

## Report 2006:5

# Fee based on performance? –An examination of 47 mutual fund companies

### Summary

A large and growing number of fund managers currently apply fees that are associated with returns on savings, and thus also with how successful the manager is in the undertaking.

These fee models can be designed in various ways, and are often very complex. At the same time that performance-based pricing is generally considered positive, its complexity poses a basic problem from a customer perspective. That is why high demands must be placed on how the company designs and applies the fee models, as well as how the models are communicated to the customer.

Of almost ninety Swedish mutual fund and securities companies, approximately half apply this type of fee model in some form and to some extent. FI has examined all 47 of these companies.

In its examination, FI found notable shortcomings in how some of the companies calculate and ensure that correct fees are charged. In some instances, there was also insufficient knowledge on the part of companies regarding how their own models work.

FI believes that a company that chooses to implement performance fees must be able to ensure that fees are correctly and reliably calculated. The company must also, for example, have reliable routines in place to quickly catch errors so that they can be rectified.

- FI presupposes that each and every company will take necessary measures in this respect, and follow up to ensure that this is the case. Furthermore, FI presupposes that company boards will ensure that corporate auditors review and follow up these issues.

In its assessment of new funds with performance fees, FI will evaluate the company's routines in place for calculating and verifying fees, and will do the same for companies that are going to be or in the process of being re-authorized.

There are also shortcomings in terms of how fund savers are provided with information. It is of utmost importance that companies provide correct and relevant information since fees have great significance on returns, and it is equally as important that companies present information in a manner that fund savers understand.

- FI presupposes that companies and their boards will perform a review and an analysis of information, and implement relevant changes in fund rules as well as full prospectus as soon as possible. Changes to fund regulations can be dealt with in the framework of re-authorization for those companies that have not yet been re-authorized. Changes to fund regulations must be implemented by February, 2007.

Two more specific issues that affect the construction of fee models, and that FI believes need to be addressed, regard in part the issue of which periods of measurement are used in the models, and in part the issue of managing

compensation in the event of lower returns, i.e., if the returns on the fund for a shorter or longer period of time are worse than the stated hurdle rate/benchmark index.

In the examination, FI saw examples of fee models in which the period of measurement is designed in a manner that causes unfair results in certain situations, and which can result in the fund saver paying incorrect fees to the company. FI will not approve such models in the future. Existing models that have these characteristics must be re-worked or terminated.

In terms of compensation for lower returns, FI believes that fund savers should not need to pay a performance fee for “performance” that has resulted in worse results than the chosen hurdle rate, which can be the result when a company chooses not to compensate for lower returns in the fund or to limit conditions for how long lower returns may be included.

Performance fee models that do not compensate for lower returns in previous periods are not acceptable in the opinion of FI. This is true of both existing and new funds. For existing funds with models of this type, FI proposes that companies should have reviewed and implemented relevant changes to the models by February, 2007, the time point by which all companies should be re-authorized.

Due to this last proposal, all companies are invited to submit viewpoints regarding the proposed change by 24 April 2006; this invitation includes all companies, not just those included in the examination. It is also possible to submit viewpoints on other parts of the report. Email the referral answer request to [finansinspektionen@fi.se](mailto:finansinspektionen@fi.se), and indicate FI Dnr 06-3422-399.

FI will then invite affected companies to a meeting to discuss the questions at issue.