Performance fees in UCITS

Response to ESMA on its consultation on the guidelines

The Association of Investment Companies (AIC) is a trade body for the closed-ended investment company sector. We represent 362 investment companies, managing assets of over £182 billion as at 30 September 2019. The AIC's members are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

The AIC's members include investment trusts, Venture Capital Trusts, UK REITs and non-EU companies. Our non-EU members are primarily domiciled in Guernsey and Jersey.

For the purposes of this paper, investment companies are closed-ended collective investment funds which are Alternative Investment Funds (AIFs) within the meaning of the Alternative Investment Fund Managers Directive (AIFMD). They have their shares admitted to public stock markets. They have a corporate structure and are governed by independent boards of directors.

Investment companies pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return. Investments include listed securities, private equity, debt, property and infrastructure.

The AIC has set out its comments below to the consultation paper titled Guidelines on performance fees in UCITS, published by the European Securities and Markets Authority (ESMA) in July 2019.

Application of the proposed guidelines to AIFs

Whilst this consultation paper specifically focuses on performance fees in UCITS, question 13 asks whether the principles set out in the proposed guidelines should also be applied to AIFs in order to ensure equivalent standards in retail investor protection.

The AIC does not agree with any guidelines on performance fees being applied to AIFs, specifically to investment companies. This would not achieve ESMA's objective to ensure equivalent standards in retail investor protection.

AIC's position on performance fees

The AIC does not take a position on whether investment companies should use performance fees to incentivise the investment manager. Approximately half our members currently use performance fees. However, the use of performance fees has been declining in recent years.

Properly designed performance fees can be an appropriate tool to incentivise the investment manager and help improve returns to shareholders. The use of performance fees may also result in lower management fees.

Where performance fees are used, boards of investment companies take an active interest in their design. Directors oversee and keep such fees under review on an ongoing basis.

Features of investment companies

Investment companies provide similar economic outcomes to other collective investment funds but have several structural features that make them operationally different.

- Investment companies do not have customers. They have shareholders who are the owners of the company. Shareholders gain access to the fund by buying shares which are traded on a stock exchange, just like the shares of ordinary trading companies. Shares are bought and sold via regulated intermediaries, such as brokers;
- Typically, investment company boards are entirely comprised of non-executive directors;
- The directors have legal duties which are set out in company law. These include acting in the best interests of the company's shareholders as a whole;
- On behalf of shareholders, directors appoint third party service providers to carry out the day-to-day running of the company. This often includes appointing an external Alternative Investment Fund Manager (AIFM). Otherwise, an investment company may be internally managed, in which case it may be the AIFM itself;
- Many of the investment company's third party service providers are regulated entities. For example, the AIFM is a regulated entity under the AIFMD and is often also regulated under the Markets in Financial Instruments Directive (MiFID); and
- Major decisions affecting the company require the agreement of shareholders, such as making changes to the company's investment policy and the appointment or re-election of directors.

Protections available to shareholders

Fundamentally, the situation of a shareholder and a customer are different. Therefore, the accompanying rights and protection mechanisms are different.

Investors in investment companies own the company as shareholders, rather than being holders of units in the company. The senior management (the board) runs the company on their behalf. They face no inherent conflict between trying to generate a return for the shareholders and providing a service to customers.

Instead of being protected via typical investor protection fund rules, shareholders are protected through long-standing legal mechanisms set out in company law, market rules, and the UK Corporate Governance Code.

Responsibilities of the directors under company law

The legal duties and liabilities of a director are set out in UK company law. Company law makes no distinction between the duties of executive and non-executive directors.

A director owes "general duties" to the company. This means that only the company can enforce them. An example of this is that a director must "*act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*". This includes "*the need to act fairly as between the members of the company*". Additionally, directors must exercise reasonable care, skill and diligence.

A significant part of the role of the board of an investment company is to oversee its service providers. This includes reviewing the contractual arrangements with the investment manager and other service providers. It also ensures the service the company receives is commensurate with the costs it pays.

In certain circumstances, company law also provides a mechanism for shareholders to enforce these duties on behalf of the company.

