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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>

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 61 corporate members EUR 21 trillion in assets under management of which EUR 12.6 trillion managed by 56,000 investment funds at end-2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investment in Transferable Securities) funds, with the remaining 25,900 funds being AIFs (Alternative Investment Funds).

**Preliminary considerations**

EFAMA welcomes the ESMA’s revised approach following the first discussion paper consultation, as well as further exchanges with industry stakeholders, and fully supports the ESMA’s objective at developing a principles-based framework for UCITS share classes. Before responding to the discussion paper’s specific questions, please consider the following preliminary observations:

* In line with our response to the ESMA’s first discussion paper, we care to reiterate the importance of a broad offer of share classes for the competitiveness of the UCITS product worldwide. As the offer of new share classes is demand-driven and thus reflects varying investor preferences – inclusive of those located outside a UCITS’ home jurisdiction - a too prescriptive framework would inevitably oblige European asset managers to alternatively launch new (sub-scale) funds (including local ones), instead of more simply activating a new share class to meet such demand. The related costs, in the form of higher management fees (to cover initial set-up and marketing expenses) and transaction costs, would outweigh the benefits to investors, achievable via the implied economies of scale behind larger funds and able to attract more investors via a broad range of share classes. More broadly, we view the offer of larger UCITS funds as complementary to the objectives of the EU Capital Markets Union, as increasing the UCITS industry’s contribution as a key capital provider to the European economy;
* Investors are able adjust their exposure to certain risk factors by switching share classes, while continuing to remain invested in a particular vehicle. For instance, in the likelihood of a higher official interest rate environment, investors may adjust by switching into a duration-hedged share class, rather than having to disinvest out of a UCITS altogether. Similarly, at times of increased volatility in the equity market, equity investors are vulnerable to its potential and sudden drawdown. Share classes would enable the latter to adjust their investment by switching to an equity market-hedged share class, rather than having to exit the equity market altogether;
* While we do acknowledge that the implementation of a derivative overlay to reduce factor risks does *per se* imply the possibility of a residual “contagion risk”, which, where not appropriately managed, may affect shareholders of other share classes, it would be for the ESMA inappropriate to discriminate among share classes purely on this basis. What the ESMA terms as “contagion risk” is intrinsic to every type of factor hedging strategy implemented on a share class basis, foreign currency ones included. It is therefore difficult to understand on which basis the ESMA is in principle more favourable to allow for currency-hedged share classes only - as per paragraph 30 of the discussion paper – and not other types of hedging overlay;
* We invite the ESMA to adopt a broader notion of “hedging”, unlike the specific meaning attributed to the term under Box 8 of the 2010 CESR *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*. Unlike under paragraph 21 of the discussion paper, we believe “hedging” should be interpreted more broadly as a general “risk-reducing” activity encompassing several strategies, unlike its narrower meaning under the CESR 2010 Guidelines, where it is intended uniquely as a metric to calculate a UCITS’ global exposure (see *infra*);
* Concerning the proposed minimum thresholds under paragraph 29, principle b. and principle c. - respectively of 95% of the net asset value of the share class for under-hedged positions and of 105% for over-hedged positions, the rationale for setting “hard” limits appears to be at odds with the interests of UCITS investors. This is particularly evident in the proposed upper limit of 105%. We would rather recommend that (i) a broader band be envisaged (i.e. between 90% - 110%), and (ii) that these thresholds be merely indicative so as not to generate a reporting requirement and guard a flexible approach which is more beneficial to investors under more extreme market circumstances;
* With regard to the ESMA’s possible next steps in finalising its work around UCITS share classes, EFAMA would recommend that the outcome of its work take the form of an opinion under Article 29 of the ESMA Regulation (rather than one under Article 34 thereof). In view of the ESMA’s primary role to promote a common supervisory culture amongst the EU’s national competent authorities and given the technical nature of the matter at hand, we deem it important that national competent authorities – exercising their direct oversight over asset management companies - be the ultimate recipients of the future ESMA opinion.

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

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

<ESMA\_QUESTION\_DP\_SC\_1>

EFAMA agrees with the description of share classes. In particular, we agree that the use of derivatives at the share class level should not increase, but reduce existing factor risks in the underlying portfolio or benchmark.

