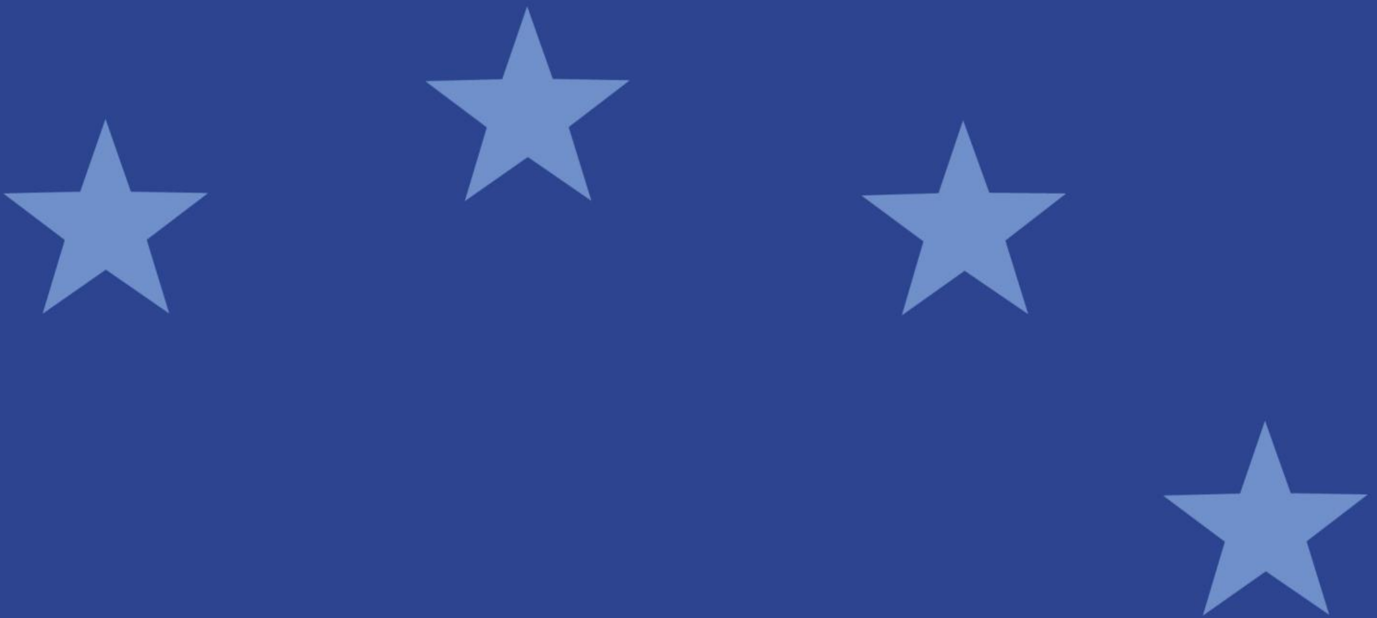
# Response Form to the Consultation Paper

## Guidelines on performance fees in UCITS



16 July 2019 ESMA

esma

# Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **31/10/2019.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

**Instructions**

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_PFG_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_PFG_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PFG_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on Position limits and position management in commodities derivatives").

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

**Who should read this paper**

This document will be of interest to asset managers managing retail funds and their trade associations, as well as institutional and retail investors investing into such funds and their associations.

## General information about respondent

| Name of the company / organisation | CFA Institute |
|---|---|
| Activity | Choose an item. |
| Are you representing an association? | ☒ |
| Country/Region | Belgium |

## Introduction

***Please make your introductory comments below, if any***

<ESMA_COMMENT_PFG_1>

CFA Institute is pleased to have the opportunity to provide comments regarding the ESMA guidelines on Performance fees in UCITS.

CFA Institute is the global association of investment professionals that sets the standards for professional excellence. We are a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. Our mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. There are more than 168,000 CFA charterholders worldwide in 164 markets. CFA Institute has nine offices worldwide and there are 157 local member societies.

We promote (and have a keen interest in) investor protection and market integrity, as stipulated in our mission statement. Historically, we have also taken part in debates about performance and costs presentation, clarity and transparency. In particular, CFA Institute promotes the adoption of GIPS® standards, which are an investment industry standard for calculating and presenting historical investment performance.

We are also of the view that regulatory reporting rules have become complicated and may be blurring the message to end investors.

On performance fees for retail schemes, we support the objective of clarifying the approach through homogeneous EU-wide rules, possibly via the single supervision of ESMA, but there are also difficulties in applying performance fees in retail-oriented funds:

- When they pursue inherently passive or low-risk strategies – in this case, expected outperformance is low and the additional costs engaged by the manager probably do not justify performance fees.

