

# **Performance Fees payable to Retail Fund Managers or Advisors**

## **Feedback Statement**

**December 2005**

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### Section A - Background

- A.1. On 17<sup>th</sup> June 2005, the Malta Financial Services Authority ('MFSA' or Authority') issued a notice of its plans to introduce new standard licence conditions relating to performance fees payable to retail fund managers or advisors. The main purpose of the proposed new standard licence conditions, was to ensure that the basis of calculation of performance fees is such as to align the economic interest of the fund manager or advisor, with that of the investor and above all, for this to be fair to investors. The notice was issued pursuant to article 8 of the Investment Services Act, 1994. A copy of the proposed requirements which were circulated with the above-mentioned notice, is included in this Feedback Statement as Annex 1.
- A.2. Locally based collective investment schemes and Category 1 to 4 Investment Services Licence Holders were initially requested to submit any comments in relation to the proposed new requirements by the 20<sup>th</sup> July, 2005. In view of interest and requests received, the Authority subsequently extended the time period for written submissions and representations to the 31<sup>st</sup> August, 2005 and also accepted individual requests for extending this time limit for consultation. In fact, the latest feedback received was on the 5<sup>th</sup> October, 2005.
- A.3. The MFSA received feedback in relation to the proposed requirements on performance fees from Investment Services Licence Holders, Associations of practitioners and other parties.
- A.4. The feedback received by MFSA in relation to the proposed requirements was both positive and negative. Whilst there were respondents who were in favour of the introduction of the new requirements and others who did not object to the proposals, there was a selection of respondents who strongly objected to the implementation of the said requirements.
- A.5. This Feedback Statement outlines (in no particular order) the main issues raised during the consultation process and the MFSA's views on these issues. It also presents – in Annex 2 hereto – the proposed up-dated requirements which the MFSA has drawn up following consideration of all feedback received. The MFSA is open to consider any further comments which may be received in relation to the italicised changes indicated in the up-dated proposed requirements detailed in Annex 2 within the timeframe indicated in the covering note to this Feedback Statement. Subject to any further changes which the MFSA considers appropriate following consideration of any final feedback received with respect to the italicised changes, the up-dated requirements are to be introduced in the MFSA's Investment Services Guidelines as standard licence conditions in Part C.II and C.III.
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Section B - Comments Received – Main Issues

B.1. The respondents who strongly objected to the implementation of the proposed requirements claimed that the proposed changes:

- a) raise serious concerns in relation to the existing performance fee structures which are already in place. It was claimed that:
  - i. the current performance fee arrangements applied by certain funds are considered to be fair and reasonable; easy to understand and calculate; and clearly disclosed and explained to investors;
  - ii. the proposed requirements would require significant changes to existing performance fee arrangements previously reviewed and approved by the Authority;
  - iii. the Authority may not now revise a decision taken previously when the proposed revision will have a drastic effect on the rights and expectations arising from existing agreements;
  - iv. such changes would create a precedent for all licence holders and would undermine confidence in the industry as licence holders require certainty in their conduct of business.
- b) raise serious concerns in relation to the performance fee structures which would be allowed under the new rules. It was claimed that:
  - i. the proposed approach is too rigid, allowing little flexibility and fails to take into account that performance fees which satisfy the broad objectives of fairness, ease of understanding and administrative simplicity may be based on other factors;
  - ii. the proposed concepts for the calculation of performance fees have their intrinsic limitations and may be inappropriate depending on the nature of the fund;
  - iii. the design and adoption of any performance fee should be left to the promoters, subject to the scrutiny and approval of MFSA;
  - iv. local schemes and their managers/ advisors could be disadvantaged as different performance fee structures are permitted in other jurisdictions and foreign UCITS schemes could be marketed freely to local retail investors;
  - v. the proposed requirements pose a very serious threat for the local regulatory framework to be perceived uncompetitive when fund promoters are considering in which jurisdictions to domicile their funds.

B.2. Whilst there were those who considered that the proposed new requirements should not be implemented in a manner so as to affect existing performance fee arrangements, others argued that certain existing structures should not have been approved in the first place.

B.3. Some respondents complimented the MFSA for taking action to address the area of performance fees payable on retail funds and highlighted the merits of the application of a high watermark.

B.4. Some respondents questioned the application of performance fees in the local market and argued that in a market with few shares to select from, the art of investment selection is heavily watered down. It was argued that this was particularly so for those funds which focus on local equities. Due to the lack of choice on the local exchange, such funds would effectively invest in the majority of the shares listed on the market,

moving close to becoming index funds. It was accordingly argued that until the local stock market increases in depth, no performance fees should be applied in such circumstances. The degree of investment management taking place in such funds was also questioned.

