Luxembourg, 6 June 2016

Response to the ESMA Discussion Paper on UCITS share classes (ESMA/2016/570)

Introduction

The Association of the Luxembourg Fund Industry (ALFI) is the representative body of the Luxembourg investment fund community. Created in 1988, the Association today represents over 1300 Luxembourg domiciled investment funds, asset management companies and a wide range of service providers such as custodian banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax experts, auditors and accountants, specialist IT providers and communication companies. The Luxembourg Fund Industry is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg-domiciled investment structures are distributed on a global basis in more than 70 countries with a particular focus on Europe, Asia, Latin America and the Middle East.

General remarks

As a general comment ALFI would like to underline that the Luxembourg fund industry is in a specific situation with regard to the creation of share classes since it has an exposure to a significant number of distribution countries and as a result has to adapt to a wide variety of investors' needs. It is also useful to note that, although a theoretical contagion risk may be attached to fund share classes, these exist since the eighties and to our best knowledge no incident has been reported up to now. Luxembourg UCITS management companies have already put in place robust systems of control in order to mitigate any contagion risk, as required by the Luxembourg regulator.

On a more global basis, the current share classes environment in various Member States ensures the competitiveness of the European fund industry by realizing economies of scale and such advantage should not be jeopardized by unnecessary organisational obligations and costs. ALFI therefore welcomes the opportunity to respond to the European Securities and Markets Authority's ("ESMA") discussion paper on share classes of UCITS.

In this paper, unless otherwise indicated, a reference to a UCITS is a reference to a sub-fund thereof in case of umbrella UCITS.

Executive summary

- ALFI agrees with the principle that one share class's specific features should not cause adverse impacts for holders of shares in other share classes of the same UCITS.

- The creation of share classes gives access to hedging features that protect investors by reducing their risk. Prohibiting some types of hedging at share class level will be detrimental to the investors, especially retail investors, who are not able to have access to such hedging features outside of the UCITS.

- ALFI agrees with the principle that share classes of the same UCITS should have a common investment objective and strategy achieved through a common pool of assets. ALFI takes the view that the key point is that the common pool of assets of the UCITS is managed according to a *common underlying investment objective and strategy*.

- As a matter of principle, no distinction should be made between currency hedging and other types of hedging (e.g., duration, volatility). Provided that the share classes comply with the different principles determined in ESMA's Discussion Paper, they should be allowed. In our view any type of hedging should be allowed at the share class level as long as the UCITS has put in place processes to mitigate any "contagion" risks between different share classes.

- Rules to ensure the minimisation of contagion risk should not be overly technical otherwise they would not be practicable and/or would be unnecessarily costly. Existing operational and accounting segregation mechanisms already enable an efficient management of contagion and spill-over risks.

- We agree with the principle of pre-determination. However this should not lead to imposing rigid quantitative limits which might raise issues under certain market conditions.

- ALFI also agrees on the principle of transparency. However we would like to underline that fund documents such as prospectuses, KIIDs, annual reports and periodic reports already provide sufficient information as to existing share classes and their respective features.

- One should avoid putting at risk the attractiveness of the European fund industry for both European and non-European investors and fragmenting the industry where there is rather a need for consolidation in line with the European Commission's Green Paper on the Capital Markets Union.

- A grandfathering clause in order to avoid costs to investors who are currently invested in such share classes and a transitional period to allow effective migration to the new rules would be necessary in the event that a restructuring of certain existing share classes would be necessary.

3 Issues for discussion

3.1 What is a share class?

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

Share classes/unit classes in a UCITS are categories of shares which belong to the same UCITS and which confer to the relevant shareholders/unitholders of the UCITS an exposure to a common investment objective and strategy achieved through a common pool of assets, and allow them to achieve some level of customisation which accommodates their specific needs. The performance of each share class can differ from another due to its set of features such as fee structure, dividend policy, currency denomination and reduced exposures due to hedging.

We agree with the principle that one share class's specific features should not cause adverse impacts for holders of shares in other share classes of the same UCITS. It must be underlined that Luxembourg UCITS management companies have already put in place robust systems of control in order to mitigate such risk, as already required by the Luxembourg regulator in practice. To our best knowledge no issue was raised with this in the past and no investors had to pay for others due to a contagion effect.

