



ESMA PROVIDES GUIDANCE ON PERFORMANCE FEES IN INVESTMENT FUNDS

On 3 April 2020, ESMA published its final report on guidelines (the Guidelines) on performance fees in investment funds – applicable to UCITS and certain types of AIFs.

The Guidelines provide comprehensive guidance to fund managers when designing performance fee models for the funds they manage, including the assessment of the consistency between the performance fee model and the fund's investment objective, policy and strategy, particularly when the fund is managed in reference to a benchmark.

Access **ESMA Guidelines** [here](#).

The document will be of interest to managers' of UCITS and AIFs.

In cases where Member States allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage in accordance with Article 43 of the AIFMD, the guidelines also apply to AIFMs of those AIFs, except for:

- a. Closed-ended AIFs; and
- b. Open-ended AIFs that are EuVECAs (or other types of venture capital AIFs), EuSEFs, private equity AIFs or real estate AIFs.

Background

Ensuring supervisory convergence regarding performance fee structures, as well as the circumstances in which performance fees can be paid, was included in the key priorities for the 2019 ESMA Supervisory Convergence Work Programme.

Convergence on this issue is essential for a number of reasons:

- A mapping exercise of NCAs conducted by ESMA in 2018, which showed a lack of harmonisation among EU jurisdictions;
- The fact that this level of detail is not provided for in EU regulation; and
- Taking into consideration the great importance of funds' cross-border distribution, supervisory convergence will be essential in ensuring a level playing field in the European Union.

On 16 July 2019, ESMA published a [Consultation Paper](#) on the proposed draft Guidelines on performance fees in UCITS. The consultation closed on 31 October 2019.

ESMA received 48 responses, 14 of which were confidential, mainly from asset management industry associations and asset managers.

In general, respondents agreed with ESMA's approach of introducing minimum standards for performance fee models. Despite the objection by some respondents, ESMA has extended the Guidelines to include some types of open-ended AIFs marketed to retail investors.

Contents of the Final Report

Section I provides an Executive summary.

Section 2 sets out an Overview of the document.

Annex I provides the Feedback Statement.

Annex II includes the opinion of the Securities and Markets Stakeholders Group (SMSG).

Annex III sets out the cost-benefit analysis.

Annex IV: Guidelines on performance fees in UCITS and certain types of AIFs.

The Guidelines

Guideline 1
Performance fee calculation method



Guideline 2
Consistency between the performance fee model and the fund's investment objectives, strategy and policy.



Guideline 3
Frequency for the crystallisation of the performance fee



Guideline 4
Negative performance (loss) recovery



Guideline 5
Disclosure of the performance fee model



As detailed in Annex IV, these comprise 5 guidelines:

The above guidelines are considered in more detail below.

Guideline 1 – Performance fee calculation method

The calculation of a performance fee should be verifiable and not open to the possibility of manipulation.

The performance fee calculation method should include, at least, the following elements:

- a. The reference indicator to measure the relative performance of the fund. This reference indicator can

be an index (e.g. Eonia, Eurostoxx 50, etc.), a HWM, a hurdle rate (2%) or a combination (e.g.: HWM + hurdle rate);

- b. The crystallisation frequency at which the accrued performance fee, if any, becomes payable to the manager and a crystallisation date at which the performance fee is credited to the manager;
- c. The performance reference period;
- d. The performance fee rate which may also be referred to as the "flat rate" i.e. the rate of performance fee which may be applied in all models;
- e. The performance fee methodology defining the method for the calculation of the performance fees based on the above mentioned inputs and any other relevant inputs; and
- f. The computation frequency which should coincide with the calculation frequency of the NAV (e.g. if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

The performance fee calculation method should be designed to ensure that performance fees are always proportionate to the actual investment performance of the fund. Artificial increases resulting from new subscriptions should not be taken into account when calculating fund performance.

A manager should always be able to demonstrate how the performance fee model of a fund it manages constitutes a reasonable incentive for the manager and is aligned with investors' interests.

The performance fee provisions and their final payments should be allocated and reversed in a symmetrical way. For example, it should not be possible to apply simultaneously an allocation rate (e.g. 20% of the performance of the fund when the performance increases) and a different reversal rate (e.g. 15% of the - negative - performance of the fund when the performance decreases).

Performance fees could be calculated on a single investor basis.