- When, on the contrary, they pursue absolute return investment strategies – in this case, applying performance fees on money market rates may be mis-representing the potential for performance achievement.

- Retail schemes under the UCITS directive are most of the time liquid open-ended structures permitting entry or exit sometimes on a daily basis,. Applying performance fees in such structures may create administrative complication, could result in unfair treatment of investors and may, ultimately harm market integrity. We will recommend regulators pay due consideration to these aspects when finalising the guidelines.

Overall, CFA Institute supports the use of performance fee structures that clearly and completely disclose all fee and costs charged to investors. Structures leading to unfair and unreasonable expenses to clients should not be permitted.
Finally, a point that is not addressed in the guidelines is about clawbacks. Our GIPS® standards require a clawback to be booked on the date this occurs and not to reverse the original fee payment. This maintains the date logic of the cash transactions. Clients may see a lower net performance because of the crystallised performance fee impact and, as a consequence, the subsequent net return could be distorted by the impact of the clawback at a subsequent date of that performance fee being returned.

<ESMA_COMMENT_PFG_1>

## Questions

**Q1** : Do you agree that greater standardisation in the field of funds' performance fees is desirable? What should be the goal of standardisation?

<ESMA_QUESTION_PFG_1>
We believe that enhanced standardisation in performance fees charged by funds would be extremely beneficial in achieving a genuine Capital Markets Union (CMU) in the EU. Having same standards for UCITS' performance fees would ensure easier cross-border distribution of funds. Foremost, these standards should aim to achieve alignment of interest between the manufacturer of the products (the agent) and the investor (the principal). Historically and when analysing financial services developments through the cycles, such balance has been difficult to find. Several questions need asking when it comes to demonstrating the value for money provided by asset managers: 1) in good times for markets, are managers remunerated for simply providing the market's performance?; 2) in times of financial crisis, are managers properly remunerated when protecting capital against a market downfall?; 3) what is the right balance between fixed management fees (to compensate the manager for their fixed costs) and performance fees (to incentivise the pursuit of superior performance at a given level of risk) that will align the interests of both parties?

Fee structures using any combination of management and performance fees should aim to achieve an alignment of interest between the manager and the investors. The latter should not be structurally disadvantaged by such structures. We understand that pursuing the lowest fees possible may not always be the best strategy in the long run. Nonetheless, we advocate for performance fee frameworks that ensure an easy understanding of the value of the fees that end investors are paying, which is a critical precondition for the CMU to prove successful through the cycles and over the long term.
<ESMA_QUESTION_PFG_1>

**Q2** : Are there any obstacles to standardisation that could be removed by regulatory action? Please elaborate.

<ESMA_QUESTION_PFG_2>
Performance fee structures are regulated in a different manner across EU member states. Some national competent authorities ban the use of specific fee structures, that are in turn allowed in other national markets. One significant regulatory solution to overcome these barriers is to have direct supervisory powers for ESMA in the cross-border investment funds sector. Harmonised standards on performance fee structures would facilitate the achievement of a Capital Markets Union.
<ESMA_QUESTION_PFG_2>

**Q3** : What should be taken into consideration when assessing consistency between the index used to calculate the performance fees and the investment objectives, strategy and policy of the fund? Are there any specific indicators which should be considered (eg: historical volatility, asset allocation composition, etc.) to ensure this consistency? Please provide examples and give reasons for your answer.

<ESMA_QUESTION_PFG_3>
A hurdle rate, which should always be integrated in performance fee structures, needs to be based on an index or benchmark that best aligns the investor stated objectives (investment policy, guidelines and financial performance objectives) and the manager interests. We believe that it would not be appropriate to set a hurdle rate based on an index/market benchmark with risk characteristics that significantly differ from those of the fund itself. However, a benchmark or index should firstly be chosen in relation to the strategy of the investment manager Risk measures to be considered when evaluating the differences or similarities between the fund and its benchmark should consider both ex-post and ex-ante factors so as to fine tune the analysis through time and against the manager' strategy, for example: ex-ante and ex-post volatility, beta, covariance, VarR. Depending on the underlying asset class, liquidity measures could also be used, such as daily trading volumes, bid-ask spreads. In the end, the hurdle rate should be chosen in a way that reflects the likelihood or difficulty for a manager to exceed the objective. This logic will obviously become more difficult when considering absolute return funds, for which typical market benchmarks are more difficult to compete against. In those cases, the traditional approach has been to use risk free money market interest rates, but it is difficult to determine the appropriateness of such benchmarks given they will behave very differently from the fund. Other approaches include model benchmarks which are meant to capture more accurately the management style, including the various underlying asset classes and strategies, which in some cases may include leverage. The shortcomings of such model benchmarks is that they can prove difficult to understand.
Another aspect we are concerned about is comprising an investment that generates capital as well as income return against a price only (principal only) benchmark. Comparison of a capital plus income investment against a price only benchmark already gives the manager an inherent advantage. Matching the risk characteristics is very important. It is very easy to gain return by drifting outside of risk boundaries in order to capture excess return for a particular period and gain a performance fee.

