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| Response Form to the Consultation Paper  |
| Guidelines on performance fees in UCITS  |

**Responding to this paper**

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all comments received by **31/10/2019.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

**Instructions**

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Please do not remove tags of the type <ESMA\_QUESTION\_PFG\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
3. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
4. When you have drafted your response, name your response form according to the following convention: ESMA\_PFG\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_PFG\_ABCD\_RESPONSEFORM.
5. Upload the form containing your responses, in Word format, to ESMA’s website ([www.esma.europa.eu](http://www.esma.europa.eu) under the heading “Your input – Open consultations” 🡪 “Consultation on Position limits and position management in commodities derivatives”).

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/legal-notice).

**Who should read this paper**

This document will be of interest to asset managers managing retail funds and their trade associations, as well as institutional and retail investors investing into such funds and their associations.

**General information about respondent**

|  |  |
| --- | --- |
| Name of the company / organisation | BETTER FINANCE – the European Federation of Investors and Financial Services Users |
| Activity | Non-financial counterparty |
| Are you representing an association? |[x]
| Country/Region | BELGIUM - EU |

**Introduction**

***Please make your introductory comments below, if any***

<ESMA\_COMMENT\_PFG\_1> BETTER FINANCE, the European Federation of Investors and Financial Services Users, welcomes the recent efforts of ESMA to clarify and harmonise across the EU the provisions and supervisory practices on the management and transparency of information concerning UCITS and AIF funds, and in particular the current proposal to codify uniform rules applicable to performance fees.

The UCITS is the most popular and used legal form of mutual investment funds in the EU distributed to the retail sector, with more than 75% share among other collective investment schemes.[[1]](#footnote-2) In addition, in markets such as Germany, UK, Netherlands and France, AIFs are in higher proportions sold to the retail sector, although the target clients should be professional (institutional) ones.[[2]](#footnote-3) As such, clarifying the rules applicable to organisational requirements, conduct of business and disclosure of information for UCITS and AIFs is timely to improve investor protection.

ESMA’s [update on the Questions & Answers for the Application of the UCITS Directive](https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits),[[3]](#footnote-4) concerning the disclosure obligation of the benchmark (investment objectives and past performance) in the Key Investor Information Document (KIID) represented a great step ahead[[4]](#footnote-5) both for information disclosure and proper management of UCITS and, where applicable, for AIFs.

As it also concerns a key information for the retail investor that is presented separately in the KIID, and on many occasions intrinsically tied to the management in relation to a benchmark, the proposal to codify harmonized rules with regards to performance fees models is timely. For legal certainty and better regulation, all provisions that make up the legal regime applicable to UCITS – dispersed through level 1 Directives, level 2 Regulations, Guidelines and Q&As - must be aligned and consistent with one another. Moreover, based on ESMA’s mapping exercise on current practices and supervisory approaches of national competent authorities (NCAs) in the EEA, it is evident that the cross-border distribution of UCITS and retail investors would very much benefit from minimum clear rules on how and when can asset managers charge performance fees.

With regards to the structure of the Guidelines, BETTER FINANCE agrees with the bi-dimensional approach: establishing general principles that guide the implementation of the rules and the supervisory functions of NCAs on one hand, and the actual provisions and limits for UCITS management companies on the other hand.

All other comments concerning these guidelines – legal instrument chosen, substance of principles and rules, applicability – will be elaborated under each corresponding section and question.

BETTER FINANCE, as a representative of retail investors (among others) encourages ESMA to continue unabated on this trend to enhance supervision of retail investment funds in the EU and harmonise the applicable rules for investor protection as these constitute one of the founding pillars of a strong and competitive Capital Markets Union that works for the EU citizens. <ESMA\_COMMENT\_PFG\_1>

**Questions**

1. : Do you agree that greater standardisation in the field of funds’ performance fees is desirable? What should be the goal of standardisation?

