Response Form to the Consultation Paper

Guidelines on performance fees in UCITS

16 July 2019 ESMA

Responding to this paper

ESMA invites comments on all matters in this consultation 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'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_PFG_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_PFG_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PFG_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on Position limits and position management in commodities derivatives").

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 publically 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.

General information about respondent

Name of the company / organisation	AFG – Association Française de la Gestion Financière
Activity	Other Financial service providers
Are you representing an association?	☒
Country/Region	France

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_PFG_1>

AFG's General remarks :

- AFG welcomes the ESMA's consultation on performance fees and sees in a **very positive** light the **introduction of overarching guidelines throughout the Union**. A transparent and level playing field with regards to the asset management company's fee structures is a strong improvement in terms of regulatory convergence and cross-border marketing potential, as practices vary sometimes strongly between countries and there are a lot of misunderstandings regarding the subject.

- Part of **asset managers in France use performance fee models** for some time and AFG and AFTI have previously worked on this subject and issued a Guide[1] last year. We have studied performance fee figures for 2017 and 2018 in France on a constant scope of 263 asset management companies having declared to have perceived performance fees on at least one of their funds. **End 2017, performance fees represented 8% of the total management fees for these managers and 3% end 2018 (-65%)**. In 2017, 173 companies (about 2 thirds) declared having perceived performance fees on at least one of their funds, whereas in 2018 they were only 133 companies (half of the studied scope). AUM for the scope is 1 706 million euros end 2018, which is a decline of 3.5% in one year. The average AUM used for the calculation of the fee remuneration has though gone up in 2018 by 2.8% (1 737 million euros in 2018 versus 1 690 million euros in 2017). We also would like to highlight that, at least in France, there is the tendency for asset management companies to **offer the choice**

[1] The "AFG-AFTI guide to performance fees for UCITS and retail investment funds November 2018" can be found at: https://www.afg.asso.fr/wp-content/uploads/2018/11/2018_12_Guide-AFG-AFTI-Performance-fees.pdf

to investors between a higher fixed fee only and performance fee share classes for the same fund (known as “dual” or “twin” share classes).

- Fees in general and performance fees specifically **require a holistic view of the asset management company’s fee structure**. Various balances can be reached between fixed and variable fees, and between different aspects of a given performance fee scheme (reference indicator, period, rate, etc.) and any one approach cannot be equally suited to all possible investment vehicles, or preferable in all cases. For instance, in the case of a pure active equity fund, aimed at outperforming a specific equity market, it can be argued that the choice of a coherent reference indicator is the most important consideration to ensure that the interests of the asset managers and those of its clients are aligned – a performance fee based on an absolute or money market reference would strongly bias the asset manager’s incentives with regard to risk, regardless of possible HWM considerations – whereas for an absolute return fund, the existence of a HWM and its time to reset are in most cases more critical that the choice of a specific benchmark or hurdle rate. By the same token, performance fees often go hand in hand with lower fixed fees, allowing asset managers to remain financially viable while charging less when not delivering on their expected returns.

- AFG agrees to the objective of framework convergence in Europe by the means of ESMA Guidelines on major principles. It is very positive that **IOSCO principles are taken as reference**, as they have long been discussed and represent a well-balanced global guidance. AFG deplores that not all jurisdictions have implemented these standards yet and hope that ESMA’s work will be a push in this direction. We caution ESMA not to get too prescriptive beyond these core principles, however, for fear it would reduce the competitiveness of the European regulation and discourage the use of performance fees in general. Performance fees, when reasonably designed and implemented, can be a vital part of building an equitable fee structure for active managers and is a positive factor in discouraging closet indexing. AFG believes however that it is of the utmost importance to set up rules that foster transparency and allow for meaningful comparisons between products, inside Union countries as well as cross-border, so that investors can make an informed choice.

- AFG draws attention to the fact that the fulcrum fee methodology mentioned in the IOSCO principles is almost inexistent in Europe, where the prevalent model is that of a fixed fee complement by a performance fee. Besides, there is no definition of the method or its parameters in the proposed guidelines, which makes it hard to answer some questions (for instance, is it allowed to set up a floor to the overall fee taken – fixed + variable – or is it mandatory that fees can be reduced to zero in adverse scenarios, or even that the asset managers have to pays into the fund in case of negative fees coming out of the calculation – which would increase the industry’s financial fragility).