- B.5. Some respondents complained about the manner in which the Authority has communicated its intentions to introduce the new requirements and that the Authority did not grant sufficient time for consultation. Reference was made to the UK approach when introducing rules regarding performance fees. However, some acknowledged that the extensions to the consultation process given by the Authority subsequently allowed for a more effective consultation.
  - B.6. Some respondents noted that it would have been useful for MFSA to identify the international regulatory developments and accepted practice it has referred to in drawing up the proposed requirements so that interested parties could consider these aspects and their relevance to the local scenario.
  - B.7. The industry seems to have embraced the concept that the interests of investors should be aligned with those of fund managers - (however it seems some qualified this with reference to the issues raised).
  - B.8. None of the respondents raised concerns that the new requirements would negatively affect the consumer of financial services - except for the issue related to equalisation as described in further detail below. The concerns raised related to the effects the proposed requirements would have on financial services practitioners and related parties benefiting from current arrangements as well as issues related to competition.
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Section C - Other Specific Comments

*MFSA Proposed Condition 1.0*

In the case of a retail collective investment scheme, a performance fee may only be adopted on the following basis:

- a) the performance fee should be fair and reasonable. In determining the fairness of such fee, consideration should be made to the other applicable fees to a Scheme;
- b) the performance fee should be easy to understand and calculate;
- c) the performance fee should be clearly disclosed and explained to investors;
- d) the performance fee may only be payable in the form specified in condition 2.0.

C.1. A respondent commented that the reference to “*fair and reasonable*” is very subjective and open to interpretation and suggested that this element of subjectivity should be eliminated or at least reduced.

C.2. The same respondent asked for clarifications regarding the reference “*consideration to the other applicable fees to a scheme*” and questioned whether this meant that there should be a benchmark against the other applicable fees to the scheme such as the management and custody fees. It was suggested that if this is the case, a maximum amount should be applied on the performance fee which could be charged to the scheme.

C.3. Objections were raised to the requirement in paragraph (d) on the basis of the arguments referred to in Section B and C.4. below.

*MFSA Proposed Condition 2.0*

Performance fees may be payable on:

- a) new high NAV per share over the life of the Scheme, where the starting price is the initial offer price or any other benchmark if this is higher; *or*
- b) the out-performance of a relevant index.

In case of (a) above, no performance fee shall be paid/accrued until the NAV per share exceeds the previous highest net asset value per share on which the performance fee was paid/accrued (if any), or the initial offer price or any other benchmark if this is higher (the “water mark”). The performance fee is only payable on the increase over the watermark.

In case of (b) above, the index must be relevant to the Scheme. The performance fee would only be payable on the amount by which the Scheme outperforms the index and any underperformance of the index in preceding periods since launch, is recouped before a fee becomes due in subsequent periods.

- C.4. It was claimed that Condition 2.0 above is unduly restrictive as it imposes particular models of performance fees, and does not allow sufficient flexibility in the design of performance fee structures which depend on various factors like the expertise of the entities managing/ advising the scheme and the peculiarities of the scheme. It was claimed that:
- i. a scheme may invest in a sector or combination of sectors for which no relevant index is available and for which it is not feasible or possible to commission such an index;
  - ii. performance fees based on a high water mark may be inadequate in certain circumstances to align the interests of the manager/ advisor with those of the investors. The NAV of a scheme may fall below its high water mark for reasons which are beyond the control of the manager/ advisor (such as for example, in a general market down turn) and in such a situation the prospect of the scheme outperforming its high water mark may be remote no matter how skilful the manager/advisor may be. It would be unfair on the manager/ advisor to be deprived of earning a performance fee for a considerable period of time notwithstanding the fund's positive performance;
  - iii. the proposed performance fee concepts may be inappropriate - for example for a scheme investing in a sector for which there is no relevant index available or markets, such as a scheme which performs positively relative to a falling market;
  - iv. the Authority's approach is prescriptive and does not take into consideration market innovation/ development;
  - v. allowance should be made for performance fees to be based on other factors such as hurdle rates.
- C.5. Other respondents agreed that the introduction of the said concepts have many merits to them as they attempt to align the interests of investors to that of the fund manager/ promoter, and one respondent stated that performance fees should always be subject to a high watermark.
- C.6. With reference to the paragraph reading "*In case of (a)...*" two respondents highlighted that the word "accrued" in the reference to "*paid/ accrued (if any)*" should be removed given that the requirement to make such accrual would not arise in practice. It was remarked that although an accrual could have been made on the highest NAV, the performance fee would have been paid at the end of the period at which point, the NAV per share could be lower than that which was accrued upon.
- C.7. While it was stated that some form of benchmarking or high watermark should be an integral part of the calculation of a performance fee, it was noted that there are many weaknesses to the proposed forms of performance fee calculation which the MFSA should be aware of.

It was questioned whether a performance fee should be charged in case where a fund's unit price has fallen from Lm1 to Lm0.50 and yet moves back up to Lm0.75. It was noted that in such case some performance would have been made by those investors who have bought in at Lm0.50 - such investors would accordingly be advantaged in comparison to existing investors if no performance fee is paid. If a performance fee is however charged at this point, it will irritate those existing investors who are still suffering losses.