3.2 Why do share classes exist?

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

Apart from the reasons outlined in the Discussion Paper, the following may also be considered:

- We agree with ESMA that the main 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 UCITS would need to be launched ex novo. It must be underlined that most platforms require funds to have a 3 year track-record before they add a fund to their platform, so time marketability can be significantly different according to whether funds or share classes are set up.

- Share classes give asset managers the possibility to offer products that are aligned to the investment profile of investors, *inter alia*, to meet investor-specific needs to hedge certain risks in terms of currency exposure, interest exposure, and other specific risks inherent to an investment in the UCITS. With these features at share class level, investors may benefit from the investment manager's expertise within the UCITS. Prohibiting some types of hedging at share class level will be detrimental to those investors who are not able to have access to such hedging features outside of the UCITS, as such types of hedging are not practical and/or are too expensive for small or individual investors, as they are not able to achieve similar pricing to funds that trade in larger lots.

- Having share classes allows investors to move from one share class to another without the need to sell securities, contrary to situations where an investor moves from one UCITS to another.

- Another crucial reason is the reduced cost for investors: as rightly mentioned by ESMA, the cost of launching a share class is between 5% and 20% of the cost of launching a new fund.

- Moreover the seeding money aspect is not to be neglected: a UCITS requires higher assets under management than a share class (up to EUR 50 million depending on the strategy). Launching a UCITS forces asset managers to tie up more capital in the form of seed money as well as make additional sales efforts versus creating a share class.

- Institutional investors often prefer to invest in dedicated share classes of a larger UCITS rather than in dedicated funds, so as to not breach their specific holding ratio requirements when investing into collective investment vehicles like UCITS.

- Finally, the creation of share classes responds to the goals of the European Commission's Green Paper on the Capital Markets Union, by ensuring a wider choice among available products for investors, lowering prices and facilitating worldwide cross-border retail participation in UCITS. In particular, allowing to leverage on existing structures to adapt to clients' needs avoids the need to set up funds at high cost. This is important in order not to defragment the European fund market.

3.3 Key elements of share classes

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

ALFI would like to underline that rather than speaking of a "*common investment objective reflected by a common pool of assets*", as mentioned in paragraph No. 13 of the Discussion Paper, one should refer to the fact that share classes of a same UCITS should be linked by a "*common investment strategy which is realised through the investment in a common pool of assets*", as rightly mentioned in paragraph No. 15 of the Discussion Paper. It is at the level of the common investment objective and strategy that the portfolio manager makes the critical investment decisions that are also the most relevant for investors when they decide to invest in the UCITS.

ALFI is moreover concerned that the requirement to have "*a common pool of assets*" for all share classes of a UCITS may be interpreted in a way that is inconsistent with the requirements for non-cleared derivatives under EMIR. ALFI is concerned that market players may face challenges to be able to implement the collateral allocation under netting arrangements with trading counterparties. The principles set out in the Discussion Paper must be able to co-exist with the RTS on the risk mitigation techniques for non-cleared derivatives under EMIR, as well as the ESMA Guidelines on UCITS issues.

It must be underlined that:

- the use of hedging techniques is aimed at reducing risk;

- share class hedging can have different objectives depending upon investor requirements
    1. base NAV performance hedged into the investors own reference currency. In this instance the hedge is directly between the base currency e.g. $ and the specific hedge share class currency e.g. €.
    2. 'look through' hedging being all currency exposure of the common pool of assets as compared to the hedge share class currency. Example: a fund with a common pool of assets denominated in both £ and CHF, a US$ base currency and a single € hedge share class. Here the hedges booked in the hedge share class would be a function of the number of currencies in the common pool ie CHF to € and £ to €. This is for investors seeking local portfolio currency exposure but mitigating currency risks.
    3. In certain circumstances the objective may be to hedge the benchmark currency exposure rather than the actual currency exposure in a portfolio, in order to accommodate active portfolio management decision making concerning currency risk.