<ESMA\_QUESTION\_PFG\_1>

A variety of fee structures and models stimulates competition, but too much complexity creates the disadvantage of no longer being understandable and transparent and the risk of even breaching investor protection principles and rules. Therefore, a clear regulatory framework surrounding performance fees is needed in order to ensure proper supervision, as well as public and private enforcement and ensure better and more consistent fund investor protection in the EU.

The ESMA mapping exercise of practices and regulatory approaches speaks for itself with regards to the need for standardization. The fact that in one EU jurisdiction there is no clear answer on whether performance fees are allowed or not, the lack of a legal definition in more than a half of EU Member States, the divergent rules on disclosure requirements, computation methods and consistency between the performance fee model and the investment objectives lead to:

* an uneven playing field between providers and regulatory barriers for the cross-border distribution of UCITS;
* confusion and legal uncertainty for retail investors concerning their safeguards; and
* ultimately, different standards of investor protection across the EU.

An integrated Single Market for financial services must ensure the same conditions for the operation of UCITS and the same legal protection regime for individual and retail investors. In addition, the application of a protection standard should not be up to the discretionary power of local NCAs.

The use of Guidelines pursuant to Article 16 of the founding regulations (for ESMA, EIOPA, and EBA) is commendable as it is the maximal use of own powers by ESMA. However, NCAs are subject to a “comply or explain” principle with regards to these Guidelines, resulting in an arbitrary decision of whether to transpose the provisions or not. Therefore, with regards to the choice of legal instruments, and considering the need for standardization justified by internal market and investor protection concerns, ESMA should have attempted to propose Regulatory or Implementing Technical Standards to the European Commission to be adopted as a delegated regulation pursuant to the UCITS V Directive and Article 290 TFEU.

A Level 2 instrument under the form of a regulation in this field does not necessarily entail maximum harmonization, but what is indeed needed to achieve is to ensure a high level of and consistent investor protection and competitive standards across all jurisdictions of the EU.

In addition, BETTER FINANCE will lay down several specific comments that cannot be introduced under any of their corresponding sections or questions below.

With regards to the scope of application of these Guidelines, considering that a large proportion of Alternative Investment Funds (AIFs) are distributed to the retail sector – either directly or through packaged investments, such as multi-option insurance-based investment products (IBIPs) and that, in some jurisdictions (such as France) AIF managers are subject to the application of the KIID Regulation for UCITS, BETTER FINANCE firmly advises ESMA to extend the material scope of these Guidelines to all AIFs sold to the retail sector, either directly or indirectly. In order to circumstantiate for indirect selling of AIFs, ESMA should specify that whenever a retail investment product (such as a company pension plan, a life-insurance product or other IBIPs) offer underlying investments in AIF units to the retail sector, AIF managers should be required to comply with these provisions.

With regards to the general principles, ESMA has duly and correctly identified several important investor protection rules, such as the obligation to act honestly and fairly and in the best interest of the UCITS, with due skill, care and diligence. These rules are already applicable in the Level 2 Directive but should be pinpointed under the general principles of these Guidelines in order to reinforce them and clarify that they should pre-empt application of any other provisions.

<ESMA\_QUESTION\_PFG\_1>

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

<ESMA\_QUESTION\_PFG\_2>

BETTER FINANCE has not identified any obstacles for standardization and a higher level of consumer protection in this field that could/should be removed by regulatory action. Moreover, it falls clearly under ESMA’s competence to issue such Guidelines as it concerns cross-border provision of UCITS and internal market rules harmonization.

<ESMA\_QUESTION\_PFG\_2>

1. : 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 (eg: historical volatility, asset allocation composition, etc.) to ensure this consistency? Please provide examples and give reasons for your answer.

<ESMA\_QUESTION\_PFG\_3>

BETTER FINANCE fully agrees with ESMA in ensuring that the investment objectives, strategy and policy of the UCITS must allow, in essence, a fund manager to charge a performance fee. One firm example BETTER FINANCE has identified in support of this argument and policy proposal is that of (potentially closet) index-tracking funds[[5]](#footnote-6).

