



European Securities and  
Markets Authority

# Final Report

**Guidelines on performance fees in UCITS and certain types of AIFs**



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## I. Executive Summary

### Reasons for publication

Ensuring supervisory convergence regarding performance fee structures as well as the circumstances in which performance fees can be paid has been included in the key priorities for the 2019 ESMA Supervisory Convergence Work Programme (SCWP).<sup>1</sup>

Being not further detailed in EU regulation and considering the great importance of funds' cross border distribution, supervisory convergence on this issue is essential to ensure a level playing field in the European Union (EU).

On 16 July 2019, ESMA published a Consultation Paper (CP)<sup>2</sup> on the proposed draft Guidelines.

The consultation closed on 31 October 2019.

This Final Report provides an overview of the feedback received through the responses to the CP and explains how ESMA took this feedback into account. It also contains the final set of Guidelines on performance fees in UCITS and certain types of AIFs.

### Contents

Section 2 sets out an Overview of the document. Annex I provides the Feedback Statement and Annex II includes the opinion of the Securities and Markets Stakeholders Group (SMSG). Annex III sets out the cost-benefit analysis which details the expected impact of the Guidelines.

The Guidelines are set out in Annex IV.

### Next Steps

The Guidelines in Annex IV of this report will be translated into the official EU languages and published on the ESMA website. The publication of the translations will trigger a two-month period during which NCAs must notify ESMA whether they comply or intend to comply with the guidelines. The Guidelines will apply from the end of this two-month period.

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<sup>2</sup> [https://www.esma.europa.eu/sites/default/files/library/esma34-39-881\\_cp\\_on\\_performance\\_fees\\_guidelines\\_in\\_ucits.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-39-881_cp_on_performance_fees_guidelines_in_ucits.pdf)

## II. Overview

### Background

1. Ensuring supervisory convergence regarding performance fee structures as well as the circumstances in which performance fees can be paid has been included in the key priorities for the 2019 ESMA Supervisory Convergence Work Programme (SCWP).<sup>3</sup>
1. Currently different practices across NCAs regarding performance fee structures as well as on the circumstances in which performance fees can be paid. This creates risks of regulatory arbitrage and inconsistent levels of investor protection.
2. At the beginning of 2018, ESMA conducted a mapping exercise among National Competent Authorities (NCAs) in order to analyse the current practices in the different Member States in relation to some aspects of performance fees.
3. The results have shown the lack of harmonisation among EU jurisdictions.

### Public consultation

2. On 16 July 2019, ESMA published a CP<sup>4</sup> on the proposed draft Guidelines.
3. The consultation closed on 31 October 2019.
4. ESMA received 48 responses, 14 of which are confidential, mainly from asset management industry associations and asset managers. The answers received are available on ESMA's website unless respondents requested confidentiality. ESMA also received the advice of the SMSG.<sup>5</sup>
5. In general, respondents agreed with ESMA's approach of introducing minimum standards for performance fee models.
6. The detailed content of the responses and ESMA feedback is outlined in the Feedback Statement.<sup>6</sup>

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<sup>4</sup> [https://www.esma.europa.eu/sites/default/files/library/esma34-39-881\\_cp\\_on\\_performance\\_fees\\_guidelines\\_in\\_ucits.pdf](https://www.esma.europa.eu/sites/default/files/library/esma34-39-881_cp_on_performance_fees_guidelines_in_ucits.pdf)

<sup>5</sup> See Annex II of this Final Report.

<sup>6</sup> See Annex I of this Final Report.

## II. Annexes

### Annex I: Feedback Statement

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

1. A vast majority of respondents agreed that greater standardisation in the field of funds' performance is desirable. According to most respondents, the goal of standardisation should be to enhance supervisory convergence. Common standards for UCITS' performance fees would provide more clarity for investors and a level playing field for funds' cross-border distribution. Some respondents also pointed out that enhancing transparency would achieve alignment of interest between managers and investors. As highlighted by several respondents, an integrated Single Market for financial services must ensure the same conditions for the operation of UCITS and the same legal protection regime for retail investors.
2. The SMSG encouraged ESMA to finalise these Guidelines to allow for pan-European convergence in the field of performance fee calculation. The SMSG also agreed with the framework proposed by ESMA and the strong link with the IOSCO principles.
3. Some respondents argued that different practices across the Member States create the risk of regulatory arbitrage. Another respondent noted that while a variety of fee structures and models may stimulate competition, the complexity might also create the disadvantage of no longer being understandable and entail the risk of hampering investors' protection.
4. Although respondents almost unanimously supported greater standardisation, diverging views were expressed regarding the most appropriate approach to be adopted. On the one hand, a majority of respondents noted that prescriptive guidelines would not capture the great diversity of performance fee models and would inevitably stifle innovation. These respondents were of the view that adopting a principles-based approach, in line with the 2016 IOSCO Good Practices, would achieve standardisation and might further encourage the use of such models. Among these respondents, some argued that despite the draft Guidelines' focus on the need to protect retail investors, there is a considerable part of UCITS funds marketed to institutional investors through dedicated share classes. In light of the greater sophistication, risk tolerance and size of invested assets of institutional investors, performance fee calculations and disclosure would deserve greater flexibility outside a mass-retail market and concomitantly allow NCAs greater latitude when authorising fee methodologies for institutional share classes.
5. On the other hand, consumers' associations underlined that with regards to the choice of legal instruments, in light of the need for standardization justified by the single market and investors' protection concerns, ESMA should have attempted to propose Regulatory or Implementing Technical Standards to the European Commission to be adopted as a delegated regulation pursuant to the UCITS V Directive and Article 290 TFEU.

**ESMA response:**

ESMA notes the support from stakeholders for the development of Guidelines on performance fees in light of the need of ensuring investors' protection and a level playing field among Member States.

ESMA takes note of the comment to adopt a principle-based approach which it considered on balance together with its overall aim of fostering supervisory convergence in this field.

ESMA takes note of the feedback regarding the opportunity to use a more prescriptive legal instrument, but this would go beyond the powers attributed to ESMA by the relevant legislative framework.

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

6. A significant number of respondents highlighted that the ESMA guidance could ensure a consistent application among Member States of the IOSCO practices and the same level of disclosure regarding performance fee models. Those respondents also added that this standardisation is important in light of funds' cross border distribution in order to avoid that any specific national rule on top of the ESMA's guidelines would be able to constrain cross-border marketing of retail share classes. They thus invited ESMA to avoid such unfortunate regulatory outcomes through the proposed Guidelines.
7. Several respondents pointed out that the adoption of a standardised terminology is a pre-requisite for greater standardisation and therefore invited ESMA to clarify the meaning of the definitions and terminology used. To support their argument, some respondents noted that the IOSCO practices refer to "crystallisation frequency" rather than "crystallisation period" and advised an alignment with the IOSCO practices, also not to confuse the concept of the "crystallisation period" with the concept of "performance reference period", potentially leading to diverging practices.

**ESMA response:**

ESMA takes note of the feedback regarding how the guidelines will standardise current practices applied across EU jurisdictions in the field of performance fees. ESMA also considers that, in any case, any specific provision applying at national level on top of the provisions set out in the guidelines should not jeopardise the rules regarding funds' cross border distribution<sup>7</sup> and the split of competences between the home and host competent authority<sup>8</sup> to this regard.

ESMA took note of stakeholders' suggestion to refer to crystallisation "frequency" rather than "period". In light of this, ESMA has decided to refer to "crystallisation frequency" in the final guidelines. However, ESMA notes that the notion of "crystallisation period", as previously employed and defined in the draft guidelines subject to consultation, was in any case not in conflict with the IOSCO practices.

**Q3 What should be taken into consideration when assessing consistency between the index used to calculate the performance fees and the investment objectives,**

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<sup>7</sup> See Chapter XI of the UCITS Directive.

<sup>8</sup> See Chapter XII of the UCITS Directive.

**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.**

8. The respondents unanimously acknowledged the need for consistency between the fund's investment objective, strategy and policy and the performance fee model.
9. Nonetheless, most respondents noted that given the wide diversity of investment strategies, consistency should be considered on a case-by-case basis. These respondents did not see any merits in providing an exhaustive list of indicators which should be considered, leaving the ultimate choice to the manager depending on the objectives of the fund. They invited ESMA to add references to historical volatility, asset allocation composition, etc. but only as mere examples.
10. A few respondents agreed that where a fund's strategy offers some form of beta exposure to an underlying asset class, any performance fee should be levied off a benchmark that is consistent with the fund's risk/reward profile and thus aligned with its investment objectives and strategy.
11. A consumers' association suggested a holistic approach in determining whether the index is appropriate or not for calculating the performance fees. One of their proposals was to refer to the examples from the March 2019 Q&As on UCITS [Q&A 8b]<sup>9</sup> and require that the benchmark mentioned in either Section 1, 2 or 3 of the KIID – the one in relation to which the fund is managed – would be the only valid basis for calculating the performance fees.<sup>10</sup> The same respondent also invited ESMA to clarify that certain UCITS and AIFs are not compatible with a performance fee model.
12. On the other hand, several asset managers representatives argued that where a UCITS references an index for the sole purpose of measuring its performance fees against it, that UCITS should not be understood as being managed according to that same index. The use of a benchmark for the sole purpose of calculating performance fees would therefore deserve to be disclosed only in the "Charges" section (and not in the "Past performance" one) of the UCITS KIID. In the case where a fund follows an absolute return investment strategy, any wording or graphic representation in the UCITS KIID or prospectus implying the fund is managed with reference to an index would inevitably mislead investors. Moreover, several respondents pointed out that some managers (i.e. funds with High-on-High model) might need to be able to combine a HWM model for an absolute return objective with a hurdle rate to better align the model to the fund's risk reward profile.
13. In light of certain national regulators' findings on the use of inappropriate benchmarks for the calculation of performance fees, the SMSG is of the opinion that the prospectus should disclose the rationale behind the choice of a specific benchmark in the context of the UCITS investment policy.
14. Finally, a majority of respondents shared ESMA's view that the excess performance should be calculated net of costs.

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<sup>9</sup> See UCITS Q&As on benchmark disclosure: <https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits>

<sup>10</sup> See Article 4 of the Commission Regulation 583/2010 ("KIID Regulation").

### **ESMA response:**

ESMA takes note of the many contributions from stakeholders regarding the principle of consistency between the performance fee model and the fund's investment objective set out in Guideline 3.

While acknowledging the fact that some stakeholders would not favour a detailed guidance on this aspect, ESMA deems important to operationalise this recommendation in order to ensure a consistent application of Guideline 3 across the EU.

ESMA deems that a harmonised approach regarding the assessment of the consistency between the performance fee model and the fund's investment objective, strategy and policy, would be highly relevant in case of a benchmark referenced UCITS which employs an index to compute performance fees. In this case, ESMA believes that more specific guidance should be provided on how to ensure consistency between the indexes/choose the index to be used in the performance fee model.

In this context, and in light of the several comments received by stakeholders, ESMA notes that the application of the benchmark disclosure Q&As published in March 2019 is not under discussion and it should not prevent the introduction of the performance fees guidelines. On the contrary, ESMA believes that a combined reading of the benchmark disclosure Q&As and the performance fee guidelines could help putting into context the concrete application of the recommended practices. For this reason, as suggested by consumers representatives, the final guidance include terms and examples already used in the Q&As, ensuring consistency as well as a clear link between the two texts.

