|  |
| --- |
| 6 April 2016 |

|  |
| --- |
| Reply form for the Discussion Paper on Share Classes |
|   |

|  |
| --- |
| 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>

The Depositary and Trustee Association (“DATA”) represents the depositaries and trustees of UK based authorised funds, including the majority of UK domiciled UCITS.

DATA welcomes the principles based approach proposed by ESMA in this discussion paper. In recent years, a number of jurisdictions have allowed funds to introduce share classes with currency hedging overlays at share class level, allowing UCITS to tailor their offerings to investors with different requirements. While such innovations have allowed UCITS to offer more flexibility, it is important to recognise, as ESMA has done, that hedging overlays at share class level introduce a contagion risk to investors in other share classes of the same UCITS.

The interests of all investors, regardless of which share class they invest in, must be protected. It is of particular importance that where there is a potential risk of contagion arising from one or more share classes, robust operational and risk procedures are adopted to minimise this risk of contagion materialising and investors in all share classes are made aware of this potential risk.

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

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

<ESMA\_QUESTION\_DP\_SC\_1>

We generally agree with the description given by ESMA. Broadly, a share class is a type of unit which provides a level of customisation which accommodates the needs of investors holding that type of unit whilst sharing the same underlying pool of assets as other share classes in the UCITS.

<ESMA\_QUESTION\_DP\_SC\_1>

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

<ESMA\_QUESTION\_DP\_SC\_2>

It is the management company which will determine whether to create share classes instead of setting up a new UCITS. The depositary's involvement in this respect is limited to an oversight capacity. The depositary will therefore typically have no involvement with such a decision, beyond ensuring the proposed share class will comply with all relevant regulation and will not be detrimental to the interests of any existing or new investors in the UCITS.

<ESMA\_QUESTION\_DP\_SC\_2>

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

<ESMA\_QUESTION\_DP\_SC\_3>

We agree that share classes of the same UCITS should all share the same investment strategy.

<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 believe currency hedging arrangements to be compatible with the principles, providing these are executed systematically and are non-discretionary (ie. the manager should not be able to determine whether or not a hedge is executed at share class level). We note that in the UK the currency risk can be hedged at fund level or at share class level (in a hedged share class) and DATA believes that it should also be possible to have a share class with a currency hedge which only covers a portion of the value of a share class, e.g. if the fund had a broad geographical mandate, the share class may only seek to hedge exposure to one of the currencies the underlying assets were exposed to.

<ESMA\_QUESTION\_DP\_SC\_4>

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

<ESMA\_QUESTION\_DP\_SC\_5>

DATA supports the principle of “non-contagion” as articulated in this discussion paper. Due to the lack of segregation between assets in different share classes it is not possible to entirely eliminate the risk of contagion, however DATA is of the view that UCITS Management Companies should implement robust procedures to minimise the risk of contagion.

<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>

We are not aware of the occurrence of any such event.

<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>

Since all share classes invest in a common pool of assets there is no legal segregation between different share classes of the same UCITS. The value of each share class is determined as an apportionment of the net asset value of the overall fund. As such, there is always a risk of contagion in the case of all types of share classes, although with a robust risk management process this risk could be reduced.

<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>

DATA fully supports the intention of the operational principles and largely agrees with the operational principles as proposed. However, there are a couple of points in relation to these which DATA believes should be clarified.

In respect of the principle in 28a, as outlined above, there is no segregation between share classes, and therefore a share class does not have an eligible pool of collateral - the share class has a proportion of the value of a fund, not of a proportion of the assets of the fund. We suggest this principle is reworded to reflect that the amount of collateral that could potentially be called on any hedging instruments used in a derivative overlay at share class level should not exceed the value of the share class.

Regarding paragraph 29a, we believe the intention is that the counterparty exposure arising from a hedging overlay at share class level should be considered in the overall calculation of the fund’s exposure to a counterparty. It would be helpful if this was clarified.

In paragraph 29d, we agree hedging positions should be regularly reviewed to ensure over- and under-hedged positions are promptly corrected if they exceed/fall short of the permitted levels. However, the requirement that positions do not exceed/fall short of the permitted levels "at any time" would operationally be impractical, particularly in the case of currency hedging positions which would require 24 hour continuous monitoring. We suggest that the principle instead require hedging to be reviewed at least on a daily basis to ensure any excess or shortfall is promptly addressed.

<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>

The proposed minimum and maximum limits seem reasonable, and are in line with general market practice. Exact buffers should be pre-determined prior to the launch of the share class.

The key point of principle in determining the permitted levels should be that the difference between the value of the hedged position and the value of the class of units should not be so large as to be speculative or to constitute an investment strategy. (In the UK, this principle is articulated in guidance given in the FCA Handbook, reference COLL 3.3.5BG(2).)

<ESMA\_QUESTION\_DP\_SC\_9>

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

<ESMA\_QUESTION\_DP\_SC\_10>

DATA agrees with ESMA that stress testing should be the responsibility of and performed by the UCITS management company. As such, it is not a matter for DATA to comment on which stresses should be analysed, but the stress testing program should be sufficiently comprehensive and robust to ensure that, as far as possible, any contagion risk is mitigated and investors in other share classes are suitably protected.