Guideline 2 – Consistency between the performance fee model and the fund's investment objectives, strategy and policy
The manager should implement and maintain a process in order to demonstrate and periodically review that the performance fee model is consistent with the fund's investment objectives, strategy and policy.

When assessing the consistency between the performance fee model and the fund's investment objectives, strategy and policy, the manager should check:

- a. Whether the chosen performance fee model is suitable for the fund given its investment policy, strategy and objective. For instance, for funds that pursue an absolute return objective, a HWM model or a hurdle is more appropriate than a performance fee calculated with reference to an index because the fund is not managed with a reference



to a benchmark; in addition, a HWM model for an absolute return objective, might need to include a hurdle to align the model to the fund's risk-reward profile;

- b. Whether, for funds that calculate the performance fee with reference to a benchmark, the benchmark is appropriate in the context of the fund's investment policy and strategy and adequately represents the fund's risk-reward profile. This assessment should also take into account any material difference of risk (e.g. volatility) between the fund's investment objective and the chosen benchmark, as well as the consistency indicators included further below. For example, it should not be deemed appropriate for a fund with a predominantly long equity-focused strategy to calculate the performance fee with reference to a money market index.

As a general principle, if a fund is managed in reference to a benchmark index and it employs a performance fee model based on a benchmark index, the two indices should be the same.

This includes, *inter alia*, the case of:

- Performance measures: the fund has a performance objective linked to the performance of a benchmark (e.g. Index A + positive absolute return objective; Index A + HWM; Index A + X% hurdle rate etc.).
- Portfolio composition: the fund portfolio holdings are based upon the holdings of the benchmark index (e.g. the individual holdings of the fund's portfolio do not deviate materially from those of the benchmark index).

In such cases, the benchmark used for the portfolio composition should be the same as the benchmark used for the calculation of the performance fee.

However, in case the fund is managed in reference to a benchmark but the fund's portfolio holdings are not based upon the holdings of the benchmark index (e.g. the index is used as a universe from which to select securities), the benchmark used for the portfolio composition should be consistent with the benchmark used for the calculation of the performance fee. Consistency should be primarily assessed against the similar risk-return profile of different benchmarks (e.g. they fall into the same category in terms of Synthetic Risk Reward Indicator and/or volatility and expected return).

The following is a non-exhaustive cumulative list of "consistency indicators" which should be taken into account by the manager, based on the type of investment of the fund (for example, equities, bonds or derivatives):

Consistency Indicators

- Expected return;
- Investment universe;
- Beta exposure to an underlying asset class;
- Geographical exposure;
- Sector exposure;
- Income distribution of the fund;
- Liquidity measures (e.g. daily trading volumes, bid-ask spreads etc);
- Duration;
- Credit rating category;
- Volatility and/or historical volatility.

Where performance fees are payable on the basis of out-performance of a benchmark (e.g. "Eurostoxx 50 + 3%", "Eonia", etc.), it would not be appropriate to take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark (e.g. computing performance fees based on "Eurostoxx -1%" where the objective of the fund is "Eurostoxx").

Where the calculation of the performance fee is based on a fulcrum fee model, the performance fee should be based on the same benchmark used to determine excess performance.

In all cases, the excess performance should be calculated net of all costs (for example, management fees or administrative fees) but could be calculated without deducting the performance fee itself as long as this would be in the investor's best interest (i.e. it would result in the investor paying less fees).

If the reference indicator changes during the reference period, the performance of the reference indicator for this period should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards.

Guideline 3 – Frequency for the crystallisation of the performance fee

The frequency for the crystallisation and the subsequent payment of the performance fee to the manager should be defined in such a way as to ensure alignment of interests between the portfolio manager and the shareholders and fair treatment among investors.

The crystallisation frequency should not be more than once a year.

Paragraph 32 of the Guidelines (crystallisation frequency) could not be applied where the fund employs a high watermark model or a high-on-high model where the performance reference period is equal to the whole life of the fund and it cannot be reset, as in this model performance fees cannot be accrued or paid more than once for the same level of performance over the whole life of the fund.

Paragraph 32 should not apply to the fulcrum fee model and other models which provide for a symmetrical fee structure (whereby performance fees would decrease or increase based on the performance of the fund), as the characteristics of these models are not compatible with the recommendation enshrined in paragraph 32.

