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ESMA

103 rue de Grenelle
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per E-Mail

Vienna, 15th October 2019

Subject: Consultation Paper on ESMA GL on Performance Fees in UCITS

Dear Sir or Madam,

VÖIG[1] welcomes the opportunity to provide some comments on ESMA's Consultation Paper.

III. Background, Point 11

11. ESMA recognises that there are a variety of performance fee **models** which may be used, taking into account the nature of the investment objective and strategy of the fund and investors' preferences, such as the use of a HWM model, a benchmark model, a hurdle rate or a fulcrum fee model. In addition, there are also various approaches to the **methodologies** which apply to these models, including the tracking or accounting of performance fees, for example, through equalisation or series of shares or on an individual investor basis.

We suggest to add a reference (red) to the whole of fund method:

*"In addition, there are also various approaches to the **methodologies** which apply to these models, including the tracking or accounting of performance fees, for example, through equalisation or whole of fund method or series of shares or on an individual investor basis."*

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

[1] The Association of Austrian Investment Fund Management Companies (Vereinigung Österreichischer Investmentgesellschaften, VÖIG) is an umbrella organisation for all Austrian investment fund management companies and all Austrian real estate investment fund management companies. VÖIG represents 100% of the fund assets managed by the Austrian investment fund management companies and real estate investment fund management companies, in total it represents assets under management of € 170 bn. www.voeig.at.

VEREINIGUNG ÖSTERREICHISCHER INVESTMENTGESELLSCHAFTEN

First of all, we welcome the standardisation and consistency with 2016 IOSCO *Good Practices* as a general principle for retail investors.

It is our view that broader adoption of performance fee models is generally desirable to investors as it creates diversity and even more choice regarding available pricing models. We believe that greater standardisation can foster the further adoption of those models by fund managers.

In our view, the primary goal of standardisation should be enhancing clarity and transparency towards investors, allowing them to make an informed decision on whether a certain fee model is desirable to them or not. We believe that performance fee models in the vast majority of cases will better align interests between fund managers and investors than the eschewal of a performance fee model.

The aim of standardisation should not be to limit the options of market participants in order to create clear and transparent fee models that may be appropriate for a certain group of investors.

We believe that recommendations on best practice would be well suited to achieve greater standardisation and might further encourage the adoption of such fee models.

Despite the draft Guidelines' retail focus, we note there is considerable usage of UCITS funds also by institutional investors through dedicated share classes. In light of such investors' greater sophistication, risk tolerance and typically greater investment amounts etc., performance fee calculations and their disclosure would deserve greater flexibility outside a mass-retail market and concomitantly allow NCAs greater latitude when authorising fee methodologies for institutional share classes.

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

We observe an unclear definition of all relevant parameters. Thus, recommendations on wordings for performance fee models to achieve a common understanding would be desirable.

Additionally, we underscore the importance for NCAs to avoid temptation of gold-plating by introducing requirements at odds with ESMA's final Guidelines and, indirectly, the IOSCO 2016 *Good Practices*. Such practices of certain NCAs, stifling cross-border marketing of UCITS as a result, shall be discouraged.

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

We basically agree with the requirement for consistency between a performance fee index and the fund's investment objectives, strategy and policy. In addition, we believe management companies are to ensure full transparency on the degree of outperformance to the end-investor in the relevant fund prospectus.

But we also want to point out that assessing consistency is a rather subjective endeavour. Overall, we do not see particular merit from guideline 2 and do not believe its benefits outweigh its costs in a framework where performance fee models are anyways fully disclosed to investors.

In terms of whether there are specific indicators which should be considered, we would recommend that the final Guidelines do not reference anyone in particular, leaving the ultimate choice to the management company depending ultimately on the fund's very own investment objectives and strategy. References to historical volatility, asset composition etc. could be cited, but only as mere examples.

We welcome the clear mention that outperformance should be represented net of costs (e.g. management, distribution, administrative fees, etc.).

