THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

CONSULTATION PAPER
GUIDELINES ON PERFORMANCE FEES IN UCITS

RESPONSE FROM THE INVESTMENT ASSOCIATION

31 OCTOBER 2019

GENERAL COMMENTS

1.1 The Investment Association[1] (IA) welcomes the opportunity to comment to the proposed guidelines on performance fees in UCITS. The IA strongly supports the need to provide full transparency and the meaningful disclosure of all cost and charges.

1.2 There are a number of methodologies for performance fees with numerous possible variations in the detailed operation of even seemingly similar methodologies. No single method can be said to be universally superior and it is for the manager to select and design the approach most appropriate to the particular circumstances.

1.3 The key to an equitable performance fee model is the alignment of the interests of the investor and the manager. The design of a good fee model incorporating a performance fee element requires the various options and techniques to be carefully selected and tested in order to understand their complex interactions.

1.4 It is essential that a manager establishes robust and effective product governance and target market structures to ensure performance fee models are well-designed, tested, documented and implemented. Strong oversight is essential to building a good performance fee model with high levels of operational resilience.

COMMENTS ON THE SPECIFIC QUESTIONS RAISED

Q1. DO YOU AGREE THAT GREATER STANDARDISATION IN THE FIELD OF FUNDS' PERFORMANCE FEES IS DESIRABLE? WHAT SHOULD BE THE GOAL OF STANDARDISATION?

1.5 Standardisation is desirable only in so far as it creates equivalent levels of investor protection and ensures a level playing field for cross border distribution. In this respect, consideration should be given to the investor type. The level of protection necessary for the mass retail market is very different to professional investors who should be able to engage with and understand more innovative performance fee structures.

1.6 Care should be taken not stifle innovation or force legitimate existing performance fee models to be rebuilt in the quest for standardisation.

Q2 ARE THERE ANY OBSTACLES TO STANDARDISATION THAT COULD BE REMOVED BY REGULATORY ACTION? PLEASE ELABORATE.

1.7 No comments

[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage nearly €8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. More information can be viewed on our website.

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.

1.8 For absolute return funds which are not making use of a benchmark, performance fees should be related to monetary indices or monetary rate indices, by setting a reference to monetary rate plus a spread which should be consistent with the return objective.

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.

1.9 Guideline 3 conflates a number of features of a performance fee arrangement. The first part of guideline 3.19 is concerned with the alignment of interests between the manager and the investors and the fair treatment amongst incoming, ongoing and outgoing investors. This is an essential overarching principle that should apply to all aspects of the performance fee model, not just crystallization, and therefore should be the first part of guideline 1.

1.10 We do not agree with the second part of guideline 3.19 concerning the link between the investors holding period and the performance fee assessment period. We believe that in this instance the crystallization period has been confused with the performance reference period. The crystallization period is simply a tool for defining the frequency of performance fee payments from the fund to the manager. It is a mere technical feature, as the performance fee due is accrued at each valuation point. Alignment of the performance fee model with the investors' holding period would be achieved by means of the performance reference period ie. the period at the end of which past underperformance can be reset.

1.11 For a typical retail fund with daily dealing every investor will have a different holding period and this cannot be reflected in the assessment period. The fair treatment of investors is achieved by ensuring that the correct performance fee accrual is reflected in the NAV every day in accordance with guideline 1.11(f) and therefore the second part of guideline 3.19 should be deleted.

1.12 In general, we agree with a minimum crystallization period of one year as set out in the first part of guideline 3.20 but this should be subject to a number of exceptions:

- It should be possible to crystallize a performance fee on redemptions during the year. Redeeming investors experience the performance fee through the accrual in the NAV and it is fair that this is then paid to the manager. Failure to crystallize this part of the accrual will cause it to transfer to the ongoing investors resulting an unfair reduction in the value of their investment.
- Typically a performance fee exists alongside a fixed rate ad valorem management fee. However, examples exist of performance fee arrangements with no other form of remuneration being payable to the manager. In such instances it may not be viable for the manager not to receive any remuneration for a whole year. In such an arrangement it would be appropriate for more frequent crystallization to take place.

- It should be possible to operate a shorter crystallization period when a fund or share class is launched or closed.

