing material or on websites, the OCF should be the prominent charges figure presented to investors. Charges must be presented to investors in a way that is consistent with the KIID. These rules apply to distributors' websites and where they produce their own marketing material.

Example of a firm ensuring investors were aware of initial charges

One firm had a number of funds that had been soft closed to limit further investment into those funds. The funds were not actively marketed and new investors would have to pay an initial charge. The firm was concerned that new investors in these funds might not realise that an initial charge would be applied. The firm wrote to each investor when their application was received to ensure that they realised their investment was subject to an initial charge and that they were happy to pay the charge to access the soft closed funds.

Example of ensuring clear information is delivered to investors

One firm was concerned about factsheets designed for investment advisers ending up with retail customers. The firm therefore designed all its factsheets to be suitable for retail investors to avoid this risk. The firm also used questionnaires to test end investors' financial knowledge and used this insight to develop additional material so investors had the information they needed to understand funds and charges.

Consistency of information provided by asset managers

Some firms provided clear information that was consistent across documents and tailored the level of information and language to retail investors.

Example of clear and consistent charge information

One firm used only the OCF (or TER when used by non UCITS funds) to illustrate charges on marketing material and on its website. This meant a combined charge figure was presented to investors, rather than other figures such as the AMC. This should allow charges to be more easily understood and compared.

Other firms were inconsistent in their use of charge information, displaying the AMC on factsheets and websites rather than the OCF/TER. Investors may be unsure about which figure to compare and how the AMC and OCF/TER differs. For UCITS funds, the OCF should be used on websites, factsheets or other marketing material when describing charges, as required by our rules.

Consistency of information provided by distributors

Platforms, advisers and other intermediaries should also provide information clearly and consistently to investors. We undertook a limited assessment and found some platforms presented the AMC as the main charge figure, which may lead to investors underestimating the cost of funds or being unsure about which figures to compare. For UCITS funds, the OCF should be the prominent charges figure, as required by our rules.[8]

Example of an asset manager ensuring clear information is provided by distributors

One firm was negotiating for the right to audit distributor produced fund literature and illustrations. It was also negotiating with platforms so only the asset manager's factsheets were provided to investors by the platform. The firm wanted to ensure its careful consideration of clearly presenting charges information was also taken up by distributors.

Prospectus descriptions

Some firms worked to write prospectuses that were more accessible to retail investors, while adhering to the legal requirements. Other firms did not try to simplify the technical legal language in which the document was first drafted. In some cases this made the prospectus difficult to understand.

Examples of poor disclosure of a charge in the prospectus

A number of firms used an administration charge. Some firms did not clearly disclose the operation of the administration charge in their prospectuses. We have seen cases where the disclosure of what happens to surpluses from administration charges is not clear. Our view is that for transparency to investors this should be made clear.

Consideration of investors

Firms have a duty to act in the best interest of investors. For this matter, that means structuring and disclosing charges so they are clear to investors, particularly retail investors.

8 COBS 4.13.2R(1) A firm must ensure that a marketing communication that comprises an invitation to purchase units in a UCITS scheme or EEA UCITS scheme and that contains specific information about the scheme:
(a) makes no statement that contradicts or diminishes the significance of the information contained in the prospectus and the key investor information document or EEA key investor information document for the scheme.

Example of a firm providing clear information to investors

One firm wanted to clearly and prominently present investors with a summary of the performance of their investment and the charges that they paid over the past year. It did this by writing to each investor annually summarising the fund performance and charges. To make charges more pertinent to investors, they were presented as a pounds and pence figure. The firm felt the effort was worthwhile as it would allow investors to better understand fund performance and charges.

Firms that did not fully consider investors in their decision-making had charging structures or information that was unlikely to provide a clear view on charges to investors. Some of these firms viewed themselves as wholesalers, whose customers were advisers and platforms rather than the individuals who invested in the funds. Firms that recognised underlying investors as their customers tended to produce clearer information on charges.

Some firms had a strong desire to interact with their investors and considered them when making decisions. This was reflected in a clear rationale for charging structures and how information was provided to investors. For example, some firms did not use performance fees because of concerns about investors' understanding of the fee.

3. Next steps

A number of new pieces of European legislation will be implemented over the coming years, including the regulation on key information documents for packaged retail and insurance based investment products, otherwise known as the PRIIPs Regulation, and the revised Markets in Financial Instruments Directive (MiFID II). Both the PRIIPs Regulation and MiFID II will change the way information is provided to investors at the point of sale. This report serves as a reminder of the current rules that firms should be following to ensure fund charges are clear to investors. We will follow up on this work through our routine supervision.

We will continue to work with the Investment Management Association (IMA) on this matter. The IMA has issued voluntary industry guidance on enhanced disclosure of charges and costs and has consulted on introducing a template presenting information about performance and charges into funds' annual reports and accounts. This will provide more information on charges to investors.

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PUB REF: 004885

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