

31 October 2019

ESMA
CS 60747 – 103 rue de Grenelle
75345 Paris Cedex 07
France

Submitted online at www.esma.europa.eu

Dear Sir, dear Madam

RE: Guidelines on performance fees in UCITS

BlackRock¹ is pleased to have the opportunity to respond to ESMA's Consultation on performance fees in UCITS issued by ESMA.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this Consultation Paper and will continue to contribute to the thinking of ESMA on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

Guillaume Galinie
Vice President
guillaume.galinie@blackrock.com

Martin Parkes
Managing Director
martin.parkes@blackrock.com

¹ BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

Benefits of supervisory convergence

We support ESMA's initiative to drive supervisory convergence in the use of performance fees by UCITS to ensure there is a consistent approach to the alignment of the interests of investors and asset managers in the EU. ESMA's draft Guidelines represent an important step to ensure different supervisory approaches to the use and disclosure of performance fees do not act as a barrier to the cross-border distribution of investment funds.

Maintain diversity of performance fee models

The Consultation highlights that a number of performance fee models (such as absolute performance, relative performance and fulcrum fees models) have evolved over time reflecting the wide variety of UCITS strategies in the market. We believe that it is important to retain this diversity in approach which reflects differing client demands.

We also believe that it is important to recognise fundamental differences inherent in the calculation methodologies of performance fees in the segregated and largely institutional market and those for UCITS and other AIFs broadly distributed to retail investors. In an institutional model with a limited number of clients it is perfectly possible to tailor performance fees to the exact investment period of the investor, for example by using a series of share classes. In a daily dealing retail fund this approach would lead to an unacceptably high level of share classes. To deliver consistent investment outcomes when using performance fees, managers have invested significantly in innovation to ensure the ongoing process of subscriptions and redemptions and consequential changes in NAV ensures ongoing alignment of interest between investor and manager.

Governance of performance fee oversight

As with investment or risk models it is important that managers put in place appropriate governance, oversight and ongoing testing of the performance models they use. This focus on developing appropriate governance, controls and testing is critical in the effective use of the critical components of performance fee models identified by ESMA and IOSCO such as benchmark selections, high water marks, crystallisation and reset periods.

While we comment on many of the technical issues related to these aspects in our response we believe it is important for managers to retain a sufficient degree of flexibility in their models so as to be able to respond to different market scenarios and client demands, while at the same time providing full disclosure and transparency to national competent authorities and clients on how their model(s) perform, particularly where exceptions to standard design parameters are permitted.

Effectiveness of disclosures

We support the ongoing development of best practice disclosures to investors including the use of case studies to illustrate different scenarios. While much of the ex-ante detail can be contained in the fund prospectus it is important to ensure that ongoing ex post information is not contained in the prospectus given that the process of updating prospectuses depends on a number of competing factors such as detailed discussions on new products.

Rather we recommend that performance reporting is contained in the annual report and accounts of the funds and reflected, as appropriate, in other ex post disclosure requirements such as MiFID costs and charges reporting through distributors. We also request ESMA to tie the work on performance fee disclosure with the ongoing Joint ESA

Consultation on the forthcoming adoption of the PRIIPs KID by UCITS to ensure that new disclosure standards provide relevant and engaging information to retail investors.

Remuneration

Finally, to include our initial comments we note that performance fees are paid to management companies to cover a variety of operating costs (not just for the remuneration of individual portfolio managers). Furthermore, the remuneration of key individuals is governed by the UCITS V rules on remuneration. An individual portfolio manager and his/her team will often manage a number of different client mandates, both collective and individual. Investment professionals will typically receive a base salary and a variable remuneration, such as a bonus. These individuals are compensated based on their performance across all the mandates they manage by reference to short, medium and longer term performance indicators. This references actual revenue from investment management fees earned in the previous years based on actual performance to align remuneration with performance achieved on mandates for all clients rather than on the basis of a single performance reference period.

Responses to questions

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

We believe it is important to define the scope of standardisation as being the development of a series of core principles along the lines of the IOSCO approach to the use of performance fees. Within this framework we see opportunity for clarification of key issues on the use of performance fees in UCITS. The development of high-level principles across EU jurisdictions should continue to promote continued cross border distribution while incentivising a clear alignment of interests between asset managers and their clients and supported by clear disclosures to investors. UCITS adopt a wide variety of strategies to meet the needs of clients in many different jurisdictions – as such we do not recommend mandating the use of a single performance fee model but rather the focus on the development of a common set of underlying principles.