However, ESMA should clarify, first, that **certain UCITS and AIFs** (from an investment objectives, strategy and policy point of view) **are not compatible with a performance fee model**.

BETTER FINANCE research has shown that a myriad of funds actually tracking the performance of a market index benchmark were charging a performance fee for generating returns higher than that of the benchmark. BETTER FINANCE believes that in circumstances such as:

* a fund has an index-tracking objective, seeking to perform as close as possible to the market index benchmark;
* a fund is not managed in relation to any benchmark and its performances are not related in any way,

it would be a breach of investor protection rules to allow a performance fee to be charged. The list provided above is not exhaustive but has an exemplificative role.

Secondly, in circumstances where it would be considered fair that a UCITS or AIF can charge a performance fee, ESMA should not necessarily consider an exhaustive list, but a more holistic approach in determining whether the index is appropriate or not for calculating the performance fee. A strict assessment of any of the elements put forward by ESMA (such as historical volatility or asset allocation) may lead to circumvention of the purpose of these Guidelines.

Considering the variety of types of UCITS and AIFs – from a benchmark point of view – it would be difficult for ESMA to identify or categorise all elements to be taken into account.

A first proposal is to take the examples from the March 2019 Q&As on UCITS, with regards to the benchmark, and indicate that the benchmark mentioned in either Section 1, 2 or 3 of the KIID – the one in relation to which the fund is managed – is the only valid basis for calculating the performance fee.

In circumstances where the fund is validly not managed in relation to a benchmark as indicated above, the UCITS and AIF manager should dispose of more freedom at hand, provided that the performance fee model and the index is in essence not contradictory to the objectives and investment policy of the fund.

<ESMA\_QUESTION\_PFG\_3>

1. : 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.

<ESMA\_QUESTION\_PFG\_4>

BETTER FINANCE agrees with ESMA’s proposal to set the minimum crystallization period of at least one year.

<ESMA\_QUESTION\_PFG\_4>

1. : 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.

<ESMA\_QUESTION\_PFG\_5>

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<ESMA\_QUESTION\_PFG\_5>

1. : 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?

<ESMA\_QUESTION\_PFG\_6>

TYPE As a matter of principle, observing the rules on acting fairly and in the best interest of the UCITS and its beneficial owners, UCITS managers charging performance fees should mirror the performance fee mechanism also for underperformance or negative performances, as it happens under the *fulcrum fee* model.

Performance fees should incentivise managers to take the appropriate level of risk in order achieve the investment objectives of the fund and, if possible, generate an additional return for the benefit of investors, while not jeopardizing their savings.

A recently published study shows the detrimental effects of performance fees for retail investors, which constitutes all the more reason for a stricter regulation. On average 7% of all EU[[6]](#footnote-7) equity mutual funds charged performance fees, but the majority have underperformed funds without a performance fee by 0.5% to 0.6% per year during 2001 and 2011, mainly attributed to unsuitable reference indicators (no stochastic benchmark or a benchmark that is very easy to beat).[[7]](#footnote-8)

**From the point of view of investor protection, the most concerning finding of the abovementioned study is that some fund managers change the contractual terms (performance fee model) in order to adjust to poor performances so that “*it becomes easier to earn performance fees in the future*”.**[[8]](#footnote-9)

What is more, according to the pre-cited study, the total expense ratio (TER) of performance-fee funds is, on average, 0.3% to 0.35% higher than that of funds without one, but unfortunately it doesn’t translate in higher excess returns**. In short, the equity funds that charge a performance fee are more expensive in net terms and perform worse than those who don’t, actually leaving the retail investor worse off than if no contractual incentive was offered to the asset manager.** Other studies have shown that performance-fee funds can result in an increase of annual charges for the retail investor between 26% and 199%.[[9]](#footnote-10)

However, since neither at EU level, nor at national level (with a few exceptions) there are regulatory limits/caps on performance fees, nor guidelines as to the proportion of the latter, ESMA must ensure that the interests of retail investors are protected by obliging UCITS managers to reduce proportionally the management fee in case of underperformance or negative performance during a reference period.