<ESMA\_QUESTION\_DP\_SC\_1>

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

<ESMA\_QUESTION\_DP\_SC\_2>

EFAMA believes that the identified reasons for setting-up different fund share classes are comprehensive and reflect the realities of our industry. One first crucial reason for offering a separate share class is time-to-market, enabling asset managers to promptly respond to investors’ needs compared to a situation where a new sub-fund would need to be launched *ex novo*. A second important reason is the reduced cost for investors. Thirdly, we observe that the management boards of institutional investors would rather prefer to invest in specific share classes of a large and established (especially in terms of investment track-record) UCITS, rather than into newly created stand-alone funds (or sub-funds), so as to not breach their specific holding ratio requirements when investing into collective vehicles. In this manner, purchasing share classes in larger funds avoids the risk of an institution becoming a dominant investor in any individual smaller fund, hence contributing positively to the dispersion of its risk.

<ESMA\_QUESTION\_DP\_SC\_2>

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

<ESMA\_QUESTION\_DP\_SC\_3>

As per our response to the ESMA’s first discussion paper, our views have not changed. Hence, we support the notion of a “common investment objective” as one common denominator, unifying all investors, regardless of the type of share class they opt to subscribe. In fact, the existence of a common pool of assets is the determining factor of a “common investment objective” and that different share classes will allow to adjust this common objective to different risk profiles. The derivative overlay referred to under paragraph 18 of the discussion paper is only intended to reduce (partially or totally) those specific factor risks one category of investor may not wish to share with others. In this respect, we wish to recall that, from a strictly legal perspective, there is no language in the UCITS Directive, or in any of its implementing measures, that would exclude one type of share class over others based on their respective investment outcome. For instance, regardless of a fund’s advertised investment objective, investors based outside the currency base area of a UCITS would, absent a currency risk-reduction overlay, be confronted by currency risk (unlike other investors based in the fund’s currency area).

Having specific regard to currency-hedged share classes, these do not have a different investment objective to the fund. While the ESMA is in principle comfortable with currency-hedged share classes, its reference to Box 8 of CESR 10-788 (which defines what is considered a hedging transaction) under paragraph 21 of the discussion paper could potentially be interpreted as not allowing for certain currency hedging techniques, as for “pure replication” currency hedging. The latter is used to hedge the fund’s base currency to the currency of the share class without needing to hedge all of the currencies in the underlying portfolio. In other terms, the hedged share class simply replicates the performance of an ordinary share class in the base currency of the fund. For example, in relation to a Brazilian equity fund whose underlying investments are all are denominated in BRL and the base currency of the fund is USD, a EUR hedged class on this fund gives an investor exposure to the BRL/USD rate, in place of the BRL/EUR rate in the absence of the overlay. In this example, the fund base currency (USD) is being hedged rather than the underlying assets’ currency exposure (BRL). The ESMA's proposal that "hedging" be understood as per Box 8 of CESR/10-788 may, arguably, prohibit such share classes[[1]](#footnote-2).

We furthermore deem it important that the ESMA’s reference to “currency risk hedging” under paragraph 20 of the discussion paper should be broad enough to not preclude different methods of implementing the aforementioned hedge; i.e. “pure replication” currency hedging versus “look-through” hedging, where each portfolio item denominated in a currency other than that of the fund’s base is hedged line by line. Both forms aim to provide investors with some optionality as to how they manage their currency risk arising from the fund’s “common investment objective”. As an example of the use of the “look-through” approach, one could consider a European equity fund that has one-third of its portfolio exposed to the GBP and two-thirds exposed to the EUR. A German investor would want to hedge only the GBP exposure by purchasing a share class that partially reduces currency risks for only one-third of the portfolio. The same considerations can be applied to duration-hedged share classes, as well as those hedging other risk factors (e.g. equity, credit spread, inflation, volatility risk, etc.), as further illustrated in our reply to Q.4 below.

On this basis, unlike the wording of paragraph 19 of the discussion paper, we observe that a “common investment objective” does not coincide with a “common risk profile”. A derivative overlay would only tier share classes on the basis of the underlying investor’s own profile, risk tolerance, investment horizons, etc. and is not intended to alter the investment objective of the common asset pool. It is intended only to reduce (partially or totally) factor risks within the portfolio in relation to investors’ preferences.