Neither should standardisation come at the expense of innovation. We have clients who have expressed preferences for relative and absolute performance fee models and there are other models such as fulcrum fees which exist in the market. With appropriate disclosure and governance, especially in respect of the choice of reference benchmarks and hurdle rate, we believe that a number of models can co-exist for different target markets.

We also highlight that in the institutional market there are many tailor-made performance fee models which are often delivered through bespoke calculations or through series equalisation which is not scalable in a multi class mass retail market. As such the Guidelines for UCITS should not be more than indicative for AIFs, though NCAs may see merit in applying the Guidelines to the national authorised retail AIFs even though they do not benefit from the pan-European distribution platform.

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

We believe that the Guidelines will provide a solid base for the development of a common level playing field across the EU. Adherence to these principles will minimise the risk of having to comply with multiple national requirements which would inhibit effective cross-border distribution. The Guidelines set out 5 “key elements” around which there should be greater convergence and standardisation of approach. We believe that asset managers should have a product governance and oversight processes which addresses these elements and provide appropriate disclosure to investors on their approach. This approach should have the effect of increasing investor understanding and facilitate the understanding of different models.

As noted above we believe that ESMA should recognise that overly prescriptive rules may have the consequence of limiting the variety of performance fee models and methodologies, and thereby limiting the ability of asset managers to meet the needs of different target client bases.

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.

We appreciate the need to maintain consistency between a fund’s investment objectives, strategy and policy, risk reward profile and its benchmark, where a benchmark is implemented. Furthermore, where an index is used to calculate performance fees it should be properly disclosed in the fund prospectus as should the rationale behind the choice of index.

If a manager chooses a relative performance fee model then we believe that the index chosen within that model should be aligned with the fund’s investment objectives, strategy and policy. If, however, in the case of an absolute return strategy (which may or may not implement a benchmark) then for the purposes of the performance fee model there should be flexibility to select a standalone high water mark (“HWM”) based on a money market fund index (for example) and possibly an additional hurdle rate; provided the manager discloses the logic for their choices. We disagree that such indices are automatically inappropriate. It should be up to the manager at the time of seeking authorisation from its national competent authority to provide justification as to why the index used is an appropriate component of the performance fee model.

We believe that predefining specific indicators such as historic volatility or asset allocation composition across all fund types would not allow managers the ability to adapt their models to reflect the specific characteristics of different fund objectives. At the most these indicators should be guidelines as to characteristics that could be, rather than *must be*, included. Rather these indicators should be considered as part of the fund’s initial and ongoing product governance process, within an ongoing review programme, as to whether they remain relevant over time.

We believe that managers should follow a number of principles when disclosing the use of reference indices to investors. These include:

1. Prospectus disclosure as to the choice of an index when calculating performance fees,
2. Corresponding disclosure in the Charges section of the UCITS KIID with an appropriate cross reference to the prospectus if more space for a description is required,
3. Disclosure in ex-ante and ex-post information on costs and charges (MiFID II).

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 believe it is good practice for the crystallisation period to run over a 12-month period, if possible, in line with the fund's financial year to facilitate reporting in the fund's annual report. There are, however a number of specific cases where exception should be made for shorter periods such as new launches (where the fund will not have a complete financial year), or a formal change of investment objective and/or portfolio management team or as a result of corporate actions such as a fund merger.

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.

Our answer to Question 4 would also apply to funds using HWM models.

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?

We do not believe that this approach would be relevant for all performance fee models. Relative performance fees models allow performance fees to be charged to shareholders in markets where the fund's performance is greater than the "relative" benchmark of reference. The choice of such a model will very much depend on client preference.

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 agree that managers should include additional disclosures to alert investors that performance fees might also exist in falling markets (i.e. a performance fees might be charged even though the overall NAV per share has decreased). We currently make the following disclosure when we use a relative performance model:

A "performance fee accrual is calculated where the Net Asset Value per Share Return of the relevant Share Class outperforms the relevant Benchmark Return [...] a performance fee accrual may be made if the Share Class has outperformed the Benchmark Return, even if the Benchmark Return is negative"

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.

We believe that where a HWM is used that investor expectations may be best met by adopting the approach of a perpetual HWM that may only be reset in specific, predefined circumstances rather than on an automatic basis. Accordingly, we do not see the benefit of defining a “performance reference period” in relation to HWM as the two concepts are often uncorrelated. As such we recommend the use of a distinct and separate timeframe for the reset of a HWM different from the definition of “performance reference period”.

While our preference is for a perpetual or rolling HWM, there are circumstances where it might be counterproductive to prevent past losses or underperformance from expiring. Circumstances may mean that it may be appropriate to reset the HWM to ensure the interests of existing investors, potential new investors and the asset manager are realigned and that the performance fee remains an effective tool.