Retail investors do not have the resources (knowledge, financial, expertise) or the negotiation power to ensure such fair treatment and balance of interests between the fund investors and the UCITS manager. Moreover, as research shows, on many occasions retail investors do not have such opportunity, as they are sold packaged products with underlying investments in UCITS and AIFs.

Neither active, nor passive management imply any promises or guarantees on the asset manager as to the results to be achieved, but retail investors pay management fees (in addition to others) in order to be delivered the investment objective of the fund. Performance fees appear as an exceptional reward for UCITS managers for exceptional returns over the reference period, in addition to reaching the investment objective.

Therefore, it falls under the fair treatment of investors to penalize the UCITS manager if the investment objective is not reached during the same reference period and in the same proportions as the performance fee, should the latter be applicable.

Guideline 4 builds a regulatory and supervisory approach in this direction by requiring recovery of losses in the reference period before the performance fee is payable. BETTER FINANCE believes that a general principle and an addition to Guideline 4, specifying that where a performance fee is charged for exceptional performance, a reduction of the management fee will be applied where the opposite is achieved, would be fit for purpose and much better align the interests of the UCITS manager and that of the UCITS investors.

In our view, this addition will not disincentivize at all risk-capital and risk taking in investment funds (for instance, for investment funds that have a high risk and reward profile and for which high losses are part of the “game”) as UCITS managers can simply refrain from charging a performance fee in addition to the management fee as remuneration.

The sustainable finance and ESG movement at EU level look very closely at corporate governance practices and remuneration standards for issuing companies. Since UCITS and AIFs present many organic similarities with the relationship between an issuer and its shareholders, it would be only consistent with the initiatives and principles taken at EU secondary law level to impose such a “mirroring” rule.

Good practice examples – both from closed-ended investment funds and from UCITS ETFs – show that asset managers charge no management fee if the investment objective is met, but charge a performance fee on returns achieved above a certain benchmark.

Moreover, we believe that this rule is part of the informal “skin in the game” principle that should be applied to financial services providers and product manufacturers in capital markets in order to stimulate better returns for investors and the EU economy.

It is up to ESMA to ascertain the best wording for such a principle and for the extension of Guideline 4. Nevertheless, BETTER FINANCE proposes the following addition to Guideline 4:

**Guideline 4 – Negative performance (loss) recovery**

“*22 (new). UCITS and AIF managers charging a performance fee, in line with the rules on reference periods, crystallization and calculation methodologies set out in these Guidelines, must replicate the mechanisms with regard to negative or underperformance of the UCITS or AIF, while observing the provisions of the following paragraphs.*”

Moreover, BETTER FINANCE is very happy to observe many justifications and proposals put forward by ESMA on its own motion that correctly identify and remedy practices that infringe on investor protection rules, such as:

* paragraphs 12-14 of Guideline 1;
* paragraph 15 and 18 of Guideline 2;
* paragraph 17 of Guideline 2, which is consistent with the latest ESMA Q&As on UCITS with regards to the reference benchmark;
* paragraphs 26-27 of Guideline 5.

BETTER FINANCE, as a representative of retail investors in UCITS and AIFs, fully endorses the aforementioned provisions.

<ESMA\_QUESTION\_PFG\_6>

1. : 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.

<ESMA\_QUESTION\_PFG\_7>

The most important rule for investor protection and, at the same time a factor for increasing trust in the financial industry, is simple, clear and prominent disclosure of key information. “Times of negative return” is not per se a justification to charge more

The mechanisms for performance fees by essence apply even in “times of negative returns”, i.e. when the fund performs better than the reference indicator (e.g. market index benchmark decreases 10% and the fund only 8%).

Therefore, a prominent warning on this aspect would fall in line with the MiFID II Article 24 on *fair, clear, and not misleading information* to be provided to investors and should be in all cases mandatory.