*MFSA Proposed Condition 3.0*

The Prospectus should contain clear disclosure on the performance fee including:

- a) details on the calculation of the performance fee including the accrual basis and when the fee is actually paid, the calculation period for determining the fee and the first such period;
- b) a risk warning that the increase in NAV which is used as a basis for the calculation of performance fees, may be comprised both of realised gains as well as unrealised gains as at the end of the calculation period, and as a result, performance fees may be paid on unrealised gains which may subsequently never be realised by the scheme;
- c) details regarding any maximum amount or percentage of NAV that a performance fee might represent in any one accounting period and appropriate warnings in case where there is no maximum;
- d) worked examples showing the operation and impact of performance fees.

C.8. While it was highlighted that transparency is vital, it was argued that the disclosure requirements should however not be overly complex as to obscure the explanation of the performance fee mechanism.

C.9. With reference to condition (3)(d), it was noted that it would be helpful if the MFSA could provide illustrations of the examples required.

*MFSA Proposed Condition 4.0*

The Scheme or its Manager or Administrator as applicable, should adopt appropriate controls and structures for the on-going supervision of the procedures and processes in the calculation and payment of performance fees.

C.10. No comments were made on this condition.

*MFSA Proposed Condition 5.0*

The calculation of the performance fee should be verified by the custodian of the Scheme.

C.11. No comments were made on this condition.

Section D - Other general remarks/ observations raised as part of the consultation exercise

- D.1. One respondent highlighted that a performance fee should not be paid upon accrual but when the fee is actually due given that the fund could be adversely affected in those cases where there is an over accrual and the fund has a low cash exposure which could result in the fund having to dispose of securities unnecessarily.
- D.2. It was noted that the Manager should not be liable to the scheme and not requested to reimburse performance fees already paid when there is an underperformance of the relevant index or watermark.
- D.3. Another suggestion received was that performance fees may be introduced or amended subject to giving existing investors 90 days written notice as is the norm for other charges.
- D.4. It was also remarked that performance fees should be allowed to be shared between certain parties to a scheme as long as this has been explicitly stated in the Prospectus.
- D.5. It was observed that investors may not be able to take educated investment decisions given the lack of sophistication of the local press and complete lack of critical analysis of the performance and comparison of funds. Fund promoters could accordingly take advantage of such lack of awareness to design charging structures which may be skewed in favour of the fund promoter and not the investors.
- D.6. Another point made was that any performance fees charged should reflect the added value that the fund manager/ advisor have brought to the fund and should vary according to the complexity of the fund.
- D.7. It was observed that in cases where it is the fund promoter who is the only benefactor in a performance fee arrangement, this gives the wrong message and damages the industry and the confidence in the industry. Rectifying any unfair arrangements will help add a building block to the improvement of confidence in our industry.
- D.8. It was also suggested that where a fund is investing in assets that inherently have a level of income, the performance fee should ideally also be subject to a threshold that recognises the level of current income that the fund is likely to generate anyway. If there is no threshold in the computation of the performance fee, there should be disclosure that the performance fee will effectively also apply to such income, and a reasonable statement explaining the expected level of such income based on the latest “current income investment yield” of the fund’s portfolio.
- D.9. Another comment made was that the adjusted NAV for the purpose of measuring any performance fee payable, should not exclude the management fee if it is payable to the same person receiving the performance fee as otherwise this would increment the performance result.
- D.10. It was further noted that the risk warnings related to performance fees should mention that performance fees may incentivise the manager/ advisor to take higher risks in investment decisions.

- D.11. As part of the disclosure requirements, it was suggested that there should be a statement regarding equalisation, namely:
- i. that where the fund is not to employ 'equalisation', a statement to this effect. This should be accompanied by an illustration of how this may affect investors;
  - ii. in the case where the fund is to employ equalisation, the methodology to be applied, together with examples of the effect on investors who buy at a time when the adjusted NAV (for performance fee purposes) is above as well as when it is below the high water mark NAV; and
  - iii. a statement explaining that the purpose of equalisation is to ensure as much as possible, an equitable treatment of both investors and the manager/ advisor receiving the performance fee regardless of when purchases and redemptions are made.
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## Section E – MFSA’s reactions

### *General*

- E.1. The Authority would like to emphasise that the overriding objective behind the proposed introduction of the new requirements on performance fees payable to retail fund managers and advisors is ‘fairness to investors’.
- E.2. As the competent authority under the Investment Services Act, 1994 and the regulator of financial services in Malta, one of the primary objectives of the MFSA is to protect investors and promote the general interests and legitimate expectations of consumers of financial services. Indeed, this responsibility overrides commercial interests of promoters and it would be most irresponsible for the Authority not to take appropriate action to prevent unfair performance fee structures. Following market experience gained, the Authority considers that the proposed requirements are needed to ensure greater fairness to investors.