ESMA agrees with the introduction of some indicators which should be used in order to assess the consistency between the index used to compute performance fees and the one to which the fund is referenced to. For this reason, ESMA has included in the final guidance a list of "consistency indicators" to be applied in case a fund managed in reference to a benchmark computes performance fees based on a benchmark index.

Nevertheless, ESMA deems it appropriate to recommend that, as a general principle, funds should use the same benchmark which they are referenced to for the computation of performance fees, in line with what is already applied in several Member States and in order to ensure full alignment between the strategy of the fund and the index used to compute performance fees. This includes, *inter alia*, the case where the fund has a performance objective linked to the performance of a benchmark (e.g.: Index A + positive absolute return objective; Index A + HWM; Index A + X% hurdle rate etc) or the case where the fund portfolio holdings are based upon the holdings of the benchmark index (e.g.: the individual holdings of the fund's portfolio do not deviate materially from those of the benchmark index). ESMA considers that in such cases it would not be appropriate for the fund to employ a different index without potentially risking harming the investor's best interest.

Furthermore, ESMA deems it appropriate to recommend, in the context of Guideline 5, that in case a fund managed in reference to a benchmark, employing a performance fee model based

on a benchmark index, computes performance fees with a different but consistent benchmark (see paragraphs 45 of the guidelines), the motivations behind the choice of not using the same index should be included in the prospectus. The aim of this recommendation is to ensure that choice of the index would not hamper investors' best interests.

Lastly, ESMA deems it appropriate to recommend that 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 in case this is in favour of the investor's best interest (i.e. it would result in the investor paying less fees).

**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.**

15. A significant number of respondents invited ESMA to clarify the notion of "crystallisation period" and many suggested that ESMA refers to "crystallisation frequency" instead.
16. Respondent generally agreed with ESMA's proposal to set the minimum crystallization period to at least one year. Several respondents supported the introduction of such a requirement since it is already a common practice in most EU jurisdictions. However, among these respondents, a few invited ESMA to clarify that new share classes launched in the interim between one crystallisation date and the following one, should crystallise at the time of the next crystallisation date provided that such date occurs no sooner than 12 months from their launch date. Some respondents highlighted that the crystallisation period shouldn't necessarily coincide with the calendar year or with the company's financial year. These respondents were of the view that it should be left to the discretion of the manager to select both the start and the end date of the 12-month minimum crystallisation frequency.
17. Several respondents argued that the Guidelines should reflect the fact that performance fees also crystallise when investors in the share class choose to redeem, as well as in exceptional circumstances for a variety of purely technical reasons, as for instance, with the launch of new share classes, fund mergers, liquidations, or other corporate actions. They argued that in these exceptional cases a crystallisation period shorter than one year should be allowed.

**ESMA response:**

ESMA noted the comments of those stakeholders who suggest referring to the "crystallisation frequency", rather than "crystallisation period" and has modified the language accordingly. Therefore, ESMA's recommendation is that the "crystallisation frequency" should not be more than once a year, in line with the IOSCO practices. Nevertheless, ESMA notes that the notion of "crystallisation period", as previously employed and defined in the draft guidelines subject to consultation, was in any case not in conflict with the IOSCO practices.

ESMA has also introduced more specific guidance in case of the creation of a new share class and in case of investors' redemptions. In this respect, ESMA believes that, in order to avoid operational risks, the payment of the performance fees, if any, should be aligned among

different share classes. Furthermore, the performance fees should be crystallised upon investors' redemptions, in line with the principle of equal treatment of investors.

ESMA believes that, under the application of the minimum crystallisation frequency, the date on which performance fees should be crystallised should coincide with the end of the calendar year or the end of the financial year of the fund, in order to ensure clarity to investors on when the performance fees can become payable to the manager.

**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.**

18. Some respondents raised concerns regarding ESMA's definition of High Water Mark (HWM) model since it appears to refer only to a HWM model variant known as the High-on-High (HoH), whereby the performance fee becomes payable if the NAV per share exceeds the highest previous value at which the last performance fee was accrued and paid out to the fund. These respondents pointed out that the IOSCO refers to HWM as the model whereby the performance fee becomes payable where the NAV per shares exceeds the highest previous value ever recorded since the fund's launch. ESMA was therefore invited to clarify and to reflect this distinction.
19. A vast majority of respondents were of the view that the requirement of a minimum crystallisation period of 12 months should not be applied to HWM models. A minimum crystallisation period would not be relevant given that the compensation mechanism is implicit in the model itself. Similarly, a few respondents argued that there is no need for a fund with a "pure" HWM model to indicate a specific performance reference period ex ante, including the need to indicate a reset date. While they saw merit in ensuring more flexibility for HWM models, these respondents highlighted the need to ensure full transparency towards investors. A few examples on how these models achieve the objectives pursued by Guideline 3 were provided by respondents.
20. On the contrary, some respondents would see the concept of the minimum crystallisation period as applicable also to HWM models.
21. The majority of respondents supported ESMA's proposal to exempt fulcrum fee models from the requirement of a minimum crystallisation period of 12 months. According to these respondents, fulcrum fee models have by nature, the potential to claw back underperformance, to a certain extent.

**ESMA response:**

ESMA takes note of the comments regarding the definition of the HWM model and points out that the definitions of the HWM and the HWM model in the draft guidelines were already aligned with the 2004 IOSCO paper.<sup>11</sup> Nevertheless, in order to avoid any potential for

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<sup>11</sup> See "The elements of international regulatory standards on fees and expenses of investment funds" issued in February 2004, available at the following link <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD164.pdf>

confusion, ESMA has now also included the definition of the HoH model in addition to the one of the HWM.

ESMA believes that the divergent feedback regarding the possibility of excluding the HWM model from the application of the minimum crystallisation frequency is due to the different national practices regarding the functioning of this model.

ESMA understands that in some Member States this model is already regulated by national legislation in a way that allows for the crystallisation of the performance fees *on any date* on which the fund reaches a new HWM<sup>12</sup> or a new HoH<sup>13</sup> during the whole life of the fund, starting from the fund's inception date. In these models the performance reference period is equal to the whole life of the fund and it cannot be reset. Furthermore, the HWM/HoH is observed during the whole life of the fund rather than on a specific date (e.g.: year-end). ESMA believes that these models *could* exceptionally be exempted from the application of the minimum crystallisation frequency, in line with the feedback of several stakeholders. ESMA notes that this exemption would not undermine the principles set out by the Guidelines regarding the need to align the interests of investors and fund managers, as these models would allow for the payment of a performance fee only if the fund reaches a new HWM/HoH over the whole life of the fund, therefore avoiding that performance fees are accrued and/or paid twice or more for the same level of fund's performance.

ESMA acknowledges the broad support for exempting the fulcrum fee model from the application of the minimum crystallisation frequency and has confirmed this approach in the final guidelines also in regards to those other models which provide for symmetrical fee structures (whereby performance fees would decrease or increase based on the performance of the fund).

**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?**

22. A large majority of respondents were of the view that a fund manager should be allowed to charge performance fees solely based on the relative performance and irrespective of the absolute performance achieved. These respondents noted that if outperformance in relation to a given index is expressly foreseen as part of a fund's investment objectives and strategy, then naturally any positive relative performance vis-à-vis that index should also be rewarded to the manager (e.g. in the context of a negative market cycle, if the portfolio manager is able to avoid a comparatively larger depreciations of the fund's value vis-à-vis its chosen benchmark this should be rewarded).

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<sup>12</sup> Under the HWM model, performance fees are payable on the basis of achieving a new highest net asset value per share or unit during the performance reference period.

<sup>13</sup> Under the HoH model, performance fee are payable if the net asset value of the fund exceeds the net asset value at which the performance fee was last crystallised.

23. Furthermore, several respondents pointed out that this Guideline would go against the fundamental principle of designing the performance fee model with no incentives to take excessive risks. Indeed, these respondents expressed concerns that if performance fees were to be levied only in the presence of absolute positive performance, individual managers might be incentivised to take on greater risks in their attempt to return to a positive absolute performance to offset losses, thereby also misaligning their incentives with those of the investor.
24. A few respondents mentioned the risk that some managers might be tempted to discontinue the performance fee option in favour of management fee-only options, which could harm investors both by reducing their choices and, more generally, by potentially creating more expensive products. Some respondents also noted that the inclusion of an “absolute positive performance” provision could act as a potential distraction for managers pursuing a long-term investment strategy which would likely include periods of down markets.
25. The SMSG noted that in case of a performance fee model, the management company is remunerated through a fixed (base) fee and a conditional fee. Therefore, the conditional fee should be in line with the fund’s promise to investors as stated in the investment objective and be paid for/ result from outperformance only. For the vast majority of funds and more particularly for benchmarked funds in Europe, the performance fee can be triggered when the fund’s performance outperformed the benchmark’s one both in upward and downward markets.
26. A respondent representing consumers highlighted that, as a matter of principle, UCITS managers charging performance fees should mirror the performance fee mechanism also for underperformance or negative performances, as it happens under the fulcrum fee model. Therefore, they would suggest that where a performance fee is charged for exceptional performance, a reduction of the management fee will be applied where the opposite is achieved, to better align the interests of the UCITS manager and that of the UCITS investors. They noted that such an addition would not disincentivize at all risk-capital and risk taking in investment funds as UCITS managers could simply refrain from charging a performance fee in addition to the management fee as remuneration.

**ESMA response:**

ESMA notes the feedback received from stakeholders and considers it appropriate to recommend that, 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 the reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided in the KIID.

ESMA notes the feedback received from consumers’ representatives regarding the opportunity to charge negative fees in case the fund underperforms its target, as in the fulcrum fee model. Nevertheless, this would require ESMA to mandate the application of a model (the fulcrum fee model) over the other models, *de facto* going beyond the purpose of the Guidelines which is to set out common principles for the calculation of performance fee and not to prescribe any specific calculation method.

**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.**

27. A vast majority of respondents agreed with the inclusion of such a prominent warning in the legal and marketing documents of the fund. They shared ESMA's view that transparency regarding the main features and effects of the chosen performance fee model is of utmost importance. A respondent representing consumers highlighted that a prominent warning on this aspect would fall in line with the MiFID II Article 24 on fair, clear, and not misleading information to be provided to investors and should be in all cases mandatory.
28. However, several respondents noted that they would refrain from calling this a "warning" in order to avoid a biased information.
29. The SMSG opined that in case ESMA decides to continue to allow relative positive performance, a clear and prominent statement explaining this feature should be included in fund documents to raise awareness among fund investors that outperformance in relation to the benchmark may lead to performance fees becoming payable in downward markets as well. As some retail investors may intuitively believe that performance fees would only be charged if he or she witnesses an absolute return on his or her investment, the insertion in fund documents of a simple simulation could illustrate this particular feature so that retail investors have more easily a clear understanding of this effect. This should also be mentioned in the KIID.
30. Moreover, although they supported the inclusion of a warning in the sales documents of the funds, some respondents invited ESMA to clarify that such information should be disclosed in the UCITS prospectus and not in the KIID. Other respondents warned ESMA against the risk of overloading documents with information difficult to understand and therefore, recommended to limit disclosure to the main points impacting the performance fee models.

**ESMA response:**

ESMA notes the support from stakeholders to include a warning in case the fund allows for the payment of performance fees also in times of negative performance.

While acknowledging the comments regarding the need for the KIID to be a concise document, ESMA considers that it should be ensured that retail investors know performance fees may be charged also in case their investment has suffered losses in order to make an informed investment decision.

To this end, ESMA considers it beneficial to recommend that this warning should be included in the KIID, in order to ensure the maximum level of protection to retail investors. ESMA notes that this warning could take the form of a brief sentence which would ensure to properly inform investors, while avoiding overloading the KIID.

