Deutsche Bank

EU Transparency Register ID Number 271912611231-56

European Securities and Markets Authority
CS 60747 – 103 rue de Grenelle
75345 Paris Cedex 07
France

Deutsche Bank AG
Winchester House
1 Great Winchester Street
London EC2N 2DB
Tel +44 20 75458000
Direct Tel +44 20 75451903

Monday, 06 June 2016

Discussion Paper – ESMA UCITS Share Classes

Dear Sir/ Madam,

Deutsche Bank welcomes the opportunity to comment on the ESMA UCITS Share Classes discussion paper. We support ESMA's objective of defining and clarifying further share classes of UCITS.

Share classes present many advantages compared to sub-funds in terms of cost efficiency and faster set-up. Share classes are also beneficial to providers by lowering their overall costs and allowing them to meet the preferences and requirements of investors.

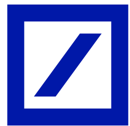
We agree that a carefully crafted common framework on share classes for all jurisdictions would be a positive development in terms of creating a level playing field for UCITS fund providers and investors. We support the high-level principles proposed in this Discussion Paper and suggest areas of clarification to ensure the framework reflects market practices. In particular, we view hedging overlays as complying with the principle of having the same investment strategy – similar to currency hedging. We believe the common investment objective is defined by the fact that the investment is realised in a common pool of assets.

Where any changes are made to the regulatory regime a "grand-fathering" system for existing products would be essential to ensure investors are not negatively impacted by changes and to provide continued legal certainty around the UCITS framework.

We would be happy to further discuss any of the points raised in the response.

Chairman of the Supervisory Board: Paul Achleitner.
Management Board: John Cryan (Co-Chairman), Jürgen Fitschen (Co-Chairman), Stuart Lewis, Sylvie Matherat, Quintin Price, Garth Ritchie, Karl von Rohr, Marcus Schenck, Christian Sewing, Jeff Urwin.

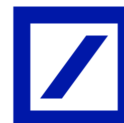
Deutsche Bank Aktiengesellschaft domiciled in Frankfurt am Main;
Local Court of Frankfurt am Main, HRB No 30 000; VAT ID No DE114103379;
www.db.com



Yours sincerely,

Matt Holmes

Global Head of Regulatory Policy



Q1: Would you agree with the description of share classes?
Yes.

Q2: Do you see any other reasons for setting up share classes?
Two additional reasons are mentioned in paragraph 16 of this Discussion Paper but not mentioned in the list set out in paragraph 12: the differentiation between groups of investors (in general retail vs. institutional investors) and different minimum investment amounts.

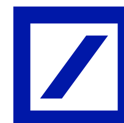
Share classes can also be created to comply with regulatory requirements. A concrete example would be the US Financial Industry Regulatory Authority (FINRA) rules in relation to new issues (such as IPOs). Entities that fall within the “insider” category (which includes broker/dealers and underwriters, and their affiliates, and fund managers) are not permitted to participate in the profits and losses of new issues on their launch day (most IPOs will have a first day “bounce” as they are generally priced at or below the expected price level). To address this issue, US mutual funds that wish to invest in new issues will often set up a restricted share class for insiders to make investments. These restricted share classes are identical to regular share classes save that they are not allocated any of new issue day one profits or losses (which are instead split pro-rata across other share classes). After that first day they participate in an identical asset pool to the other share classes.

UCITS should be able to make use of this type of restricted share class in the same way. Without this option, either the fund would not accept FINRA insiders (which could include European financial institutions with US affiliates or the European affiliates of US broker-dealers) or would not be able to participate in US new issues (potentially harming performance). This would not infringe upon the principle of a common investment objective as set out in 3.3.2 (see question 3).

For Exchange Traded Funds (ETF), share classes also offer an important benefit for clients in the form of liquidity pooling. As the underlying assets of the different share classes of an ETF are the same, authorised participants can switch between share classes of a fund in a cost effective way, without needing to trade the common assets, and support the associated transaction costs. ETF share classes thus benefit from the liquidity of other share classes where authorised participants have the option of trading the more liquid share class and conducting a switch trade from one class to another. Clients ultimately benefit from this efficiency through being offered tighter spreads.

