European Securities and Markets Authority

Consultation Paper

Guidelines on performance fees in UCITS

16 July 2019 | ESMA34-39-881

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **31/10/2019.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper

This document will be of interest to asset managers managing retail funds and their trade associations, as well as institutional and retail investors investing into such funds and their associations.

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I. Executive Summary

Reasons for publication

Ensuring supervisory convergence regarding performance fee structures as well as the circumstances in which performance fees can be paid has been included in the key priorities for the 2019 ESMA Supervisory Convergence Work Programme (SCWP).[1]

Being not further detailed in EU regulation and considering the great importance of the cross-border distribution of Undertakings for Collective Investment in Transferable Securities (UCITS), supervisory convergence on this issue is essential to ensure a level playing field in the EU.

Currently there are different practices across National Competent Authorities (NCAs) regarding performance fee structures as well as on the circumstances in which performance fees can be paid. This creates risks of regulatory arbitrage and inconsistent levels of investor protection.

At the beginning of 2018, ESMA conducted a mapping exercise among NCAs in order to analyse the current practices in the different Member States in relation to some aspects of performance fees.

The results have shown the lack of harmonisation among EU jurisdictions. Therefore, ESMA decided to carry out further convergence work which led to the development of this consultation paper (CP).

The draft Guidelines included in this CP set out common criteria in order to promote supervisory convergence on the following areas: general principles on performance fee calculation methods; consistency between the performance fee model and the fund's investment objectives, strategy and policy; frequency for the crystallisation of the performance fee; the circumstances where a performance fee should be payable; disclosure of performance fee model. The draft Guidelines are designed in order to align the interests of fund managers and investors.

Contents

Section III explains the background to our proposals and outlines its legislative basis. Section IV details ESMA's initial cost-benefit analysis concerning the draft Guidelines. At all stages stakeholders' input is sought through specific questions, which are summarised in Annex I.

Annex II provides an overview of the applicable UCITS legislation related to performance fees and Annex III includes excerpts from the IOSCO Good Practice for Fees and Expenses of Collective Investment Schemes which were considered while developing the CP.

[1] https://www.esma.europa.eu/sites/default/files/library/esma42-114-647_2019_supervisory_convergence_work_programme.pdf

Annex IV includes the results of the ESMA mapping of NCAs' practices on performance fees.

The proposed Guidelines are set out in Annex V to this CP.

Next Steps

ESMA will consider the feedback it receives to this consultation in Q4 2019 with a view to finalising the guidelines for publication afterwards.

II. Legislative references, abbreviations and definitions

Legislative references

For a list of legislative references, abbreviations and definitions used in this CP, please see Section 2 of the draft Guidelines (page 47).

III. Background

1. Ensuring supervisory convergence with regard to performance-based fee structures and payment has been included in the key priorities for the 2019 ESMA Supervisory Convergence Work Programme (SCWP).[2] Although EU regulation does not go into further detail about performance fees (see Annex II), they are nevertheless a feature of UCITS which may materially affect the range of choices allowed to investors and the income available to asset management companies (AMCs). Considering the great importance of funds' cross border distribution, supervisory convergence on this issue is essential to ensure a level playing field in the EU.

2. At the beginning of 2018, ESMA conducted a mapping exercise in order to analyse the current practices and approaches in the EEA as regards performance-based fee models and payments.

3. The survey showed that there is no convergence at EU level on performance-based fee models and computation mechanisms. Nevertheless, some common elements can be identified among Member States. Broadly, the following methodologies represent the computation mechanisms most commonly applied in the asset management industry:

    a) performance fees subject to a High-Water Mark (HWM) model, sometimes combined with a hurdle rate;

    b) performance fee models based on the comparison between present and past performance (for example, performance fees can be charged if the NAV at the end of the period "t" is higher than the NAV at the end of the period "t-3");

    c) remuneration of performance exceeding a certain threshold (for example: performance exceeding a benchmark or a fixed pre-determined amount; returns exceeding the central bank's deposit rate or the rate of return of the benchmark; relative performance of the share class compared to the benchmark over the last three years).

4. As for consistency between the fund strategy and the benchmark or index chosen, a number of NCAs have reported that, within their jurisdictions, funds are not subject to

[2] https://www.esma.europa.eu/sites/default/files/library/esma42-114-647_2019_supervisory_convergence_work_programme.pdf

any specific condition or limitation when choosing the benchmarks or indices used in the performance fee computation models.

5. The majority of Member States have either legal provisions or supervisory practices aimed at ensuring consistency between a fund's strategy and the benchmark or index chosen, based, for example, on the asset classes or the geographical area funds are invested in.

6. Computation mechanisms are applied differently in each Member State. According to the ESMA survey, the majority of NCAs require funds to calculate performance fees daily and to charge them on an annual basis. Other methodologies include monthly calculation and payments on a quarterly basis.

7. Several NCAs indicated that they apply additional requirements to the EU legislation on performance fee disclosure. Disclosure requirements can be grouped mainly in three categories:

   a) information to be provided in the constitutional document / fund rules / instrument of incorporation (such as: computation methodology and payment of performance fees; disclosure that a performance fee may be charged and potential increases in fees subject to prior approval by unitholders; computation methodology, reference parameters and due date);

   b) information to be provided in the annual report (such as: disclosure of the index used for a performance fee computation; disclosure of all the fees which can be charged, including performance fees; reference period used for calculations, the base for calculation and the impact that a performance fee model may entail);

   c) information to be provided in the prospectus (such as: the impact of the fees on the fund's return over a certain period, or the actual fees charged).

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

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

8. The proposed Guidelines aim at setting convergence principles in regard to five key elements:

   a) general principles on performance fee calculation methods (Guideline 1);

b) consistency between the performance fee model and the fund's investment objectives, strategy and policy (Guideline 2);

c) frequency for the performance fee crystallisation and payment (Guideline 3);

d) the circumstances where a performance fee should be payable (Guideline 4);

e) disclosure of performance fee model (Guideline 5).

9. In defining the aforementioned principles, ESMA considered the IOSCO Good Practice for Fees and Expenses of Collective Investment Schemes (see Annex III).[4]

10. For the purpose of these Guidelines, performance fees should be interpreted as the variable management fees linked to the performance of a fund and usually payable in addition to the basic fee, whose objective is to create an incentive for the fund operator to optimise the performance of the fund.

11. ESMA recognises that there are a variety of performance fee **models** which may be used, taking into account the nature of the investment objective and strategy of the fund and investors' preferences, such as the use of a HWM model, a benchmark model, a hurdle rate or a fulcrum fee model. In addition, there are also various approaches to the **methodologies** which apply to these models, including the tracking or accounting of performance fees, for example, through equalisation or series of shares or on an individual investor basis.

12. ESMA is of the view that certain arrangements regarding the way performance fees are calculated might not be in the interest of the UCITS, since they might lead to undue costs being charged to the UCITS and/or its unit holders and they might not comply with the obligation for the management company to act with due skill, care and diligence, in the best interest of the UCITS it manages.

13. Given funds' cross border distribution, a common minimum level of protection across the EU should be ensured towards retail investors, as well as promoting common supervisory approaches and practices and ensuring common standards of disclosure.

[4] More specifically, ESMA considered the following IOSCO Good Practices: "A performance fee should be consistent with the investment objectives of the CIS" (Good Practice 3); "The frequency for crystallising the performance fee and transferring the amount earned in such fees to the CIS operator should not be more than once a year except when the CIS uses a fulcrum fee model" (Good Practice 3); "CIS operators should design calculation methods allowing for the performance fee to result in a value that is proportionate to the investment performance of the CIS" (Good Practice 3); "The scope of fees and expenses that may and/or may not be deducted from the assets of a CIS should at least be set out in documents disclosed to investors before they invest and afterwards at the times mandated by legislation / regulation" (Good Practice 1).
"It remains important for investors to be adequately informed of the existence of the performance fee and of its potential impact on the return that they will get on their investment" (Good Practice 5). See the IOSCO "Good practices for fees and expenses of Collective Investment Schemes - FRO9/16, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

14. The proposed Guidelines are based on the IOSCO "Good Practice for Fees and Expenses of Collective Investment Schemes – FRO9/16 August 2016", that were considered as best practices (see Annex III). The IOSCO practices were considered to as a valid set of rules on the basis of which to harmonise the current practices in the various Member States.

