

CP 134 – Consultation on new Central Bank performance fee guidance for UCITS and certain types of retail AIFs – Irish Funds Response

Executive Summary

The Irish Funds Industry Association (“**Irish Funds**”) is the representative body for the international investment funds industry in Ireland. Our members include fund managers, fund administrators, transfer agents, depositaries, professional advisory firms and other specialist firms involved in the international fund services industry in Ireland. By enabling global investment managers to deploy capital around the world for the benefit of internationally based investors, we support saving and investing across economies.

As the Central Bank is aware, Ireland is a leading location in Europe and globally for the domiciling and administration of investment funds. The funds industry employs over 16,000 professionals across 12 counties in Ireland¹, providing services to 7,864 Irish regulated investment funds with net assets of over EUR 3 trillion².

We welcome the opportunity to provide comment on consultation paper 134 on new Central Bank performance fee guidance for UCITS and certain types of retail AIFs (“Draft Guidance”).

Key Areas of Concern:

1. Schedule A Draft Guidance Paragraph 4 – Taking into account the following wording, “*Artificial increases resulting from new subscriptions should not be taken into account when calculating fund performance*”, can the Central Bank of Ireland (CBI) confirm that currently approved performance fee models, to the extent that they include some measures to mitigate against artificial increases from subscriptions, are still permitted for use?
2. Schedule A Draft Guidance Paragraph 9 – this paragraph appears to go beyond the current requirements as laid out in Regulation 40 (3) of the CBI UCITS Regulations whereby benchmark consistency with the investment policy is only required when a fund’s performance fee is based on out-performance of the index it is tracking. In particular we would seek confirmation whether, in the case of non-benchmark tracking long-only equity funds, there needs to be an interest rate hurdle (greater than a money market hurdle) or appropriate equity index applied or if it is permitted to charge performance fee on positive PnL over the High Water Mark (HWM)?
3. Schedule A Draft Guidance Paragraph 14 – Confirmation that the use of GAV (Gross Asset Value) i.e. net assets before performance fee accrual, as the standard point within the NAV (Net Asset Value) calculation process that performance fees are calculated by industry in Ireland is still permitted.

¹ Source: Economic Impact of the Funds Industry on the Irish Economy, Indecon, 2019.

² Source: Central Bank of Ireland, November 2020.

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

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

General Queries

1. Clarification on where the regulatory responsibility for compliance lies

Under the CBI UCITS Regulations 2019 and related CBI web-based guidance/queries, the obligations to ensure compliance with the existing requirements rests with the “responsible person”. The CBI UCITS Regulations defines “responsible person” as a management company, where one has been designated to act in respect of a particular UCITS and in the absence of any such designation, the UCITS itself. Additionally, the “responsible person” is considered the board of directors of the SMIC in the case of a SMIC.

In the case of retail AIFs, the obligation to ensure that the performance fee is verified by the Depositary rests with the retail AIF. However, the remainder of the performance fee rules applicable to RIAIFs are set down in the Section 2 application form and therefore from a regulatory perspective, it is not clear on which entity the responsibility to ensure compliance with the rules (as set down in the relevant Section 2 form) rests.

The Draft Guidance is currently written in such a way that “**UCITS, retail AIFs (“funds”) and their managers**” are required to ensure that the various requirements set out in the Draft Guidance are met. This indicates that in the case of a UCITS, both the manager and the UCITS fund itself are responsible for ensuring compliance. However, this is inconsistent with UCITS Regulations 2019 which is definitive on which party has responsibility for compliance and is therefore likely to cause unnecessary uncertainty in the case of externally managed funds.

It would be helpful if the CBI could clarify, in the finalised guidance, where exactly the regulatory responsibility for complying with the guidance lies in the case of externally managed retail AIFs and UCITS.

2. Scope of the Draft Guidance

Paragraph 3 - of Schedule A (which is understood to be stand-alone guidance once finalised) provides that the “*Guidance is applicable to UCITS and retail AIFs authorised and supervised by the Central Bank*”. It would be helpful if this is revised to clarify in the guidance itself that it does not apply to “*Retail AIFs that are closed-ended or open-ended AIFs established as EuVECAs, venture capital AIFs, EuSEFs, private equity AIFs or real estate AIFs*” as per paragraph 2 under “Introduction”.

3. Existing web-based guidance for UCITS performance fees

It would be useful to understand if the CBI intend to withdraw the existing web-based guidance for UCITS performance fees and replace it with the Draft Guidance once finalised? Confirmation of approach would help avoid confusion for industry participants, including multi-manager structures.

4. New Share Class Launch within an Existing fund

Can the CBI confirm, as the matter is not dealt with explicitly, that the transitional period also applies for new share classes introduced to existing funds that already charge performance fees in existing classes i.e. new share classes established in a sub-fund existing prior to 5 January 2021 will not need to comply with the updated Guidance until the beginning of the financial year 2022 (assuming a 31 December year end)? If new share classes have to comply immediately with the Draft Guidance this may lead to an inconsistency when compared with the performance fee methodology applied to the existing share classes.