**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.**

31. The vast majority of respondents shared the view that ESMA should not set a performance reference period for the purpose of resetting the HWM. They were of the view that a one-size-fits-all reference period would wrongly impact asset management performance fee models and that it is important to ensure sufficient flexibility for the manager to choose the most appropriate method. Moreover, numerous respondents underlined that the reset period should be no less than one year, so as to ensure fair treatment between investors, while not impacting fee structures negatively.
32. A few respondents also invited ESMA to distinguish between the notion of "performance reference period" and the notion of "reset period". According to these respondents, the latter should be intended as the period at the end of which any past negative or under-performance is reset.
33. While they agreed in principle with a reference period after which the High-Water Mark should be reset, a respondent representing consumers argued that this period should be sufficiently long as to ensure that investors do not end up paying performance fees twice or more for an overall low performance. This is since retail investors are likely to be invested in the fund for a time period which would be sufficiently longer than just one year as they would be advised to do so. For these reasons, they advised ESMA to recommend a performance reference period for the HWM model of at least 5 years in order to ensure that investors do not pay any performance fee if the fund has overall underperformed over the reference period.
34. On the other hand, many respondents representing the industry were of the view that the performance reference period should be left to the discretion of the manager depending on different factors: asset class, recommended holding period, actual holding periods or investor turnover, investor type (retail vs institutional), the chosen investment objectives and strategy, the portfolio's underlying asset classes, the overall fee model and its impact on the investor, the existence or not of other fee features such as claw back, the choice between performance fee and non-performance fee share classes.
35. Several respondents also stressed that the reset period's ultimate duration should not be directly and/or mechanically linked to a recommended holding period, especially when considering an individual investor whose investment horizon may de facto be substantially different from the one recommended in the disclosure documents. Hence, portfolio managers are generally not able to precisely record the duration of each investor's holding, as investors are not known to the manager. According to these respondents, a recommended or predefined reset period would in addition, if not adapted to the particular context of the fund's strategy, bear the risk of a significant wealth transfer between investors whose investments have contributed to build the performance fee provision and those whose investments have not.

36. A global association of investment professionals argued that the appropriate performance reference period should be based on the whole life of the fund.

**ESMA response:**

ESMA notes that setting a performance reference period of 12 months for the HWM model would be against investors' interests, as this could potentially lead to a situation where each year performance fees are paid for the same level of fund's performance.

ESMA believes that the performance reference period for the HWM model should be set equal to the whole life of the fund or to a minimum of 5 years, in order to ensure an adequate protection of retail investors. This would avoid the possibility to pay performance fees twice or more for the same level of performance, in line with the feedback received from consumers' representatives.

**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.**

37. Although a majority of respondents agreed that a very short time horizon would undermine the objective of balancing the interests of investors and fund managers, diverging views were expressed by the respondents regarding the optimal length of the minimum reference period for resetting the HWM. Many respondents supported that it should be at least equal to one year as i) it offers simplicity and clarity being fully aligned with the spirit of MiFID II and ii) it is sufficiently long for a fund manager to compensate for losses without taking excessive risk. Several respondents noted that a standardised period of 3 years would be a good compromise as a longer period could be detrimental for investors. These respondents warned ESMA against the risk that a longer period for resetting the HWM may incentivise managers to increase fixed management fees or to liquidate the fund if they do not see a possibility to recoup past performance.

38. This view was not shared by consumers' representatives who suggested ESMA to impose a standardised reference period for resetting the High-Water Mark at 5 years. They noted that the regulatory and supervisory practice followed in one jurisdiction<sup>14</sup> should be considered as a good practice, next to the IOSCO Guidelines. A respondent representing consumers also invited ESMA to alternatively consider to set the length of the reference period for the purpose of resetting the High-Water Mark equal to the recommended holding period for the retail investor, as described in the Key Investor Information Document (KIID) in order to be aligned with the investment objectives and horizon of the fund.

39. However, several respondents argued that different asset classes and investment strategies may call for different time horizons. Therefore, these respondents supported that managers should be able to exercise discretion when determining the period appropriate for a specific fund.

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<sup>14</sup> Germany.

### **ESMA response:**

As already highlighted in the ESMA response to the previous question, ESMA has decided to recommend that the performance reference period for the HWM model, where this is shorter than the whole life of the fund, should be set equal to at least 5 years. This should not prevent NCAs to require funds to apply longer periods if they deem it appropriate. ESMA also considers that, in any case, any specific provision applying at national level on top of the provisions set out in the guidelines should not jeopardise the rules regarding funds' cross border distribution<sup>15</sup> and the split of competences between the home and host competent authority<sup>16</sup> to this regard.

**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.**

40. The majority of respondents shared the view that for a fair treatment of investors, the performance period should be equal to one year for performance fee models based on a benchmark index. According to these respondents, this would strike a balance between the need to measure performance over a sufficient time period and the need to reward outperformance, while minimising wealth transfer effects and perfecting the alignment of economic interests between the investors and the manager. Here again, some respondents drew ESMA's attention on the risk that a longer period requirement might accentuate free-riding phenomena, entail higher management fees and incentivise liquidations in case of a critical market drop.
41. In this context the SMSG suggested considering that one fundamental principle linked to the performance fee is its proportionate nature, i.e. the methodology should seek to limit as much as possible unfair situations arising from two types of situations: (i) between investors contributing differently to the performance fee provision depending on their time experience in the fund, as well as (ii) between the investors seen as a group and the asset management company. As a consequence, and depending on the market situation, type of strategy and investor turnover (effective holding period of investors), the lengthier the reference period, the more wealth transfers may occur between investors in the fund.
42. Consumers' representatives recalled that retail investors should receive suitable investment advice to invest in UCITS that are aligned with their risk profile and investment horizon. Therefore, rewarding the UCITS or AIF manager for overperformance should be done only for overall exceptional returns at the end of the recommended holding period.

### **ESMA response:**

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<sup>15</sup> See Chapter XI of the UCITS Directive.

<sup>16</sup> See Chapter XII of the UCITS Directive.

ESMA acknowledges the comments regarding the recommended length of the performance reference period for the benchmark model. ESMA understands the potential shortcomings linked to possible free riding phenomena, but notes that this is a potential consequence of every method which does not compute fees on a single investor basis. ESMA considers that it should be ensured that any underperformance of the fund compared to the benchmark is clawed back before any performance fee becomes payable. For this reason, ESMA is of the view that the relevant period should be equal at least to 5 years in order to ensure high standards of investors' protection. ESMA considers that such period would be long enough for the fund to close or for investors to redeem in case the fund underperforms the index and performance fees are not paid for the last five years. However, this should not prevent NCAs to require funds to apply longer periods if they deem it appropriate. ESMA also considers that, in any case, any specific provision applying at national level on top of the provisions set out in the guidelines should not jeopardise the rules regarding funds' cross border distribution and the split of competences between the home and host competent authority to this regard.

**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.**

43. A majority of respondents agreed that the performance reference period should coincide with the minimum crystallisation period or longer. For most respondents, aligning the performance reference period and the minimum crystallisation period will increase transparency for shareholders and will allow to reduce disparity between investors since they do not necessarily follow the recommended holding period.
44. This view was also shared by consumers' representatives who supported generally ESMA's approach. In their view, the performance reference period, the minimum crystallisation period and the recommended holding period have the same role and purpose for the performance fee model and should, therefore, be equal for the benchmark model.
45. Nonetheless, a few respondents did not see any merit in requiring the performance reference period and the minimum crystallisation period to coincide. They noted that the latter is a mere technical feature, as the performance fee is accrued on fund level on each valuation day anyway. Aligning the performance fee model with the investors' holding period is therefore best achieved by means of the performance reference period.
46. In line with their response to previous questions, some respondents simply argued that the performance reference period should not be defined in the Guidelines.

**ESMA response:**

ESMA acknowledges the comments regarding the recommended length of the performance reference period for the benchmark model. ESMA considers that it should be ensured that any underperformance of the fund compared to the benchmark is clawed back before any performance fee becomes payable. For this reason, ESMA recommends that this should be equal at least to 5 years in order to ensure high standards of investors' protection.

**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?**

47. The vast majority of respondents indicated that the Guidelines should foresee a transition period of at least 18 to 24 months after their application. They argued that an appropriate implementation period is needed in light of the various constraints as any change in the performance fee model described in the prospectus would take at least 12 months (i.e. the crystallisation period). These respondents also invited ESMA to take into account factors like the legal and operations needed to adapt fee mechanisms, the time necessary to amend existing UCITS disclosure and marketing materials (in certain cases, even the articles of incorporation of the fund will need to be amended).
48. This view was not shared by a respondent representing consumers who noted that the Guidelines should become applicable as soon as the implementation period by competent authorities has ended. According to this respondent, considering the risks for the level playing field in the cross-border distribution of UCITS and AIFs and those posed to investor protection principles, all UCITS and AIF managers should revise their performance fee models and the corresponding disclosure documents in a delay of 2 months from the entry into force for all types of UCITS and AIFs.

**ESMA response:**

ESMA believes that the Guidelines set out principles which are in many cases already applied by stakeholders and/or enshrined in national regulation. Therefore, ESMA deems it appropriate that any new funds created after the date of application of the Guidelines that includes a performance fee, or any existing fund at that date that introduces a performance fee for the first time after that date, should comply with the Guidelines immediately. However, in light of the concerns expressed by many respondents on the operational issues in applying the guidance to existing performance fees, ESMA deemed it appropriate to foresee that managers of funds applying a performance fee before the application of the Guidelines should apply these guidelines in respect of those funds by the beginning of the financial year following 6 months from the application date of the Guidelines.

**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.**

49. Several respondents did not consider that the principles set out in the Guidelines should be applied to AIFs marketed to retail investors or at least, they considered that such an extension of the application of the principles set out in the Guidelines would not be appropriate.
50. First of all, several respondents noted that the AIFs do not benefit from a comparable harmonised product regulation requirement and unlike UCITS, they do not have a cross-border passport (i.e. UCITS cross-border retail passport). Given the absence of harmonised EU requirements, performance fee models charged for AIFs vary significantly. According to these respondents, the application of the principles set out

in the Guidelines to AIFs would also entail the risk that it could spill-over and affect the cost-structure of other AIFs marketed to institutional investors.

51. Moreover, a few respondents highlighted that many AIFs are closed-end unlisted funds, thereby introducing very different considerations than those applicable to UCITS. They pointed out that the principles applicable to UCITS are simply not relevant, nor applicable, to AIFs. But as recalled by some respondents, AIFs' share classes generally develop specific fee structures targeted to professional clients to match their specific needs.

52. Nonetheless, it is worth noting that this view was not shared unanimously. Some stakeholders, including consumers' representatives, argued that the Guidelines should be applied to AIFs market to retail investors. This view was shared by the SMSG which advised ESMA to include retail AIFs in the scope of the guidelines to ensure consistency of treatment on performance fees between UCITS and retail AIFs.

#### **ESMA response:**

ESMA takes note of the comments received. ESMA has decided to include in scope of the Guidelines UCITS as well as some types of open-ended AIFs marketed to retail investors, in order to ensure a level playing field and a consistent level of protection to retail investors, as also suggested by consumers' representatives. However, ESMA saw merit in excluding from the scope of application of the guidelines certain types of AIFs marketed to retail investors.

