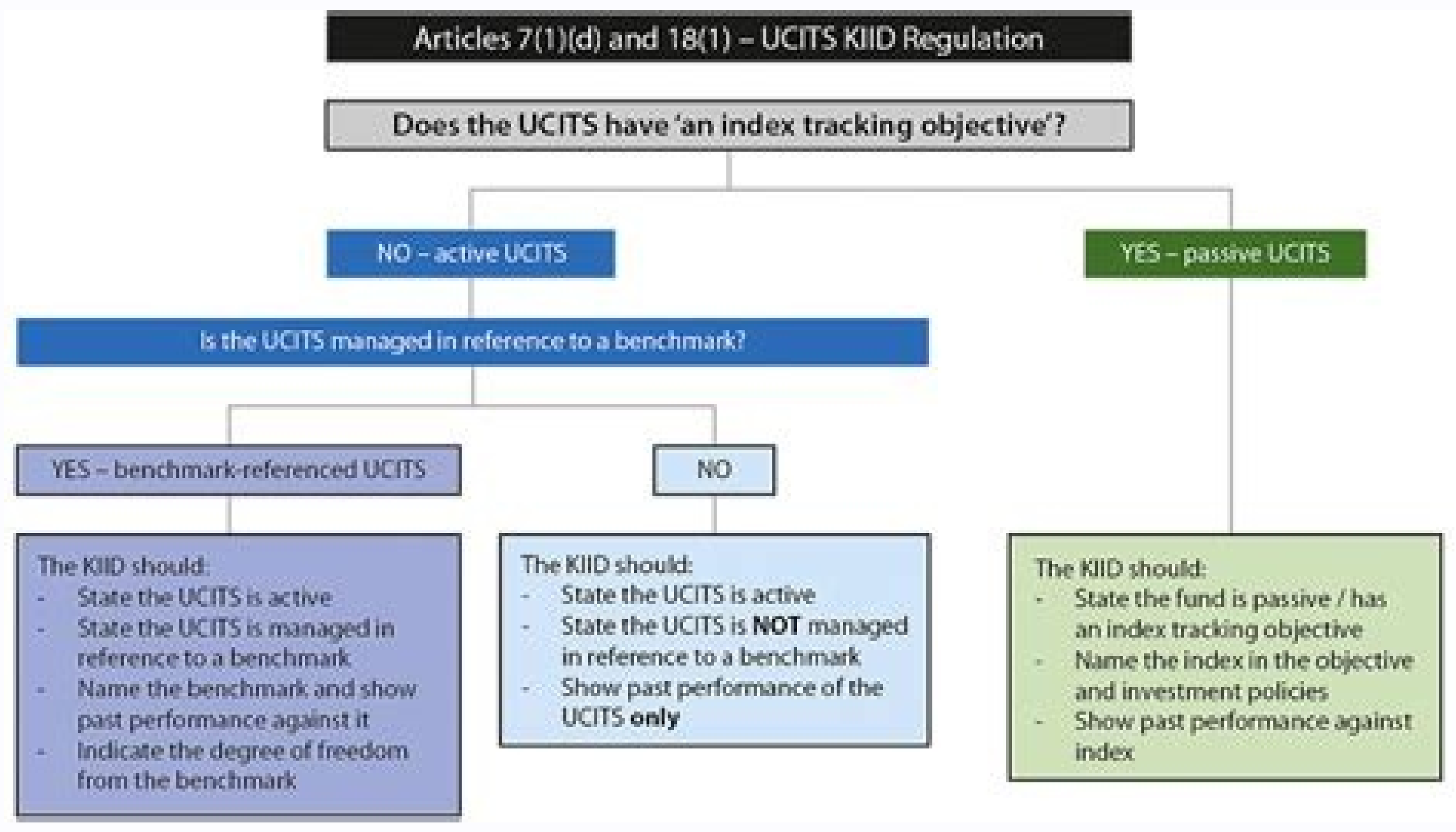
Esma guidelines on performance fees in ucits



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Managers should be able to demonstrate that managers' and investors' interests are aligned. Where the performance reference period is shorter that the whole life of the fund, it should be set equal to at least five years (on a rolling basis for funds using a HWM) 5. Disclosures Investors should be adequately informed about the performance fees and their impact on return All ex-ante documents (prospectus, KIID, marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters, the payment date. Artificial increases arising from new subscriptions should not be taken into account when calculating fund performance. In case the fund is managed by reference to a benchmark, but the fund’s holdings are not based upon the holdings of the benchmark index, a different benchmark may still be used in the performance fee model, but specific governance arrangements and processes will be required to demonstrate the ongoing consistency of that benchmark versus the prescribed consistency indicators. If the reference indicator changes during the performance reference period, the performance should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards. However, where both merging and receiving funds are managed by the same manager, crystallization should be presumed to be contrary to investors’ best interests, unless justified otherwise by the manager Generally, it should coincide with the end of the financial year of the fund 4. Loss recovery Any loss or underperformance previously incurred during the performance reference period should be recovered before a performance fee becomes payable A performance fee could be payable in case the fund outperformed the benchmark but had a negative performance The performance reference period should be, as far as possible, consistent with the recommended investor holding period. The Guidelines became applicable on 6 January 2021 and in Luxembourg, by way of its Circular 20/764, the CSSF confirmed the integration of those Guidelines into its administrative practices and regulatory approach. Primary Changes For Luxembourg-based funds, the five-year performance period prescribed by ESMA is aligned with the German BaFIN’s practice and is likely to have a significant impact. The guidelines will also apply to open-ended AIFs marketed to retail investors. Where the fund is managed by reference to a benchmark, but the fund’s holdings are not based upon the holdings of the benchmark index, the benchmark used for the calculation of the performance should be consistent with the benchmark used for the portfolio composition, according to a non-exhaustive list of consistency indicators: Expected return Investment universe Beta exposure to an underlying asset class Geographical exposure Sector exposure Income distribution of the fund Liquidity measures (e.g. daily trading volumes, bid-ask spreads, etc) Duration Credit rating category Volatility and/or historical volatility Performance should be calculated net of all costs but may be calculated without deducting the performance fee as long at this would be in the investor’s best interest. IFMs of funds with a performance fee existing before the date of application of the Guidelines, must apply the Guidelines in respect of those funds by the beginning of the financial year following 6 months from the date of application of the Guidelines. However, EuVECAs or other types of venture capital AIFs, EuSEFs, private equity and real estate AIFs remain out of scope. Scope All UCITS are in scope of the guidelines. In practice, a benchmark index used in a performance fee model may need to be changed to align with the benchmark index used for performance objective or portfolio composition. On one hand, the introduction of a minimum performance reference period, combined with tighter requirements in terms of benchmark index selection and disclosure could incentivize managers to increase their fixed remuneration. As a general principle, a fund which is managed by reference to a benchmark, or where the fund’s portfolio does not deviate materially from a benchmark index portfolio, should use the same benchmark in the performance fee model. The selection of a benchmark index for the performance model is also heavily restricted . 