<ESMA\_QUESTION\_PFG\_7>

1. : 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.

<ESMA\_QUESTION\_PFG\_8>

We agree in principle with a reference period after which the High Water Mark should be reset, but ESMA should bear in mind that most retail investors have an investment objective, investment horizon, and are recommended to hold the investment a certain period and what matters, in the end, is the cumulative performance of the fund.

Therefore, the reference period for resetting the High-Water Mark should be sufficiently long as to ensure that investors do not end up paying twice or more performance fees for an overall low performance, as exemplified in the graph below.

1y

2yy

*Source*: BETTER FINANCE own composition; the performance is not real, but has an exemplificative nature; HWM = High-Water Mark

For these reasons, BETTER FINANCE advises ESMA to impose the High-Water Mark over at least the previous 5 years in order to ensure that UCITS and AIF investors do not pay any performance fee is the fund has in overall underperformed in the reference period. With respect to this proposal, we refer to the 2018 Model Cost Clauses of the German supervisory authority (Bundesanstalt für Finanzdienstleistungsaufsicht)[[10]](#footnote-11) which sets the High-Water Mark rule:

* over the previous five reference periods, for performance fees charged in relation to a performance tied to a market index benchmark;
* over the previous five reference periods, with or without a hurdle rate, if the performance fee is not related to a market index benchmark; and
* over the previous five reference periods, if the performance fee is calculated in reference to a money market index.

Therefore, in all circumstances permitted by BaFin, performance fees are not allowed if the value of the fund at the current reference period does not exceed the highest value of the fund at the end of the fifth past reference period. It is up to fund managers to determine the reference period, which cannot be shorter than one year.

In addition, the study mentioned earlier[[11]](#footnote-12) found that 44% of the EU-, Norwegian-, and Swiss-domiciled equity mutual funds that use a performance fee model have a High-Water Mark, but only 29% have a permanent HWM, meaning that a performance fee cannot be charged if the fund does not reach an “all-time high”. A significant proportion (15%) simply use a hurdle rate, which exposes investors to unduly paying performance fees. The median accrual frequency for the funds under research was 1 day and the median crystallization period was 365 days.

<ESMA\_QUESTION\_PFG\_8>

1. : 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.

<ESMA\_QUESTION\_PFG\_9>

As indicated for Question 8 above, BETTER FINANCE strongly advises ESMA to impose a standardized reference period for resetting the High-Water Mark at 5 years. In this light, we believe that the regulatory and supervisory practice of BaFin should be considered as a good practice, next to the IOSCO Guidelines.

Alternatively, ESMA could consider to impose the length of the reference period for the purpose of resetting the High-Water Mark the same as the recommended holding period for the retail investor, as described in the Key Investor Information Document (KIID) in order to be aligned with the investment objectives and horizon of the fund. In this way, the reference period would be neither too long, nor too short, for the UCITS or AIF manager.

<ESMA\_QUESTION\_PFG\_9>

1. : 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.

<ESMA\_QUESTION\_PFG\_10>

The reference period is crucial in building a fair performance fee model and must be analysed from the retail investor’s point of view, in light of the rules of suitability of advice and providing fair, clear, and not misleading information.

Retail investors should receive **suitable** investment advice to invest in UCITS that are aligned with their risk profile and **investment horizon**. Therefore, the purpose of investment for the retail saver is that the fund reaches its investment objective at the end of the recommended holding period, which should be aligned with his investment horizon.

Therefore, rewarding the UCITS or AIF manager for overperformance should be done only for overall exceptional returns at the end of the recommended holding period. To achieve this, the reference period to base performance fee models on should be the same as the recommended holding period described in the UCITSs’ or AIFs’ Prospectuses or KIIDs.

Only by aligning the recommended holding period with the reference period will a fair balance be struck between the fund investors’ interests and those of the asset managers. However, ESMA should consider the highly divergent – and sometimes inconsistent – recommended holding periods of certain UCITS and AIF in comparison with their investment objectives.

