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Regulatory News Alert

ESMA publishes final performance fees guidelines for UCITS and certain types of AIFs

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On 3 April 2020, the European Securities and Markets Authority (ESMA) published its final **performance fees guidelines for UCITS and certain types of AIFs**. This is a key step to ensure a supervisory convergence and provide standardization in determining the performance fees structures and mechanisms within the EU. This will definitely contribute to an integrated Single Market where the same conditions will apply to the operations of UCITS (notably) as the ultimate pan-European vehicle.

Scope

These guidelines apply to **managers** and **competent authorities**.

In case 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**:

- closed-ended AIFs
- open-ended AIFs that are EuVECAs (or other types of venture capital AIFs), EuSEFs, private equity AIFs, or real estate AIFs.

Date of application

These guidelines apply from **two months after the date of publication** of the guidelines on ESMA's website in all EU official languages.

After the date of application of the guidelines, any new funds or any existing funds that introduces a performance fee for the first time after the date of application of the guidelines **should comply with the guidelines immediately.**

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 six months from the application date of the guidelines**.

Guidelines on performance fees

Guideline 1: Performance fee calculation method

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

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, a hurdle rate or a combination)
b) The **crystallization frequency** at which the accrued performance fee, if any, becomes payable to the manager and a crystallization date at which the performance fee is credited to the manager
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"**
e) The **performance fee methodology**
f) The **computation frequency.**

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 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.**

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 to demonstrate, and periodically review, that the performance fee model is **consistent with 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.

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:

- If the fund has a performance objective linked to the performance of a benchmark
- If the fund portfolio holdings are based upon of the holdings of the benchmark index.

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**, the benchmark used for the portfolio composition should be **consistent** with the benchmark used for the calculation of the performance fee.

The manager should take into account "**Consistency Indicators**" as 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.

Guideline 3: Frequency for the crystallization of the performance fee

The frequency for the crystallization 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 crystallization frequency **should not be more than once a year**.

This requirement could not be applied where the fund employs a **high-water mark 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.

Definition of "High-Water Mark" models:

- High-Water Mark (HWM) model: a performance fee model whereby the performance fee may only be charged on the basis of achieving a new HWM during the performance reference period.
- High-on-High (HoH) model: a performance fee model whereby the performance fee may only be charged if the NAV exceeds the NAV at which the performance fee was last crystallized.

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 benchmar**k but **has a negative performance**, as long as a **prominent warning** to the investor is provided.

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 utilizes a **HWM model**, a performance fee should be payable only where, during the performance reference period, the new HWM exceeds the last HWM. 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 fees may only be claimed if the out-performance exceeds any under-performances during the previous five years and performance fees should not crystallize more than once a year.

Guideline 5: Disclosure of the performance fee model

In case a fund allows 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, 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. 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**.

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.

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.

Your contacts

Subject matter specialists

Xavier Zaegel, FRM
Partner – Financial Industry Solutions
Tel: +352 45145 2748
xzaegel@deloitte.lu

Jean-Paul Frisot
Director – Performance Fee Specialist
Tel : +352 45145 2607
jpfrisot@deloitte.lu

Lou Kiesch
Partner – Regulatory Consulting Leader
Tel : +352 45145 2456
lkiesch@deloitte.lu

Marie-Anne Mandroux
Senior Manager – Financial Industry Solutions
Tel : +352 45145 2234
mmandroux@deloitte.lu

Regulatory Watch Kaleidoscope service

Simon Ramos
Partner – IM Advisory & Consulting Leader & Regulatory Watch services Co-Leader
Tel : +352 45145 2702
siramos@deloitte.lu

Marijana Vuksic
Manager – Regulatory & Consulting
Tel : +352 45145 2311
mvuksic@deloitte.lu

Benoit Sauvage
Director – RegWatch, Strategy & Consulting
Tel : +352 45145 4220
bsauvage@deloitte.lu

Deloitte Luxembourg
20 Boulevard de Kockelscheuer
L-1821 Luxembourg
Grand Duchy of Luxembourg

Tel: +352 451 451
Fax: +352 451 452 401
www.deloitte.lu

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