#### **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.**

53. The respondents almost unanimously agreed with the Cost-Benefit Analysis underpinning ESMA's proposal to ensure greater consistency between the performance fees model and the fund's investment objective. Most respondents indicated that pending the final Guidelines, the cost derived from their implementation would not be prohibitive as most EU jurisdictions have aligned their domestic regulations with the IOSCO 2016 Good Practices, provided management companies are granted sufficient time to comply with the Guidelines. In addition to the above-mentioned costs, one respondent pointed out that the entry into force of the Guidelines may also entail product governance, fund accounting and audit costs.

54. Several respondents noted that if Guidelines were to go beyond the original scope of the IOSCO 2016 Good Practices and if they were setting more prescriptive parameters, it would undoubtedly have far-reaching and negative implications for the management companies' operational cost structures.

#### **ESMA response:**

ESMA believes that the Guidelines, while remaining principles-based, are, to some extent, more prescriptive than the IOSCO practices (for examples, in setting the recommendations on how to evaluate the consistency between the performance fee model and the fund's investment objective where a fund is managed in reference to a benchmark). This is motivated by the need

to harmonise the various practices currently applied across the EU, in order to ensure a common level of protection of retail investors in the context of funds' cross border distribution.

Nevertheless, ESMA notes that the recommended practices mainly reflect regulatory approaches already applied in several jurisdictions. Therefore, the cost of applying the Guidelines may be variable depending on whether the recommended practices are not already applied in the various jurisdictions where the managers/the funds that they manage are established.

**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.**

55. A vast majority of respondents shared the view that models of performance fee without a hurdle rate or with a hurdle rate not linked to the investment objective should be permissible. These respondents argued that it's the role of the fund's product governance to ensure, just as with any index-based benchmarks, that any such hurdle rate is substantively connected to the investment objective and anticipated returns of the fund. Moreover, a few of these respondents noted that as long as they are fully disclosed, such models can be easily understood and investors who are focused on absolute performance of their investments may prefer to pay a lower total fee in years of flat or negative performance.
56. Logically, these respondents were of the view 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. They noted that comparing the performance of an absolute return equity strategy with a money market index (as the EONIA) can be allowed to the extent it is more appropriate to capture excess performance in line with the fund's absolute return objective and notwithstanding the equity exposure's greater degree of risk.
57. Conversely, consumers' representatives strongly opposed these models and even invited ESMA to ban them. According to those respondents, the reference indicator must be aligned with the investment objective and strategy of the fund, whereas the example given (EONIA for an equity fund) is very misaligned and detrimental for retail investors.

**ESMA response:**

ESMA believes that allowing for an equity fund to compute performance fees based on a money market index (or as long as the fund has a positive performance) would not be compliant with the main principle set out under Guideline 2 regarding the consistency between the performance fee model and the fund's investment objectives. Therefore, ESMA considers that this practice should not be allowed.

**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.**

58. Most respondents referred to the response already provided to Question 14. Some respondents specified that most EU jurisdictions have already aligned their domestic regulations with the IOSCO 2016 Best Practices, meaning that most funds are compliant. These respondents were of the view that costs, in the form of legal and operation costs, should remain limited.

59. One respondent noted that some costs might still arise in cross-border cases where funds are marketed in more than one Member State. No quantitative figures were provided by respondents with regard to additional costs and benefits that the compliance with the proposed Guidelines would bring.

**ESMA response:**

ESMA notes that the recommended practices mainly reflect regulatory approaches already applied in several jurisdictions. Therefore, the cost of applying the Guidelines may be variable depending on whether the recommended practices are not already applied in the various jurisdictions where the managers/the funds that they manage are established.

**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.**

60. Most respondents noted that the proposed Guideline 4 would not be appropriate for all types of performance fee models, namely for those funds choosing to measure their performance against an index.

61. A few respondents reiterated their feedback regarding the possibility of allowing the payment of performance fees in case of relative positive performance. Those respondents pointed out that if this is not allowed, in case of negative market environment, the investment manager would not be incentivised to deliver an excess performance as the investment manager would not be rewarded for it. In the case of an index benchmark, if the performance of the index were -10%, but the fund's performance was -5%, then no performance fee could be earned. According to these respondents, such a situation would be neither fair to asset managers nor beneficial to investors, since the investors' alternative to the actively-managed product with performance fees is either a) a passive product, which would be delivering a negative return in this hypothetical scenario, or b) an actively-managed product with fixed management fees which may be at a higher level.

**ESMA response:**

ESMA takes note of the feedback received regarding the payment of performance fees in case of positive relative performance and has recommend that performance fees could also be payable in case the fund has overperformed the benchmark but had an overall negative performance. ESMA deems that this would ensure the alignment of interests between fund managers and investors.

ESMA notes the feedback on how the application of the concept of the performance reference period should be assessed based on the type of performance fee model used by the fund. For this reason, ESMA has decided to differentiate the recommended practices based on whether a HWM model is employed, or a benchmark index is used to compute performance fees.

**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.**

62. In line with responses to Q6 and Q14, respondents indicated that the operational and legal costs incurred by the compliance with the Guideline should remain limited as 1) most EU jurisdictions have aligned their domestic regulations with the IOSCO 2016 Good Practices and 2) provided management companies are granted sufficient time to comply with the Guidelines. However, some respondents specified that the proposed Guideline may result in some asset managers either increasing their fixed management fees or closing funds. The inability to earn a performance fee when absolute performance is negative would mean that some funds would not be economically viable.
63. One respondent took the example of some funds that charge only passive-like management fees when performance is at or below stated benchmarks whilst such management fees only cover most but not all, the costs. No quantitative figures were provided by respondents.

**ESMA response:**

ESMA notes that the recommended practices mainly reflect regulatory approaches already applied in several jurisdictions. Therefore, the cost of applying the Guidelines may be variable depending on whether the recommended practices are not already applied in the various jurisdictions where the managers/the funds that they manage are established.

ESMA believes that the Guidelines will be highly beneficial in order to ensure a common level of investors' protection, regardless of where the fund is domiciled. Therefore, the benefits coming from the application of the Guidelines will largely counterbalance the cost of their implementation.

**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.**

64. General support was expressed by respondents regarding the requirements to disclose performance fees model. They saw merits in ensuring clarity and transparency in relation to performance fees, especially given the complexity to understand this type of fees. Most respondents agreed that it would better align the interests of investors and managers.
65. As for the costs associated to the disclosure, several respondents indicated that they would concur to the overall compliance cost to management companies in meeting the final Guidelines, but that those should not be prohibitive.
66. Most respondents noted that the benefits mostly concern investors as they will be able to access more details on the functioning of performance fee models, including their

calculations. As specified by some respondents, this will reduce the risk of confusion of investors, will ease comparative analytics and will reduce unforeseen outcomes by both managers and investors.

**ESMA response:**

ESMA considers that, in line with stakeholders' general feedback, the Guideline will further improve disclosure of the performance fees model to retail investors and ensure that retail investors are put into the position to make an informed decision when investing in funds.

## **Annex II: Advice of the Securities and Markets Stakeholder Group**

### **Response to ESMA's Consultation Paper on "Guidelines on performance fees in UCITS"**

#### **Executive summary**

The SMSG welcomes ESMA's consultation on performance fees in UCITS as part of its key supervisory priorities. ESMA rightly seeks to set common Guidelines and criteria with the objective of ensuring alignment of interests between portfolio managers and investors as well as fair treatment among investors. The mapping exercise performed by ESMA confirmed the necessity to achieve more convergence with regard to performance-based fee structures in UCITS in order to enhance investor protection and ensure a level playing field in the EU.

The SMSG advises ESMA to gather more data and analyses regarding the use and the effects of performance fees. In light of ESMA's recent report on costs and performance of retail products, the SMSG believes that it would be useful to enrich the information regarding fee structures by providing further details on the trends of fixed fees and performance fees. To assess the effects of a performance fee model, all the main features and parameters of the model should be seen together.

The performance fee should reflect as accurately as possible the returns generated, be verifiable and avoid any risk of manipulation, ensure that investors receive an adequate share of the return achieved from the risks taken, and respect the principle of equitable treatment of investors. As different share classes may have different fee structures, the SMSG advises ESMA to clarify that the performance fee model applies at the level of the share class and not necessarily at the level of the fund.

Concerning standardisation, the SMSG is in favour of ESMA establishing clear Guidelines that help investors to understand the main features and effects of the application of the performance fee. The SMSG agrees with ESMA's Guideline regarding the consistency of the performance fee model with the fund's investment objectives, strategy and policy. Regarding the crystallisation frequency, the SMSG agrees that, apart from few exceptional cases, this period should be no shorter than one year. The time horizon over which the performance is measured and compared with that of the reference indicator should also be clearly specified and the reference period for measuring the outperformance should be at least equal to one year. The SMSG advises ESMA to include retail AIFs in the scope of the Guidelines to ensure consistency of treatment on performance fees between UCITS and retail AIFs.

The SMSG encourages fair, clear and not-misleading disclosures of the performance fee model and its effects. A rigorous implementation throughout the whole chain is essential: performance fee models should be accurately described, unambiguous and non-discretionary to allow fund administrators to accurately apply the performance fees formulas.

The SMSG encourages ESMA to finalise these Guidelines to allow for pan-European convergence in the field of performance fee calculation. The SMSG agrees with the framework proposed by ESMA and the strong link with the IOSCO principles.

#### **Background**

1. Within the key priorities of the 2019 ESMA Supervisory Convergence Work Programme, ESMA proposes a set of Guidelines meant to ensure supervisory convergence for performance fee structures and circumstances in which performance fees can be paid.
2. Currently, performance fees are detailed under differing national rules and under the IOSCO principles<sup>1</sup> issued in August 2016. UCITS performance fees are not regulated at the EU level and due to the importance of their cross-border distribution, ESMA considers that supervisory convergence on this issue is essential to ensure a level playing field in the EU.
3. One of the main features of the performance fee model is that it seeks to better align interests between the asset management company and investors while comforting fair treatment among investors. ESMA seeks to set common criteria with the objective of ensuring alignment of interests.

## **II. ESMA Consultation Paper on performance fees**

4. ESMA's draft Guidelines propose 5 areas of convergence: general principles on performance fee calculation methods; consistency between the performance fee model and the fund's investment objectives, strategy and policy; frequency of the crystallisation of the performance fee; circumstances where a performance fee should be payable; and disclosure of performance fee model.
5. Guideline 1 is about the performance fee calculation method and lists a set of minimum elements to be defined allowing to characterise a performance fee model. Guideline 2 tackles the need for consistency between the performance fee model and the fund's investment objectives, strategy and policy, while Guideline 3 sets the minimum pace regarding the frequency of the crystallisation of the performance fee. Guideline 4 deals with the concept of negative performance (loss) recovery, while Guideline 5 requests that investors be adequately informed about the existence of performance fees and about their potential impact on investment return.

## **III. General Comments**

6. ESMA's Guidelines legitimately seek to ensure further convergence of the applicable rules at the panEuropean level. The mapping exercise conducted by ESMA shows a need to achieve more convergence with regard to performance-based fee structures in order to enhance investor protection and ensure a level playing field in the EU. It will also help removing any existing or potential cross-border barriers to the distribution of funds. The SMSG advises ESMA, however, to clarify how eventual more stringent local guidelines apply.
7. As different share classes may have different fee structures, ESMA should further clarify that the performance fee model applies at the level of the share class and not necessarily at the level of the fund. The SMSG observes that funds increasingly offer the possibility of charging different structures to retail investors. For instance, a recent report<sup>2</sup> by Fitz Partners found evidence that asset managers are increasingly giving retail investors the right to choose between 'twin' share classes, where retail investors have a choice between a share class based on a single (and higher) fixed fee and a share class having both a (lower) fixed fee and a performance fee.

