SIGMA PARTNERS
REGULATORY WATCH
FOR ASSET MANAGEMENT

ESMA GUIDELINES
ON PERFORMANCE FEE

December 2019

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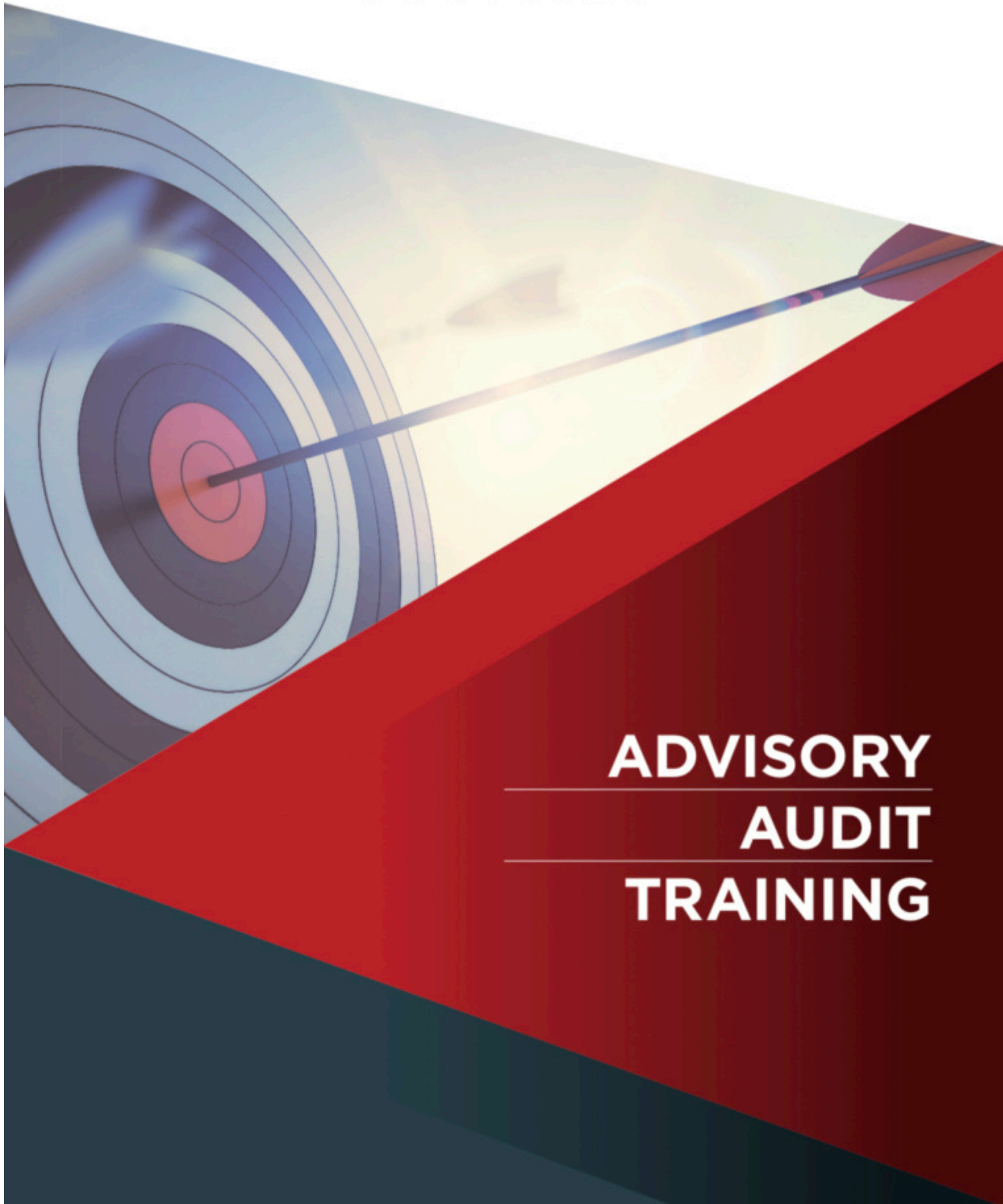

AGENDA

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BACKGROUND OF THE ESMA CONSULTATION

WHY?

