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| 6 April 2016 |

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| Reply form for the Discussion Paper on Share Classes |
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| Date: 6 April 2016 |

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Discussion Paper on Share Classes (SC), published on the ESMA website.

*Instructions*

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

* use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
* do not remove the tags of type < ESMA\_QUESTION\_DP\_SC\_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
* if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

* if they respond to the question stated;
* contain a clear rationale, including on any related costs and benefits; and
* describe any alternatives that ESMA should consider

***Naming protocol***

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA\_DP\_SC \_NAMEOFCOMPANY\_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA\_DP\_SC \_XXXX\_REPLYFORM or

ESMA\_DP\_ SC \_XXXX\_ANNEX1

***Deadline***

Responses must reach us by **6 June 2016.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input/Consultations’.

***Publication of responses***

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

***Data protection***

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the headings ‘Legal notice’ and ‘Data protection’.

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_ DP\_SC\_1>

BVI gladly takes the opportunity to contribute its views to the envisaged common approach to the use of share classes under the UCITS Directive.

BVI represents the interests of the German investment fund and asset management industry. Its 95 members manage assets of some EUR 2.6 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients in over 21 million households. BVI’s ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en

<ESMA\_COMMENT\_ DP\_SC\_1>

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

<ESMA\_QUESTION\_DP\_SC\_1>

We agree with ESMA’s definition in par. 9 of the discussion paper. In our view, it is in line with the definition actually contained in § 96 of the German Capital Investment Code.

<ESMA\_QUESTION\_DP\_SC\_1>

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

<ESMA\_QUESTION\_DP\_SC\_2>

There are some other reasons which are not mentioned in par. 12 of the discussion paper, but in par. 16. We therefore assume that ESMA has already taken into account that share classes may also be set up in order to better identify and quantify different groups of investors. This may for example help to improve the fund’s liquidity management.

<ESMA\_QUESTION\_DP\_SC\_2>

1. What is your view on the principle of “common investment objective”?

<ESMA\_QUESTION\_DP\_SC\_3>

We agree with the principle of “common investment objective” as described in par. 15 to 17 of the discussion paper. However, we do not share the view that currency hedging at share class level is the only type of hedging overlay fully compatible with this principle. ESMA’s reasoning in favour of currency hedging is based on a rather political point of view. Though we fully agree with it, it does not reveal, on an operational level, material distinctions between currency hedging and hedging of other types of risk leading to the conclusion that other hedging types are in general less compatible with the principle of a common investment objective.

<ESMA\_QUESTION\_DP\_SC\_3>

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

<ESMA\_QUESTION\_DP\_SC\_4>

We are of the opinion that there is no type of hedging arrangement that can be considered a priori as not in line with said principle. Every hedging influences the risk profile of an investment, but as we understand from par. 15 to 17, an identical risk profile is not part of the common investment objective. We consider this an important aspect as most distinctive features of share classes lead to a different risk profile from the point of view of investors. For example, if there is one share class where revenues are paid out to investors and a second share class where they are reinvested in the fund, the risk profile regarding these revenues is different. If the principle of common investment objective would encompass a common risk profile, most existing types of share classes would not comply with this principle.

We concede that there may be some problematical aspects in cases where share classes have, due to hedging overlays, extremely different risk profiles that make it difficult for the fund management to act in the best interest of all investors. However, we think that these problems can be successfully addressed in connection with the principles of non-contagion and transparency.

As regards the definition of hedging, we do not consider the description in Box 8 of the “CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS” to be appropriate for hedging overlays as discussed here. The CESR Guidelines deal with the calculation of exposure and therefore take a mathematical approach. When it comes to overlays for share classes, hedging should be more generally interpreted as “risk reducing / risk eliminating activity”. The crucial point is in our view that such overlays shall not increase any given risk or even introduce new kinds of risk that are not inherent to a given portfolio of assets.

<ESMA\_QUESTION\_DP\_SC\_4>

1. What is your view on the principle of “non-contagion”?

<ESMA\_QUESTION\_DP\_SC\_5>

We agree to this principle but would advise to clarify its relation to the principle of common investment objective. Especially par. 28 and 29 of the discussion paper contain some passages that might be considered as contradictive to the first principle. In our view, the overarching rule should be that all share classes of a fund invest in a common pool of assets. From a legal point of view it should be impossible that unit-holders of one share class have a claim on a certain portion of this common pool (see par. 28 lit. a), that there is a NAV of only one share class (par. 29 lit. a) or that a share class has an investment strategy of its own (par. 29 lit. c). The figures mentioned are of course useful and important for accountancy and risk management purposes. However, from the point of view of an external creditor or business partner, in most jurisdictions there is only the fund as a whole. This means that no liability limitations linked to share classes exist. We would therefore welcome a clarifying statement that the principle of non-contagion has only to be followed as far as it does not directly collide with the principle of common investment objective.

