EFAMA Response

ESMA Consultation on Guidelines on Performance Fees in UCITS

(ESMA34-39-881)

31 October 2019

Preliminary remarks

EFAMA[1] resolutely welcomes ESMA's chosen principles-based approach as a foundation for its final Guidelines and supports their underlying objective of achieving greater consistency between fund investment objectives and the management company's choice of performance indicators when charging and disclosing performance fees. We also commend ESMA's approach of ensuring the draft Guidelines' essential alignment with IOSCO's own 2016 Final Report on *Good Practice for Fees and Expenses of Collective Investment Schemes*.

Observing the operational realities of our industry, there are indeed countless possibilities to combine performance fees with (fixed) management fees, where lower management fees are usually applied in the presence of performance fees to better align investors' interests with those of the management company. Variable performance fees in turn reflect a management company' s very own fee structures, intended both for a variety of fund products across investment strategies, asset classes, geographies, as well as for different investor types. The need to offer a variety of possible investment outcomes to a diversified investment audience is thus also met by calibrating variable performance fees with typically lower fixed management fees applied at the individual share class level, in a manner that is consistent with the advertised investment objectives.

Before responding to the consultation's questions in greater detail, we make the following preliminary considerations on ESMA's draft Guidelines:

– Apart from performance fees' primary purpose of optimising the alignment of incentives between the management company and fund investors, it is important for ESMA to recognise the widespread and growing use of dual fee structures which consist in the offer of dual share classes (i.e. a choice for investors to opt between a share class with a lower fixed management fee in the presence of a potential performance fee; and a share class with a relatively more expensive fixed management fee, but with no performance fee). Such fee structures are of paramount importance to preserve the viability and diversity of a traditionally "active" investment proposition in the face of growing margin pressures and ongoing consolidation across the European investment management industry. At the same time, they create a natural incentive for a fund to be managed

[1] EFAMA is the trade association representing the European investment management industry, representing 28 member associations, 59 corporate members and 22 associate members. At end 2018, total net assets of European investment funds reached EUR 15.2 trillion. These assets were managed by almost 62,000 investment funds, of which more than 33,000 were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining funds being of AIFs (Alternative Investment Funds).

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to the best of a manager's ability in view of generating outperformance for investors[2]. When finalising the draft Guidelines, we would therefore encourage ESMA to consider existing fee structures holistically, realising that individual methods to calculate performance fees rely on several parameters which would risk being upset by more prescriptive approaches. ESMA should additionally recognise that management companies do subject their performance fee models to internal governance, control and testing standards as well;

- In relation to the proposed minimum for a crystallisation period of no less than one year, EFAMA responds favourably, while recognising that shorter crystallisation periods should however be conceivable in relation to the "pure" HWM model (see our response to Q5 below), as well as under a series of limited exceptional circumstances, i.e. investor redemptions and corporate events (fund mergers and demergers, liquidations and new fund/share class launches);
- With regard to the relationship between a one-year minimum crystallisation frequency and the recommended holding period of the investment, we believe the two should not be interrelated. ESMA is certainly familiar with the widespread use of *omnibus* account structures across several EU jurisdictions for UCITS products, whereby the precise identification of the end-investor is not possible. Hence, the exact profiling and rationale of an individual investor would not be known to the UCITS management company for it to calibrate the calculation of a performance fee based on the effective holding period at an individual investor level;
- In terms of performance fee models and in line with the 2016 IOSCO *Best Practices*, we believe that various performance fee models would all prove compatible with the key principles of ESMA's draft Guidelines. Among these, as a minimum, we consider a benchmark model, a hurdle rate model and a "pure" HWM. Concerning the so-called "high-on-high" HWM model variant, we consider that the performance reference period and related reset period should be chosen by the management company based on a series of concurring factors. While considering that the reset period <u>should be no less than one year</u>, management companies should nevertheless have the option to choose longer reset periods depending for instance on the fund's investment strategy, the portfolio's underlying assets, the nature of the investor base, etc. Reinforcing the fact that a more prescriptive, "one-size-fit-all" approach would not be justified is also the absence of any indication as to the length of (high-on-high) HWM reset periods in IOSCO's 2016 *Best Practices*;
- In terms of disclosing the use of performance fees in the UCITS KIID, the relevant benchmarks/indices used to gauge the actual performance of the fund against them shall <u>not</u> automatically imply that the fund is managed with reference to a benchmark (as implied by the March 2019 update to the existing ESMA UCITS Q&As, in particular, under Question 8b thereof). In this regard, EFAMA wishes to strongly re-iterate that a reference to a benchmark for the mere purpose of calculating performance fees against it should not be construed as an indication that that benchmark defines the UCITS' ultimate investment objective. We invite ESMA to additionally link its ongoing work on performance fees and their disclosure with the ongoing ESA Joint Consultation (JC 2019 63) on amendments to existing rules underpinning the PRIIPs KID;
- During negative market cycles, we believe that <u>relative</u> positive performance in relation to a chosen performance benchmark should be rewarded. Hence, the application of a performance fee should not apply solely in circumstances of absolute positive performance, but also reward the manager for having protected investors' capital by outperforming the chosen benchmark even during a falling market;
- Welcoming ESMA's question on whether the final Guidelines should be extended to include retail AIF products, we deem this would be premature in the absence of a comparable product

