Managed Funds Association

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Dear Sir or Madam,

AIMA and MFA comments on ESMA's consultation on UCITS performance fees guidelines

The Alternative Investment Management Association (AIMA)[1] and Managed Funds Association (MFA)[2] appreciate the opportunity to respond to the European Securities and Markets Authority (ESMA) regarding its public consultation on draft guidelines on performance fees under the Undertakings for Collective Investments in Transferable Securities ('UCITS') Directive.

We welcome ESMA's recognition and support for the variety of performance fee models and structures that may be used to create an incentive for the fund operator to optimise the performance of the fund for the benefit of the investor.

As acknowledged by ESMA in the consultation paper, we would emphasise that the UCITS Directive already requires Member States to ensure that a management company acts honestly and fairly

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage $400 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

[2] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market. This includes the prevention of undue costs being charged to the UCITS and its unit holders.

The overarching goal of performance fee guidelines should be appropriate transparency in the area of funds' performance fees to enable investors to select a fund with fees that they deem appropriate rather than introducing overly prescriptive standards. Moreover, it is important to emphasise that fee guidelines for UCITS should differ from any guidelines for non-UCITS products and those for sophisticated investors.

In general, we think that investment managers should continue to have the flexibility to utilise a performance fee model and structure that is appropriate to the fund strategy and investors' objectives. Prescribing standards that are too rigid may harm investors by limiting their choices or misaligning incentives, while imposing standards that are ill-defined might lead to after-the-fact second-guessing, which would expose investment managers to unnecessary compliance costs and potential legal and regulatory risks.

We believe that there needs to be flexibility around the models to match funds' different investment objectives, and acknowledgement that any principle of equality of treatment for investors needs to be appropriately balanced by the need for a robust, intelligible and easily verifiable methodology with minimal operational risk.

In order to achieve such flexibility, the guidelines should permit different types of performance fee calculation methodologies that match funds' different investment objectives, provided the performance fees are properly disclosed. For example, in the case of funds whose performance is measured by reference to an appropriate index or market and are relative (rather than absolute) return products, as sought by certain investors, we believe that UCITS should permit an investment manager to earn a performance fee if it outperforms the relevant index or market, even if in absolute terms the fund has negative returns. Similarly, a fund with positive absolute performance that underperforms an index would not result in performance fees to the manager. In such cases, performance relative to the index determines the fees.

We agree that high-level principles on performance fee methodologies are important and in the interest of retail investors. We would also highlight that UCITS are frequently sold to institutional investors and therefore reiterate the need for more flexibility when designing products for more sophisticated investors.

In relation to the specific questions of particular relevance to our members, we would like to highlight the following four points:

- multiple types of performance fee calculation methodologies, including relative performance fees, should be acceptable if they are properly disclosed to investors;

- flexibility in choosing a benchmark, or indeed having no benchmark, could still be in the best interest of investors and overly prescriptive guidelines may be detrimental for investors;

- the guidelines should not be extended to apply to performance fees in AIFs which are a different regulatory regime; and
- there should be flexibility for more frequent crystallisation than annual, e.g., if it is in the interest of investors or for technical reasons.

Our detailed responses to the questions are provided in the annex and in the relevant places in ESMA's online response form.

Finally, we would highlight that various national competent authorities ('NCAs') have already consulted on performance fees and have implemented regulations, e.g., Germany, Ireland and the United Kingdom. In our view, ESMA should encourage a principles-based approach consistent with the 'Good Practice for Fees and Expenses of Collective Investment Schemes' by the International Organization of Securities Commissions (IOSCO). Equally, we would be of the view that ESMA should ensure that any new guidelines be in the form of high-level principles that are adopted in a harmonised manner so as to preserve the integrity of the single market, especially where individual NCAs have already implemented regulations in this area which may not be consistent with the final ESMA guidance.

We would be happy to elaborate further on any of the points raised in this response. For further information, please contact James Delaney (jdelaney@aima.org) or Matthew Newell (mnewell@managedfunds.org).

Yours faithfully,

/s/ Jiří Król	/s/ Michael Pedroni
Jiří Król Deputy CEO Global Head of Government Affairs	Michael Pedroni Executive Vice President & Managing Director, International Affairs
Alternative Investment Management Association	Managed Funds Association

ANNEX

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

The overarching goal should be appropriate transparency in the area of funds' performance fees to enable investors to select a fund with fees that they deem appropriate rather than introducing overly prescriptive standards.