8. The MSG advises ESMA to gather more data and analyses regarding the use of performance fees, as few studies on recent data are available. We refer for instance to the conclusions of one study<sup>3</sup> on 'The costs and benefits of performance fees in mutual funds' which has found that equity mutual funds offered for sale in the European Union, Norway, and Switzerland over the period 2001-2011 would on average have charged higher costs compared to funds without performance fees. In light of ESMA's recent works on the costs and performance of retail products and of the need to have analysis on recent data and trends, the MSG believes it useful for ESMA to enrich the information regarding fees evolutions further by providing detail on fixed fees versus performance fees patterns as well as more granularity on the effect on total fees when a performance fee applies by strategy, by member state of domiciliation, etc. Such additional reporting would also fit into ESMA's responsibility under Article 32 of its Founding Regulation to report on the trends, risks and vulnerabilities in the areas of its competence.

9. As part of the asset management company remuneration structure, the performance fee model should not be regarded in isolation. The same applies for one or another of its parameters, the effect of which should be assessed and apprehended in its interaction with all other applicable parameters.

10. Some non-exhaustive high-level desirable characteristics of the performance fee models (as also recognized by IOSCO) should be kept in mind: the performance fee should reflect as accurately as possible the returns generated, be verifiable and avoid any risk of manipulation, ensure that investors are not denied an adequate share of the return achieved from the risks taken on their behalf and previously accepted by them, and respect the principle of equitable treatment of investors.

11. ESMA proposes 5 high level principles inspired by the IOSCO Principles and then gives a certain degree of granularity depending on the issue. The MSG highlights that some specification will improve supervisory convergence, while on the other hand, too much specification might be difficult to achieve in light of national differences, and a one-size-fits-all-model would hinder the appropriateness and fairness of the fee.

#### **IV. Specific Comments**

##### Performance fee calculation method

12. The MSG agrees that the proposed elements should consist of a minimum list of elements to be defined. In order to assess the effect of a performance fee model, all main features and parameters should be seen together.

13. In addition, the specification of the calculation base (in addition to the rate) and the first date of crystallisation could be valuable information to give to investors. Redemption processing should be specified, ie it should be clarified whether the crystallisation (mechanism for the performance fee to be locked in for future payment) is applied on redeeming shares. Other optional elements or conditions that may impact the fee calculation, such as the existence of a cap or of a condition on absolute positive performance, might be added.

##### Standardisation

14. The group welcomes ESMA's consultation and agrees that the IOSCO principles are a good basis for ESMA's guidelines. IOSCO's principles are proportionate and encompass a wide variety of performance fee models in different jurisdictions. ESMA's mapping exercise showed uneven implementation of the IOSCO principles and other discrepancies between the European member states' treatment of performance fees. The group thus agrees with the objective pursued by ESMA with this consultation in terms of ensuring further European convergence in the field, starting with the respect of the IOSCO principles.

15. The SMSG is in favour of ESMA establishing clear Guidelines that help investors understand the main features and effects of the application of the performance fee formula. Performance fee models should be designed to be readable, easy to understand and not misleading.

16. The adoption of ESMA Guidelines should ensure a European common global understanding for NCAs in this field so as to avoid barriers to cross-border distribution of funds and a level playing field for investor protection. Indeed, funds may have several share classes with differing fee structures and imposing one model over the other may ultimately remove choices for investors.

#### Consistency between the performance fee model (and index used to calculate the performance fee) and the investment objectives, strategy and policy of the fund

17. The group agrees with the objectives of Guideline 2 regarding the consistency of the performance fee model with the fund's investment objectives, strategy and policy. The performance fee based on a benchmark or hurdle rate should be determined in such a way that it is consistent with the investment objective, strategy and policy. A money market index might not be compatible for a fund with a directional market bias. In light of certain national regulators' findings on the use of inappropriate benchmarks for the calculation of performance fees, the SMSG is of the opinion that the prospectus should disclose the rationale behind the choice of a specific benchmark in the context of the UCITS investment policy. IOSCO's Good practice 3 requires that the calculation methods be designed so as to allow for the performance fee to be proportionate in value to the investment performance of the fund. The SMSG agrees that this overarching principle should guide ESMA when taking a holistic view on the effects of different formulas. In case a specific benchmark is designed to determine excess performance, as per IOSCO's Good practice 4, the performance fee should be based on the same reference.

#### Absolute vs relative positive performance

18. ESMA's Guideline 4 lays down the principle that a performance fee is triggered if a positive performance has been accrued during the performance reference period and that any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.

19. For the sake of clarity, the SMSG advises ESMA to complete Guideline 4 with a definition relative and absolute positive performance (as mentioned in para 23 on page 12). The group discussed several elements and factors to be assessed, including the fund's commitment to respect its investment objectives and risk profile as well as different understandings of investor's objectives. In case of a performance fee model, the asset management company is

remunerated through a fixed (base) fee and a conditional fee. The conditional fee should be in line with the fund's promise to investors as stated in the investment objective and be paid for/result from outperformance only. For the vast majority of funds and more particularly for benchmarked funds in Europe, the performance fee can be triggered when the fund's performance outperformed the benchmark's one both in upward and downward markets. There are also funds that decided to add an absolute performance condition depending on different elements linked for instance to the fund's strategy and/or type of investors.

20. In the case ESMA decides to continue to allow relative positive performance, a clear and prominent statement explaining this feature should be included in fund documents to raise awareness among fund investors that outperformance in relation to the benchmark may lead to performance fees becoming payable in downward markets as well. As some retail investors may intuitively believe that performance fees would only be charged if he or she witnesses an absolute return on his or her investment, the insertion in fund documents of a simple simulation could illustrate this particular feature so that retail investors have more easily a clear understanding of this effect. Also the KIID should mention this feature.

21. In addition to the potential mismatch with the investment objective, another risk of setting overly burdensome constraints on performance fees (such as the introduction of an absolute performance criterion) is that it could lead to increased fixed management fees, which would be detrimental to investors. In addition, ESMA should remain cautious when using the negative performance fee concept in order to avoid spill-over between performance and management fees: a negative performance should reduce the performance fee but not reduce the management fee. Management fees are generally calibrated when a fund is launched, taking into consideration all costs incurred by the management company for the management of the considered fund, which notably includes fixed costs, which by nature do not depend on the fund performance. A reduction of the management fee in case of insufficient performance of the fund could undermine the economic viability of the considered fund or share class.

### Crystallisation

22. ESMA defines the crystallisation period as the period within which the performance fee, if any, is accrued and at the end of which the fee is crystallised and credited to the management company. The crystallisation frequency is mentioned in the IOSCO's Good practice 3, which requires it should not occur more frequently than once a year. The MSG advises ESMA to clarify that this is the frequency of locking in the calculation of the fee, which then becomes payable (without necessarily being paid at that moment in time). The majority of formulas in Europe use a frequency with a pace of one year. The group agrees that, apart from few exceptional cases listed by ESMA, like corporate events or equivalent protection through another mechanism, this period should not be no shorter than one year.

### Time Horizon

23. The fund should be transparent on all main parameters of the performance fee formula. The time horizon over which the performance is measured and compared with that of the reference indicator should be clearly specified. Taking into account the recommendation of a crystallisation frequency on a pace of one year or more, the reference period for measuring

the outperformance should be of one year at least. The performance fee methodology should ensure that the same performance is not remunerated twice within this timeframe.

24. One fundamental principle linked to the performance fee is its proportionate nature, ie the methodology should seek to limit as much as possible unfair situations arising from two types of situations: (i) between investors contributing differently to the performance fee provision depending on their time experience in the fund, as well as (ii) between the investors seen as a group and the asset management company. In this respect, IOSCO Good practice 2 prescribes that in any event, a performance fee should respect the principle of equitable treatment of investors. Indeed, ESMA's proposed Guidelines are meant to apply to UCITS, which operate very often through omnibus accounts and where it is not possible to attribute the exact performance experience of each investor on each one of his investments in the fund. Conversely, for funds with series accounting or equalisation accounting, each investor may be attributed the exact performance and be charged with the corresponding performance fee. As a consequence and depending on the market situation, type of strategy and investor turnover (effective holding period of investors), the lengthier the reference period, the more wealth transfers may occur between investors in the fund. Therefore, regarding more specifically the fund manager's calibration of the reference period, which is one element among other parameters of the performance fee formula, there are several elements and concerns to take into consideration.

25. On the one hand, ESMA is right regarding the fact that the reference period calibration should safeguard the best interest of investors and allow that the performance fee be payable only in circumstances where positive (out)performance has been accrued during the period. This principle seeks that any underperformance or loss previously incurred should be recovered before a performance fee becomes payable.

26. On the other hand, a mandatory one-size fits all calibration of the length of the reference period would not sufficiently take into account the open-ended nature of UCITS that may have side effects as mentioned previously.

27. Therefore, depending on the performance fee model's parameters and the specific open-ended fund conditions, the asset manager should take due care when setting parameters of the performance fee formula. More precisely, the global effect and key parameters such as the appropriate benchmark, the provisioning rate rigorous and fair application, the appropriate reference period reset, the proportionate effect with regard to the (out)performance generated, etc. should be given due consideration so as to ensure acting fairly in the best interest of investors. In any case, bearing in mind the overarching objective that the performance fee should effectively align investors and managers' interests and be proportionate and fair to investors, resetting more frequently than one year would not be considered appropriate.

### Disclosures

28. The SMSG encourages fair, clear and not-misleading disclosures relative to the performance fee model and its effects. Regarding the potential impact of the fee model on the fund, one or more simple scenarios included in the prospectus might be of help. The SMSG advises ESMA to clarify in the guidelines that the fund should include a prominent disclaimer in case of a relative positive performance model. In addition, investors should be highlighted all the types of fees of the fund, ie the presence of a fixed fee and a performance fee.

29. The SMSG would like to highlight the important role of supervisors to ensure that performance fee models are appropriate, fair and proportionate. On the regulator's demand, fund managers should be able to submit, with the fund's authorisation file, a simulation of the main effects of the formula as well as the explanation of the rationale behind the choice of a particular benchmark/hurdle.

#### Scope

The SMSG advises ESMA to include retail AIFs in the scope of the Guidelines so as to ensure consistency of treatment on performance fees between UCITS and retail AIFs.

#### Fund administrators

31. The SMSG would like to highlight the importance of a rigorous implementation throughout the whole chain. We advise ESMA to add a principle clarifying that the models should be accurately described, unambiguous and non-discretionary so as to allow fund administrators to accurately apply the performance fees formulas.

#### V. Concluding remarks

32. The SMSG encourages ESMA to finalise these Guidelines so as to allow for pan-European convergence in the field of performance fee calculation. The SMSG agrees with the framework proposed by ESMA and the strong link with the IOSCO principles. The objective is to ensure, with sufficient detail but avoiding to be overly prescriptive, that the performance fee model allows for alignment of interest of asset managers and investors and that it is fair.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 14 November 2019

[signed]

Veerle Colaert

Chair

Securities and Markets Stakeholder Group

## Annex III: Cost-Benefit Analysis

### 1. Introduction

1. This Cost-Benefit Analysis (CBA) analyses specific questions related to four areas: 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 of the performance fee model. Furthermore, it also focuses on the scope of the guidelines and on the length of the performance reference period in the context of Guideline 4.
2. The following options were identified and analysed by ESMA to address the policy objectives of the good practices for fees and expenses of funds.
3. In identifying the options set out below and choosing the preferred ones, ESMA was also guided by the mapping exercise (“ESMA Survey”) conducted during 2018 among the competent authorities which analysed the current practices within different Member States and which can be found in Annex IV to the Consultation Paper. The results showed a lack of harmonization among EU jurisdictions in the aforementioned areas. A common approach on an EU level should eventually encourage competition among funds operators and lead to a more efficient market. The following tables summarise the potential costs and benefits resulting from the implementation of the Guidelines.