- hedged share classes with a derivative overlay aiming to hedge investor-specific risk factors of the UCITS should not be considered as having a different investment objective and strategy than such UCITS; these hedged share classes share with the non-hedged share classes the same investment objective and strategy, and the same common pool of assets invested in accordance with such investment objective and strategy; the management of such common pool of assets is operationally separated from the management of the individual share class's features; the costs and income of the derivative overlay are simply attributed to the relevant hedged share classes;

- the aim of the derivative overlay is not to offer a different investment objective and strategy compared to the non-hedged share classes but simply to allow some customisation to accommodate investors' specific needs, remaining however within the common investment objective and strategy;

- in principle, no distinction should be made between currency hedging and other hedging (e.g., duration and volatility). Provided that the share classes comply with the different principles, they should be allowed.

As a conclusion ALFI agrees with ESMA's opinion that UCITS management companies should implement appropriate procedures to minimise or eliminate the risk of contagion. However we are of the opinion that one should avoid that it makes it impossible to comply with future European regulations (more specifically EMIR), and we would also recommend not to be too prescriptive technically with regard to this topic, and to avoid imposing processes that would be impossible to implement in practice (see our response to question No. 8 below).

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

In our view, any types of hedging should be allowed at the share class level as long as the UCITS has in place processes to mitigate any "contagion" risks between share classes. As long as the purpose of the customization at the share class level is only to reduce a risk that is relevant to investors, the relevant share class should be authorized. From this perspective, referring to the hedging definition contained in box 8 of CESR's Guidelines on Risk Measurement is too restrictive. Indeed, this box refer to hedging the portfolio risk, whereas the share class hedging may have as objective to hedge risks arising at different levels, from an investor risk perspective.

Let's take the example of currency risks in a UCITS invested in emerging markets, with a base currency in USD and distributed to investors in the Euro zone. Box 8 would refer to the hedging of the currency exposure arising between the portfolio (emerging countries currency) and the fund base currency (USD). Some investors may also want to be protected against the USD/EUR risk. It is therefore important to continue to offer to investors choices regarding currency exposure (or hedging) so that they may decide, based on their individual circumstances, to hedge the portfolio currency exposure to USD or directly to their own reference currency (EUR in our example).

It must also be underlined that there is no provision in the UCITS Directive nor any legal rationale that would prohibit to have a specific type of hedging at share class level.

Duration hedging:
ALFI takes the view that duration hedging at share class level should also be permitted. Interestingly, as per our understanding of box 8 of CESR's Guidelines on Risk Measurement, duration hedging is recognised as a hedging technique. Moreover, to the extent the duration hedging is ensured through listed futures, an additional safeguard is provided as compared to the use of OTC derivatives, as such listed futures are approved by regulators and traded on regulated exchanges.

Volatility hedging:
It is also our understanding of box 8 of CESR's Guidelines on Risk Measurement that volatility hedging at share class level should also be permitted. In case of equity market volatility hedging, such hedging

can be achieved through the purchase of put options or through shorting stock index futures in relation to which there is no unknown remaining financial risk.

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

We refer to the developments above regarding duration hedging and equity volatility hedging.

We agree that management companies should only employ share classes where contagion risk is minimized or eliminated. Therefore where operational segregation can be effectively applied via a separate share class valuation process, "contagion" risks from the risk-reducing overlay to other share classes (with the likely dilution of the underlying NAV for all investors) are sufficiently contained.

Indeed, if management companies keep to the principle of hedging then the risk of contagion can be largely resolved with a robust operational process. For example, if a group of investors is interested in a particular fixed income strategy, more specifically in the portfolio manager's ability to select certain credits, but feel that duration risk of the portfolio is too high, they could choose a share class reducing the duration by 1/3.

By combining the principles of common investment objective and strategy, pre-determination and transparency, while ensuring that any obligation of the UCITS in respect of hedging transactions at share class level remain covered, at all times, by the NAV of the relevant share class, and by relying on a robust operational process in place, any losses resulting from such hedging transactions would in any circumstances be covered by the NAV of the relevant share class.

We reiterate that, to the best of our knowledge, the operational and accounting segregation currently applied and requested by the CSSF enables to mitigate efficiently the spill-over 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?