- AFG believes strongly that it is a completely **valid approach to take performance fees when a fund outperforms its reference indicator, even when showing negative absolute performance.** While we believe these guidelines agree with this stance, it should be made clearer in our opinion.

- AFG believes that **clear definitions** of the concepts used in the ESMA proposed Guidelines are of paramount importance. We take note of the Definitions section and propose further clarification of the concepts used. We think the following elements need more clarity:

- ESMA proposal	- AFG proposal
- *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.	- ***Crystallisation frequency –*** - **The frequency at which the accrued performance fee becomes payable to the management company**.
- Hurdle rate - A predefined minimum rate of return.	- **Hurdle rate** - **A predefined fixed or variable minimum rate of return.**
- 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 forthe calculations (i.e. performance fees should be payable based on the subsequent outperformance	- **High-Water Mark (HWM) The highest Net Asset Value at which the fund last charged a performance fee.** - - **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 at crystallisation points. It is one example of possible mechanisms for compensating for past underperformance (or negative performance).** - *Explanation : The origin of this concept is linked to series accouting in hedge funds. AFG considers that a generic use of the term High Watermark to be somewhat inappropriate in the context of methods used to calculate performance fees for open-ended funds. In general, this is a special type of compensation mechanism that is specifically adapted for instance to funds that use series accounting (or the equalisation method).*
- Performance reference period - The time horizon over which the performance is measured and compared with that of the reference indicator.	- **Performance reference period** - **The time horizon over which the performance is measured and compared with that of the reference indicator. At the beginning of each reference**

	period, the mechanism for the compensation for past underperformance (or negative performance) is reset.

- The paper makes sometimes references to staff remuneration, which is not related to the asset management company performance fee models. The regulatory framework does not mix the two notions and we would like this clear distinction to remain. The individual manager time horizon and motivation is not to be confused with the asset management company time horizon, organisation and fee models.

- **AFG agrees to a crystallisation frequency of no less than one year** (Q4). Generally, the crystallisation frequency is set on a yearly basis. We would recommend to use the notion of "frequency" (as it is the case with IOSCO principles) rather than "period" for the crystallisation so as to clearly distinguish between the notions of *crystallisation frequency* at which the fee becomes payable and *reference period* for the observation of outperformance. It should also be clarified that new share classes may only crystallise after no less than 12 months from their inception date. It should also be specified that crystallisation also takes place at the redemption time for the redeeming units. We do not understand the link with the recommended holding period for the crystallisation period and strongly suggest removing it. In particular, the recommended holding period regularly exceeds the actual holding period of investors.

- (Q8/9/10/11) AFG believes that **ESMA should not set a predefined timeline for the reference period and leave this to the asset management company's decision**. A one size fits all reference period setting would wrongly impact asset management fee models with no added benefit. AFG strongly supports that defining a reference period that is less than the crystallisation frequency (yearly) would not be in favour of a fair treatment of investors. Indeed, generally the performance of funds is looked at on a yearly basis and this ensures that the same outperformance is remunerated only once on this generally accepted horizon. A longer reference period bears the risk of a too high wealth transfer between investors whose investments contributed to the building of the provision and those who have not. Also, it bears the risk of putting pressure on the management company to prefer setting a higher fixed fee model. It should be clarified that the objective of preventing undue costs is also represented by the global framework of parameters of the method, where the reference period is only one element. A very important element for AFG members and our regulator is ensuring that the effect of flows (especially incoming flows) do not artificially and unduly give rise to performance fees simply because of the AUM effet. Some funds may make use of historical reference periods, such as closed ended funds. AFG totally agrees that it should be allowed to reset the observation period for the outperformance for open ended funds, which is the case today. The vast majority of funds do not set periods of less that on year, nor periods of more than one year. AFG reiterates its strong position against mandatory predefined time horizons, with the condition that less that one year reset periods are not allowed.

- It is very important that the #23 in page 12 is fully integrated in the Guidelines text, which seems not to be the case today. To be clearer, we suggest to amend this # :

“However, in case of a benchmark model, a fund can achieve positive performance visà-vis its benchmark, notwithstanding that its net asset value may have declined (relative positive performance) , or in absolute terms (absolute positive performance).. Thus, the positive performance principle is to be understood as either a relative positive performance or absolute positive performance (in absolute terms).” AFG totally disagrees with setting only a positive performance criteria in absolte terms. It would negate the principle of rewarding outperformance face to the benchmark. Bechmarks are following the economic cycles and the management company’s achievements to outperform the benchmark should be possible to be rewarded even in those cases. On an individual basis, nothing prevents a company that wishes to set an absolute positive performance condition in its fee model to do so.