The ESMA[1] launched on July 17, 2019 a **public consultation on draft guidelines on performance fees** under the Undertakings for Collective Investments in Transferable Securities (UCITS) Directive. Comments were to be provided **until 31 October 2019.**

ESMA's draft guidelines aim to further **clarify the provisions of the UCITS Directive**, which requires EU Member States to **ensure that a management company acts honestly and fairly** in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market. This includes the **prevention of undue costs** being charged to the UCITS and its unit holders.

In developing its draft guidelines, ESMA also considered the **Good Practice for Fees and Expenses of Collective Investment Schemes** by the International Organization of Securities Commissions (IOSCO).

The proposed guidelines **follow a mapping exercise ESMA conducted in 2018** among national competent authorities (NCAs), which analysed the **current national practices for key aspects of performance fees**, revealing a lack of harmonisation among EU jurisdictions.

WHAT ?

ESMA's draft guidelines propose c**ommon criteria so as to promote convergence on** following aspects:

1. **General principles** on performance fee calculation methods;
2. **Consistency** between the performance fee model and the fund's investment objectives, strategy and policy;
3. **Frequency** for the performance fee crystallisation and payment;
4. **Circumstances** where a performance fee should be payable; and
5. **Disclosure** of the performance fee model.

ESMA is seeking stakeholders' feedback on the proposals made in these areas as well as on how and whether the principles set out in the Guidelines should also be applied to Alternative Investment Funds (AIFs) marketed to retail investors.

[1] *European Securities and Markets Authority*

PERFORMANCE FEE CALCULATION METHOD

HOW ?

AS A MINIMUM, the **performance fee calculation method** should include the following:

1. **THE REFERENCE INDICATOR** to measure the relative performance of the fund (i.e. an index, hurdle rate ot a HWM)
2. **THE CRYSTALLIZATION PERIOD** within which the performance fee is accrued and a date at which the performance fee is crystallized and credited to the management company
3. **THE PERFORMANCE REFERENCE PERIOD**, at the end of which the mechanism for compensating for past underperformance or negative performance can be reset
4. **THE PERFORMANCE FEE RATE** which may also be referred to as the "flat rate" i.e. the rate of the performance fee which may be applied to all models
5. **THE PERFORMANCE FEE METHODOLOGY** which enables the calculation of the performance fees
6. **THE COMPUTATION FREQUENCY** which should coincide with the calculation frequency of the NAV

PROPORTIONATE FEES

The 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.

REASONABLE INCENTIVE

A management company should always be able to demonstrate how the **performance fee model of a fund** it manages constitutes a **reasonable incentive** for the manager and is **aligned with investors' interests**.

CONSISTENCY WITH FUND'S INVESTMENT OBJECTIVES, STRATEGY & POLICY

A MANAGEMENT COMPANY SHOULD CHECK….

SUITABILITY OF THE FUND

Demonstrate whether the chosen performance fee model is suitable for the fund given its investment policy and strategy

For instance, for funds that pursue an absolute return objective, a HWM (high water mark) model or a hurdle might be more appropriate than a performance fee calculated with reference to an index

REFERENCE TO A BENCHMARK

Prove, for funds that calculate the performance fee with reference to a benchmark, that the benchmark is appropriate in the context of the fund's investment policy and strategy and adequately represents the fund's risk-reward profile.

This assessment should also take into account any material difference of risk (e.g. volatility) between the fund's aims and the chosen benchmark.

Where performance fees are payable on the basis of out-performance of a benchmark (e.g. Eurostoxx 50 + X percent, Eonia etc.), the management company should ensure that the benchmark is consistent with the investment policy and strategy of the fund.