III.1 General principles on performance fee calculation methods

15. The performance fee calculation method should include, at least, the following elements (Guideline 1):

   a) a **reference indicator** to measure the relative performance of the fund such as an index (e.g. Eonia, Eurostoxx 50, etc.), a HWM or a hurdle rate[5];

   b) a **crystallisation period** within which the performance fee, if any, is accrued and a **crystallisation date**, coinciding with the end of the crystallisation period, at which the performance fee is crystallised and credited to the management company;

   c) a **performance reference period** at the end of which the mechanism for compensating for past underperformance or negative performance can be reset;

   d) a **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) a **performance fee methodology** enabling the calculation of the performance fees based on the abovementioned inputs and any other relevant inputs; and

   f) a **computation frequency** which should coincide with the calculation frequency of the NAV (e.g. if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

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

16. With reference to consistency between the performance fee model and the fund's investment aims, the proposed Guideline recommends to ensure that the performance fee model is suitable for the fund given its investment policy and strategy and its risk-reward profile.

[5] For the avoidance of doubt, a flat-rate performance fee may be applied (for example, X% performance fee charged on any performance achieved or performance achieved above a certain threshold).

17. For funds which calculate the performance fee with reference to a benchmark, the benchmark should be appropriate in the context of the investment objectives, strategy and policy of the fund (Guideline 2).

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 (eg: historical volatility, asset allocation composition, etc.) to ensure this consistency? Please provide examples and give reasons for your answer.

III.3 Frequency for the crystallisation of the performance fee

18. Performance fee models and the related methodologies may have very different characteristics. In principle, the minimum crystallisation period should be linked to the recommended holding period of the fund and the performance fee should ideally be charged to each investor when exiting the fund.

19. ESMA is of the view that the minimum crystallisation period for performance fees 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. To this end, the manager should not be incentivised to take excessive risks and cumulative gains should be duly offset by cumulative losses. The manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the investors' holding period (Guideline 3).

20. In line with the above, the crystallisation period should be long enough to ensure that any over-performance of the fund does not reflect short-term gains due to random market factors. In any case, the crystallisation period should not be shorter than one year and, generally, it should end either on 31 December or at the end of the financial year of the fund (Guideline 3).

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.

21. ESMA considers that, in line with the IOSCO Good Practices, fulcrum fee models should be exempted from the requirement of a minimum crystallisation period of 12 months, as the characteristics of this model are not compatible with a minimum crystallisation period.[6]

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

[6] See also IOSCO Good Practice 3.

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.

III.4 General principles on performance fee calculation methods

22. In order to safeguard the best interests of investors, Guideline 4 recommends that a performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period. The intention of the principle is to ensure that any underperformance or loss previously incurred during the performance reference period should be recovered before a performance fee becomes payable.

23. However, in case of a benchmark model, a fund can achieve positive performance vis-à-vis its benchmark, notwithstanding that its net asset value may have declined (relative positive performance), or in absolute terms (absolute positive performance).

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?

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.

24. The performance reference period should not apply to the fulcrum fee model, as in this model the level of the performance fees increases or decreases proportionately with the investment performance of the fund.

25. Where an HWM model applies, Guideline 4 recommends that it should only be reset where during the performance reference period (i) the new HWM exceeds the last HWM or (ii) the fund has undergone significant structural changes. For the purpose of resetting the HWM, a performance reference period should be defined.

Q8 What are your views on setting a performance reference period for the purpose of resetting the HWM? What should be taken into account when setting the performance reference period? Should this period be defined, for example, based on the whole life of the fund (starting from the fund's inception date), the recommended holding period

of the investor or the investment horizon as stated in the prospectus? Please provide examples and reasons for your answer.

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.

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.

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.

III.5 Disclosure of the performance fee model

26. Guideline 5 outlines the content of the information on performance fees to be disclosed *ex ante* in the KIID and prospectus and, *ex post*, in the annual report.

27. A performance fee should be disclosed in such a way as to be understood by retail investors. Investors should be adequately informed about the existence of performance fees and about their potential impact on the investment return. To this end, all features necessary to get a proper understanding of the computation methodology should be described; tables could help investors to gain a better understanding and examples of performance fees computation might be provided in the prospectus. The *ex post* information should include at least the actual total amount of performances fees collected per share class.

III.6 Application of the principles set out in the Guidelines

28. A proposal for a transitional provision to deal with existing funds currently operating a performance fee mechanism not compliant with the common principles is laid down.

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?

29. The common principles defined by the Guidelines are intended to apply to UCITS, as the existence of the EU retail passport and the importance of actual cross border marketing of UCITS make supervisory convergence a key issue to achieve the objectives of the EU legislation.

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.

III.7 Legislative basis

30. These Guidelines relate to provisions in the UCITS framework.

31. Article 14(1) of the UCITS Directive sets out that the general requirement according to which Member States shall "ensure that a management company: (a) acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market; (b) acts with due skill, care and diligence, in the best interest of the UCITS it manages and the integrity of the market".

32. In this context, Article 22(3) of the UCITS Level 2 Directive sets out that "Without prejudice to requirements under national law, Member States shall require management companies to ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS they manage, in order to comply with the duty to act in the best interests of the unit-holders. […]".

33. Furthermore, Article 22(4) of the UCITS Level 2 Directive provides that "Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unit holders".

34. These Guidelines also apply in relation to Article 78(3)(d) of the UCITS Directive, whereby "key investor information shall provide information on the following essential elements in respect of the UCITS concerned: […] costs and associated charges".

35. Based on Article 12(3) of the UCITS Level 2 Regulation, performance fees shall be disclosed in accordance with Article 10(2)(c). In line with this provision, "*The 'Charges' section of the key investor information document shall contain a presentation of charges" to be completed with the list and explanation of "any charges taken from the UCITS under certain specific conditions, the basis on which the charge is calculated, and when the charge applies*". As per Article 14, "*the 'Charges' section shall include, where relevant, a cross-reference to those parts of the UCITS prospectus where more detailed information on charges can be found, including information on performance fees and how they are calculated*".

36. Moreover, these Guidelines apply taking into consideration Article 14b(3) of the UCITS Directive, which provides that *the remuneration principles set out therein have to be applied to any benefit of any type paid by the management company, to any amount paid directly by the UCITS itself, including performance fees*.

37. In this respect, these Guidelines apply in relation to the requirement for the UCITS prospectus to include *"(a) the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, […] or (b) a summary of the remuneration policy and a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated*" (Article 69(1) of the UCITS Directive).

38. Furthermore, under Article 69(1) of the UCITS Directive the annual report shall include, among other things, "*any significant information which will enable investors to make an informed judgement on the development of the activities of the UCITS and its results", as well as "(a) the total amount of remuneration for the financial year, split into fixed and variable remuneration paid by the management company and by the investment company to its staff; […] (c) a description of how the remuneration and the benefits have been calculated*".

39. For a comprehensive list of the relevant articles, see Annex II.

40. These Guidelines are without prejudice to the Guidelines on sound remuneration policies under the UCITS Directive.[7]

[7] See ESMA/2016/575, https://www.esma.europa.eu/sites/default/files/library/2016-575_ucits_remuneration_guidelines.pdf

IV. Cost-benefit analysis

Cost-benefit analysis

1. Introduction

41. The IOSCO Final Report on "Good practice for fees and expenses of Collective Investment Schemes (CIS)" sets out high standards of transparency and conduct to encourage competition among CIS operators.

42. The focus of the regulatory approach is to promote competitive and informed markets to help investors understand fees and expenses and make informed investment decisions, especially for those funds applying performance fees.

43. The regulatory steps taken in different EU jurisdictions may include general principles, prohibited practices and precise rules in relation to performance fees models, computation mechanisms and disclosure requirements. The approach varies among jurisdictions depending on their regulatory framework, the structure of their national asset management landscape and the regulator's assessment of the risks and problems facing investors. It is therefore necessary to achieve convergence in this field in order to avoid the risk of different levels of protection for the retail investor depending on where the fund is domiciled.