<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>

TYPE YOUR TEXT HERE

<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 are not aware of any additional operational principles that should apply to address this principle.

<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>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_DP\_SC\_13>

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

<ESMA\_QUESTION\_DP\_SC\_14>

DATA agrees that the features and rights of a share class should be pre-determined before the share class is launched. However, DATA believes clarity is required in respect to where a share class is created for an existing fund.

The last sentence of paragraph 33 might be read as suggesting that a fund would not be able to introduce a currency hedged share class if it did not already have one, since the paragraph requires that “the new share class should not affect the features and characteristics of the fund for investors already in other share classes”. Given the risk of contagion associated with currency hedged share classes, one might interpret that a hedged share class could not be introduced. This would clearly put older funds, launched before hedged share classes were widely available, at a competitive disadvantage vis-à-vis newer funds.

We do not believe this was necessarily ESMA’s intention, and suggest this principle be clarified with respect to launching a new share class on an existing fund. We do not believe that a potential contagion risk should absolutely prevent a hedged share class being introduced on an existing fund, rather there should be a requirement that if the introduction of a share class introduces a potential contagion risk to existing investors in other share classes, such investors should at minimum be notified in advance of the share class being launched of the contagion risk, with sufficient time to reconsider and withdraw or switch their investment. Consideration may also be given to requiring the consent of existing investors (e.g. through the approval of an extraordinary resolution at a meeting of shareholders) to be obtained prior to the introduction of a new share class which introduces a material contagion risk to existing investors. Such measures would ensure the interests of existing investors were protected, without absolutely preventing an existing fund from introducing a currency hedged share class.

We also note that the documentation for funds may provide for share classes, including hedged share classes, which have yet to be launched. In such cases, it may be difficult for managers to provide a detailed level of information on the features of the share class. For example, it may not be possible to know all the risk warnings required until the manager actually decides on launching this share class and therefore understands the impact of this share class on the other investors. We would therefore suggest that the requirement for pre-determination be restricted to the main features of the share class where the share class has not yet been launched.

<ESMA\_QUESTION\_DP\_SC\_14>

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

<ESMA\_QUESTION\_DP\_SC\_15>

No. We do not believe any additional requirements are necessary to implement this principle.

<ESMA\_QUESTION\_DP\_SC\_15>

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

<ESMA\_QUESTION\_DP\_SC\_16>

We agree with this principle. It is important that investors receive appropriate, meaningful and relevant information in order to make investment decisions, as well as ensuring the information they receive is accurate, clear, fair and not misleading including share classes and hedging within share classes and associated risks. It is of particular importance that where there is a potential risk of contagion arising from one or more share classes, investors in all share classes are aware of this potential risk.

We note that paragraph 36c states that stress test should be made available to national competent authority “on a regular basis”. While, as stated in our response to question 10, we would expect this to be the responsibility of the UCITS Management Company, we would suggest ESMA provide some further clarity on what “on a regular basis” means in practice.

<ESMA\_QUESTION\_DP\_SC\_16>

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

<ESMA\_QUESTION\_DP\_SC\_17>

We agree with paragraph 35 of the discussion paper, that it is important to ensure investors in all share classes are aware of any contagion risk.

In the UK, where a UCITS has currency hedged share classes, UCITS Management Companies are required to give clear disclosures in the Prospectus that a class hedging transaction may be undertaken for the relevant share classes, and the risks that such a transaction may pose to investors in all share classes of the UCITS. In addition, there are requirements to disclose material features of a share class in the Key Investor Information Document (KIID), and details of hedging transactions undertaken in the annual and interim reports to investors. The KIID should have sufficient information to ensure investors are aware of the existence of other share classes and should advise of any material risk of contagion arising from any other share class.

<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>

Please refer to our response in question 17.

<ESMA\_QUESTION\_DP\_SC\_18>

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

<ESMA\_QUESTION\_DP\_SC\_19>

We agree with the disclosures proposed in paragraph 36, subject to the clarification to paragraph 36c suggested in our response to question 16.

<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>

TYPE YOUR TEXT HERE

<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>

A transitional period will be required to allow sufficient time for UCITS Management Companies to determine what share classes may be non-compliant, what action it should take regarding those share classes, to review disclosure requirements and operational procedures and to make any necessary changes to these. Taking action regarding a share class may necessitate closing or merging that share class, and in some cases possibly require a separate UCITS or compartment to be established to accommodate an arrangement previously within a particular share class. Making these changes could take considerable time, particularly for UCITS Management Companies which have a large number of UCITS and share classes under management, and this should therefore be taken into account when setting the transitional provisions.

We would therefore urge ESMA to consider carefully the suggestions for transitional periods given in responses by UCITS Management Companies, their trade associations and/or other entities (eg transfer agents, law firms) providing services to UCITS Management Companies when setting a transitional period.

<ESMA\_QUESTION\_DP\_SC\_21>