association of the
luxembourg fund industry

Luxembourg, 31 October 2019

Response to ESMA consultation on guidelines on performance fees in UCITS

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank ESMA for the opportunity to participate in this consultation on guidelines on performance fees in UCITS.

We generally support the submission of the European Fund and Asset Management Association (EFAMA).

Response to the consultation

General comment:

ALFI recommends a revision of the glossary in the introduction of the guidelines (see our propositions in our below answers), and a clear definition of all terms used.

In particular, ALFI does not agree with ESMA's own definition of HWM as it only refers to a "pure" HWM, whereby the performance fee becomes payable where the NAV per share exceeds the highest previous value ever recorded since the fund's launch. The IOSCO 2004 Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds additionally includes the definition of a HWM model variant known as the "high-on-high" (HoH). Accordingly, the performance fee is payable only if the NAV per share exceeds the highest previous value at which the last performance fee was accrued and paid out to the fund.

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

ALFI agrees that it would be good to have high-level principles or guidelines on performance fees in UCITS across the European Union. Greater standardisation helps to provide clarity for both asset managers and investors. Different national requirements create barriers to the cross-border distribution of funds and contravene the legal requirement to make every effort to comply with guidelines adopted by the European Supervisory Authorities. They should be avoided to ensure a level playing field across Europe. IOSCO adopted in 2016 'Good Practices for Fees and Expenses of Collective Investment Schemes'[1], which are applied by many national regulators as a minimum.

While working on a market standard, ESMA should in ALFI's view not be too prescriptive, which would correspond to the principle-based approach chosen by IOSCO. As stated on page 9 of the consultation paper, there are a variety of performance fee models which are used, and there are also various approaches to the methodologies which apply to these models. Given that UCITS are set up by initiators from various geographical and other backgrounds, and that they are distributed globally, it would not be appropriate to require only one model or methodology. There are valid reasons why the models and methodologies are different, e.g. because of the investor type and expectations, the fund's structure or the fund's strategy. Indeed while the draft Guidelines have a retail focus, we note there is considerable usage of UCITS funds also by institutional investors through dedicated share classes. In light of such investors' greater sophistication, risk tolerance and typically greater investment amounts, etc. performance fee calculations and their disclosure would deserve greater flexibility outside a mass-retail market and concomitantly allow national competent authorities greater latitude when authorising fee methodologies for institutional share classes.

One should also bear in mind the relationship between performance fees and fixed management fees to measure the combined impact for the investor. The outcome of having a higher fixed management fee may result in having investors paying a higher total fee when the fund is underperforming. Where a performance fee is used in conjunction with the fixed management fee, the asset manager has an enhanced incentive to outperform. The additional revenue opportunities from the performance fee for the asset manager may be balanced by lower annual fixed management fees[2].

Performance fee models should ensure that interests of investors and asset managers are aligned. The basic principle for the alignment of interest is that when the investor benefits from absolute or relative outperformance, depending on the methodology used, the asset manager benefits financially. Conversely, during periods when the investor fails to receive outperformance, the asset manager receives reduced remuneration accordingly.

ALFI agrees that high level principles on performance fee methodologies and guidelines related to disclosures on performance fee methodologies, calculations and actual figures are important and in the interest of retail investors to help them understand the products they are investing in.

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

The European performance fee landscape is currently very different from one country to another: the IOSCO principles are widely accepted by all, however, not necessarily in a formal way, and some countries introduced additional national specific requirements.

The proposed high-level guidelines are therefore important to set up a common level playing field. It would thus be important to ensure that UCITS would not have to comply with different national

[1] In particular Good Practices 2 to 4 concern performance fees
[2] See article published by IPE, which refers to a study made by Fitz Partners: https://www.ipe.com/news/costs/performance-fee-funds-can-be-cheaper-research/10020721.article

requirements in addition to what may be agreed at EU level. Stricter local rules would be an obstacle to the cross-border distribution of funds.

On the other hand, as outlined in our response to Q1, ALFI is of the view that too prescriptive rules or a full harmonisation limiting significantly the variety of performance fee models and methodologies would be counterproductive.

The draft Guidelines specify five “key elements” around which there should be greater convergence. Although asset managers will require some flexibility in defining certain elements, we believe that all five warrant full disclosure and some degree of standardisation as we will develop in the next answers.