### *Main issues*

- E.3. The MFSA’s views on the main issues raised are as follows:

- a) *Claim that certain performance fee arrangements currently in place are considered to be fair and reasonable*

Such a claim has not been substantiated. No arguments or basis on which such a statement is being made were provided to the Authority.

The examples provided to the Authority to demonstrate the “inadequacy” of the proposed high water mark method (‘HWM’) for the fund manager/ advisor can similarly be applied to demonstrate the unfairness to the investor of certain existing performance fee structures. For example, it was argued that it would be unfair on the manager/ advisor not to earn a performance fee when a scheme’s NAV would have fallen below its HWM for reasons over which the manager/ advisor has no control, such as in a general market down turn. It was remarked that in such circumstances, it could be remote for the manager/ advisor, no matter how skilful he is, to lead the scheme to perform above its HWM. However, it can similarly be argued that it would be unfair for investors if the manager/ advisor would be earning a performance fee (in addition to its other management/ advisory fees) for reasons over which it has no control and which are not a reflection of any particular skills or value added by the manager or advisor, such as due to a general upward market movement.

- b) *Claim that the proposed changes should not be made or applied to current arrangements as MFSA did not raise objections in the first place with respect to agreements relating to existing performance fee structures*

Operators in a regulated environment should be aware that regulatory requirements can be, and in fact are, subject to change depending on experience and market developments. One cannot expect a decision to be crystallised forever and not be changed or revised, particularly in light of regulatory developments, experience and hindsight. The MFSA as the competent authority under the Investment Services Act, 1994 is empowered to alter and introduce new regulatory requirements from time to time as it considers appropriate and subject to adequate notice to licence holders and consideration of any representations received. Indeed, one of the Standard Licence

Conditions (currently numbered 1.24 in Part C.II) applicable to all currently licensed locally based schemes, provides that the MFSA has the right, from time to time, to vary or revoke any condition of a Licence or to impose any new condition.

At the time when the Authority had reviewed existing agreements, there were no regulatory requirements and/or licence conditions addressing the manner in which performance fees should be charged. The Authority strongly believes that in the interest of unsophisticated / retail investors, the proposed new requirements should be applied across the board to all licensed retail funds and sees no reason why currently licensed schemes should be exempt from such requirements. The MFSA is not the only authority which has revised its approach towards fees charged on funds, in particular performance fee structures. As stated by the Technical Committee of IOSCO in its report on fees and expenses on investment funds issued in November 2004, "*Fees and expenses have long been a concern for regulators, and many jurisdictions are in the process of revising their approaches to these issues*"<sup>1</sup>.

- c) *Claim that such changes would create a precedent and would undermine confidence in the industry as licence holders require certainty*

The Authority questions how one can claim that changes which are being made with the aim of ensuring greater fairness for investors, can undermine confidence in the industry. Rather, the contrary should be the case. The new requirements are not being introduced capriciously, but are based on the premise of fairness.

- d) *Claim that proposed requirements are unduly restrictive and may be inappropriate*

The MFSA has a legal obligation to protect investors and with this objective in mind, it has considered it necessary to introduce the new requirements on performance fees, which seek to ensure fairness to investors. The HWM method ensures that performance fees are payable only on net new gains. The MFSA has also opted for the HWM and the index-related benchmark methods as these are widely recognized and used in the funds industry. According to research, the high water mark methodology is used by a substantial proportion of funds, whilst a significant number use an index-related benchmark<sup>2</sup>.

- i. *It was pointed out that not all funds would be able to utilize the index related benchmark method as there may be no relevant index for the nature of assets of a particular fund*

Indeed, the MFSA agrees that the index-related benchmark method cannot be used for all types of funds and that is why there is the HWM alternative.

- ii. *It was also pointed out that the HWM method may be inadequate in certain circumstances to align the interests of managers, advisors and investors. The argument here is that the scheme's NAV may fall below its HWM for reasons over which the Manager, or Advisor have no control e.g. a general market down turn. In such a situation, a scheme performing above its HWM may be remote*

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<sup>1</sup> "Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds" – Technical Committee of IOSCO, November 2004.

<sup>2</sup> Performance Fees for Investment Funds – Technical Discussion Paper by the Investment Management Association and the Depository and Trustee Association, in conjunction with Fitzrovia International Ltd, February 2005. pg.14/15

*no matter how skilful the manager or advisor may be, and it would be unfair to deprive the manager or advisor from earning a performance fee for a considerable period of time, notwithstanding the Fund's positive performance.*

Apart from the issues raised in (a) above, the MFSA would like to highlight that it is seeking to ensure fairness to investors first and foremost. Performance fees are ordinarily payable over and above the basic management and advisory fees which are set as a flat percentage of NAV irrespective of the fund's performance. The manager/ advisor would thus already be rewarded irrespective of the fund's performance and also irrespective of whether any increase in NAV is due to a general market upturn.

Accordingly, the MFSA considers it important to ensure that performance fees are only payable when they are appropriately justified and when they reflect superior returns which can be attributed to the manager/ advisor. The Authority considers that the proposed new requirements will satisfy such objective.