<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>

Please consider the following examples relating to other types of share classes (i.e. non currency-hedged ones), where we maintain that these do not seek to offer a separate investment and should thus not call for the establishment of separate funds or compartments thereof. The examples below represent a series of common uses by our Members and are clearly non-exhaustive:

1. Duration-hedged share classes

It is common knowledge that fixed income portfolios are generally vulnerable to interest rate increases when macro-level economic conditions tend to improve. “Duration” is the sensitivity of the price of the underlying portfolio instruments, bonds in this case, to changes in the level of the interest rate. Such interest rate is the outcome of a central bank’s monetary policy and corresponds to the yield of a “risk-free” referenced government bond. As a second yield component above the “risk free” rate is the credit spread, i.e. the incremental yield that bond issuers (e.g. a corporate) must pay to investors to compensate them for taking on the risk that the issue may default on its future payment obligations, including regular coupons and principal at maturity[[2]](#footnote-3). All investors in a fixed income portfolio are exposed to both duration and credit risks, while standing to gain from both respective yield components as part of a “common investment objective”, i.e. a total return from exposures to a specific credit market. The aim of duration-hedged share classes is to simply reduce risks associated with changes to the “risk-free” rate, isolating only the latter credit spread component[[3]](#footnote-4). For instance, such types of share classes cater to insurance company clients needing to match the maturity of their portfolios with their liabilities, or to target a minimum yield. Another evident advantage is the fact that investors would not confront switching costs from having to move into other funds to adjust their maturity or yield levels.

1. Volatility-hedged share classes

Volatility is a classic risk factor that investors take into account when deciding to subscribe shares in a UCITS fund. In line with the CESR’s 2009 Methodology for the calculation of the synthetic risk and reward indicator (SRRI), such indicator is based on the volatility of the fund and allows investors to quantify the risk of their investment from the historical or target ex-ante volatility of their investment.

Investment strategies can be deployed with different levels of volatility notably through the use of a hedging overlay that allows investors to choose a predetermined level of volatility, compatible with their risk profile. In the absence of such overlay, as for currency hedging, or duration hedging, investors would alternatively need to subscribe into new dedicated funds (i.e. different from the main fund implementing the chosen core strategy) or implement a volatility hedge themselves by choosing and trading the relevant derivative contracts. Such costs are additional to those charged by the main core fund and will in practice outweigh any benefit, especially for moderate investment amounts.

In this context, the aim of a volatility-hedged share class is to offer, for the same core investment strategy, varying levels of volatility below that implied by the common strategy. For instance, if a given investment strategy discloses a volatility of 20%, an offer of volatility-hedged share classes will allow investors accessing the same investment strategy to target a volatility level of 5%, 10%, or 15%. This opportunity exhibits two key advantages: (i) various levels of volatility are pooled into one large fund, thus reducing costs for all investors; and (ii) increased flexibility for the investors when selecting investments that are in line with their own risk tolerance.

Given the ESMA’s recent concerns as to the admission of hedged share classes other than those hedging foreign currency risks, European asset management companies are presently able to satisfy institutional client demand for volatility-hedged share classes only by launching new dedicated stand-alone funds. For the reasons illustrated above, this outcome remains sub-optimal for our industry and our clients alike.

1. Equity (drawdown) protection share classes

These share classes have the same “common investment objective” of the underlying portfolio, i.e. providing long-term capital growth via exposure to equity markets. The derivative overlay is designed to partially offset the impact of a sudden and significant decline (or drawdown) of a main equity index. Typically, such protection is obtained via the use of an overlay consisting in the trading of OTC put options on an equity index, or alternatively via other types of cleared/listed derivatives (either stand-alone or in combination). This innovative share class has emerged to satisfy investors’ needs for equity exposure with risk hedging features, combining volatility and drawdown mitigation strategies in an integrated single approach. This type of hedge is, for instance, popular with insurance companies looking to combine an equity investment with their Solvency II requirements. For these investors, option premiums are paid with the objective of limiting potential downside risks in case of a sudden and significant equity market drawdown. Oppositely, in the event of a sudden equity market rally, investors of the hedged or protected share class will still benefit from the equity rally, albeit more limitedly compared to the non-hedged share class investors due to the costs (premium) of the option overlay.