Finally, we would like to highlight that the more constraints applying to performance fee models are adopted, the more retail investment funds will be induced to charge higher fixed fees. There is a trade-off between these two types of costs. Let us reiterate that performance fees are essential for the competitiveness of active management strategies.

<ESMA_COMMENT_PFG_1>

Questions

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

<ESMA_QUESTION_PFG_1>
As ESMA observed through the mapping of NCAs’ practices regarding performance fees, there is a lack of harmonisation among EU jurisdictions on this field. ESMA setting major principles to follow is, therefore, appropriate in order to enhance supervisory convergence in the EU.

In this regard, we strongly believe that ESMA should stick to the IOSCO principles in the final guidelines, especially knowing that all jurisdictions have not yet implemented the minimum standards IOSCO defines.

We also would like to insist on the importance of preserving the possibility to use performance fees models in open-ended funds. The classical and quasi-unique model of performance fees in Europe is a model where there is a base fixed fee complemented by a performance related fee. The model mentioned by IOSCO that is called fulcrum fee is not really used in the European jurisdictions.

We think that the ESMA principles should apply to UCITS. Indeed, AIF share classes generally develop, as the case may be, specific performance fees structures targeted to professional clients to match their specific needs.

AFG would like ESMA to clarify in the guidelines that different share classes in a same fund may have distinct fee models and may bear or not performance fees. ESMA Guidelines should therefore target share classes rather than funds.

<ESMA_QUESTION_PFG_1>

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

<ESMA_QUESTION_PFG_2>
We think two major obstacles could be removed by regulatory action in the field of fund's performance fees.

First, these guidelines should, in our opinion, primarily ensure that all EU jurisdictions implement the minimum standards IOSCO defined.

Secondly, once these commun guidelines have been agreed and published, we think NCAs should aknowledge that any specific national rule on top of the ESMA's guidelines cannot be applied to funds domiciled in another member state and cannot constrain cross-border marketing of retail share classes.

<ESMA_QUESTION_PFG_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.

<ESMA_QUESTION_PFG_3>
AFG believes that globally Guideline 2 provides a suitable framework when assessing consistency between the investment objectives, strategy and policy of the fund and the index used to calculate the performance fees. However, we would like to clarify that it is the investment objective that determines how a performance fee is suitable, not the other way round. Indeed, to be clear, an absolute/total return fund often uses a money market index as hurdle rate, but this does not mean that the fund is managed in reference to that index! These funds are not market funds.The paragraph 16.a on page 52 should therefore be clarified so as to be clear that a hurdle rate can be a fixed hurdle (ex 2%) or a variable hurdle using a money market index (ex EONIA+1%). Using EONIA or other market index in the hurdle composition is not managing in reference to the index.

Regarding the paragraph 17 on page 52, we disagree that ESMA advises as inappropriate any lower threshold for the fee calculation versus the stated benchmark. In our maket, the experience shows that compatibility with the benchmark is the key element together with the transparency on the performance fee reference indicator. For marketing reasons, the performance fee threshold may be somewhat lower, however when this happens, this is clearly disclosed and can be approved only under the constraint that this is not disproportionate.

Thus, in our opinion, no specific indicators are needed in these guidelines to ensure appropriateness of the benchmark used as a reference. The management company should be able to demonstrate this consistency to its clients or NCA.

Our members would like to inform also that there should be clear rules on the change of a reference indicator during the reference period. If the reference indicator changes during a reference period, the performance of the reference indicator for this period should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards. Recommandations of the regulators on this subject might differ from a country to another. Alignment on this topic is important.

<ESMA_QUESTION_PFG_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.

<ESMA_QUESTION_PFG_4>

We agree with setting a crystallisation frequency of no less than one year, as IOSCO principles recommend.

Generally the crystallisation frequency is set on a year basis, which may correspond to the calendar year, the accounting year or any other date. In any case, the date of the first crystallisation should be mentioned in the fund documents. We would recommend to set the notion of “frequency” (as it is the case with IOSCO principles) than “period” for the crystallisation so as to clearly distinguish the notion of the frequency of the fee becoming payable from the period for the observation of outperformance (the reference period).

It should also be clarified that new share classes may only crystallise on no less than 12 months the first time (this means 12 months + x months at the anniversary date).