44. The IOSCO standards are not intended to serve as comprehensive requirements for the regulation of fees and expenses of CIS, but they reflect approaches and identify good practices to issues currently acknowledged by regulators in some key areas.[8]

45. This draft Cost-Benefit Analysis (CBA) analyses specific questions related to four areas: consistency between the performance fee model and the fund's investment objectives, strategy and policy; frequency for the crystallisation of the performance fee; negative performance (loss) recovery; disclosure of the performance fee model.

46. Specific questions have been introduced in the text below in order to elicit market participants' input on the quantitative impact of the proposals. Should relevant data be received through the consultation process, ESMA will take it into account when finalising the report and will include it in the CBA accompanying the final report.

[8] Namely: permitted or prohibited costs for a CIS; disclosure of fees and expenses to the investor, including use of electronic media; remuneration of CIS operator; performance-related fees; transaction costs; hard and soft commissions on transactions; fees associated with CIS that invest in other funds; fee differentiation in multi-class CIS; and changes to the fees and expenses of a CIS. See IOSCO, Good practice for fees and expenses of Collective Investment Schemes, Final Report, August 2016.

47. The following options were identified and analysed by ESMA to address the policy objectives of the good practices for fees and expenses of funds.

48. In identifying the options set out below and choosing the preferred ones, ESMA was also guided by the mapping exercise ("ESMA Survey") conducted during 2018 among the NCAs which analysed the current practices within different Member States and which can be found in Annex IV to this Consultation Paper. The results showed a lack of harmonization among EU jurisdictions in the aforementioned areas. A common approach on an EU level should eventually encourage competition among funds operators and lead to a more efficient market.

49. The following tables summarise the potential costs and benefits resulting from the implementation of the Guidelines.

2. Technical options for ensuring consistency between the performance fee model and the fund's investment objectives, strategy and policy

Policy Objective	Under "Good Practice 3", IOSCO indicates that a performance fee should be consistent with the investment objectives of the CIS and should not create incentive for the CIS operator to take excessive risks in the hope of increasing its own remuneration. The IOSCO principle also specifies that the calculation of a performance fee should be verifiable and not open to the possibility of manipulation; the following items should be unambiguously determined: - how investment performance will be assessed - what reference benchmark will be used - what the calculation formula will be
Baseline scenario	The baseline scenario should be understood for this CBA as the lack of prescriptive requirements for performance fees models in relation to their consistency with the investment objectives, policy and strategy of the fund. This would leave discretion to fund managers to determine the definitions, calculation methodologies and presentation formats of the performance fee model, regardless of the fund's investment policy, which reflects the actual situation in the EU investment fund market.
Technical proposal	In order to address this issue of inconsistency (as pointed out in the results of the mapping exercise referred to above) and comply with the stated objectives, ESMA deems necessary that

	the management company ensure that the performance fee model is consistent with the fund's investment objectives, strategy and policy. In assessing consistency between the performance fee model and the fund's investment objectives, strategy and policy a management company should check: - whether the chosen performance fee model is suitable for the fund given its investment policy and strategy. For instance, for funds that pursue an absolute return objective, a HWM model or a hurdle is 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, a HWM model for an absolute return strategy, might need to include a hurdle to align the model to the fund's risk-reward profile; - whether, for funds that calculate 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 funds and the chosen benchmark. For example, it would 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. Where performance fees are payable on the basis of out-performance of a benchmark (e.g. "Eurostoxx 50 + 3%", "Eonia", etc.), the management company should ensure that the benchmark is consistent with the investment policy and strategy of the fund. For instance, it is not appropriate to take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark (eg: computing performance fees based on "Eurostoxx -1%" where the objective of the fund is "Eurostoxx"). In case the calculation of the performance fee is based on a fulcrum fee model, the performance fee should be based on the same benchmark used to determine excess performance. In all cases, the excess performance should be calculated net of costs.

Benefits	The introduction of this Guideline aims to contribute to the creation of a level playing field across Member States, reducing the scope for regulatory arbitrage, which could otherwise hamper investor protection. In this context, the IOSCO Report highlighted that "high standards of transparency and conduct in this area should encourage competition among funds' operators, which should lead to a more efficient market from which investors will eventually benefit".[9] Conversely, a lack of common practices in this field could lead to a situation where some Member States would adopt different rules, bringing greater uncertainty for investors in different jurisdictions, which could be problematic in the context of the EU passport. In this scenario, investors would not know the extent to which the performance fees characteristics model will reflect a specific feature of the investment strategy, benchmark used or return objective of the investment itself, or just a specific feature of the regulatory framework in place in the Member State of the fund. Indeed, the ESMA Survey showed that in fourteen jurisdictions there are no specific conditions in relation to the choice of benchmark or indexes; while other NCAs reported to have either legal provisions or supervisory practice to ensure consistency between the fund's strategy and the benchmark/index chosen. Among the latter are three NCAs assessing this consistency during the approval phase and on-sites visits or in the occasion of subsequent modifications of the KIID/prospectus. Eight other NCAs mentioned that their authority checks for consistency between the fund's strategy and the benchmark or index chosen by taking into consideration the type of assets or the geographical area in which the fund is invested. Furthermore, another NCA challenges the fund managers during the approval process or during on-sites visits. Finally, in one jurisdiction guidance on the choice of appropriate benchmark or index was provided but the NCA encountered some supervisory difficulties which would require some further clarification from ESMA. Considering the above, the introduction of those principles would avoid the application of different regulatory and supervisory practices among legislations and ensure a higher level of comparability among the same type of funds in different Member

[9] Good practice for fees and expenses of Collective Investment Schemes, Final Report, IOSCO, FR09/16, August 2016, p. 1, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

	States, thus enabling investors to compare the cost of different funds with similar investment objectives more clearly. A higher level of transparency in this specific market segment is welcomed also given the level of complexity of performance fees computation models to be disclosed to retail investors. The Guideline will also benefit managers and NCAs in terms of providing clear guidance over the main aspects to be assessed in the determination and control over performance fees model.
Costs to regulators	The Guideline is not expected to add significant additional costs to ESMA and NCAs. The latter could even benefit from the potential for a reduction in the resource needed to analyse the performance fees computation mechanisms. Indeed, greater standardisation following the application of the Guidelines, should make performance fee structures and computation models clearer and easier to understand, both for investors and NCAs.
Compliance costs	Broadly, the ESMA Survey showed some common features among funds' computation mechanisms of performance fees, such as: the use of the high water-mark principle, sometimes combined with a hurdle rate; comparison between actual and past performance; the use of performance levels exceeding a certain threshold. Nevertheless, the computation mechanism practices are heterogeneous and tend to vary between jurisdictions. Concerning consistency between the fund policy and strategy and the benchmark or index chosen, most of the jurisdictions do not provide for any specific condition in relation to the choice of benchmarks or indices. Nonetheless, in some Member States competent authorities already check the consistency between the fund's strategy and the benchmark/index, sometimes during the approval phase or in the event of on-site visits. ESMA anticipates that fund managers already adopting those measures would not incur significant initial, on-going or ad-hoc costs, aside from the costs related to reading and responding to this Consultation and ensuring standards meet those specified in the Guidelines. On the other hand, the compliance cost would be higher for those managers who do not implement these minimum standards, especially in terms of initial costs related to the first adoption of those standard requirements.

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.

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.

