NEWS

ESMA Performance Fees Guidelines

The European Securities and Markets Authority (ESMA) published its final performance fees guidelines for Undertakings for the Collective Investment in Transferable Securities (UCITS) and certain Alternative Investment Funds (AIFs).

Sowatec

We herewith provide you a summary of the new guidelines from ESMA (European Securities and Markets Authority) which are a key step to ensure a supervisory convergence and provide standardization in determining the performance fees

Date of application

The guidelines were published on the 5th of November, 2020 on ESMA's website in all EU official languages. They will apply as from two months after this publication date.

Any new fund or any existing fund that introduces a performance fee for the first time after the date of application of the guidelines should comply with the guidelines immediately.

Funds with a performance fee existing before the date of application should apply these guidelines in respect of those funds by the beginning of the financial year following six months from the application date of the guidelines.

Overview

- Funds using a performance fee model based on a benchmark index should recover any underperformance compared to the benchmark, during a reference period of at least five years or the whole life of the fund, before any performance fee becomes payable.
- The crystallization frequency should not be more than once a year.
- Funds allowing performance fee payment in times of negative performance should include a prominent warning to this effect in the KIID (Key-Investor-Information-Document).
- The performance fee model and the computation methodology should be explained in legal documents (specially prospectus) as well as marketing material.
- Performance fees for funds using a high water-mark model should only be payable where the new high watermark exceeds the previous one, during a reference period of at least five years or the whole life of the fund.

Five Guidelines - details on next page

- Calculation method
- Consistency between the performance fee model and the fund's investment objectives, strategy and policy
- Crystallization frequency
- Negative performance recovery
- Performance fee model disclosure

Guidelines 1 - Calculation Method

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

As a minimum, the performance fee calculation method should include:

- The **reference indicator** to measure the relative performance of the fund (i.e. an index, a HWM, a hurdle rate or a combination of those).
- The **crystallization frequency** at which the accrued performance fee, if any, becomes payable to the manager and a crystallization date at which the performance fee is paid to the manager.
- The performance reference period, at the end of which the mechanism for compensating for past underperformance or negative performance can be reset.
- The performance fee rate.
- A **performance fee methodology** clearly defining the method for the calculation of the performance fees.
- The **computation frequency** which should match with the NAV calculation frequency.

Guideline 2 - Consistency between the performance fee model and the fund's investment objectives, strategy and policy

The manager should implement and maintain a process to demonstrate, and periodically review, that the performance fee model is consistent with the **fund's investment objectives**, strategy, and policy.

Guideline 3 -Crystallization Frequency

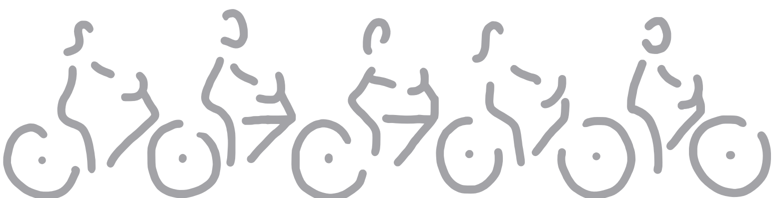
- It should allow the alignment of the managers' and the investors' interests.
- It should not be **more than once a year, except for the high watermark (HWM) model or high-on-high (HoH) model** where these cannot be reset during the whole life of the fund.

i. HWM: a performance fee model whereby the performance fee may only be charged on the basis of achieving a new HWM during the performance reference period.

ii. HoH: 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 crystallized.

- It should be the same for **all share classes of a fund** with a performance fee.
- Performance fee should **crystallize in due proportion** in case of closure/merger of funds or upon investor's redemption. However, where both merging and receiving funds are managed by the same manager, crystallization should be presumed to be contrary to investors best interests, unless justified otherwise by the manager.
- Generally, it should coincide with **the end of the financial year** of the fund.

In order to avoid operational risks, the payment of a performance fee should be aligned among different share classes and crystallised on investors' redemptions, in line with the principle of equal treatment of investors.



Guideline 4 - Negative Performance Recovery

The performance fee model should ensure that the manager is not incentivised to take excessive risks. Cumulative gains should be offset by cumulative losses, with the manager's performance being on a time horizon that is, as far as possible, consistent with the recommended investors' holding period.

- **Any loss** or underperformance previously incurred during the performance reference period **should be recovered** before a performance fee becomes payable.
- A performance fee could be payable in case the fund has over-performed the reference benchmark but has a negative performance, as long as a prominent warning to the investor is provided.
- The performance reference period should be, as far as possible, consistent with the recommended investor holding period. Where the performance reference period is shorter than the whole life of the fund, it should be set equal to **at least five years** (on a rolling basis for funds using a High Watermark).

Guideline 5 - Performance fee model disclosure

- Investors should be adequately informed about the performance fees and their impact on return.
- All ex-ante documents (prospectus, KIID, marketing documents) should **clearly set out all information necessary to understand** the performance fee model and the computation methodology, including the main elements and parameters (i.e. the payment date.) Concrete examples should be included in the prospectus.
- Where a performance fee model uses a different but consistent benchmark, **the explanation of the choice of benchmark** should be included in the prospectus.
- Where a performance fee is payable in times of negative performance **a prominent warning must be included in the KIID (Key-Investor-Information-Document)**.
- Where applicable the KIID and the prospectus should display the name of the benchmark index and disclose past performance against it.
- The annual and semi-annual reports and any other ex-post information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent.

Attachment: PDF-File Final Report from ESMA.

Fabrice Castelein
Senior Business Consultant
& Project Manager
castelein@sowatec.com, +352 621 518 620

Sowatec AG
Mattenstrasse 14
CH-8330 Pfäffikon ZH
T +41 44 952 55 55

Sowatec Solutions AG
Taunustor 1
D-60310 Frankfurt
T +49 69 77 07 62 30

Sowatec (Luxembourg) Sàrl
2, Rue Edward Steichen
L-2540 Luxembourg
T +352 621 518 620