Advice to ESMA

Response to ESMA’s Consultation Paper on “Guidelines on performance fees in UCITS”

Executive summary

The SMSG welcomes ESMA’s consultation on performance fees in UCITS as part of its key supervisory priorities. ESMA rightly seeks to set common Guidelines and criteria with the objective of ensuring alignment of interests between portfolio managers and investors as well as fair treatment among investors. The mapping exercise performed by ESMA confirmed the necessity to achieve more convergence with regard to performance-based fee structures in UCITS in order to enhance investor protection and ensure a level playing field in the EU.

The SMSG advises ESMA to gather more data and analyses regarding the use and the effects of performance fees. In light of ESMA’s recent report on costs and performance of retail products, the SMSG believes that it would be useful to enrich the information regarding fee structures by providing further details on the trends of fixed fees and performance fees. To assess the effects of a performance fee model, all the main features and parameters of the model should be seen together.

The performance fee should reflect as accurately as possible the returns generated, be verifiable and avoid any risk of manipulation, ensure that investors receive an adequate share of the return achieved from the risks taken, and respect the principle of equitable treatment of investors. As different share classes may have different fee structures, the SMSG advises ESMA to clarify that the performance fee model applies at the level of the share class and not necessarily at the level of the fund.

Concerning standardisation, the SMSG is in favour of ESMA establishing clear Guidelines that help investors to understand the main features and effects of the application of the performance fee. The SMSG agrees with ESMA’s Guideline regarding the consistency of the performance fee model with the fund’s investment objectives, strategy and policy. Regarding the crystallisation frequency, the SMSG agrees that, apart from few exceptional cases, this period should be no shorter than one year. The time horizon over which the performance is measured and compared with that of the reference indicator should also be clearly specified and the reference period for measuring the outperformance should be at least equal to one year. The SMSG advises ESMA to include retail AIFs in the scope of the Guidelines to ensure consistency of treatment on performance fees between UCITS and retail AIFs.

The SMSG encourages fair, clear and not-misleading disclosures of the performance fee model and its effects. A rigorous implementation throughout the whole chain is essential: performance fee models should be accurately described, unambiguous and non-discretionary to allow fund administrators to accurately apply the performance fees formulas.

The SMSG encourages ESMA to finalise these Guidelines to allow for pan-European convergence in the field of performance fee calculation. The SMSG agrees with the framework proposed by ESMA and the strong link with the IOSCO principles.
I. Background

1. Within the key priorities of the 2019 ESMA Supervisory Convergence Work Programme, ESMA proposes a set of Guidelines meant to ensure supervisory convergence for performance fee structures and circumstances in which performance fees can be paid.

2. Currently, performance fees are detailed under differing national rules and under the IOSCO principles\(^1\) issued in August 2016. UCITS performance fees are not regulated at the EU level and due to the importance of their cross-border distribution, ESMA considers that supervisory convergence on this issue is essential to ensure a level playing field in the EU.

3. One of the main features of the performance fee model is that it seeks to better align interests between the asset management company and investors while comforting fair treatment among investors. ESMA seeks to set common criteria with the objective of ensuring alignment of interests.

II. ESMA Consultation Paper on performance fees

4. ESMA’s draft Guidelines propose 5 areas of convergence: general principles on performance fee calculation methods; consistency between the performance fee model and the fund’s investment objectives, strategy and policy; frequency of the crystallisation of the performance fee; circumstances where a performance fee should be payable; and disclosure of performance fee model.

5. Guideline 1 is about the performance fee calculation method and lists a set of minimum elements to be defined allowing to characterise a performance fee model. Guideline 2 tackles the need for consistency between the performance fee model and the fund’s investment objectives, strategy and policy, while Guideline 3 sets the minimum pace regarding the frequency of the crystallisation of the performance fee. Guideline 4 deals with the concept of negative performance (loss) recovery, while Guideline 5 requests that investors be adequately informed about the existence of performance fees and about their potential impact on investment return.