The crystallisation date should be the same for all share classes of a fund that levies a performance fee.

In case of closure/merger of funds and/or upon investors' redemptions, performance fees, if any, should crystallise in due proportions on the date of the closure/merger and/or investors' redemption. In case of merger of funds, the crystallisation of the performance fees of the merging fund should be authorised subject to the best interest of investors of both the merging and the receiving fund. For instance, in case where all involved funds are managed by the same manager (e.g. in the context of a cross-border merger), crystallisation of performance fees should be presumed contrary to investors' best interest unless justified otherwise by the manager. Generally, the crystallisation date should coincide with 31 December or with the end of the financial year of the fund.



Guideline 4 - Negative performance (loss) recovery

A performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period. Any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable. In order to avoid misalignment of interests between the fund manager and the investors, a performance fee could also be payable in case the fund has over performed the reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided.

The performance fee model should be designed to ensure that the manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses.

The manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the recommended investors' holding period.

In case the fund employs a performance fee model based on a benchmark index, it should be ensured that any underperformance of the fund compared to the benchmark is clawed back before any performance fee becomes payable. To this purpose, the length of the performance reference period, if this is shorter than the whole life of the fund, should be set equal to at least five years.

Where a fund utilises a HWM model, a performance fee should be payable only where, during the performance reference period, the new HWM exceeds the last HWM. The starting point to be considered in the calculations should be the initial offering price per share. For the HWM model, in case the performance reference period is shorter than the whole life of the fund, the performance reference period should be set equal to at least five years on a rolling basis. In this case, performance fee may only be claimed if the outperformance exceeds any underperformances during the previous five years and performance fees should not crystallise more than once a year.

The performance reference period should not apply to the fulcrum fee model and other models which provide for a symmetrical fee structure, as in these models the level of the performance fee increases or decreases proportionately with the investment performance of the fund.

Guideline 5 – Disclosure of the performance fee model

Investors should be adequately informed about the existence of performance fees and about their potential impact on the investment return.

In case a fund allows for a performance fee to be paid also in times of negative performance (for example, the fund has over performed its reference benchmark index but, overall, has a negative performance), a prominent warning to investors should be included in the KIID.



In case a fund managed in reference to a benchmark computes performance fees with a benchmark model based on a different but consistent benchmark (as per the case under paragraph 26 (benchmark consistency indicators) of the guidelines), the manager should be able to explain the choice of benchmark in the prospectus.

The prospectus and, if relevant, any ex-ante information documents as well as marketing material, should clearly set out all information necessary to enable investors to understand properly the performance fee model and the computation methodology. Such documents should include a description of the performance fee calculation method, with specific reference to parameters and the date when the performance fee is paid, without prejudice to other more specific requirements set out in specific legislation or regulation. The prospectus should include concrete examples of how the performance fee will be calculated to provide investors with a better understanding of the performance fee model especially where the performance fee model allows for performance fees to be charged even in case of negative performance.

In line with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated.

The KIID should clearly set out all information necessary to explain the existence of the performance fee, the basis on which the fee is charged and when the fee applies, consistently with Article 10(2)(c) of the KIID Regulation. Where performance fees are calculated based on performance against a reference benchmark index, the KIID and the prospectus should display the name of the benchmark and show past performance against it.

The annual and half-yearly reports and any other ex-post information should indicate, for each relevant share class, the impact of the performance fees by clearly displaying: (i) the actual amount of performance fees charged and (ii) the percentage of the fees based on the share class NAV.

Next Steps

The Guidelines that are set out in Annex IV will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which NCAs must notify ESMA whether they comply, intend to comply or intend not to comply with the guidelines.

The Guidelines will apply from the end of this two-month period.

Managers of any new funds created after the date of application of the guidelines with a performance fee, or any funds existing before the date of application that introduce a performance fee for the first time after that date, should comply with these guidelines immediately in respect of those funds.

Managers of funds with a performance fee existing before the date of application of these guidelines should apply these guidelines in respect of those funds by the beginning of the financial year following 6 months from the application date of the Guidelines.

ⁱ Manager:

- a) A management company (as defined in Article 2(1)(b) of the UCITS Directive);
- b) An investment company that has not designated a management company authorised pursuant to the UCITS Directive; and
- c) An AIFM (as defined in Article 4(1)(b) of the AIFMD) of the AIFs referred to in these guidelines.



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