Investment Management Association

# Guidance on TER calculations

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## Guidance on TER calculation

### Introduction

The requirement to publish a TER in the simplified prospectus derives from the EU UCITS Directive and is set out in FSA rules, COLL 4 Annex 1[1] ("the rules"). This note is consistent with those rules and its purpose is to assist in achieving consistency of application across all funds by clarifying some questions that have arisen. In principle, the TER represents an investor's cost of holding a pool of investments via a fund instead of investing in the assets directly.

### Scope

Where there are different classes of units or shares, a separate TER calculation needs to be performed for each share class.

### Source of operating costs

The rules give a list of the types of costs to be included in the TER. The following list is representative of what should be included in the TER:

- Fund management fees
- Investment management fees
- Administration fees
- Trustee or depositary fees
- Custody fees
- Audit fees
- Fund accounting fees
- Valuation fees
- Fees for shareholder services
- Registration fees and regulatory fees
- Legal and advisory fees relating to fund establishment and operation
- Other remuneration arising from fee sharing arrangements
- Performance fees (these should also be disclosed separately)

The rules specifically exclude:

- Transaction costs (including transfer taxes)
- Interest on borrowing
- Payments incurred because of derivatives
- Fees paid directly by investors, such as entry/exit fees
- Soft commissions

Paragraph 3a of the rules refers to "ex post basis, generally with reference to the fiscal year". Therefore, the cost figures will normally relate to the accounts of the last audited annual accounting period. Where there are adjustments or refunds relating to costs incurred in previous accounting periods (for example VAT reclaims in relation to the 2006 Abbey case) such amounts should not be included in the costs used to calculate the TER.

[1] Prior to 1/11/07 the TER requirements were in COB 6 Annex 2

Where a fund has more that one share class, the expenses reported in the audited accounts will not reflect the expenses attributable to any individual class. The methodology should set out how the expenses attributable to each share class will be determined and the procedures that will be adopted for reconciling the aggregate of the expenses for each class to the total reported expenses. In general, expenses should be on an "as incurred" basis. Accordingly, where adjustments are made, for example adjustments to remove interest expenses from the total expenses incurred by a class, these adjustments should reflect the actual allocation of the expenses to each class rather than any other method.

Managers need to be aware that the TER is an annual percentage rate. If a period shorter than the annual period of account would result in a material difference to an annual TER, then this should be addressed and explained.

The rules do not provide for a new fund that has not yet produced accounts. If a TER is to be prepared, the TER should be based on estimated costs and revised once the annual accounts are available.

The methodology for estimated TERs for new funds is not subject to the requirement for validation by the auditor. However, to reduce the risk of discontinuity of TERs, a consistent methodology should be used.

## Transaction costs

Paragraph 2b of the rules states that fees linked to depositary duties are included within operating costs for the TER calculation. However paragraph 2c states that transaction costs relating to the portfolio are excluded. This raises the question of whether the custody fees and other expenses levied on a transactions basis should be included within operating costs for the TER calculation. The principle is that costs that relate to safekeeping are included within the TER and costs that relate to portfolio transactions are excluded.

This ambiguity has been addressed in CESR's guidelines[2] on the methodology for calculation of the ongoing charges figure. These guidelines make it clear that transaction-based payments to various parties, including the depositary and custodian, shall be taken into account in the published figure. Therefore, in the interests of consistency between the charges disclosures of UCITS and UK NURS, this guidance has been amended to include depositary and custody fees based on transactions in TER calculations.

Where the Manager receives a fee based on portfolio transactions, that fee should be included in the TER calculation. The remuneration of the Manager is an operating cost irrespective of the basis used for its calculation.

There have been some questions as to whether Stamp Duty Reserve Tax should be included in TER calculations. The FSA, in its newsletter issued in July 2005, clarified that SDRT should not be included.

[2] CESR/10-674

## NAV

Paragraph 3b of the rules refers to the use of average NAV in the TER calculation and specifies that the average should be calculated using net assets of each share class at each NAV calculation point. For consistency, this NAV calculation must relate to the same period as the costs. For example, if the costs relate to the accounting year ended 30 June 2005, and NAVs are calculated daily, then the average NAV will be the average of all daily NAV calculations over the year ended 30 June 2005.