Prescribing standards that are too rigid may harm investors by limiting their choices or misaligning incentives, while prescribing standards that are ill-defined might lead to after-the-fact second-guessing, which would expose investment managers to unnecessary compliance costs and potential legal and regulatory risks. A requirement that sets a principle that the disclosure needs to be clear in a manner addressing the material facts about the operation of the performance fee model sets an appropriate balance between a requirement for disclosure and a basis for supervisory action without inadvertently limiting investor choice.

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

We do not think rigid fee standardisation is the right objective. Instead, we favour more transparency around how fees are calculated, providing investors with the ability to choose based on easy-to-compare information.

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 to ensure this consistency? Please provide examples and give reasons for your answer.

In certain cases, a benchmark unrelated to the strategy of the fund could still be in the best interest of the investor. As an example, we are aware of an investment manager of a managed futures UCITS that utilises leverage, in relation to which the manager applies a hurdle rate ('a predefined minimum rate of return') incorporating a benchmark to mitigate any performance fees being accrued for returns on excess cash. The fund is 80-90% cash (similar to many managed futures funds) and so would earn a performance fee on the 200bps+ that they hold in T-bills without a cash-linked hurdle. By having a hurdle rate tied to a cash benchmark this mitigates that return and benefits investors compared to a situation where a performance fee were based only on the return related to the underlying futures contracts. This particular approach is, however, different to the overall investment strategy that this manager deploys so it shows an example of where a benchmark seemingly unrelated to the strategy is still in the best interest of investors. An overly prescriptive rule here may be detrimental for investors.

An alternative suggestion may be to place an obligation on the management company to justify the suitability of the method for the strategy in question.

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.

In general, we cannot see any persuasive rationale for mandating the timing (i.e., as of 31 December) of annual crystallisation. There are cost and efficiency savings for firms to be able to have a performance year end other than as of 31 December. By way of example, we are aware of a number of investment managers whose performance year end is 30 September. The performance fee year end generates additional work for the administrator and manager of the fund and some managers deliberately time it so that it does not coincide with other busy times, i.e., calendar year end. This saves money and creates efficiencies for the fund and investment manager and it has no detrimental impact on the fund.

As regards the frequency of crystallisation, there should be flexibility for more frequent crystallisation than annual. For instance, there should be technical exceptions. The obvious one is to allow shorter crystallisation periods for the first (part) year of a class' launch. The frequency point can also relate to the liquidity of the investment strategy and the assets it uses. Thus, a more liquid strategy could have more frequent periods.

We note also that any minimum crystallisation period should not be keyed to each individual subscription or investor as, for example, this would result in substantial additional operational costs for the fund and its investors, as described in response to Question 8.

Furthermore, if the standard references a holding period, it should not mean until an investor actually redeems, but should rather be linked to allowable redemption periods and underlying investment strategy. Investors may choose to invest in even the most liquid of funds for many years if they are satisfied with its performance. That does not mean that the investment manager should not realise performance fees it has earned.

In our view, it is critical to ensure that the performance reference period is consistent with the crystallisation frequency and linked to the adjustment of the high-water mark (HWM). The better these are aligned, the greater the chance of ensuring equity between the different cohorts of investors and ensuring alignment with the incentives for the investment manager.

The longer the reference period, the greater the likelihood of instances of performance fee 'free rides' and different experiences by otherwise similar investors i.e., when new investors enter into a fund during periods when the NAV is below the HWM. Those new investors will not be charged performance fees until the fund has reached level which is above its HWM. The problem also arises when subscriptions are made above the HWM. Reference periods longer than one year can appear to have the attraction of facilitating better evaluation of outperformance by the manager over the cycle, but they also indirectly require movement towards measuring performance fees at the individual investor level, e.g., to ensure the fees are fairly allocated between each investor in the fund which may be impractical for some funds and unworkable for some investors. This is particularly the case where there are funds with thousands of individual investors or with large holdings by private wealth management investors who may not be able to manage operationally the complexities of investor level performance fee accounting adjustments.

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.

We agree that 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.

In relation to a minimum crystallisation period and its application to HWM models, we believe that funds that utilise HWMs should be permitted to crystallise performance fees more frequently than annually since investors will have a chance to earn back losses through better performance. The frequency of the crystallisation period should not be the only factor in the alignment of interests between the investment manager and the investors. There are different tools to be used which can be combined in different ways to achieve alignment in a way that works for the particular strategy. In all cases, the setting of the performance fee model should be clearly disclosed to investors.