5. Past Performance Prospectus Disclosures

For Prospectus disclosure requirements with respect to past performance – can the CBI confirm that cross referring to a web-link that would give up-to-date information (rather than stale information being included in Prospectus that may not be updated from year to year) would be an acceptable approach?

6. Multi-Manager Structures

The existing regime applicable to UCITS (as set out in the CBI UCITS Regulations, as supplemented by the "Regulatory Guidance Paper – UCITS Performance Fees") acknowledges the nuances which apply in the context of multi-manager structures. We note that there is nothing in the ESMA Guidelines which specifically conflicts with the presumption that the principles can be applied on a sleeve/portfolio basis when a sub-IM manages a portion of the assets of a fund. On this basis, we would consider it helpful for industry for such clarity to be carried across into the new CBI Guidance such that the following points are clearly addressed:

- a. Where a UCITS has multiple managers or advisers the responsible person shall 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. [Ref Reg 40(6)]
- b. Risk warning inclusion - for multi-manger/adviser UCITS, the responsible person should include a risk warning in the prospectus which provides that it is possible that incentive fees in respect of performance achieved may be payable to one or more of the investment advisers even though the overall net asset value of the fund may not have increased.
- c. In addition, it would be helpful for the new CBI Guidance to provide clarity on whether it is possible, in the context of a multi-manager structure, to make a payment of a performance fee upon termination of one of the multi-managers during the calculation period rather than holding such fees until the end of the calculation period. It is noted that any amounts which would be payable to the resigning manager will be the same amount as from the point of termination up to the annual crystallisation date of the fund. In such circumstances, the earlier crystallisation and payment of the performance fee to the relevant manager should not result in a negative impact on the shareholder as the NAV of the fund will already reflect this as an accrual.

7. Section I Paragraph 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.

Acknowledging the existing legislative and regulatory restrictions that prevent the 3 areas of the ESMA Guidelines (highlighted above) being adopted within the CBI's Draft Guidance, we would still like to note the importance of implementing these in the shortest possible timeframe to ensure full alignment with the ESMA Guidelines. This will allow the Irish fund industry access to provisions similar to other European jurisdictions and ensure a level playing field exists. In relation to item b. in particular, more frequent crystallisation could be applied while aligning the interests of investors and incentivising the manager with consistent periods of good performance during the performance period, as the ESMA Guidelines (paragraph 33) note, for this model, that "performance fees cannot be accrued or paid more than once for the same level of performance over the whole life of the fund". Also, in cases where the performance fee can crystallise each time the HWM is exceeded, it has the following advantages over an annual crystallisation HWM performance fee:

- It automatically prevents artificial increases due to subscriptions, without the need for complex adjustments³.
- It limits transfers of wealth between investors. A new investor will not benefit from a dilution in negative performance as a result of a reversal of a performance fee accrual.

Schedule A - Draft Guidance

Performance fee calculation methodology

Paragraph 3 – It is our understanding that typically the High on High (HoH) method is used where crystallisation is more frequent than annual. This means that where a fund's "NAV exceeds the NAV at which the performance fee was last crystallised" the performance fee is crystallised per the agreed crystallisation frequency rather than on an annual basis. Given that the Draft Guidance provides only for annual crystallisation, can the CBI confirm that the HoH method is currently not permitted under the CBI Draft Guidance? However, should the HoH method remain within the Draft Guidance can the CBI confirm that until more frequent than annual crystallisation is permitted, there is no tangible difference between the HoH and HWM models as described within the Draft Guidance?

Paragraph 4 - Can the CBI confirm that existing approved Irish performance fee methodologies will remain valid to the extent that they have features which provide some mitigation against "artificial increases resulting from new subscriptions"?

³ artificial increases happen because an investor subscribes at a price greater than the HWM. As the performance fee crystallises each time a new HWM is achieved, this can never happen.

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

Paragraph 9 – This section, and in particular paragraph 9 (paragraph 22 per ESMA Guidelines), would appear to go beyond the current requirements as laid out in Regulation 40 (3) of the CBI UCITS Regulations whereby benchmark consistency with the investment policy is only required when a fund's performance fee is based on out-performance of the index it is tracking.

There is a lack of clarity around how to interpret this guideline, given the ESMA Response on Page 20 of the Guidelines which states as follows:

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

However, the following line from paragraph 9 “for a fund that pursues an absolute return objective, a HWM model or a hurdle should be considered as more appropriate than a performance fee calculated with reference to an index because the fund is not managed with a reference to a benchmark” seems to be contradictory and would seem to permit absolute return funds to charge performance fees based on positive performance without reference to a benchmark.

The current wording seems to make it mandatory for long-only equity funds to use an equity index or an interest rate hurdle that is greater than that provided by a money market index (e.g. EONIA) and more closely aligns the model with the funds risk/reward profile for the purpose of calculating performance fees. However, confirmation on whether performance fees charged on positive PnL can continue to be utilised as a permitted performance fee methodology for this fund type would be welcome.