*iii. It was pointed out that the MFSA's prescriptive approach fails to take account of the fact that other methods may evolve from time to time which meet the attributes required in condition 1 of the proposed requirements. Hurdle rates (fixed or variable) were mentioned as an example*

The proposed rules are not aimed to be static but may evolve and be further developed and expanded as appropriate from time to time. The regulatory approach adopted will also be reviewed from time to time and updated as considered necessary by taking into consideration various factors including market developments and practices abroad.

The use of hurdle rates are not prohibited as long as these are used in combination with the HWM or index-related benchmark methods.

*e) Reference to the (initial) consultation period having been insufficient*

It is customary for MFSA to apply a four week consultation period in relation to proposed new regulatory requirements. However, further to interest and requests received, the MFSA extended the consultation period and the industry was provided with sufficient time to review and comment on the proposed changes.

*f) Reference to international regulatory developments and accepted market practice*

The MFSA finds it somewhat surprising that certain respondents would like to consider the developments and accepted practice the Authority has referred to in drawing up the proposed requirements so that they could assess their relevance to the local scenario, given that this exercise would have already been carried out by the regulator itself.

Notwithstanding this, the Authority would like to inform interested parties that it has referred to accepted practices relating to performance fees in a number of EU member jurisdictions and reports/papers relating to performance fees including the 'Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds' issued by the Technical Committee of the International Organisation of Securities Commission in November 2004.

g) *Reference to possible discrimination against local managers, advisors and schemes*

The Authority is aware that there are no harmonized EU regulatory requirements concerning the permissible methodology for calculating performance fees. Competent authorities in each Member State are free to set their own requirements in this regard. Whilst some Member States, do not require any specific performance fee structure, others, have more prescriptive requirements. Indeed, Ireland only permits performance fees on the basis of the high water mark (new high NAV) or on the out-performance of a relevant index for UCITS and non-UCITS schemes incorporated in this country.

The Authority considers that in the interests of retail investors the majority of whom are considered as relatively unsophisticated, it is preferable to adopt a more prescriptive approach in respect of performance fees than that adopted in certain other more developed financial centres.

The Authority has taken into account the nature of the fee charging structures adopted by foreign retail schemes actively marketed in Malta and does not consider that the new requirements will result in any real discrimination against local schemes or providers.

h) *Claims that the proposed requirements pose a very serious threat for the local regulatory framework to be perceived uncompetitive*

The Authority fails to see the basis on which such a statement has been made considering that Malta is not the only jurisdiction with similar requirements to those proposed and also given that research shows that the HWM method is used by a substantial proportion of funds and a significant number use an index-related benchmark<sup>3</sup>.

i) *Request for illustrations with reference to condition 3(d)*

The worked example in the Prospectus should indicate a period in which the fee is due, then not due and then due again. The effects of the payment of such fee on the NAV should be clearly portrayed.

Annex 3 provides a specimen illustration for the use of either of the two proposed methodologies.

j) *Claim that the proposed concepts for calculating performance fees have intrinsic limitations*

The Authority acknowledges that each performance fee model may have its own limitations. However, it believes that the permitted methodologies stipulated in the proposed new requirements, are reasonable and ensure greater fairness to investors particularly within the local scenario.

The HWM method ensures that the manager/ advisor would not be paid twice for the same increase in NAV. In this manner, any subsequent falls of the NAV on which a performance fee was paid would have to be first recouped before any other performance

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<sup>3</sup> Performance Fees for Investment Funds – Technical Discussion Paper by the Investment Management Association and the Depositary and Trustee Association, in conjunction with Fitzrovia International Ltd, February 2005. pg.14/15

fee is paid. With respect to the example indicated in Section C.7., no performance fee would be paid in line with the new requirements where the NAV of a fund has fallen from Lm1 to Lm0.50 and returns back to Lm0.75, given that the fund would have not yet exceeded its highest NAV or HWM (i.e. Lm1 or any other applicable higher NAV).

The payment of a performance fee in the case of the out-performance of a relevant index would ensure that the manager/ advisor would be rewarded for superior performance and not for market-related movements.

The Authority acknowledges that the proposed methods may have certain drawbacks such as the possible inequitable treatment of investors where equalisation or individual investor calculation is not accounted for or the possibility of having no relevant index to cater for the sector targeted by the fund. In case where there is no relevant index, one acknowledges that it may be impractical to develop and calculate a specific index for a fund. In such circumstances, a manager/ advisor can always adopt the HWM method if it still wants to introduce a performance fee structure.

The Authority has also taken into consideration the fact that the proposed structures are also commonly used by overseas managers/ advisors who adopt performance fee structures.

k) *Suggestion not to allow the application of performance fees on funds focusing on the local market*

The Authority expects that in order for a performance fee to be considered as fair and reasonable, the amount of such fee should justify the work undertaken by and the skills of the manager/ advisor, taking also into consideration any other fees payable to the manager/ advisor. As observed by the IOSCO Technical Committee<sup>4</sup>, performance fees should not be so excessive as to bear no reasonable relationship to the services rendered by the manager/ advisor.