<ESMA\_QUESTION\_DP\_SC\_5>

1. 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?

<ESMA\_QUESTION\_DP\_SC\_6>

As regards the German fund industry, we are not aware that such a situation has ever occurred.

<ESMA\_QUESTION\_DP\_SC\_6>

1. 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)

<ESMA\_QUESTION\_DP\_SC\_7>

We think that spill over risks as described in par. 23 can be adequately managed and thus minimized by operational segregation and a rigorous risk management. However, as we pointed out above, they cannot be fully eliminated due to the common pool of fund assets.

If a hedging overlay eliminates risk factors that are of great significance for a given investment strategy, it may become difficult for the fund management to choose a level of risk-taking that is in the best interest of all investors. One share class would be fully exposed to the risk, whereas the other class might profit from higher return chances without bearing the higher risk connected with it. However, we think that potential conflicts of this kind can be minimized by assiduously applying the principles of pre-determination and transparency. <ESMA\_QUESTION\_DP\_SC\_7>

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

<ESMA\_QUESTION\_DP\_SC\_8>

We agree with the operational principles set out in par. 28 except for lit. d. This one principle seems superfluous and should be deleted. In most cases, UCITS management companies have neither direct contact to their actual investors, nor to prospective investors of a new share class. It would therefore be impossible to demonstrate that a certain hedging overlay better aligns with the specific needs of any concrete investor or investor group. The management company could only describe why it is of the opinion that a certain overlay can generate additional value to some anonymous group of (potential) investors. For obvious economic reasons, every UCITS management company assesses the probable interest of investors before setting up a new share class. It is then up to the investors to decide whether they consider the new share classes’ features as advantageous for their individual purposes.

With regard to par. 28 lit e., it is our understanding that a “detailed” and “transparent” definition of hedging overlays does not mean that management companies have to name and/ or describe in advance every single derivative instrument that might be used for hedging purposes. The type of risk that shall be hedged as well as the envisaged degree of hedging and the general way of how to do it have of course to be defined, but the choice of concrete instruments or counterparties to achieve this result has to be in the discretion of the management company. <ESMA\_QUESTION\_DP\_SC\_8>

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

<ESMA\_QUESTION\_DP\_SC\_9>

We do not consider the exposure limits as appropriate in every case. Due to aspects such as asset class size, net asset flows, market impact on volume or active management decisions within the common investment objective, the proposed limits could lead to a high frequency of hedging readjustments. This would lead to higher costs to be borne by investors. Management companies should be given enough flexibility to find the best possible balance between readjustment and costs. According to the principle of transparency, the specific exposure limits should be disclosed in the fund’s prospectus.

In case of currency hedging, we would recommend allowing a limit up to + / - 10%. Regarding other hedging strategies, an even broader approach should be considered. Since not all relevant hedging strategies are designed in a way that an exposure limit as specified seems appropriate, it should be possible to freely define an adequate limit in relation to the hedging purpose. E.g. in case of duration hedging, the relevant reduction for the duration may be reached by only a 30% hedge ratio. It should be possible to define a target duration range as limit for such hedges.

<ESMA\_QUESTION\_DP\_SC\_9>

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

<ESMA\_QUESTION\_DP\_SC\_10>

In our view, appropriate stress scenarios highly depend on the kind of risk that is being hedged by an overlay. There are other individual factors that should probably be taken into consideration, for example the types of assets held in the fund’s portfolio or the size of hedged and non-hedged share classes. <ESMA\_QUESTION\_DP\_SC\_10>

1. 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.

<ESMA\_QUESTION\_DP\_SC\_11>

Principally, every arrangement that meets the definition of “hedging” as suggested in our answer to question 4 should be compatible with the operational principles as outlined. There may be some derivative instruments which would be appropriate to achieve a defined hedging target, but which turn out to be problematic with view to the operational requirements. However, it is then up to the management company to choose other instruments and implement the overlay not only in the most (cost) efficient way, but also in line with ESMA’s principles.

<ESMA\_QUESTION\_DP\_SC\_11>

1. 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?

<ESMA\_QUESTION\_DP\_SC\_12>

We don’t think that any additional operational principles are necessary.