Responsibilities of the directors under the corporate governance code

The board is collectively responsible for the long-term success of the company. The AIC Code of Corporate Governance (as endorsed by the UK Financial Reporting Council (FRC)) outlines the role of the board. This includes:

- Being responsible for the governance of the company notwithstanding any delegation of responsibilities to third parties;
- Demonstrating throughout their reporting how the governance of the company contributes to its long-term success and achieves the company's wider objectives;
- Maintaining effective and appropriate controls; and
- Ensuring effective and timely shareholder communication.

Outsourcing carries a certain level of risk for directors as they can only delegate the performance of tasks, not the responsibilities which accompany them.

Rights of shareholders

Investment companies afford their shareholders a level of participation that is usually not available to investors in other types of collective investment funds. When an investor buys a share in an investment company, they become a shareholder with the right to:

- Vote on matters raised at the company's annual general meeting;
- Table motions to be discussed;
- Call for extraordinary general meetings; and
- Vote in a new board of directors if they are not happy with the current one.

Shareholders exercise their rights collectively. Their rights are determined according to the rights associated with the class of security they hold. They have rights as shareholders not as customers.

Regulatory environment

The AIFMD places certain obligations on investment companies and their AIFMs over certain size thresholds (this includes the majority of investment companies). These conditions include:

- Appointing a depositary whose function it is to safeguard the assets of the company. The depositary must also ensure that the investment company's cash flows are monitored and payments, such as dividend income, are correctly received. For assets that are held in custody (e.g. equities and bonds) the depositary has strict liability for those assets, and they must be segregated and kept in a separate account. This enables them to be identified as belonging to the investment company;

  For assets that are not held in custody (e.g. derivatives, real estate and private equity instruments) the depositary must verify the ownership of the assets and maintain records of those assets. The depositary is appointed by the investment company, and it reports to the company.

- Having an independent valuation of the investments performed at least once a year. This could either be by the AIFM, which may be the investment manager, or an external valuer. The valuer is also required to have appropriate procedures so that a proper and independent valuation of the investment can be performed. The valuation function can only be performed by the AIFM if it is functionally independent from the portfolio management function and no conflicts of interest exist;

- Requiring the AIFM to have permanent risk management and compliance functions. These functions must have adequate risk management controls, procedures, and systems, which must be reviewed annually. Where proportionate, the AIFM must also have an internal audit function. The AIFM is required to have adequate systems in place to identify, manage, measure and monitor all the risks applicable to the investment fund's strategy. These rules formalise the risk management process.

Investment companies are subject to a variety of other rules including company law, the Listing Rules, Prospectus Rules, Disclosure Rules and Transparency Rules, Market Abuse Regulations, Shareholders Rights Directive and accounting standards.

Q1 Do you agree that greater standardisation in the field of funds' performance fees is desirable? What should be the goal of standardisation?

There may be a case for standardising performance fees of funds that do not have a corporate structure with the oversight of a board of directors.

However, for investment companies, which have boards of directors with legal duties to act in the best interests of shareholders, standardisation of performance fees is not desirable.

It is the role of the board to oversee the investment company and to ensure that the investment manager and other service providers are appropriately remunerated. Commercial fee negotiations are a matter of judgement for the board. It is not the role of the regulator to set parameters around these negotiations or to provide guidelines to standardise the remuneration model used to incentivise investment managers to generate greater returns for shareholders.

Provided that the existence of a possible performance fee is disclosed to investors and the methodology to calculate the performance fee is appropriately explained, the AIC does not advocate any greater standardisation in relation to performance fees for investment companies.

Q2 Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.

The AIC has no comment on this question.

Q3 What should be taken into consideration when assessing consistency between the index used to calculate the performance fees and the investment objectives, strategy and policy of the fund? Are there any specific indicators which should be considered (e.g.: historical volatility, asset allocation composition, etc.) to ensure this consistency? Please provide examples and give reasons for your answer.

