ESMA Final Guidelines on Performance Fees in UCITS and RIAIFs (April 2020)

Introduction

On April 3rd 2020 the European and Securities Markets Authority ("ESMA") published its final guidelines on Performance fees in UCITS and certain types of AIFs marketed to retail investors (RIAIFs). The guidelines reflect ESMA's continued efforts to create supervisory convergence amongst EU national competent authorities, thereby supporting its efforts in monitoring the cost of retail investment products. This recently issued ESMA update is split into five key areas as follows:

- Performance fee calculation method
- Consistency between the performance fee model and the fund's investment objectives, strategy and policy
- Frequency for the crystallisation of the performance fee
- Negative performance (loss) recovery
- Disclosure requirements of the performance fee model

A summary of the key features of each section of the guidelines is included below.

In May 2019, the Central Bank of Ireland ("CBI") published its guidance on UCITS performance fees. The ESMA guidelines are more detailed. We also include a short summary of extra measures which UCITS and RIAIF managers will need to consider from the ESMA guidelines that were not previously covered by the CBI.

Key Features of the ESMA Guidelines

Performance fee calculation method

The guidelines are built on the premise that the performance fee calculation method of the fund should be constituted of both a reasonable incentive for the manager and alignment with investors' interests. To this end, the guidelines outline 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, that they are verifiable and not open to the possibility of manipulation. The guidelines explicitly state minimum elements that should be included in each performance fee calculation method. The following elements are mentioned:

- A reference indicator;
- The crystalisation frequency;
- The performance reference period;
- The performance fee rate; and
- The performance fee methodology.

Consistency between the Performance Fee Model and the Fund's Investment Strategy and Policy

It is advised that the manager should 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.

An example of a performance fee model that is not appropriate for the investment strategy would be a fund that pursues an absolute return objective with a performance fee calculated with reference to an index because the fund is not managed with reference to a benchmark. A High Water Mark ("HWM") model or a hurdle is more appropriate for such as fund strategy.

The guidelines also state, that in all cases, the excess performance should be calculated net of all costs (for example, management fees or administrative fees) but could be calculated without deducting the performance fee itself as long as this would be in the investor's best interest (i.e. it would result in the investor paying lower fees).

Frequency for the Crystallisation of the Performance Fee

The guidelines state that the crystallisation date should be the same for all share classes of a fund that levy a performance fee and should not be more than once a year. The frequency of crystallisation should be clearly defined in the fund documents and, in general, it is recommended that the crystallisation date coincide with December 31st or the relevant financial year end of each fund.

Negative performance (loss) recovery

The guidelines confirm that a performance fee should only be payable in circumstances where 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.

With reference to situations where a fund utilises a HWM model, a performance fee should only be payable where, during the performance reference period, the new HWM exceeds the last HWM.

Disclosure of the Performance Fee Model

Investors should be adequately informed about the existence of performance fees and about their potential impact on their investment return. To such end, the prospectus should clearly set out all information necessary to enable investors to understand properly the performance fee model and the computation methodology. 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. Specifically, the prospectus should include concrete examples of how the performance fee will be calculated to provide investors with a better understanding of the performance fee model.

With respect to the KIID, it 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 relative to it.

The annual and half-yearly reports should indicate, for each relevant share class, the impact of the performance fees by clearly displaying: (i) the actual amount of performance fees charged and (ii) the percentage of the fees based on the share class NAV.

Comparison between the ESMA 2020 Guidelines and the CBI 2019 Guidelines

For the most part, there is alignment between the new ESMA guidelines and the current CBI rules on performance fees. However, there are some instances where the proposed ESMA guidelines are more extensive than the existing CBI rules and some differences exist. Examples of these include the following:

- The ESMA guidelines contain more explicit elements in relation to performance fee calculations which are not included in the CBI rules.
- The ESMA guidelines contain a broad requirement to ensure that performance fees are consistent with each fund's investment objectives, strategy and policy. In contrast, the CBI rules only require consistency with the fund's investment objectives where performance fees are payable on the basis of out-performance of an index.
- The CBI rules require prospectus disclosures in relation to performance fees. The ESMA guidelines are more prescriptive and require that detailed examples of how performance fees are calculated should be included in the prospectus. In addition, the ESMA guidelines introduce new KIID and annual and half-yearly reports disclosure requirements.
- It should also be noted that RIAIFs are in scope within the ESMA guidance, unlike the CBI guidance. As such, managers of existing RIAIFs with a performance fee should review their calculation methodology to ensure compliance with the guidelines.

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Next Steps

Following translation into the official EU languages and publication on ESMA's website, there will be a two-month window in which national competent authorities must notify ESMA whether they intend to comply with the guidelines. For new funds, the guidelines become effective immediately after this two-month window. For existing funds (with performance fees), managers should apply the guidelines in respect of their funds by the beginning of the financial year following six months from the application date of the guidelines.

The CBI's policy has generally been to comply in full with ESMA guidelines and opinions. It is anticipated that the existing CBI rules will be updated to comply with the new ESMA requirements.

KB Associates' Services

KB Associates offers a range of services to investment funds and ManCos including:

- The provision of UCITS ManCo/AIFM services.
- The provision of designated persons to perform UCITS business plan and AIFMD programme of activity managerial functions

If you would like to discuss any issues raised in this article or related to KB Associates' services in general, please feel free to contact Mike Kirby (+353 1 667 1980), Peadar De Barra (+353 1 667 1983), Barry Harrington (+353 1 667 1986), Frank Connolly (+353 1 667 1987), or Andrew Kehoe (+353 1 613 6396).