[2] In this respect, please refer to a recent October 2019 study authored by the consultancy Fitz Partners, entitled "Performance Fees, An Alternative Way Offering Investors Choice"; available on demand at the following link.

regulation under the AIFMD and where retail AIF distribution is presently possible only in selected EU jurisdictions, thereby lacking a clear pan-EU cross-border dimension;

- Finally, we care to note that the proposed definitions – specifically under draft Guideline 1 (paragraph 11) and in the relevant "definitions" table – deserve greater clarity. For instance, important would be for the final ESMA Guidelines to refer to a "crystallisation frequency" in *lieu* of "crystallisation period" to possibly avoid confusion with the accompanying notion of "performance reference period". We include some further suggestions to amend some of the proposed definitions in the responses to the individual questions below, but would also point ESMA to closely consider the wording amendments put forward in the responses of some of our own Members.

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

EFAMA welcomes the objective of improving standardisation in management companies' use of performance fees. In this respect, as mentioned above, we applaud the ESMA draft Guidelines' principles-based approach and alignment with the 2016 IOSCO *Good Practices* as a positive outcome for retail investors and management companies alike in Europe.

In our view, greater standardisation via a dedicated set of ESMA Guidelines will offer investors greater clarity around a few commonly applied performance fee models, enabling them to make a better informed decision when investing in a UCITS. It is therefore important for the final Guidelines to not become prescriptive, recognising that the various performance fee models all share the objective of aligning the incentives of the management company with the interests of the investors.

In relation to the nature of these same investors, despite the draft Guidelines' 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, performance fee calculations and their related disclosures would deserve greater flexibility outside a mass-retail market and concomitantly allow NCAs greater latitude when authorising fee methodologies for institutional share classes. We believe ESMA should consequently clarify that the intended Guidelines apply predominantly to UCITS retail share classes.

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

We wish to underscore the importance for NCAs to avoid the temptation of gold-plating by introducing requirements at odds with ESMA's final Guidelines and, indirectly, with the IOSCO 2016 *Best Practices*. Practices of certain NCAs stifling cross-border marketing of UCITS as a result should be discouraged. In this respect, we would point to one notable case, whereby one NCA is presently barring access to its domestic market for foreign funds on condition that these are not in compliance with domestic requirements on performance fees, involving *inter alia*, a HWM or clawback mechanism of at least five years. Our view is that such practices jeopardise the very freedom to distribute funds cross-border in the EU Single Market. We thus support greater standardisation through the proposed Guidelines to avoid such unfortunate regulatory outcomes.

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.

EFAMA in principle agrees with the requirement for consistency between a performance fee model and the fund's investment objectives, strategy and policy. We also welcome the clear mention that outperformance should be represented net of costs (e.g. management, distribution, administrative fees, etc.), as per paragraph 18 of draft Guideline 2.