It should also be specified that crystallisation takes place also at the redemption time for the redeeming units. We do not understand paragraph 19 of Guidelines 3 (p. 53) when indicating that the “minimum crystallisation period” should be linked to the recommended holding period of the fund. There is no link between the frequency of the performance fee becoming payable and the holding period. For clarilty, hedge funds with series accounting have up to annual crystallisation periods (monthly, quarterly or annual frequency). We suggest deleting the paragraph 19.

<ESMA_QUESTION_PFG_4>

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.

<ESMA_QUESTION_PFG_5>

As indicated in our answer to question 1, we would like to clarify that HWM is the highest NAV **at which the fund last charged a performance fee**. It is not the highest level at all times. The level of the HWM is based on the net asset value at the point in time when the performance fee was last crystallised. Further performance fees cannot be earned until the net asset value at the crystallisation points exceeds this level.

We also believe the 12 months should not necessarily apply on a systematic basis for HWM models, unless for the first year following fund inception.

<ESMA_QUESTION_PFG_5>

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?

<ESMA_QUESTION_PFG_6>
It is very important that the #23 in page 12 is fully integrated in the Guidelines text, which seems not to be the case today. To be clearer, we suggest to amend this # : "*However, in case of a benchmark model, a fund can achieve positive performance visà-vis its benchmark, notwithstanding that its net asset value may have declined (relative positive performance)* ***~~, or in absolute terms (absolute positive performance).~~*** ***_. Thus, the positive performance principle is to be understood as either a relative positive performance or absolute positive performance (in absolute terms_*)."**

AFG totally disagrees with setting only a positive performance criteria in absolute terms. It would negate the principle of rewarding outperformance face to the benchmark. Benchmarks are following the economic cycles and the management company's achievements to outperform the benchmark should be possible to be rewarded even in those cases. It should be recalled that the investment manager's duty is to implement the strategy corresponding to the stated investment objective of the fund, ie for an equity fund is to deliver the performance in line with the equity market (and the index chosen has been chosen because of its representativeness of the underlying market).

On an individual basis, nothing prevents a company that wishes to set an absolute positive performance condition in its fee model to do so.

So as to increase clarity of the ESMA guidelines, we insist that this amended paragraph be fully integrated in the Guidelines text.

<ESMA_QUESTION_PFG_6>

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.

<ESMA_QUESTION_PFG_7>
AFG agress with the inclusion of a prominent disclaimer in fund documentation stating that performance fees may be payable in times of positive outperformance even during negative markets for further transparency. Transparency of main features and effects of the performance fee models is of utmost importance. We would however call this a disclaimer, as it is a normal feature of the concept of outperformance, not a warning for an "unusual" feature.

In addition, we would like to highlight the importance of giving meaningful transparency on the main points impacting the performance fee model/calculation and thus avoiding to overload documents with information difficult to understand.

<ESMA_QUESTION_PFG_7>

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.

<ESMA_QUESTION_PFG_8>
We believe that ESMA should not set a predefined timeline for the reference period and leave this to the asset management company's decision. A one-size fits all reference period setting would wrongly impact asset management fee models with no added benefit.

AFG strongly supports that defining a reference period that is less than the crystallisation frequency (yearly) would not be in favour of a fair treatment of investors. Indeed, generally the performance of funds are looked at on a yearly basis and this ensures that the same outperformance is remunerated only once on this generally accepted horizon. A longer reference period bears the risk of a too high wealth transfer between investors whose investments contributed to the building of the provision and those who have not. Also, it bears the risk of putting pressure on the management company to prefer setting a higher fixed fee model.

It should be clarified that the objective of preventing undue costs is also represented by the global framework of parameters of the method, where the reference period is only one element. A very important element for AFG members (*1*) and our regulator is ensuring that the effect of flows (especially incoming flows) do not artificially and unduly give rise to performance fees simply because of the AUM effect. Some funds may make use of historical reference periods, such as closed ended funds. AFG totally agrees that it should be allowed to reset the observation period for the outperformance for open ended funds, which is the case today. The vast majority of funds do not set periods of less that one year, nor periods of more than one year.

AFG reiterates its strong position against mandatory predefined time horizons, with the condition that less than one year reset periods are not allowed.