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

The need of consistency between the investment objectives, strategy and policy of a fund and its benchmark is stated in numerous documents including:

- The IOSCO statement on Matters to Consider in the Use of Financial Benchmarks from 5 January 2018
- ESMA Q&A on the application of the UCITS Directive.

ALFI believes the consistency should be considered on a case-by-case basis and not according to pre-defined indicators considering the diversity of investment objectives, strategies and policies for which performance fee models could be applied to.

Considering draft Guideline 2 point 16 (page 52 of the consultation paper), ALFI disagrees with the example provided in the last sentence[3], and in particular with the vague wording “not be deemed appropriate”. It is a common standard for many types of funds to calculate the performance fee with reference to a money market index (plus possibly a hurdle rate). The use of such indices should be aligned to the investment objectives of the fund. The asset manager could provide further clarification on why the money market index is used as appropriate benchmark in this case.

ALFI also thinks that ESMA’s guidelines should not name any specific indicators underlying the choice of an index, such as historic volatility or asset allocation composition: these indicators should be assessed for each fund depending on its investment policy and strategy and might in addition change over time. The requirement to ensure consistency should be described in a general way.

ALFI therefore advocates for clear and proportionate disclosures to investors:

1. The choice of an index in the context of calculating performance fees should be disclosed and explained in the prospectus,

2. The use of an index in the performance fees calculation should be disclosed in the “Charges” section of a UCITS KIID in addition to a possible cross-reference to the prospectus considering the limited KIID format.

   In this context, it is important to refer to the interpretation recently introduced by ESMA on the disclosure of benchmarks in UCITS KIIDs[4]. ESMA provides a very wide definition of explicit or implicit uses of a benchmark / benchmarks by funds. These benchmarks must be

[3] ESMA writes: “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

[4] See ESMA Q&A 34-43-392 on the application of the UCITS Directive, as updated in March 2019

disclosed in the “Objectives and investment policy” section and in the “past performance” section of a KIID.

ALFI considers that, in order to provide clear and fair information to investors, the use of a benchmark in the context of the performance fee calculation should continue to be only disclosed in the “Charges” section of the KIID as mentioned above.

3. The use of an index should be disclosed when providing investors with the required ex-ante and ex-post information on costs and charges (MiFID) as it is relevant for the calculations provided.

In any case, ESMA should provide clarity on whether and how this information should be disclosed, bearing in mind the mandatory size of the UCITS KIID.

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.

Regarding terminology, we would firstly suggest that the notion of “crystallisation period” be clarified. In the definitions section of the draft Guidelines, it is defined as a “(…) period during which the performance fee, if any, is accrued and at the end of which it becomes payable to the management company”. However, draft Guideline 1, under paragraph 11, point b) thereof, defines “crystallisation date” as the one coinciding with the end of the crystallisation period and at which the performance fee, if any, is crystallised and directly “credited” to the management company. We note there is hence some uncertainty on whether the performance fee is only virtually booked on the account of the management company or de facto paid out and settled at the end of the crystallisation period. Pending our uncertainty around this semantic, yet important nuance, we shall provisionally assume that a “crystallisation period” does not yet imply the direct pay-out of the performance fee to the management company (please refer to our response to Question 5 below).

We would secondly suggest that the final Guidelines refer to “crystallisation frequency” in lieu of “crystallisation period”. The previous connotation would not only be consistent with the IOSCO 2016 Best Practices, but also avoid confusion with the accompanying notion of “performance reference period” as per the draft Guidelines.

ALFI disagrees with the statement in point 18 (page 11 of the consultation), according to which the minimum crystallisation frequency should be linked to the fund’s recommended holding period, for the following reasons:

- Practical limitations due to the open-ended nature of UCITS. Considering that UCITS offer daily redemptions and subscriptions, it would be difficult to have a crystallisation frequency in line with each investor recommended holding period (RHP) without creating daily series of shares. This would result in substantial additional costs for the fund and its investors,

- Many investors in UCITS invest via distributor’s nominee or omnibus account which aggregate many investors in one account and trade on a net position basis, therefore it is not possible to determine how long each investor’s share has been held,

- The use of the RHP may only be appropriate for certain types of UCITS such as capital protected funds or structured funds with a multiple year performance period.

