# Regulatory outlook

## Performance fees

### ESMA consultation on performance fees

In July 2019, the European Securities and Markets Authority (ESMA) launched a public consultation on performance fee draft guidelines under the UCITS Directive. ESMA stated: *"draft guidelines aim to harmonize how performance fees can be charged to the UCITS and its investors while ensuring common standards of disclosure, as current practices vary among EU Member States."* (ESMA News)

These guidelines aim to achieve supervisory convergence in the following areas:

- General principles on performance fee calculation methods.
- Consistency between the performance fee model and the fund's investment objectives, strategy and policy, for example regarding benchmarks.
- Frequency of performance fee crystallization and payment — with the minimum crystallization period consistent with the investors' holding period and one-year minimum.
- Circumstances where a performance fee should be payable.
- Disclosures of performance fee models. For example, new disclosures could be ex-ante, providing concrete examples of how the performance fee will be calculated in the prospectus; or ex-post, how performance fees are charged per share class (currently at sub-fund level).

The respondents will give feedback on the proposals, including their opinion on whether the scope of the guidelines' principles should be extended to AIFs distributed to retail investors. ESMA will analyze the consultation results in Q4 2019 and plans to finalize the guidelines for publication afterward.

### Performance-based fee models replacing fixed-fee models

The main goal of the new fee models is to align asset managers and investor interests by significantly decreasing the fixed based Assets Under Management (AUM) fees and increasing the performance-fee model remuneration. In a nutshell, asset managers are only remunerated if they can deliver Alpha, a performance over a certain benchmark. This should help the industry regain investor trust.

### Creation of local performance fee requirements in Germany, Ireland and the UK

Additional local restrictions on performance fees were recently implemented in Germany, Ireland and the UK, piling more pressure on asset managers. They'll need to urgently adapt their fee models if they wish to keep distributing their products in these countries.

However, the Luxembourg Fund Industry Association (ALFI) stated: *"it should not be possible to block Luxembourg-domiciled funds from distribution in Germany when changes to the regulation take effect in December."* They called for the industry to urgently adapt their products and prevent new barriers of entry to local markets.

According to ALFI's legal and tax director Marc-André Bechet, *"acceptance by other EU regulators of the extraterritorial effect of national rules would be in violation of the 'passport principle' and would be disruptive to the UCITS framework in general."* (Funds Europe.) ALFI believes that best practice is to follow the International Organization of Securities Commissions' (IOSCO) principles until ESMA provides further guidelines on that topic.

The regulatory reform agenda has continued its steady advance across the EU and worldwide. Today's landscape reflects current policy priorities: financial stability and systemic risk, maintaining an open and well-functioning EU financial market and promoting sustainable private finance. We have summarized the main initiatives of interest to loan fund managers below.

# Liquidity stress testing

## ESMA guidelines on liquidity stress testing

Following consultations that began in April 2019, ESMA published the final guidelines on liquidity stress testing (LST) for UCITS and AIFs on 2 September 2019.

The newly-released guidelines will take effect on 30 September 2020.

ESMA released an economic report — *"Stress simulation for investment funds 2019"* (STRESI) — documenting a comprehensive study on liquidity resilience of bond funds to liquidity shocks. The report also describes the methodologies and tools applied during the stress exercise which could potentially help asset managers implement their internal LST framework.

## Why is LST so important?

Liquidity risk has recently hit the headlines. The announced suspension of the Woodford Equity Income fund — followed by H2O Asset Management's heavy outflows due to concerns about the liquidity of certain bonds — has resulted in increased regulatory scrutiny and market attention.

ESMA's STRESI also highlights the need for additional consideration regarding liquidity management. Overall the report showed that, in the event of a weekly redemption shock of 5% to 10%, most funds would be able to meet investors' redemptions. However, up to 40% of high-yield bond funds could experience a liquidity shortfall — likely resulting in a material impact on the market, even if these funds were able to sell securities.

## What does this mean for asset managers?

Asset managers are faced with a challenging 12-month implementation timeline to comply with the new requirements.

LST will need to be carried out on an annual basis at least. However, ESMA recommends quarterly testing, as there are specific situations that will increase or decrease the frequency required like high-dealing frequency.

To decide on the appropriate frequency and the LST features, proportionality will be the founding principle underpinning all relevant decisions.

Asset managers are also required to document the LST policy framework in the risk management process (RMP). This represents a substantial and favorable development compared to the consultation paper which required asset managers to document the LST twice — namely in a stand-alone LST policy and the RMP itself.

Following consultations, ESMA also clarified that reverse stress testing (RST) — albeit especially useful for funds exposed to high-impact, low-probability events — will not be mandatory for all funds due to the implementation's complexity and low-added value for the majority of funds.

As a result, the LST should consider both historical and hypothetical scenarios and, if necessary, RST.

To ensure the overall framework's soundness, an initial validation of the LST models and assumptions will need to be carried out by an independent — but not necessarily external — entity.

Last but certainly not least, the guidelines will require the asset management industry to demonstrate or build up an acceptable level of substance regarding liquidity risk management and measurement knowledge.