Our position is also that performance fees should probably not be used for funds that feature low levels of risk and, therefore, where the resulting performance potential is also low. We believe charging performance fees for products whose primary objective is to produce low volatility returns would be inappropriate and fail to align interests between the parties, as the expected benchmark outperformance is low relative to total returns. For these funds, the disadvantages of performance fee structures may outweigh the benefits.
<ESMA_QUESTION_PFG_3>

**Q4** : What is the anticipated impact of the introduction of Guideline 3? Do you agree with setting a minimum crystallisation period of one year? Do you think this could help better aligning the interests of fund managers and investors? Please provide examples.

<ESMA_QUESTION_PFG_4>
In principle, we agree with a minimum crystallisation period of one year to encourage long-termism. However, a longer period may also cause issues. For instance, after a period of outperformance, the size of a fund could increase leading to unfairness between investors.

We also agree on the exemption for fulcrum fees, but we think that also reserve fund performance fee structures should be excluded from the scope of the guideline. The main reason is that because these fees are not paid directly to the investment manager, and only at the end of the performance period (this is actually the crystallisation date for the portfolio manager), the manager takes a percentage of the reserve fund NAV as its performance fee. We advocate for a minimum one-year period for the payment of such a reserve.
However, a caveat concerns the way performance fees are calculated, irrespective of the crystallisation period. There are many tricks that could put investors at disadvantage (e.g., annual reset). The notion and the implementation of HWM should be clearly defined. In general, there is no good method but the calculation method must be consistent and treat investors fairly.
<ESMA_QUESTION_PFG_4>

**Q5** : Are there any other models or methodologies currently employed that, in your view, should be exempted from this requirement? For example, do you think that the requirement of a minimum crystallisation period of 12 months should also apply to HWM models? Please provide examples on how these models achieve the objectives pursued by Guideline 3.

<ESMA_QUESTION_PFG_5>
Reserve fund performance fees should also be exempted from Guideline 3. Please see our response to Q4.
<ESMA_QUESTION_PFG_5>

**Q6** : In your view, should performance fees be charged only when the fund has achieved absolute positive performance? What expected financial impact (e.g. increase or decrease of the manager's remuneration or increase or decrease of the financial return for investors) would the proposed Guideline 4 have for you/the stakeholder(s) you represent? Are there models or methodologies currently employed where the approach set out in Guideline 4 would not be appropriate?

<ESMA_QUESTION_PFG_6>
CFA Institute believes that performance fees should not only be charged when the fund has obtained relative outperformance, i.e when the fund has only outperformed the benchmark but the fund return may still be negative. Performance fees could be applicable when there is relative outperformance, provided that the fund is not underwater.
Performance fees should be based on performance relative to the hurdle rate (see response 3). Where a fund bases the performance fee on a benchmark that reflects the fund objectives and the manager outperforms this benchmark, a performance fee may still be charged even if the fund suffers negative performance. In a 'bear market' scenario, if no performance fee is paid, then an asymmetry is created and a mis-alignment of interests such that the PF fails to incentivise the manager to outperform so long as the market is in a 'bear market' period and overall values are falling. In order to reduce the adverse reputational consequences arising then performance fee payments accrue in a period of negative absolute performance, managers could add structural features to their performance fee framework, such as longer performance measurement periods, the introduction of a deferral mechanism or waiver of the actual

payment of performance fees, or a cap on the performance fee amount when performance is negative.
<ESMA_QUESTION_PFG_6>

**Q7** : If the performance fee model that you currently use provides for performance fees to be payable in times of negative returns, is a prominent warning on this provided to investors in the legal and marketing documents of the fund? If not, should this be provided? Please give examples for your answer and details on how the best interests of investors are safeguarded.

<ESMA_QUESTION_PFG_7>
Please see our response to question 6.
<ESMA_QUESTION_PFG_7>

**Q8** : What are your views on setting a performance reference period for the purpose of resetting the HWM? What should be taken into account when setting the performance reference period? Should this period 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? Please provide examples and reasons for your answer.