3. Technical options for the frequency for the crystallisation of the performance fee

Policy Objective	Under "Good Practice 3", IOSCO indicates that that the frequency for crystallising the performance fee and transferring the amount earned in such fees to the CIS operator should not be more than once a year.
Baseline scenario	The baseline scenario should be considered for this CBA to be the absence of a specific obligation regarding the minimum performance crystallisation frequency and the transferring of the amount earned in such fees to the fund management company. ESMA Survey showed that the majority of the fund management companies across Member States calculate performance fees on a daily basis and charge them on an annual basis. Other responses to the survey referred to calculation on a monthly basis and payments on a quarterly basis. In some Member States there is no minimum requirement, but the frequency should be "appropriate"; and some jurisdictions carry out a case-by-case analysis. In some Member States the crystallisation frequency also depends on the performance fee model used by the fund.
Technical proposal	The frequency for the crystallisation and the subsequent payment of the performance fee by the management company 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. The manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the investors' holding period. The crystallisation period should not be shorter than one year, except when a fulcrum fee model applies. Generally, it should

	end either on 31 December or at the end of the financial year of the fund. The minimum crystallisation period should not apply to the fulcrum fee model, as the characteristics of this model are not compatible with a minimum crystallisation period.
Benefits	The aim of this Guideline is to seek to avoid investor detriment through the application of performance fee models with methodologies which are not considered reasonable and to contribute to the creation of a level playing field across Member States. Supervisory convergence will help ensure that the conditions under which the performance fee may be crystallised and paid is harmonised. Lack of harmonisation would hamper investors' ability to easily compare the costs of different funds over the same investment horizon. The standardisation of those practices is a fundamental step in ensuring the maximum level of transparency in performance fees structures and payments. IOSCO explained in its principles that "Calculation methods should not deny investors an adequate share of the return achieved from the risks taken on behalf and previously accepted by them". In light of the above, ESMA expects that the introduction of the Guideline will help ensuring the fulfilment of this objective, while also resulting in less incentive for the fund to take inappropriate risks potentially detrimental to investors.
Costs to regulators	NCAs would incur costs in supervising compliance with those computation techniques and providing support to investment managers, especially when the Guidelines are adopted. On the other hand, the introduction of this principles could have a beneficial effect in terms of standardising supervisory practices in this specific area over time.
Compliance costs	Given the variety of practices and requirements among Member States, as shown by the ESMA Survey, ESMA expects higher initial costs for the introduction of this requirement, especially for those managers who do not comply with those minimum standards. Fund managers could conceivably incur costs from the implementation/update of their IT infrastructures, investment software and reporting systems. To a certain extent, minimum requirements over performance fees crystallisation and payment frequency may also affect the fees' structure and the profitability of some investment funds, possibly impacting investment strategies, budgeting provisions and, therefore, business planning. However, those costs are likely to be counterbalanced by the beneficial effects of fostering competition in the asset management industry, aligning the interest of fund managers

	and investors and allowing an easier investment comparison in the EU investment fund sector.

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.

4. Negative performance (loss) recovery

Policy Objective	In order to safeguard the best interests of investors, a performance fee should only be payable in circumstances where positive performance has been accrued during the performance reference period. Any underperformance or loss previously incurred should be recovered before a performance fee becomes payable. The reference period should be set based on specific criteria.
Baseline scenario	The baseline scenario should be understood for this CBA as the absence of a harmonised set of principles regarding the compensation of underperformances / losses before a performance fee becomes payable.
Technical proposal	A performance fee should only be payable 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. The performance fee model should be designed to ensure that the fund manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses. Where a fund utilises a HWM this should only be reset where during the performance reference period (i) the new HWM exceeds the last HWM or (ii) the fund has undergone significant structural changes. For the purpose of resetting the HWM, a performance reference period should be defined. The performance reference period should not apply to the fulcrum fee model, as in this model the level of the performance fee increases or decreases proportionately with the investment performance of the fund
Benefits	ESMA anticipates that the suggested approach would benefit all stakeholders and particularly investors. The proposed standardisation should provide more clarity to market participants on best practices aligning the best interest of

	investors and fund managers. Setting a reference period for the purpose of compensating past underperformance and losses is a fundamental step in ensuring that the fee is paid on condition that the fund has achieved the objective of providing a specific positive return to the investor over a specified time horizon.
Compliance costs	Given the variety of practices and requirements among Member States, as shown by the ESMA Survey, ESMA expects higher initial costs for the introduction of this requirement, especially for those managers who do not comply with those minimum standards. However, those costs are likely to be counterbalanced by the beneficial effects of fostering competition in the asset management industry, as well as investor protection .

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.

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.

5. Disclosure of the performance fee model

Policy Objective	Under "Good Practice 1", IOSCO indicates that the scope of fees and expenses that may and/or may not be deducted from the assets of a CIS should at least be set out in documents disclosed to investors before they invest and afterwards at the times mandated by legislation/regulation. IOSCO "Good Practice 5" states that it remains important for investors to be adequately informed of the existence of the performance fee and of its potential impact on the return that they will get on their investment. Other applicable principles in this field are those contained in Practices 6 to 11.
Baseline scenario	The baseline scenario should be understood for this CBA as the lack of further disclosure requirements in addition to the EU

	existing legislative framework [such as Article 10(2)(c) of the KIID Regulation].
Technical proposal	Investors should be adequately informed on the existence of performance fees and on their potential impact on the investment return. The prospectus and, if relevant, any ex-ante information documents as well as marketing material, should clearly set out all information necessary to get a proper understanding of 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 date when the performance fee is paid without prejudice to other more specific requirements set out in specific legislation or regulation. The prospectus should include concrete examples of how the performance fee will be calculated to provide investors with a better understanding of the performance fee model. In compliance with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated. The KIID should clearly set 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 the prospectus should show past performance against it.[10] The annual and half-yearly reports and any other ex-post information should indicate, for each relevant share class, the impact of the fees over the crystallisation period, by clearly displaying: (i) the actual amount of performance fees charged and (ii) the percentage of the fee based on the share class NAV.
Benefits	ESMA anticipates that the suggested approach would be beneficial to all stakeholders and particularly to investors. Indeed, the introduction of additional *ex ante* and *ex post* disclosure requirements would further enhance the improvements in market transparency gained through the introduction of the other Guidelines on performance fees. These additional requirements will help in standardising performance fees disclosure and reporting, allowing investors to more easily

[10] See UCITS Q&As on benchmark disclosure https://www.esma.europa.eu/press-news/esma-news/esma-qas-clarify-benchmark-disclosure-obligations-ucits

	compare different investment options, thus contributing to the creation of a level playing field across Member States. More detailed and transparent information to investors would largely benefit the fund management industry from a reputational side, while reducing the need for correction and enforcement by NCAs.
Compliance costs	ESMA takes the view that the proposed approach is unlikely to lead to significant additional costs to the extent that it provides clarifications and further details on the existing legislative provisions and enhances the benefits of the other Guidelines on performance fees. Several NCAs already provide for additional disclosure requirements in the fund rules / instruments of incorporation, the annual report and the prospectus. Therefore, the cost of complying with this requirement is likely to be counterbalanced by its beneficial effects, also given the complementarity with the other Guidelines over performance fees and the flexible approach it allows in detailing the information to be disclosed.

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.

V. Annex I: Summary of questions

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

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

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 (eg: historical volatility, asset allocation composition, etc.) to ensure this consistency? Please provide examples and give reasons for your answer.

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.

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.

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?

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.

Q8 What are your views on setting a performance reference period for the purpose of resetting the HWM? What should be taken into account when setting the performance reference period? Should this period be defined, for example, based on the whole life of the fund (starting from the fund's inception date), the recommended holding period of the investor or the investment horizon as stated in the prospectus? Please provide examples and reasons for your answer.

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.

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.

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.

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?

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.

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.

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.

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.

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.

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.

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.

VI. Annex II: Relevant provisions in the UCITS framework

Directive 2009/65/EC

Article 14(b)3

3. The principles set out in paragraph 1 shall apply to any benefit of any type paid by the management company, to any amount paid directly by the UCITS itself, including performance fees, and to any transfer of units or shares of the UCITS, made for the benefit of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls into the remuneration bracket of senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profile of the UCITS that they manage.