1. Sectoral- or geographically-hedged share classes

In line with their risk tolerance and/or regulatory constraints, investors may demand exposure to a large pool of investments, while hedging away some idiosyncratic risks thereof, as for instance, exposure to a given industry (e.g. pharmaceuticals, technology, financial, etc.) or to certain geographic regions (e.g. Eurozone peripheral countries). Analogous to the previous examples, in order to avoid the implied costs and inconveniences linked to the launch of new dedicated funds, these hedged share classes allow more investors to gather around a larger investment pool and thus to scale gains for the benefit of all.

In the experience of one member, the fiscal problems characterising some EU countries at the Eurozone’s periphery over recent years have spurred demand for share classes able to reduce exposure to the latter region (typically, via return swaps), all while preserving an investment strategy aiming to deliver returns of a Euro core fixed income fund. The same need has been recorded for equity portfolios (e.g. those tracking an index like the Euro Stoxx 50) bearing material exposures to these same countries’ banking stocks for instance. Apart from the evident cost savings from avoiding the duplication of the fund by purchasing the identical underlyings composing the index (minus the depreciated bank stocks), the activation of tailored hedged share classes would be beneficial also in allowing the asset management company to respond more promptly to institutional client demands, in turn the result of important changes in market conditions. In this regard, we care to note that, in the event of improving economic prospects in a given region or industry, such types of share classes may be de-activated once solvency risks subside and given industries return to be profitable. In which case, institutional clients will have remained continuously invested in the common underlying portfolio.

Finally, we wish to clarify that, for all these examples, the holders of hedged share classes are not immune to certain risks inherent in the overlay, e.g. the underperformance of the hedged share class compared to non-hedged share classes should the intended risk factors not materialise, or alternatively, materialise in the opposite sense as foreseen by the hedging overlay[[4]](#footnote-5).

<ESMA\_QUESTION\_DP\_SC\_4>

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

<ESMA\_QUESTION\_DP\_SC\_5>

Acknowledging that absolute “non-contagion” cannot be fully guaranteed, as investors’ exposures in different share classes can only be segregated operationally rather than legally, we fundamentally share the view that additional risks to the value of a specific share class - introduced via the application of a derivative overlay - should be closely monitored so as to not affect other shareholders (i.e. those that did not expressly choose to subscribe into share classes with a specific derivative overlay). For this purpose, exposures from the derivative overlay are typically collateralised and managed on the basis of internal limits set in relation to the AuM accounted for by the hedged share class. Also, the hedge is readjusted periodically to account for changes in the risk factors. The costs relative to the overlay, as paragraph 26 of the discussion paper also points out, should correctly be borne only by those investors choosing the overlay. In connection to our earlier response, EFAMA maintains that such outcome can be obtained via a separate share class valuation process, in addition to the other abovementioned techniques aimed to contain “spill-over” risks, .

More specifically, regarding the separate share class valuation process, this is initially carried out with each asset in the fund’s underlying portfolio being valued and with the liabilities relating to the entire UCITS being deducted. The resulting fund’s general P&L will be allocated to each class based on that specific class percentage in the overall AuM (based on the previous day’s NAV and accounting for initial margin specific to that share class). This initial valuation will form the basis of a series of second‐step valuations for each share class, where any hedging instruments specific to that share class will be valued and where hedging costs specific to that share class will be accrued (see *infra* our answer to Q.7).

<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>

EFAMA is not aware of any particular case.

<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>

With regard to paragraph 23 of the discussion paper, we contend that the derivatives used for the purpose of offering a hedging overlay for some investors do not in fact “become part of the common pool of assets”. In addition, the overlay should not introduce additional counterparty, nor operational risk, for those non-hedged investors, as the overlay-related risks (and related costs) can be managed and accounted for separately, hence mitigating the aforementioned “contagion risk” to the largest extent possible.

More specifically, each UCITS compartment has a single pool of assets with no segregation of these assets between share classes. The value of each share class is determined for accounting purposes by an apportionment of the change in value of the pool of assets on the basis of a distribution coefficient. Moreover, the management of the common pool of assets in which all share classes have an interest is functionally separated from the management of the individual share class’s features. When the investment manager decides on the UCITS portfolio’s allocation itself, he/she will not decide for each share class, but rather manage the portfolio as a whole, ensuring subscriptions are invested in the portfolio and assets sold from the portfolio in order to meet redemption requests. For those share classes with an overlay, the hedging strategy will operationally be implemented separately from the investment strategy and applied systematically (see *infra*).