<ESMA_QUESTION_PFG_8>
Yes, we believe that the appropriate performance reference period should be based on the whole life of the fund. If a fund has been running for a period longer than three years, that period should reflect the advertised time horizon of the fund and its strategy. Conversely, for new funds with no established past performance covering the full measurement period, performance fee should be "Since Inception" based, not paid at all, average-in or accrued/reserved and not crystallised.
<ESMA_QUESTION_PFG_8>

**Q9** : Alternatively, would it be possible to envisage predefined time horizons for the purpose of resetting the HWM, such as 3 or 5 years? Please provide examples and details on what you think would be the best practice in order to better align the interests of fund managers and investors.

<ESMA_QUESTION_PFG_9>
We are not in favour of arbitrary re-sets which could undermine the integrity and purpose of the HWM.
<ESMA_QUESTION_PFG_9>

**Q10** : How long do you think the performance reference period should be for performance fee models based on a benchmark index? What should be taken into account when setting the performance reference period for a performance fee benchmark model? Would it be possible to envisage predefined time horizons for the purpose of resetting the performance fee based on a benchmark, such as 3 or 5 years? Please provide examples and details on what you think would be the best practice in order to better align the interests of fund managers and investors.

<ESMA_QUESTION_PFG_10>
We are not in favour of HWM fee structures based on benchmark-relative performance results. Where an absolute HWM is used:
- in a 'Bear Market' an asymmetry is created where the manager receives no incentive for outperforming their peers as the absolute performance on which their fund's PF is based is market driven.
- in a 'Bull Market', managers can still be paid a PF for poor performance just because the overall market has gone up.
<ESMA_QUESTION_PFG_10>

**Q11** : Alternatively, do you think the performance reference period should coincide with the minimum crystallisation period or should it be longer/shorter? Please provide examples and reasons for your answer.

<ESMA_QUESTION_PFG_11>
A performance fee based on a performance reference period of 1 year or shorter could lead to managers adopting a strategy that would cause excessive risk-taking for end-investors as the fund gets closer to the end of the crystallisation period if the manager has not managed to achieve their objectives earier. In general, the longer the performance reference period the more long-term the fund strategy will be and the less excessive or unwarranted risks will be taken by managers.
However, longer performance reference periods could also lead to greater potential misalignment between performance produced and performance fees paid at individual investor level in case of open-end fund as investors might enter and exit the fund throughout the reference period – the risk of market timing. These unequality risks for investors should be adequately disclosed.
A caveat is that not necessarily a performance fee based on performance reference period of 1 year or shorter leads to more risk-taking if rights safeguards are put in place (e.g. a high watermark).
<ESMA_QUESTION_PFG_11>

**Q12** : What are your views on when the Guidelines should become applicable? How much time would managers require to adapt existing fee mechanisms to comply with the requirements of these Guidelines?

<ESMA_QUESTION_PFG_12>
CFA Institute encourages such guidelines to be voluntary. They should become applicable as soon as they are available: new offerings could adopt these guidelines while existing agreements could not unless the costs charged to investors are shown that under all performance scenarios where equal or less than the existing arrangement. <ESMA_QUESTION_PFG_12>

**Q13** : Do you consider that the principles set out in the Guidelines should be applied also to AIFs marketed to retail investors in order to ensure equivalent standards in retail investor protection? Please provide reasons.

<ESMA_QUESTION_PFG_13>
Alternative Investment Funds are different vehicles, which are offered to a different type of investors compared to UCITS. We expect the use of performance fees to be

more prevalent in AIFs than UCITS. Hence, we believe that extending the scope of these guidelines to AIFs as well would be potentially disruptive.

By nature and as designed by regulation itself, AIFs are more complex products that are permitted more freedom in terms of how they are operated and the levels of risk they may engage in. The AIFMD specifies that AIFs may only be marketed to investors who qualify as professional (defined under MiFID), unless local jurisdictions decide to also allow their marketing to local categories of investors that cannot qualify as professional, most often high net worth individuals or sophisticated investors. In some cases, the definition becomes quite large and retail investors can gain access if they simply choose to forgo some of the protection they are granted in general as retail investors. These are the instances where it is particularly important for proper interaction to take place between the manufacturer and the distributor to ensure that investors understand the levels of risk they face, the potentially illiquid nature of their chosen investment, the eventual longer time horizon and, ultimately whether the charging structure differs from what they are used to in the UCITS world. This is why CFA Institute, in general, advocates in favour of marketing rules, transparency and reporting standards that are as clear and informative as possible – at the moment, definitions and standards continue to vary between MiFID, PRIIPs and AIFMD, which is not ideal. Hence also why in this case, we believe in the freer nature of AIFs vehicles, provided investors are properly and efficiently informed. A broader corollary question should be about whether the complexity of local implementation of the AIFMD is ultimately making cross-border distribution of such products, which are very complicated, where investors may be at an information disadvantaged when they do not benefit from proper professional advice.
<ESMA_QUESTION_PFG_13>

**Q14** : Do you agree with the above-mentioned reasoning in relation to the possible costs and benefits as regards the consistency between the performance fees model and the fund's investment objective? What other types of costs or benefits would you consider in this context? Please provide quantitative figures, where available.