- Finally we do not agree with the proposal to link the duration of the crystallisation frequency with the recommended holding period for given share classes. The performance fee remunerates the asset management company as a whole, not only the individual portfolio manager (as assumed under paragraph 19 relatively to draft Guideline 3). Alignment of interests between the latter and the end-investor is more effectively guaranteed via existing remuneration requirements in line with ESMA's own 2016 Guidelines on sound remuneration policies under the UCITS Directive (ESMA/2016/575), as well as by resetting the fund's performance reference period.

In most cases, the performance (crystallisation) period should be a 12-month period, typically the fund's financial year, with accruals at each NAV point and crystallisation of the performance fee on the last day of the performance period or upon the redemption of shares or units by the investor. Therefore, the standard performance period for the crystallisation of performance fee should be, in principle, 12 months.

Shorter periods should be allowed if they are in the interest of investors or for technical reasons (such as the first period of operation, liquidations or restructurings) or other practical circumstances and have to be disclosed to investors in advance, in particular:

- There are cases of corporate actions, such as closure or merger of funds (which have to be approved a priori by the national competent authorities), that could justify shorter performance periods on an exceptional basis. These corporate actions have to be notified to the investors in advance,

- A shorter performance period should also be possible if it ensures a fair treatment of investors, for example:

    - In case of a sub-investment manager model where performance fees would be payable to sub-advisers appointed by the manager for the over-performance they achieve on the portion of the fund's assets allocated to them. A performance fee crystallisation would typically happen every time the assets managed by a sub-investment manager are reduced as a result of a decision of the primary investment manager, or when the allocation to that sub-investment manager is terminated,

    - There might also be circumstances where the performance period could also be longer than 12 months. When the prescribed investment objective or a specified target return date require it, it may be appropriate to extend the performance period,

    - In addition, where investors redeem before the end of the performance period, the performance fee accrued on the redeemed units or shares can be crystallised under certain operating models. Not accruing performance fees for redemption may cause distortions in the NAV and provide investors with misleading performance measures. If a fund, which has performance fees accrued, experiences significant redemptions and does not realise the accrued performance fee on those redeemed shares or units, the reduction in the performance fee accrued given lower assets in the fund at the next valuation point will cause an inappropriate uplift in performance for the fund resulting solely from the change in the performance fee accrual.

- Shorter periods should also be allowed depending on the investment objective of the fund. For example, money market funds may choose to have very low fixed management fees combined with performance fees with quarterly crystallisations. Investors are benefitting from the low fixed management fees and from the alignment of interest to achieve returns within the constraint of investment objectives. Investors in this type of funds typically have an observed holding period of less than one year.

Regarding point 20 specifically, we do not believe that a crystallization period minimum alleviates the risk that over-performance results from "short-term gains due to random market factors." First, we believe that all gains are created equally, regardless of the time period over which they are generated. Ceteris paribus, an asset manager who generates a 12% annual return in its fund by earning a 12%

return during the first half of the year and 0% for the remainder of the year generates the same 12% annual fund return as an asset manager who generates a 1% return in each month of the year. Second, we believe that the risk of compensating asset managers for “random market factors” should be mitigated, but not through the crystallization period. This risk should instead be controlled by requiring asset managers to select an appropriate benchmark, thereby eliminating performance compensation resulting from market appreciation alone.

ALFI in conclusion agrees with a standard crystallisation period of typically 12 months, but some flexibility should be allowed to take into consideration events such as non-exhaustively listed above to ensure the best interests of the investors are taken into consideration.

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.

ALFI agrees that fulcrum fee models should be exempted from the requirement of a minimum crystallisation period of 12 months because fulcrum fees, by their nature, have the potential to claw back, to some degree, relative underperformance.

However, ALFI believes that the crystallisation period and the possible claw back duration should be clearly disclosed to investors.

All funds should have a minimum crystallisation period/frequency of typically 12 months, regardless of whether they utilize HWMs or not and with the flexibility, to adopt shorter measurements periods as explained above and in our answer to Q4.

However and in relation with our comment on the HWM indicated at the top of this document related to the distinction between a “pure” HWM model and a HoH one, we observe that a minimum crystallisation period of 12 months should not apply to the former. Considering that a “pure” watermark model consists in the accrual and pay-out of the performance fee at each calculation point (i.e. daily) where the last NAV per share positively exceeds the highest one previously recorded since the fund’s launch. A minimum crystallisation period would thus be at odds with this model’s operation. On the same grounds, there would be 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.