Article 14(1)(a) and (b)

1. Each Member State shall draw up rules of conduct which management companies authorised in that Member State shall observe at all times. Such rules shall implement at least the principles set out in this paragraph. Those principles shall ensure that a management company:

(a) acts honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market;

(b) acts with due skill, care and diligence, in the best interests of the UCITS it manages and the integrity of the market

Article 14b(1) and (3)

1. *When establishing and applying the remuneration policies referred to in Article 14a, management companies shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities:*

(a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk taking which is inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS that the management company manages;

(b) the remuneration policy is in line with the business strategy, objectives, values and interests of the management company and the UCITS that it manages and of the investors in such UCITS, and includes measures to avoid conflicts of interest;

(c) the remuneration policy is adopted by the management body of the management company in its supervisory function, and that body adopts, and reviews at least annually, the general principles of the remuneration policy and is responsible for, and oversees, their implementation; the tasks referred to in this point shall be undertaken only by members of the management body who do not perform any executive functions in the management company concerned and who have expertise in risk management and remuneration;

(d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

(e*) staff engaged in control functions are compensated in accordance with the achievement of the objectives linked to their functions, independently of the performance of the business areas that they control;*

(f) the remuneration of the senior officers in the risk management and compliance functions is overseen directly by the remuneration committee, where such a committee exists;

(g) where remuneration is performance-related, the total amount of remuneration is based on a combination of the assessment as to the performance of the individual and of the business unit or UCITS concerned and as to their risks and of the overall results of the management company when assessing individual performance, taking into account financial and non-financial criteria;

(h) the assessment of performance is set in a multi-year framework appropriate to the holding period recommended to the investors of the UCITS managed by the management company in order to ensure that the assessment process is based on the longer-term performance of the UCITS and its investment risks and that the actual payment of performance-based components of remuneration is spread over the same period;

3. The principles set out in paragraph 1 shall apply to any benefit of any type paid by the management company, to any amount paid directly by the UCITS itself, including performance fees, and to any transfer of units or shares of the UCITS, made for the benefit of those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls into the remuneration bracket of senior management and risk takers, whose professional activities have a material impact on their risk profile or the risk profile of the UCITS that they manage.

Article 25(2)

2. In carrying out their respective functions, the management company and the depositary shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS. In carrying out their respective functions, the investment company and the depositary shall act honestly, fairly, professionally, independently and solely in the interest of the investors of the UCITS.

Article 69(1)(2)(3)(4)

1. The prospectus shall include the information necessary for investors to be able to make an informed judgement of the investment proposed to them and, in particular, of the risks attached thereto. The prospectus shall include either: (a) the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identities of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, where such a committee exists; or (b) a summary of the remuneration policy and a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of persons responsible for awarding the remuneration and benefits, including the composition of the remuneration committee where such a committee exists, are available by means of a website – including a reference to that website – and that a paper copy will be made available free of charge upon request.

2. The prospectus shall contain at least the information provided for in Schedule A of Annex I, in so far as that information does not already appear in the fund rules or instruments of incorporation annexed to the prospectus in accordance with Article 71(1).

3. The annual report shall include a balance-sheet or a statement of assets and liabilities, a detailed income and expenditure account for the financial year, a report on the activities of the *financial year and the other information provided for in Schedule B of Annex I as well as any significant information which will enable investors to make an informed judgement on the development of the activities of the UCITS and its results.*

4. The half-yearly report shall include at least the information provided for in Sections I to IV of Schedule B of Annex I. Where a UCITS has paid or proposes to pay an interim dividend, the figures must indicate the results after tax for the half-year concerned and the interim dividend paid or proposed.

Article 78(2), (3)(d)(e) and 4 (first paragraph)

2. Key investor information shall include appropriate information about the essential characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product that is being offered to them and, consequently, to take investment decisions on an informed basis.

3. Key investor information shall provide information on the following essential elements in respect of the UCITS concerned:

(d) costs and associated charges; and

(e) risk/reward profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investments in the relevant UCITS.

Those essential elements shall be comprehensible to the investor without any reference to other documents.

4. Key investor information shall also include a statement to the effect that the details of the up-to-date remuneration policy, including, but not limited to, a description of how remuneration and benefits are calculated, the identity of persons responsible for awarding the remuneration and benefits including the composition of the remuneration committee, where such a committee exists, are available by means of a website – including a reference to that website – and that a paper copy will be made available free of charge upon request.

Commission Regulation (EU) No 583/2010

Article 3(1) and (2)

1. This Regulation specifies in an exhaustive manner the form and content of the document containing key investor information (hereinafter referred to as key investor information document). No other information or statements shall be included except where this Regulation states otherwise.

2. The key investor information shall be fair, clear and not misleading.

Article 10(1) and (2)

1. The 'Charges' section of the key investor information document shall contain a presentation of charges in the form of a table as laid down in Annex II.

2. The table referred to in paragraph 1 shall be completed in accordance with the following requirements:

(a) entry and exit charges shall each be the maximum percentage which might be deducted from the investor's capital commitment to the UCITS;

(b) a single figure shall be shown for charges taken from the UCITS over a year, to be known as the 'ongoing charges,' representing all annual charges and other payments taken from the assets of the UCITS over the defined period, and based on the figures for the preceding year;

(c) the table shall list and explain any charges taken from the UCITS under certain specific conditions, the basis on which the charge is calculated, and when the charge applies.

Article 12(3)

3. Performance fees shall be disclosed in accordance with Article 10(2)(c). The amount of the performance fee charged during the UCITS' last financial year shall be included as a percentage figure.

Article 14

The 'Charges' section shall include, where relevant, a cross-reference to those parts of the UCITS prospectus where more detailed information on charges can be found, including information on performance fees and how they are calculated.

Commission Directive 2010/43/EU

Article 22(1)(3) and (4)

1. Member States shall require management companies to ensure that unit-holders of managed UCITS are treated fairly.

Management companies shall refrain from placing the interests of any group of unit-holders above the interests of any other group of unit-holders.

3. Without prejudice to requirements under national law, Member States shall require management companies to ensure that fair, correct and transparent pricing models and valuation systems are used for the UCITS they manage, in order to comply with the duty to act in the best interests of the unit-holders. Management companies must be able to demonstrate that the UCITS portfolios have been accurately valued.

4. Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its unit-holders.

VII. Annex III: IOSCO Good Practice for Fees and Expenses of Collective Investment Schemes

The following text includes the relevant extracts from the IOSCO "Good practices for fees and expenses of Collective Investment Schemes - FRO9/16"[11] relating to performance fees which were taken into specific consideration for the purpose of the present CP:

Performance-related fees

29. As noted in the Glossary in Annex 1, performance-related management fees aim to align the economic interests of the CIS operator and the investors in the CIS. Proponents of performance-related management fees believe that these fees can be more effective than a standard, ad valorem fee in rewarding the operator of an actively-managed-CIS for the results it has achieved.

30. A few jurisdictions have entirely forbidden the use of performance fees, but the large majority allow them subject to specific regulatory requirements. Some that allow performance fees report that their use has generally increased over the past 20 years, though to differing degrees across regions and CIS types. Although originally introduced in CIS aimed at institutional investors, they have also become more popular in retail CIS in certain jurisdictions.

Good practice 2

A regulatory regime that permits performance fees should set standards for:

- their method of calculation;
- the information the CIS operator should disclose to investors about their use;
- the disclosure medium to be used.

In any event, a performance fee should respect the principle of equitable treatment of investors.

31. Since the 2004 report, some jurisdictions that allow performance fees have put in place requirements to mitigate the risks they pose. These requirements include:

- imposing a limit on the amount that can be charged as a performance fee
- requiring the CIS operator to inform its regulator if the fee reaches a certain limit
- alleviating potential inequitable treatment of investors by banning charging methods such as 'last in, first out'.

[11] See pp. 7-10 of the Report, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf

32. Performance fees give CIS operators a further incentive to outperform the chosen benchmark, but they may reward luck rather than management skill, or there may be a mismatch between the CIS and the chosen benchmark. Even where such fees are properly linked to the operator's success and skill, they may incentivise an inappropriate degree of risk-taking. For example, if the CIS operator sets the management fee at a low level, sufficient to cover the actual management costs only, and then relies on a performance fee to generate its profit, there is a greater incentive for the operator to take excessive risks.
33. The CIS operator should consider what level of performance fees achieves the right balance between rewarding it for its skills in achieving the performance, while remaining in the investors' best interests.

Good practice 3

A performance fee should be consistent with the investment objectives of the CIS and should not create an incentive for the CIS operator to take excessive risks in the hope of increasing its own remuneration. To that end:

- **The calculation of a performance fee should be verifiable and not open to the possibility of manipulation; in particular, the following items should be unambiguously determined:**
  - **how investment performance will be assessed (i.e. including or excluding subscription and redemption fees, etc.);**
  - **what reference benchmark will be used[12];**
  - **what the calculation formula will be (including a description, if applicable, of the method for offsetting gains against past losses).**
- **The frequency for crystallising the performance fee and transferring the amount earned in such fees to the CIS operator should not be more than once a year, except when the CIS operator uses a fulcrum fee model (see below).**
- **Any benchmark to which the performance of the CIS is to be compared should be verifiable and provided by an independent party.**

CIS operators should design calculation methods allowing for the performance fee to result in a value that is proportionate to the investment performance of the CIS.
Calculation methods should not deny investors an adequate share of the return achieved from the risks taken on their behalf and previously accepted by them.

