ESMA Consults on Performance Fees – Key Considerations for Irish UCITS

Authored by Dechert's Financial Services Practice

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Introduction

On 16 July 2019, ESMA published a consultation (the "**Consultation**") on draft guidelines for UCITS performance fees (the "**Draft Guidelines**"). The objective of the Consultation is to obtain stakeholder feedback on the Guidelines in five principle areas, namely:

1. performance fee calculation methodologies;
2. consistency between performance fee calculation models and investment objectives, strategies and policies;
3. frequency of crystallisation;
4. negative performance (loss) recovery; and
5. disclosure of performance fee models in fund documents.

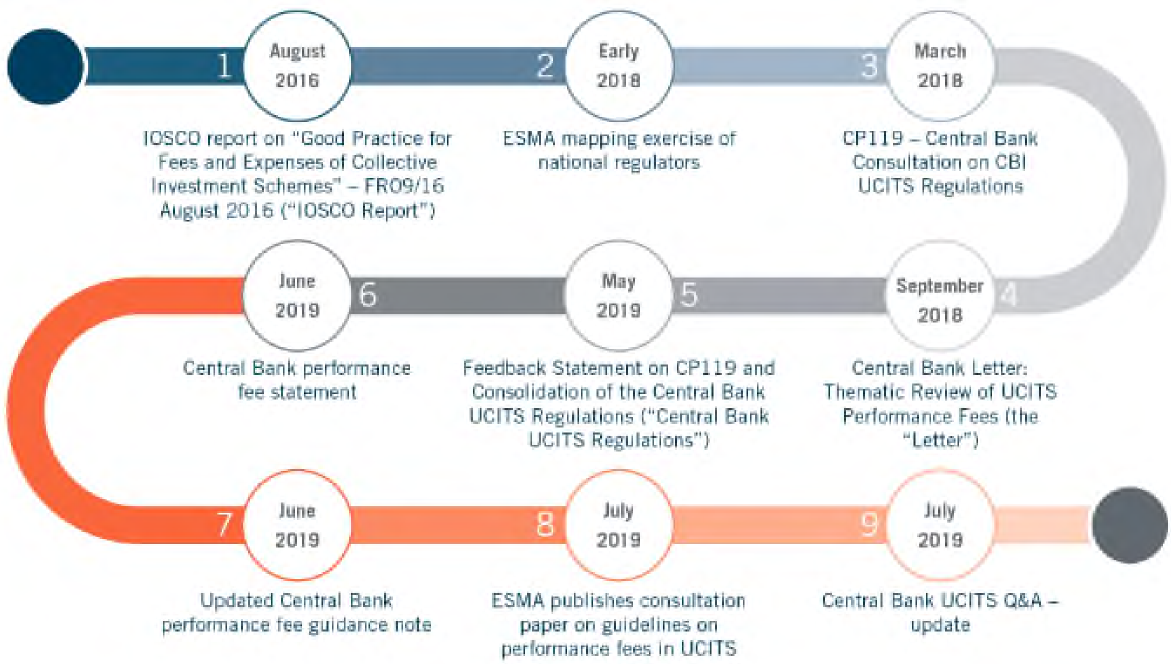
The Draft Guidelines will apply to UCITS in Ireland charging a performance fee.

ESMA is also seeking stakeholder feedback on whether the Draft Guidelines should be extended to apply to AIFs.

ESMA will consider responses to the Consultation submitted before the deadline of **31 October 2019**.

Background

The Consultation is published at a time of increased investor awareness and greater demand for transparency of performance-based fee models. The Consultation follows a number of reviews conducted by various regulators, including IOSCO, ESMA and the Central Bank of Ireland (the "**Central Bank**"). Set out below is a summary timeline of the key publications which provide a backdrop to the Consultation.



1 **IOSCO report on “Good Practice for Fees and Expenses of Collective Investment Schemes” – FRO9/16 August 2016 (“IOSCO Report”)**

IOSCO publishes a summary of good practices for fees and expenses, which includes four specific recommendations relating to performance fees.

2 **ESMA mapping exercise of national regulators**

Taking into account a number of the good practices suggested by IOSCO, ESMA conducts a mapping exercise among national competent authorities to analyse current practices and approaches in the EEA in relation to performance-based fee models and payments. ESMA finds a lack of harmonisation at EU level on performance-based fee models and computation mechanisms.