Q6 In your view, should performance fees be charged only when the fund has achieved absolute positive performance? What expected financial impact 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?

Guideline 4 states that "a performance fee should only be payable in circumstances where positive performance has accrued during the performance period" – i.e. only in periods of positive performance. We disagree with this premise. Many funds are designed to outperform a particular market (e.g. equities) or to track an index and the funds' performance fees are earned based on performance relative to that market or index, not absolute performance. If the fund achieves returns in excess of the relevant market or index, even if absolute returns are negative, the investment manager earns a performance fee. Similarly, if the fund earns returns below the relevant market or index, even if the returns are positive in absolute terms, no performance fee is earned.

For example, the performance fee for some UCITS, such as those that pursue an equity strategy (either long only or long/short) and whose performance is measured against an equity benchmark, may employ a hurdle rate model (rather than, or in addition to, a HWM), which provides that a performance fee can be payable in circumstances of negative performance provided that outperformance of the relevant hurdle (e.g., a benchmark) is achieved. From an investor perspective, the potential payment of a performance fee in periods of negative performance is considered reasonable due to the nature of the product as an equity investment, i.e., as a relative return, not absolute return, product.

Moreover, the investment manager of a relative (benchmark hurdle) performance fee product is no more incentivised to take excessive risk than the manager of a HWM performance fee product.

In other words, if an investment manager's investment performance is measured by reference to an index (i.e., runs with a target beta of 1 to the index with some targeted excess return) and that index is used to calculate performance fees then, even if there are negative returns, if the fund outperforms the relevant index, alpha/outperformance has been generated for the investors and the manager should be able to earn a performance fee. In this way, if an index goes down -10% and the fund only goes down -4%, then the investment manager has benefited the investor.

Moreover, in the event that a "positive performance" requirement were implemented, we believe that certain firms may discontinue the performance fee option in their funds in favour of management fee-only options or discontinue offering certain types of funds altogether, which could harm investors both by reducing their choices and in absolute terms by creating a potentially more expensive product.

Furthermore, consideration needs to be given to the fact that an asset portfolio is part of a wider asset allocation strategy where preservation of capital in down markets is a critical component of such asset allocation strategies. Inclusion of an "absolute positive performance" provision could act as a potential distraction for management companies pursuing a long-term investment strategy which likely would include periods of down markets. Focus on short-term measures moves the incentive to the management company away from being fully aligned with the fund objective and policy.

Accordingly, as long as performance fees of this type are clearly disclosed to investors, we believe they should continue to be permitted.

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.

We are in favour of any proper disclosure addressing enough information to the investors to orientate their choice. This does include the prospectus as well as the marketing documents.

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

In order to assess the appropriateness of the performance fee method and alignment with the investment objectives and strategy of the fund, all the components of the calculation method need to be examined in aggregate. Maintaining flexibility for the management company to set different reference periods (together with the other method criteria) for different funds provides increased scope for management companies to define the method appropriate to the different characteristics of the fund or investor base, i.e., asset class, recommended holding period, actual holding periods or investor turnover, investor type (retail vs institutional). The introduction of a predefined reference period also reduces scope for arbitrage between management companies on this point.

The following are observations on longer reference periods:

(i) the longer the reference period, the greater the likelihood of instances of performance fee ‘free rides’ and different experiences by otherwise similar investors;

(ii) a permanent HWM mechanism or a three to five year reset period can lead to increased risk exposure, especially if the fund's share price is well below the HWM. This could actually lead to misalignment with the fund’s investment objectives incentivising the management company to take excess risk to recoup prior losses;

(iii) a HWM from inception or predefined one would also rule out the ability to reset the reference period in other circumstances, e.g., the replacement of a sub-investment manager who has incurred absolute losses on the fund. Without a reset or with a long reference period, this could also hinder the management company in appointment of a new sub-investment manager;

(iv) therefore, from an economic point of view, the liquidation of such a fund and a new launch of a similar product might be the sensible measure for an asset manager. Such measure is not necessarily in the interest of the investors, incurring liquidation cost and realisation of losses;

(v) increased reference periods reduce the comparability of funds’ performance and cost; funds may have outperformed over a three or five year period but not incurred performance fees, due to older historical losses.