Fund share classes exist since the eighties and to our best knowledge no incident has been reported up to now. Although there can be a residual risk for investors in one share class suffering losses as a result of the crystallisation of risk in another share class, operational and accounting segregation measures enable to mitigate and eliminate such risk.

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)

See our remarks in answer to question 5 above.

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

Referring to our response to question No. 3 above, ALFI would like to stress that processes to ensure the minimisation of risk should not be so technical that they wouldn't be practicable or unnecessarily costly. We would like to underline again that to our best knowledge there has never been any contagion incident up to now.

With regard to paragraph 28 (b) on the identification of assets, in our view the objective should be to identify the proportion of assets and liabilities of the portfolio attributable to the relevant share class and any specific derivative transaction entered into for hedging purposes for instance for this share class but not the specific assets and liabilities of the portfolio by share class. Segregation would be contrary to the idea that share classes participate in the same pool of assets. Moreover we would like to underline that one should not mix the legal concepts of assets and liabilities and the accounting concepts of profit and loss, as seems to suggest this paragraph. This should be clarified in paragraph 28 (b). The same comment in the context of the stress tests mentioned in paragraph 28 (c).

As to paragraph 28 (d), we find it difficult to say ex-ante whether the share class is better aligned with the specific risk profile of the investor as it depends on the individual situation of each investor. Moreover we think that it would be better to refer to “target investor” where regulators may carry on the relevant checks when they approve the share class. Management companies should not set up share classes when there is a material risk that spill-over might exist and must therefore test the share class model before inception within the operational framework to be used.

If a manager uses an index-based derivative to hedge certain risks at share class level, it should be understood that the hedging strategy embedded into the index necessarily satisfies the criteria defined in paragraph 28 (e);

Regarding paragraph 29 (a), this obligation would, in most cases, be impossible to meet in practice and there is no legal rationale behind it.

Finally, regarding paragraph 29 in general, the principle of limiting over-hedging is appropriate, but discretion should be left to allow for decisions that consider transaction costs and operational risks.

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

The limit of 95% referred to in c) seems to apply to all currencies. One must underline that there are different degrees of volatility depending on the currencies. Contagion happens if there is over-hedging only. We wonder why the limits set by ESMA in the Discussion Paper are fixed at 95-105% and we take the view that the suggested limits are too narrow. Such limits would also necessitate a number of regular adjustments. When partial hedging is performed, why should these limits be applied? Therefore ALFI would advocate for a more flexible approach rather than setting hard limits. Proper disclosure in the prospectus (explaining clearly whether the hedging is partial (together with the applicable percentages) or full, whether it is systematic or not) should be sufficient in our view. Rendering those limits automatic in all instances could deprive investors from the benefit of the managers’ knowledge and expertise in appreciating the necessity to undertake hedging or not depending on the currency market fluctuations for instance. Hedged share classes indeed offer the opportunity for investors to have access to hedging techniques which they would not have via another type of investment structure, and that may not be accessible for them outside of the fund structure.

We would add that these exposure limits are suited for share class NAV hedging but not for look-through hedging.

As look-through hedging is aimed at reducing 100% of the FX risk directly embedded in the portfolio of investments and should ESMA impose prescriptive percentage limits and systematic hedging (despite the above), the wording should be amended to target 95%-105% of the FX exposure (versus NAV of the share class). This would make both types of hedging compliant with the operational rule.

Moreover, our view is that duration hedging and volatility hedging should be allowed at share class level as they aim to reduce the overall risk level for the investor. However, the exposure limits set out in this section should be mentioning specific rules for duration and volatility hedged share class. For example, the level of target duration should be pre-determined, lowered and not become negative as they would add exposure instead of reducing it. The same could be outlined for volatility hedged share classes.

If a manager uses an index-based derivative to hedge certain risks at share class level, the portfolio manager is following the hedging strategy of the index provider which might result in limits mentioned in paragraphs 29 (b) and 29 (c) not being complied with.

In general, the limits shall be adapted to the risk to be offset.

