Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Performance fees of UCITS and certain types of Retail Investor AIFs

Guidance

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Guidance: Performance fees of UCITS and certain types of Retail Investor AIFs

This Guidance incorporates, to the extent currently possible and practicable, ESMA Guidelines on performance fees in UCITS and certain types of AIFs[1] into the Central Bank's regulatory framework.

Scope

1. This Guidance applies only to UCITS and to Retail Investor AIFs other than those Retail Investor AIFs that are closed-ended and open-ended Retail Investor AIFs that have been established as EuVECA, EuSEF or follow venture capital, private equity or real estate strategies (**in-scope funds)**.

2. The Guidance applies at fund level. New classes within an existing in-scope fund with performance fees availing of the transition period shall continue to comply with the regulatory regime that applies to other classes within the fund.

Responsibility

3. Where the Guidance is being applied in the context of a UCITS, responsibility for compliance with this Guidance rests with the Responsible Person of the UCITS as such term is defined in the Central Bank UCITS Regulations[2]. Where the Guidance is being applied in the context of a Retail Investor AIF, responsibility rests with the Retail Investor AIF.

Effective date

4. The date of application of the Guidance is:

    a. for in-scope funds which are established or which amend or introduce a performance fee on or after 5 January 2021 the Guidance applies from the date of establishment, amendment or introduction.

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[1] https://www.esma.europa.eu/press-news/esma-news/esma-publishes-guidance-performance-fees-in-ucits-and-certain-aifs. ESMA Guidelines have an effective date of 5 January 2021.

[2] Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019 (S.I. 230 of 2019) (**Central Bank UCITS Regulations**)

b. for in-scope funds with existing performance fees as at 5 January 2021, the Guidance will apply from the beginning of the accounting period, which occurs six months after the Effective Date (5 July 2021)[3].

Definitions

"benchmark"	a market index against which to assess the performance of a fund
"benchmark model"	a performance fee model whereby the performance fees may only be charged on the basis of outperforming the reference benchmark
"crystallisation frequency"	the frequency at which the accrued performance fee, if any, becomes payable to the management company
"excess performance"	the difference between the net performance of the portfolio and the performance of the benchmark
"fund managed in reference to a benchmark"	a fund where the benchmark 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
"High-Water Mark" or "HWM"	the highest NAV per share or unit
"High-Water Mark model"	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. Under this model a performance fee is payable where a new highest NAV per share or unit is achieved during the performance reference period
"High-on-High (HoH) model"	a performance fee model whereby the performance fee may only be charged if the NAV exceeds the NAV of the fund at which the performance fee was last crystallised. Under this model a performance fee is payable where the NAV of the fund exceeds the NAV of the fund at which the performance fee was last crystallised
"hurdle rate"	a predefined minimum fixed rate of return
"NAV"	net asset value
"performance reference period"	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. The performance reference period shall be the whole life of the fund

[3] For example, a fund with an accounting period ending on 31 December 2021 must comply for the period starting 1 January 2022. If a fund has an accounting period ending on 30 September 2021, then they must comply from 1 October 2021.

"reference indicator"	the reference indicator against which the relative performance of the fund will be measured

Performance fee calculation method

5. A Responsible Person[4] or Retail Investor AIF, in in respect of a performance fee calculation method:

   a. should ensure the calculation of a performance fee is verifiable and not open to the possibility of manipulation.

   b. should ensure the performance fee calculation method includes, at least, the following elements:

      i. the reference indicator to measure the relative performance of the fund. For this purpose the 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).

      ii. 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;

      iii. the performance reference period;

      iv. 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;

      v. 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

      vi. the computation frequency, which should coincide with the calculation frequency of the NAV (for example, if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

   c. should ensure in relation to UCITS, reference to a new high net asset value in Regulation 40(1)(a) of the Central Bank UCITS Regulations is understood to include either a High-Water Mark model or a High-on-High model; and reference to an index in Regulations 40(1)(b) and 40(3) of the Central Bank UCITS Regulations is understood to include a benchmark or a hurdle rate.

   d. should ensure the performance fee calculation method is 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

[4] As defined in the Central Bank UCITS Regulations.

into account when calculating fund performance.

e. should ensure they are always able to demonstrate how the performance fee model of a fund constitutes a reasonable incentive for the manager and is aligned with investors' interests.

f. should ensure the performance fee provisions and their final payments are 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).

g. could calculate performance fees on a single investor basis.

h. should, in the case of Retail Investor AIFs which have multiple managers or advisers, ensure that a performance fee is payable only on the performance of that part of the portfolio for which the investment manager or adviser is responsible.

