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ESMA Finalises Guidance on Performance Fees for Funds Marketed to Retail Investors

Introduction

Following a consultation process in 2019, ESMA has now published Guidelines on performance fees charged to (i) UCITS investment funds and (ii) certain open-ended alternative investment funds which are marketed to retail investors within one or more EU Member States in accordance with Article 43 of Directive 2011/61/EU[1]. The harmonisation of EU rules regarding fund performance fees was identified by ESMA last year as a key priority given that fund performance fees are not substantively regulated under EU law and the importance of cross-border distribution of funds in the EU.

Competent authorities, including the Central Bank of Ireland (the "**Central Bank**") must confirm whether they intend to comply in full with the Guidelines within two months of the Guidelines being published in the official languages of the EU on ESMA's website. We expect that the Central Bank will fully comply with the Guidelines. [2]

The Central Bank revised the rules applicable to UCITS performance fees in June of last year which broadly align with the principles set down in the Guidelines. It also imposes similar rules on RIAIF funds.

[1] Article 43 of AIFMD empowers Member States to allow AIFMs to market to retail investors in their territory units or shares of AIFs they manage in accordance with this Directive, irrespective of whether such AIFs are marketed on a domestic or cross-border basis or whether they are EU or non-EU AIFs.

[2] As readers may be aware, two types of regulated AIF can be established in Ireland, the first being the "Retail Investor Alternative Investment Fund" or "RIAIF" the universe of potential investors in which is not restricted. The second, being the Qualifying Investor Alternative Investment Fund" or "QIAIF" can only be marketed or sold to "Qualifying Investors" which, as defined, may include retail EU investors.

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To date the Central Bank has not imposed any specific rules relating to the performance fee methodologies which must be adhered to in the case of QIAIFs[3].

We do not yet know with certainty how the Guidelines will be introduced into existing Irish laws and regulations applicable to UCITS management companies and AIFM of in-scope AIFs which are marketed to EU retail clients (each a "Management Company"). Once the legal and regulatory position has been clarified by the Central Bank, Management Companies of any in-scope Irish funds which are marketed to retail investors in one or more Member States will need to review existing performance fee methodologies (and related disclosures) to determine what changes will need to be made in order to comply with the Guidelines. The following is an overview of some of the potential implications for Irish funds.

Timing of the Guidelines

The Management Companies of all new in-scope funds established after the application date of the Guidelines and all existing in-scope funds which are subject to a performance fee for the first time after that date must comply with its provisions immediately[4]. A transitional period will be afforded to Management Companies of funds which already provide for a performance fee whereby they must ensure compliance with the Guidelines by the beginning of the financial year following 6 months from the application date of the Guidelines.

Scope of the Guidelines

The Guidelines apply to all Management Companies of UCITS that are charged performance fees. [5]The Guidelines do not apply to AIFM of any closed-ended AIF nor do they apply to the AIFM of any open-ended AIF which is authorised as an EuVECA (or other types of venture capital AIF), EuSEF, private equity AIF or real estate AIF.[6] However, the Guidelines will apply to AIFM of any other open-ended AIFs which are marketed in accordance with Article 43 of AIFMD to retail investors within one or more Member States of the European Union[7].

The Guidelines will not apply in respect of any otherwise in scope AIFs which are not marketed to retail investors within the European Union in accordance with Article 43, nor will

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[3] Irish domiciled funds authorised by the Central Bank as Qualifying Investor Alternative Investment Funds

[4] The Guidelines will apply from two months after the date on which they are published on the ESMA website in all EU official languages.

[5] The Guidelines do not expressly provide that they apply to Non-EU AIFM or non-EU AIF funds which would otherwise be in scope and which are marketed to retail investors in one or more EU Member States in accordance with Article 43. It remains to be seen how the Central Bank of Ireland and other EU Member State regulators implement the Guidelines in this regard.

[6] "Retail Investor" is defined under AIFMD as any investor which is not a "professional investor". "Professional investor" is defined with reference to the definition of "professional client" within the meaning of MiFID II, which applies to both those considered to be professional clients and those who "opt-up" to be treated as professional clients.

[7] Marketing to retail investors in any EEA Member State (as opposed to just EU) in accordance with Article 43 would appear to fall within the scope of the Guidelines.

they apply in respect of any otherwise in scope AIFs which are only marketed to retail clients that are outside of the European Union.

It would appear to be the case that Management Companies of existing AIF funds which receive a subscription from an EU retail investor as a result of reverse solicitation not involving marketing, will fall outside of the scope of the Guidelines.