Clearly, for a new fund the average NAV will be based on an estimate, just as the costs are estimated.

## Fee sharing arrangements

Although fee sharing arrangements are not common in the UK, they do exist: for example, in relation to the income generated from stock lending activities. It is recommended that the calculation methodology should specifically document the existence or non-existence of any and all fee sharing arrangements.

Paragraph 4 of the rules is not easily read in the context of the typical operational features of a UK authorised fund. However, the intention is that fee sharing should not result in an understatement of the TER. Where, as a result of a fee sharing arrangement, a fund remunerates the Manager, or any other party, for expenses which would be included in the TER in the absence of the fee sharing arrangement, then such expenses should be included in the TER.

## Change in Manager's or other fee rates

There have been some concerns that a change in fee rates at a period end might distort the TER. Paragraph 3a of the rules requires the TER to be calculated *ex post* for a historic period and not at a point in time or, indeed, on a prospective basis. Therefore, any change in fee rates is reflected in the costs for the year and the TER is generated therefrom.

## Investments in other funds – the need to determine a synthetic TER

The rules require a synthetic TER to be calculated for all funds that invest 10% or more in other funds (10% or more in total).

There is therefore the question of how to determine whether the 10% point is reached. In the interest of not creating excessive costs, the 10% should be with reference to the balance sheet date. It is acknowledged that, for example, an average over the period would be a fairer assessment. However, it is thought that the cost of monitoring the percentage of investments in other funds for this purpose would create an additional level of cost.

If the Manager considers the balance sheet position to be unrepresentative, then the Manager should use a reasonable estimation technique (such as weighted average month-end investments in other funds) to support the application or non-application of the synthetic TER requirements. The method to be used to determine whether or not the balance sheet date is unrepresentative should be included in the procedures.

Similarly, in the interest of not creating excessive costs, where it has been established that a synthetic TER is required, the synthetic TER should be calculated with reference to the average of the percentages held in the underlying funds at quarterly valuation points.

It is suggested that whether or not the Manager has funds which invest more than 10% in other funds that the methodology makes provision for such circumstance in order to be “future proofed” in this regard. If no provision is made in the calculation methodology for investment of 10% or more in other funds there is an increased risk that the need to apply the synthetic TER requirements may be overlooked.

In respect of the synthetic TER, paragraph 6 of the rules refers to “the simplified prospectus scheme’s total operating costs expressed by its TER and all the costs borne by the scheme through holdings in underlying funds (i.e. those expressed by the TER of the underlying funds weighted on the basis of the simplified prospectus scheme’s investment proportion) ...”. The TER of the underlying funds should be obtained from their most recent published annual accounts. It is recognised that their year-ends may not coincide with the simplified prospectus scheme’s year end.

Paragraph 6 also refers to subscription and redemption fees in respect of the underlying funds. For the avoidance of doubt, the subscription and redemption fees to be included in the TER are the actual fees incurred in the period.

**Funds of funds**

In a fund of funds where there is a rebate of the underlying funds’ management fees back to the fund of funds, in order to prevent double counting of costs, the rebated amount should be deducted from costs in the TER calculation. This applies generally regardless of whether a synthetic TER is to be calculated. Thus, rebates of fees in underlying funds should be taken into account in determining the TER or the synthetic TER of a fund of funds.

**Interest payable and geared funds**

As paragraph 2c of the rules confirms, interest on borrowing should not be included in operating costs and NAV is clearly after borrowing. The result is that the effect of gearing is reflected in the TER.

As an example, for a leveraged fund with 50% gearing, material interest on borrowing would not be included in expenses; however, the management fees will be calculated on the gross assets, with the effect that gearing is reflected in a higher TER. For example, a fund with an annual management fee of 1.5% (no other expenses) and 50% gearing would have a TER of 2.25%.

