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European Securities and Markets Authority
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6 June 2016

Dear Sir/Madam

ESMA DISCUSSION PAPER ON UCITS SHARE CLASSES (6 April 2016) (the "Discussion Paper")

BlackRock, Inc. ("BlackRock")[1] is pleased to have the opportunity to respond to the Discussion Paper.

About BlackRock

As a fiduciary for our clients, BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and we will continue to contribute to the thinking of ESMA on any specific issues that may assist in improving the final outcome.

BlackRock's asset management business incorporates numerous ranges of UCITS domiciled across Germany, Ireland, Luxembourg and the UK and we have drawn on experience from these ranges and these jurisdictions in responding to the Discussion Paper.

Executive Summary

BlackRock supports ESMA's initiative to ensure harmonisation of the UCITS share class regime. The common application of the UCITS Directive in member states is, of course, paramount to the protection of the UCITS brand.

We are pleased to see in the Discussion Paper that ESMA is looking to adopt a principles based regime as part of its regulation of UCITS share classes which will importantly serve to maintain some flexibility afforded by the UCITS Directive.

We note also ESMA's acceptance of the use of currency hedged share classes in UCITS but would welcome express clarification in the final guidelines that both fund base currency level and fund portfolio currency level hedging methodologies are permitted.

As stated in our response to ESMA's 23 December 2014 Discussion Paper (the "First Discussion Paper"), our view remains that ESMA should look to maintain flexibility to launch different types of share classes, including those with different hedging strategies, within the general principles of common pooling and furtherance of a common investment objective. The flexibility and breadth of choice the

[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

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industry is able to offer investors through share classes is key to the competitiveness of the European asset management industry and to reducing barriers to investment in UCITS.

Yours faithfully

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Schedule

Response to Discussion Paper Questions

Q1. Would you agree with the description of share classes?
Yes.
Q2. Do you see any other reasons for setting up share classes?
We believe that the Discussion Paper covers the main themes. A couple of points that are not expressly covered but would probably fall under the stated themes are as follows: Customisation for investor needs (para 12(b)): in the context of the UCITS ETF regime it would be helpful to have both listed and unlisted share classes within a UCITS without this affecting the UCITS' ability to use the ''UCITS ETF'' label. The ability to operate such a model will bring economies of scale. Economies of scale (para 12(c)): a share class may be preferred to the launch of a separate UCITS where a particular strategy requires a large sum of assets under management to be viable as a separate UCITS. In such circumstances it may not be possible to launch a separate UCITS with sufficient scale and so a new share class would be preferable. The use of share classes can therefore prevent the proliferation of funds in this scenario.
Q3. What is your view on the principle of "common investment objective"?
We agree with the principle. We would add that whilst there should be a common investment objective requirement, the investment outcome and risk profile should not be required to be identical. Risk is an integral part of a UCITS investment strategy and is something that is assessed (from a risk measurement and risk profile perspective) at share class level. Whilst the differences should not be fundamental we believe that certain tolerances should be acceptable provided those differences do not detract from the common investment objective. We agree that the use of derivative overlays which layer additional (i.e. new) risks/risk factors to that of the common pool of assets should not generally be considered as compliant with this principle whereas derivative overlays which seek to minimise or otherwise address existing risks within the UCITS (e.g. FX currency risks) should be considered as compliant with this principle. As we mentioned in our response to the First Discussion Paper, the common investment objective requirement should not, in our view, prevent the existence of share class specific overlays used to vary an investment exposure (e.g. currency or interest rates) or investor experience within that common investment objective, provided of course that those variations and associated risks (if any) are managed and clearly disclosed in UCITS documents and that the costs and liabilities particular to the share class are attributed only to that class. Different share classes can (and do) co-exist within the same investment strategy. Please note in relation to the following statement at paragraph 20 that, whilst of course not incorrect, it has been worded too restrictively and could be misconstrued to be limited to fund base currency hedging only, where only the base currency of the UCITS is hedged against the share class currency notwithstanding that the UCITS holds investments in multiple currencies: "*Currency risk hedging is therefore a means to ensure that investors participate to the maximum extent possible in the same performance of the common pool of assets as other investors, even though their*

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exposure to the fund is obtained through a different currency from the base currency of the fund."