Whereas the invested assets are booked into the general common portfolio, the instruments for hedging purposes (e.g. a forward rate agreement, a futures contract, and interest rate swap, etc.) at the share class level will need to be booked separately. As anticipated in our reply to Q.5 above, this allows the corresponding P&L to be isolated and allocated only to the shareholders of the hedged share class. Trades are routed/booked by the portfolio/hedging manager to the particular share class in order to allow for the isolation of the related costs and benefits and thereby also ensuring that no cross‐contamination occurs between the hedged and non‐hedged share classes. From an accounting perspective, therefore, the share classes are operationally segregated.

Any eventual variation margin requirements relating to the hedging instruments - depending on whether these are exchange‐traded or OTC ‐ are allocated to the hedged share class for accounting purposes as well and reflected in the relevant share’s value[[5]](#footnote-6). In this regard, as an example, a systematic hedging strategy ‐ sometimes used for duration‐hedged share classes – would for instance use bond futures, with e.g. 1% of the investor’s initial cash outlay being used to cover the initial margin call (according to the exchange rules) from the fund’s broker and the remaining 99% invested in the actual underlying pool. In this example, the hedged shareholder’s investment is actually diluted compared to that of the non‐hedged one who remains fully invested.

There may, however, be a residual risk of “contagion” that could occur given the time lag between the timing the hedging trades are booked and the time the portfolio’s NAV is calculated (in an ideal world, these moments would match). More than a “contamination” of the non‐hedged share classes, it is rather a risk for hedged shareholders to be over‐ or under-hedged during a very brief period (and which may in any case be adjusted for afterwards).

In conclusion, we do acknowledge that the implementation of a derivative overlay to reduce factor risks – regardless if foreign currency-related, duration-related, etc. – does *per se* imply the possibility of a residual “contagion risk”, which, where not appropriately managed, may affect shareholders of other share classes. However, it would be for the ESMA inappropriate to discriminate among share classes purely on this basis, as the risk is intrinsic to every type of factor hedging strategy implemented on a share class basis, foreign currency ones included.

<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>

Regarding the operational principles under **paragraph 28** of the discussion paper, we agree with **principle a.** and **principle b**. and welcome their acknowledgment that operational segregation is feasible. With regard to principle a., we would only recommend that the counterparty risk limits prescribed under Article 52 of the directive be calculated with respect to the NAV of the entire underlying portfolio instead to that of the sole affected share class.

We would have some reservations on the following principles c. and d. As to the stress-test requirement under **principle c.**, we deem the available controls – from the implementation of operational segregation to the daily monitoring of the hedge, collateralisation, etc. - to be sufficient. Given these and other governance processes in place, it is not clear what incremental value stress-tests would achieve. Moreover, one could assume the relevant risk-management function would need to stress-test against a scenario whereby derivative commitments implementing the overlay with a counterparty would be substantially greater than the market value of the share class *cum* posted collateral. Such assumption appears to contrast with the logic of the following **letter b. under paragraph 29**, where a “hard” ceiling of no more than 105% of the value of the hedged share class should not be exceeded. We would also urge ESMA to consider that implementing a stress-test per hedged share class inevitably implies costs and greater operational complexity. For instance, a large asset manager would be obliged to implement a stress-test on each of its 650 active currency share classes alone, not to mention several hundreds more for those hedging other risk factors (see infra).

Coming to **principle d.**, we note that, by design, a share class with an overlay is intended to reduce a specific factor-risk for a targeted investor profile. If any *ex ante* evidence is to be provided, it should merely consist of a justification as to how the hedged-share class caters to an individual investor’s needs. To this end, a UCITS should be allowed to rely on identified demand trends preceding the initial product launch/activation of a new share class, as identifying each individual investor post-launch/activation may be impossible given existing fund distribution models.

