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European Securities and Markets Authority
103 rue de Grenelle
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FRANCE

(submitted via ESMA online portal)

Re: DISCUSSION PAPER – UCITS SHARE CLASSES

Introduction

The Bank of New York Mellon Corporation (BNY Mellon) is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to the Discussion Paper on UCITS Share Classes (ESMA/2016/570).

BNY Mellon operates in Europe through: (i) branches of The Bank of New York Mellon (a New York state chartered bank) and (ii) directly established and duly authorised subsidiaries established in certain EU jurisdictions and branches of those entities operating in core EU member states. BNY Mellon provides services to clients and end-users of financial services globally. It is accordingly keenly interested to ensure financial markets operate fairly and consistently globally and that common standards ensure playing fields are kept level.

General Comments

As a major financial institution, BNY Mellon has an interest in this Discussion Paper from an investment management and investment services perspective. Many of BNY Mellon's investment management boutiques in the EMEA region are members of the Investment Association. BNY Mellon endorses the response of the Investment Association to this Discussion Paper.

<u>Responses to Specific Questions</u>

Our responses to the specific questions raised by ESMA are contained in Annex 1 below.

BNY Mellon looks forward to further engagement with ESMA in regard to this Discussion Paper and any future consultation papers on this topic.

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Annex 1 – Responses to Specific Questions

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

Yes, we agree with the description of share classes given in the paragraphs under Section 3.1 of the Discussion Paper. We note in paragraph 8 that "ESMA is of the view that the UCITS Directive should be interpreted in such a way that it requires the segregation of assets between compartments". We do not agree that the regulation should be interpreted that way, on the basis that there are no benefits from doing so, and it is impractical from a fund and share class perspective to mandate such segregation.

Q2. Do you see any other reasons for setting up share classes?

No, we do not believe that there are currently any other reasons for setting up share classes. Our view is that the establishment of share classes within a UCITS structure allows for growth of a particular investment strategy without proliferation of separate funds, which are confusing for investors, expensive and have economies of scale challenges.

Q3. What is your view on the principle of "common investment objective"?

We support the principle of a fund having a common investment objective. Indeed it is on this basis that investors commit to purchasing units in a fund. Share class hedging does not alter the fundamental investment strategy to which an investor subscribes. Share class hedging simply removes an element of investment risk but does not change the underlying securities held by the fund nor change the overall investment strategy, or "common investment objective."

Q4. Which kinds of hedging arrangements would you consider to be in line with this principle?

We consider that share class currency hedging is in line with the principle of a "common investment objective", as such hedging does not compromise the principle of a common pool of assets. All that currency hedging does is seeking to eliminate the currency exposure of the various securities in a portfolio. The underlying securities remain the same across all investors in the UCITS, but the secondary currency exposure is removed. Doing so does not change the portfolio of assets nor investment strategy.

Q5. What is your view on the principle of "non-contagion"?

We fully support the principle of non-contagion and believe that it is critically important to investors that they are not exposed to investment or portfolio risk to which they have not subscribed or given consent to. Indeed the transparency of UCITS has been a key hallmark of their success over the years and this transparency should continue in order that UCITS remain successful.

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, we are not aware of any such losses.

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)

In most EU jurisdictions, there is no segregation of assets between share classes. The value of each share class is an apportionment of the NAV of the overall fund. The impact of any derivative overlay is then applied at class level. This gives rise to a theoretical risk of contagion to other share classes should any claim arising on instruments used at share class level exceed the value of assets in that share class.

In practice, provided robust risk management and operational controls are applied, such a risk is unlikely to materialise - as noted in our response to Q6, and in paragraph 25, there have been no known cases where a loss arising from the use of a hedging instrument at the level of a share classes has resulted in losses being attributed to other share classes. The use of a hedging instrument at share class level is solely to reduce a risk attributed to a single risk variable; these are not used to increase the risk exposure of a share class. As such, the use of a derivative instrument at share class level will be limited to that necessary to hedge the identified risk, allowing for a suitable tolerance range.