We would also comment on the point made in paragraph 12(e) that share classes take less time to set up than new investment compartments. In our experience, the time to market in most jurisdictions (as opposed to ‘some' jurisdictions as set out in the Discussion Paper) for a new investment compartment is not a matter of weeks or months, but in all cases several months. Time to market will generally be a minimum of 4 to 6 months. The benefits of share classes from this perspective are therefore much clearer.

Q3: What is your view on the principle of “common investment objective”?
We agree with this principle, but some elements should be further specified.



Regarding the hedging overlays, we do not understand why all share classes should have the same risk profile to define a common investment objective. As stated in paragraph 15, we believe the common investment objective is defined by the fact that the investment is realised in a common pool of assets. As described in paragraph 12 (b) (iv), one major reason for the use of share classes from an investor perspective is the mitigation of certain investment risks. It is therefore important that there are no restrictions on share classes accessing hedging overlays. It is not clear whether interest rate hedging for instance is permitted, and this common investment objective principle could be subject to different interpretations. As exchange rates are closely linked to interest rates, if currency risk hedging is considered compatible with the principle of a common investment objective, it should be clarified that the same should apply for interest rate risk hedging.

Q4: Which kinds of hedging arrangements would you consider to be in line with this principle?
As mentioned in our response to Q3, we do not believe that any hedging arrangements should be out of scope as long as they mitigate any risk arising from the common pool of assets.

Q5: What is your view on the principle of "non-contagion"?
We agree with this principle in general, but it needs to be carefully designed, and should focus on direct impacts between one share to another (e.g. stating that a share class A should not become liable for a FX hedge of share class B).

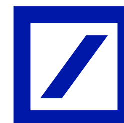
Indirect impacts (e.g. to enable the annual distributions of class A the fund may need to sell assets in unfavourable market situations, which indirectly also influences the performance of class B or of the portfolio) may be unavoidable in certain instances, and their practical consequences would be difficult to measure. Drawing a clear line between acceptable and unacceptable indirect influencing factors would be challenging.

Q6: Are you aware of any material evidence of investors in one share class suffering losses as a result of the crystallisation of risk in another share class?
No.

Q7: Where do you see a potential for contagion risk arising from the use of derivative hedging arrangements? What are the elements of this contagion risk? (cf. paragraph 23)
Due to existing risk management and accounting procedures, based on the technical segregation of the different share classes, the potential for contagion risk is sufficiently mitigated.

Q8: Do you agree with the operational principles set out in paragraphs 28 and 29?
We agree overall with the operational principles, but the following should be taken into account:

For the principle in 28c., there should be a balance between the oversight and the level of sophistication of the share class overlay. Obligatory stress test for plain vanilla currency hedges may only be needed for assets with a high volatility, if they are necessary at all.



The principle in 28 (d), if interpreted strictly, will be very difficult if not impossible to comply with. Given the different types of distribution channels (e.g. via banks, online platforms) investment managers cannot in practice consult every single investor about his risk profile and store this information centrally to analyse it. In addition, it should be taken into account that an individual risk profile is a complex and individual composition of different factors. Given that a single investment fund could have hundreds or thousands of single retail investors, it will be impossible in practice to compare each single risk profile with the risk profile of the investment fund.

Other regulations, such as MiFID II and PRIIPs, already define standards regarding product disclosures (e.g. target market) as well as suitability and appropriateness when investment advice is provided. Provide additional ex ante evidence on top of that would be burdensome and bring limited added value. Fund are required to offer transparently documented features to investors and the investor themselves (or their advisor) need to determine whether or not this corresponds to their preferences.

Q9: Do you consider the exposure limits in paragraphs 29.b and 29.c to be appropriate?

A 105% over-hedge limit may not be appropriate for benchmark tracking funds /share classes in certain instances. This would include where an ETF has share classes which offer currency hedged exposures to the benchmark of the ETF. In such instance it would be industry practice to benchmark the performance of such a currency hedged share class against the performance of the currency hedged version of the index, as calculated by the relevant index provider. As a monthly hedged index is calculated on the basis that the currency hedge is reset on a monthly basis, this calculation methodology can result in an "over-hedge" existing at the index level in between each monthly rebalance.