**Derivatives**

The use of derivatives gives rise to certain costs and revenues associated directly with the derivative contract, for example, the cost of buying an option is the premium payable to the counterparty. Paragraph 2c of the rules recognises such costs are directly associated with the nature of the asset class involved and excludes them from the total operating costs used in the TER.

## Real property

Investment in real property assets is quite different to investment in financial instruments and there are a number of additional costs directly associated with the asset class. The rules are silent regarding the treatment of these costs. The TER should represent the costs associated with operating a fund, as listed on page 1, and should not include the additional costs associated with the day to day maintenance of the assets. We understand that in other jurisdictions costs associated directly with property assets are excluded from TER calculations, resulting in relatively lower TERs. Therefore, the exclusion of such costs maintains consistency of application across the EU. The Manager should exclude the following items from the TER:

- Costs included in the Property Expense Ratio
- Property acquisition and disposal costs (including transfer taxes)
- Property development fees
- Project management fees
- Service charges and other costs that are recoverable from tenants

It is generally the case that the Manager's fees are calculated as a flat rate of the net assets of a fund. Sometimes property funds structure Manager's remuneration in other ways and may charge separate fees for different aspects of management, for example, there may be a separate charge for the transaction management function. However, the nature of such fees remains the same and all remuneration of the Manager should be included in the TER unless it is unequivocally part of the Property Expense Ratio.

The nature of investment in real property is such that there are significant costs associated with the property assets. Although these costs are not part of the TER it is appropriate that they are reported to investors alongside the TER. Therefore real property funds should report a **Property Expense Ratio (PER)** calculated in accordance with the principles in this guidance. It is not possible to catalogue all expenses that may arise, but the following list is representative of what should be included in the PER. Such expenses should be included only to the extent that they are not recoverable from tenants. Other expenses not recorded here should follow the principles established by this guidance and this list.

- Real property management fees (such as rent collection services)
- Lease renewal costs
- Rent review fees
- Legal fees related to management of property (such as rental agreements)
- Letting costs (including marketing properties for letting)
- Property maintenance/repairs (excluding improvements)
- Ground rent and head rent
- Property insurance costs and rebates
- Non recoverable service charges
- Acquisition costs for failed transactions
- Incentivised fees in relation to the items above

It is acknowledged that in some instances a Manager will charge a bundled fee which is in part for managing the fund (including investment management) and in part for day to day management of the underlying properties. It would be inappropriate for this guidance to recommend a standard formula for unbundling such a fee to identify the day to day property management portion. However, where it is appropriate to unbundle these fees the Manager should document the circumstances in sufficient detail to satisfy the auditor's review of the methodology.

## Documentation and integrity of the calculation method and its application

The calculation method should be documented and in sufficient detail to enable users to understand how the average NAV and each cost type will be determined and how each cost type is to be dealt with consistently over time. Equally, without adequate documentation auditors would be unable to form a view as to whether the methodology is consistent with the requirements of the rules. In order to prevent unauthorised changes to the calculation models used by firms, there should be adequate control over the models, the application of the models, and the subsequent inclusion of TERs in the simplified prospectus and other documents. The application of the model should reflect changes in the Manager's fund range, including new circumstances such as fee sharing, performance fees, rebate of underlying management fees, investments in other funds exceeding 10% etc.

## Presentation of the TER

It is recommended that the TER is stated as a percentage to two decimal places. This equates to stating the calculated amount to the nearest basis point.

## Responsibility of the Manager

The Manager is responsible for the calculation of the TER in accordance with the rules and the accurate statement of TERs.

In order to discharge this responsibility the Manager should ensure that it has a methodology consistent with the rules and that there are adequate written procedures relating to the methodology and its use.

Should a Manager identify that it is unable to calculate a TER using the validated methodology (except for a new fund), the Manager should communicate that fact to the FSA.

## The requirement to have the TER calculation method validated by auditors

The auditor's work relates to the consistency of the Manager's methodology to the rules and not to the application of the methodology. Having obtained validation of the methodology, there is no requirement to obtain auditor checks in respect of the application of the methodology.