Finally, we endorse **principle e.**, which well reflects our belief that any hedging overlay should be implemented systematically (see *infra*). The use of the terms “detailed”, “pre-defined” and “transparent” as referred to the overlay, however, should not be understood as an obligation for disclosures as to the detailed mechanics of the overlay *vis-à-vis* investors. For example, it should not be necessary to disclose to investors a detailed list of the derivative instruments that will be used for hedging purposes (please see also our answer to Q.14 below). Rather, they should imply that the hedging strategy has been devised and implemented according to a clear process.

<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>

As per our response above, we notice a contradiction between **letter b.** of **paragraph 29** and the above operational **principle c** of **paragraph 28**. As to **letter c.** of **paragraph 29**, we firstly wish to stress that the hedging could also be partial. Secondly, we agree that under-hedged positions should not fall short of a minimum threshold set by a percentage band disclosed in the prospectus. We suggest in this respect that the indicated limit of 95% of the share class’ NAV be indicative and not be set as a threshold giving rise to a reportable event. In practice, the proposed band for a share class’s exposure to fluctuate between 95% - 105% appears too narrow. We do not believe an absolute level for a buffer should be set by ESMA, rather a certain degree of flexibility should allow the management company to set a buffer *ex-ante*, which is appropriate to the hedging instruments in question and aligned to the proposed principles. Alternatively, if at all, more reasonable would be a band between the indicative values of 90% - 110%, as better able to account for the potential greater volatility of certain underlying values, e.g. pairs involving frontier market currencies.

The need for the proposed minimum threshold to remain indicative, and thus flexible, is further demonstrated by current practices for hedging certain passive UCITS products through the offer of currency-hedged share classes with an overlay that replicates certain hedged indices (e.g. MSCI Currency Hedged Indexes). Practically, this entails the selling of currency forward one-month contracts to hedge against swings in foreign currencies included in the index and in the underlying portfolio. The exposure for each currency forward is fully collateralised (i.e. 100%), but is only reset at the end of each month to account for changes in the indices due to price movements of securities, corporate events or any other changes. Over the course of the month, the exposure may fluctuate below the proposed minimum threshold of 95%[[6]](#footnote-7). In light of such practice, it would be impossible to offer index funds or ETFs on hedged indices if strict compliance with the ESMA-proposed thresholds were to be ensured “at any time” (as per **letter d.** of paragraph 29).

<ESMA\_QUESTION\_DP\_SC\_9>

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

<ESMA\_QUESTION\_DP\_SC\_10>

Overall, stress tests carried out at the level of the fund portfolio, rather than at the level of each share class, are sufficient to gauge the sensitivity of the portfolio to a series risk factors. EFAMA wishes to underscore the fact that exposures to a counterparty deriving from any derivative overlay should primarily be managed and contained by ensuring sufficient collateral has been exchanged (in line with EMIR and additional UCITS requirements[[7]](#footnote-8)), as well as by applying internal risk limits (as illustrated in our answer to Q.5 above), instead of estimating the more hypothetical and remote probability of a material “contagion” effect on the other shareholders. Eventually, a simple sensitivity test (short and long) - or “reverse stress-test” - performed on a market benchmark or reference portfolio with a price shock of +/- 1% could be sufficient to identify any “contagion risks” inherent to the share class exceeding the committed collateral amounts.

<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>

In general, all hedging that aims to reduce risk for the investor should be within the principles and there is little difference between hedging foreign currency, duration, equity, volatility, etc. Use and choice of derivatives to implement the overlay should not be restrained, as these depend on the most cost-efficient way to implement the risk mitigation strategy. Important is that such implementation be done systematically, i.e. with no discretion on whether to apply the hedge or not, as well as on whether the hedge is partial or total. Over several years, European asset management companies have successfully implemented several types of factor-hedged share classes, which when carefully designed are compatible with the ESMA’s proposed principles.

Further to our preliminary remarks, we question the apparent reasoning behind the wording of paragraph 30(a), suggesting that, because foreign currency overlays are “delivered through an FX forward or FX swap with a notional amount (…) and rolled over systematically as necessary”, such overlays would conform to the proposed principles, as opposed to the “other share classes with overlays that are not linked to FX hedging” referred to in the following paragraph b. Unlike the ESMA appears to believe, forwards and swaps are just as well commonly used to implement “overlays that are not linked to FX hedging”, making any doubts – as expressed in paragraph 30(b) - unconvincing and difficult to justify in light of the proposed 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 do not think there are.