In particular, since there is no regulatory prescription on how to set or understand the recommended holding period, BETTER FINANCE’s research has shown that:

* some UCITS indicate arbitrarily a recommended holding period, not aligned with the long-term objectives of the fund;
* some UCITS or even PRIIPs indicate the recommended holding period as the time-frame necessary for the investor to hold his investment in order to benefit from tax breaks.

In this light, ESMA should consider also clarifying the rules and criteria with regards to recommended holding periods.

Therefore, BETTER FINANCE proposes to ESMA adding the following to Guideline 1:

**Guideline 1 - Performance fee calculation method**

11. The performance fee calculation method should include, at least, the following elements:

[…]

c) the performance reference period at the end of which the mechanism for compensating for past underperformance or negative performance can be reset, “*which must be the same as the recommended holding period indicated in the Key Investor Information Document (KIID) pursuant to Article 7(2)(f) of Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website*. *If the RHP is longer than one year, this calculation can be done on a rolling basis.*”

<ESMA\_QUESTION\_PFG\_10>

1. : 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.

<ESMA\_QUESTION\_PFG\_11>

ESMA rightly identified that the minimum crystallization period should be equal to the recommended holding period (para 18) and should avoid rewarding the UCITS or AIF manager due to short-term overperformances explainable by random market factors (para 20).

For clarity and legal certainty, BETTER FINANCE agrees with the proposal of ESMA that the recommended holding period should be equal to the minimum crystallization period. In addition, in line with the argumentation provided above with regards to the reference period and the High-Water Mark, which should be equal to the recommended holding period, it follows logically that the all three concepts have the same role and purpose for the performance fee model and should, therefore, be equal.

ESMA should consider simplifying the Guidelines and equivalize the three concepts in specifying that the fund manager must choose a recommended holding period for the purpose of:

* correctly identifying that a UCITS or AIF is suitable for the retail investor from the time horizon point of view; and
* for fairly applying and calculating the performance fee.

ESMA should consider adding the following to Guideline 1:

**Guideline 1 - Performance fee calculation method**

11. The performance fee calculation method should include, at least, the following elements:

[…]

b) the crystallisation period within which the performance fee, if any, is accrued, “*which must be the same as the recommended holding period of the fund indicated in the Key Investor Information Document (KIID) pursuant to Article 7(2)(f) of Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website*,” and a crystallisation date, “*representing* ~~coinciding with~~ ” the end of the crystallisation period and “*coinciding with the end of the recommended holding period*” at which the performance fee is crystallised and credited to the management company. *If the RHP is longer than one year, this calculation can be done also on a rolling basis.*”

<ESMA\_QUESTION\_PFG\_11>

1. : 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?

<ESMA\_QUESTION\_PFG\_12>

BETTER FINANCE believes that the Guidelines should become applicable as soon as the implementation period by NCAs has ended. Considering the risks for the level playing field in the cross-border distribution of UCITS and AIFs and those posed to investor protection principles, all UCITS and AIF managers should revise their performance fee models and the corresponding disclosure documents (Prospectus or Rules of Incorporation, and the KIID) in a **delay of 2 months** from the entry into force for all types of UCITS and AIFs (paragraphs 31 and 32 of *Transitional provisions*).

BETTER FINANCE believes that the Guidelines are sufficiently clear and simple so as to not impose too much compliance effort from UCITS and AIF managers.

<ESMA\_QUESTION\_PFG\_12>

1. : 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.

<ESMA\_QUESTION\_PFG\_13>

Yes, BETTER FINANCE believes the Guidelines should also be applied to AIFs marketed to retail investors or used for retail investment products, such as Multi-Option Products.

<ESMA\_QUESTION\_PFG\_13>

1. : 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.

<ESMA\_QUESTION\_PFG\_14>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_PFG\_14>

1. : 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.