Investors seeking currency hedged share classes may be seeking local market exposure provided by the fund minus currency risks.

For completeness therefore, we recommend that any future guidance issued by ESMA expressly includes portfolio or asset level hedging, to allow investors the choice of participating in the returns of the underlying portfolio (i.e. market exposure provided by the underlying portfolio minus currency fluctuation impact). Such investors do not want the currency risk between the portfolio currencies to which the rest of the fund is exposed and the share class reference currency. As an example, a French or Belgian investor (with a EUR reference currency) investing in a UCITS with a global market exposure and US Dollar fund base currency may want to minimise currency risk between fluctuations in the currencies of the portfolio and EUR which is their currency of investment (and not just limit this to currency risk between USD and EUR).

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

We agree with ESMA's statement at paragraph 20 of the Discussion Paper that currency risk hedging is compatible with the principle. We would add that through correct structuring it should also be possible to create interest rate hedged classes (or other types of share classes) that operate in line with the principle.

Duration hedged share classes work in a similar way to currency hedged share classes. The objective is that a fixed income fund will have exposure to a number of risks: credit, foreign exchange, interest rates. A duration hedged share class would keep the exposure to the other risk factors but seek to hedge out the interest rate exposure, just for that share class thus allowing an investor to isolate a desired exposure/outcome. They might achieve this using, say, treasury or gilt futures or by using swaps. These derivative exposures would be segregated from the rest of the UCITS so that the instruments only affect the performance of the duration hedged class. This works in much the same way as a currency hedged share class which enters into FX forwards to close out its FX risk. As with currency hedging, the cost and liabilities of interest rate hedging (e.g. margin costs on interest rate futures) can be allocated to the duration hedged share class holders to prevent any adverse impact to non-duration hedged class holders.

We acknowledge that in some limited circumstances it might be the case that interest rate hedging can fundamentally change the risk and return profile of the share class so that it differs from the UCITS' common investment objective but provided that this difference is disclosed appropriately we do not see that there is any increased risk to investors. We feel that to prohibit interest rate hedged share classes would be a disproportionate response to such concern.

Compliance with the principle should be the determining factor, rather than a categorised blanket prohibition.

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

We agree that contagion is an operational risk that must be managed as part of a multiple share class UCITS.

As we set out in our response to the First Discussion Paper the two common methods of managing contagion risk (i.e. accounting model and share class model) ensure that the costs and liabilities of hedging trades are attributable to the hedged share classes specifically, and not to the UCITS' common pool of assets, as the rest of the UCITS' trading activity would be. Both methods ensure that the costs and liabilities related to a hedged share class are separated (although of course not legally segregated

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given the absence of the requisite legal regime).

Operational processes should be designed to monitor the risk of contagion and eliminate or mitigate its effects. The return and risk profile of a share class should be matched, such that if a share class receives all the return from a class specific overlay, it should as a matter of principle be subject to all of the related risk of that return. Operational processes include the following:

(1) allocation of share class specific returns solely to that share class;

(2) allocation of share class specific costs solely to that share class;

(3) apportionment of common portfolio returns and costs in proportion to the relative ownership of each share class; and

(4) anti-dilution mechanisms can ensure minimal to nil contagion of net returns across classes.

Since, due to the legal construction of UCITS, elements of risk (notably counterparty risk) can only be managed and mitigated and contagion is theoretically still present for certain events, this should be expressly disclosed and managed through principles such as those outlined in paragraphs 28 and 29 of the Discussion Paper. A proportionate materiality approach needs to be applied which looks at operational complexity versus contagion risk.

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. Whilst we have not experienced such an event at BlackRock and the risk is largely theoretical, events such as the Swiss National Bank's removal of the CHF peg in 2015 may present a useful stress test scenario of contagion prevention measures.

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)

Contagion risk can be effectively managed in UCITS and has been so managed for many years. There could however be a theoretical potential for contagion risk arising from a market event or a counterparty default. A couple of examples are set out below.

Movement in emerging market currencies
UCITS dedicated to emerging markets are more likely to see significant net asset value drops and large foreign currency moves. A scenario might arise where due to extreme moves in the UCITS net asset value and FX rates within a given month the level of realised losses on a hedging sleeve (with a monthly derivatives roll process) are greater than the value of the share class' respective share of the underlying pool of assets.