What is meant by "marketing"?

The Guidelines apply to all UCITS but only certain open-ended AIFs that are marketed to retail investors in one or more EU Member States in accordance with Article 43 of AIFMD. The Guidelines do not provide a definition of "marketing". However the term is defined in AIFMD as meaning *"a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors domiciled or with a registered office in the Union"* which we would consider is the appropriate definition for use in this context.

Type of Performance Fee Model Used

When selecting a performance fee model, Management Companies must be able to demonstrate that the model is "*consistent with the fund's investment objectives, strategy and policy*".

Absolute Return Funds

ESMA notes that a fund which pursues an absolute return objective should use a high water-mark model or hurdle rate in order to measure performance because the fund is not being managed with reference to any benchmark[8]. It also notes that for certain absolute return funds, it may not be appropriate to use the high water-mark model alone. The Guidelines provide that it may be necessary in certain circumstances to incorporate a hurdle rate[9] into a high water-mark performance fee methodology in order to ensure that the chosen methodology aligns with the fund's risk-reward profile.

Funds Using Benchmark Performance Fee Methodology: Selection of an Appropriate Benchmark

Where a Management Company decides to apply a performance fee model which is based on outperformance of a benchmark, the Guidelines provide that it must ensure that not only must such benchmark be "appropriate" taking into account the fund's investment policy and strategy but also taking into account the fund's risk-reward profile. Management Companies

[8] "HWM model" is defined in the Guidelines as "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*". It is distinguished under the Guidelines from a "High-on-High Model" which is described as 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*."

[9] The term "hurdle rate" is defined in the Guidelines as "a predefined minimum fixed rate of return".

must assess any "material difference of risk" between the fund's objective and the benchmark and must take into account certain "consistency indicators" based on the type of investment fund. These include by way of example only, expected return, investment universe, beta exposure to an underlying asset class and liquidity measures (e.g. daily trading volumes, bid-ask spreads etc).[10]

The Guidelines specifically provide that a predominantly long-only equity fund should not calculate performance fees with reference to a money market index.

Where a fund is "managed in reference to a benchmark" and is also subject to a performance fee which is based on outperformance of an index, the same benchmark should be used. The Guidelines note for example that where a fund's portfolio holdings are based on the holdings of a benchmark[11], that same benchmark should be used for performance fee calculation purposes. Helpfully, the Guidelines provide that where a fund uses a benchmark as a universe from which to select securities (without that fund's portfolio holdings being based on the holdings of the benchmark), the benchmark used for performance fee calculation purposes may be different. However, in such circumstances, the Management Company will need to be able to demonstrate that the benchmark chosen for performance fee calculation purposes is "consistent" with the benchmark used for the portfolio composition. In this case, the benchmarks used should have a similar risk-return profile and should be deemed consistent taking into account the specific "consistency indicators" mentioned above.

While ESMA acknowledged in its consultation paper which preceded the publication of the Guidelines[12] that Management Companies applied various approaches relating to the accounting of performance fees such as equalisation or series accounting, it does not specifically address equalisation or series accounting in the finalised Guidelines.

Frequency of Crystallisation of Performance Fees

Under the revised performance fees applicable to Irish UCITS funds introduced last year, Management Companies of UCITS funds must ensure that performance fees do not crystallise more than once a year, regardless of the calculation methodology used. The Central Bank does not currently impose this requirement on RIAIF and QIAIF funds.

Under the Guidelines Management Companies of any fund marketed to EU retail investors will also be required to ensure that performance fees do not crystallise more frequently than annually subject to certain exceptions. In this regard, ESMA has provided that funds which adopt a high-water-mark model or high-on-high model where the performance reference

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[10] The list of consistency indicators which should be taken into account when selecting a benchmark for computing performance fees (which ESMA notes is a "non-exhaustive list") is set down in Paragraph 26 of the Guidelines.
[11] ESMA notes that this will arise where "*the individual holdings of the fund's portfolio do not deviate materially from those of the benchmark index*".
[12] https://www.esma.europa.eu/sites/default/files/library/esma34-39-881_cp_on_performance_fees_guidelines_in_ucits.pdf

period is equal to the life of the fund do not need to comply with this requirement that the performance fee cannot crystallise more than once a year. It remains to be seen how the greater flexibility afforded by ESMA under the Guidelines will impact on the current Irish legal and regulatory framework.