Q8. Do you agree with the operational principles set out in paragraphs 28 and 29?

We agree generally with the principles set out in paragraphs 28 and 29. However, 28.b states that there should be a level of operational segregation which ensures that there is a clear identification of assets, liabilities, and profit/loss to the respective share classes. We are not certain what “operational segregation” should occur here beyond accurate accounting for these items in the fund’s books and those held for the fund by the independent fund accountant.

The principles are correctly focused on control and transparency for the fund investors. We fully support this.

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

Exposure limits should be a matter for the fund’s management company to establish given the currencies being hedged and the relative volatility of each. However, the buffers/exposure limits should be disclosed in the prospectus documents of the fund to make all investors aware of the fund’s policy.

In respect of 29.d, we would suggest that the hedged positions be reviewed in line with the valuation of the fund and/or dealing point so that the hedged positions stay in line with the fund valuation itself.

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

Currency volatility for the relevant currency pairings should be the primary stress test to be applied to the hedge share class. A secondary test should be the volatility of the instruments that are accepted as collateral, so that the management company may know at any given time the extent to which the fund may be called for excess liquidity to support margin calls.

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.

In our view, currency hedging is compatible with the operating principles described above, as it does not change the common investment objective, underlying holdings or swap any of the exposures. Currency hedge share classes simply allow a broader group of investors into a fund, rather than the management company being required to set up an entirely new UCITS in an exclusive currency class. In creating a hedged shared class, investors in the non-hedge share class benefit from a wider spread of investors and shared costs as a consequence of an aggregation of assets.

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?

We believe that there should be a separation of function between the portfolio manager and the currency hedging management. Doing so will prevent undue influence on a portfolio manager who may find a conflict in investment strategy and retaining liquid assets to cover hedging margin.

Q13. What effect would these additional measures have on the compatibility of the operational principles with further hedging arrangements?

We do not believe that there is any impact on compatibility from segregation of responsibilities, but note that there may be inherent tensions between the portfolio manager and hedge share class manager on the basis that the hedge will require liquidity over and above normal liquidity for subscriptions and redemptions netting mismatches.

Q14. What is your view on the principle of "pre-determination"?

We do not support pre-determination for currency hedge share classes. In the interests of full transparency though, we would advocate that any existing fund without share class hedging in place that subsequently decides to launch a hedged share class, should notify all existing shareholders before such class is launched. This is firstly to give existing shareholders the opportunity to participate, and secondly to ensure that any shareholders who do not wish to participate are aware of any potential risks to the fund and can make decisions accordingly.

Q15. Are there additional requirements necessary to implement this principle?

We do not think there are additional necessary measures, beyond the notification to existing shareholders as referred to in our response to Q14.

Q16. What is your view on the principle of “transparency”?

We fully support transparency in fund documentation at prospectus level. Where a fund subsequently decides to launch a currency hedge share class, such notification should be given in writing to existing shareholders.

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

As noted in our response to Q16, we fully support transparency in fund documentation at prospectus level, and where a fund subsequently decides to launch a currency hedge share class, such notification to existing shareholders should be given in writing.

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?

Making share class hedging available to investors in UCITS should promote investment in UCITS and drive down costs of UCITS as economies of scale kick in. Giving investors in UCITS the ability to hedge out currency risk, ought to be a further attraction to the UCITS brand and provide an opportunity for Europe to reduce the numbers of funds available to the market while still retaining investment strategy choice.

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?

Any change in a fund’s hedging arrangements should be cognisant of the implications of closing out the hedge contract, returning collateral, recognising any profit & loss in the hedge share class and where necessary redeeming/repatriating investors’ cash. A reasonable transition period should be put in place to avoid any pressure on liquidations. In our view, a 12 month transition period ought to be viable as a general rule to facilitate such a scenario.