3 **CP119 – Central Bank Consultation on Central Bank UCITS Regulations**

The Central Bank issues a Consultation Paper - CP119 which includes proposals to codify its guidance on the charging of performance fees in the Central Bank UCITS Regulations. The Central Bank conducted a parallel thematic review of charges relating to the calculation and payment of performance fees charged by UCITS.

4 **Central Bank Letter: Thematic Review of UCITS Performance Fees (the “Letter”)**

The Central Bank issues a Letter outlining the results of its performance fee review. The Letter highlights the Central Bank’s concern that its performance fee guidance is not being applied in a consistent and comprehensive manner. The thematic review requires UCITS to carry out a review of their methodologies to ensure full compliance with the Central Bank guidance, by 30 November 2018. Please see a link to the Dechert OnPoint which examines the Letter in more detail.

5 **Feedback Statement on CP119 and Consolidation of the Central Bank UCITS Regulations**

The Central Bank UCITS Regulations are updated to provide that the performance fee rules, previously set out in Central Bank website guidance and the UCITS Application Forms are placed on a statutory footing. While many of the legislative requirements mirror the existing guidance, a requirement that the calculation of the performance fee does not crystallise more than once a year was also introduced, as recommended by the IOSCO Report. A transitional period of 18 months is provided for, meaning UCITS have to comply with the new rules by November 2020.

6 **Central Bank performance fee statement**

The Central Bank confirms that its thematic review of UCITS performance fees has concluded with redress of €1.5 million paid to shareholders as a result of the miscalculation of performance fees.

7 **Updated Central Bank performance fee guidance note**

The Central Bank publishes revised, shortened website guidance, as the principal requirements relating to performance fees are now incorporated in the Central Bank UCITS Regulations.

8 **ESMA publishes consultation paper on guidelines on performance fees in UCITS**

ESMA issues the Consultation with the stated aim of achieving supervisory convergence in the area of performance fees.

9 **Central Bank UCITS Q&A – update**

The Central Bank updates the UCITS Q&A to provide that it is permissible to charge performance fees at (i) an individual investor level, or (ii) at a share class/fund level, as adjusted for subscriptions and redemptions. The UCITS Q&A also clarifies that the crystallisation and payment of a performance fee by a UCITS upon a redemption is not considered an annual calculation for the purposes of this requirement.

The Consultation Questions

The Consultation invites comment to a number of specific questions covering issues such as:

- the desirability of greater standardisation of funds' performance fees;
- identifying obstacles to standardisation;
- factors to be taken into account when assessing the consistency between the index used to calculate performance fees and the objectives, strategy and policy of the fund;
- whether any performance fee models should be exempted from the Draft Guidelines;
- whether a performance fee should only be paid when a fund has achieved absolute positive performance, as opposed to outperforming a benchmark;
- whether a prominent risk warning should be provided if a performance fee is payable in times of negative returns;
- at what point in time should a high-water mark ("**HWM**") be set; and
- the duration of the performance reference period.

Central Bank Requirements

Most of these questions are addressed/answered by the Central Bank UCITS Regulations. The Central Bank permits the payment of a performance fee on the outperformance of an index (even if negative) and has no requirement for enhanced risk disclosure in that context.

The Draft Guidelines – Summary of Key Principles and Comparison with Central Bank Requirements

The Draft Guidelines are, to a large extent, consistent with the relevant provisions of the Central Bank UCITS Regulations and related guidance. Accordingly, if following the Consultation the Draft Guidelines are "watered down," there is a risk that the Central Bank requirements might constitute gold-plating. This is, however, an unlikely scenario.

Set out below are the five principles outlined in the Draft Guidelines, compared against the existing Central Bank requirements.

i. Performance fee calculation methodologies

The Draft Guidelines provide that the performance fee calculation method should contain at least:

a) a reference indicator to measure the relative performance of the fund (e.g. an index, HWM or a hurdle rate);

b) a crystallisation period, within which any performance fee is accrued, and a crystallisation date, on which the performance fee is credited to the management company;

c) a performance reference period (so the previous underperformance is recovered before a performance fee is paid);

d) a performance fee rate or a “flat rate”;

e) a performance fee methodology in line with the Draft Guidelines; and

f) calculation frequency (which should align with how often the Net Asset Value (”**NAV**”) is calculated).