In terms of whether there are specific indicators which should be considered, we would recommend that the final Guidelines do not reference anyone in particular, leaving the ultimate choice to the management company, with these depending ultimately on the fund's very own investment objectives and strategy. References to historical volatility, asset composition, etc. could be cited, but only as mere examples, as these may change over time. Consistency should therefore be determined on a case-by-case basis and subject to NCAs' satisfaction when the fund is authorised. In this regard, for absolute return funds where portfolio managers exercise ample discretion on terms of portfolio design and strategy implementation, we would also note that these typically calculate their performance fees based on a risk-free "hurdle rate" (e.g. LIBOR, EONIA, etc.), with or without a spread expressed in terms of percentage or basis points, to better gauge their absolute performance in relation to current money market/deposit rates. Our view is that benchmarking an absolute fund's performance to a risk-free hurdle money market rate is consistent with the objective of demonstrating the value added of an unconstrained portfolio management style.

In relation to the recommended approaches for management companies under draft Guideline 2, we have the following important reservation. In relation to paragraph 16 letter a), we agree that funds pursuing an absolute return objective would naturally choose to benchmark their performance against a HWM, coupled or not with a given spread. In the latter case, as mentioned above, such funds often represent their performance as a hurdle rate, expressed as the sum between a money market index and a certain spread expressed in percentage or basis points (e.g. EONIA + X%/X bps). Such money market index – unlike for money market funds – should in any case <u>not</u> be understood to define the absolute return fund's risk/reward profile, nor its chosen investment objectives and strategy. In line with our reservations expressed in our letter to ESMA of 27 June 2019 (and accompanying memorandum) in relation to the March 2019 update to the UCITS Q&As (ESMA34-43-392), we wish to reiterate that where a UCITS references an index for the sole purpose of measuring its performance fees against it, that UCITS should <u>not</u> be understood as being managed according to that same index. The use of a benchmark for the sole purpose of calculating performance fees would therefore deserve to be disclosed only in the "Charges" section (and <u>not</u> in the "Past performance" one) of the UCITS KIID. Disclosing one or more benchmarks that are not necessarily representative of the UCITS' chosen "Objectives and investment policy" in the respective section of the KIID will only confuse investors as to the true objectives of the UCITS. In our example above, the fund follows an absolute return (i.e. unconstrained) investment strategy and any wording or graphic representation in the UCITS KIID or prospectus implying the fund is managed with reference to an index (as per answer 8b in the UCITS Q&As) would inevitably mislead investors. In such cases, we believe a fund's prospectus could possibly provide further clarifications as to why a money market rate is used in such cases (i.e. to measure capital appreciation *vis-à-vis* one or more risk-free rates). Moreover, such information is already disclosed under the MiFID II product management rules in relation to an investment product's costs and charges (see our response to Q5).

Another observation relates to opportunity for management companies to combine a HWM for an absolute return objective with a hurdle rate to better align the HWM to the fund's risk reward profile (as per the last sentence of paragraph 16 letter a under draft Guideline 2). We note that such possibility would make sense only in the presence of a HWM model variant known as the high-on-high (see our response to Q5).

As per the following letter b) of the same paragraph, we agree that where a fund's strategy offers some form of *beta* exposure to an underlying asset class, any performance fee should be levied off a benchmark that is consistent with the fund's risk/reward profile and thus aligned with its investment objectives and strategy.

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 also refer to our response to Q5 below).

Secondly, we would 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. We therefore refer to "crystallisation frequency" for the remainder of this response.

Understanding it is already a common praxis in a majority of EU jurisdictions adhering to the IOSCO *Best Practices*, EFAMA certainly favours clarifying under draft Guideline 3, paragraph 20, that performance fees' crystallisation frequency should not be less than one year. Therefore, in relation to new share classes launched in the interim between one crystallisation date and the next, these should crystallise at the time of the next crystallisation date provided that such date occurs no sooner than 12 months from their launch date. In addition, it is important for the crystallisation frequency to not necessarily coincide with the management company's financial year, or even with the calendar year. In practice, the company should have the freedom to select both the start and the end date of the 12-month minimum crystallisation frequency, commensurate with the share class/fund launch date.

The final Guidelines should also reflect the fact that performance fees also crystallise when investors in the share class choose to redeem, as well as in exceptional circumstances for a variety of purely technical reasons, as for instance, with the launch of new share classes or with new fund authorisations occurring shortly after the end of the previous 12-month period, with fund mergers or demergers, liquidations, or other corporate actions. In the latter cases, shorter crystallisation frequencies should be justified, provided they are truly exceptional and broadly disclosed to investors for these to be treated fairly.