Reference is made to the comments referred to under Section B.4. The Authority considers that rather than prohibiting performance fees being charged for schemes whose objective is to invest primarily in equities listed on the MSE, it would expect the promoters of such a scheme to take into consideration the MSE Share Index in drafting the respective performance fee structure so as to ensure that the structure is fair and genuinely rewards the manager/ advisor for his skills and not for general positive market movements. Taking this aspect into consideration as well as the nature of the local exchange, the Authority believes that for those schemes whose objective is to invest primarily in equities listed on the MSE and who are to apply a performance fee arrangement, the MSE Share Index should either be used as the benchmark, or such index included as a hurdle in combination with the HWM method. The proposed requirements have been updated accordingly.

Similarly, where a scheme's objective is to invest primarily in securities listed on one exchange, in circumstances where the scheme's portfolio would broadly represent the composition of an index pertaining to such exchange, then such index should be used as a benchmark in the HWM methodology.

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<sup>4</sup> Technical Committee of IOSCO - "Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds" November 2004.

## *Other comments*

E.4. Certain comments included in Section C and D have been addressed in reply to the main issues under E.3. The Authority's views - in addition to those made in E.3. – on the remaining material comments raised under Section C and D and other points arising are as follows:

a) *Consideration to other applicable fees to a scheme*

The proposed MFSA's condition 1.0(a), states that in determining the fairness of the performance fee, consideration needs to be made to the other applicable fees to the Scheme. The Authority believes that performance fees should be structured in a manner as to benefit and be fair to investors. The economic interests of the manager/ advisor should thus be aligned with those of investors.

In this regard, the Authority would expect that where a performance fee is to be charged in addition to any flat (i.e. fixed % of NAV) manager/ advisory fees, care should be exercised in order to ensure that the aggregate fees charged are fair and reasonable. This may be achieved by setting the flat management/ advisory fees applicable to a fund which is also charged performance fees, at a somewhat lower level to that ordinarily applicable in the case of a similar fund which is not charged a performance fee. Other methods could alternatively be considered, such as arrangements whereby a lower management fee could be charged in case of underperformance.

The objective of the performance fee should be for the manager/ advisor to be compensated in return for the skills exercised in achieving the fund's performance. In the absence of a fulcrum type fee - where under-performance would result in a reduction of the manager/ advisor's fee - one would not expect the manager/ advisor to earn a high fixed fee and a performance fee at the same time as this would not reflect an equitable approach given that the manager/ advisor would be enjoying all the benefits in all scenarios – that is, earning a high flat fee irrespective of the fund's performance whilst receiving additional remuneration in case of over-performance. The fee structure should also not be structured in a way as to incentivise the manager/ advisor to take excessive risks in order to increase its fees.

b) *Allowance for performance fees to be based on other factors*

The requirements do not allow the use of hurdle rates on their own. However, hurdle rates can be used in conjunction with the HWM method. This would remove the possibility of earning a performance fee more than once on the same performance.

c) *Deletion of the word "accrued"*

The Authority accepts the recommendation to delete the word "accrued" so that the paragraph in condition 2.0 is revised to read as follows "*In case of (a) above, no performance fee shall be paid/ accrued until the NAV per share exceeds the previous highest net asset value per share on which the performance fee was paid (if any), or ...*".

d) *Equalisation*

Equalisation is usually used to ensure that investors are treated equitably so that certain investors would not be advantaged or others disadvantaged depending on the timing at which one enters into/ leaves a fund. Individual investor calculations and the levying of performance fees on individual investors rather than on the fund may be used with the aim to ensure the equitable treatment of investors.

The drawback of such methods is that they increase the administrative burden on the manager. This would thus increase the costs and also the complexity of the structure. Such methods may also not be practical particularly for retail funds having a large number of investors and dealing on a daily basis.

The Authority recognises the difficulties involved in the use of such methods, and accordingly agrees with the suggestions made that the Prospectus should include statements regarding equalisation as recommended in D.11 above.

e) *Timing for the payment of performance fee/ accruals*

A performance fee should be paid at a reasonable frequency. The Technical Committee of IOSCO<sup>5</sup> highlights that the payment of a performance fee once a year is considered to be a reasonable period. The payment of the performance fee on an annual basis would have the benefit of addressing the possibility of any short-term trading and would reduce volatility of performance fee payments. The Authority favours the payment of a performance fee on a yearly basis (in line with common practice abroad<sup>6</sup>) and also in line with the standard indicated by the Technical Committee of IOSCO.

Accruals are expected to be carried out at the same frequency of the NAV calculation.

f) *Introduction of performance fees and changes thereto and sharing of fee*

The Authority would expect the introduction of performance fees for existing schemes which are not contemplated in the schemes' constitutional documents or prospectus, to be made subject to shareholders' approval, given that this would entail a major change to the charging structure of a scheme. Advance notification to investors would need to be made in respect of other changes such as a change in the calculation methodology or other feature pertaining to existing performance fees.

