ESMA consults on its proposal for Guidelines on performance fees in UCITS. October 2019.

On 16 July, the European Securities and Markets Authority (ESMA) published a consultation on its proposal for Guidelines on performance fees (management fee or success fee) for undertakings for collective investment in transferable securities (UCITS or funds).

At the beginning of 2018, ESMA carried out a mapping exercise to analyse the practices in relation to certain aspects of performance fees in the different Member States. The conclusions showed a lack of harmonisation between the different European jurisdictions. As it is not a very detailed issue in European regulation and affects the cross-border distribution of UCITS, achieving supervisory convergence is key, together with the other work undertaken, to facilitating its cross-border distribution, ensuring equal conditions in the European Union (EU) and promoting the European fund market.

For this reason, ESMA decided to intensify its supervisory convergence work in the area, including it as one of the priorities of ESMA's 2019 supervisory convergence work programme.

In light of the above, the proposed Guidelines are intended to establish common criteria to promote supervisory convergence in the following areas: 1) general principles on performance fee calculation methods; 2) consistency between the performance fee model and the investment objectives, strategy and policy of the fund; 3) frequency for the crystallisation of the performance fee; 4) circumstances in which a performance fee should be payable and 5) disclosure of the performance fee model.

For the purpose of the Guidelines, performance fee should be interpreted as the variable management commission linked to the performance of a fund and normally payable in addition to a basic fee, whose objective is to generate an incentive for the fund manager to optimise the performance of the fund.

Analysis of the situation in the different jurisdictions of the EU

In a discussion on performance fees held by the national competent authorities in June 2017, the following two issues were identified as potential issues that would need to be addressed to ensure supervisory convergence: a) the lack of harmonisation in relation to the minimum frequency for the computation and crystallising of performance fees and b) the need for good practices that ensure consistency between the performance fee models and the fund's investment policy.

A questionnaire was prepared to analyse the practices in the 31 jurisdictions of the European Economic Area and the conclusions showed a lack of harmonisation and the lack of regulatory requirements related to performance fees. In summary, this is the information that was extracted from the answers:

– performance fees are permitted in 26 jurisdictions and of these only in 8 are defined in some way, although this definition is not always included in a law.

– Despite the lack of convergence a number of common elements were identified in the methodologies that represent the computation mechanisms most commonly applied in the asset management industry: a) performance fees subject to a High-Water Mark (HWM) model[1] sometimes combined with a hurdle rate; b) models based on the comparison between present and past performance and c) remuneration of performance exceeding a certain threshold.

– Regarding the consistency between the fund's strategy and the chosen benchmark or index, although 14 competent authorities stated that in their jurisdictions the funds are not subject to specific conditions or limits when choosing the benchmarks or indices used in the computation models, the rest of the Member States have either legal provisions or supervisory practices aimed at ensuring consistency between the fund's strategy and the chosen benchmark or index.

– Computation mechanisms are applied differently in each jurisdiction. Although the majority require to calculate performance fees daily and to charge them on an annual basis, other methodologies include the monthly calculation and quarterly payments.

– Finally, several competent authorities indicated that they have additional requirements to those established in European legislation in relation to performance fee disclosure, among which are those related to the information included in: a) the constitutional documents (such as the computation methodology and payment of performance fees; disclosure that a performance fee may be charged and potential increases in fees subject to prior approval by unitholders; computation methodology, reference parameters and due date); b) the annual report (such as the disclosure of the index used for a performance fee computation; disclosure of all the fees which can be charged, including performance fees; reference period used for calculations, the base for calculation and the impact that a performance fee model may entail) and c) the prospectus (such as the impact of the fees on the fund's return over a certain period of time and the actual fees charged).

The proposed Guidelines

The proposed Guidelines are based on the 2016 International Commission of Securities Commissions (IOSCO) document "Good Practices for Fees and Expenses of Collective Investment Schemes"[2] and seek to establish the principles of convergence in the five areas mentioned above, including a Guideline for each of them.

ESMA recognises that there are a variety of models of performance fees and approaches to the methodologies that are applicable to them but, at the same time, it is aware that some ways of calculating these fees are not made in the best interest of the funds as they may imply undue costs charged to the fund and/or its unit holders.