### 2. Technical options for ensuring consistency between the performance fee model and the fund’s investment objectives, strategy and policy

<b>Policy Objective</b>	<p>Under “Good Practice 3”, IOSCO indicates that a performance fee should be consistent with the investment objectives of the CIS and should not create incentive for the CIS operator to take excessive risks in the hope of increasing its own remuneration. The IOSCO principle also specifies that the calculation of a performance fee should be verifiable and not open to the possibility of manipulation; the following items should be unambiguously determined:</p> <ul style="list-style-type: none"> <li>- how investment performance will be assessed</li> <li>- what reference benchmark will be used</li> <li>- what the calculation formula will be</li> </ul>
<b>Baseline scenario</b>	<p>The baseline scenario should be understood for this CBA as the lack of prescriptive requirements for performance fees models in relation to their consistency with the investment objectives, policy and strategy of the fund. This would leave discretion to fund managers to determine the definitions, calculation methodologies and presentation formats of the performance fee model, regardless of the fund’s investment policy, which reflects the actual situation in the EU investment fund market.</p>

<p><b>Technical proposal</b></p>	<p>In order to address the issue of inconsistency and comply with the stated objectives, ESMA deems necessary that the management company ensures that the performance fee model is consistent with the fund’s investment objectives, strategy and policy. In order to ensure a harmonised application of this principle across the EU, ESMA considers that this policy objective should be concretely operationalised. Therefore, the recommendations enshrined in Guideline 2 defines some indicators to be considered for the purpose of checking the consistency between the performance fee model and the fund’s investment objective, policy and strategy and identifies a specific case where the fund should use the same index in case it computes performance fees with a benchmark model.</p> <p>As a general principle, where the fund is managed in reference to a benchmark index and it employs a performance fee model based on a benchmark index, the two indices should be the same.</p> <p>This includes, <i>inter alia</i>, the case of:</p> <ul style="list-style-type: none"> <li>- performance measures: the fund has a performance objective linked to the performance of a benchmark (e.g.: Index A + positive absolute return objective; Index A + HWM; Index A + X% hurdle rate etc)</li> <li>- portfolio composition: the fund portfolio holdings are based upon the holdings of the benchmark index (e.g.: the individual holdings of the fund’s portfolio do not deviate materially from those of the benchmark index).</li> </ul> <p>In such cases, the benchmark used for the portfolio composition should be the same as the benchmark used for the calculation of the performance fee.</p> <p>However, in case the fund is managed in reference to a benchmark but the fund’s portfolio holdings are not based upon the holdings of the benchmark index (e.g.: the index is used as a universe from which to select securities), the benchmark used for the portfolio composition should be consistent with the benchmark used for the calculation of the performance fee. Consistency should be primarily assessed against the similar risk-return profile of different benchmarks (e.g.: they fall into the same category in terms of Synthetic Risk Reward Indicator and/or volatility and expected return). The non-exhaustive cumulative list of “consistency indicators”, set out by the</p>
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	<p>guideline, should be taken into account by the management company, based on the type of investment of the fund (for example, equities, bonds or derivatives).</p> <p>When assessing the consistency between the performance fee model and the fund’s investment objectives, strategy and policy the management company should check:</p> <ul style="list-style-type: none"> <li>- 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 model or a hurdle is more appropriate than a performance fee calculated with reference to an index because the fund is not managed with a reference to a benchmark; in addition, a HWM model for an absolute return strategy, might need to include a hurdle to align the model to the fund’s risk-reward profile;</li> <li>- whether, for funds that calculate the performance fee with reference to a benchmark, 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 funds and the chosen benchmark, as well as the consistency indicators provided by the guideline. For example, it should not be deemed appropriate for a fund with a predominantly long equity-focused strategy to calculate the performance fee with reference to a money market index.</li> </ul> <p>Where performance fees are payable on the basis of out-performance of a benchmark (e.g. “Eurostoxx 50 + 3%”, “Eonia”, etc.), it would not be deemed appropriate to take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark (eg: computing performance fees based on “Eurostoxx -1%” where the objective of the fund is “Eurostoxx”).</p> <p>In case the calculation of the performance fee is based on a fulcrum fee model, the performance fee should be based on the same benchmark used to determine excess performance.</p>
<p><b>Benefits</b></p>	<p>The introduction of this Guideline aims at contributing to the creation of a level playing field across the EU, reducing the scope for regulatory arbitrage, which could otherwise hamper investors’ protection.</p>

Conversely, a lack of common practices in this field could lead to a situation where some Member States would adopt different rules, bringing greater uncertainty for investors in different jurisdictions, which could be problematic in the context of the EU passport. In this scenario, investors would not know the extent to which the performance fee model will reflect a specific feature of the investment strategy, benchmark used or return objective of the investment itself, or just a specific feature of the regulatory framework in place in the Member State of the fund.

Indeed, the ESMA Survey showed that in fourteen jurisdictions there are no specific conditions in relation to the choice of benchmark or indexes; while other competent authorities reported to have either legal provisions or supervisory practice to ensure consistency between the fund's strategy and the benchmark/index chosen. Among the latter are three competent authorities assessing this consistency during the approval phase and on-sites visits or in the occasion of subsequent modifications of the KIID/prospectus. Eight other competent authorities mentioned that their authority checks for consistency between the fund's strategy and the benchmark or index chosen by taking into consideration the type of assets or the geographical area in which the fund is invested. Furthermore, another competent authority challenges the fund managers during the approval process or during on-sites visits. Finally, in one jurisdiction guidance on the choice of appropriate benchmark or index was provided but the competent authority encountered some supervisory difficulties which would require some further clarification from ESMA. Considering the above, the introduction of those principles would avoid the application of different regulatory and supervisory practices among legislations and ensure a higher level of comparability among the same type of funds in different Member States, thus enabling investors to compare the cost of different funds with similar investment objectives more clearly. A higher level of transparency in this specific market segment is welcomed also given the level of complexity of performance fee computation models to be disclosed to retail investors. The Guideline will also benefit managers and competent authorities in terms of providing clear guidance over the main aspects to be assessed in the determination and control over performance fee models. Lastly, ESMA believes that a combined reading of the benchmark disclosure Q&As and the performance fee guidelines could help putting into context the concrete application of the recommended practices. Therefore, the final guidance includes terms and

	examples already used in the Q&As, ensuring consistency as well as a clear link between the two texts.
<b>Costs to regulators</b>	The Guideline is not expected to add significant costs to ESMA and competent authorities. The latter could even benefit from the potential for a reduction in the resource needed to analyse the performance fee computation mechanisms. Indeed, greater standardisation following the application of the Guidelines, should make performance fee structures and computation models clearer and easier to understand, both for investors and competent authorities.
<b>Compliance costs</b>	<p>Broadly, the ESMA Survey showed some common features among funds' computation mechanisms of performance fees, such as: the use of the high water-mark principle, sometimes combined with a hurdle rate; comparison between actual and past performance; the use of performance levels exceeding a certain threshold. Nevertheless, the computation mechanism practices are heterogeneous and tend to vary between jurisdictions.</p> <p>Concerning the consistency between the fund policy and strategy and the benchmark or index chosen, most of the jurisdictions do not provide for any specific condition in relation to the choice of benchmarks or indices. Nonetheless, in some Member States competent authorities already check the consistency between the fund's strategy and the benchmark/index, sometimes during the approval phase or in the event of on-site visits. ESMA anticipates that fund managers already adopting those measures would not incur significant initial, on-going or <i>ad-hoc</i> costs, aside from the costs aimed at ensuring standards meet those specified in the Guidelines.</p> <p>On the other hand, the compliance cost would be higher for those managers who do not implement these minimum standards, especially in terms of initial costs related to the first adoption of those standard requirements.</p>

### 3. Technical options for the frequency for the crystallisation of the performance fee

<b>Policy Objective</b>	Under "Good Practice 3", IOSCO indicates that that the frequency for crystallising the performance fee and transferring the amount earned in such fees to the CIS operator should not be more than once a year. Alternatively,
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<p>methods to ensure that cumulative gains are offset in some way by cumulative losses could be considered (e.g. the High-Water Mark model and High-on-High, which require an absolute improvement in investment performance before the performance fee can be paid), as they incentivise the CIS operator not to take excessive risks that might result in losses, since any such losses will then need to be offset before any performance fee can be levied again.</p>	
<p><b>Baseline scenario</b></p>	<p>The baseline scenario should be considered for this CBA to be the absence of a specific obligation regarding the minimum performance crystallisation frequency and the transferring of the amount earned in such fees to the fund management company. ESMA Survey showed that the majority of the fund management companies across Member States calculate performance fees on a daily basis and charge them on an annual basis. Other responses to the survey referred to calculation on a monthly basis and payments on a quarterly basis. In some Member States there is no minimum requirement, but the frequency should be “appropriate”; and some jurisdictions carry out a case-by-case analysis. In some Member States the crystallisation frequency also depends on the performance fee model used by the fund.</p>
<p><b>Technical proposal</b></p>	<p>The frequency for the crystallisation and the subsequent payment of the performance fee by the management company should be defined in such a way as to ensure alignment of interests between the portfolio manager and the shareholders and fair treatment among investors. The crystallisation frequency should not be more than once a year. This could not be applied where the fund employs a high water-mark model or a high-on-high model where the performance reference period is equal to the whole life of the fund and it cannot be reset, as in this model performance fees cannot be accrued or paid more than once for the same level of performance over the whole life of the fund.</p> <p>The crystallisation date should be the same for all share classes of a fund that levies a performance fee, in order to avoid operational issues.</p> <p>Generally, the crystallisation date should coincide with 31 December or with the end of the financial year of the fund. The recommendation regarding the crystallisation frequency of no more than once a year should not apply to the fulcrum fee model</p>

	and other models which provide for a symmetrical fee structure (whereby performance fees would decrease or increase based on the performance of the fund), as the characteristics of this model are not compatible with such recommendation .
<b>Benefits</b>	<p>The aim of this Guideline is to seek to avoid investor detriment through the application of performance fee models with methodologies which are not considered reasonable and to contribute to the creation of a level playing field across Member States. Supervisory convergence will help ensure that the conditions under which the performance fee may be crystallised and paid is harmonised. Lack of harmonisation would hamper investors' ability to easily compare the costs of different funds over the same investment horizon. The standardisation of those practices is a fundamental step in ensuring the maximum level of transparency in performance fees structures and payments. IOSCO explained in its principles that "Calculation methods should not deny investors an adequate share of the return achieved from the risks taken on behalf and previously accepted by them".</p> <p>In light of the above, ESMA expects that the introduction of the Guideline will help ensuring the fulfilment of this objective, while also resulting in less incentive for the fund to take inappropriate risks potentially detrimental to investors.</p>
<b>Costs to regulators</b>	Competent authorities would incur costs in supervising compliance with those computation techniques and providing support to investment managers, especially when the Guidelines are adopted. On the other hand, the introduction of this principles could have a beneficial effect in terms of standardising supervisory practices in this specific area over time.
<b>Compliance costs</b>	Given the variety of practices and requirements among Member States, as shown by the ESMA Survey, ESMA expects higher initial costs for the introduction of this requirement, especially for those managers who do not comply with those minimum standards. Fund managers could conceivably incur costs from the implementation/update of their IT infrastructures, investment software and reporting systems. To a certain extent, minimum requirements over performance fees crystallisation and payment frequency may also affect the fees' structure and the profitability of some investment funds, possibly impacting investment strategies, budgeting provisions and, therefore, business planning. However, those costs are likely to be counterbalanced by the beneficial effects of fostering competition in the asset management industry, aligning the interest of fund managers

	and investors and allowing an easier investment comparison in the EU investment fund sector.
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#### 4. Negative performance (loss) recovery