III. General Comments

6. ESMA’s Guidelines legitimately seek to ensure further convergence of the applicable rules at the pan-European level. The mapping exercise conducted by ESMA shows a need to achieve more convergence with regard to performance-based fee structures in order to enhance investor protection and ensure a level playing field in the EU. It will also help removing any existing or potential cross-border barriers to the distribution of funds. The SMSG advises ESMA, however, to clarify how eventual more stringent local guidelines apply.

7. As different share classes may have different fee structures, ESMA should further clarify that the performance fee model applies at the level of the share class and not necessarily at the level of the fund. The SMSG observes that funds increasingly offer the possibility of charging different structures to retail investors. For instance, a recent report\(^2\) by Fitz Partners found evidence that asset managers are increasingly giving retail investors the right to choose between ‘twin’ share classes, where retail investors

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have a choice between a share class based on a single (and higher) fixed fee and a share class having both a (lower) fixed fee and a performance fee.

8. The SMSG advises ESMA to gather more data and analyses regarding the use of performance fees, as few studies on recent data are available. We refer for instance to the conclusions of one study\(^3\) on ‘The costs and benefits of performance fees in mutual funds’ which has found that equity mutual funds offered for sale in the European Union, Norway, and Switzerland over the period 2001-2011 would on average have charged higher costs compared to funds without performance fees. In light of ESMA’s recent works on the costs and performance of retail products and of the need to have analysis on recent data and trends, the SMSG believes it useful for ESMA to enrich the information regarding fees evolutions further by providing detail on fixed fees versus performance fees patterns as well as more granularity on the effect on total fees when a performance fee applies by strategy, by member state of domiciliation, etc. Such additional reporting would also fit into ESMA’s responsibility under Article 32 of its Founding Regulation to report on the trends, risks and vulnerabilities in the areas of its competence.

9. As part of the asset management company remuneration structure, the performance fee model should not be regarded in isolation. The same applies for one or another of its parameters, the effect of which should be assessed and apprehended in its interaction with all other applicable parameters.

10. Some non-exhaustive high-level desirable characteristics of the performance fee models (as also recognized by IOSCO) should be kept in mind: the performance fee should reflect as accurately as possible the returns generated, be verifiable and avoid any risk of manipulation, ensure that investors are not denied an adequate share of the return achieved from the risks taken on their behalf and previously accepted by them, and respect the principle of equitable treatment of investors.

11. ESMA proposes 5 high level principles inspired by the IOSCO Principles and then gives a certain degree of granularity depending on the issue. The SMSG highlights that some specification will improve supervisory convergence, while on the other hand, too much specification might be difficult to achieve in light of national differences, and a one-size-fits-all-model would hinder the appropriateness and fairness of the fee.

IV. Specific Comments

Performance fee calculation method

12. The SMSG agrees that the proposed elements should consist of a minimum list of elements to be defined. In order to assess the effect of a performance fee model, all main features and parameters should be seen together.

13. In addition, the specification of the calculation base (in addition to the rate) and the first date of crystallisation could be valuable information to give to investors. Redemption processing should be specified, ie it should be clarified whether the crystallisation (mechanism for the performance fee to be locked in for future payment) is applied on redeeming shares. Other optional elements or conditions that may impact the fee calculation, such as the existence of a cap or of a condition on absolute positive performance, might be added.

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**Standardisation**

14. The group welcomes ESMA’s consultation and agrees that the IOSCO principles are a good basis for ESMA’s guidelines. IOSCO’s principles are proportionate and encompass a wide variety of performance fee models in different jurisdictions. ESMA’s mapping exercise showed uneven implementation of the IOSCO principles and other discrepancies between the European member states’ treatment of performance fees. The group thus agrees with the objective pursued by ESMA with this consultation in terms of ensuring further European convergence in the field, starting with the respect of the IOSCO principles.

15. The SMSG is in favour of ESMA establishing clear Guidelines that help investors understand the main features and effects of the application of the performance fee formula. Performance fee models should be designed to be readable, easy to understand and not misleading.