34. For a given investor, the effective performance of their investment in a CIS depends on the particular points in time when they acquire and later dispose of the shares / units. So, a performance fee should ideally be calculated separately for each investor. However, where this is not practical, the fee could be a fulcrum fee. An operator that charges a fulcrum fee is less likely to take inappropriate risks in selecting assets for the CIS, because under-performance would result in a reduction of the operator's fee.[13]

[12] Generally, it may not be considered good practice for the CIS operator to be allowed to create its own benchmark (even if independently verifiable) or to use one created by an affiliated party

[13] Generally, a fulcrum fee arrangement provides a fee averaged over a specified period that increases or decreases proportionately with the investment performance of the CIS in relation to the returns from an appropriate securities index.

35. Alternatively, methods to ensure that cumulative gains are offset in some way by cumulative losses can be considered. Examples of relevant methods include the high-watermark and high-on-high, which require an absolute improvement in investment performance before the performance fee can be paid. Such methods incentivise the CIS operator not to take excessive risks that might result in losses, since any such losses will then need to be offset before any performance fee can be levied again.

Good practice 4

Where the calculation of the performance fee is based on the fulcrum fee model:

- **the calculation of the fee is compared to an appropriate benchmark and is based on the same benchmark used to determine excess performance;**
- **the fee increases or decreases proportionately with the investment performance of the CIS over a specified period of time; and**
- **the CIS's investment performance should be calculated on the CIS's net asset value, calculated net of costs.**

Where the performance of the CIS is not based on a fulcrum fee model but is measured with reference to a benchmark:

- calculation of the fee is based on the same benchmark used to determine excess performance;
- the excess performance is calculated net of costs.[14]

36. To respect the principle of equitable treatment of investors, a CIS operator may also resort to one or both of the following (admittedly imperfect) solutions, to alleviate the difficulty associated with calculating the performance fee separately for each investor:

- Using different notional classes of shares depending on the date of entry of the investor in the CIS (since it is unlikely to be possible to establish one class of share per date of entry, investors will need to be grouped in different share classes)
- Accruing the performance fee at each date of calculation of the NAV. This solution achieves a satisfactory, though not absolute, level of equality between investors: it does not take into account the fact that investors who enter the CIS may benefit from accrued performance fees (if the NAV of the CIS subsequently decreases, part of the decrease will be offset by the decrease in accrued performance fees which were deducted from the assets of the CIS before the investor entered it).

37. Regardless of the rules applicable to the calculation of performance fees, disclosure requirements should be defined to ensure that investors will get the necessary information to

[14] The "excess performance" should be the difference between the net performance of the portfolio and the performance of the benchmark.

assess whether they get a fair remuneration of the risks taken on their behalf. Jurisdictions now have specific disclosure requirements in place.

Good practice 5 **It remains important for investors to be adequately informed of the existence of the performance fee and of its potential impact on the return that they will get on their investment.**

38. If rules have been put in place to ensure appropriate disclosure, the information should aim for simplicity rather than absolute accuracy. This could be achieved by requiring the CIS operator to give concrete examples of how the fee will be calculated, rather than a theoretical description of how it works. The information provided to investors should be sufficient to enable them to assess the effect of the performance fee on their returns. If no steps are taken to minimise inappropriate incentives, information to investors about the performance fee could also be accompanied by a prominent statement drawing attention to the risks posed by the way the performance fee operates.

VIII. Annex IV: Summary of the results of the ESMA Survey on performance fees

1. In the June 2017 NCAs' discussion on performance fees, it was outlined that fees and expenses have been a concern for regulators for some time and that a regulatory response might be necessary. In particular, the following were identified as potential issues that would need to be addressed to ensure supervisory convergence:

- the lack of harmonisation in relation to the minimum frequency for the computation and crystallising of performance fees and

- the need for good practices that would ensure consistency between the performance fee models and investment policy of the fund.

2. A questionnaire was prepared in which NCAs were asked 10 questions in relation to both UCITS funds and retail AIFs.

3. From the analysis of the responses received for the (2017) questionnaire, it can be observed that among EEA jurisdictions there is still a lack of harmonisation and few regulatory requirements for performance fees.

4. The following sections of this paper briefly summarise the content of these responses.[15] The answers report some demonstrative examples.

The questions of the mapping (hereinafter referred to as 'QM') were as follows:

QM1: Are performance fees permitted in your jurisdiction?

5. In twenty-six jurisdictions, performance fees are permitted. In one jurisdiction, performance fees are not permitted while in another one they are neither explicitly permitted nor forbidden.

QM2: Is there any specific definition of "performance fee"?

6. Eight respondents have provided some definition of performance fee used in their jurisdiction. These definitions are not necessarily established by law. Among these respondents, one NCA mentions that the definition of performance fees is linked to the intra-annual growth of the fund assets per one share of the fund when this growth outperforms a specific benchmark[16]. Two other respondents indicate that is a form of compensation based on the return generated by the fund over a certain period[17]. Finally, three respondents make a link between performance fees and management fees. In one jurisdiction, performance fees are

[15] For the acronyms used in the footnotes, referring to the EU countries, refer to http://publications.europa.eu/code/pdf/370000en.htm#pays ; for Liechtenstein, Island and Norway, the following acronyms were used: LI, IS, NO.
[16] CZ
[17] IT and MT

defined as an eventual variable component of the management fee[18], in another one these are fees in addition to the management fee, determined by reference to the growth in net asset value over a given period[19]. According to the third respondent, by its national law, performance fees are part of management fee which amount depends on the fund's performance[20].

QM3: Are there any specific disclosure requirements for performance fees (In addition to EU requirements such as Article 10(2)(c) of the KIID Regulation)?

7. Fourteen respondents indicate they do have additional requirements (in addition to EU ones) in relation to the disclosure of performance fees. Disclosure requirements can be grouped in three types:

- information that need to be provided in the constitutional document/fund rules/Instrument of Incorporation;

- information that need to be provided in the annual report and;

- information that need to be provided in the prospectus.

8. Examples of information that need to be provided in the constitutional document/fund rules/Instrument of Incorporation are, performance fee paid and criteria of calculation[21], communication that a performance fees might be charged (with the additional requirement that increases have to be approved by unitholders)[22], computation methodology[23], reference parameters, and due date[24].

9. Among the information that need to be disclosed in the prospectus, some examples include the following: disclosure of the index used for the computation of the fee[25], presentation of performance fees in a table[26] next to the other fees charged and the methodology used to calculate the fee[27], calculation period[28], the base of calculation[29] and the impact that a performance fee model may entail[30].

10. Finally, examples of information that need to be added in the annual report are the impact of the fees over a certain period, or actual fees charged.

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[18] PT
[19] MT
[20] PL
[21] CY, DE
[22] IE
[23] NO
[24] PT
[25] BE
[26] FR, IT
[27] FR, IT, MT
[28] IE
[29] ES
[30] MT, SE

QM4: Are performance fees subject to any prescribed computation mechanism at national level? Please respond according to the following subcategorization (please see also General note III below): 1) Absolute funds, 2) Relative funds.

11. Ten respondents indicate they have in place requirements in relation to the computation mechanisms of performance fees. These requirements are not necessarily set up by national legislation but are also established by guidelines and supervisory practices of the NCA. Five respondents[31] mention that a high watermark has to be used, one of them also makes a distinction between absolute and relative high watermark[32]. The latter, calculates performance fees using as proxy the gross value of share (GVS) and once having done so, the change of GVS is compared either to the benchmark or the performance target (with or without relative high watermark clause) either to the maximum value reached by share. The percentage value established for computing the performance fees is applied to the excess return, if any, and the result is multiplied by the smaller amount between the NAV (t-1) and the average NAV recorded during the reference period (t0 – t-1).