Consistent with the Irish rules applicable to UCITS funds, ESMA has confirmed that this requirement does not apply to investor redemptions.

Negative Performance Recovery

The Guidelines provide that where a fund's performance calculation methodology measures its performance against a benchmark, the performance reference period applicable to clawback of underperformance can be limited to 5 years rather than being required to look back over the entire life of the fund (if in existence for more than 5 years).

ESMA has also confirmed that where a fund uses a high water-mark model[13], the performance reference period can be re-set after five years meaning that a performance fee can be claimed if the outperformance exceeds any underperformances during the previous five years (in which case the performance fees should not crystallise more than once a year).

The Central Bank will need to looks at its existing requirements for UCITS and RIAIF performance fees in light of the additional flexibility afforded under the Guidelines in respect of negative performance recovery.

Enhanced Disclosure Requirements

Prospectus Disclosures

On the presumption that the Guidelines will be adopted in full by the Central Bank, Irish Management Companies of in scope funds will need to review and revise prospectuses of any in-scope funds in order to comply with the requirement set down in the Guidelines that 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*".

KIID Disclosures

For any UCITS fund which may be charged a performance fee in circumstances where it has outperformed its reference benchmark index notwithstanding an overall negative performance, a prominent risk warning must be included in the KIID.

Annual and Half-Yearly Reports

[13] As noted above, the high water-mark model is to be distinguished from the high-on-high model.

The annual and half-yearly financial reports should disclose the impact of the performance fees by disclosing not only the percentage of the fees based on the net asset value of the relevant share class but also the actual amount of performance fees charged during the period under review.

Next Steps

At present, we do not yet know how exactly the Guidelines will be implemented in Ireland. There are several questions which need to be addressed by the Central Bank, including (i) whether the Central Bank will amend its existing UCITS and RIAIF performance fee rules to comply fully with the Guidelines; (ii) whether the Guidelines will be applied to QIAIFs to the extent that their shares are marketed to retail investors in one or more EU Member States in accordance with Article 43 of AIFMD (iii) the treatment of non-EU AIFs marketing to retail investors in Ireland and (iv) the position of non-EU AIFMs of in scope Irish domiciled AIFs.

In the context of AIFs, it may be that in order to comply with the Guidelines, Management Companies will want to be able to create a specific "EU retail" class of shares that would be designed to be marketed solely to retail EU investors and where the relevant performance fee methodology attributable to that share class would comply with the Guidelines while other classes within the same fund could be established which are marketed only to professional investors will not be required to comply with the Guidelines.

An important consideration for those Management Companies who will change their performance fees to comply with the Guidelines is whether or not it will require shareholder approval to be obtained.

Once the Central Bank has confirmed how it intends to implement the Guidelines and noting the transitional arrangements outlined above under "Timing of the Guidelines", Management Companies should consider taking the following steps:

UCITS

(i) Identify any UCITS funds under management which are currently subject to a performance fee;

(ii) Review applicable performance fee model and methodology against the finalised Guidelines to determine what changes, if any, will need to be made to the model and methodology currently used; and

(iii) Review existing prospectus, KIID and periodic report disclosures and identify any changes to be made.

AIF

(i) Identify any AIFs under management which fall within the scope of the Guidelines (as outlined above under “Scope of the Guidelines”) and which are charged a performance fee;

(ii) Determine whether such AIFS are marketed to retail investors within any EU Member State in accordance with Article 43 of AIFMD;

In the case of AIFs that are in scope, their AIFMs will then need to consider appropriate action to be taken.

AIFMs may decide to re-structure the performance fee model/methodology to align with the Guidelines if the AIFM intends to market to EU retail investors going forward.

Alternatively, AIFMs may decide to re-structure their funds such that retail EU investors are housed going forward in specific “retail” Classes which comply with the Guidelines and other investors are housed in separate share classes (assuming this will be consistent with the Central Bank’s implementation of the Guidelines).

AIFMs may decide to review their existing categorisation of their EU investors to ensure that all investors who can properly be categorised as professional clients have been so categorised.

Alternatively AIFMs may decide to cease marketing to EU retail investors.

In each case, disclosures in the prospectus of the relevant AIF should be reviewed and revised as necessary. Periodic reports should also comply with the disclosure requirements set down in the Guidelines.

Conclusion

We will keep our clients updated as and when further information on how the Central Bank will implement the Guidelines emerges. In the meantime, if you have any questions relating to this topic, please contact your usual Dillon Eustace contact.

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