ALLEN & OVERY

GREAT FUND INSIGHTS

ESMA Guidelines in respect of performance fees in UCITS and certain types of AIFs

On 3 April 2020, ESMA published its final report on guidelines regarding performance fees in UCITS and certain types of AIFs, including the guidelines, as appendix IV (the **Report**). On 5 November 2020 (the **Publication Date**), ESMA published the official translations of the guidelines on performance fees in UCITS and certain types of AIFs dated 5 November 2020 (ESMA34-39-992 EN)[1] (the **Guidelines**). In its Report, ESMA stressed the lack of harmonisation between member states of the European Union with respect to performance fee structures, as well as the circumstances under which performance fees may be paid by investors. The purpose of the Guidelines is to establish a common standard in relation to the disclosure of performance fees to investors in undertakings for collective investments in transferable securities (**UCITS**) and retail investors in certain types of alternative investment fund (**AIFs**).

Fund managers should carefully review the Guidelines and their current and/or future performance fee models to assess the potential changes needed to their performance fee models to ensure timely compliance with the Guidelines.

[1] Please refer to the following link for the Guidelines in the English language: https://www.esma.europa.eu/sites/default/files/library/esma34-39-992_guidelines_on_performance_fees_en.pdf

Scope

The Guidelines will apply to UCITS and certain types of AIFs that are marketed to retail investors by alternative investment fund managers managing those AIFs in accordance with article 43 of the AIFMD. However, the following AIFs will be excluded from the scope of the Guidelines:

(a) closed-ended AIFs; and

(b) open-ended AIFs that are EuVECAs (or other types of venture capital AIFs), EuSEFs, private equity or real estate AIFs.

Certain exemptions apply to the fulcrum fees (ie, a type of performance fee which provides for the level of the fee to increase or decrease proportionately with the investment performance of the fund over a specified period of time in relation to the investment record of an appropriate reference indicator (including a negative fee deducted from the basic fee charged to the fund)) and other fee models which provide for a symmetrical fee structure, as in these models the level of the performance fee increases or decreases proportionately with the investment performance of the fund.

Entering Into Force and Transitional per IOD

The Guidelines will apply from the date which falls two months after the Publication Date (ie, as of 6 January 2021). The Guidelines will be effective immediately for any UCITS or AIFs created or starting to apply for the first time a performance fee model on or after the effective date.

For existing UCITS and in scope AIFs created prior to the effective date, a transitional period starting as of the financial year following six months from the effective date applies. For existing UCITS and in scope AIFs having the calendar year as their financial year, this means the Guidelines apply as of 1 January 2022.

Overview of the Guidelines

Guideline 1 – Performance fee calculation method

Guideline 1 provides a non-exhaustive list of elements to be included in the performance fee calculation method. These are as follows:

(a) the reference indicator (eg, an index, a high-water-mark (**HWM**), a hurdle rate, a combination of a HWM and a hurdle rate, etc.);

(b) the crystallisation frequency – Please refer to guideline 3 below;

(c) the performance fee reference period;

(d) the performance fee rate;

(e) the performance fee methodology; and

(f) the computation frequency which should coincide with the calculation frequency of the NAV (eg, daily NAV, daily calculation and accrual of the performance fee, etc.).

Guideline 2 – Consistency between the performance fee model and the fund's investment objectives, strategy and policy

The fund manager should ensure that the employed performance fee model is consistent with the investment strategy, objective and policy of the fund. ESMA provides examples of how to calculate the performance fee where funds pursue an absolute return objective or a long-equity strategy. Guideline 2 also sets out a non-exhaustive list of "consistency indicators" (eg, expected return; geographical exposure; credit rating category, etc.) which should be taken into account by the fund manager based on the type of investments of the fund.

The performance fee should always be calculated net of all costs (eg, management company fees, administration fees, etc.). However, where this is in the best interest of investors, the net performance fee could be calculated without deducting the performance fee itself.

Guideline 3 – Frequency of the crystallisation of the performance fee

The crystallisation of the performance fee of the fund should not occur more than once a year. The crystallisation year should be the same for all share classes issued in a fund. The crystallisation date should coincide with the end of the financial year of the fund.

Guideline 4 – Negative performance (loss) recovery

A performance fee should only be payable where the fund enjoyed a positive performance during the performance reference period. As long as the fund underperforms or is in a loss situation, any underperformance or losses incurred during a performance reference period should first be recovered prior to the fund manager being entitled to performance fee payments. In order to avoid misalignment of interests between the fund manager and the investors, a performance fee could also be payable in case the fund has overperformed its reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided.

In case the fund employs a performance fee model based on a benchmark index, it should be ensured that any underperformance of the fund compared to the benchmark is clawed-back before any performance fee becomes payable. To this purpose, the length of the performance reference period, if this is shorter than the whole life of the fund, should be set equal to at least five years.

Where a fund utilises a HWM model, a performance fee should be payable only where, during the performance reference period, the new HWM exceeds the last HWM. For the HWM model, in case the performance reference period is shorter than the whole life of the fund, the performance reference period should be set equal to at least five years on a rolling basis. In this case, 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.

Guideline 5 – Disclosure of the performance fee model

The prospectus (and any ex-ante information documents) of the fund should include among others:

(a) a description of the performance calculation method;

(b) all information allowing the investors to understand the performance fee model and the computation methodology;

(c) the date on which the performance fee is paid; and

(d) concrete examples of how the performance fee will be calculated.

The key investor information document (**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.

For each relevant share class of the fund, the annual and semi-annual reports (and any ex-post information documents) should indicate:

(a) the actual amount of the performance fee charged to investors; and

(b) the percentage of the fees based on the share class NAV.

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.