Good practice 3 set out by the International Organization of Securities Commissions (IOSCO), in its Final Report on Good Practices for Fees and Expenses of Collective Investment Schemes, dated August 2016, (IOSCO paper) states that:

"*A performance fee should be consistent with the investment objectives of the CIS and should not create an incentive for the CIS operator to take excessive risks in the hope of increasing its own remuneration. To that end:*

- *The calculation of a performance fee should be verifiable and not open to the possibility of manipulation; in particular, the following items should be unambiguously determined:*
  - *how investment performance will be assessed (i.e. including or excluding subscription and redemption fees, etc.);*
  - *what reference benchmark will be used;*
  - *what the calculation formula will be (including a description, if applicable, of the method for offsetting gains against past losses).*
- *The frequency for crystallising the performance fee and transferring the amount earned in such fees to the CIS operator should not be more than once a year, except when the CIS operator uses a fulcrum fee model...*
- *Any benchmark to which the performance of the CIS is to be compared should be verifiable and provided by an independent party.*
- *CIS operators should design calculation methods allowing for the performance fee to result in a value that is proportionate to the investment performance of the CIS.*

Calculation methods should not deny investors an adequate share of the return achieved from the risks taken on their behalf and previously accepted by them."

This guideline is sufficient and appropriate. ESMA should not seek to further standardise the individual approaches funds may take to setting a performance fee. This will result in increased regulatory and time costs. It may also result in unintended consequences for investors.

Q4 What is the anticipated impact of the introduction of Guideline 3? Do you agree with setting a minimum crystallisation period of one year? Do you think this could help better aligning the interests of fund managers and investors? Please provide examples.

The AIC does not agree with ESMA's statement that:

> "*In principle, the minimum crystallisation period should be linked to the recommended holding period of the fund and the performance should ideally be charged to each investor when exiting the fund.*"

The IOSCO paper takes a more pragmatic stance and recognises that the impact of the performance fee will be felt differently by each investor depending on when they entered and exited the fund. IOSCO sets out the overriding principle that, "*In any event, a performance fee should respect the principle of equitable treatment of investors.*" This is appropriate.

The AIC does not agree with setting a minimum crystallisation period of one year for investment companies. As stated in our response to question 1 above, investment companies are governed by boards of directors with legal duties to shareholders. In these cases, commercial fee negotiations are a matter of judgement for the board. It is not the role of the regulator to set parameters around commercial negotiations by providing guidelines to standardise the remuneration model used to incentivise investment managers.

Q5 Are there any other models or methodologies currently employed that, in your view, should be exempted from this requirement? For example, do you think that the requirement of a minimum crystallisation period of 12 months should also apply to HWM models? Please provide examples on how these models achieve the objectives pursued by Guideline 3.

The AIC does not support the introduction of these Guidelines for investment companies.

Q6 In your view, should performance fees be charged only when the fund has achieved absolute positive performance? What expected financial impact (e.g. increase or decrease of the manager's remuneration or increase or decrease of the financial return for investors) would the proposed Guideline 4 have for you/the stakeholder(s) you represent? Are there models or methodologies currently employed where the approach set out in Guideline 4 would not be appropriate?

Introducing Guideline 4 is not appropriate for investment companies. ESMA's consultation paper recognises that, "*in [the] case of a benchmark model, a fund can achieve positive* *performance vis-à-vis its benchmark, notwithstanding that its net asset value may have declined (relative positive performance), or in absolute terms (absolute positive performance).”*

The IOSCO paper provides a more appropriate solution. It states:

> "*CIS operators should design calculation methods allowing for the performance fee to result in a value that is proportionate to the investment performance of the CIS. Calculation methods should not deny investors an adequate share of the return achieved from the risks taken on their behalf and previously accepted by them.*"

As stated in our response to question 1 above, commercial fee negotiations are a matter of judgement for the boards of investment companies. It is not the role of the regulator to set parameters around commercial negotiations by providing guidelines to standardise the remuneration model used to incentivise investment managers.

Q7 If the performance fee model that you currently use provides for performance fees to be payable in times of negative returns, is a prominent warning on this provided to investors in the legal and marketing documents of the fund? If not, should this be provided? Please give examples for your answer and details on how the best interests of investors are safeguarded.

The AIC has no comment on this question.