<b>Policy Objective</b>	In order to safeguard the best interests of investors, 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 should be recovered before a performance fee becomes payable. The reference period should be set based on specific criteria and harmonised among Member States.
<b>Baseline scenario</b>	The baseline scenario should be understood for this CBA as the absence of a harmonised set of principles regarding the compensation of underperformances/losses before a performance fee becomes payable, as well as the lack of harmonisation on the length of the performance reference period over which to compensate such losses/underperformances.
<b>Technical proposal</b>	<p>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. 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 the reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided.</p> <p>The performance fee model should be designed to ensure that the fund manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses. The management company's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the recommended investors' holding period.</p> <p>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 5 years.</p>

	<p>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. The starting point to be considered in the calculations should be the initial offering price per share. 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. The performance reference period should not apply to the fulcrum fee model and other 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</p>
<p><b>Benefits</b></p>	<p>ESMA anticipates that the suggested approach would benefit all stakeholders and particularly investors. Setting a reference period for the purpose of compensating past underperformance and losses is a fundamental step in ensuring that the fee is paid on condition that the fund has achieved the objective of providing a specific positive return to the investor over a specified time horizon. In order to concretely harmonise current practices across the EU and ensure equal standards of investors' protection, ESMA deems necessary harmonising supervisory practices on the minimum performance reference period for the purpose of compensating underperformances both for the HWM model and for the benchmark model.</p> <p>For the HWM model, ESMA considers that a minimum performance reference period of 5 years should apply, in case this is shorter than the whole life of the fund. This would set high standards of investors protection in line with the principle that investors should not pay performance fees twice or more for the same level of performance. In order to reach this objective, it is of utmost importance that the performance reference period is long enough in order to avoid this risk.</p> <p>Consistently, ESMA deems appropriate setting a minimum performance reference period of 5 years for the benchmark model, in case this is shorter than the whole life of the fund. ESMA considers that the length of the performance reference period should be aligned for both models and should be long enough in order to compensate underperformance over a substantive period of time. ESMA acknowledges the potential shortcomings linked to possible free riding phenomena but notes that this is a potential consequence of every method which does</p>

	<p>not compute fees on a single investor basis. ESMA staff sees merit in recommending a sufficiently long period given the important investors protection component and in order to ensure higher standards in the harmonisation of performance fee models throughout the EU.</p> <p>Lastly, in order to avoid misalignment of interests between the fund manager and investors, ESMA deems it appropriate recommending that a performance fee could also be payable in case the fund has overperformed the reference benchmark but had a negative performance. However, if this is the case, a prominent warning to the investor is provided.</p>
<p><b>Compliance costs</b></p>	<p>Given the variety of practices and requirements among Member States, as shown by the ESMA Survey, ESMA expects higher initial costs for the introduction of this requirement, especially for those managers who do not comply with those minimum standards. However, those costs are likely to be counterbalanced by the beneficial effects of fostering competition in the asset management industry, as well as investor protection. To a certain extent, those recommended practices may also affect the fees' structure and the profitability of some investment funds, possibly impacting investment strategies, budgeting provisions and, therefore, business planning. However, those costs are likely to be counterbalanced by the beneficial effects of fostering competition in the asset management industry and allowing an easier investment comparison in the EU investment fund sector. Lastly, ESMA notes that in several jurisdictions a performance reference period of either 5 years or the whole life of the fund is already applied and, in those jurisdictions, no compliance cost is expected.</p>

**5. Disclosure of the performance fee model**

<p><b>Policy Objective</b></p>	<p>Under “Good Practice 1”, IOSCO indicates that the scope of fees and expenses that may and/or may not be deducted from the assets of a CIS should at least be set out in documents disclosed to investors before they invest and afterwards at the times mandated by legislation/regulation.</p> <p>IOSCO “Good Practice 5” states that it remains important for investors to be adequately informed of the existence of</p>
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the performance fee and of its potential impact on the return that they will get on their investment.	
<b>Baseline scenario</b>	The baseline scenario should be understood for this CBA as the lack of further disclosure requirements in addition to the EU existing legislative framework [such as Article 10(2)(c) of the KIID Regulation].
<b>Technical proposal</b>	<p>Investors should be adequately informed on the existence of performance fees and on their potential impact on the investment return.</p> <p>The prospectus and, if relevant, any <i>ex-ante</i> information documents as well as marketing material, should clearly set out all information necessary to get a proper understanding of 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 date when the performance fee is paid without prejudice to other more specific requirements set out in specific legislation or regulation. 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.</p> <p>In compliance with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated.</p> <p>In line with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated.</p> <p>The 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, consistently 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.</p> <p>The annual and half-yearly reports and any other <i>ex-post</i> information 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 fee based on the share class NAV.</p>
<b>Benefits</b>	ESMA anticipates that the suggested approach would be beneficial to all stakeholders and particularly to investors. Indeed, a consistent application of the <i>ex-ante</i> and <i>ex-post</i> disclosure requirements would further enhance the improvements in market transparency gained through the

	introduction of the Guidelines on performance fees. These additional requirements will help in standardising performance fees disclosure and reporting, allowing investors to more easily compare different investment options, thus contributing to the creation of a level playing field across Member States. More detailed and transparent information to investors would largely benefit the fund management industry from a reputational side, while reducing the need for correction and enforcement by competent authorities.
<b>Compliance costs</b>	ESMA takes the view that the proposed approach is unlikely to lead to significant additional costs to the extent that it provides clarifications and further details on the existing legislative provisions and enhances the benefits of the other Guidelines on performance fees. Several competent authorities already provide for additional disclosure requirements in the fund rules / instruments of incorporation, the annual report and the prospectus. Therefore, the cost of complying with this requirement is likely to be counterbalanced by its beneficial effects, also given the complementarity with the other Guidelines over performance fees and the flexible approach it allows in detailing the information to be disclosed.

## 6. Scope of the guidelines

<b>Policy Objective</b>	<p>These guidelines apply to managers and competent authorities.</p> <p>In case Member States allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage in accordance with Article 43 of the AIFMD, the guidelines also apply to AIFMs of those AIFs, except for:</p> <p>(a) closed-ended AIFs; and</p> <p>(b) open-ended AIFs that are EuVECAs (or other types of venture capital AIFs), EuSEFs, private equity AIFs or real estate AIFs.</p>
<b>Baseline scenario</b>	The baseline scenario should be understood for this CBA as applying the principles enshrined in the guidelines only to UCITS and not to AIFs marketed to retail investors.

<b>Technical proposal</b>	<p>As a general principle, retail investors should be equally protected, whether they invest in UCITS or retail-AIFs. This does not imply that ESMA is neglecting the specific characteristics of AIFs marketed to retail investors, which may entail investment strategies that differ from the ones which are allowed to UCITS by the relevant legislation. In order to take into account those specificities, ESMA deems appropriate to extend the scope of the guidelines to certain types of retail AIFs, carving out those whose characteristics would broadly differ from UCITS-like products (closed-ended AIFs and open-ended AIFs that are EuVECAs, or other types of venture capital AIFs, EuSEFs, private equity AIFs or real estate AIFs).</p>
<b>Benefits</b>	<p>In those jurisdictions which allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage ESMA anticipates that the suggested approach would be beneficial to all stakeholders and particularly to retail investors. A consistent application of the minimum standards set by the guidelines would ensure a common level of protection to retail investors, regardless of the product in which they are invested, as long as its characteristics are compatible with the principles enshrined in the guidelines. The extension of the scope of the guidelines will therefore contribute to the creation of a level playing field across Member States.</p> <p>On the other hand, without the extension of the scope of the guidelines to the aforementioned types of retail AIFs there would be the risk of creating a supervisory loophole, whereby diverging standards regarding performance fee models, payments and disclosure could be applied to very similar types of products potentially addressed to the same retail investor. This could potentially entail the risk of management companies setting up retail AIFs rather than UCITS funds in order to circumvent the practices recommend by the guidelines.</p> <p>In light of the above, ESMA expects that the extension of the scope to certain types of AIFs will help avoiding this risk, while also resulting in higher standards of retail investors' protection.</p>
<b>Compliance costs</b>	<p>ESMA takes the view that the proposed approach is likely to lead to additional costs only in relation to those retail AIFs that are marketed in Member States allowing AIFMs to market to retail investors in their territory units or shares of AIFs they manage. Furthermore, some competent authorities already provide for additional requirements in case those funds are sold to retail investors. Moreover, the cost of complying with this requirement is likely to be counterbalanced by its beneficial effects, also given the complementarity with the overarching principle of the</p>

	guidelines of setting higher standards in retail investors' protection and ensuring that investors are treated fairly and not charged with undue costs.
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## **Annex IV: Guidelines on performance fees in UCITS and certain types of AIFs**

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## I. Scope

### Who?

1. These guidelines apply to managers and competent authorities.
2. In case Member States allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage in accordance with Article 43 of the AIFMD, the guidelines also apply to AIFMs of those AIFs, except for:
  - (a) closed-ended AIFs; and
  - (b) open-ended AIFs that are EuVEGAs (or other types of venture capital AIFs), EuSEFs, private equity AIFs or real estate AIFs.

### What?

3. These guidelines relate to performance fees in UCITS and in the AIFs referred to in paragraph 2.
4. In respect of UCITS, they apply primarily in relation to Article 14 of the UCITS Directive as further specified by Article 22 of the UCITS Level 2 Directive. They also apply in relation to Article 78 of the UCITS Directive as further specified by Articles 10, 12 and 14 of the UCITS Level 2 Regulation and in relation to Article 69 of the UCITS Directive.
5. In respect of the AIFs referred to in paragraph 2, they apply in relation to Article 43 and 43a of the AIFMD.

### When?

6. These guidelines apply from two months after the date of publication of the guidelines on ESMA's website in all EU official languages.
7. Managers of any new funds created after the date of application of the guidelines 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, should comply with these guidelines immediately in respect of those funds.
8. Managers of funds with a performance fee existing before the date of application of these guidelines should apply these guidelines in respect of those funds by the beginning of the financial year following 6 months from the application date of the Guidelines.

## II Legislative references, abbreviations and definitions

### Legislative references

<i>AIFMD</i>	Directive 2011/61/EU on Alternative Investment Fund managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 <sup>17</sup>
<i>AIFMD Level 2 Regulation</i>	Commission Delegated Regulation (EU) No 231/2013 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision <sup>18</sup>
<i>ESMA Regulation</i>	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC <sup>19</sup>
<i>KIID Regulation</i>	Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website <sup>20</sup>
<i>UCITS Directive</i>	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) <sup>21</sup>
<i>UCITS Level 2 Directive</i>	Commission Directive 2010/43/EU implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the

<sup>17</sup> OJ L 174, 1.7.2011, p.1

<sup>18</sup> OJ L 83, 22.3.2013, p.1.

