Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Consultation Paper 134

Consultation on new Central Bank performance fee guidance for UCITS and certain types of retail AIFs

December 2020

Contents

Introduction

1. ESMA published its Final Report on Guidelines on performance fees for certain types of authorised funds on 3 April 2020 ("ESMA Guidelines")[1]. The ESMA Guidelines official translations were published on 5 November 2020[2] and apply two months after the date of publication of the translations (i.e. from 5 January 2021). The ESMA Guidelines, which are addressed to competent authorities and fund managers, seek to promote greater convergence and standardisation of performance fees as well as convergent supervision by competent authorities. The ESMA Guidelines were informed by IOSCO's Good Practice for Fees and Expenses of Collective Investment Schemes (FR09/16[3]).

2. The ESMA Guidelines apply to UCITS and to certain types of retail AIF. Retail AIFs that are closed-ended or open-ended AIFs established as EuVECAs, venture capital AIFs, EuSEFs, private equity AIFs or real estate AIFs are excluded from the scope of the ESMA Guidelines.

3. The Central Bank has published requirements for performance fees for many years. In the context of UCITS, these are reflected in the Central Bank's UCITS Regulations 2019[4] ("CBI UCITS Regulations"), certain provisions of which have an implementation deadline of 27 November 2020 and in relation to retail AIFs, the AIF Rulebook.

4. As a result, implementation of the ESMA Guidelines will have certain complexities and for a period of time the existing performance fee requirements as well as the performance fee regime established under the ESMA Guidelines will run in parallel. For the avoidance of doubt, in the event of any inconsistency between the ESMA Guidelines and the CBI UCITS Regulations or the AIF

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1 The Guidelines are available at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-guidance-performance-fees-in-ucits-and-certain-aifs

2 https://www.esma.europa.eu/document/guidelines-performance-fees-in-ucits-and-certain-types-aifs

3 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

4 S.I. No. 230/2019 – Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2019.

Rulebook, the statutory obligations of the CBI UCITS Regulations and the AIF Rulebook will prevail.

5. The Central Bank is proposing a phased implementation of the ESMA Guidelines over time due to the need to consult on amending the domestic framework to incorporate the ESMA Guidelines, to reflect the transitional periods provided for under the ESMA Guidelines and to maintain a consistent approach for retail investor funds.

6. In order to incorporate the ESMA Guidelines into the Central Bank's regulatory framework it is proposed to issue specific Central Bank Performance Fee Guidance. The Central Bank is therefore consulting on the general approach to incorporating the ESMA Guidelines into our regulatory framework.

7. The ESMA Guidelines apply from 5 January 2021.

Format of this consultation paper

8. Section I contains details of the approach taken for funds seeking authorisation or for funds amending existing performance fees or introducing new performance fees.

9. Section II contains details of the approach taken for funds with performance fees in place prior to 5 January 2021.

10. Schedule A contains the draft Guidance that is to apply to UCITS and to retail AIFs.

Consultation responses

1. The Central Bank invites all stakeholders to provide comments on the proposed changes.

2. Please submit responses electronically by email to fundspolicy@centralbank.ie.

3. Responses should be submitted no later than 15 January 2021. The Central Bank will acknowledge, by email, all responses sent by email. If you do not receive acknowledgement of an emailed response please contact the Central Bank on +353 1 224 6000 to correct the situation.

4. It is the policy of the Central Bank to publish all responses to its consultations. As all responses will be made available on the Central Bank's website, commercially confidential information should not be included in responses.

Next Steps

5. Stakeholders are requested to provide responses to the questions posed in this Consultation Paper. They are also invited to provide any general observations on the matters discussed or issues raised herein. Following the closing of the consultation period, the Central Bank will consider responses received in order to finalise guidance.

Markets Policy Division
Central Bank of Ireland
3 December 2020

Background

1. The area of performance fees is viewed as very important by the Central Bank and based on this and supervisory work undertaken in that area our requirements for UCITS moved from Guidance to a legislative basis in 2019. The AIF requirements are set out as conditions of authorisation and as part of the authorisation process. This existing regime provides strong protections for investors and continues in force notwithstanding the ESMA Guidelines, which supplement the existing regime in certain respects. This consultation paper sets out how these supplementary aspects of the ESMA Guidelines will apply pending a further consultation of amending legislation to incorporate the ESMA guidelines into our existing regulations for UCITS and the existing requirements of the AIF Rulebook.

