

Guidelines on performance fees

What are the consequences for fund managers?

By Marie-Thérèse WICH, Lawyer, Senior Associate – GSK Stockmann

In return for a positive performance of the portfolio management function, investment fund managers frequently charge a performance fee to the investment funds they manage. In this respect, discussions have taken place, also involving national financial supervisory authorities, about the balance between such performance fee and investor protection rules. As a consequence, the European Securities and Markets Authority ("ESMA") reviewed current performance fee models and recently issued final guidelines for the purpose of harmonizing the interests of fund managers and investors, which apply from 6 January 2021.

On 5th November 2020, ESMA published its guidelines on performance fees in UCITS and certain types of AIFs on its website ("Guidelines"), translated into all official languages of the member states of the EU. The final report on the Guidelines had already been published by ESMA on 3 April 2020 and since that date, Luxembourg investment fund managers expected the publication of the translated Guidelines in order to know when they would enter into force, which would be two months following their publication.

During this two-months transition period, the CSSF has to declare to ESMA if in Luxembourg, it will comply with the Guidelines, which the regulator is expected to confirm.

So far, it has been market practice that a management company, an alternative investment fund manager or a delegate portfolio manager charges a fixed remuneration for its services as well as a variable remuneration for a successful active portfolio management, the so-called "performance fee".

No concrete and binding legal provision in Luxembourg or on a European level existed for the calculation of the performance fee, except for some policies applied by some national supervisors. The law of 17 December 2010 relating to undertakings for collective investment, as amended ("Law of 2010") contains some general principles for the performance fee but not detailed provisions⁽¹⁾.



Guidelines mainly apply to UCITS funds, most AIFs are excluded

Going forward, the Guidelines will restrict the scope and application of performance fees charged by investment fund managers within the EU. In Luxembourg, the Guidelines are addressed to management companies in the sense of the Law of 2010, to alternative investment fund managers and to delegate portfolio managers. It also applies to investment advisors in case they receive a performance fee for their services.

Besides UCITS, the Guidelines apply to open-ended alternative investment funds which are sold to retail investors and are not EUVECA or invest in private equity, venture capital or real estate. Consequently, it is mostly UCITS funds and so called Part II funds of the Law of 2010 which are concerned by the Guidelines.

Detailed performance fee calculation model – to be disclosed in the fund documentation

The new Guidelines contain different elements which shall in future be part of the performance fee calculation of a fund manager charging a performance fee to an investment fund or a sub-fund or share class of an investment fund. Any performance fee calculation has to include a reference indicator such as an index or a hurdle rate for measuring the relative performance of the fund. In addition, a crystallisation frequency and a crystallisation date have to be determined. The third part of the calculation method defined by the Guidelines is a performance fee reference period which should correspond to either the term of the fund or a period of at least

five years. In addition, the performance fee rate, any specific methodology and computation frequency - which should be in line with the calculation frequency of the net asset value of the relevant fund - should be part of the performance fee calculation model. Furthermore, the Guidelines refer to a consistency which is expected to exist between the performance fee model and the fund's investment strategy. In case of a negative performance, the ESMA Guidelines stipulate that a performance fee can still be charged in case of an overperformance by the investment fund, and if a prominent warning is added to the fund documentation.

Therefore, with regard to existing investment funds, the prospectus and the key investor document (UCITS or PRIIP KIID) have to be amended. This has to be done at the beginning of the financial year six months after the entering into force of the Guidelines. In case the financial year of the investment fund corresponds to the calendar year, the Guidelines will apply as of 1 January 2022. For newly established investment funds, the performance fee rules apply immediately.

Consequences

It can be expected that many investment fund managers in Luxembourg have to adapt their performance fee calculation, and that consequently the fund documentation will also have to be amended. This is likely to result in additional costs, and also approval procedures with the CSSF which will need to be conducted.

On a positive note, the Guidelines could lead to more investor protection and create a level playing field in all EU member

states, avoiding problems in the cross-border distribution. Over the last years, there were cases where a Luxembourg investment fund had been notified for marketing purposes to another European member state, and that during this notification procedure, the financial supervisory authority of a host member state challenged the performance fee model as set out in the fund's prospectus.

The host member state claimed that the performance fee model defined in the fund documentation was not in line with its own national performance fee policy. Such refusal to admit the relevant fund for marketing does not comply with the notification procedure as defined by the relevant legislation, as the host authority is not competent for a legal review of the fund documents. Common rules in all member states should therefore avoid such situations and also avoid conflicts between the national supervisory authorities of the member states. Market participants also expect that the risk appetite of investment fund managers to earn a performance fee should be lowered as certain incentives of a performance fee will not exist anymore due to the different elements of the Guidelines.

Restrictions on performance fee models are not necessarily an advantage for service providers in Luxembourg

On the other side, the performance fee has always been a way for the management company as well as for the portfolio manager to be incentivised for a good performance, which is also aligned with investors' interests. It can recompense the special knowledge of a portfolio manager in a certain asset class. Such incentive will in future be restricted and might therefore attract less portfolio managers to offer their expertise to a Luxembourg investment fund. Brexit can make it even more complicated: Many portfolio managers from the UK could potentially be prevented from offering their services within the European Union when the transition period expires. A restrictive performance fee model would even make it less attractive for UK portfolio managers to continue to offer their services to investment funds based in Luxembourg.

The Guidelines have no legally binding effect like a European regulation or directive. It is still possible – albeit unlikely – that some member states will not comply with the Guidelines. Such member states could offer better options for portfolio managers or investment advisors to the benefit of a flexible performance fee policy.

Apart from that it should also be possible for investment fund managers to adapt their performance fee model to specific situations and investment policies of an investment fund. It has to be put into question if the new Guidelines can cover all those specific situations.

During the last years, performance fees charged by UCITS investment advisors have also been challenged. An investment advisor does not take any investment decisions but has a purely consultative role. The argument was that, as a matter of principle, the highest remuneration should be paid to the management company or the portfolio manager as the party responsible for taking any investment decision. This argument however does not reflect the entire reality, as frequently investment advisors not only provide a significant added value to the performance of a fund and are often the source of many investment opportunities, but in a considerable number of cases they also perform the largest part of the work (analytics, due diligences etc.) that is necessary for any investment decisions to be taken. To exclude such special expertise and work from a performance fee will be detrimental to the spread of know-how that investment funds can call upon.

Summary/ Outlook

In Luxembourg, the Guidelines on performance fees can be considered as an advantage for transparency purposes and investor protection. On the other side, such performance fee calculation rules also restrict the remuneration for the performance of portfolio managers with certain expertise. Luxembourg benefits from portfolio managers and investment advisors from other jurisdictions. Time will tell if the Guidelines have an impact on those foreign fund managers and their decision to offer their services in Luxembourg. An advantage for several investment fund managers will be that most AIFs are out of scope of the Guidelines.

As a consequence, AIFs can still apply their own, specific performance fee models without any further restrictions. This could, however, change in the near future in the context of the review of the AIFMD 2011/61/EU⁽²⁾. During its review, several involved parties like ESMA have discussed a harmonization of UCITS and AIF rules.

¹⁾ Article 111b of the Law of 2010.

²⁾ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulation (EC) No 1060/2009 and (EU) No 1095/2010.



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