12. In another jurisdiction, no computation mechanism are in place but the NCA reviews it on a case-by-case basis[33]. One NCA[34] has issued Guidance that establishes that performance fees can be paid based on achieving a new high NAV per share, or out-performing an index. In the first case, the performance fee can be paid only when the NAV per share exceeds the previous highest NAV per share on which the fee was paid and is payable only over this “water mark”, in the second case, the index has to be relevant and the fee is only payable on the amount by which there is outperformance of the index. The depositary has to supervise performance fees.

13. Finally, in one Member State[35], a NCA’s Circular disciplines the way asset managers calculate performance fees in absolute funds and two possibilities are contemplated, the calculation of the performance fee on the fund’s total performance or on the performance got individually by each investor. With the first approach, the amount of performance fee is accrued daily, based on the annual cumulative fund performance as long as the NAV is higher than the watermark. The watermark can be reset every three years and crystallisation is due as of the last day of the year. In relation to the second methodology, the asset manager may also opt for charging the amount of performance fee either directly to the investors or to the fund.

QM5: Using the same categorization as in Q4, what are the computation mechanisms adopted in practice by funds in your jurisdiction? If you do not have quantitative data, please provide a general indication.

[31] DK, IT, NL, NO, SE
[32] IT
[33] MT
[34] IE
[35] SP

14. The computation mechanism used in practice by funds is heterogeneous and varies between jurisdictions. However, some common elements can be identified between different countries. In practice, funds use as a computation mechanism:

- the high water-mark principle that in certain cases can be combined with a hurdle rate[36],

- comparison of the actual and the past performance (for example, performance fees are charged in case the NAV at the end of t1 is higher than at the end of t-1[37]),

- performance levels that exceed a certain threshold (for example, revenues exceeding a benchmark or a fixed amount pre-determined[38], returns exceeding the central bank's deposit rate or the return of the benchmark[39], relative performance of the share class compared to the benchmark over the last three years[40]).

15. The proxies that are most frequently used in the computation are variations in the net asset value per unit or variation of the fund net asset value.

QM6: Are relative funds subject to any condition that ensures consistency between the fund strategy and the benchmark/index chosen?

16. In relation to the existence of any condition that would ensure consistency between the fund strategy and the benchmark or index chosen, fourteen respondents[41] have answered that within their legislation funds are not subject to any condition in relation to the choice of benchmarks or indexes. The other respondents have either legal provisions or supervisory practices. Among these, three respondents explained that the consistency between the fund's strategy and the benchmark or index is assessed during the approval phase[42] and during on-site visits[43] or subsequent modifications of the KIID/prospectus[44].

17. Eight other[45] respondents mentioned that their authority checks for consistency between the fund's strategy and the benchmark or index chosen (consistency is for example measured taking in consideration the type of assets invested by the fund or the geographical area[46]). Furthermore, another respondent[47] challenges the fund managers during the approval process or during in-site visits, if it finds out that the benchmark or index chosen is not suitable. The same authority also ensures whether the fees are calculated in the same way as disclosed.

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[36]CZ, EE, ES, FI, LT, LU, MT, PL, SK
[37] BG, PT, SK
[38] CZ
[39] FI, PT
[40] NL
[41] AT, BE, BG, CY, CZ, EE, ES, HR, HU, LI, LV, RO, SI, SK
[42] FI, PL
[43] NL
[44] PL
[45] DE, FR, IE, IS, IT, LU, MT, NO
[46] IT
[47] NL

Finally, one respondent[48] has provided guidance on appropriate benchmark or index however, as they have experienced some supervisory difficulties in relation to the assessment of appropriateness of the benchmark or index, they would like to receive some clarification from ESMA.

QM7: If not already covered in Q4, is there any condition regarding frequency of calculation of performance fees and frequency of payment of performance fees?

18. Among the respondents, the majority calculates performance fees on a daily basis and charges them on an annual basis. Other responses that have been received include calculation on a monthly basis and payments on a quarterly basis. One respondent[49] said that they do not have yet any requirement, but they plan to consult on a proposal that indicates that payments/accruals of performance fees must not be less than one year. In two jurisdictions there are no requirements, but the frequency has to be appropriate[50] and performance fees have to be paid with a reasonably frequency[51]. Furthermore, in two other jurisdictions[52] where there are no prescribed requirements, a case-by-case analysis is carried out. Finally, in a few cases, disclosure requirements apply, funds have to be transparent vis-a-vis their investors regarding the calculation and payment of fees[53] and in some cases the framework has to be included in the funds' rules[54].

QM8: Does your authority have in place any specific supervisory practice in relation to performance fees?

19. The responses that have been received from NCAs show diverse supervisory practices adopted by the NCAs. Some NCAs analyse the framework adopted for the calculation of performance fees during the approval phase or with on-site inspections during the life of the fund[55]. For example, during the approval phase, two authorities check the consistency between the structure of the performance fees and the investment policy[56] while in the on-going supervision phase they supervise offering documents (prospectus and KIID)[57]. Two authorities use IOSCO's principles as a reference during the examination phase[58] as well as to assess the situation of foreign funds on the same issues[59]. One NCAs checks if the amount charged matches with what has been set by the prospectus[60] while another one, that has planned to

48 SE
49 IE
50 IS
51 MT
52 LI, NL
53 NL, SK
54 FI, IT,
55 FI, IT, LU, NL, SE
56 IT, PL
57 IT
58 LU
59 FR
60 ES

conduct a thematic inspection of performance fees in 2018, assess the suitability of benchmarks[61].

QM10: In your jurisdiction is there any cap on fees (whether on specific fees or all types of fee) charged by the fund?

20. Results show that performance fees are not subject to a cap in any jurisdiction. However, in some jurisdictions there are caps on other fees charged during the life of the fund while some NCAs have put in place supervisory practices that are aimed to assess whether fees are appropriate and in the interests of investors. In two jurisdictions, exit and entry fees of UCITS and retail AIFs are capped[62]. Five NCAs[63] mention in their responses that even though there are no legal limitations to fees in place, funds have to set a limit in their own rules (and usually this is in relation to all the fees charged). Two authorities have set limits covering entry fees and management fees, with one[64] imposing capped entry fees and management fees to fund of fund and the other one[65] limiting management fees only. Other two authorities have put in place regulatory practices that limit risks of unfair treatment to investors being when the fees are higher than a certain level. In one case[66] it has to be explained why these are in the best interest of unit-holders and in the other one has to be provided a technical justification[67]. Finally, two authorities have set other tools that permit them to keep under control fees which are charged: a guidance that states that fees above 20% in UCITS are unlikely to be permitted and the disclosure of an indicator of total amount of all costs that should not exceed 3,5% of the average annual net value of assets of the UCITS fund.

QM11: What is the average percentage level of performance fees in your Member State (this can be a general indication if you do not have precise figures)?

21. From the analysis of the responses, it appears that 20% is the average level of performance fees in the majority of jurisdictions. Some jurisdictions have a range that goes from 10% to 20%[68]. In two jurisdictions have been observed performance fee levels peaking at 30%.[69]

[61] IE
[62] SE, SK (technically the first one only exit)
[63] DE, EE, FI, IT, RO
[64] BE
[65] ES
[66] AT
[67] FR
[68] FI, FR, IS
[69] AT, EE

IX. Annex V: Draft Guidelines on performance fees in UCITS

Table of Contents

1. Scope

Who?

1. These guidelines apply to management companies as defined under Article 2(1)(b) of the UCITS Directive and competent authorities. They also apply to investment companies that have not designated a management company authorised pursuant to the UCITS Directive.

What?

2. These Guidelines relate to performance fees in UCITS.

3. They apply primarily in relation to Article 14 of the UCITS Directive as further specified by Article 22 of Commission Directive 2010/43/EU. They also apply in relation to Article 78 of the UCITS Directive as also further specified by Articles 10, 12 and 14 of Commission Regulation (EU) No 583/2010 and in relation to Article 69 of the UCITS Directive.

When?