IN ALL CASES, THE EXCESS PERFORMANCE SHOULD BE CALCULATED NET OF COSTS

OTHER EXPECTATIONS

FREQUENCY OF THE CHRYSTALLIZATION

The frequency for the crystallization should be defined so as to ensure alignment of interests between the portfolio manager, the shareholders, and fair treatment among investors.

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

The crystallization period should **not be shorter than one year**. Generally, it should end either on December 31 or at the end of the financial year of the fund.

The minimum crystallization period should **not apply to the fulcrum fee model**, as the characteristics of this model are not compatible with a minimum crystallization period.

NEGATIVE PERFORMANCE (LOSS) RECOVERY

A performance fee should only be payable in circumstances where net positive performance has been accrued during the performance reference period. Any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.

Furthermore, the performance fee model should be defined to ensure (i) that the fund manager is not incentivized to take excessive risks and (ii) that cumulative gains are duly offset by cumulative losses.

DISCLOSURE REQUIREMENTS

The prospectus, as well as the marketing material, should clearly give all information necessary to enable investors to understand properly the performance fee model. Such documents should include a **description of the performance fee calculation method**, with specific reference to parameters and the date when the performance fee is paid. The prospectus should include **concrete examples** of how the performance fee will be calculated. In addition, the main elements of the calculation method should be indicated.

The KIID[2] should clearly provide all information necessary to explain the existence of the performance fee, the basis on which the fee is charged, and when the fee applies, in a consistent way with Article 10 (2)(c) of the KIID Regulation.

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.

REPORTING

The annual and half-yearly reports should indicate, for each relevant share class, the **impact of the fees over the crystallization 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.

[2] *Key Investor Information Document*

WHAT TIMELINE?

Q4 2019
End of ESMA consultation

Year 2017
ESMA surveys
national regulators (NCAs)

July 16, 2019
ESMA UCITS Performance Fee
guideline consultation

2017 | 2018 | 2019 | 2020

Early 2018
ESMA mapping exercise

October 31, 2019
Closing of ESMA consultation

Sometime in 2020
ESMA issues final guidelines

TRANSITIONAL PROVISIONS

Once the final version of the Guidelines is adopted, any new UCITS or any existing UCITS that introduces a performance fee for the first time after the date of application of the Guidelines should comply with the Guidelines immediately.

Existing UCITS that already operated a performance fee before the application date of the Guidelines should align their procedures with the Guidelines within 12 months of the application date.

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WHAT CAN ASSET MANAGERS DO?

ARE ESMA GUIDELINES ALREADY STABLE?

The **suggested guidelines are far from set in stone, at an early phase,** and could undergo significant changes.

However, **some road signs are already visible**, including ESMA's choice to heavily base their Consulting Paper on the IOSCO Final Report on "Good practice for fees and expenses of Collective Investment Schemes (CIS)".

A BIG PICTURE TO HAVE IN MIND

The trend is becoming fairly clear. In one way or another, general market trends will duly impact the design of performance fee models such as increasing retail investor protection, faster information dissemination and digitization.

Consequently, it's more important than ever to set-up a proper performance fee framework along those lines — as it is a key component of the industry's wider asset management transformation.

KEY QUESTIONS FOR ASSET MANAGERS

1. Are the design of your performance fee model and selected benchmarks aligned in any way to your fund's investment strategy and risk/reward profile?
2. Is your selected crystallization and fee payment period linked to the average detention period of your fund's shares or units?
3. Does your prospectus clearly and without ambiguity any describe the performance fee calculation? For instance, is the opinion of your auditor positive as regards to the performance fee calculation described in your prospectus? Does it reconcile with the fees actually computed and charged?

A positive answer to these questions will have to be mandatory to fulfill the leading principles of the draft guidelines.

OUR VIEWS

As performance fees constitute a key income source for portfolio managers and considering that related models consequently need to be revised, ManCos' and portfolio manager's income might be significantly impacted and their respective business model might be changed.

In fact, we foresee that a significant portion of performance fee models currently in use would need to undergo major overhauls because they do not meet ESMA's suggested requirements.

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