(*1*) AFG has issued last year a professional Guide with the depositaries association that explains the core concepts around the best practices seen in the French market for the calculation of performance fees in UCITS and other retail share classes. Complementary issues are dealt with among which operational aspects and aspects pertaining to the parameters of the formula. One important feature for us and our regulator is to avoid in the application of the performance fee formulas undue fee transfer between the fund and the asset management company, for instance the case where high subscriptions are taking place at the end of the observation period and may overstate the fee. **All aspects should be taken into consideration when setting the performance fee formulalas (and the length of the performance period is only one aspect whose benefits shoud not be overstated).**

The *"AFG-AFTI guide to performance fees for UCITS and retail investment funds November 2018"* can be found at*:*

https://www.afg.asso.fr/wp-content/uploads/2018/11/2018_12_Guide-AFG-AFTI-Performance-fees.pdf

Focus analysis on wealth transfers:

In the case of open-ended funds (that naturally experience investor turnover due to their mutual nature), AFG members would like to remind the issue of possible unfairness of performance fee allocation between investors that could be exacerbated with a longer period for resetting the reference period. Certainly, it is a technical question of accounting accuracy, but ESMA decision makers cannot ignore such a matter and suppose that in all cases at industry-wide level the longer the period before the reset, the better.

Regarding the suggestion to use the recommended holding period in the case of open-ended funds, AFG strongly thinks there should be no mechanical link with the recommended holding period, which is only an indication of the hierarchy between the recommended periods of different asset classes and this ordinal indication is only one element among others to look at. Effective holding periods differ very much.

From a technical standpoint, AFG strongly advises that the performance fee reset of the observation period be shorter than the effective average holding period of the unitholders. Indeed, an average holding period of 1,5 year for instance means only that the "average investor" has this holding period. Part of them leave in reality earlier than 1,5 year.

Due to distributors and omnibus accounts, it is difficult to gather information on real holdings. However, for instance, one of our members shared a study of a large European equity fund (2 billion in AUM) with a history of 10 years showing that the effective average holding period per customer segment was as low as 20 months for one of the segments. In this case, it is clearly advisable to set the observation period to 1 year to minimize the adverse impact of wealth transfers between investors.

The potential for unfairness is related to the fair allocation of performance fees between investors in the fund and the investment manager getting paid the correct performance fee.

1) Fair allocation of performance fees between each investor in the fund

It would be ideal to identify each investor's investment experience in the fund and apply to it an "individualized" performance fee. Thus, the idea is to ensure that each investor pays the amount that it should be paying and is not subsidized by, or does not subsidize, another investor.

We give some examples hereafter to show that there are cases where:

- Investors could pay a performance fee despite having booked a loss;
- Investor A pays less than what he should have paid whereas investor B pays more, thus subsidizing investor A;
- Investor A makes profit, but does not pay performance fees, thus having a "free ride" effect;

- Investor B pays the same performance fee as Investor A, despite having effectively made a higher profit that investor A, thus displaying too a “free ride” effect.

2) The investment manager is getting paid the correct performance fee (alignment) when there is a reset of the reference period.

It should also be reminded that if a loss occurs, with the principle of a HWM, the investment manager has to recoup the total loss before any further incentive fees can be paid. What must be made clear is that, if an investor redeems during a drawdown period and thereby accepts a portion of the loss, the residual amount of loss that the investment manager has effectively to recoup shall be in theory reduced pro rata to be fair. In this case, without pro rata, a reference period with a longer reset may require the investment manager to still earn back the full loss before he can earn any incentive fee, although in reality the remaining shareholders have only suffered a smaller loss. These may seem to be accounting technicalities, but if the asset manager were required to earn back the full sum, those shareholders would get a "free ride" effect on that technical “gap” profit.

We would like to recall that typically hedge funds responded to this issue with 2 accounting methods: series accounting and equalization credit/depreciation deposit method that permit to identify each investor’s personal experience in the fund. This is not possible with the vast majority of UCITS, which are mutualised retail schemes.

Whereas a fund based performance fee cannot be perfect, as a general rule, the longer the reset of the reference period, the more averaging between the investors: this leads to investors paying a performance fee even if they have so far a negative performance and also to investors realizing a positive performance without paying the performance fee, or to middle cases like paying too few or too much performance fees.

Therefore setting arbitral one size fits all reference period resets of more than one year may bear the risk of increasing the dilution effect and ultimately lead to unfairness. AFG believes that the wealth transfers should be as limited as possible, within a reasonable minimum timeframe of one year. We recall that the idea behind the use of performance fees is to lower total fees paid by investors by setting lower base fees while remunerating outperformance.