A one-year reference period offers simplicity and clarity being fully aligned with the spirit of MiFID II which has introduced once a year reports on all charges and costs.

While crystallisation periods of one year have become the norm, requiring a longer reference period would increase the complexity of calculations, costs in administration and risks of calculation error. There is the further complication of no generally accepted practice on the application of longer reference periods, e.g., three-year reference period being current one-year crystallisation period plus underperformance of prior two years or rolling three year period (start date of reference period changing throughout the year).

Furthermore, when examined from a fund administrator’s perspective, the proposal to apply a performance reference period based on the holding period of the investors would be akin to requiring performance fees to be calculated at the investor level. Thus, significant additional development would be required to facilitate this and it brings with it significant operational risk.

Alternatively, a NAV-based performance fee methodology could be used in conjunction with a longer reference period provided that the reference period is calculated at the share class level and not at the investor level. This would facilitate annual crystallisation of performance fees, and the resetting of a HWM every x number of years, but would be executed in a less administratively complex manner.

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.

We believe that this is impractical for the reasons articulated above. It only works where there are a very small number of investors in the fund.

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.

For index tracking funds, the performance reference period for performance fee is based on the performance of index during that same period, e.g., on a quarterly basis.

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.

We believe that they should be the same as consistency is critical.

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?

We would submit that there should be a minimum 18-24 months transition period from the date of publication of the Guidelines to the effective date of application. This will give investment managers sufficient time within which to make the necessary modifications to their performance fee models and make any necessary notifications to investors.

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.

Performance fees for AIFs should also be designed with regard to IOSCO principles. However we do not think that ESMA should be extending these guidelines to AIFs which are a different regulatory regime.

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.

We would state that any such change will undoubtedly incur additional costs, as additional guidelines will require additional compliance, operational and legal work.

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.

We think that these models should be permissible.

It is critical that the performance fee method needs to be consistent with the investment objective so that genuine outperformance is rewarded as well as ensuring alignment of interests between investor and investment manager alike.

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.

The provision envisaged in Guideline 1, paragraph 12 which in essence requires a reference asset methodology would entail very significant implementation cost for fund administrators, as well as being very challenging to explain to retail investors.

Guideline 1, paragraph 12 provides that the fee calculation method should be designed to ensure that performance fees are always proportionate to the actual investment performance of the fund and that “artificial increases resulting from new subscriptions should not be taken into account when calculating fund performance”. However, this is a performance fee methodology adopted by a majority of UCITS in Ireland and it is also common practice in other jurisdictions. The simple formula is as follows:

Outperformance per unit x Number of units at end of performance fee period x Performance fee rate.

The above formula will not be in compliance with the proposed Guideline 1, paragraph 12, because the fee increases as the number of units increases (with the outperformance per unit remaining constant). While such a methodology may achieve greater equity between different generations of investors, it is significantly more complex from an administration point of view, more likely to result in calculation error and also much more difficult to explain to unitholders. Furthermore, we would submit that the degree of equity achieved by the methodology as between different generations of unitholders is marginal given the conditions that need to be satisfied in this approach, as against the current, more simplified approach.

These conditions include extreme levels of outperformance of the fund coupled with material, rapid growth of the fund. It should also be noted that the current approach is overall more favourable to investors than the management company even if not quite as equitable as between different generations of investors. Overall, it is important to find a balance between the competing goals of transparency, cost, the pursuit of an individual performance fee methodology and reduction of calculation error risk.

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.

Any performance fee methodology should be designed to remunerate investment managers for positive performance or outperformance and designed as far as possible so that the investment manager has to make good negative performance or underperformance before being able to receive future positive performance. However, ESMA should not be prescriptive about how the performance fee methodology is designed.

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.

The proposed Guideline may result in some investment managers either increasing their management fees or closing funds. In particular, the inability to earn a performance fee when absolute performance is negative would mean that some funds would no longer be commercially viable.

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.

On Guideline 5, we would agree that the prospectus should include appropriate detail to enable a prospective investor to understand the proposed fee structure. This does become harder for more complex fee models where the exact methodology will be agreed via a spreadsheet example which the prospectus may talk to.

We believe that the requirement for concrete examples of how the performance fee will be calculated is superfluous and would create additional and unnecessary drafting.

A KIID should clearly set out the existence of any performance fee bearing in mind the size limits of the KIID it would be impractical to set out any detailed calculation methodology.