In relation to the recommended approaches for management companies under draft Guideline 2, we have the following important reservation. In relation to paragraph 16 letter a), we agree that funds pursuing an absolute return objective would naturally choose to benchmark their performance against an HWM, or alternative hurdle rate. In the latter case, such funds often represent their performance as a sum between a money market index and a hurdle rate (e.g. EONIA + 1%). Such money market index – unlike for money market funds – should in any case not be understood to define the absolute return fund's risk/reward profile, nor the +chosen investment objectives and strategy.

As per the following letter b) of the same paragraph, we agree that where a fund's strategy offers some form of *beta* exposure to an underlying asset class, any performance fee should be levied off a benchmark that is consistent with the fund's risk/reward profile and thus aligned with its investment objectives and strategy.

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.

Regarding terminology, we would firstly suggest that the notion of "crystallisation period" be clarified. In the definitions section of the draft Guidelines, it is defined as a "(…) period during which the performance fee, if any, is accrued and at the end of which it becomes payable to the management company". However, draft Guideline 1, under paragraph 11, point b) thereof, defines "crystallisation date" as the one coinciding with the end of the crystallisation period and at which the performance fee, if any, is crystallised and directly "credited" to the management company. We note there is hence some uncertainty on whether the performance fee is only virtually booked on the account of the management company or de facto paid out and settled at the end of the crystallisation period. Pending our uncertainty around this semantic, yet important nuance, we shall provisionally assume that a "crystallisation period" does not yet imply the direct pay-out of the performance fee to the management company (please refer to our response to Q 5 below).

We would secondly suggest that the final Guidelines refer to "crystallisation frequency" in lieu of "crystallisation period". The previous connotation would not only be consistent with the IOSCO 2016 *Good Practices*, but also avoid confusion with the accompanying notion of "performance reference period" as per the draft Guidelines.

The Guidelines should also reflect the fact that performance fees also crystallise when investors in the share class choose to redeem, as well as in exceptional circumstances for a variety of purely technical reasons, as for instance, with the launch of new share classes, with fund mergers, liquidations, or other corporate actions. In the latter cases, shorter crystallisation frequencies should be justified, provided they are truly exceptional and disclosed in advance to end-investors for these to be treated fairly.

Furthermore, we do have reservations regarding the notion that shorter crystallisation periods would severely distort the interests of fund managers and investors: we believe that a transparent performance fee model is generally suited to better align the interests of investors and fund managers than employing no performance fee model at all.

In this context we want to stress that further extension of the period will significantly reduce the incentive for any fund manager to implement a performance fee model.

Understanding it is already a common praxis in a majority of EU jurisdictions in adherence to the IOSCO *Good Practices*, EFAMA certainly favours clarifying under draft Guideline 3 (paragraph 20) that performance fees' crystallisation frequency should not be inferior to one (financial) year. Therefore, in relation to new share classes launched in the interim between one crystallisation date and the next, these should crystallise at the time of the next crystallisation date provided that such date occurs no sooner than 12 months from their launch.

Lastly, we do not agree with the proposal to link the duration of the crystallisation frequency with the recommended holding period for the given share class. We clarify in this regard that the performance fee remunerates the asset management company as a whole, not the individual portfolio manager (as assumed under paragraph 19 relatively to draft Guideline 3). Alignment of interests between the latter and the end-investor is more effectively guaranteed via existing remuneration requirements in line with ESMA's own 2016 *Guidelines on sound remuneration policies under the UCITS Directive* (ESMA/2016/575), as well as by resetting the fund's performance reference period once past underperformance has been recovered.

We suggest a wording as follows:

"18. Performance fee models and the related methodologies may have very different characteristics. In principle, the minimum crystallisation period should be ~~linked to the recommended holding period of the fund~~ at least one year and the performance fee should ideally be charged to each investor when exiting the fund."