<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 refer to our answer above.

<ESMA\_QUESTION\_DP\_SC\_13>

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

<ESMA\_QUESTION\_DP\_SC\_14>

In our earlier response and in conformity with the principle of “pre-determination”, we stressed the importance of having any separate hedging arrangement at a share class level apply systematically, i.e. with no discretion by the portfolio manager in determining whether or not to apply the hedge, and in line with the “common investment objective” of the underlying asset pool. However, although the overlay management team will merely trade the necessary derivative instruments required to hedge the identified risk, some discretion must be retained as to the choice of the type of instrument (e.g. a forward rate agreement, a futures contract, and interest rate swap, etc.), as well as their respective terms. For instance, the choice on whether to implement an overlay using the more liquid (and less-margin intensive) futures market, as opposed to a OTC forward contract or a swap, ultimately depends on several factors, including the precise composition of an asset portfolio, of the investor base, the individual portfolio manager’s “view” on several external factors, such as the future rate environment, company creditworthiness and valuations, etc.

We therefore only partially agree with the wording of paragraph 32 of the discussion paper, whereby the risk to be hedged should not be left to the discretion of the asset manager. We also wish to caution against any requirement demanding managers to justify the choice of hedging instruments or the specific construct of the related overlay to investors. As an example, we deem the amount of information reflected in the example in our response to Q.4 above as sufficient to illustrate the key features of a share class with a hedging overlay.

While we agree that the features of a share class should be pre-determined so that investors have a clear understanding of the features of the share classes and the potential risks associated with them, we are not comfortable with the final sentence in paragraph 33 of the discussion paper. Our reading of this paragraph would appear to suggest that, unless all share classes are set up at the outset when a fund is launched, it will not be possible to offer any other share classes at a later date. As explained in our response to Q.5 above, even if share classes can be operationally segregated, this may not entirely eliminate the risk of contagion between share classes, as it is not possible to segregate liability between respective share classes from a legal perspective. Furthermore, in our opinion the final sentence of paragraph 33 would appear to contradict the statement in paragraph 36, **principle b.**, since the latter suggests that it is possible to create “share classes with a contagion risk” at a later date.

As explained, given the necessity for an asset manager to preserve at least some degree of discretion and given this does not call into question a fund’s investment objective, we understand the ESMA’s conclusion in paragraph 34 of the discussion paper as a principle. Indeed, if we agree that the decision to hedge and the level of hedging must be decided on an systematic basis, some degree of discretion remains necessary in the choice of the hedging instruments used and is compatible with the aforementioned principle to the extent a hedging overlay is applied consistently.

<ESMA\_QUESTION\_DP\_SC\_14>

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

<ESMA\_QUESTION\_DP\_SC\_15>

We do not think there are.

<ESMA\_QUESTION\_DP\_SC\_15>

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

<ESMA\_QUESTION\_DP\_SC\_16>

EFAMA essentially agrees with this important principle and believes that the current UCITS reporting requirements do already translate it in practice, in the fund’s respective KIID, in the prospectus and in the annual report. Important is that these documents remain available to investors via the asset management company’s website.

<ESMA\_QUESTION\_DP\_SC\_16>

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

<ESMA\_QUESTION\_DP\_SC\_17>

Indeed we do. Existing reporting requirements under UCITS are sufficiently informative for a potentially very large investment audience, spanning varying degrees of financial literacy from retail to professional investors, and without over-complicating the information or over-burdening the readers. Ultimately, the existing requirements also strike an appropriate balance in not over-burdening compliance staff at individual asset management companies with having to provide too detailed information with little or no added-value for the end-investor.

<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 believe the UCITS asset management industry already provides a wealth of information to investors via the existing reporting requirements, hence no modifications are in our view necessary. Consequently, we would suggest the removal of the operational principle b. under paragraph 36 of the discussion paper, as a list of share classes bearing “contagion risk” remains superfluous given the existing disclosures in fund prospectuses and annual reports. For the reasons explained above, such risk is aptly controlled and monitored. Please also refer to our answer to Q.17 above.