16. The adoption of ESMA Guidelines should ensure a European common global understanding for NCAs in this field so as to avoid barriers to cross-border distribution of funds and a level playing field for investor protection. Indeed, funds may have several share classes with differing fee structures and imposing one model over the other may ultimately remove choices for investors.

**Consistency between the performance fee model (and index used to calculate the performance fee) and the investment objectives, strategy and policy of the fund**

17. The group agrees with the objectives of Guideline 2 regarding the consistency of the performance fee model with the fund’s investment objectives, strategy and policy. The performance fee based on a benchmark or hurdle rate should be determined in such a way that it is consistent with the investment objective, strategy and policy. A money market index might not be compatible for a fund with a directional market bias. In light of certain national regulators’ findings on the use of inappropriate benchmarks for the calculation of performance fees, the SMSG is of the opinion that the prospectus should disclose the rationale behind the choice of a specific benchmark in the context of the UCITS investment policy. IOSCO’s Good practice 3 requires that the calculation methods be designed so as to allow for the performance fee to be proportionate in value to the investment performance of the fund. The SMSG agrees that this overarching principle should guide ESMA when taking a holistic view on the effects of different formulas. In case a specific benchmark is designed to determine excess performance, as per IOSCO’s Good practice 4, the performance fee should be based on the same reference.

**Absolute vs relative positive performance**

18. ESMAs’ Guideline 4 lays down the principle that a performance fee is triggered if a positive performance has been accrued during the performance reference period and that any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.

19. For the sake of clarity, the SMSG advises ESMA to complete Guideline 4 with a definition relative and absolute positive performance (as mentioned in para 23 on page 12). The group discussed several elements and factors to be assessed, including the fund’s commitment to respect its investment objectives and risk profile as well as different understandings of investor’s objectives. In case of a performance fee model, the asset management company is remunerated through a fixed (base) fee and a conditional fee. The conditional fee should be in line with the fund’s promise to investors as stated in the investment objective and be paid for/ result from outperformance only. For the vast majority of funds and more
particularly for benchmarked funds in Europe, the performance fee can be triggered when the fund’s performance outperformed the benchmark’s one both in upward and downward markets. There are also funds that decided to add an absolute performance condition depending on different elements linked for instance to the fund’s strategy and/or type of investors.

20. In the case ESMA decides to continue to allow relative positive performance, a clear and prominent statement explaining this feature should be included in fund documents to raise awareness among fund investors that outperformance in relation to the benchmark may lead to performance fees becoming payable in downward markets as well. As some retail investors may intuitively believe that performance fees would only be charged if he or she witnesses an absolute return on his or her investment, the insertion in fund documents of a simple simulation could illustrate this particular feature so that retail investors have more easily a clear understanding of this effect. Also the KIID should mention this feature.

21. In addition to the potential mismatch with the investment objective, another risk of setting overly burdensome constraints on performance fees (such as the introduction of an absolute performance criterion) is that it could lead to increased fixed management fees, which would be detrimental to investors. In addition, ESMA should remain cautious when using the negative performance fee concept in order to avoid spill-over between performance and management fees: a negative performance should reduce the performance fee but not reduce the management fee. Management fees are generally calibrated when a fund is launched, taking into consideration all costs incurred by the management company for the management of the considered fund, which notably includes fixed costs, which by nature do not depend on the fund performance. A reduction of the management fee in case of insufficient performance of the fund could undermine the economic viability of the considered fund or share class.

Crystallisation.

22. ESMA defines the crystallisation period as the period within which the performance fee, if any, is accrued and at the end of which the fee is crystallised and credited to the management company. The crystallisation frequency is mentioned in the IOSCO’s Good practice 3, which requires it should not occur more frequently than once a year. The SMSG advises ESMA to clarify that this is the frequency of locking in the calculation of the fee, which then becomes payable (without necessarily being paid at that moment in time). The majority of formulas in Europe use a frequency with a pace of one year. The group agrees that, apart from few exceptional cases listed by ESMA, like corporate events or equivalent protection through another mechanism, this period should not be no shorter than one year.

Time Horizon.

