



FINANCIAL SERVICES

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New ESMA Q&As on  
Performance Fees for UCITS

# New ESMA Q&As on Performance Fees for UCITS and certain types of AIFs

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ESMA released new questions and answers on the application of the UCITS Directive (2009/65/EC) (UCITS Q&A) and the AIFM Directive (2011/61/EU) (AIFMD Q&A) on 30 March 2021.

The Q&As clarify the application of paragraphs 40 and 41 of ESMA's Guidelines on performance fees in UCITS and certain types of AIFs. This includes clarifying how performance fees should crystallise and how the performance reference period should be set for UCITS and certain types of AIFs. The AIFMD Q&A also clarifies whether European Long-Term Investment Funds (ELTIFs) come within the scope of the Guidelines.

In this article, we consider paragraphs 40 and 41 of the Guidelines, outline ESMA's clarification on those paragraphs and their response to whether the Guidelines apply to ELTIFs.

## Background

ESMA published the Guidelines on 5 November 2020. They apply to UCITS ManCos and AIFMs (Managers) in relation to UCITS and AIFs marked to retail investors (Funds), except for closed-ended AIFs and open-ended AIFs that are European Venture Capital Funds (or other types of venture capital AIFs), European Social Entrepreneurship Funds, private equity AIFs or real estate AIFs.

The Guidelines became applicable on 5 January 2021 (Application Date).

Paragraph 40 of the Guidelines provides guidance for Funds that employ a performance fee model based on a benchmark index. For those Funds, ESMA recommends that any underperformance of the Fund compared to the benchmark should be clawed back before any performance fee becomes payable. ESMA also recommends that if the length of the performance reference period is shorter than the whole life of the Fund then the performance reference period should be set equal to five years.

Paragraph 41 of the Guidelines provides guidance for Funds that use a high-water mark (HWM). For those Funds ESMA recommends that performance fees should only become payable if during the performance reference period the new HWM exceeds the last HWM. ESMA clarifies that in making that calculation the initial HWM should be the initial offer price per share. ESMA also recommends that if the performance reference period is shorter than the life of the Fund then the performance reference period should be set equal to at least five years on a rolling basis. In such cases, ESMA provides that Managers may only be paid a performance fee if the performance of the Fund exceeds any underperformance during the previous five years. Lastly, ESMA states that performance fees should not crystallise more than once a year.

The first two questions of the Q&As clarify the application of paragraphs 40 and 41 of the Guidelines. The third question of the AIFMD Q&A clarifies the application of the Guidelines to ELTIFs.

## Question 1 – Performance Fee Crystallisation

Question 1 of the Q&As: Based on paragraphs 40 and 41 of the Guidelines, should performance fees be paid only at the end of the performance reference period of five years?

ESMA answers that question in the negative. ESMA clarifies that Managers can be paid a performance fee during the performance reference period of five years. Managers can also be paid a performance fee in the first years of a Fund's existence in cases where the Fund has not existed for five years.

For example, if at the end of the Fund's second year of existence the Fund has overperformed the reference indicator (e.g. a benchmark index) and there is a positive accrual of performance fees, then those performance fees can be paid to the Manager.

However, ESMA provides that where a Fund underperforms its reference indicator and there is no accrued performance fee in a year then the Manager cannot be paid a performance fee. The underperformance must be brought forward to calculate whether a performance fee is payable in the following year.

ESMA also states that National Competent Authorities (in Ireland the Central Bank) have the discretion to apply stricter rules to Funds than the Guidelines, subject to certain limitations.

## **Question 2 – Setting the Performance Reference Period**

Question 2 of the Q&As: How should the performance reference period be set for the first time considering the Application Date of the Guidelines?

ESMA clarifies that Funds already compliant with paragraphs 40 and 41 of the Guidelines before the Application Date should look at the past five years or the entire life of the Fund to set the performance reference period. Managers should not reset the performance reference period after the Application Date.

In other cases, ESMA provides that Managers should set the performance reference period starting from the beginning of the financial year following six months from the Application Date. This means that the performance reference period should start at the beginning of the financial year following 5 July 2021. For example, if a Fund's financial year starts on 1 September 2021 then the first year of the Fund's performance reference period will start on 1 September 2021 and end on 1 September 2022.

## **Question 3 – Application of Guidelines to ELTIFs**

Question 3 of the AIFMD Q&A: Do ELTIFs fall within the scope of the Guidelines?

ESMA clarifies that the Guidelines apply to an ELTIF if:

1. the units of the ELTIF are marketed to retail investors;
2. the ELTIF is open-ended; and
3. the ELTIF is not a venture capital, private equity, or real estate AIF.

## **How LK Shields Can Assist**

Our Financial Services team has extensive experience advising Managers on the structuring of performance fees in UCITS and AIFs. In particular, we can assist Managers with navigating the Guidelines and Q&As for each UCITS or in-scope AIF that they manage.

Please contact a member of our Financial Services team if you have any questions or would like assistance with the Guidelines or Q&As.

## About the Authors



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