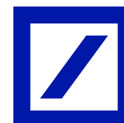
Should this occur, a 105% over-hedge limit could require the investment manager to deviate from the investment policy of the fund and reduce the level of the currency hedge to that below the level of the hedge within the index being tracked.

This scenario would apply to both index funds and ETFs. Specifically, it would apply where any fund has a share class structure, and tracks indices.

Q10: Which stresses should be analysed as part of the stress tests?

Market risks and liquidity risks. Although share classes are not yet officially defined, share classes of UCITS are already following the same rules as any other UCITS, and therefore are submitted to stress tests which include market risks as well as liquidity risks.

Furthermore, as stated in our response to Q8, there should be a balance between the oversight and the level of sophistication of the share class overlay. Obligatory stress test for plain vanilla currency hedges may only be needed for assets with a high volatility, if necessary at all.



Q11: Which hedging arrangements would you consider as compatible with the operational principles outlined above? Insofar as you consider some (or all) of the hedging strategies in paragraph 30(a)-(b) as being compatible with these operational principles, please justify how such strategies are compatible with each one of the principles.
Please refer to our response to Q3 and Q4.

Q12: Notwithstanding the fact that ESMA considers the above operational principles as minimum requirements, are there additional operational principles that should apply to address the non-contagion principle?
Given that UCITS are already a product with high regulatory standards, we do not see any need for additional requirements.

Q13: What effect would these additional measures have on the compatibility of the operational principles with further hedging arrangements?
Please refer to our response to Q12.

Q14: What is your view on the principle of "pre-determination"?
We agree with this principle. We would however argue that it is possible to have pre-determination that is not numerically based. As an example, the FINRA restricted share classes referenced in our answer to Q2 can be set-up so the mechanism is rules-based with no discretion as to how to operate the day one profits and losses approach.

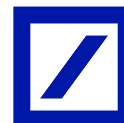
The main features and objective of the share class should be defined. However, the technical implementation details should allow some flexibility. For example, different currencies may have different efficient hedging contracts in terms of trading volume, liquidity and price (1M, 3M, 6M) and this may vary over time. Markets, interest rates and volatility are not static and so implementation details may need to be modified during the lifetime of a class to respond to market changes.

Q15: Are there additional requirements necessary to implement this principle?
Given that UCITS are already subject to stringent regulatory requirements, we do not see any need for additional requirements.

Q16: What is your view on the principle of "transparency"?
We agree with this principle. It should be clear to investors which share class types might be launched and which share classes have been launched for a particular fund. As common practice for dormant share classes the respective launch should be updated with the next regular update of the fund's prospectus.

Q17: Do you consider the disclosure requirements to be sufficient?
Yes.

Q18: Notwithstanding the fact that ESMA considers the above operational principles on transparency as minimum requirements, which modifications would you deem necessary?



We see little benefit in an additional list of share classes as proposed in Paragraph 36 (b) for the investor.

Given that the investor should be aware of all necessary information, based on existing disclosure documents and following the principle of pre-determination as described in this Discussion Paper, this list would be operationally complex and result in limited added value for investors.

Q19: Do you see merit in further disclosure vis-à-vis the investor?

UCITS investment managers are already required to disclose all information relating to the investment funds (including the share classes) in the prospectus and UCITS Key Information Document (KID).

Any additional documents would provide little benefit and could lead to 'information overload'.

Q20: If a framework for share classes, based on the principles as outlined in this paper, was introduced at EU level, what impact on the European fund market could this have?

The answer will depend on the final definition of share classes. For instance, guaranteeing access to hedging overlays for share classes would be beneficial to meet investors' needs and risk appetite. However, if only a limited set of hedging arrangements were allowed, this would decrease the benefits and flexibility of UCITS funds.

Q21: Given ESMA's view that certain hedging arrangements currently in place might not be compliant with the common principles of share classes as outlined above, which kinds of transitional provision would you deem necessary?

Consistency in the legal framework around UCITS funds has been key to its success - across Europe as well as globally. To the extent that the rules relating to share classes are changed, we would strongly recommend a ''grand-fathering'' system for existing products. The forced closure of share classes serving investor needs and requirements would mean that they need to redeem or have their shares merged into a class that is less well suited to their investment objectives. There would also be a cost to closures or mergers that in many cases would be borne by the fund and therefore its investors.