Lastly, EFAMA does not agree with the proposal to link the duration of the crystallisation frequency with the recommended holding period for the given share class. We clarify in this regard that the performance fee remunerates the asset management company as a whole, not the individual portfolio manager (as assumed under paragraph 19 relatively to draft Guideline 3). Alignment of interests between the latter and the 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). For this reason, we recommend that paragraph 19 of draft Guideline 3 be adjusted accordingly, for instance, by replacing "portfolio manager" with "management company" and by deleting the last sentence in relation to the investors' holding period.

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.

In relation to the compatibility between the HWM and a minimum 12-month crystallisation frequency, we observe that ESMA's own definition of HWM remains narrow, i.e. it appears to refer only to a HWM model variant known as the high-on-high [3]. 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. Yet, IOSCO has also recognised a "pure" HWM model, whereby the performance fee becomes payable where the NAV per share exceeds the highest previous value ever recorded since the fund's launch. In certain EU jurisdictions (e.g. Italy), such model has become widely accepted and is furthermore disciplined by more detailed NCA guidance[4].

EFAMA would suggest the final ESMA Guidelines reflect this distinction, as management companies may apply one or the other in line with existing national regulations. In principle, however, we are supportive of applying the minimum 12-month crystallisation frequency to all performance fee models, with the following caveat: In relation to the "pure" HWM model, we observe that a minimum crystallisation frequency of 12 months will not be applicable to the former. Considering that a "pure" HWM model consists in the daily accrual and regular pay-out (e.g. monthly) of the performance fee at each calculation point where the last NAV per share positively exceeds the highest one previously recorded since the fund's launch, a minimum crystallisation frequency would thus be at odds with this model's operation. On the same grounds, there is 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. Where applied in line with existing national regulatory guidance from the NCA (e.g. Italy), this model has established a positive track record not only in terms of aligning the management company's incentives with the interests of the investors, but also by treating the latter fairly[5].

Finally, in relation to fulcrum fee models, we support ESMA's choice to exempt these from the minimum crystallisation frequency (as per paragraph 21 of draft Guideline 3).

In sum, as anticipated in our preliminary remarks, we believe that the following performance fee models can all prove compatible with the key principles of ESMA's draft Guidelines: a benchmark model, a hurdle rate model, a "pure" HWM, and a high-on-high HWM variant (where the management

[3] Such notion is also referenced in the IOSCO 2016 *Best Practices*, as well as in IOSCO's 2004 *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*. Please refer to the IOSCO *Final Report* of November 2004, Annex 3 thereof; available at the following link.

[4] We point to the Bank of Italy's own 2015 "Regulation on the collective management of savings" (*Regolamento sulla gestione collettiva del risparmio*), in particular Title V, Chapter I thereof.

[5] In this regard, we note that with a "pure" HWM modem, performance fees are paid out less because distributed over a longer time horizon, i.e. one that is not regularly reset. Secondly, over such longer periods, the effects of market volatility are smoothened and would thus not be factored into the performance fee calculation often. A possible disadvantage, conversely, would consist in the difficulty for managers to recover previous losses before being able to levy performance fees again and the consequent potential for managers to take on more risks in order to recoup negative performance. A fund in such cases could underperform for years (in theory for its whole life-cycle) and would reasonably face the prospect of being liquidated in the meanwhile.

company is free to set an appropriate performance reference period and reset dates of no less than one year as an minimum – see our response to Q8).

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?

EFAMA does not support the principle of charging a performance fee only in concomitance with an absolute positive performance. If outperformance in relation to a given index is expressly foreseen as part of a fund's investment objectives and strategy, then naturally any positive relative performance *vis-à-vis* that index should also be rewarded to the management company (e.g. the in the context of a negative market cycle, where good management is able to avoid a comparatively larger depreciation of the fund share class' value *vis-à-vis* its chosen benchmark). Moreover, were performance fees to be levied only in the presence of absolute positive performance, we fear that individual managers may be incentivised to take on greater risks (as per paragraph 23 under draft Guideline 4) in their attempt to return to a positive absolute performance to offset losses, thereby also misaligning their incentives with those of the investor. For these reasons, we believe that the reference to "positive performance" under paragraph 22 of draft Guideline 4 should be more clearly qualified to mean both absolute and relative positive performance (see our suggestion as per the footnote below)[6]. In addition, we believe that the application of relative positive performance fees deserves a clear reference in fund disclosures documents. The same principle should apply to cases where the management of a portfolio is delegated to one or more sub-advisors, where each is mandated to manage its own respective "sleeve" of a larger portfolio[7].