Counterparty default
A material event affecting a derivative counterparty may have an impact on numerous UCITS.

Elements of contagion risk
The potential for contagion risk would generally arise in the following circumstances:
(1) accounting process misallocates common portfolio returns across share classes;
(2) accounting which does not wholly allocate share class specific returns to the relevant share class;
(3) accounting which results in class specific costs impacting other share classes; or
(4) sharing of elements of risk associated with the derivative overlay e.g. counterparty risk. When rolling

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the forward contract a contract cash flow is realised which represents the crystallisation of the gain or loss resulting from the hedging activity of the prior period. This cash flow is used to invest / disinvest into the portfolio of the UCITS which will generate transaction costs to the entire UCITS.

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

Yes. These principles are currently reflected in BlackRock's processes and operational systems.

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

The limits proposed seem broadly appropriate and BlackRock's operational processes operate within these stated guidelines. We suggest however that a degree of flexibility is maintained (rather than inflexible hard limits) to enable portfolio managers to protect shareholders interests in all market conditions.

Generally a level or tolerance should be set such that an appropriate balance is achieved for the investor between risk mitigation and reduction of transactional costs. Appropriate disclosure of this risk should be made to investors in the UCITS prospectus.

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

We suggest that operational risk, counterparty exposure, governance and conflicts of interests management and mitigation are more important than pure investment risk when considering stress tests. In terms of investment risk, it makes sense to focus on less liquid currencies, and the impact of potentially large trades triggered by breaches of hedging ratio or early net present value thresholds.

Stress testing must cover specific parameters and specific events, for example:

Parameters testing

- early termination trigger setting
- hedging threshold setting
- one month forward contracts (allows readjustment of the hedge more frequently than three month contracts)

Event testing

- Swiss National Bank removal of CHF peg in January 2015.
- FX counterparty failure (see below further)
- Back testing to identify what it would take to “break” the UCITS. This could include sizing of hedging sleeves as percentage of NAV especially in more volatile markets

FX counterparty default may have an immediate consequence in terms of counterparty exposure, as summarised below.

(1) The straight credit risk arising from the derivative relationship, which needs to be managed or mitigated through the appropriate legal documentation, collateral or credit terms.

(2) Key counterparty dependency: these strategies' operative model places heavy reliance on services supplied by certain counterparts, therefore their overall quality, integrity and ultimately long term success are dependent on the quality and continuity of the services supplied by one or very few counterparts. The complexity of the model makes it difficult and time-consuming to replace such service providers, so it is hard to diversify or mitigate this risk.

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(3) Once the strategies are live, our negotiation power versus the main counterpart/service provider may be impaired by the high dependency on their services, which may result in higher cost to us or to investors and reduced chance of success.

(4) The business of offering different share classes defined on a common investment pool requires allocation of market exposures, fees and costs to each share class, and there is the risk of trading or activities related to one share class "contaminating" other share classes or the entire common pool. This needs to be addressed with a more sophisticated governance, monitoring, performance attribution, and cost allocation framework.

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.

We would consider that both operational principles are compatible.

a) We believe that the determining factor should be whether the hedging strategy reduces or eliminates risk factors present in the common pool of investments and whether it is constructed in such a way as to be pre-determined and if so, it is compatible with the operational principles outlined, provided the accounting and operational mechanisms to eliminate or minimise the contagion are effective. If a currency hedge or other type of hedge meets these criteria, it should be permissible as maintaining a common investment objective.

b) Currency hedging FX forward / FX swap:

- FX forward model implies that there is a split of FX spot and FX forward with the impact that FX rates used for both transactions are not identical. FX spot transactions booked as a single transaction are normally not booked in accounting against one share class. Pre-determination is therefore important.

- FX swap will include FX spot and FX forward trade. As both are done in one transaction, one can ensure that it is done at the same time using the same FX rate which means that the hedge is done using exactly the same values. As FX spot and FX forward transaction are done via one FX swap contract, non – contagion and pre-determination is clearly provided to the investor.

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?