2. Following publication of the ESMA Guidelines and in the context of an existing framework for performance fees which applies to both UCITS and certain types of retail AIF, the Central Bank has considered the manner in which the ESMA Guidelines will be incorporated into our existing regime.

3. This necessarily involves consideration of the existing regulatory framework for performance fees, specifically the CBI UCITS Regulations and the AIF Rulebook.

4. The Central Bank wishes to ensure a consistent approach to application of the ESMA Guidelines to UCITS and to in-scope retail open-ended AIFs that impose performance fees.

5. In the context of UCITS and arising from provisions of the CBI UCITS Regulations that will continue to apply, the Central Bank considers it is not possible to implement certain features of the ESMA Guidelines with immediate effect for UCITS. The Central Bank therefore proposes to implement those aspects of the ESMA Guidelines, which are consistent with the CBI UCITS Regulations through Central Bank Guidance.

6. In the context of in-scope AIFs, it would be possible to implement the ESMA Guidelines in full. This would, however, lead to different approaches to performance fees for the two forms of retail fund authorised by the Central Bank.

7. Accordingly, with a view to maintaining consistency between the approaches to performance fees for both forms of retail fund, the Central Bank proposes to adopt an approach for in-scope retail AIFs that is consistent with that proposed approach for UCITS (above).

Application of the Central Bank Guidance

8. Consistent with the transition period provided for in the ESMA Guidelines and due to the need to consult further on any amendment to the Central Bank's existing performance fee regime to incorporate the ESMA Guidelines, the Central Bank is proposing that for:

   a. new UCITS or in-scope retail AIFs established, the Central Bank Guidance, draft attached in Schedule A, will apply from the date of establishment of those funds.

   b. existing UCITS and in-scope retail AIFs which amend an existing performance fee or introduce a new performance fee, the Central Bank Guidance, draft attached in Schedule A, will apply from the date of amendment or introduction of the performance fee.

   c. existing UCITS and in-scope retail AIFs with performance fees: Central Bank Guidance, draft attached in Schedule A, will apply from the next accounting period, which occurs six months after 5 January 2021. Until that time, these funds must continue to comply with the current applicable requirements for performance fees.

Section I: New UCITS or in-scope retail AIFs established and existing UCITS and in-scope retail AIFs which amend an existing performance fee or introduce a new performance fee

1. In addition to the existing legislative requirements for UCITS or conditions for AIFs, the draft Guidance in Schedule A will apply to all newly authorised UCITS and AIFs of the type specified in the Guidance. It will also apply to all UCITS and the certain types of AIFs specified if they wish to amend existing performance fee arrangements or introduce performance fees.

2. New Retail AIFs which are not in scope of the ESMA Guidelines (e.g. venture capital RIAIFs or closed-ended RIAIFs), are not required to comply with the Guidance, but shall continue to comply with the performance fee regime as currently set out in the AIF Rulebook, the application form etc.

3. Due to Regulations 40 and 74 of CBI UCITS Regulations, it is not currently possible to provide for:

    a. the possibility of a performance reference period of less than the life of a fund, or

    b. crystallisation of performance fees more frequently than annually, for HWM models with a performance reference period of the life of the fund, or

    c. fulcrum fees.

    We intend that the same approach be taken for the certain types of retail AIFs to which Guidance applies.

Question 1:
Stakeholders are requested to indicate whether they agree with this approach and to provide comments and / or observations.

Section II: UCITS or in-scope retail AIFs with existing performance fees prior to 5 January 2021

1. From the beginning of the accounting period following 5 July 2021 (5 January +6 months), in addition to the existing legislative requirements for UCITS or conditions for AIFs, the Performance Fee Guidance (set out in Schedule A) as published on the Central Bank's website will apply to all UCITS and AIFs of the type specified in the Guidance that had performance fees in place prior to 5 January 2021.

2. Retail AIFs which are not required to comply with the Guidance shall continue to comply with the performance fee regime as set out in the AIF Rulebook, the application form etc.