In addition, we do not believe it should be mandatory to apply an index for other non-benchmark tracking fund types e.g. long-short type equity funds (or absolute return) or mixed asset funds but would welcome confirmation of this.

CBI Paragraph 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).*

The well-established practice in Ireland is that the performance fee is calculated using the GAV (Gross Asset Value) i.e. net assets before performance fee accrual and is entirely reasonable. We understand that the CBI is seeking clarity that the use of GAV is still permissible (based on the current wording highlighted above). We would welcome this clarity, noting again that a change in this approach will require a significant change in performance fee calculation methodologies in Ireland.

The use of GAV would also appear to be consistent with the wording in paragraph 4 from the “performance fee calculation methodology” section, “the performance fee calculation method should be designed to ensure that performance fees are always proportionate to the actual investment performance of the fund”. This approach is also usually a standard disclosure in the prospectus.

Frequency for the crystallisation of the performance fee

Please see comments in Section I – Paragraph 3 and Section II – Paragraph 3.

In addition, funds with HWM models, with a performance reference period of the life of the fund, which seek to ensure compliance with CBI Paragraph 18 (crystallisation date alignment for all share classes) and CBI Paragraph 20 (crystallisation date alignment with 31 December or end of the financial year) should be permitted to crystallise on a less than annual basis (i.e. a once off non-annual crystallisation during a 12 month period) as part of such alignment without breaching Regulation 40(4) in order to mitigate operational and financial disruption in respect of the performance fee share classes in the fund.

Can the CBI also confirm that, as per standard wording within the prospectus, that a change of the investment manager will be a crystallisation event even though this is not included in the Draft Guidance?

Negative performance (loss) recovery

No Comment

Disclosure of the performance fee model

Paragraph 27 - Permits disclosure in the Prospectus and/or the KIID - ESMA Guidelines only permits disclosure in the KIID. Given this, confirmation that disclosure in either the prospectus or KIID is acceptable would be welcome.

Paragraph 29 - provides that information on the performance fee model and computation methodology should be set out in “*any ex-ante information documents as well as marketing material*”. Could the CBI please clarify what is included within “**ex-ante information documents**”, noting that this category of documentation would appear to be different from (i) marketing material (as specific reference is made to them) and (ii) the UCITS KIID (as the disclosures relating to performance fee methodologies in the UCITS KIID document is already prescribed under Article 12 and Article 10(2)(c) Commission Regulation 583/2010)? For example, is this referring to the PRIIPs KID or another category of document?

Paragraph 30 - With respect to the requirement that concrete examples be provided to investors on how the performance fee will be calculated, where should such examples be included: the prospectus or the marketing materials? In addition, a narrative description of the performance fee methodology may be easier for retail investors to digest, rather than purely numeric examples. Given the objective to ensure investors have a clear understanding of the performance fee and how it is applied, coupling basic numeric examples that demonstrate the main performance fee model calculation features (e.g. impact on performance fee in terms of annual crystallisation when in and out of performance) with a descriptive narrative may provide the most value, in terms of understanding, for investors.

Paragraph 33 - Could the CBI confirm what is meant by “ex-post information” as it suggests that in addition to such information being included in the annual and half-yearly reports, information on the performance fees paid by the fund should be disclosed in any other “ex-post information”?

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

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

General Query

Section I Paragraph 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.

Acknowledging the existing legislative and regulatory restrictions that prevent the 3 areas of the ESMA Guidelines (highlighted above) being adopted within the CBI's Draft Guidance, we would still like to note the importance of implementing these in the shortest possible timeframe to ensure full alignment with the ESMA Guidelines. This will allow the Irish fund industry access to provisions similar to other European jurisdictions and ensure a level playing field exists. In relation to item b. in particular, more frequent crystallisation could be applied while aligning the interests of investors and incentivising the manager with consistent periods of good performance during the performance period, as the ESMA Guidelines (paragraph 33) note, for this model, that "performance fees cannot be accrued or paid more than once for the same level of performance over the whole life of the fund". Also, in cases where the performance fee can crystallise each time the HWM is exceeded, it has the following advantages over an annual crystallisation HWM performance fee:

- It automatically prevents artificial increases due to subscriptions, without the need for complex adjustments⁴.
- It limits transfers of wealth between investors. A new investor will not benefit from a dilution in negative performance as a result of a reversal of a performance fee accrual.

Schedule A - Draft Guidance

Performance fee Guidance

Paragraph 4 (C) – Section II of the Consultation Paper provides as follows: "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 CBI'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".

Can the CBI confirm that the obligations apply for the first time in respect of any accounting period **beginning on or** after 5 July 2021? Therefore, for UCITS/in-scope RIAIF funds which have a 31

⁴ artificial increases happen because an investor subscribes at a price greater than the HWM. As the performance fee crystallises each time a new HWM is achieved, this can never happen.

December year-end, they will be required to comply with the guidance in respect of the financial period beginning on 1 January 2022.

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