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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 | Morningstar |
| Activity | Other Financial service providers |
| Are you representing an association? |[ ]
| Country/Region | International |

**Introduction**

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

<ESMA\_COMMENT\_PFG\_1>

Morningstar welcomes the opportunity to respond to the Consultation Paper 34-39-881 on Performance Fee Guidelines. Morningstar’s primary mission is to help investors reach their financial goals. Because we offer an extensive line of products for individual investors, professional financial advisers, and institutional clients, we have a broad view on the proposals to improve the structure, disclosure and comparability of performance fee structures for investors.

We hope the response is helpful, and we would be happy to discuss it with you further.

Yours sincerely,

Andy Pettit

Director, Policy Research

<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>

Yes, we agree. The goals of greater standardisation should be to provide direct benefits to investors by making it much easier to

1. compare the terms of performance fees levied by different funds in order that they may assess whether they consider it fair and reasonable
2. understand the lower and upper (if any) cost of investing in fund share classes that are using performance fees
3. evaluate their fairness and potential cost

Standardisation doesn’t necessarily have to extend defining or permitting certain types of performance fee structures, or to inhibit new innovative fee structures. A clear table, providing the following key attributes would provide much needed clarity to investors and transparency from UCITS.

|  |  |
| --- | --- |
| Base Management Fee | 0.90% |
| Performance Fee | 20% |
| Hurdle | 0.90% |
| Benchmark | FTSE 100 |
| High-water mark(Absolute, Relative, None) | YesAbsolute |
| Crystallisation period | 3 Years |
| Date HWM last reached | D/M/Y |
| Ability to Reset HWM | No |
| Date of last reset to HWM | N/A |
| Fee Cap | 2.50% |

Regardless of the level of standardisation it would be helpful for investors if the terms of performance fees were explained in simple language, like the over-arching requirements of both the UCITS KIID and PRIIPs KID. Prospectus explanations are often long, technical and complex for even professional investors or analysts to interpret. We will be happy to provide examples from our database if that will be of further help.

Supplementing these textual explanations with worked examples that illustrate what the fees would be in different scenarios would provide helpful additional information.

<ESMA\_QUESTION\_PFG\_1>

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

<ESMA\_QUESTION\_PFG\_2>

Clearer and more complete disclosure would be the most positive development, prior to considering the need for more detailed and specific regulation.

Standardisation should extend to ensure all performance fees are calculated on net returns i.e. after deduction of other costs, to prevent fees being charged in part on other fees. In the absence of this criteria, that fact should also be added to the above table.

<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>

The selection of an appropriate benchmark is vital when it comes to assessing fund performance and critical in the case of setting performance fees. The starting factor is that the chosen index is reflective of the investable universe that a UCITS specifies in its KIID investment objective – factors such as the types of security, geography, currency, market-cap. Secondly, the index should as far as possible be calculated on an equivalent basis to the UCITS, in terms of currency, hedging policy and dividend income.

The use of benchmarks that do not fulfill these basic requirements will result in funds potentially receiving additional fees from investors regardless of how well they have met their stated investment objective. The worst examples of this are equity funds that levy a performance fee on any positive, or cash+, return.

The correlation and best fit of a subset of indices meeting the above criteria should be considered in making the final selection. This would tend toward using indices that have an established track record, or reliable back-tested data, and ideally be calculated by an independent provider than in-house by the fund firm.

Lastly, where a manager’s remuneration is in part based on their performance relative to a benchmark, it is worth considering a requirement to report where that benchmark differs from the one on which the funds’ performance fee is based.

<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>

The anticipated impact of guideline 3 would be the prevention of managers collecting intra-year fees based upon a single strong short-term return, regardless of the UCITS performance over a full year or more.

1 year is a reasonable minimum crystallisation period, providing a balance for those funds whose primary fee income is in the form of the performance fee. While aligning it with the funds financial year-end may be neat, we see no specific benefits to requiring this.

Consideration should also be given to ensuring the crystallisation date and period are the same for all share classes of a UCITS that levy the performance fee. The first crystallisation may therefore be greater than one year after the inception of a share class.

With UCITS increasingly using synthetic performance to provide indicative past performance information for young share classes, for example, as allowed for in the October 2019 PRIIPs consultation issued by the European Supervisory Authorities, it is important that the historic pricing records of a donating share class are consistent with the actual prices of the receiving share class.