<ESMA_QUESTION_PFG_14>
The application of performance fees to funds offered to retail investors may lead to complication when performance fee structures are compared to the "ad valorem fee model", and because of retail investors' low level of understanding regarding potential outcomes under different fee structures.
Also, it is important to mention that funds offered to retail investors in the UCITS regulatory framework are by nature liquid and open-ended. The application of performance fees in open-ended fund structures may lead to administrative complication when managing the various share classes and ensuring, ultimately, equal treatment of all investors. Performance fees may result in discrepancies between investors entering the fund at different times, yet required to pay the same charges. As such, consideration must be given to the adequacy of liquidity rules under UCITS and the application of performance fees. We are of the view that regulators should be mindful of how investors are treated fairly, the potential for market timing of fund shares and therefore, the potential threat to market integrity.
<ESMA_QUESTION_PFG_14>

**Q15** : In relation to Guideline 2, do you think that models of performance fee without a hurdle rate, or with a hurdle rate not linked to the investment objective (but clearly stated in the offering documents), should be permissible? For example, do you think that equity funds with a performance fee linked to EONIA, or a performance fee which is accrued as long as there are positive returns, should be allowed? Please give examples and reasons for your answer.

<ESMA_QUESTION_PFG_15>
Please see our response to question 3.
<ESMA_QUESTION_PFG_15>

**Q16** : What additional costs and benefits would compliance with the proposed Guideline bring to you/the stakeholder(s) you represent? Please provide quantitative figures, where available.

<ESMA_QUESTION_PFG_16>
The guidelines should strike the right balance between ensuring minimum standards of investor protection and enabling innovative structures, such as the use of performance fee reserves. With a performance fee reserve, an amount equivalent to the outperformance of the fund multiplied by the participation rate is set aside into a reserve. The reserve would be used to make refunds to the fund in the event of underperformance based on the same participation rate. At the end of the performance period, the manager will take a portion of the reserve fund NAV as its performance fee. The fee paid to the manager could be based on a fixed percentage of the reserve, the excess of the reserve above a predefined level or a combination of both. The amount paid to the manager, from the reserve, may be subject to a performance fee cap calculated in relation to the NAV of the primary fund.
Once fees flow from the reserve to the manager, they are no longer available for refund. However, the reserve cannot have a negative value. A reserve introduces a greater degree of symmetry into the performance fee structure than either a fulcrum fee or the traditional performance fee structure.
<ESMA_QUESTION_PFG_16>

**Q17** : What is the anticipated impact from the introduction of this proposed Guideline? Are there models or methodologies currently employed where this Guideline would not be appropriate? If so, please provide examples of these and details of how the best interests of investors are safeguarded.

<ESMA_QUESTION_PFG_17>
We agree with the proposed guideline. Investors should not be asked to pay twice for the same performance when the fund recovers a previous loss with a subsequent outperformance. A performance fee should not be payable until a previous underperformance or loss is completely recovered.
<ESMA_QUESTION_PFG_17>

**Q18** : What additional costs and benefits would compliance with the proposed Guideline bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

<ESMA_QUESTION_PFG_18>
CFA Institute is an association of investment professionals. We are not an investment manager.
<ESMA_QUESTION_PFG_18>

**Q19** : Which other types of costs or benefits would you consider in the disclosure of the performance fees model? Please provide quantitative figures, where available.

<ESMA_QUESTION_PFG_19>
Performance for existing clients should be disclosed gross and net of fees in order to allow end-investors understand the value of their investment for the money paid. For prospective clients, our GIPS® standards require that disclosure of\ performance fees may apply to a specific product while further details could be available upon request. Given that performance fees depend on the inception date of the investment, for a prospective client presentation of any specific performance fee amount could be considered misleading.
Finally, we underline that the different components of the fees charged should also be disclosed. Retail investors (but also institutional investors) have the right to a clear explanation of all fees and costs charged to them, and information showing these expenses to be fair and reasonable.
<ESMA_QUESTION_PFG_19>