Please see hereafter an example illustrating different outcomes in terms of provisioning rates for investors experiencing various investment periods in the same open ended fund:

Date	Event	Return on assets	Total Assets	Invested assets	Value Creation	Perf fee provision	Provision per share	Holder A	Holder B	Holder C	Holder D
t0	A subscribes		100,00	100,00	-	-	-	100,00	-	-	-
t1	End of t1	-5%	95,00	100,00	- 5,00	-	-	95,00	-	-	-
t1	B subscribes		190,00	195,00	- 5,00	-	-	95,00	95,00	-	-
t2	End of t2	3%	195,70	195,00	0,70	0,14	0,07	97,78	97,78	-	-
t2	C subscribes		293,48	292,78	0,70	0,14	0,05	97,78	97,78	97,78	-
t3	End of t3	10%	322,83	292,78	30,05	6,01	2,00	105,61	105,61	105,61	-
t3	D subscribes		428,43	398,39	30,05	6,01	1,50	105,61	105,61	105,61	105,61
t4	End of t4	-5%	407,01	398,39	8,63	1,73	0,43	101,32	101,32	101,32	101,32
	Total return							1,32%	6,65%	3,62%	-4,06%
	Provision deduced							0,43	0,43	0,38	- 1,07
	as share of investment							0,43%	0,45%	0,39%	-1,01%
	Effective provisioning rate							24,60%	6,39%	9,80%	20,00%

<ESMA_QUESTION_PFG_8>

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.

<ESMA_QUESTION_PFG_9>
Please see our answer to question 8.

<ESMA_QUESTION_PFG_9>

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.

<ESMA_QUESTION_PFG_10>
Please see our answer to question 8.

<ESMA_QUESTION_PFG_10>

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.

<ESMA_QUESTION_PFG_11>
Please see our answer to question 8.

<ESMA_QUESTION_PFG_11>

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?

<ESMA_QUESTION_PFG_12>
Given the crystallisation period of at least 12 months, any change in the performance fee model described in the prospectus would take at least 12 months before the performance fees accrued become payable to management company.

With this in mind, and taking into account legal and operational operations needed to adapt existing fee mechanisms, especially in Member States wher the IOSCO principles are not yet fully implemented, we believe that at least 24 months are needed to be able to comply with the requirements of these Guidelines.

<ESMA_QUESTION_PFG_12>

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.

<ESMA_QUESTION_PFG_13>
We think that these principles should be applied to UCITS. We would like to recall that AIF share classes generally develop, as the case may be, specific performance fees structures targeted to professional clients to match their specific needs.

We would like to recall our comment that these requirements should apply at the level of the share class and not at the level of the fund (a fund may have distinct fee models and may bear or not performance fees).

It should also be clarified that when a share class bearing performance fee is created during a performance reference period, this period should be extended in order to last at least 12 months the first time (this means 12 months + x months at the anniversary date).

<ESMA_QUESTION_PFG_13>

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.

<ESMA_QUESTION_PFG_14>
On the proposed Guideline 2, please see our response to question 3.

We insist on the fact that the consistency should be looked in relation with the fund's objective. It is the performance fee that should be compatible with the assigned investment objective. They should be compatible, but not necessarily identical.

<ESMA_QUESTION_PFG_14>

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.

<ESMA_QUESTION_PFG_15>
AFG believes that the principle that ESMA should follow is the one of the compatibility of methods used with the investment objectives and the risk profile of the fund (as AFG advised in its Performnace fee Guide released last year and mentioned at question 8)

The performance of the fund that is used as the basis for calculating performance fees must be compared with a relevant reference, taking into account the objective and the management style of the portfolio. In particular, the risk levels inherent in the fund and the reference must be similar. This principle means that appropriate references must be chosen for the calculation of performance fees, i.e. they must be compatible with those expressed in the investment objective, although they do not necessarily have to be identical.

As an example, it is advisable not to use a fixed threshold (zero risk) or a money market benchmark index (low risk) to calculate the excess performance of a fund that invests in shares (high risk). However, this type of indicator can be used to calculate the excess performance of a fund that aims to generate an absolute performance, insofar as the potential performance of

the fund and the trigger threshold are consistent and there is no structural directional bias in the strategy implemented.
<ESMA_QUESTION_PFG_15>

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.

