A&L Goodbody

ESMA Guidelines on Performance Fees in UCITS and certain types of AIFs

These Guidelines aim to harmonise EU supervisory practices. While generally aligned with current Central Bank of Ireland (CBI) requirements for UCITS, the Guidelines are more detailed.

Existing UCITS with performance fees will need to analyse whether adjustments will be necessary to comply with the Guidelines. In-scope AIFs with performance fees will need to look at the requirements.

The Guidelines will apply two months after translations are published on ESMA's website. There are transitional provisions for existing UCITS and in-scope AIFs with performance fees.

Scope

The Guidelines apply to the following where the UCITS and in-scope AIFs under management charge performance fees

- UCITS management companies
- AIFMs who manage in-scope AIFs
- internally managed UCITS
- in-scope internally managed AIFs (collectively managers)

When we refer to Funds in this briefing we mean UCITS and in-scope AIFs which charge performance fees.:

What AIFs are in scope?

The AIFs in scope are AIFs marketed to retail investors but not:

- closed-ended AIFs
- open-ended AIFs that are
  - EuVECAs or other types of venture capital AIFs
  - EuSEFs
  - private equity AIFs
  - real estate AIFs

Effective Date

The Guidelines apply from two months after the date of publication in all EU official languages on ESMA's website (Effective Date).

Application and Transitional Provisions

Managers of any new Fund (which includes a performance fee) authorised after the Effective Date must comply with the Guidelines immediately in respect of that Fund. This includes any newly created sub-funds (which include a performance fee) launched in existing umbrellas.

Managers of any existing Fund that introduce a performance fee after the Effective Date must comply with the Guidelines immediately in respect of that Fund.

Managers of Funds with a performance fee existing before the Effective Date must apply the Guidelines in respect of that Fund by the beginning of the financial year following six months after the Effective Date. This is a change from the proposed 12 month transition in ESMA's consultation paper.

As an example, a Fund with a 31 December year end will need to comply with the Guidelines by 1 January 2022 (assuming the translations are published by 30 April 2021).

CBI approach

The publication of the translations will trigger a two month period during which the CBI must notify ESMA whether it complies or intends to comply with the Guidelines. We expect the CBI to notify ESMA that it complies (or will comply) with the Guidelines within this timeframe.

We will see how the requirements of the Guidelines are incorporated into the CBI's regulatory requirements for Irish authorised managers. A straightforward approach is that the CBI will expect Irish managers to comply with the terms of the Guidelines as published by ESMA.

It may be that for UCITS, the Central Bank UCITS Regulations will be updated. You can read about the CBI's current position on UCITS performance fees and the changes which may need to be put in place by 27 November 2020 below.

For Irish managers with in-scope AIFs, the performance fee provisions of the CBI's AIF Rulebook may be updated to reflect the Guidelines. Alternatively it may be dealt with in the CBI AIF Regulations although there is yet no published timeline on when these will be introduced.

ESMA's 5 Performance Fee Guidelines

01	02	03	04	05
Performance fee calculation methods	Consistency between performance fee model and the Fund's investment objectives, strategy and policy	Frequency for performance fee crystallisation	Negative performance (loss) recovery	Disclosure of performance fee model

The Guidelines cover the areas detailed above. Please see below for the detail on each Guideline and for the likely impact on Irish Funds, taking account of existing Irish requirements which are similar in many cases.

Key initial considerations for Irish managers

Irish managers of existing Irish Funds with performance fees should consider the following:

UCITS

- undertake a gap analysis against the requirements of the Guidelines. The analysis may trigger:
  - revisions to the performance fee model, which in some cases may include a change in benchmark, or revisions to the methodology
  - revision of processes to ensure that the performance fee model is consistent with the Fund's investment objectives, strategy and policy
  - updates to performance fee disclosure in prospectuses, KIIDs or financial statement disclosure
- consider whether the changes will require investor notification or approval and factor in time for submission of revised offering documents to the CBI for approval before filing with the CBI for noting
- existing UCITS Funds may be making changes to comply with recent (though unrelated) CBI changes to performance fee rules (which have a deadline of 27 November 2020 for implementation) and such UCITS may want to make any changes called for by the Guidelines at the same time.