Guideline 1 refers to general principles on performance fee calculation methods. ESMA believes that these should include at least: a) a reference indicator to measure the relative performance of the fund; b) the crystallisation period within which the performance fee is accrued and a crystallisation date that coincides with the end of this period; c) the performance reference period at the end of which the mechanism for compensating for past underperformance or negative performance can be reset; d) a performance fee rate also referred to as a "flat rate"; e) the methodology for the calculation of the performance fees and f) the computation frequency that should coincide with the frequency of calculation of the net asset value.

The calculation method should be designed to ensure that the performance fees are always proportionate to the actual performance and that the artificial increases resulting from new subscriptions are not taken into account when calculating the performance. The model should constitute a reasonable incentive for the manager (without prompting him to take greater risks) and be aligned with the interests of investors.

Guideline 2 on the consistency between the performance fees model and investment objectives, strategy and policy of the fund recommends that, in assessing the consistency, the management company should check 1) whether the chosen model is suitable for the fund, given its strategy and investment policy and 2) whether, for funds that calculate the performance fee with reference to a benchmark, this is appropriate in the context of the fund's investment policy and strategy and adequately represents the risk-reward profile of the fund.

Guideline 3 covers the frequency for the crystallisation of the performance fee and subsequent payment to the management company. The frequency should allow the alignment of interests of the different parties and the fair treatment of investors, so the time horizon should be consistent, to the extent possible, with the investors' holding period. It should not be shorter than one year and should end either on 31 December or at the end of the fund's financial year.

Guideline 4 deals with the negative performance (loss) recovery and indicates that a performance fee should only be payable where positive performance has been accrued during the performance reference period. Any underperformance or loss incurred within the reference period should be recovered before the performance fee is payable. The model should ensure that the manager does not take excessive risks and that the cumulative gains are greater than the cumulative losses.

If a fund uses a HWM, it should only be reset if during the reference period (i) a new HWM exceeds the last one or (ii) the fund has undergone significant structural changes.

Guideline 5 outlines the content of the information on performance fees to be disclosed ex ante in the KIID and prospectus and, ex post, in the annual report. Investors should be informed of the existence of a performance fee and its potential impact on their investment return.

The pre-contractual documents delivered to potential participants should allow them to understand the performance fee model and the computation methodology while the ones subsequently delivered, such as periodic reports, should provide, for each relevant share class, information on the amount actually charged and the percentage of the fees based on the share class net asset value.

Likewise, Guidelines 2, 3 and 4 include references to the specifics of the fulcrum fee model. A fulcrum fee is a type of performance fee that may be negative as it increases or decreases proportionately with the investment performance of a fund in relation to an index over a certain period of time (the higher the return on the index, the higher the performance fee and vice versa).

Finally, the proposal of the Guidelines includes a **transitional provision** that would allow a period of 12 months after their publication so that those funds already registered adapt and comply with the Guidelines.

The Consultation

The consultation tries in first place to know the opinion regarding the appropriateness of standardisation in the field of funds' performance fees, the goals that should be pursued and the obstacles that could be removed by regulation.

Regarding the Guidelines, it seeks to ascertain whether the stakeholders consider them appropriate, whether they can anticipate the impact they might have, whether they have proposals other than those presented or if they can supplement them.

It is also expected to know the opinion on the transitional period necessary for managers to adapt to comply with the Guidelines.

Likewise, it is considered whether it would be appropriate to apply the Guidelines to alternative investment funds marketed to retail investors to homogenise the degree of protection of these investors regardless of the type of fund in which they invest.

The deadline to respond to the consultation ends on 31 October. ESMA will analyse the comments received in Q4 2019 in order to finalise the Guidelines and publish them afterwards.

[1] The watermark implies that a fund manager may only charge the performance fee when the net asset value of the fund on the accrual date of the fund is higher than the net asset value at the end of the last year for which the fund manager charged a performance fee. If the manager does not fulfil this condition or receive a performance fee for three years, it may be established as the new net asset value to be exceeded in order to receive the commission corresponding to the end of the third year.

[2] Good Practice for Fees and Expenses of Collective Investment Schemes – FRO9/16 August 2016 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

Link of interest:

ESMA public consultation on the Guidelines on performance fees in UCITS (only available in English)