The Authority finds no objection for the sharing of fees as long as this is clearly disclosed to investors.

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<sup>5</sup> Technical Committee of IOSCO - "Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds" November 2004.

<sup>6</sup> Performance Fees for Investment Funds – Technical Discussion Paper by the Investment Management Association and the Depository and Trustee Association, in conjunction with Fitzrovia International Ltd, February 2005.

g) *Measurement of performance fee*

The performance fee should be calculated on the net asset value, after all the costs and liabilities of the fund are deducted. That is, in measuring performance fee one should not exclude management fees and other expenses chargeable to the fund.

h) *Disclosure of additional warnings*

The Authority concurs with the views that the disclosure to investors should be transparent and should not be overly complex so that it can be easily understood. The Authority believes that the proposed disclosure requirements ensure full transparency and should not give rise to complications. The promoters also have an important role in ensuring that the disclosures made are drafted in a manner so as to be simple and easy to understand.

The Authority agrees with the recommendations to introduce a risk warning that performance fees may incentivise the manager/ advisor to take higher risks in investment decisions (as suggested in D.10.) and the recommendations relating to equalisation as suggested in D.11. above.

i) *Use of fund's initial offer price as a hurdle to be incorporated in the calculation of performance fees*

The Authority is of the view that it is important to ensure consistency in application of the underlying principle of fairness to investors across both the HWM and index-related benchmark methodologies which may be both used for calculating performance fees. In this regard, in order to avoid situations where a performance fee is payable at a time when the fund's unit price is below its initial offer price, the Authority considers that such initial offer price should be incorporated as a hurdle rate not only for the HWM method but also for the index-related benchmark method. The proposed requirements have been up-dated accordingly.

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## Annex 1 – Original proposed requirements

- 1.0 In the case of a retail collective investment scheme, a performance fee may only be adopted on the following basis:
- a) the performance fee should be fair and reasonable. In determining the fairness of such fee, consideration should be made to the other applicable fees to a Scheme;
  - b) the performance fee should be easy to understand and calculate;
  - c) the performance fee should be clearly disclosed and explained to investors;
  - d) the performance fee may only be payable in the form specified in condition 2.0.

- 2.0 Performance fees may be payable on:

- a) new high NAV per share over the life of the Scheme, where the starting price is the initial offer price or any other benchmark if this is higher *or*
- b) the out-performance of a relevant index

In case of (a) above, no performance fee shall be paid/accrued until the NAV per share exceeds the previous highest net asset value per share on which the performance fee was paid/accrued (if any), or the initial offer price or any other benchmark if this is higher (the “water mark”). The performance fee is only payable on the increase over the watermark.

In case of (b) above, the index must be relevant to the Scheme. The performance fee would only be payable on the amount by which the Scheme out performs the index and any underperformance of the index in preceding periods since launch, is recouped before a fee becomes due in subsequent periods.

- 3.0 The Prospectus should contain clear disclosure on the performance fee including:

- a) details on the calculation of the performance fee including the accrual basis and when the fee is actually paid, the calculation period for determining the fee and the first such period;
- b) a risk warning that the increase in NAV which is used as a basis for the calculation of performance fees, may be comprised both of realised gains as well as unrealised gains as at the end of the calculation period, and as a result, performance fees may be paid on unrealised gains which may subsequently never be realised by the scheme;
- c) details regarding any maximum amount or percentage of NAV that a performance fee might represent in any one accounting period and appropriate warnings in case where there is no maximum;
- d) worked examples showing the operation and impact of performance fees.

- 4.0 The Scheme or its Manager or Administrator as applicable, should adopt appropriate controls and structures for the on-going supervision of the procedures and processes in the calculation and payment of performance fees.

- 5.0 The calculation of the performance fee should be verified by the custodian of the Scheme.

## Annex 2 – Up-dated proposed requirements (With Changes in Italics)

1.0 In the case of a retail collective investment scheme, a performance fee may only be adopted on the following basis:

- a) the performance fee should be fair and reasonable. In determining the fairness of such fee, consideration should be made to the other applicable fees to a Scheme;
- b) the performance fee should be easy to understand and calculate;
- c) the performance fee should be clearly disclosed and explained to investors;
- d) the performance fee *should be paid at a reasonable frequency* and may only be payable in the form specified in condition 2.0.

2.0 Performance fees may be payable on:

- a) new high NAV per share over the life of the Scheme, where the starting price is the initial offer price or any other benchmark if this is higher *or*
- b) the out-performance of a relevant index

In case of (a) above, no performance fee shall be paid/accrued until the NAV per share exceeds the previous highest net asset value per share on which the performance fee was paid (if any), the initial offer price, or any other benchmark if this is higher (the “water mark”). The performance fee is only payable on the increase over the watermark.