AIFs

- establish if the Guidelines apply to the AIF because it markets to retail investors. Some AIFs may have already done analysis for this when considering if the AIF has retail investors and is obliged to publish a PRIIPs KID under the PRIIPs Regulation. The AIF may be able to use that analysis and any subsequent decision making process in this context
- undertake a gap analysis against the requirements of the Guidelines to see if changes need to be made to the performance fee model, methodology or process to comply with the Guidelines
- establish if changes need to be made to performance fee disclosure in prospectuses, PRIIPs KID or financial statements. Irish AIFs established as RIAIFs will need to submit prospectus changes to the Central Bank for advance review and approval. Irish AIFs established as QIAIFs can avail of the CBI's 24-hour approval process
- consider whether investor approval or notification is required

The Managers' and Funds' administrator and depositary should be involved in discussions about any performance fee changes.

The Guidelines in more detail.

Guideline 1

The calculation of a performance fee should be verifiable and not open to the possibility of manipulation.

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

- reference indicator to measure the relative performance of the Fund - an index, a high water mark (**HMW**), a hurdle rate, or a combination
- crystallisation frequency at which the performance fee accrues and becomes payable and a crystallisation date at which it is credited to the manager
- performance reference period
- performance fee rate
- performance fee methodology
- computation frequency, which should be aligned with NAV calculation frequency

Artificial increases from new subscriptions should not be taken into account when calculating Fund performance.

Performance fee provisions and their final payments should be allocated and reversed in a symmetrical way. Performance fees could be calculated on a single investor basis.

Compared to the current Irish UCITS requirements, there should be nothing controversial in this Guideline. The gap analysis for Irish UCITS should be fairly straightforward. In-scope AIFs will need to look at these requirements.

Guideline 2

The Manager must implement and maintain a process in order to demonstrate and periodically review that the performance fee model is consistent with the Fund's investment objectives, strategy and policy.

For example, a high water mark or hurdle is likely to be more appropriate for absolute return Funds than reference to an index. For Funds that calculate the performance fee with reference to a benchmark, the benchmark must be appropriate in the context of the Fund's investment policy and strategy and must adequately represent the Fund's risk-reward profile. The assessment should also take into account any material difference of risk, such as volatility, between the Fund's investment objective and the chosen benchmark, as well as consistency indicators discussed below. The Manager of a Fund with a long equity-focused strategy should consider it inappropriate to calculate its performance fee by reference, for example, to a money market index.

As a general principle, if a Fund is managed in reference to a benchmark index and it employs a performance fee model based on a benchmark index, the two indices should be the same.

If performance fees are payable on the basis of out-performance of a benchmark "X" then calculating performance fees based on "X-1%" would not be appropriate.

When assessing the consistency between the benchmark used for portfolio composition and the benchmark used to calculate a performance fee, consistency should be primarily assessed against the similar risk-return profile of different benchmarks (such as whether they fall into the same category in terms of Synthetic Risk Reward Indicator and/or volatility and expected return). ESMA also includes a non-exhaustive cumulative list of consistency indicators which should be used in this assessment.

This seems reasonable and the gap analysis for Irish UCITS should be straightforward. In-scope AIFs will need to look at the requirements. Funds will likely need to refine their process for ensuring consistency between the performance fee model and the Fund's investment objectives, strategy and policy.

Guideline 3

The frequency for the crystallisation and the subsequent payment of the performance fee should be defined so as to ensure the interests of the portfolio manager and the shareholders are aligned and the fair treatment of investors.

The crystallisation frequency should not be more than once a year. This should not apply to:

- the HWM or high-on-high model, where the performance reference period is equal to the whole life of the Fund and it cannot be reset
- the fulcrum fee model and other models which provide for a symmetrical fee structure (whereby performance fees would decrease or increase based on the performance of the Fund), as the characteristics of these models are incompatible

The crystallisation date should be the same for all share classes of a Fund.

In case of Fund closures, mergers and investor redemptions, any performance fees should crystallise in due proportions on the date of closure, merger and investor redemption.

Generally the crystallisation date should co-incide with 31 December or the financial year end of the Fund.

A one year period aligns with current CBI guidance for UCITS. In-scope AIFs will need to look at the requirements.

Guideline 4

A performance fee should only be payable where positive performance has been accrued during the performance reference period. Underperformance or loss should be recovered before a performance fee becomes payable.

