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Regulatory News Alert

ESMA to encourage greater convergence and standardization within the UCITS performance fees calculation field

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Context and objectives

On 16 July 2019, the European Securities and Markets Authority (ESMA) launched a consultation paper (CP) seeking feedback on the **draft Guidelines on performance fees in UCITS (Guidelines)**.

Currently, several National Competent Authorities use different practices regarding performance fee structures, as well as have different circumstances in which performance fees can be paid. This creates risks in regulatory arbitrage and inconsistent levels of investor protection. Therefore, ESMA decided to carry out further convergence work, which led to the development of this CP.

The draft Guidelines set out common criteria in order to promote supervisory convergence on the following areas:

- General principles on performance fee calculation methods
- Consistency between the performance fee model and the fund's investment objectives, strategy, and policy
- Frequency for the crystallization of the performance fee
- The circumstances in which a performance fee is payable
- Disclosure of performance fee model

Performance fee calculation method

As a minimum, the performance fee calculation method should include:

a) The **reference indicator** to measure the relative performance of the fund (i.e. an index, a HWM or a hurdle rate)

b) The **crystallization period** within which the performance fee is **accrued** and a date at which the performance fee is **crystallized and credited to the management company**

c) The **performance reference period**, at the end of which the **mechanism for compensating** for past underperformance or negative performance can be reset

d) The performance fee rate which may also be referred to as the “**flat rate**” i.e. the rate of the performance fee which may be applied to all models

e) The **performance fee methodology** enabling the calculation of the performance fees

f) The **computation frequency** which should coincide with the calculation frequency of the NAV

The 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 management company 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**.

Consistency with fund’s investment objectives, strategy and policy

A management company should check:

a) Whether the chosen performance fee model is **suitable for the fund** given its investment policy and strategy.

For instance, for funds that pursue an absolute return objective, a HWM (high water mark) model or a hurdle might be more appropriate than a performance fee calculated with reference to an index;

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 aims and the chosen benchmark.

Where performance fees are payable on the basis of out-performance of a benchmark (e.g. Eurostoxx 50 + 3 percent, Eonia etc.), the management company should **ensure that the benchmark is consistent with the investment policy and strategy** of the fund.

In all cases, **the excess performance** should be calculated **net of costs**.

Frequency for the crystallization

The frequency for the crystallization should be defined in such a way as to ensure **alignment of interests** between the portfolio manager, the shareholders, and **fair treatment among investors**. The manager's performance should be assessed and remunerated at a time that is, as far as possible**, consistent with the investors' holding period**.

The crystallization period **should not be shorter than one year**. Generally, it should end either on 31 December or at the end of the financial year of the fund.

The minimum crystallization period should not apply to the fulcrum fee model, as the characteristics of this model are not compatible with a minimum crystallization period.

Negative performance (loss) recovery

A performance fee should only be payable in circumstances where **net 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.

Furthermore, the performance fee model should be designed to ensure that the fund manager is not incentivized to take **excessive risks** and that cumulative gains are duly offset by cumulative losses.

Disclosure requirements

The **prospectus**, as well as the **marketing material**, should clearly set out all information necessary to enable investors to understand properly the performance fee model. 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. The prospectus should include **concrete examples** of how the performance fee will be calculated. Furthermore, the **main elements of the 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** should indicate, for each relevant share class, the impact of the fees over the crystallization period, by clearly displaying: (i) the actual amount of performance fees charged and (ii) the percentage of the fees based on the share class NAV.

Transitional provisions

Once the final version of the Guidelines is adopted, any new UCITS or any existing UCITS that introduces a performance fee for the first time after the date of application of the Guidelines **should comply with the Guidelines immediately**.

Existing UCITS that already operated a performance fee before the application date of the Guidelines should align their procedures with the Guidelines **within 12 months of the application date**.

Next steps

ESMA will consider the feedback it receives to this consultation in **Q4 2019** with a view to finalizing the Guidelines for publication afterwards.

How can Deloitte help?

Deloitte's advisory performance fees specialists can help you review your performance fees wording and spreadsheets in light of the evolution of the regulatory framework and market trends.

Via our Regulatory Watch Kaleidoscope service, Deloitte can also help you stay ahead of the regulatory curve to better manage and plan upcoming regulations.

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