Q8 What are your views on setting a performance reference period for the purpose of resetting the HWM? What should be taken into account when setting the performance reference period? Should this period be defined, for example, based on the whole life of the fund (starting from the fund's inception date), the recommended holding period of the investor or the investment horizon as stated in the prospectus? Please provide examples and reasons for your answer.

The AIC does not agree with ESMA setting any guidelines regarding the performance reference period for the purpose of resetting the high-water mark (HWM) for investment companies.

The performance reference period is a matter for the board of an investment company to negotiate with the investment manager. It is not the role of the regulator to set parameters around these negotiations.

Please also see our response to question 4 above.

Q9 Alternatively, would it be possible to envisage predefined time horizons for the purpose of resetting the HWM, such as 3 or 5 years? Please provide examples and details on what you think would be the best practice in order to better align the interests of fund managers and investors.

Please see our response to question 8 above.

Q10 How long do you think the performance reference period should be for performance fee models based on a benchmark index? What should be taken into account when setting the performance reference period for a performance fee benchmark model? Would it be possible to envisage predefined time horizons for the purpose of resetting the performance fee based on a benchmark, such as 3 or 5 years? Please provide examples and details on what you think would be the best practice in order to better align the interests of fund managers and investors.

Please see our response to question 8 above.

Q11 Alternatively, do you think the performance reference period should coincide with the minimum crystallisation period or should it be longer/shorter? Please provide examples and reasons for your answer.

Please see our response to question 8 above.

Q12 What are your views on when the Guidelines should become applicable? How much time would managers require to adapt existing fee mechanisms to comply with the requirements of these Guidelines?

The AIC does not support the introduction of these Guidelines for investment companies. Please see our comments in the opening section and our response to question 1 above for more detail.

Q13 Do you consider that the principles set out in the Guidelines should be applied also to AIFs marketed to retail investors in order to ensure equivalent standards in retail investor protection? Please provide reasons.

The AIC does not agree that these Guidelines should apply to investment companies. Please see our comments in the opening section and our response to question 1 above for more detail.

Q14 Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits as regards the consistency between the performance fees model and the fund's investment objective? What other types of costs or benefits would you consider in this context? Please provide quantitative figures, where available.

The AIC has no comment on this question.

Q15 In relation to Guideline 2, do you think that models of performance fee without a hurdle rate, or with a hurdle rate not linked to the investment objective (but clearly stated in the offering documents), should be permissible? For example, do you think that equity funds with a performance fee linked to EONIA, or a performance fee which is accrued as long as there are positive returns, should be allowed? Please give examples and reasons for your answer.

Such models should be permissible for investment companies. The structure of performance fees is a matter of judgement for the board of an investment company. As set out above, it is not the role of the regulator to set parameters around commercial negotiations by providing guidelines to standardise the remuneration model used to incentivise investment managers. This will result in increased regulatory and time costs. It may also result in unintended consequences for investors.

Provided that the existence of a possible performance fee is disclosed to shareholders and the methodology to calculate the performance fee is appropriately explained, the AIC **recommends** that performance fee models without a hurdle rate, or with a hurdle rate not linked to the investment objective, should be permissible for investment companies.

Q16 What additional costs and benefits would compliance with the proposed Guideline bring to you/the stakeholder(s) you represent? Please provide quantitative figures, where available.

The AIC has no comment on this question.

Q17 What is the anticipated impact from the introduction of this proposed Guideline? Are there models or methodologies currently employed where this Guideline would not be appropriate? If so, please provide examples of these and details of how the best interests of investors are safeguarded.

Guideline 4 recommends that a performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period.

However, as identified in ESMA's consultation paper:

> *"… in the case of a benchmark model, a fund can achieve positive performance vis-à-vis its benchmark, notwithstanding that its net asset value may have declined (relative positive performance), or in absolute terms (absolute positive performance)."*

This can be an appropriate model. As set out above, the structure of performance fees is a matter of judgement for the boards of investment companies. Please see our response to question 15 for more information.

Q18 What additional costs and benefits would compliance with the proposed Guideline bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

The AIC has no comment on this question.

Q19 Which other types of costs or benefits would you consider in the disclosure of the performance fees model? Please provide quantitative figures, where available.

The AIC has no comment on this question.

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To discuss the issues raised in this paper please contact:
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