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?

We disagree with the negative performance (loss) recovery as currently suggested by Guideline 4.

Asset Managers can notably deliver superior performance by avoiding greater losses for investors in times of falling markets, which should entitle them to a performance fee. Therefore, it should be possible to realise performance fees even in falling market (the so called “relative performance fees”) for funds that do not strive to provide absolute returns. The same applies to a “claw back model” where a performance fee can be charged even if the share class performance is negative, so long as the benchmark has decreased more than the NAV.

The proposed guideline 4 would be especially unfair to asset managers whose compensation models include a performance fee compared to funds having only a fixed management fee.

In all cases, managers should include additional disclosures to alert investors that performance fees might also exist in falling markets (i.e. a performance fees might be charged even though the overall NAV per share has decreased).

Clear disclosure is also required in a sub-investment manager model where the management of a portfolio is sub-delegated to sub-investment managers, each of them managing a portion of the portfolio. Their remuneration can include a performance fee calculated based on their performance in managing their respective sleeve. With this model, performance fees are calculated in a similar way to the high watermark model, except that what is measured is not the share class performance, but the performance of each sub-investment manager. Where there are several sub-investment managers managing a portfolio who perform differently, a performance fee may be payable to one or more sub-investment managers, even though the overall portfolio performance is negative.

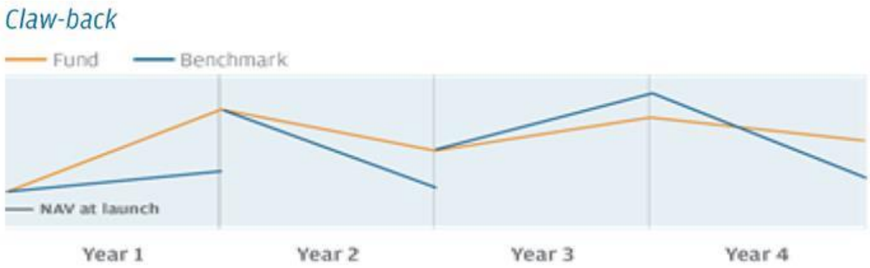
Q7. If the performance fee model that you currently use provides for performance fees to be payable in times of negative returns, is a prominent warning on this provided to investors in the legal and marketing documents of the fund? If not, should this be provided? Please give examples for your answer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

In a large majority performance fee models used provide for performance fee to be payable in times of negative returns. In such cases, warnings are indicated to investors in the fund prospectus and other legal and marketing documents (generally through cross references to the prospectus).

Further to our answer to Q6, ALFI is pleased to share with ESMA the following examples of disclosure in a fund prospectus on the risk of performance fees being payable in times of negative returns.

Example 1 (Source: excerpt of JPMorgan Funds prospectus):

> The performance fee has been designed so that no performance fee is paid merely for making up for earlier underperformance against the benchmark or Hurdle Rate in the reference period (that is, for making up ground that was lost to earlier underperformance against the benchmark or Hurdle Rate). Note, however, that a performance fee can in some cases be charged even when performance is negative. For Sub-Funds that use the Sub-Investment Manager model, this can happen when one or more Sub-Investment Managers have earned performance fees for the assets they manage but overall Share Class performance is negative. For Sub-Funds using the claw back method it can happen when the benchmark has decreased more than the Share Class.



Year 1 Share Class outperforms benchmark. *Performance fee payable; a new measurement period begins.*

Year 2 Share Class performance is negative, but still outperforms benchmark. *Performance fee payable; a new measurement period begins.*

Year 3 Share Class underperforms benchmark. *No performance fee payable; measurement period extended for another Financial Year.*

Year 4 Share Class goes from underperforming benchmark to outperforming it. *Performance fee payable; a new measurement period begins*

<u>Example 2</u> (Source: Aperture Investors SICAV prospectus):

"Over performance of the Net Asset Value per Share over the Performance Fee Benchmark is determined by comparing the difference between the Net Asset Value per Share on each Valuation Day and the Net Asset Value per Share of the preceding Valuation Day with the change in the Performance Fee Benchmark between the same Valuation Days.
At the end of the Performance Fee Period, the Investment Manager will receive the Performance Fee, if the performance, as calculated above, is greater than the performance of the Performance Fee Benchmark. For the avoidance of doubt, the Investment Manager may also receive a Performance Fee even in case of negative performance of a particular Share Class as long as the performance of such Share Class is greater than the performance of the Performance Fee Benchmark."