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 line with our answer to Q6 above, we agree with ESMA on the need to disclose relative positive performance fees clearly, both in legal and marketing documents, along with related explanations as to how the chosen performance fee mechanism operates. As to the details of such mechanism, we strongly recommend such information be disclosed in the UCITS prospectus and not in the KIID. The KIID should nevertheless clearly mention that relative positive performance fees will apply where foreseen. Finally, we would refrain from designating relative positive performance fees with a "warning", as this term is inherently biased. After all, even in falling markets, a manager's skill is no less valuable in mitigating a more severe depreciation of the investment portfolio (with resulting losses to investors) compared to the reference indicator and broader (falling) market.

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

[6] Our suggestion would be to amend draft Guideline 4, paragraph 22, as follows: "A performance fee should only be payable in circumstances where positive **(absolute or relative)** 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" (emphasis added by EFAMA).
[7] In this instance, the sub-advisor is rewarded not on the basis of the NAV per share, but on its own performance for managing its own respective "sleeve" of the portfolio.

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.

EFAMA believes that for UCITS management companies opting for a (high-on-high) HWM model, the reset period should be no less than one year, so as to ensure investors' fair treatment, while not impacting existing fee structures negatively with no apparent benefit. In this respect, the future ESMA Guidelines should therefore not recommend a standardised reset period, leaving its choice solely to the management company, depending on several factors for its computation, e.g. the chosen investment objectives and strategy, the portfolio's underlying asset classes, the typical investor profile, etc.

In light of the above, we believe that when considering a (high-on-high) HWM model, important is to distinguish between the notion of "performance reference period" (as in the "definitions" table in the ESMA consultation paper) and the notion of "reset period". The latter should be intended as the period at the end of which any past negative or under-performance is reset, although ESMA seems to have incorporated it into the definition of "performance reference period" under draft Guideline 1, paragraph 11, letter c. Hoping to avoid confusion in the final Guidelines, we believe that for the high-on-high HWM model, only the reset period is relevant.

We stress that the reset period's ultimate duration should not be directly and/or mechanically linked to a recommended holding period, especially when considering an individual investor whose investment horizon may *de facto* be substantially different form the one recommended in the disclosure documents. Indeed, UCITS funds are typically sold through several affiliated or third-party distributors/advisors in Europe. Hence, portfolio managers are generally not able to precisely record the duration of each investor's holding, as investors are not known to the management company. A recommended or predefined reset period would in addition, if not adapted to the particular context of the fund's strategy, bear the risk of a significant wealth transfer between investors whose investments have contributed to build the performance fee provision and those whose investments have not.

In addition, supporting a minimum reset period of no less than one year for UCITS are also the MiFID II-related product disclosure requirements, requiring product distributors to provide the annual *ex-post* information related to all relevant costs and charges to their end-clients on a personalised and comprehensible basis[8], thus ensuring that investors are only charged once for the same outperformance over the same period.

For models with reset periods longer than one year, ESMA should recognise that these operate on the basis of a rolling interval, whereby at the end of a 1-year period the oldest year is dropped and the last one added into the computation of the reset period. This allows for the most recent performance year to be factored into the calculation, rather than starting with a new reference period "from scratch" (as the draft Guideline 4, paragraph 24, seems to imply)[9].

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.

In line with our response to Q8 above, we consider that – beyond a no-less-than-one-year minimum – management companies should be allowed to set – uniquely for high-on-high HWM models - reset

[8] As per Article 50(9) of the delegated regulation (EU) 2017/565 of 25 April 2016, implementing MiFID II.

periods as they deem appropriate to their underlying investment strategy, the fund's risk profile, the portfolio's underlying asset classes, the typical investor profile, etc.

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 applying a performance fee model based on a benchmark index, we believe that an appropriate performance reference period should be no more than one year. For a benchmark model and for a hurdle rate model, we believe that a reset period of one year could be appropriate, thus balancing the need to measure performance over a sufficient time period with that of rewarding outperformance, while minimising wealth transfer effects and perfecting the alignment of economic interests between the management company and the investors.

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 refer to our responses to Q8 and Q10 above.