23. The fund should be transparent on all main parameters of the performance fee formula. The time horizon over which the performance is measured and compared with that of the reference indicator should be clearly specified. Taking into account the recommendation of a crystallisation frequency on a pace of one year or more, the reference period for measuring the outperformance should be of one year at least. The performance fee methodology should ensure that the same performance is not remunerated twice within this timeframe.

24. One fundamental principle linked to the performance fee is its proportionate nature, ie the methodology should seek to limit as much as possible unfair situations arising from two types of situations: (i) between investors contributing differently to the performance fee provision depending on their time experience in the fund, as well as (i) between the investors seen as a group and the asset management
company. In this respect, IOSCO Good practice 2 prescribes that in any event, a performance fee should respect the principle of equitable treatment of investors. Indeed, ESMA’s proposed Guidelines are meant to apply to UCITS, which operate very often through omnibus accounts and where it is not possible to attribute the exact performance experience of each investor on each one of his investments in the fund. Conversely, for funds with series accounting or equalisation accounting, each investor may be attributed the exact performance and be charged with the corresponding performance fee. As a consequence and depending on the market situation, type of strategy and investor turnover (effective holding period of investors), the lengthier the reference period, the more wealth transfers may occur between investors in the fund. Therefore, regarding more specifically the fund manager’s calibration of the reference period, which is one element among other parameters of the performance fee formula, there are several elements and concerns to take into consideration.

25. On the one hand, ESMA is right regarding the fact that the reference period calibration should safeguard the best interest of investors and allow that the performance fee be payable only in circumstances where positive (out)performance has been accrued during the period. This principle seeks that any underperformance or loss previously incurred should be recovered before a performance fee becomes payable.

26. On the other hand, a mandatory one-size fits all calibration of the length of the reference period would not sufficiently take into account the open-ended nature of UCITS that may have side effects as mentioned previously.

27. Therefore, depending on the performance fee model’s parameters and the specific open-ended fund conditions, the asset manager should take due care when setting parameters of the performance fee formula. More precisely, the global effect and key parameters such as the appropriate benchmark, the provisioning rate rigorous and fair application, the appropriate reference period reset, the proportionate effect with regard to the (out)performance generated, etc. should be given due consideration so as to ensure acting fairly in the best interest of investors. In any case, bearing in mind the overarching objective that the performance fee should effectively align investors and managers’ interests and be proportionate and fair to investors, resetting more frequently than one year would not be considered appropriate.

Disclosures

28. The SMSG encourages fair, clear and not-misleading disclosures relative to the performance fee model and its effects. Regarding the potential impact of the fee model on the fund, one or more simple scenarios included in the prospectus might be of help. The SMSG advises ESMA to clarify in the guidelines that the fund should include a prominent disclaimer in case of a relative positive performance model. In addition, investors should be highlighted all the types of fees of the fund, i.e the presence of a fixed fee and a performance fee.

29. The SMSG would like to highlight the important role of supervisors to ensure that performance fee models are appropriate, fair and proportionate. On the regulator’s demand, fund managers should be able to submit, with the fund’s authorisation file, a simulation of the main effects of the formula as well as the explanation of the rationale behind the choice of a particular benchmark/hurdle.

Scope
30. The SMSG advises ESMA to include retail AIFs in the scope of the Guidelines so as to ensure consistency of treatment on performance fees between UCITS and retail AIFs.

**Fund administrators**

31. The SMSG would like to highlight the importance of a rigorous implementation throughout the whole chain. We advise ESMA to add a principle clarifying that the models should be accurately described, unambiguous and non-discretionary so as to allow fund administrators to accurately apply the performance fees formulas.

V. **Concluding remarks**

32. The SMSG encourages ESMA to finalise these Guidelines so as to allow for pan-European convergence in the field of performance fee calculation. The SMSG agrees with the framework proposed by ESMA and the strong link with the IOSCO principles. The objective is to ensure, with sufficient detail but avoiding to be overly prescriptive, that the performance fee model allows for alignment of interest of asset managers and investors and that it is fair.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

Adopted on 14 November 2019

[signed]

Veerle Colaert

Chair

Securities and Markets Stakeholder Group