BlackRock believes that adding an "early termination" process to the hedging model will reduce the cash flows resulting from the crystallisation process of the unrealised gain / losses. This process is triggered when the unrealised gain or loss of a hedge exceeds a stated threshold and would therefore result in an increase in the number of cash flows generated during the year. Importantly, however, the amounts involved will decrease which will as a result decrease the impact of investing the cash flows once a month. This will therefore reduce the contagion risk exposure to non-hedged share classes.

The operational principles should include processes to ensure:
(1) allocation of class specific returns solely to that share class;
(2) allocation of class specific costs solely to that share class;
(3) apportionment of common portfolio returns and costs in proportion to the relative ownership of each share class; and

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(4) anti-dilution mechanisms can ensure minimal to nil contagion of net returns across share classes.

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

The addition of an "early termination" process will not impact the compatibility of the operational principles with further hedging arrangements.

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

We agree that pre-determination of all features of a share class, the risks to be hedged and the hedging mechanism, is a sensible requirement to ensure transparency for investors. At BlackRock all share class features are pre-determined (and, where appropriate, disclosed in the prospectus).

The ESMA guidelines on ETFs and other UCITS issues contains a similar requirement in relation to eligible indices for UCITS, where the index methodology of these must be pre-determined and published. There is already therefore a successful precedent for such a principle.

We expect the principle of pre-determination to be helpful in framing what is acceptable in the context of share class hedging. It would also be helpful for the parameters within which hedging would be carried out for a share class to also be pre-determined and disclosed to enable investors to better assess risks.

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

Disclosure in the prospectus (and KIID where appropriate) is deemed adequate.

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

Transparency is fundamentally important to investor understanding. It is current practice at BlackRock to disclose the differences between UCITS share classes in the prospectus. Where required by local regulation it is also current practice to notify existing investors ahead of the introduction of the first hedged share class within a UCITS umbrella.

We support the operational principles outlined in paragraph 36 of the Discussion Paper. In relation to the second limb (a list of share classes which have contagion risk) please note that contagion risk will exist wherever a UCITS has two or more share classes – the existence of the risk is symptomatic of the fact the law does not segregate liability between share classes. Assuming that it is not ESMA's intention that the names of all share classes should be listed as part of this requirement, it might therefore make sense to clarify that it is only those share classes with a heightened contagion risk (i.e. beyond contagion of insolvency/default risk which applies to all) that are in scope.

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

We agree that the prospectus is the appropriate document for disclosure. It might be helpful in addition to require key features of the share classes to be disclosed on the website on which the UCITS is marketed.

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

ESMA could consider permitting share classes under Q16 to be disclosed by describing the type or category of share class, instead of having to list the name of every single share class, as this could be

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more reader friendly where the list would be very long. For example, describing a category of share class as currency hedged share classes or interest rate hedged share classes.
Q19. Do you see merit in further disclosure vis-à-vis the investor?
In general terms, we feel that the current disclosures required in the UCITS prospectus and KIID are adequate and strike a proportionate balance to disclosure by highlighting differences in structure, costs and risk. One refinement to the current disclosures might be the disclosure (where appropriate) of the difference of expected cost between hedged share classes and non-hedged share classes for share classes which charge variable ongoing charges.
Q20. If a framework for share classes, based on the principles as outlined in this paper, was introduced at EU level, what impact on the European fund market could this have?
The currency hedged share class regime should be largely unaffected assuming the intention is to permit both fund base currency level and fund portfolio currency level hedging methodologies and provided that the proposals for Q3 in this response paper are adopted. If ESMA recommends that the industry move assets out of interest rate hedged share classes (which we understand account for multiple millions of Euro) into separate UCITS, this could have a significant detrimental impact to investors as it may not be viable to offer the exposure outside the critical mass of a common pool of assets. If investors are forced to switch out of existing share classes they may face significant transaction costs and negative tax consequences. Investors may also look to non-EU funds for more tailored solutions.
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?
At BlackRock we do not offer interest rate hedged share classes so it is not appropriate for us to comment here but see Q20 for those matters that will need to be carefully considered by ESMA in framing the transitional period. Certainly in the shorter term we would expect the launch of any new share classes which do not meet the requirements to be prohibited.

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