*Where the investment objective of a Scheme is to invest primarily in local equity securities listed on the Malta Stock Exchange, the MSE Share Index should be used as a benchmark in (a) above. Similarly, where a scheme’s objective is to invest primarily in securities listed on one exchange, in circumstances where the scheme’s portfolio would broadly represent the composition of an index pertaining to such exchange, then such index should be used as a benchmark in (a) above.*

In case of (b) above, the index must be relevant to the Scheme. The performance fee would only be payable on the amount by which the Scheme out performs the index and any underperformance of the index in preceding periods since launch, is recouped before a fee becomes due in subsequent periods. *Provided that a performance fee shall not be payable if its NAV per share is below its initial offer price.*

3.0 The Prospectus should contain clear disclosure on the performance fee including:

- a) details on the calculation of the performance fee including the accrual basis and when the fee is actually paid, the calculation period for determining the fee and the first such period;
- b) a risk warning that the increase in NAV which is used as a basis for the calculation of performance fees, may be comprised both of realised gains as well as unrealised gains as at the end of the calculation period, and as a result, performance fees may be paid on unrealised gains which may subsequently never be realised by the scheme;
- c) *a risk warning that performance fees may incentivise the manager/ advisor of a Scheme to take higher risks in its investment decisions or advice;*

- d) details regarding any maximum amount or percentage of NAV that a performance fee might represent in any one accounting period and appropriate warnings in case where there is no maximum;
  - e) worked examples showing the operation and impact of performance fees;
  - f) *details related to the treatment of unit holders including:*
    - i. *reference to any method, such as equalisation, which is to be adopted by the scheme with the objective of ensuring equal treatment of unit holders irrespective of the timing of their investment in/redemption from the Scheme, including a description of the methodology to be used in this regard and an illustration of how this affects unit holders in different scenarios; or*
    - ii. *where no such method is to be used, disclosure to this effect, together with an illustration of the potential inequalities which could arise and their materiality on unit holders.*
- 4.0 The Scheme or its Manager or Administrator as applicable, should adopt appropriate controls and structures for the on-going supervision of the procedures and processes in the calculation and payment of performance fees.
- 5.0 The calculation of the performance fee should be verified by the custodian of the Scheme.

### Annex 3 - Worked examples

A. The following is a worked example using the high water mark ('HWM') method in combination with a benchmark such as an appropriate stock exchange index. The fund has the following features:

- i) daily calculation and accrual of performance fee;
- ii) performance fee is paid on annual basis at the end of accounting period;
- iii) performance fee is paid when the fund exceeds the HWM or the initial offer price or the benchmark which in this case shall be an appropriate stock exchange index;
- iv) an initial offer price of 1.0.

<i>End of year</i>	<i>Net Asset Value of Fund</i>	<i>Benchmark – reflecting the performance of the Index</i>	<i>High water mark</i>	<i>Performance fee payable</i>	<i>Outperformance on which fee is calculated</i>
1	1.05	1.03	1.00	Yes	0.02
2	1.11	1.08	1.05	Yes	0.03
3	0.90	0.95	1.11	No	-
4	0.98	0.96	1.11	No	-
5	1.09	1.08	1.11	No	-
6	1.13	1.12	1.11	Yes	0.01
7	1.15	1.14	1.13	Yes	0.01
8	1.10	1.12	1.15	No	-
9	1.17	1.20	1.15	No	-
10	1.20	1.22	1.17	No	-

B. The following is a worked example of a performance fee payable on the out-performance of a relevant index. The fund has the following features:

- i) daily calculation and accrual of performance fee;
- ii) performance fee is paid on annual basis at the end of accounting period;
- iii) performance fee is paid on the amount by which the fund outperforms the index and any underperformance of the index in preceding periods since launch, is recouped before a fee becomes due in subsequent periods. Provided that a performance fee is not payable if its NAV per share is below its initial offer price;
- iv) an initial offer price of 1.0.

<i>End of year</i>	<i>Net Asset Value of Fund</i>	<i>Index</i>	<i>Over performance - current</i>	<i>Cumulative underperformance of index</i>	<i>Performance fee payable</i>	<i>Outperformance on which fee is calculated</i>
1	1.02	1.01	0.01	0	Yes	0.01
2	1.11	1.04	0.07	0	Yes	0.07
3	0.90	0.88	0.02	0	No*	-
4	0.96	0.91	0.05	0	No*	-
5	1.03	1.01	0.02	0	Yes	0.02
6	1.09	1.04	0.05	0	Yes	0.05
7	1.15	1.14	0.01	0	Yes	0.01
8	1.13	1.12	0.01	0	Yes	0.01
9	1.17	1.20	0	0.03	No	-
10	1.19	1.23	0	0.07	No	-
11	1.30	1.24	0.06	0.07	No	-
12	1.35	1.33	0.02	0.01	Yes	0.01

\*NAV per share is still below its initial offer price of 1.