<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>

In our view no models should be exempted from this requirement.

<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>

Where performance fees are operated on a basis that is equitable to both investors and a UCITS, a performance fee should not be confined to levying a performance fee only on absolute positive performance. For instance, if a UCITS structures its fees such that it will receive little or no fixed management fee in the event of underperformance, it should still be entitled to receive its fee based on outperforming its benchmark even if making a loss over the performance fee period.

<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>

TYPE YOUR TEXT HERE

<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>

Any downward reset of an HWM should be very rare, public and embarrassing. Having said that, any fund that is so far away from its HWM that a performance fee will never be earned negates the point of having a performance fee.

Potentially a fund can could be permitted one reset over an elongated time period (e.g. twice the recommended holding period), but any reset is problematic for reasons outlined in our response to Q9.

<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>

TYPE YOUR TEXT HERE

<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>

This question would seem to reinforce the need for performance fees to be relative to an appropriate benchmark, as described in our response to Q2. In that case, where both the benchmark and fund experience a significant fall below a previous HWM, the fund would still be justified in claiming performance fees where it exceeds its benchmark related hurdle rate on the way back up.

Resetting on a schedule is problematic from an investor equity perspective and would create similar potential for managers to take the kinds of risks referred to in Guideline 3. The investor equity perspective is that some investors will be in the fund only a few weeks before a periodic reset, others might have been in for months so a reset would mean different things to both.

This highlights the problem with performance fees being charged at the fund level, rather than the investor level. The investors who suffer the loss then exit the fund provide unrecompensed value for those entering the fund; who may not have to pay a performance fee but still benefit from the manager’s efforts to exceed the HWM.

<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>

The performance reference period should align with the investment objective of the UCITS and its recommended holding period. For example, an absolute return fund seeking a stated annual return should assess itself on a rolling annual period. A similar fund seeking a specified annualized return over a 3-year period should have a rolling 3-year performance reference period.

<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>

From our data, of around 26,400 UCITS, approximately 5,000 operate a performance fee. The majority of these are asymmetric, and many operate a HWM or hurdle rate. We recommend aligning the effective date of the Guidelines with that of the PRIIPs Key Investor Document. UCITS will necessarily be reviewing their documentation and calculating their costs and charges. Alignment will reduce the cost of re-publishing documentation and the scope for confusion of investors.

<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, we would ideally like to see the same guidelines apply to all PRIIPs. If the UCITS performance fee guidelines purport to be best practice, then retail investors should expect equivalent practices from similar products that are marketed to them. While AIF’s may be less constrained in areas such as their investment limits and liquidity, they should not be subject to less rigor in the setting of their variable fees to the potential detriment of investors. Indeed, the cost-benefit analysis section of the CP says, ‘a lack of common practices across Member States could bring uncertainty for investors.’ We contend the same would be true for a lack of common practices across the two most common types of investment fund.

<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>

Yes, we agree. The proposed guidelines are good practice. Funds that already operate many of the guidelines will be able to comply at low cost. Other funds may incur more costs but which would not be disproportionate to the benefits for both investors and supervisory authorities.

<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>

We would refer to our answers to Q1, Q2 and Q9. If a performance fee structure is set in a way that it is equitable to both the fund and its investors, then these scenarios can solve themselves.

A fulcrum fee structure will achieve this, but also asymmetric structures that levy a low fixed management fee and a performance fee on outperformance of a relevant benchmark would be justified in receiving the fee when they exceed the benchmark even though the absolute return may be negative.

Performance fees that supplement a base management fee and operate without a hurdle rate are a blatant double charging structure equivalent to an employee receiving a guaranteed bonus on top of a salary, regardless of performance. A performance fee should not supplement a typical management fee but provide a win-win situation to a UCITS and its investors.

Lastly in relation to this point, LIBOR is in the process of being phased out. It would be precautionary to include in the guidelines a clause to prevent UCITS from gaining at investors expense when they switch to a new performance fee benchmark, for example, if the new benchmark results in lowering the HWM mark.

<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>

TYPE YOUR TEXT HERE

<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>

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<ESMA\_QUESTION\_PFG\_19>