A performance fee could be payable where a Fund overperformed the reference benchmark but had a negative performance as long as a prominent warning is given to investors. This should avoid misalignment of interests between the manager and investors.

The investment manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the recommended investors' holding period.

For the benchmark model, any underperformance of the Fund compared to the benchmark should be clawed back before any performance fee becomes payable. Accordingly, the length of the performance reference period, if shorter than the life of the Fund, should be at least five years.

For the HWM model, a performance fee should be payable only where, during the performance reference period, the new HWM exceeds the last HWM. Where the performance reference period is shorter than the life of the Fund, the performance reference period should be at least five years on a rolling basis. In this scenario, the performance fee may only be claimed if the outperformance exceeds any underperformances during the previous five years and performance fees should not crystallise more than once a year.

The performance reference period should not apply to the fulcrum fee model and other models which provide for a symmetrical fee structure, where the level of the performance fee increases or decreases proportionately with the investment performance of the Fund.

The gap analysis for Irish UCITS should be straightforward. The ability to pay a performance fee where a Fund over performed the reference benchmark but had a negative performance subject to a prominent warning to investors is in line with CBI requirements and is a welcome change to the draft Guidelines. The ability to reset the HWM will also be new for Irish UCITS and it will be interesting to see how the CBI implements this. In-scope AIFs will not have been subject to this level of requirement.

Guideline 5

Investors should be adequately informed about the existence of performance fees and about their potential impact on the investment return.

There should be clear and adequate disclosure in the Fund's prospectus, marketing material, KIID and financial statements. The prospectus should contain concrete examples of how the performance fee will be calculated, especially where the performance fee model allows for performance fees to be charged in case of negative performance. The prospectus should explain the choice of benchmark where a Fund managed using one benchmark computes performance fees using a different benchmark.

The KIID should clearly set out all information necessary to explain the existence of the performance fee, the basis on which the fee is charged and when the fee applies.

Where performance fees are calculated based on performance against a reference benchmark index, the KIID and the prospectus should display the name of the benchmark and show past performance against it. Where a Fund allows for a performance fee in times of negative performance (for example, the Fund has over performed its reference benchmark index but, overall, has a negative performance), a prominent warning should be included in the KIID.

The annual and half-yearly reports should display clearly for each relevant share class:

a. the actual amount of performance fees charged and
b. the percentage of fees based on the share class NAV

For Irish UCITS, the gap analysis should be straightforward. Most UCITS will need to include concrete examples of how the performance fee will be calculated in prospectuses as this is not a current requirement. UCITS KIIDs may also need to be updated and possibly KIDs for in-scope AIFs. This ESMA guideline refers in some sections specifically to UCITS KIIDs, but not to PRIIPs KIDs. It's unclear whether this is a deliberate distinction or a carryover from the ESMA consultation paper which contemplated only UCITS and not AIFs.

Central Bank of Ireland's current position on UCITS' and AIF performance fees

The Guidelines are generally aligned with current CBI requirements for UCITS, but are more detailed and prescriptive.

The CBI codified its guidance on UCITS performance fees in the updated and consolidated CBI UCITS Regulations which issued 27 May 2019. You can read the ALG publication about the 2019 CBI UCITS Regulations here. They should be read with CBI guidance on UCITS performance fees and UCITS Q&A.

The CBI issued a letter on 4 September 2018 after a thematic review of Irish UCITS's performance fees. The letter highlighted supervisory issues identified from the review. The CBI commented it will use the industry letter as a reference in any supervisory engagement carried out on UCITS performance fees.

As noted above, existing UCITS Funds may be making changes to comply with recent (though unrelated) CBI changes to performance fee rules (which have a deadline of 27 November 2020 for implementation) and such UCITS may want to make any changes called for by the Guidelines at the same time.

RIAIFs are already subject to performance fee rules under the AIF Rulebook which are closer to UCITS performance fee requirements, such as disclosures in the prospectus and accounts and having to reclaim underperformance. QIAIFs are subject to less prescriptive rules.

Conclusion

Existing Irish Funds with performance fees and Irish UCITS and in- scope AIFs seeking to set up new Funds or new sub-funds with performance fees will need to carefully consider ESMA's new Guidelines. Please contact a member of A&L Goodbody's Asset Management & Investment Funds team for more detailed analysis and advice.

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