Matheson

ESMA Guidelines on Performance Fees

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On 3 April 2020, ESMA published its final report on guidelines on performance fees for UCITS and certain types of AIFs marketed to retail investors ("**Guidelines**"). The Guidelines aim to 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. ESMA's Guidelines aim at harmonising the way fund managers charge performance fees to retail investors, as well as the circumstances in which performance fees can be paid.

Scope

The Guidelines relate to UCITS and certain types of AIFs (including self-managed funds), in order to ensure a level playing field and a consistent level of protection to retail investors. The July 2019 consultation that preceded the publication of the final report only addressed performance fees charged by UCITS and so the application of the Guidelines to certain AIFs constitutes a broadening of scope that may not have been anticipated. The guidelines apply to AIFs marketed to retail investors in the EU in accordance with article 43 of the Alternative Investment Fund Managers Directive ("**AIFMD**") except for: (a) closed-ended AIFs; and (b) open-ended AIFs that are European Venture Capital Funds ("**EuVECAs**"), European Social Entrepreneurship Funds ("**EuSEFs**"), private equity AIFs or real estate AIFs.

Timeframe

The Guidelines will be translated into the official EU languages and subsequently published on ESMA's website. National competent authorities will have two months from the date of publication to confirm whether they intend to comply with guidelines. It is expected that the Central Bank or Ireland ("**Central Bank**") will implement the Guidelines. Until the official translations are published, the effective date of the Guidelines will remain unclear.

Funds established after the date of application (that is, two months after the publication of the official translations) and existing funds which subsequently introduce a performance fee must comply with the Guidelines immediately.

Existing funds with a performance fee in place prior to the date of application of the Guidelines must comply with the Guidelines by the beginning of the financial year following six months from the date of application.

Current Central Bank Rules

The current rules relating to UCITS charging performance fees in Ireland are contained in the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (SI 230 of 2019 – the "**Central Bank UCITS Regulations**"), the Central Bank Guidance on UCITS Performance Fees and the Central Bank UCITS Q&A. The Central Bank's rules and guidance are, for the most part, aligned with the Guidelines, although the Guidelines are more prescriptive in some respects and more flexible in others; funds will have to conduct a gap analysis to assess the implications of the Guidelines. An important point to note is that funds have until 27 November 2020 to implement the new rules on performance fees that were introduced by the Central Bank UCITS Regulations in late May 2019, so they may wish to implement the changes required by the Guidelines at the same time as implementing the changes arising from the May 2019 rules.

There are some rules relating to performance fees charged by retail investor alternative investment funds ("**RIAIFs**") and (to a lesser extent) qualifying investor alternative investment funds ("**QIAIFs**") set out in the Central Bank's AIF Rulebook, but those rules are significantly less detailed and prescriptive than the requirements set out in the Guidelines (which will apply to RIAIFs and, to the extent marketed to retail investors, QIAIFs).

The Guidelines

The five Guidelines and the key points in relation to each Guideline are set out in the tables below, including a general analysis as to how the guidelines differ from the Central Bank's current rules and guidance on performance fees.

Guideline 1

Key Points

Performance Fee Calculation Method

1. Calculation should be verifiable and not open to the possibility of manipulation
2. The calculation method should include at least:
   (a) the reference indicator to measure the relative performance of the fund – an index, a high water mark ("HWM"), a hurdle rate or a combination;
   (b) crystallisation frequency and crystallisation date at which the performance fee is credited to the manager;
   (c) the performance reference period;
   (d) the performance fee rate;
   (e) the performance fee methodology;
   (f) calculation frequency, which should coincide with the frequency of NAV calculation.
3. The calculation method should ensure that performance fees are always proportionate to the actual performance of the fund; artificial increases due to new subscriptions should not be taken into account.
4. The manager should be able to demonstrate that the performance fee model constitutes a reasonable incentive for the manager and is aligned with investors' interests.
5. Performance fee provisions and their final payments should be allocated and reversed in a symmetrical way.
6. Performance fees may be calculated on a single investor basis.

Alignment with Current Central Bank Rules and Guidance

The Central Banks UCITS rules and guidance are substantially aligned with these requirements. However, there is no equivalent requirement in the Irish framework to the requirement in the Guidelines that a prescribed list of elements must be included in the performance fee calculation method (and, according to Guideline 5, disclosed in the prospectus).

In-scope AIFs that wish to continue to market to retail investors will have to consider these new requirements.

Guideline 2

Key Points

Consistency between the Performance Fee Model and the Fund's Investment Objectives, Strategy and Policy

1. A process must be implemented and maintained to demonstrate and periodically review that the performance fee is consistent with the fund's investment objectives, strategy and policy.
2. Absolute return funds: a HWM model or a hurdle is more appropriate than a performance fee calculation with reference to an index; there may be a need to combine a HWM model with a hurdle to align the model to the fund's risk-reward profile.
3. For funds that calculate the performance fee with reference to a benchmark, the benchmark must be appropriate in the context of the fund's investment policy and strategy and must adequately represent the fund's risk-reward profile.
4. 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.
5. Where a fund is managed in reference to a benchmark but its portfolio holdings are not based upon the holdings of the benchmark index (eg, 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.
6. When assessing the consistency between the benchmark used for portfolio composition and the benchmark used for performance calculation, consistency should be primarily assessed against the similar risk-return profile of the different benchmarks (such as whether they fall into the same category in terms of Synthetic Risk Reward Indicator and / or volatility and expected return). The following non-exhaustive list of "consistency indicators" should also be considered:
   - expected return;
   - investment universe;
   - beta exposure to an underlying asset class;
   - geographical exposure;
   - sector exposure;
   - income distribution of the fund;
   - liquidity measures (eg,: daily trading volumes, bid-ask spreads etc);
   - duration;
   - credit rating category;
   - volatility and / or historical volatility
7. If performance fees are payable on the basis of out-performance of a benchmark "A", then calculating performance fees based on "A – 1%" would not be appropriate.