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.

This answer should only apply when the performance fee model uses a HWM. We strongly believe that there should be flexibility to have performance fee models without a HWM. We consider this situation in Q10.

We believe that the mention of a "performance reference period" in relation to HWM is not appropriate: indeed the performance reference period, as defined on page 49 of the consultation paper, and the reset of a HWM are uncorrelated. The performance reference period is typically a 12 months period like the crystallisation period (but it could be different from the crystallisation period in case of certain innovative performance fee models). We would advocate the introduction of a distinct and separate timeframe for the reset of a HWM different from the definition of "performance reference period", for example a "HWM reset period".

Performance fees taking into account past losses/underperformance ensure that asset managers are eligible for extra remuneration at times when they provide outperformance to investors not only on a yearly basis, but also over an extended period of time. Nevertheless, it can be detrimental to never let past losses or underperformance expire. The asset manager might indeed reach a point where the performance fee ceases to act as an incentive and the alignment of the asset manager's and investors' interests are diminished in case the asset manager sees no chance ever making up for some periods of past underperformance.

In order to best align the interests of investors and asset managers, the validity period of losses or past underperformance may be limited therefore we advocate for the introduction of a "HWM reset period".

The purpose of the limited validity of the underperformance is to restore the effectiveness of the performance fee structures and consequently, to ensure that the interests are aligned between existing investors, potential new investors and the asset manager.

When setting the "HWM reset period", the following non-exhaustive list of criteria might be taken into account:

- 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.

ALFI insists on the fact that, as mentioned in our answers to previous questions, it is key to keep some flexibility as foreseen in point 24 of the draft guidelines considering the various possible situations in a fund lifecycle.

ALFI agrees that in all cases investors should be informed about the approach adopted by clear disclosures in the prospectus.

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.

Regarding performance fee models with a HWM, ALFI is of the view that it is acceptable to envisage a predefined time horizon of three years for the purpose of resetting the HWM. The longer the period is, the more detrimental it might be for investors, because in that case it would motivate higher fixed management fees. Therefore, it can be seen that resetting HWM more frequently should lead to lower fixed management fees.

However, other performance fee models might exist without HWM taking into account the overall compensation that is paid to the asset manager, especially a fee model charging below market average fixed management fees. As mentioned in our response to Q8, we strongly believe that there should be flexibility to have performance fee models without a HWM.

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.

When performance fee models are only using a benchmark index (excluding HWM), the performance reference period could be one year and might not be aligned with crystallisation frequency. The turnover of shareholders in the fund as well as the volatility of the fund's NAV might be examples of criteria to be taken into account.

As stated in our answer to Q4, some flexibility should be allowed to take into consideration events such as those non-exhaustively listed in Q4 to ensure the best interests of the investor are taken into consideration.

Furthermore, as already mentioned under Q9, it should be noted that a longer reset period would naturally motivate the use of a higher fixed management fee, which would be detrimental to investors during an underperformance period.

To summarise our previous answers:

ALFI agrees with a standard performance period for the crystallisation of performance fee of typically 12 months, but some flexibility should be allowed to take into consideration events such as non-exhaustively listed above to ensure the best interest of the investor is taken into consideration (Q4).

In order to best align the interests of investors and asset managers, when the performance fee model is using a HWM, the validity period of losses or past underperformance may be limited. Thus, it is acceptable to limit this observation period to three years. However, shorter periods should be acceptable if deemed appropriate and in line with the best interests of investors (Q8), e.g. in case a fulcrum fee model is applied. In case of longer periods, asset managers tend to close funds (Q9).

When performance fee models are only using a benchmark index (excluding HWM), the performance reference period could be one year and might not be aligned with crystallisation frequency.

And in all cases, ALFI agrees that increased disclosure requirements with numbered examples around the setting of the performance fee model are key.

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.

Please see our response to Q10.

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?