The Draft Guidelines also provide that the performance fee calculation method should be designed to ensure that performance fees are always proportionate to the actual investment performance of the fund. Artificial increases resulting from new subscriptions should not be taken into account when calculating fund performance.

Central Bank Requirements

The Central Bank’s requirements are materially consistent with the Draft Guidelines. It should be noted that where an index is used as a reference indicator, the UCITS will also need to comply with ESMA Q&A regarding benchmark disclosure obligations. Please see a link to a Dechert OnPoint in relation to “closet-indexing,” which provides more background in this regard.

ii. Consistency between performance fee calculation models and investment objectives, strategies and policies

The Draft Guidelines seek to ensure that the performance fee model is consistent with the fund’s investment policy and strategy, as well as its risk-reward profile. For example, a HWM (and a hurdle) will be more suitable for absolute return funds than reference to an index. Where performance fees are payable on the basis of out-performance of a benchmark, the UCITS should ensure the benchmark is appropriate. In all cases, excess performance should be calculated net of costs.

Central Bank Requirements

The Central Bank’s requirements are materially consistent with the Draft Guidelines.

iii. Frequency of performance fee crystallisation

The Draft Guidelines provide that the minimum crystallisation period for a performance fee should be linked to the recommended holding period for a fund (commonly estimated at one year) and the performance fee should ideally be charged to each investor when exiting the fund. Generally, it should end either on 31 December or at the end of the financial year of the fund.

Central Bank Requirements

In line with the Draft Guidelines, the Central Bank UCITS Regulations provide that a crystallisation period should not be shorter than one year.

iv. Negative performance (loss) recovery

The Draft Guidelines provide that:

a) A performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period (either in absolute terms or against a benchmark). Any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.

b) The performance fee model should be designed to ensure that the fund manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses;

c) Where a fund utilises a HWM, it should only be reset where during the performance reference period:

- the new HWM exceeds the last HWM; or
- the fund has undergone significant structural changes.

As part of the Consultation, ESMA is seeking feedback in relation to setting a performance reference period, at the end of which the mechanism for payment for past underperformance or negative performance can be reset (i.e. how it should be defined[1]).

The performance reference period should not apply to the fulcrum fee model[2], as in this model the level of the performance fee increases or decreases proportionately with the investment performance of the fund.

Central Bank Requirements

The Central Bank's requirements are materially consistent with the Draft Guidelines, however it is worth noting that the Draft Guidelines provide for the resetting of HWM during a performance reference period where a UCITS fund has undergone "significant structural changes."

v. Disclosure of the performance fee model

The prospectus, any other fund documents such as the KIIDs and any marketing material, should clearly set out all information necessary to enable investors to properly understand the performance fee model and the computation methodology, including, where relevant, the performance benchmark index and past performance.

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[1] ESMA has asked whether this period should 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. Alternatively, a fixed period of three to five years has been suggested by ESMA.

[2] When a fulcrum fee is used, the level of the fee increases or decreases proportionately with the investment performance of the fund over a period of time in relation to the investment record of an appropriate securities index. This means that a fulcrum fee can be negative, and thus deducted from the basic fee charged to the fund.

The prospectus should also include “concrete” examples of how the performance fee will be calculated rather than a theoretical description of how it works in order to provide investors with a better understanding of the performance fee model.

The financial reports for a fund should indicate the impact of performance fees for each share class over the crystallisation period, by clearly displaying (i) the actual amount of performance fees charged and (ii) the percentage of the fees based on the share class NAV.

Central Bank Requirements

The Central Bank’s requirements are materially consistent with the Draft Guidelines. The Draft Guidelines suggest that all marketing materials should set out a performance fee disclosure which is aligned with the prospectus. Prospectuses currently do not include “concrete” or worked examples of performance fee calculations, although they are typically produced in the background. While the Central Bank requirements do not mirror the Draft Guidelines’ disclosure requirements for annual and half-yearly accounts, it is standard practice to include this information in UCITS financial statements. However, it is still advisable for funds to confirm compliance by reviewing existing disclosures in their financial statements.

Timing

The timing for responses to the Consultation and details of the transition period as outlined in the Draft Guidelines are set out below.

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