We do not support resetting the HWM on annual basis as, in effect, this would mean resetting the HWM whatever the performance achieved.

Some of the criteria which may be taken into account when resetting the HWM could include:

- The overall fee model and its impact on the investor;
- The existence or not of other fee features such as claw back on underperformance and whether this has operated effectively;
- The history of subscriptions and redemptions in the fund – for example do accrued losses mean at the time of a change in portfolio manager or strategy mean it is very unlikely that the new manager will ever recoup previous losses?
- The choice between performance fee and non-performance fee share classes;
- The time elapsed since the last reset – we would suggest a minimum of 3 to 5 years.

Managers should inform investors about the approach adopted by clear disclosures in the prospectus and with advance notice of any changes.

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.

As noted above our approach for performance fees with a HWM is to follow a perpetual HWM approach save in exceptional circumstances where it might be counterproductive.

A 3 to 5 year period before any loss reset type seems reasonable if managers do not want to adopt a “permanent HWM” model. Any such mechanism / principle should be clearly disclosed in the fund’s prospectus.

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.

We have no additional comments beyond our comments in Questions, 4, 5, 8 and 9.

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 to the extent possible, the performance reference period should coincide with the crystallisation period. However, as noted in answers above, the performance reference period should not be reset to coincide with an annual crystallisation period (or at the very least not before 3–5 years of losses in consecutive reference periods).

As noted above we believe that there are only limited circumstances in which the crystallisation period should be shorter than 1 year as noted in our reply to Question 4.

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?

12 months from end of financial year OR 18 months

Depending on the extent of the final requirements, the Guidelines could lead managers to adapt existing strategies and models. Additional time would be required by fund administrators to transpose these new models and carry out appropriate resiliency testing. In that regards, we believe that the guidelines should only become applicable 18 months after their application, or 12 months after the end of the fund's current financial year. In addition, we recommend that the application of the Guidelines should not require changes to existing terms where after agreement with the fund's national competent authority it would be contrary to the interests or expectations of existing investors to adopt the changes.

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.

As retail AIFs (apart from a limited number of funds such as the ELTIF) do not benefit from a cross-border retail passport we do not see the benefit of applying the Guidelines to AIFs marketed to retail investors. However, national competent authorities may wish to use some of the disclosure standards in the Guidelines to improve clarity and consistency of disclosure.

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 support the reasoning behind aligning performance fees model and the fund's investment objective. As noted above the Guidelines should be flexible enough to allow room for innovation provided the rationale is properly disclosed in the fund prospectus.

Even if many managers' models are reasonably aligned with the forthcoming Guidelines, additional costs will arise from the product governance, fund accounting costs (including those of external providers) legal (including external counsel), compliance and audit costs from reviewing existing models for compliance. In the event performance fee models including the asset manager's remuneration models require adaption, costs will be higher and at this stage in the process are difficult to estimate.

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 believe that the Guidelines should permit the use of non-index hurdle rates (e.g. interest rates, absolute return benchmarks). The fund's product governance process should ensure, just as with index-based benchmarks, that any such hurdle rate is substantively connected to the investment objective and anticipated returns of the fund. This is particularly the case where performance fee models where absolute negative losses must be recouped before any performance fees is accrued and/or with performance fees with a HWM.

In terms of the specific example we believe that where the fund has an absolute return objective, a hurdle based on EONIA (or similar) and a HWM should be allowed. In these circumstances the choice of the performance fee reference index and the rationale behind should be clearly set out and should be considered as part of the fund's product governance process.

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.

Please refer to our answer to Question 14.

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.

As noted in our answer to Question 14, we expect to have to review our existing performance fee models to assess the ongoing compatibility of the models with the future Guidelines.

In addition,

- requirements regarding the "consistency" of performance fee indexes with fund's objectives may lead to noticeable adjustments across funds if strictly defined;
- if "Relative Performance fees" are no longer allowed, then considerable remodelling of alternative methods and client communication will be required;
- we do not see the benefit of mandating the application of the Guidelines to retail AIFs given the lack of a retail passport, the broader range of potential eligible assets and different dealing frequencies. Rather we recommend allowing national competent authorities to decide which aspects of the Guidelines they wish to apply to retail AIFs.

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.

Please refer to the answer to Q14.

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.

Clearer and more and comprehensive disclosures standards should lead to better informed investors. We also consider that these enhanced disclosure requirements will ease comparative analysis, increase transparency and reduce unforeseen outcomes by both managers and investors.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by the Consultation and will continue to work with ESMA on any specific issues which may assist in the finalisation of the Guidelines.