4. These guidelines apply from [dd month yyyy].

2. Legislative references, abbreviations and definitions

Legislative references

AIFMD	Directive 2011/61/EU on Alternative Investment Fund managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.[70]
ESMA Regulation	Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.[71]
KIID Regulation	Commission Regulation (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website.
UCITS Directive	Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).[72]
UCITS Level 2 Directive	Commission Directive 2010/43/EU implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company.[73]

[71] OJ L 331, 15.12.2010, p. 84.
[72] OJ L 302, 17.11.2009, p. 32.
[73] OJ L 176, 10.7.2010, p. 42–61

UCITS Level 2 Regulation	Commission Delegated Regulation (EU) 2016/438 supplementing Directive 2009/65/EC of the European Parliament and of the Council with regard to obligations of depositaries.[74]

Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
ESFS	European System of Financial Supervision
ESMA	European Securities and Markets Authority
IOSCO	International Organisation of Securities Commission
NAV	Net Asset Value
NCA	National Competent Authority
UCITS	Undertaking for Collective Investments in Transferable Securities

Definitions

benchmark	A market index against which to assess the performance of an investment fund.
crystallisation period	The period during which the performance fee, if any, is accrued and at the end of which it becomes payable to the management company.
excess performance	The difference between the net performance of the portfolio and the performance of the benchmark.
fulcrum fee	A type of performance fee. When a fulcrum fee is used the level of the fee increases or decreases proportionately with the investment performance of the fund over a specified

[74] OJ L 78, 24.3.2016, p. 11–30

	period of time in relation to the investment record of an appropriate securities index. This means that a fulcrum fee can be negative, and thus deducted from the basic fee charged to the investment fund.
fund	A collective investment undertaking subject to the requirements of the UCITS Directive.
High-Water Mark (HWM)	The highest Net Asset Value per share or unit.
High-Water Mark (HWM) model	A performance fee model whereby the performance fees are payable on the basis of achieving a new High-Water Mark. The initial offer price should be taken as the starting price for the calculations (i.e. performance fees should be payable based on the subsequent outperformance by the net asset value per share of the initial offer price).
hurdle rate	A predefined minimum rate of return.
management company	Management companies (as defined in Article 2(1)(b) of the UCITS Directive) and investment companies that have not designated a management company authorised pursuant to the UCITS Directive.
performance reference period	The time horizon over which the performance is measured and compared with that of the reference indicator.
reference indicator	The parameter against which the relative performance of the fund will be measured. This can be a market index or a target return.

3. Purpose

5. These guidelines are issued under Article 16 (1) of the ESMA Regulation. The purpose of these Guidelines is to establish consistent, efficient and effective supervisory practices within the ESFS and to ensure the common, uniform and consistent application of Union law. Their objective is to promote greater convergence and standardisation in the field of performance fees and promote convergent supervision by NCAs. In particular, they aim at ensuring that performance fee models used by the UCITS management companies comply with the principles of acting honestly and fairly in conducting their business activities and acting with due skill, care and diligence, in the best interest of the UCITS they manage, in such a way as to prevent undue costs being charged to the UCITS and its unit holders. Also, they aim at establishing a common standard in relation to the disclosure of performance fees to investors.

4. Compliance and reporting obligations

Status of the guidelines

6. In accordance with Article 16(3) of the ESMA Regulation, competent authorities and financial market participants must make every effort to comply with these guidelines.

7. Competent authorities to which these guidelines apply should comply by incorporating them into their national legal and/or supervisory frameworks as appropriate, including where particular guidelines are directed primarily at financial market participants. In this case, competent authorities should ensure through their supervision that financial market participants comply with the guidelines.

Reporting requirements

8. Within two months of the date of publication of the guidelines on ESMA's website in all EU official languages, competent authorities to which these guidelines apply must notify ESMA whether they (i) comply, (ii) do not comply, but intend to comply, or (iii) do not comply and do not intend to comply with the guidelines.

9. In case of non-compliance, competent authorities must also notify ESMA within two months of the date of publication of the guidelines on ESMA's website in all EU official languages of their reasons for not complying with the guidelines.

10. A template for notifications is available on ESMA's website. Once the template has been filled in, it shall be transmitted to ESMA.

5. Guidelines on performance fees

Guideline 1 - Performance fee calculation method

11. The performance fee calculation method should include, at least, the following elements:

a) the **reference indicator** to measure the relative performance of the fund. This reference indicator can be an index (*e.g.* Eonia, Eurostoxx 50, etc.), a HWM or a hurdle rate (2%);[75]

b) the **crystallisation period** within which the performance fee, if any, is accrued and a **crystallisation date**, coinciding with the end of the crystallisation period, at which the performance fee is crystallised and credited to the management company;

c) the **performance reference period** at the end of which the mechanism for compensating for past underperformance or negative performance can be reset;

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** enabling 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 (eg: if the fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

12. 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.

13. A management company should always be able to demonstrate how the performance fee model of a fund it manages constitutes a reasonable incentive for the manager and is aligned with investors' interests.

14. The performance fee provisions should be allocated and reversed in a symmetrical way. For example, it should not be possible to apply simultaneously an allocation rate

[75] For the avoidance of doubt, a flat-rate performance fee may be applied (for example, X% performance fee charged on any performance achieved or performance achieved above a certain threshold).

(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).

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

15. The management company should ensure the performance fee model is consistent with the fund's investment objectives, strategy and policy.

16. In assessing consistency between the performance fee model and the fund's investment objectives, strategy and policy, a management company should check:

    a) whether the chosen performance fee model is suitable for the fund given its investment policy and strategy. For instance, for funds that pursue an absolute return objective, a HWM model or a hurdle is 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, a HWM model for an absolute return objective, might need to include a hurdle to align the model to the fund's risk-reward profile;

    b) whether, for funds that calculate 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 aims and the chosen benchmark. 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.

17. Where performance fees are payable on the basis of out-performance of a benchmark (e.g. "Eurostoxx 50 + 3%", "Eonia", etc.), the management company should ensure that the benchmark is consistent with the investment policy and strategy of the fund. For instance, it might not be appropriate to take a reference indicator that would set a systematically lower threshold for fee calculation than the actual benchmark (e.g. computing performance fees based on "Eurostoxx -1%" where the objective of the fund is "Eurostoxx"). Where the calculation of the performance fee is based on a fulcrum fee model, the performance fee should be based on the same benchmark used to determine excess performance.

18. In all cases, the excess performance should be calculated net of costs.

Guideline 3 - Frequency for the crystallisation of the performance fee

19. The frequency for the crystallisation and the subsequent payment of the performance fee to the management company 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. The manager's performance should be assessed and remunerated on a time horizon that is, as far as possible, consistent with the investors' holding period.

20. The crystallisation period should not be shorter than one year. Generally, it should end either on 31 December or at the end of the financial year of the fund.

21. The minimum crystallisation period should not apply to the fulcrum fee model, as the characteristics of this model are not compatible with a minimum crystallisation period.

Guideline 4 – Negative performance (loss) recovery

22. A performance fee should only be payable 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.

23. The performance fee model should be designed to ensure that the fund manager is not incentivised to take excessive risks and that cumulative gains are duly offset by cumulative losses.

24. Where a fund utilises a HWM, it should only be reset where during the performance reference period (i) the new HWM exceeds the last HWM or (ii) the fund has undergone significant structural changes. For the purpose of resetting the HWM, a performance reference period should be defined.

25. The performance reference period should not apply to the fulcrum fee model, as in this model the level of the performance fee increases or decreases proportionately with the investment performance of the fund.

Guideline 5 - Disclosure of the performance fee model

26. Investors should be adequately informed about the existence of performance fees and about their potential impact on the investment return.

27. The prospectus and, if relevant, any *ex-ante* information documents as well as marketing material, should clearly set out 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. The prospectus should include concrete examples of how the performance fee will be calculated to provide investors with a better understanding of the performance fee model.

28. In line with the principles set out in Guideline 1, the main elements of the performance fee calculation method should be indicated.

29. The KIID should clearly set 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.[76]

30. The annual and half-yearly reports and any other *ex-post* information should indicate, for each relevant share class, the impact of the fees over the crystallisation period, by clearly displaying: (i) the actual amount of performance fees charged and (ii) the percentage of the fees based on the share class NAV.

Transitional provisions

31. Any new UCITS created after the date of application of the Guidelines that includes a performance fee, or any existing UCITS at that date that introduces a performance fee for the first time after that date, should comply with the Guidelines immediately.

32. Existing UCITS that already operated a performance fee before the application date of the Guidelines should align their procedures with the guidelines within 12 months of the application date of the Guidelines.

[76] See Section II Key Investor Information Document (KIID) for UCICTS, 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