April 2016

ESMA Discussion Paper on UCITS Share Classes

Background

On 6th April, 2016 the European Securities and Markets Authority ("**ESMA**") published a discussion paper on UCITS Share Classes (the "**Discussion Paper**"), following on from its earlier consultation on different share classes of UCITS (December 2014).

ESMA is now proposing the development of a common framework throughout the EU for the operation of share classes within UCITS based on a series of high level principles to be followed when setting up different share classes together with a set of supporting operational principles.

ESMA is seeking detailed feedback (by 6th June, 2016) on whether and how share classes can actually work under the principles it has outlined.

The full text of ESMA's Discussion Paper may be accessed here.

High-level Principles

ESMA has identified the following four high-level principles that should be followed when setting up different share classes within a UCITS fund:-

1. **Common investment objective;** *share classes of the same fund should have a common investment objective reflected by a common pool of assets.*

For further information on any of the issues discussed in this article please contact:

Jennifer Fox
DD:+ 353 (0)1 673 1717
jennifer.fox@dilloneustace.ie

ESMA has recognized that there are many examples of share classes which provide investors with different features where, as the performance of the investor as such is not modified by the characteristics of those share classes, they share a common investment objective. Examples it has given include retail -v- institutional, means of investment, management fees, minimum subscriptions, voting rights, currency.

The key issue with ESMA's paper in this context is what it has said about how to approach the meaning of "common investment objective" where classes are set up with a derivative hedge or overlay. ESMA feels that it could lead to such classes having a risk profile (and therefore an investment objective) which would no longer be in line with the investment objective in the fund.

However, of particular note is ESMA's statement that it regards currency hedging at share class level as compatible with the principle of a common investment objective. In this regard, ESMA is also of the view that hedging should be understood as coming within the parameters as set out in its Guidelines on Risk Measurement[1], i.e. that the hedging arrangement should not aim to generate a return, there should be a verifiable reduction of risk at the level of the UCITS, the risks relating to derivatives should be offset, should relate to the same asset class and should be efficient in stressed marked conditions.

2. **Non-Contagion;** *UCITS management companies should implement appropriate procedures to minimise the risk that features are specific to one share class could have a potentially adverse impact on other share classes of the same fund.*

ESMA has given a very useful, simple summary of the potential contagion or spillover implications for investors where class level derivative overlays are used. It has reminded stakeholders of the lack of asset segregation at class level, if the potential counterparty and operational rights are assumed by <u>all</u> investors in the class (i.e. not just those in the class which "uses" the hedge) and highlights the principal sources of contagion risk.

Importantly, (perhaps sometimes overlooked we think) it recognizes that these risks cannot be eliminated but can be mitigated by applying operational principles.

Accordingly, ESMA has proposed a set of <u>operational principles</u> which it considers, should be the minimum standard applicable to share classes with a derivative overlay which are as follows:

- the notional of the derivative should not lead to a commitment to deliver or receive securities with a value that cannot be serviced by that portion of the portfolio represented by the share class;

- a level of operational segregation should be put in place to ensure a clear identification of assets/liabilities and profit and loss to the respective share class(es) on an ongoing basis and at the very least, at the same valuation frequency of the fund;

[1] CESR's Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS – CESR/10-788

- the implementation of stress tests to quantify the impact of losses on all share classes due to loss in a hedged share class;
- evidence on an *ex-ante* basis that the implementation of the derivative overlay will lead to a share class which better aligns with the specific risk profile of the investor;
- the derivative overlay should be implemented according to a detailed, pre-defined and transparent hedging strategy.

In addition, EMSA has also recommended adherence to a number of exposure limits. These involve, *inter alia*: (a) that exposure to the counterparty is in line with the UCITS limits; (b) that overhedged positions do not exceed 105% of the NAV of the share class with underhedged positions not falling short of 95% of the NAV of the share class; (c) that overhedged/underhedged positions are monitored; and (d) the incorporation of a procedure to reset the hedging arrangements on a regular basis so as to ensure the position stays within the permitted position levels and is not carried forward from month to month.

In fact, it is worth noting that the exposure limits as set out above are already imposed by the Central Bank of Ireland in respect of hedged share classes.

Of particular interest, is the statement made by ESMA that whilst it believes that currency hedged share classes can operate in line with these principles it doubts that duration risk, hedged or volatility risk hedged classes can be seen as compatible with these operating principles as it states *"that they may not be implemented according to a detailed, pre-defined and transparent strategy."*

3. **Predetermination;** *all features of the share class should be predetermined before it is set up.*

   With regard to the above principle, ESMA is of the opinion that any form of discretion on the part of the UCITS management company (i.e. after the hedged class is set up) with regard to hedging mechanisms would contravene this principle of predetermination.

4. **Transparency;** *differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes.*

   With regard to hedged share classes with derivative overlays and associated counterparty and operational risks, ESMA is of the view that new and existing investors in a UCITS should be informed about the creation and existence of such share classes in a timely fashion through periodic reporting. Further, information should be provided through the fund's prospectus. The UCITS management company should also keep a list of share classes in the form of readily available information with regard to share classes with a contagion risk and stress tests should be made available to national competent authorities on a regular basis.

ESMA has also stated that share classes should never be set up to circumvent the rules of the UCITS Directive on diversification derivatives eligibility and liquidity.

Impact on Existing Share Classes

ESMA acknowledges that the introduction of the framework for share classes at EU level based on the principles outlined in the Discussion Paper could have a considerable impact on fund promoters in member states where share class arrangements may contravene such principles With this in mind, ESMA has acknowledged that transitional provisions would have to be introduced and as part of its consultation, has sought feedback from stakeholders on what kind of transitional provisions would be necessary.

ESMA has not clarified what type of instrument it might issue on the topic of share classes but notes that it is probable that it could lead to an ESMA opinion addressed to EU institutions or national competent authorities.

Conclusion

The Discussion Paper sets out 21 questions for stakeholders to consider with a deadline for responses on 6th June, 2016.

We would like to emphasise the importance for fund promoters with multi-class UCITS funds to consider this Discussion Paper. In particular, the principles and operational framework proposed would be of relevance to all promoters currently offering hedged share classes who will have an opportunity to comment on the practicality and feasibility of such proposals.

The consultation will also be of particular interest to fund promoters offering duration/interest rate or volatility risk hedged share classes. Noting that the Central Bank of Ireland permits interest rate hedging at share class level on the basis provided they comply with specific regulatory parameters (see Guidance on “UCITS and AIF Share Class hedging”); the Discussion Paper presents a real opportunity for such promoters to present their case that interest rate/duration hedged share classes can comply with the high-level principles and have been operating within a well established regulatory framework in Ireland.

Dillon Eustace will be preparing a response to the Discussion Paper ahead of the 6th June, 2016 deadline and should you wish to provide any comments on the Discussion Paper to ESMA we would be happy to incorporate them.

Please forward any feedback you may have on the ESMA proposals to your usual contact at Dillon Eustace.

Dillon Eustace
April 2016

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.