ESMA Guidelines on performance fees in UCITS and certain types of AIFs

Executive Summary

The European Securities and Markets Authority ("**ESMA**") published its final report on the guidelines on performance fees in UCITS and certain types of AIFs on 3 April 2020 (the "**Guidelines**").

The Guidelines apply to management companies of undertakings for collective Investments in transferable securities ("**UCITS**") and to alternative investment fund managers ("**AIFM**" and together with the UCITS management companies, the "**Managers**") that manage alternative investment funds ("**AIF**" and together with the UCITS, the "**Investment Funds**"), which are marketed to retail investors.

The Guidelines do not apply to:

a) Closed-ended AIFs; and

b) Open-ended AIFs that are European Venture Capital Funds (EuVECA) (or other types of venture capital AIFs), European Social Entrepreneurship Funds (EUSEF), private equity AIFs or real estate AIFs.

Although delegate investment managers appointed by a Manager do not fall within the scope of the Guidelines, it seems likely that the *Commission de Surveillance du Secteur Financier* ("**CSSF**") will also indirectly apply the Guidelines to investment managers (irrespective of their domicile) that perform the portfolio management function for Luxembourg Investment Funds that are charging a performance fee, in order to avoid any circumvention of the present rules.

In Luxembourg the Guidelines therefore applies to open-ended investment funds established pursuant to part II of the law dated 17 December 2010 on undertakings for collective investment ("**Part II Funds**"), specialised investment funds ("**SIF**"), investment companies in risk capital ("**SICAR**"), reserved alternative investment funds or other AIFs which allow an investment of non-professional investors and therefore must issue a key information document for packaged retail and insurance-based investment products ("**PRIIPs KID**").

A great number of Luxembourg AIFs will therefore be out of scope of the Guidelines as they are closed-ended and/or do not allow for retail investors. It is more likely that UCITS management companies or AIFs that invest into securities (such as for example hedge funds set up as Part II Funds) are more immediately concerned by the Guidelines.

I. Effective date

The Guidelines apply two (2) months after the date of the publication of the Guidelines on the webpage of ESMA in all official languages of the EU. So far, the Guidelines have not been translated (the "**Application Date**"). This concerns Managers intending to launch new Investment Funds or Managers of existing Investment Funds who intend to introduce a performance fee for the first time.

A grandfathering period applies for Managers of Investment Funds with a performance fee existing before the Application Date. In this case the Guidelines apply by the beginning of the financial year following six months from the Application Date. By way of example, if the Application Date is 15 July 2020, the Managers will have to comply with the Guidelines by the beginning of 2022 if the financial year of the Investment Fund corresponds to the calendar year.

II. Performance fee calculation method

The calculation of a performance fee should be verifiable and not able to be manipulated. It should at least include the following elements:

a) the reference indicator against which the relative performance of the Investment Fund will be measured (the "**Reference Indicator**"), such as an index, a High-Water Mark (i.e. the highest net asset value per share or unit ("**NAV**")), a hurdle rate (i.e. a predefined minimum fixed rate of return) or a combination thereof;

b) the crystallisation frequency at which the accrued performance fee, if any, becomes payable to the manager and a crystallisation date at which the performance fee is credited to the manager

c) the performance fee reference period which is the time horizon which the performance is measured and compared with that of the Reference Indicator, at the end of which the mechanism for the compensation for past underperformance (or negative performance) can be reset;

d) the performance fee rate which is the rate of performance fee which may be applied in all models;

e) the performance fee methodology defining the method for the calculation frequency of the NAV (e.g. if the Investment Fund calculates its NAV daily, the performance fee should be calculated and accrued in the NAV on a daily basis).

III. Negative performance

A performance fee should only be payable in circumstances where positive performance has been accrued during the Performance Reference Period. However, a performance fee could be payable in case the Investment Fund has over performed the benchmark, but had a negative performance. In such a case, a prominent warning will need to be provided to the investors and to be included in the Key Investor Information Document ("**KIID**") or PRIIPs KID.

IV. Disclosure of the performance fee model

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

The prospectus (and any marketing material provided to the investors before subscription) should clearly set out all information to enable the investors to properly understand the performance fee model by indicating the main elements of the performance fee mentioned in section II above.

In addition, the KIID or PRIIPs KID respectively should clearly describe the existence of the performance fee, the basis on which said fee is charged and when the fee applies.

The annual and semi-annual reports of the Investment Funds should indicate for each relevant share/unit class (i) the actual amount of performance fee charged and (ii) the percentage of the fees based on the share/unit class NAV.

V. Consequences

Taking the effective date explained in section I above into account, Managers and boards of Investment Funds will have to assess their current performance fee model(s) as well its computation methodology and review the prospectuses and the KIIDs and/or PRIIPs KIDs in order to assess any required amendments thereto.

In case there is need for amendments of such documents, they will have to be updated accordingly. For Investment Funds subject to CSSF supervision (UCITS, Part II Funds and SIFs mainly), an approval process with the regulator will need to be conducted. Also, a notice period and the option to redeem their units may have to be granted to investors before the new provisions can become effective, which may impact the timeline for compliance with the Guidelines further.

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