1 February 2017

ESMA issues Opinion on UCITS Share Classes

Background and Introduction

Following earlier consultations (in December 2014 and April 2016), ESMA has now issued an opinion to EU regulators on the extent to which share classes of the same UCITS fund can differ from one another (the "**Opinion**"). The aim of the Opinion is to introduce a harmonized approach throughout the EU for the treatment of share classes through the adoption of a common set of principles. A copy of the Opinion can be found here: https://www.esma.europa.eu/sites/default/files/library/opinion_on_ucits_share_classes.pdf.

Key points - High Level Principles

The Opinion sets out a number of high level principles which ESMA considers should be followed when setting up different share classes within a UCITS fund:-

1. ***Common investment objective***; *share classes of the same fund are linked by a common investment objective which is realised through the investment in a common pool of assets.*

   ESMA indicates that share classes which have been set up to differentiate between groups of investors, (e.g., retail vs institutional) or means of investment (e.g., management fees, minimum investments, voting rights currency meet with the criteria of a common investment objective on the basis that the performance of the investment is not modified by the characteristics of such classes. ESMA has however taken the

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

view that it does not regard the use of derivative overlays/hedging arrangements at share class level as consistent with the principle of a common investment objective on the basis that it could lead to that class having a risk profile which is not in tandem with the overall investment objective of the fund. Importantly however, ESMA has made an exception for *currency risk hedged share classes*

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

   ESMA has set down a number of operational principles together with exposure limits for the mitigation and monitoring of risks associated with share class hedging (although it recognises that such risks cannot be fully eliminated). In summary the operational principles are as follows:-

   - The notional of the said derivative should not lead to a payment or delivery obligation with a value exceeding that of the share class;

   - The UCITS management company should put in place a level of operational and accounting segregation which at a minimum ensures that there is a clear identification of the values of assets and liabilities and profit and losses in the respective share classes on an ongoing basis and at least at the same valuation frequency of the fund;

   - The implementation of stress testing to quantify the impact of losses on all share classes that are due to losses relating to share class specific assets that exceed the value the respective share class;

   - The derivative overlay is implemented according to a detailed, pre-defined and transparent hedging strategy.

   ESMA has also set down a number of exposure limits including limitation of exposure to the counterparty in line with the UCITS diversification limits at share class level, a limit on overhedged and underhedged positions and procedures for monitoring and rebalancing of such positions.

3. *Predetermination*; *all features of the share class should be predetermined before the share class is set up.* This is to enable investors to obtain a full overview of the rights and/or features attributed to their investment.

   Whilst the features of a share class would need to be clearly determined and disclosed set out prior to the launch of the share class, according to ESMA, this would not limit a fund manager in respect of the type of derivative used to hedge currency risk or its operational implementation.

4. *Transparency*;

   The Opinion sets out a number of principles addressing disclosure r to investors. In this regard, all investors are made aware of the existence and nature of all share classes, whether or not they invest in those share classes. Further, any share classes with counterparty and operational risks (i.e. currency hedged classes) have to be notified to new and existing investors in a timely fashion, including through the fund's periodic reports.

Timing and Transitional arrangements

ESMA is of the view that the following timing and transitional arrangements should apply:-

(i) Existing share classes which do not comply with the above principles should be allowed to continue to operate in order to mitigate the effect for investors in those share classes.

(ii) However, any share classes which do not comply with the above principles **<u>within 6 months after publication of the opinion, i.e. by 30 July 2017</u>** should not be able to accept subscriptions from new investors;

(iii) Existing Share classes which do not comply with the principles **<u>within 18 months of publication, i.e. by 30 July 2018</u>** should not be able to accept subscriptions from additional investors or new investors.

Impact on existing share classes in a UCITS fund

The Opinion is addressed to national competent authorities of EU member states under Article 29 (1) of Regulation No 1095/2010. We do not yet have an indication of the approach that the Central Bank will take in respect of Irish UCITS Funds and will provide further updates on any developments.

The Opinion will impact fund sponsors with multi-class UCITS funds in a number of ways.

Existing UCITS funds with currency hedged share classes will need to comply with all of the principles set out in the Opinion by 30 July 2017 if they wish to continue marketing such classes to new investors.

In particular, fund sponsors offering multi-class UCITS funds will need to carry out a review of their offering documents and to ensure that they can comply with the various transparency (disclosure) requirements and that the disclosures are consistent with the principle of pre-determination. In addition, further consideration will need to be given to the operational provisions. Whilst it is worth noting that many of exposure limits and operational principles are already imposed by the Central Bank (e.g. those relating to accounting/operational segregation and rebalancing of overhedged/underhedged positions), some requirements such as stress testing are new and require further practical consideration.

As noted above, the Opinion effectively precludes UCITS funds establishing interest rate / volatility hedged share classes or using derivative overlays at share class level other than for currency hedging. Whilst UCITS funds currently offering interest rate/duration hedged or volatility hedged share classes can continue to operate, such share classes will effectively be closed to new investment in accordance with the transitional provisions.

Dillon Eustace
1 February 2017

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.