<ESMA\_QUESTION\_PFG\_15>

BETTER FINANCE strongly advises against these models and suggests ESMA to ban them on the basis of the argumentation provided for Question 3 above. The reference indicator must be aligned with the investment objective and strategy of the fund, whereas the example given (EONIA for an equity fund) is very diasligned and detrimental for retail investors.

Accruals of performance fees without the High-Water Mark over the past five years or reference periods (whichever is longer) is detrimental to the rights and interests of UCITS and AIF fund investors. The rationale is provided in the answer for Question 7 above.

<ESMA\_QUESTION\_PFG\_15>

1. : 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.

<ESMA\_QUESTION\_PFG\_16>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_PFG\_16>

1. : 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.

<ESMA\_QUESTION\_PFG\_17>

BETTER FINANCE’s study on *Closet Indexing*, and the follow-up on *Benchmark Disclosure Compliance report*, has identified a significant number of **actively managed *equity* funds** that used indices that where not aligned with the investment objectives and policy of the fund, for instance money market indices as reference indicators for the purpose of calculating the performance fee.

As in the example given by ESMA, but many others identified by BETTER FINANCE, a money market index reflects short-term strategies and considerably lower yields than an equity index, thus artificially creating the impression for retail investors that the fund is overperforming. The same rationale for artificial increases of the Net Asset Value (NAV), as is with the cases of net positive inflows due to new subscriptions, albeit negative returns on investments (para 12 of Guideline 1) should be applied in this hypothesis as well.

The reference indicator must reflect the risk -free rate and risk premia specific for the assets held by the fund, in which case a bond fund should be benchmarked and evaluated against a bond fund, an equity fund to an equity index and so forth.

Moreover, the geographic or sectorial focus are also an element to be considered. As indicated for Question 3 above, a fund investing in U.S. equities cannot be benchmarked and evaluated (from a performance fee point of view) with a German large-cap index.

The ESMA Guidelines must ensure symmetry between the evaluation (and reward) models and the investment objective disclosed to the retail investor in order to achieve reliable and clear information in the pre-contractual disclosure documents

<ESMA\_QUESTION\_PFG\_17>

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

<ESMA\_QUESTION\_PFG\_18>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_PFG\_18>

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

<ESMA\_QUESTION\_PFG\_19>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_PFG\_19>

1. <https://ec.europa.eu/info/business-economy-euro/growth-and-investment/investment-funds_ro>. [↑](#footnote-ref-2)
2. ESMA Annual Statistical Report: EU Alternative Investment Funds – 2019, 7 March 2019, ESMA50-165-748. [↑](#footnote-ref-3)
3. ESMA Q&As clarify benchmark disclosure obligations for UCITS – 29 March 2019, <https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits>. [↑](#footnote-ref-4)
4. See BETTER FINANCE blogpost [↑](#footnote-ref-5)
5. <https://betterfinance.eu/wp-content/uploads/publications/EN_-_Press_Release_and_Annexes_2_3_-_Better_Finance_replication_of_ESMA_study_on_Closet_Indexing.pdf>. [↑](#footnote-ref-6)
6. plus Norway and Switzerland. [↑](#footnote-ref-7)
7. Kari Sigurdsson, Henri Servaes, ‘The Costs and Benefits of Performance Fees in Mutual Funds’ (December 2018) ECGI Finance Working Paper No. 588/2018, available at <https://ecgi.global/sites/default/files/working_papers/documents/finalservaessigurdsson.pdf>. [↑](#footnote-ref-8)
8. Ibid, page 31. [↑](#footnote-ref-9)
9. *Which?* Magazine, July 2012 issue, ‘Fair Game?’ on performance fees, pp. 14-17, page 16. [↑](#footnote-ref-10)
10. BaFin-Musterbausteine für Kostenklauseln offener, Publikumsinvestmentvermögen, (ohne Immobilien-Sondervermögen), Stand 20.06.2018 - <https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2018/meldung_180222_Kon_Musterbausteine.html>. [↑](#footnote-ref-11)
11. Sigurdsson, Servaes (n 5), page 38. [↑](#footnote-ref-12)