Alignment with Current Central Bank Rules and Guidance

The Central Bank UCITS Regulations currently require consistency with the fund's investment objectives only where performance fees are payable on the basis of out-performance of an index. The Guidelines apply the requirement for consistency more broadly, ie, to all performance fee models whether the model references a benchmark, a HWM or a hurdle. There is no equivalent in the Irish framework to the "consistency indicators" in the Guidelines.

Guideline 3

Key Points

Frequency for the Crystallisation of the Performance Fee

1. Crystallisation frequency should not be more than once a year. This will not apply to:
    - (a) funds using the HWM or high-on-high model, where the performance reference period is equal to the whole life of the fund and it cannot be reset; or
    - (b) funds using the fulcrum fee model and other models with provide for a symmetrical fee structure (whereby performance fees would decrease or increase based on the performance of the fund).
2. The crystallisation date should be the same for all share classes of a fund that levy a performance fee.
3. 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. Generally, the crystallisation date should coincide with 31 December or with the end of the financial year of the fund.

Alignment with Current Central Bank Rules and Guidance

The one year crystallisation frequency aligns with the Central Bank requirements for UCITS. The Central Bank does not currently impose this requirement on RIAIFs and QIAIFs. The ESMA Guidelines for funds employing HWM or high-on-high model where the performance reference period is equal to the life of the fund are more flexible than the current Central Bank rules.

Guideline 4

Key Points

Negative Performance (Loss) Recovery

1. A performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period.
2. Any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.
3. A performance fee may be payable in case the fund has out-performed the reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided.
4. 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.
5. Where a fund uses a performance fee model based on a benchmark index, underperformance should be clawed back before any performance fee becomes payable. The length of the performance reference period, if this is shorter than the whole life of the fund, should be at least five years.
6. Where a fund uses a HWM model, a performance fee should only be payable where, during the performance reference period, the new HWM exceeds the last HWM. If the performance fee reference period is shorter than the whole life of the fund, the performance fee reference period should be at least five years on a rolling basis. A 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.
7. The performance reference period should not apply to the fulcrum fee model and other models which provide for a symmetrical fee structure.

Alignment with Current Central Bank Rules and Guidance

The original guidelines consulted upon in July 2019 did not allow for the payment of performance fees where a fund over performed a reference benchmark but had a negative performance. The Guidelines are now aligned with the Central Bank UCITS requirements in this respect. The Irish framework does not currently allow the flexibility regarding recovery of negative performance, including the ability to reset the HWM, permitted under the Guidelines.

There are no equivalent requirements applicable to in-scope AIFs under the current Irish framework.

Guideline 5

Key Points

Disclosure of the Performance Fee Model

1. Where a performance fee is payable in the event of negative performance (eg, where the fund has out-performed its reference benchmark index but overall has a negative performance), a prominent warning to investors should be included in the KIID.
2. Where a fund managed in reference to a benchmark calculates performance fees using a benchmark model based on a different but consistent benchmark (applying the consistency indicators referred to in Guideline 1) the prospectus should include an explanation of the choice of benchmark.
3. The prospectus and any ex-ante documents including marketing material should include a description of the performance fee calculation method, with specific reference to parameters and the date when performance fee is paid, without prejudice to other more specific requirements set out in specific legislation or regulation.
4. The main elements of the performance fee calculation method set out in Guideline 1 should be included in the prospectus.
5. 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.
6. 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.
7. Periodic reports should disclose, for each relevant share class: (i) the actual amount of performance fees charged; and (ii) the percentage of the fees based on the share class NAV.

Alignment with Current Central Bank Rules and Guidance

There is currently no requirement for the prospectus to include concrete examples of how performance fees will be calculated and it is not clear what exactly a concrete example must be (eg, must it be a numerical, calculated example?).

UCITS KIIDs (and, for in-scope AIFs, PRIIPs KIDs) may need to be updated.

The Irish framework currently does not require the disclosures in periodic reports set out in the Guidelines.

Comment

The ESMA Guidelines are for the most part consistent with the performance fee rules and guidance currently applicable to Irish UCITS, although some additional regulatory measures may be introduced following the Central Bank's adoption of the Guidelines to address areas where the ESMA Guidelines are more expansive than the current rules. The Guidelines are significantly more detailed and prescriptive that the current Irish rules and guidance on performance fees for in-scope AIFs.

Ensuring greater supervisory convergence regarding performance fees in funds marketed to retail investors is an integral part of ESMA's broader efforts on the cost of retail investment products. ESMA has also started to publish an annual statistical report on the performance and costs of retail investment products in the EU in order to enhance transparency and ameliorate investor protection.

Costs and fees have also been the subject of regulatory focus for some time at a domestic level. In September 2018, the Central Bank issued a letter to industry following its thematic review of performance fees, highlighting the issues identified during the review. The Central Bank stated that it will use the industry letter as a reference in any supervisory engagement carried out on UCITS performance fees.

The effective date of the Guidelines is unclear as we await publication of the official translations on ESMA's website. It also remains to be seen how the Central Bank will chose to implement the changes arising out of differences between the current Irish framework and the Guidelines, although we may expect to see amendments to some or all of the following: Central Bank UCITS Regulations, the Central Bank Guidance on UCITS Performance Fees, the Central Bank UCITS Q&A and the Central Bank AIF Rulebook. We will continue to keep our clients and contacts updated as to further developments.

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