ALFI thinks that managers need enough time to review models and prospectuses or even call an extraordinary general meeting to amend fund's articles. Therefore, the Guidelines should at the earliest become applicable at the end of the first full financial year following publication of the Guidelines, or consider that it might take between 18 to 24 months for the managers to comply.

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.

ALFI is of the view that the principles set out in the Guidelines should not apply to AIFs marketed to non-professional investors, because AIFs are typically intended to sophisticated investors and are distributed in a more restrictive manner than UCITS, and because the performance fee models applied by AIFs:

- take into account the larger variety of assets an AIF can invest in,
- are not all covered by the draft guidelines.

However, we believe that AIFs sold to retail investors should anyway take into account disclosure standards on their performance fee models in the best interest of 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.

We generally agree with the above-mentioned reasoning. In particular, we believe that the draft principles related to the appropriateness of the benchmark represent good practices, and should not add significant additional expenses. Realistically, any such change will undoubtedly create additional costs, as additional guidelines will require additional compliance, operational and legal work.

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.

We think that non-index hurdle rates should be allowed (e.g. interest rates, absolute return benchmarks). However, just as with index-based benchmarks, such a hurdle rate needs to be substantively connected to the investment objective and anticipated returns of the fund.

The example used in Q15 of an equity fund linked to EONIA does make sense to us as long as a comprehensive disclosure explaining the choice of such benchmark is made in the offering documents. We believe that such models can ultimately be aligned with the interests of investors.

For example, some of our members are using money market benchmarks (such as EONIA) with or without hurdle rate for synthetic long-short equity strategies (therefore in principal zero beta), because they believe that over time it approximates the return one could earn, and they want their managers to outperform that return before they can earn a performance fee.

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.

We refer to our answer to Q1 and Q14. Any change will undoubtedly incur additional costs, as additional Guidelines will require additional compliance, operational and legal work.

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.

As mentioned in our answer to Q6, we disagree with the negative performance (loss) recovery as currently suggested by Guideline 4. We believe that clear disclosures on the performance fee model and on what might happen in positive and negative market conditions as well as during a main event of a fund lifecycle are important so that investors may take informed decisions.

The “policy objective” described on page 23 of the Consultation Paper should be clarified. “Performance” is distinguishable from “out” or “under”-performance, and so these terms should not be used interchangeably. Since the Guidelines rightly contemplate performance fees for both relative return and absolute-return-based funds, the language must be precise. If the reference period is 12 months, we agree that negative under-performance within the period should be offset by out-performance in order to earn a performance fee. In the case of an absolute return fund, this would also mean that negative performance needs to be offset by positive performance. However, in the case of an index-based benchmark that would not be true - total return could be negative even though outperformance could be positive, therefore triggering a performance fee.

In addition, a possible negative impact of this Guideline could be that in the case of negative market environment the investment manager would not be incentivised (the performance fee would not align interests of asset managers and investors) to deliver an excess performance as the investment manager would not be rewarded for it. A requirement to have positive absolute performance before a performance fee can be earned negates the efficacy of any benchmark-based performance fee. In the case of an index-based hurdle, if the performance of the index were -10%, but the fund’s performance was -5%, then no performance fee could be earned. In the case of an interest rate benchmark the same principle would apply in a negative interest rate environment. Such a situation seems neither fair to asset managers nor beneficial to investors, since the investors’ alternative to the actively-managed product with performance fees is either a) passive products, which would be delivering a negative return in this hypothetical scenario, or b) actively-managed products with fixed management fees which may be at a higher level.

We refer to the example given in our answer to Q7.

As regards the second part of the policy objective:

> “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.”

we refer to our answer in Q8 with respect to UCITS.

Taking into account the above comments and our answer to Q13, we believe that the proposed Guideline may not be appropriate for some performance fee models applicable to alternative investment funds marketed to retail investors.

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.

The proposed Guideline may result in some asset manager either increasing their fixed management fees or closing funds. Notably the inability to earn a performance fee when absolute performance is negative would mean that some funds would not be economically viable. For example some funds charge only passive-like management fees when performance is at or below stated benchmarks. Such management fees serve only to cover most, but not all, of the manager’s costs.

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.

We believe that ESMA is right to insist on increased disclosure around the use of performance fees.