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?

EFAMA believes that a sensible transition period would need to be of at least 24-months, including both newly launched share classes/funds and existing ones, taking various factors into account; i.e. the average crystallisation frequency of at least 12-months, the time necessary for management companies to recalibrate their existing fee structures, as well as to amend existing UCITS disclosure and marketing materials (in certain instances, even the Articles of the fund).

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.

EFAMA believes that an extension of the draft Guidelines to retail AIFs would be largely premature. We observe in this regard that, unlike UCITS, AIFs do not (yet) benefit from comparable harmonised product regulation requirements - where "performance" is genuinely tied to a specific product more than to a management company - and do not share the distinct EU cross-border vocation that characterises the UCITS regime. Where retail-AIF regulatory regimes already exist, these are confined to only a few key jurisdictions, each implementing its own domestic set of rules to permit AIFs to access a retail market. Moreover, as a result, there are varying notions as to what type of collective investment vehicle could qualify as a "retail AIF" in the absence of harmonised EU requirements for a product market that caters still almost exclusively to professional investors. As a result, fee models charged for AIFs would vary significantly, with the additional risk that a theoretical application of the Guidelines as drafted for "retail AIFs" could spill-over and affect the cost structure of other AIF offerings for a very different (i.e. institutional) and less homogeneous client base. In this regard, we note that fee structures applicable to AIFs are different to those that apply to UCITS.

Many AIFs are additionally closed-end funds and not listed/traded, thereby introducing different considerations. For example, in many AIFs, "carried interest" is the traditional method adopted for awarding investment managers' performance, but often implies an upfront capital commitment from an individual manager. As a result, the considerations that arise are wholly different from those that are applicable to UCITS, such that the approach and principles set out in the draft Guidelines are generally not relevant, nor applicable, to AIFs.

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.

EFAMA agrees with the cost-benefit analysis underpinning ESMA's technical proposal to ensure greater consistency (as per the relevant table in the consultation paper). Pending the outcome of the final Guidelines, costs derived from their implementation, in the form of compliance and legal work, may not be prohibitive, as (i) most EU jurisdictions have already aligned their domestic regulations with the IOSCO 2016 *Best Practices*; and (ii) provided management companies and other service providers (e.g. fund administrators, depositaries, distributors, etc.) are granted sufficient time to comply with the Guidelines, as suggested in our answer to Q12 above. Sensitive deviations from the IOSCO *Best Practices* and/or the recommendation of more prescriptive parameters (e.g. in relation to the duration of the performance reference period) will have far-reaching and negative implications for management companies' operational cost structures.

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.

For performance fee models with no hurdle rate, or one not linked to the stated investment objective, we believe these are permissible, provided they pursue an absolute return strategy and their details are clearly explained in the fund's disclosure documents. As per ESMA's example, comparing the performance of an absolute return equity strategy with a money market index (as the EONIA) can be allowed to the extent it is more appropriate to capture excess performance in line with the fund's absolute return objective and notwithstanding the equity exposure's greater degree of risk (implicit in an active manager's proposition to investors).

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.

Please refer to our answer to Q14 above.

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.

In line with our answer to Q6, we observe that the draft Guideline 4 would not be appropriate for all types of performance fee models, namely for those funds choosing to measure their performance against an index. We specifically refer to the possibility for funds to levy performance fees even in bear markets, provided their performance relative to that of the chosen index is positive (i.e. positive relative performance) and thereby rewarding outperformance.

In terms of minimising incentives for managers to take on excessive risks (as per paragraph 23 under draft Guideline 4), we believe that the proposed performance reference period of no less than one year (or more depending on a set of factors) would allow a management company a sufficient amount of time to recover any cumulative negative performance before levying a performance fee once again.

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.

Please refer to our answer to Q14 above.

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.

In relation to disclosure costs, we refer ESMA to our answer to Q14 above, knowing these will concur to the overall compliance cost to management companies in meeting the future final Guidelines. As to the benefits, we clearly see a positive outcome for investors in receiving more details on the functioning of certain performance fee models, including their calculations. Such information should be clearly contained in the fund's prospectus, so as to avoid being at odds with the mandatory length constraints of the UCITS KIID and where a mere mention of the application of performance fees and related model in the relevant "Charges" section of the KIID is sufficient.

[19-4093]

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