<sup>19</sup> OJ L 331, 15.12.2010, p. 84.

<sup>20</sup> OJ L 176, 10.7.2010, p. 1.

<sup>21</sup> OJ L 302, 17.11.2009, p. 32.

	agreement between a depositary and a management company <sup>22</sup>
<i>UCITS Level 2 Regulation</i>	Commission Delegated Regulation (EU) 2016/438 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries <sup>23</sup>

### Abbreviations

<i>AIF</i>	Alternative Investment Fund
<i>AIFM</i>	Alternative Investment Fund Manager
<i>ESFS</i>	European System of Financial Supervision
<i>ESMA</i>	European Securities and Markets Authority
<i>EuSEF</i>	European Social Entrepreneurship Fund
<i>EuVECA</i>	European Venture Capital Fund
<i>IOSCO</i>	International Organisation of Securities Commission
<i>NAV</i>	Net Asset Value
<i>UCITS</i>	Undertaking for Collective Investments in Transferable Securities

### Definitions

<i>benchmark</i>	a market index against which to assess the performance of a fund.
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<sup>22</sup> OJ L 176, 10.7.2010, p. 42–61

<sup>23</sup> OJ L 78, 24.3.2016, p. 11–30

<i>benchmark model</i>	a performance fee model whereby the performance fees may only be charged on the basis of outperforming the reference benchmark.
<i>crystallisation frequency</i>	the frequency at which the accrued performance fee, if any, becomes payable to the management company.
<i>excess performance</i>	the difference between the net performance of the portfolio and the performance of the benchmark.
<i>fulcrum fee</i>	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).
<i>fund</i>	a collective investment undertaking subject to the requirements of the UCITS Directive and an AIF referred to in paragraph 2
<i>fund managed in reference to a benchmark</i>	a fund where the benchmark index plays a role in the management of the fund, for example, in the explicit or implicit definition of the portfolio's composition and/or the fund performance objectives and measures
<i>High-Water Mark (HWM)</i>	the highest NAV per share or unit.
<i>High-Water Mark (HWM) model</i>	a performance fee model whereby the performance fee may only be charged on the basis of achieving a new High-Water Mark during the performance reference period.
<i>High-on-High (HoH) model</i>	a performance fee model whereby the performance fee may only be charged if the NAV exceeds the NAV at which the performance fee was last crystallised.
<i>hurdle rate</i>	a predefined minimum fixed rate of return.
<i>manager</i>	<ul style="list-style-type: none"> <li>a) a management company (as defined in Article 2(1)(b) of the UCITS Directive);</li> <li>b) an investment company that has not designated a management company authorised pursuant to the UCITS Directive; and</li> </ul>

	c) an AIFM (as defined in Article 4(1)(b) of the AIFMD) of the AIFs referred to in paragraph 2 of these guidelines.
<i>performance reference period</i>	the time horizon over which the performance is measured and compared with that of the reference indicator, at the end of which the mechanism for the compensation for past underperformance (or negative performance) can be reset.
<i>reference indicator</i>	the reference indicator against which the relative performance of the fund will be measured.

### **III Purpose**

9. These guidelines are issued under Article 16(1) of the ESMA Regulation. The purpose of these guidelines is to establish consistent, efficient and effective supervisory practices within the ESFS and to ensure the common, uniform and consistent application of Union law. Their objective is to promote greater convergence and standardisation in the field of performance fees and promote convergent supervision by competent authorities. In particular, they aim to ensure that performance fee models used by the management companies comply with the principles of acting honestly and fairly in conducting their business activities and acting with due skill, care and diligence, in the best interest of the fund that they manage, in such a way as to prevent undue costs being charged to the fund and its investors. Also, they aim at establishing a common standard in relation to the disclosure of performance fees to investors.

## **IV Compliance and reporting obligations**

### **Status of the guidelines**

10. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with these guidelines.
11. Competent authorities to which these guidelines apply should comply by incorporating them into their national legal and/or supervisory frameworks as appropriate, including where particular guidelines are directed primarily at financial market participants. In this case, competent authorities should ensure through their supervision that financial market participants comply with the guidelines.

### **Reporting requirements**

12. Within two months of the date of publication of the guidelines on ESMA's website in all EU official languages, competent authorities to which these guidelines apply must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.
13. In case of non-compliance, competent authorities must also notify ESMA within two months of the date of publication of the guidelines on ESMA's website in all EU official languages of their reasons for not complying with the guidelines.
14. A template for notifications is available on ESMA's website. Once the template has been filled in, it shall be transmitted to ESMA.

## V Guidelines on performance fees

### Guideline 1 - Performance fee calculation method

15. The calculation of a performance fee should be verifiable and not open to the possibility of manipulation.
16. The performance fee calculation method should include, at least, the following elements:
  - a. the reference indicator to measure the relative performance of the fund. This reference indicator can be an index (e.g. Eonia, Eurostoxx 50, etc.), a HWM, a hurdle rate (2%) or a combination (e.g.: HWM + hurdle rate);
  - b. the crystallisation frequency at which the accrued performance fee, if any, becomes payable to the manager and a crystallisation date at which the performance fee is credited to the manager;
  - c. the performance reference period;
  - d. the performance fee rate which may also be referred to as the “flat rate” i.e. the rate of performance fee which may be applied in all models;
  - e. the performance fee methodology defining the method for the calculation of the performance fees based on the abovementioned inputs and any other relevant inputs; and
  - f. the computation frequency which should coincide with the calculation frequency of the NAV (e.g.: if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).
17. The performance fee 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.
18. A manager 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.
19. The performance fee provisions and their final payments should be allocated and reversed in a symmetrical way. For example, it should not be possible to apply simultaneously an allocation rate (e.g. 20% of the performance of the fund when the performance increases) and a different reversal rate (e.g. 15% of the – negative – performance of the fund when the performance decreases).
20. Performance fees could be calculated on a single investor basis.

### Guideline 2 - Consistency between the performance fee model and the fund’s investment objectives, strategy and policy

21. 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.
22. When assessing the consistency between the performance fee model and the fund's investment objectives, strategy and policy, the manager should check:
  - a. whether the chosen performance fee model is suitable for the fund given its investment policy, strategy and objective. For instance, for funds that pursue an absolute return objective, a HWM model or a hurdle is more appropriate than a performance fee calculated with reference to an index because the fund is not managed with a reference to a benchmark; in addition, a HWM model for an absolute return objective, might need to include a hurdle to align the model to the fund's risk-reward profile;
  - b. whether, for funds that calculate the performance fee with reference to a benchmark, 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 investment objective and the chosen benchmark, as well as the consistency indicators included below under paragraph. For example, it should not be deemed appropriate for a fund with a predominantly long equity-focused strategy to calculate the performance fee with reference to a money market index.
23. As a general principle, if a fund is managed in reference to a benchmark index and it employs a performance fee model based on a benchmark index, the two indices should be the same.
24. This includes, *inter alia*, the case of:
  - performance measures: the fund has a performance objective linked to the performance of a benchmark (e.g.: Index A + positive absolute return objective; Index A + HWM; Index A + X% hurdle rate etc)
  - portfolio composition: the fund portfolio holdings are based upon the holdings of the benchmark index (e.g.: the individual holdings of the fund's portfolio do not deviate materially from those of the benchmark index).
25. In such cases, the benchmark used for the portfolio composition should be the same as the benchmark used for the calculation of the performance fee.
26. However, in case the fund is managed in reference to a benchmark but the fund's portfolio holdings are not based upon the holdings of the benchmark index (e.g.: the index is used as a universe from which to select securities), the benchmark used for the portfolio composition should be consistent with the benchmark used for the calculation of the performance fee. Consistency should be primarily assessed against the similar risk-return profile of different benchmarks (e.g.: they fall into the same category in terms of Synthetic Risk Reward Indicator and/or volatility and expected return). The following is a non-exhaustive cumulative list of "consistency indicators" which should be taken into account by the manager, based on the type of investment of the fund (for example, equities, bonds or derivatives):

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.

27. Where performance fees are payable on the basis of out-performance of a benchmark (e.g. “Eurostoxx 50 + 3%”, “Eonia”, etc.), it would not be appropriate to take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark (e.g. computing performance fees based on “Eurostoxx -1%” where the objective of the fund is “Eurostoxx”).
28. Where the calculation of the performance fee is based on a fulcrum fee model, the performance fee should be based on the same benchmark used to determine excess performance.
29. 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 less fees).
30. If the reference indicator changes during the reference period, the performance of the reference indicator for this period 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.

### **Guideline 3 - Frequency for the crystallisation of the performance fee**

31. The frequency for the crystallisation and the subsequent payment of the performance fee to the manager should be defined in such a way as to ensure alignment of interests between the portfolio manager and the shareholders and fair treatment among investors.
32. The crystallisation frequency should not be more than once a year.
33. Paragraph 32 could not be applied where the fund employs a high water-mark model or a high-on-high model where the performance reference period is equal to the whole life of the fund and it cannot be reset, as in this model performance fees cannot be accrued or paid more than once for the same level of performance over the whole life of the fund.
34. Paragraph 32 should not apply to the fulcrum fee model and other models which provide for a symmetrical fee structure (whereby performance fees would decrease or increase based on the performance of the fund), as the characteristics of these models are not compatible with the recommendation enshrined in paragraph 32.
35. The crystallisation date should be the same for all share classes of a fund that levies a performance fee.
36. In case of closure/merger of funds and/or upon investors' redemptions, performance fees, if any, should crystallise in due proportions on the date of the closure/merger and/or investors' redemption. In case of merger of funds, the crystallisation of the performance fees of the merging fund should be authorised subject to the best interest of investors of both the merging and the receiving fund. For instance, in case where all involved funds are managed by the same manager (e.g. in the context of a cross-border merger), crystallization of performance fees should be presumed contrary to investors' best interest unless justified otherwise by the manager. Generally, the crystallisation date should coincide with 31 December or with the end of the financial year of the fund.

#### **Guideline 4 – Negative performance (loss) recovery**

37. 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. 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 the reference benchmark but had a negative performance, as long as a prominent warning to the investor is provided.
38. The performance fee model should be designed to ensure that the manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses.
39. The manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the recommended investors' holding period.
40. 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 5 years.
41. 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. The starting point to be considered in the calculations should be the initial offering price per share. 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.
42. The performance reference period should not apply to the fulcrum fee model and other 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.

#### **Guideline 5 - Disclosure of the performance fee model**

43. Investors should be adequately informed about the existence of performance fees and about their potential impact on the investment return.
44. In case a fund allows for a performance fee to be paid also in times of negative performance (for example, the fund has overperformed its reference benchmark index but, overall, has a negative performance), a prominent warning to investors should be included in the KIID.

45. In case a fund managed in reference to a benchmark computes performance fees with a benchmark model based on a different but consistent benchmark (as per the case under paragraph 26 of the guidelines), the manager should be able to explain the choice of benchmark in the prospectus.
46. The prospectus and, if relevant, any ex-ante information documents as well as marketing material, 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, without prejudice to other more specific requirements set out in specific legislation or regulation. 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 especially where the performance fee model allows for performance fees to be charged even in case of negative performance.
47. In line with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated.
48. The 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, consistently 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.<sup>24</sup>
49. The annual and half-yearly reports and any other ex-post information 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.

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<sup>24</sup> See Section II Key Investor Information Document (KIID) for UCITS, Question 8 (Disclosure of the benchmark index in the objectives and investment policies) of the UCITS Q&A document (ESMA34-43-392), available at <https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits>.