<ESMA\_QUESTION\_DP\_SC\_18>

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

<ESMA\_QUESTION\_DP\_SC\_19>

Please refer to our responses above.

<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>

EFAMA fully supports the development of the principles-based framework envisaged by the ESMA and agrees it should act as a reference point for the creation of new share classes within the UCITS industry. Nevertheless, we urge the ESMA not to limit the range of acceptable share classes to only those intended to hedge against currency risks. As the creation of share classes is entirely demand-driven and given that there are multiple risk factors in today’s markets other than currency ones, the European UCITS industry is wary of limitations that may jeopardise its need to meet existing client demands through various types of hedged share classes and to reap larger economies of scale by attracting more investors (across the EU and from non-EU jurisdictions) into larger funds. Were duration-hedged share classes to be deemed incompatible under the ESMA final principles, duration hedging would need to be performed via the offer of a stand-alone product, or via a master-feeder structure[[8]](#footnote-9), with considerably higher costs and longer time-to-market. The same would occur with regard to other types of share classes. Investors are likely to turn to non-EU competitors in search of more and better tailored solutions, further exacerbating the problem of sub-scale funds in Europe. Alternatively, or possibly even in parallel, European asset management companies would seek the launch of non-EU domiciled funds to satisfy investors’ demand for alternative risk factor hedged share classes. The latter would, nevertheless, constitute a sub-optimal outcome for the unity of the UCITS brand.

<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>

Several EFAMA corporate Members presently offer duration-hedged UCITS share classes, together with the other types illustrated in this response, across multiple EU and non-EU jurisdictions. Non-compliance with the ESMA common principles would introduce a necessary transition period of at least two years, during which new funds would need to be launched and tested, as well as existing portfolios fundamentally re-balanced to reflect investors’ needs and preferences. An appropriate and extensive grandfathering clause should be envisaged for existing share classes, as long as they are limited to the former holders and are not marketed to new investors.

<ESMA\_QUESTION\_DP\_SC\_21>

1. More specifically, we refer to the following text from the first sentence of Box 8 which states: “Hedging arrangements may only be taken into account when calculating global exposure **if they offset the risks linked to some assets** and, in particular, if they comply with all the criteria below: […]” (emphasis added by EFAMA). In our view, the term “hedging” should be used to explain a scenario whereby the base currency returns of a fund are hedged into another currency of denomination (i.e. that of the investor) as well. [↑](#footnote-ref-2)
2. The sensitivity of the price of the underlying bond to changes in the credit spread is known as “spread duration”. [↑](#footnote-ref-3)
3. More specifically, duration-hedged share classes mitigate investors’ exposure to parallel shifts in the yield curve via the systematic sale of futures in line with the duration of the fund’s benchmark, whilst keeping exposure to the core investment strategy. Where the portfolio manager anticipates a drop in interest rate, the duration of the portfolio compared to its benchmark may be extended and the investor of the duration hedged share class will be exposed to the long position of the core portfolio through the residual duration of the share class. Similarly, where the portfolio manager anticipates an increase in interest rates, the duration of the portfolio compared to its benchmark may be shortened and the investor of the duration hedged share class will remain exposed to the short position of the core portfolio through the residual duration of the share class. [↑](#footnote-ref-4)
4. Taking the example of a duration-hedged share class, designed to reduce the negative effect of rising interest rates on the underlying portfolio, holders of the hedged shared class may actually stand to lose compared to non-hedged shareholders should rates remain constant, rise less than predicted, or ultimately actually decrease in the opposite sense intended by the hedge. [↑](#footnote-ref-5)
5. With OTCs, collateral requirements, including related netting arrangements, will tend to vary depending on commercial discussion and negotiation with the broker. [↑](#footnote-ref-6)
6. For more information, please refer to the MSCI hedged indices’ methodology, available at: <https://www.msci.com/msci-currency-hedged-indexes>. [↑](#footnote-ref-7)
7. As per the ESMAs 2012 *Guidelines on ETFs and other UCITS issues* (ESMA/2014/937), as updated in August 2014 and complemented by a Q&A. [↑](#footnote-ref-8)
8. In case of a master-feeder structure, the commercial implications of global distribution outside of Europe should be taken into consideration (e.g. legal requirements, registration process, etc.). [↑](#footnote-ref-9)