3. Due to Regulations 40 and 74 of CBI UCITS Regulations, it is not currently possible to provide for:

    a. the possibility of a performance reference period of less than the life of a fund, or

    b. crystallisation of performance fees more frequently than annually for HWM models with a performance reference period of the life of the fund, or

    c. fulcrum fees.

   We intend that the same approach be taken for the certain types of retail AIFs to which Guidance applies.

Question 2:
Stakeholders are requested to indicate whether they agree with this approach and to provide comments and / or observations.

Schedule A:

The Central Bank Performance Fee Guidance for UCITS and certain types of retail AIF

Performance Fee Guidance

1. This Guidance incorporates, to the extent currently possible and practicable, ESMA Guidelines on performance fees into the Central Bank's supervisory framework for both UCITS[5] and retail AIF[6].

2. The Guidance is in addition to the existing legislative requirements for UCITS or conditions for AIFs. For the avoidance of doubt, in the event of any inconsistency between the Guidance and the CBI UCITS Regulations or the AIF Rulebook, the statutory obligations of the CBI UCITS Regulations and the AIF Rulebook will prevail.

3. The Guidance is applicable to UCITS and retail AIFs authorised and supervised by the Central Bank.

4. The Guidance is effective as follows for:

   a. new UCITS or retail AIFs established: Guidance will apply from the date of establishment of those funds.

   b. existing UCITS and retail AIFs which amend an existing performance fee or introduce a new performance fee: Guidance will apply from the date of amendment or introduction of the performance fee.

   c. UCITS and retail AIFs with existing performance fees prior to the 5 January 2021: Guidance will apply from the beginning of the accounting period, which occurs six months after 5 January 2021 (i.e. the next accounting period after 5 July 2021).

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5 The regulatory framework for which is set out in the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment In Transferable Securities) Regulations 2019 ("CBI UCITS Regulations").

6 Retail AIFs established as closed-ended AIFs or open-ended AIFs that are EuVECAs, venture capital AIFs, EuSEFs, private equity AIFs or real estate AIFs are excluded from the scope of this Guidance and so reference to "retail AIFs" in this Guidance should be read accordingly.

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.
"High-on-High (HoH) model"	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.
"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
"reference indicator"	the reference indicator against which the relative performance of the fund will be measured

UCITS, retail AIFs ("funds") and their managers:

In respect of a performance fee calculation methodology:

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

2. should ensure the performance fee calculation method should include, at least, the following elements:
   a. 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 (e.g. 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.

   For this purpose if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

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

4. should ensure 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.

5. 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.

6. should ensure 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).

7. may permit performance fees to be calculated on a single investor basis.

As regards consistency between the performance fee model and the fund's investment objectives, strategy and policy:

8. 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.

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

    a. 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;

b. 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 12. 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.

10. should 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:

a. 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

b. 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).

11. should 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.

12. should, 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.

13. should 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

14. should calculate the excess performance net of all costs (for example, management fees or administrative fees). The fund or the manager may calculate excess performance without deducting the performance fee itself provided that in doing so it is in the investors' best interests (i.e. it would result in the investor paying less fees).

15. should, 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.

As regards frequency of crystallisation of the performance fee:

16. should ensure the frequency for the crystallisation and the subsequent payment of the performance fee 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.

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

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

19. should, in case of closure/merger of funds and/or upon investors' redemptions, 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.

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

As regards negative performance recovery:

21. in the case of retail AIFs, should 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.

22. should, in order to avoid misalignment of interests between the manager and investors, a performance fee could also be payable in case the fund has out-performed the reference benchmark but overall had a negative performance, as long as a prominent warning to the investor is provided.

23. should 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.

24. in the case of retail AIFs, where the fund employs a performance fee model based on a benchmark index, should ensure 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, should be set equal to the whole life of the fund.

25. in the case of retail AIFs, 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, the performance reference period should be the whole life of the fund.

As regards disclosure:

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

27. should, 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 and/or the Prospectus.

28. should, 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 12), explain the choice of benchmark in the prospectus.

29. should 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.

30. should 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;

31. should ensure the main elements of the performance fee calculation method should be indicated.

32. should 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.[7]

33. should 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.

[7] 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]

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