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

6. A Responsible Person or Retail Investor AIF, should, as regards consistency between the performance fee model and the fund's investment objectives, strategy and policy:

a. 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.

b. when assessing the consistency between the performance fee model and the fund's investment objectives, strategy and policy, check:

i. whether the chosen performance fee model is suitable for the fund given its investment policy, strategy and objective. For a fund that pursues an absolute return objective, a HWM model or a hurdle should be considered as being 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, consideration should be given to the extent a HWM model for a fund with an absolute return objective might need to include a hurdle to align the model to the fund's risk-reward profile;

ii. whether, for a fund that calculates 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 6(d). 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.

c. ensure, where a fund is managed in reference to a benchmark and where it employs a performance fee model based on a benchmark, that the two indices are the same. For the purposes of this paragraph, this includes, in the case of:
   i. 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); and
   ii. portfolio composition: the fund portfolio holdings are based upon the holdings of the benchmark (e.g.: the individual holdings of the fund's portfolio do not deviate materially from those of the benchmark).
   iii. ensure in such cases, the benchmark used for the portfolio composition is the same as the benchmark used for the calculation of the performance fee.

d. where a fund is managed in reference to a benchmark but the fund's portfolio holdings are not based upon the holdings of the benchmark (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 non-exhaustive cumulative list of "consistency indicators" should be taken into account 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.

e. not, where performance fees are payable on the basis of out-performance of a benchmark, take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark.

f. calculate the excess performance net of all costs (for example, management fees or administrative fees). Excess performance may be calculated without deducting the performance fee itself provided that in doing so it is in the investors' best interests.

g. if the reference indicator changes during the reference period, calculate the performance of the reference indicator for the period by linking the benchmark that was previously in force until the date of the change and the new reference indicator used afterwards.

Frequency for the crystallisation of the performance fee

7. A Responsible Person or Retail Investor AIF, should, as regards frequency for the crystallisation of the performance fee:
   a. ensure the frequency for the crystallisation and the subsequent payment of the performance fee is defined in such a way as to ensure alignment of interests between the portfolio manager and the shareholders and fair treatment among investors.

   b. in the case of retail AIFs, ensure crystallisation occurs no more frequently than once a year.

   c. ensure the crystallisation date is the same for all share classes that levy a performance fee.

   d. in case of closure/merger of funds and/or upon investors' redemptions, ensure that performance fees, if any, 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), crystallisation of performance fees should be presumed contrary to investors' best interest unless justified otherwise by the manager.

   e. seek to align the crystallisation date with 31 December or with the end of the financial year of the fund.

Negative performance (loss) recovery

8. A Responsible Person or Retail Investor AIF, should, as regards negative performance (loss) recovery:
   a. in the case of retail Investor AIFs, only pay a performance fee 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.

   b. provide a prominent warning to the investor when, in order to avoid misalignment of interests between the manager and investors, the fund pays a performance fee if it has out-performed the reference benchmark but overall had a negative performance.

c. ensure the performance fee model is designed to ensure that the manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses.

d. in the case of a Retail Investor AIF, where the Retail Investor AIF employs a performance fee model based on a benchmark index, ensure that any underperformance of the Retail Investor AIF compared to the benchmark in preceding periods is clawed back before any performance fee becomes payable in subsequent periods. To this purpose, the length of the performance reference period should be set equal to the whole life of the Retail Investor AIF.

e. in the case of a Retail Investor AIF, where a fund utilises a HWM model, ensure the performance fee is only payable or paid on the increase of the net asset value per share over the amount in subparagraph (i) or (ii), whichever is higher.
   i. the previous highest net asset on which a performance fee was paid or accrued; or
   ii. the initial offer price, if higher. The starting point to be considered in the calculations should be the initial offering price per share.

For the HWM model, the performance reference period should be the whole life of the Retail Investor AIF.

Disclosure of the performance fee model

9. A Responsible Person or Retail Investor AIF, should, as regards disclosure of the performance fee model:

a. ensure investors are adequately informed about the existence of performance fees and about their potential impact on the investment return.

b. where a performance fee may be paid also in times of negative performance (for example, the fund has out-performed its reference benchmark index but, overall, has a negative performance), include a prominent warning to investors in the KIID if there is one and, if there is no KIID, in the prospectus.

c. in the 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 6(d)), explain the choice of benchmark in the prospectus.

d. clearly set out in the prospectus and, if relevant, any ex-ante information documents as well as marketing material, 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.

e. ensure the main elements of the performance fee calculation method are indicated and disclose the following in the prospectus:
   i. the calculation period for determining the performance fee;
   ii. the first calculation period;
   iii. how the performance fee is calculated, for example in the context of UCITS, whether it is calculated in accordance with Regulation 40(1)(a) or (b) of the Central Bank UCITS Regulations;
   iv. the amount of the performance fee payable, i.e. the percentage payable; and
   v. accrual basis of performance fee and when it is actually paid.

f. in the prospectus, provide investors with 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;

g. include a risk warning in the prospectus which provides that performance fee is based on net realised and net unrealised gains and losses as at the end of each calculation period and as a result, incentive fees may be paid on unrealised gains which may subsequently never be realised.

h. ensure the KIID clearly sets 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[5] or provide a signpost as to where such information can be freely and easily located (such as a website).

i. ensure the annual and half-yearly reports and any other ex-post information indicates, 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.

j. in the case of a fund which has multiple managers or advisers, include in the prospectus a risk warning that it is possible that performance fees may be payable to one or more of the investment managers or advisers where the overall net asset value of the fund may not have increased.

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[5] 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. [Guidelines 48 - to remain guidance]