<ESMA\_QUESTION\_DP\_SC\_12>

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

<ESMA\_QUESTION\_DP\_SC\_13>

Please see our answer to question no. 12.

<ESMA\_QUESTION\_DP\_SC\_13>

1. What is your view on the principle of “pre-determination”?

<ESMA\_QUESTION\_DP\_SC\_14>

We agree with the principle of pre-determination as outlined in par. 31 to 34 of the discussion paper. In our view, it is a precondition for adequate investor information. It would be impossible to adhere to the principle of transparency by describing to investors the nature and risks of share classes if it remained unclear what the distinctive features are, or to which extent there are any differences at all between share classes.

However, par. 29 lit. b and c of the discussion paper seem to indicate that, when defining a hedging overlay as share class feature, the UCITS management company may set up a “hedging corridor” and explicitly allow for example a certain level of under-hedging. ESMA should therefore clarify that such pre-defined ranges or corridors are not considered as management discretion and do not contradict the principle of pre-determination.

As already pointed out in our response to question 8, the principle of pre-determination should not refer to every single derivative instrument that might be used for hedging purposes. Only the type of risk that shall be hedged, the envisaged degree of hedging and the general way of how to do it have to be defined in advance. The management company will then decide which instrument or counterparty, at a given point in time, seems most suitable and/ or least expensive to achieve the defined hedging. If concrete instruments were to be listed in advance, this would hinder an effective management and lead to additional costs.

<ESMA\_QUESTION\_DP\_SC\_14>

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

<ESMA\_QUESTION\_DP\_SC\_15>

We don’t see any need for additional requirements.

<ESMA\_QUESTION\_DP\_SC\_15>

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

<ESMA\_QUESTION\_DP\_SC\_16>

We fully agree with this principle as described in par. 35 of the discussion paper.

<ESMA\_QUESTION\_DP\_SC\_16>

1. Do you consider the disclosure requirements to be sufficient?

<ESMA\_QUESTION\_DP\_SC\_17>

We deem disclosure via the fund prospectus and the periodic reports to be sufficient. German legislation already provides for it (§ 165 par. 2 no. 27 KAGB, § 15 KARBV).

<ESMA\_QUESTION\_DP\_SC\_17>

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

<ESMA\_QUESTION\_DP\_SC\_18>

We advise to delete par. 36 lit. b as we are of the opinion that a separate list of share classes with contagion risk will not be of additional use to investors. If the principle of pre-determination is adhered to, it should be clear for any new share class right from the beginning from/ to which other share classes risks may spill over. This aspect should be part of the information given in the prospectus and in the fund reports as from the setting up of a new share class. In our view, the relation between share classes in terms of risk influence will not materially change as long as the share classes’ features remain the same. If features are changed, we assume that investors have to be informed via the prospectus and fund reports. Therefore an additional list seems superfluous.

<ESMA\_QUESTION\_DP\_SC\_18>

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

<ESMA\_QUESTION\_DP\_SC\_19>

No, we don’t think any further disclosure would be of use to investors. As we already indicated in ESMA’s previous consultation, investors are already being informed about the characteristics and risks of share classes not only in the prospectus, but also in the KIID.

<ESMA\_QUESTION\_DP\_SC\_19>

1. 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?

<ESMA\_QUESTION\_DP\_SC\_20>

A common understanding regarding the nature and possible features of UCITS share classes could contribute to further harmonisation of the supervisory practices and hence strengthen the Single Market for UCITS. However, the impact of a new framework will very much depend on the provided level of flexibility for the use of share classes. If hedging overlays were to be restricted, this could be detrimental to the competitiveness of the EU fund industry in worldwide terms. It would also reduce UCITS managers’ ability to improve the (cost) effectiveness of their operations.

<ESMA\_QUESTION\_DP\_SC\_20>

1. 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?

<ESMA\_QUESTION\_DP\_SC\_21>

Speaking on behalf of the German fund industry, we are currently not allowed to use hedging overlays except for currency hedging. However, as Germany is target market for many funds from other EU jurisdictions, the question of transitional provisions is not merely academic to us.

If the use of UCITS share classes should be restricted despite the negative consequences outlined above, a grandfathering rule for existing share classes would be necessary. Investors have confidence in the UCITS regime as a stable and well-proven system. This should not be undermined by mandatory changes that may materially impact the compatibility of an existing investment with the investor’s needs and wishes.

<ESMA\_QUESTION\_DP\_SC\_21>