Although we believe that when properly structured performance fees can better align investor interests with those of asset managers than only fixed management fees, they can also be more complicated to explain. We think that an increased ability (or even requirement) to show hypothetical scenarios under fixed management fee and performance fee-based models would help investors understand the costs and benefits of such models.

Hypothetical scenarios are important because we believe that what ultimately matters is the net return to the client, and a focus only on the level of potential fees is counterproductive. For example, ceteris paribus, a fund which charges a fixed management fee of 0.5% while delivering a net return of 5% is clearly inferior to a fund which ends up charging a combined fixed management fee and performance fee of 2% while delivering a net return of 6%. Disclosure based only on costs could be misleading, as the fund with the performance fee is four times more expensive, even though in this hypothetical case it delivers a superior net return. Because of the potential complexity of performance fee models we believe that certain forms of graphical illustration can be beneficial.

ALFI is pleased to share with ESMA the following example of disclosure of hypothetical scenarios in a fund prospectus (Source: JPMorgan Investment Funds prospectus):

COMPARISON WITH A SHARE CLASS THAT DOES NOT HAVE A PERFORMANCE FEE

Some Sub-Funds offer Share Classes with performance fees and without performance fees. Share Classes with no performance fee will have a higher annual management and advisory fee. Which Share Class provides the greater net return to Shareholders will vary and is dependent on whether there is outperformance or underperformance. The tables below show examples of the net return of Share Classes with and without a performance fee under different scenarios.

Outperformance scenario

The Share Class without a performance fee may generate a higher return even though it has a higher annual charge.

	Share Class with a performance fee	Share Class without a performance fee
Share Class return	7.00%	7.00%
Minus annual management and advisory fee and operating and administrative expenses	- 1.20%	- 1.40%
	= 5.80%	= 5.60%
Minus benchmark return	2.00%	N/A
Outperformance	= 3.80%	= 5.60%
Minus 10% performance fee	0.38%	N/A
Net return	**5.42%**	**5.60%**

Underperformance scenario

The Share Class with a performance fee generates a higher return than the Share Class with a higher annual charge.

	Share Class with a performance fee	Share Class without a performance fee
Share Class return	1.50%	1.50%
Minus annual management and advisory fee and operating and administrative expenses	- 1.20%	- 1.40%
	= 0.30%	= 0.10%
Minus benchmark return*	2.00%	N/A
Outperformance	= 0.00%	= 0.10%
Minus 10% performance fee	0.00%	N/A
Net return	**0.30%**	**0.10%**

* Only the portion necessary to bring the result to zero is subtracted.

ALFI disagrees with the statement written in the “Technical Proposal” on page 25 of the Consultation Paper stating that:

“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 the prospectus should show past performance against it.”

With a reference to: UCITS Q&As on benchmark disclosure https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarifybenchmark-disclosure-obligations-ucits

We fully agree that if a reference benchmark index is used, it shall be disclosed in the prospectus as well as in the KIID. We however do not agree with the statement that “[*the prospectus should display the name of the benchmark and*] <u>the prospectus should show past performance against it</u>”: it would imply a yearly update of the prospectus, which is not the purpose of that document.

In the same manner we do not agree with the recently published provision of the UCITS Q&A stating that whenever a benchmark is used / implied, its past performances should be disclosed in the "Past performance" section of the KIID. In the case of performance fees, the benchmark index used might possibly differ from the performance benchmark (for example when a money market benchmark and a hurdle rate are used): such disclosure would be highly unclear and even misleading for non-professional investors. As foreseen in the KIID Regulation and CESR documents on the UCITS KIID, the disclosure of a performance fee mechanism shall be done in the "Costs and charges" section.

The annual ex-post reporting on costs and charges according to MiFID informs investors on the impact of performance fees on their investments and the financial reports shall provide the general view on the impact on the fund.

Finally we would like to comment on the future migration of UCITS KIID to PRIIPs KID: ALFI has previously advised ESA's against the use of the future performance scenarios contained in a PRIIPs KID as this is likely to be misleading even on a professional best efforts basis. It concerns performance fees as well, which are presented in the "incidental cost" section and calculated based on the past 5-year average of performance fees paid. We believe costs should be adequately disclosed and illustrative examples could be beneficial. The PRIIPs Reduction in Yield calculation and average 5 year incentive fee disclosures do not adequately inform investors.