<ESMA_QUESTION_PFG_16>
If the question is related to the requirement of yearly crystallisation frequency, French funds already comply as this is a structural IOSCO principle already implemented and required by our NCA.
<ESMA_QUESTION_PFG_16>

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.

<ESMA_QUESTION_PFG_17>
The negative performance (loss) recovery principle as understood by our members is a principle that is applied **on a fund by fund basis at the own decision of the asset management company**. Knowing that all French funds cannot have a crystallisation frequency less than one year, **the related application of a year at least for the observation period is seen as a good practice by our members.**

If this principle is to be understood differently, it may impose unjustified requirements and even lead to the incitation to give up performance fees. **2 errors may be made**:

- If ESMA wrongly decides to go far beyond the IOSCO principles by imposing a length of more than one year. This is mainly wrong for two reasons:
  - **it negates the open ended feature of mutual funds** where <u>each investment of each investor</u> cannot be easily tracked to apply <u>on each investment</u> the precise fee; Unless such a treatment, the lengthier the period, the higher the wealth transfer between investors present at different times in the fund.
  - it **misunderstands the benefit to investors** as performance fees are fundamentally a fee structure whose aim is to ensure better alignment between the interests of investors and asset management companies, with a view to outperforming a predefined index or exceeding a predefined threshold; In order to be perceived, the beneficial effects require **an appropriate and fair calculation method** to be used. The performance fee formula must not be regarded in isolation, but as one of several elements in the asset management company's remuneration structure and **the calibration and proportionate nature of the parameters used in the method for calculating performance fees must be understood in their entirety.**

- If ESMA wrongly decides to apply ***only an absolute recovery principle***, as **it negates the <u>out</u>perfomance fundamental concept** underlying the performance fee philosophy.

<ESMA_QUESTION_PFG_17>

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.

<ESMA_QUESTION_PFG_18>
If we take a step back and try to draw a "global picture", we believe that, once the concept of applying performance fees in open ended retail mutual funds is aknowledged, then in order to enhance fair treatment of the fund and investors, the fundamental principle is the one of no incentives to take excessive risks.

Indeed, a method of determining performance fees must not result in excessive risks being taken.

The following approaches, by way of example, may help to achieve this objective:
• Linking risk-taking by management with a risk of penalization of the capacity to generate performance fees. This could translate into an option for the asset management company not to make any provisions as long as any cumulative underperformance during the reference period has not been offset.

The definition of the reference (or catch-up period) would then be a decisive factor. The asset management company must be able to reset its calculation after a certain time if it has become difficult or even impossible to restore an excess performance.

Nevertheless, a minimum reference (or catch-up period) is necessary in order to prevent excessive risk-taking. **The minimum catch-up period may not be less than one year.**

• Imposing **an upper limit on the fee provision** that the asset management company can deduct, which must be consistent with the risk profile of the portfolio.

Also, the rate of allocation to the provision that is applied in the event of an increase in the excess
performance must be equal to the rate of reversal applied in the event of a reduction in the excess performance. If the reversal rate were lower than the allocation rate, this would favour the fund management company to the detriment of the fund.

Each method has an assembly of parameters that should globally ensure this principle. If ESMA decides to impose arbitrarily more restrictive criteria on one parameter or another, this could have detrimental effects on the application of performance fees by asset management companies. In France we have a long lasting experience of applying performance fees on a wide basis and we think that IOSCO Principles should remain the basis of the ESMA Guidelines.
<ESMA_QUESTION_PFG_18>

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.

<ESMA_QUESTION_PFG_19>
AFG believes that investors should ideally be informed via the prospectus:
• Of the existence of a performance fee and the method used to calculate it, which must enable the fee to be verified, by outlining all the characteristics of the method chosen;

• Of the potential impact of the fee on the fund, for example by presenting a few simple scenarios. It is possible to emphasise that the performance fee will be deducted only if the fund effectively overperforms (in accordance with the chosen method) for the reference period. However, it would be necessary to specify that this principle may not apply to the investor if the period of his investment in the fund does not coincide with a reference period. When excess performance scenarios are presented, a scenario demonstrating that the fund may levy a performance fee even if the investment has declined in absolute value should also be presented if the method allows such an effect;

• Of systematic biases between unit holders that the calculation method may cause; for example, other than the "equalisation reserve" method, a potential transfer from existing holders to new holders in the event of a pre-existing provision (as the provision that is "given" to new arrivals may be used to offset potential underperformance in future).

<ESMA_QUESTION_PFG_19>