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.

In relation to the compatibility between the HWM and a minimum 12-month crystallisation period, we observe that ESMA's own definition of HWM remains narrow, i.e. only refers to a "pure" HWM, whereby the performance fee becomes payable where the NAV per share exceeds the highest previous value ever recorded since the fund's launch. We note, nevertheless, how the IOSCO 2004 *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds* additionally includes the definition of an HWM model variant known as the "high-on-high" (HoH). Accordingly, the performance fee is payable only if the NAV per share exceeds the highest previous value at which the last performance fee was accrued and paid out to the fund.

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?

We believe that in the framework of a benchmark model, a fund manager may well be allowed to charge performance fees solely based on the relative performance and irrespective of the absolute performance achieved. Regulation should in our view safeguard that, if implemented that way, this is prominently disclosed.

Thus, we do not support the principle of charging a performance fee only in concomitance with an absolute positive performance. If outperformance in relation to a given index is expressly foreseen as part of a fund's investment objectives and strategy, then naturally any positive relative performance vis-à-vis that index should also be rewarded to the management company (e.g. the in the context of a negative market cycle, where good management is able to avoid a comparatively larger depreciations of the fund's value vis-à-vis its chosen benchmark). Moreover, were performance fees to be levied only in the presence of absolute positive performance, we fear that individual managers may be incentivised to take on greater risks (as per paragraph 23 under draft Guideline 4) in their attempt to return to a positive absolute performance to offset losses, thereby also misaligning their incentives with those of the end-investor. In any event, we believe that the application of relative positive performance fees deserves clear and prominent references in fund disclosures documents.

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.

In line with our answer to Q6 above, we agree with ESMA on the need to disclose relative positive performance fees prominently, both in legal and marketing documents, along with related explanations as to how the chosen performance fee mechanism operates. We strongly recommend such information be disclosed in the UCITS prospectus and not in the KIID.

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.

In relation to performance reference periods - regardless of HWM models or not – we believe these should generally not be pre-defined, allowing management companies to tailor them based on a variety of factors implied by the chosen investment objectives and strategy, asset class, investor profile, etc. and, in any case, this should be no less than one year.

The main bias of HWM is that under certain circumstances it might increase inequality of treatment for investors: The "free ride" which benefits to shareholders who subscribe when the fund is underperforming and is below its HWM. Between the subscription value and the fund's HWM, the client benefits from an outperformance, but without paying the price, as no provision for performance fees will be accrued until the net asset value is over the HWM.

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.

We believe that for a fair treatment of the investors the minimum period for a reset should be at least equal to one year for the following reasons:

- One-year calendar reset period offers simplicity and clarity being fully aligned with the spirit of MiFID II, which has introduced once a year a report on all charges and costs.
- One year is a period long enough for a fund manager to compensate for losses without taking excessive risk.

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.

We believe that for a fair treatment of the investors the minimum period for a reset should be at least equal to one year.

Especially in case of a fundamental market drop the recovery of a major loss might take a very long time until a performance fee could again be generated. Therefore, from an economic point of view, the liquidation of such a fund and a new launch of a similar product might be the sensible measure for an asset manager. Such a measure is not necessarily in the interest of the investors.

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.

The performance reference period could, in order to best align the performance fee model with the investment objective, coincide with the minimum crystallisation period of one year, but potentially it could also be longer if more in line with the investment objective of the fund. Having said that, we do not believe that a shorter reference period is in the interest of a fair treatment of the investors.

Having both crystallisation period and period of reference at the end of the calendar year increases transparency for the shareholders, since it could be easily compared with the performance of the year.

A one-year crystallisation period and period of reference might reduce a disparity between investors. Indeed, investors do not necessarily follow the recommended holding period (RHP) and therefore this ensures a fair treatment of the investors regardless of their individual holding period (see notably following section on HWM).

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?