1.13 We do not agree with the second part of guideline 3.20 which restricts the crystallization period to the fund's financial year or the calendar year. In terms of investor protection, the date on which the crystallization period ends is entirely arbitrary and inconsequential. Therefore there is no purpose in referring to it in the guidelines and it should be deleted. We are aware, for example, of crystallization periods being aligned with the management company's financial year in order that the revenue received from a performance fee can be recognized (accounting standards to do allow recognition of contingent income, so an accrued but not crystallized performance fee cannot be recognized).

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.

1.14 No comments

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?

1.15 In relation to the first part of guideline 4.22 it is not inherently unfair to charge a performance fee in a period where there has been negative performance. The manager may have outperformed a falling market and therefore protected the investors from larger losses. Subject to appropriate disclosures being made, guideline 4 should permit a performance fee to be paid where performance exceeds the benchmark return, even if negative on absolute basis. Managers should have the flexibility to assess whether the structure of their performance fee is appropriate for their target market in order to ensure it is perceived as fair. They might reach different conclusions where the performance fee is applied to mass retail or professional investors.

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.

1.16 We agree that disclosure should be made. It should be part of the documentation of the performance fee model included in the prospectus. The space available in the KIID/KID means only the most basic details can be accommodated and it will be necessary to signpost the location of a more detailed explanation. The risk of outcomes arising in various specific conditions, such as negative absolute returns while outperforming a falling market, will generally be a level of detail for the prospectus rather than the KIID/KID.

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.

1.17 The high water mark concept is fair to all interested parties. However, there are situations when it might be appropriate to be able to reset the high water mark.

1.18 If a fund has underperformed the manager might decide to replace the portfolio manager. If the fund is considerably below its high water mark then there is little prospect of earning a performance fee in the foreseeable future. This might make it difficult to attract a top quality portfolio manager to take on the fund. In this instance it might be in the best interests of investors to replace the portfolio manager and reset, or partially reset, the high water mark.

1.19 If there has been a slump in markets, a fund may have little prospect of recovering the level of its high water mark. UK markets took 15 years to return to the levels attained at the end of 1999, when the FTSE 100 reached 6,950. However, newer funds would be unconstrained by such unrealistic targets and top portfolio managers might be attracted to the prospect of participating in the profits of new funds rather than running older funds with unattainable high water marks. It might be in the best interests of investors if there was a facility for the Manager to reset the high water mark in response to such extreme circumstances.

1.20 An alternative to forgiving poor performance by resetting the high water mark is to use a rolling high water mark in which only the oldest underperformance is forgiven each year.

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.

1.21 We support the idea of a minimum period during which a high water mark cannot be reset but we prefer qualitative criteria to a fixed length of time as the determinant of a reset. If the period is too short and the high water mark can be routinely reset there would be a dilution the protection provided by the high water mark.

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 IN ORDER TO BETTER ALIGN THE INTERESTS OF FUND MANAGERS AND INVESTORS.

1.22 In our view, the appropriate minimum period depends on the interaction with other features of the performance fee model, such as whether the minimum period is coupled with qualitative criteria as envisaged in guideline 4.24. This should be at least three years and may be longer depending on the circumstances. This is in line with the average investor holding periods (median and mode) according to analysis carrying out by one of our members.

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.

1.23 We see no purpose in aligning the crystallization period with the performance reference period. The crystallization period is simply a tool for defining the frequency of performance fee payments from the fund to the manager. It is a mere technical feature, as the performance fee due is accrued at each valuation point. Alignment of the performance fee model with the investors' holding period would be achieved by means of the performance reference period ie. the period at the end of which past underperformance can be reset.

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?

1.24 Performance fees are complex and their implementation requires significant testing. Similarly re-calibration of the performance fee parameters will create a significant piece of work for firms. Implementation can only take place from the beginning of a new performance assessment period. Therefore, in our view, there should be a period of 12 months before the start of the period to which the guidelines will apply in order to re-design, test, document and implement the new arrangements thoroughly.

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.

1.25 No comments

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.

1.26 No comments

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.

1.27 It should be permissible for absolute return funds to operate performance fees linked to cash rates such as EONIA.

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.

1.28 No comments

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.

1.29 No comments

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.

1.30 No comments

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.

1.31 No comments