3. Crystallization frequency It should allow for the alignment of the managers` and the investors`` interests It should not be more than once a year, except for the high water-mark model or high-on-high model where these cannot be reset during the whole life of the fund and fulcrum fee model and other models which provide a symmetrical fee structure It should be the same for all share classes of a fund with a performance fee Performance fee should crystallize in due proportion in case of closure/merger of funds or upon investor’s redemption. Read ESMA Guidelines [1] see question 8 of UCITS Q&A, ESMA34-43-392 On 5 November 2020, ESMA published Guidelines on performance fees in UCITS and certain types of AIFs ("Guidelines") on its website in all EU official languages. Key Points ESMA’s report comprises five guidelines: 1. The calculation of a performance fee should be verifiable and the method should include at least: a performance reference indicator, i.e. an index, a high-water mark (“HWM”), a hurdle rate or a combination the crystallization frequency and the crystallization date the performance reference period the performance fee rate the calculation methodology the computation frequency which should match with the NAV calculation frequency Performance fees should be proportionate to the fund’s performance. The Guidelines apply to UCITS management companies and to AIFMs of AIFs allowed by Member States to market their units to retail investors in their territory in accordance with Article 43 of the AIFM Directive, except for closed-ended AIFs and open-ended AIFs that are EuVECAs1 (or other types of venture capital AIFs), EuSEFs2, private equity AIFs or real estate AIFs. The Guidelines provide guidance on (i) the performance fee calculation method, (ii) the assessment of the consistency between the performance fee model and the fund's investment objectives, strategy and policy (particularly when the fund is managed in reference to a benchmark), (iii) the frequency for crystallisation of the performance fee, (iv) recovery in case of negative performance and (v) disclosure of the performance fee model. On the other hand the comparison with cheaper, passively managed funds should limit such increase to maintain attractiveness of actively managed products. Investment Fund Managers (“IFMs”) of any new funds created after the date of application of the Guidelines (i.e. 6 January 2021) with a performance fee, or any funds existing before the date of application that introduce a performance fee for the first time after that date, must comply with the Guidelines immediately in respect of those funds. The guidelines will therefore become applicable as of 6 January 2021 for all new funds or funds introducing a performance fee after this date. Funds with a performance fee existing before this date should comply from the beginning of the financial year following 6 July 2021. 2. The performance fee model implemented must be and remain consistent with the fund’s investment objectives, strategy and policy. Timeline The translations of the guidelines into all EU official languages were published on 5 November 2020. Concrete computation examples should be included in the prospectus Where a performance fee model uses a different but consistent benchmark, the explanation of the choice of benchmark should be included in the prospectus Where a performance fee is payable in times of negative performance a prominent warning must be included in the KIID Where applicable the KIID and the prospectus should display the name of the benchmark index and disclose past performance against it The annual and semi-annual reports and any other ex-post information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent Practical Considerations Fund managers may need to review the way they design the charging structure of their funds. While requirements are becoming stricter in terms of disclosure of performance against benchmarks[1], ESMA released its Guidelines on performance fee in UCITS and certain types of AIFs on 3 April 2020. The manager should implement and maintain a periodic review process to ensure that the performance fee model is consistent with the fund’s investment objectives, strategy and policy. It is permissible to calculate performance fees on a single investor basis. As an example: End of financial year of an investment fund with a performance fee and existing before 6 January 2021 Date of application of the Guidelines 31 December 1 January 2022 30 April 1 May 2022 30 September 1 October 2021 The value for money delivered by actively managed funds has come under increased scrutiny over the recent years. The guidelines are more prescriptive than the principle-based 2016 IOSCO good practices applied by most national competent authorities, notably in terms of consistency between the performance fee model used and the fund’s investment objective, where a fund is managed by reference to a benchmark index, or as regards to the minimum performance reference period.

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