Performance fee models usually refer to the financial year of the fund and any adoptions should therefore be implemented on the beginning of the next financial year. Taken into account this aspect as well as the necessary technical and operational modifications, a **two-year period** in advance prior to compliance with the Guidelines is estimated as reasonable.

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.

We are in principle in favour of a convergence of regimes under the different regulations, but this to the extent that the guidelines will not introduce any gold plating to the IOSCO 2016 *Good Practices* and only with respect to AIF share classes offered to retail investors.

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.

We agree with the cost-benefit analysis underpinning ESMA's technical proposal to ensure greater consistency (as per the relevant table in the consultation paper). But we want to notice that in general, we do not agree with any ambition of limiting the scope of (transparent) performance fee models depending on the strategy employed.

Costs derived from the implementation of the future final Guidelines, in the form of compliance and legal work, would not be prohibitive, as (i) most EU jurisdictions have already aligned their domestic regulations with the IOSCO 2016 *Good Practices*; and (ii) provided management companies are granted sufficient time to comply with the Guidelines, as suggested in our answer to Q12 above. However, the above is based on the assumption that the final Guidelines will not introduce any gold plating to the IOSCO 2016 *Good Practices*. Conversely, we would believe that if the final Guidelines were to go beyond the original scope of the IOSCO 2016 *Good Practices*, that would dis-incentivize the use of performance fee models.

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.

Yes, models of performance fee without a hurdle rate, or with a hurdle rate not linked to the investment objective are permissible, if they are clearly stated in the fund's disclosure documents. We believe that investors do find such models desirable when fully disclosed. Such models can be understood very easily and we do not see any reason to limit the available possibilities for investors.

More precisely, we believe that those investors who are focused on absolute performance of their investments may prefer to pay a lower total fee in years of flat or negative performance and such fee models allow fund managers to offer exactly that.

In this context, standardising disclosures regarding a potential maximum performance related remuneration per crystallisation period may have its merit.

As per ESMA's example, comparing the performance of an absolute return equity strategy with a money market index (as the EONIA) can be allowed to the extent it is more appropriate to capture excess performance in line with the fund's absolute return objective and notwithstanding the equity exposure's greater degree of risk (implicit in an active manager's proposition to end-investors).

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.

We do believe that enforcing a minimum crystallisation period greater than 12 months will hinder the adoption of performance fee models by fund managers, therefore creating costs for investors of limited availability of (transparent) performance related fee models.

In addition, please refer to our answer to Q 14.

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.

In line with our answer to Q6, we observe that the draft Guideline 4 would not be appropriate for all types of performance fee models, namely for those funds choosing to measure their performance against an index. We specifically refer to the possibility for funds to levy performance fees even in bear markets, provided their performance relative to that of the chosen index is positive (i.e. positive relative performance) and thereby rewarding outperformance. Generally, from our point of view further restrictions would reduce incentives for an adoption of performance fee models by fund managers.

In terms of minimising incentives for managers to take on excessive risks (as per paragraph 23 under draft Guideline 4), we believe that the proposed performance reference period of no less than one year would allow a management company a sufficient amount of time to recover any cumulative negative performance before levying a performance fee once again.

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.

Please refer to our answer to Q 14.

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.

In relation to disclosure costs, we refer ESMA to our answer to Q14 above, knowing these will concur to the overall compliance cost to management companies in meeting the future final Guidelines.

As to the benefits, we clearly see a positive outcome for end-investors in receiving more details on the functioning of certain performance fee models, including their calculations. Such information, accompanied preferably by graphics depicting potential performance scenario outcomes (including one of relative positive performance where applicable) should clearly be contained in the fund’s <u>prospectus</u>.

We strongly believe that disclosure will be crucial in respect of transparency and acceptance of performance fee models.

Kind regards,

VEREINIGUNG ÖSTERREICHISCHER
INVESTMENTGESELLSCHAFTEN

Barbara Flor

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