ALFI is of the view that there should be no exhaustive list of compatible share classes since the creation of share classes responds to requests from investors. It is essential that the asset management industry be able to continue to create products in line with investors' investment profiles and needs. A case by case assessment when proposed new share classes are being reviewed by local supervisory authorities based on the ESMA principles should be sufficient. As mentioned above, there is neither a provision in the UCITS Directive nor any legal rationale that would prohibit having a specific type of hedging at share class level.
We would also like to add that in our view information available in the prospectus is already comprehensive. When share classes are authorised it is always on the condition that risks are identified in the prospectus, and appropriate risk management processes are put in place.

Q10. Which stresses should be analysed as part of the stress tests? (cf. paragraph 28.c)

Subject to operational segregation as outlined above, there isn't any need for stress tests in our view.

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 consider all three hedging (FX hedging, duration hedging and volatility hedging) methodologies outlined above as acceptable for those principles.

Indeed, as FX hedging, duration and volatility hedging can also be compliant with the principles set out in the Discussion Paper:

- Common investment objective: the pool of common assets stays the same. Part of their risk would be offset at share class level with derivatives and only the interest rate risk and volatility, respectively, is being hedged.

- Non-contagion: derivatives used can be segregated from an operational and accounting perspective in order to minimise/eliminate any spill-over risk, as explained above.
- Pre-determination: the parameters of the hedging used (including the target duration or volatility reduction) can be defined from inception.
- Transparency: the type of hedging used can be clearly described in the prospectus

In our view the use and choice of derivatives to implement the overlay should not be restricted, as these depend on the most cost-efficient way to implement the risk mitigation strategy. Such implementation should 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.

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?

See our response to question 11 above.

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

Non applicable.

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

We agree with the principle of pre-determination. However this should not lead to imposing specific figures or quantitative limits which might raise issues according to market conditions. Some degree of discretion remains therefore necessary and is compatible with the aforementioned principle to the extent a hedging overlay is applied consistently and that appropriate transparency in the prospectus is ensured.

If a manager uses an index-based derivative to hedge certain risks at share class level, it should be understood that the hedging strategy of the index providers systematically meets the pre-determination principle.

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

There is no additional requirement to be added in our view.

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

ALFI agrees on the principle of transparency. It would be useful to clarify what is meant by the terms "in a timely fashion" (last sentence of paragraph 35). We would like to underline that fund documents such as prospectuses, KIIDs, annual reports and periodic reports already provide sufficient information as to existing share classes. The basis for providing adequate information about the classes of UCITS therefore already exists. Best practice in this context encourages transparency in the fund documents.

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

Yes.

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

We do not see the need for further requirements.

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

See response to questions above.

3.4 Impact on existing share classes and transitional provisions

Q20. If a framework for share classes, based on the principles as outlined in this paper, were to be introduced at EU level, what impact on the European fund market could this have?

We support EFAMA's position that advocates for a principle-based framework but not limited to currency hedged share classes. One should avoid putting at risk the attractiveness of the European fund industry for both European and non-European investors and fragmenting the industry.

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?

ALFI would recommend that existing share classes benefit from a grandfathering clause in order to avoid costs to investors who are currently in such share classes. Transitional provisions will be necessary in any case to allow effective migration to the new rules. We would therefore suggest a transition period of 18 months between the date of publication of the final provisions and the date of implementation.

Appendix: Identification of the stakeholder

- Association of the Luxembourg Fund Industry

  12, rue Erasme
  L-1468 Luxembourg
  Contact person for this consultation: Evelyne Christiaens (evelyne.christiaens@alfi.lu)

- If you are registered with the Commission as an "interest representative" your identification number:

  6182372280-83

- Are you a recognised European social partner organisation or a representative of a European (sectoral) social dialogue committee?

  No.

- Field of activity of the respondent. Please specify your field of activity. Please indicate if you are directly affected by any of the measures and if so, which one and to what extent:

  ALFI is the official representative body for the Luxembourg investment fund industry. Being a non-profit organisation, ALFI is not directly affected by any of the measures.

- If the respondent is an association of stakeholders, how many members do you represent and what is your membership structure?

  ALFI represents over 1188 investment funds, 247 service provider and 19 associate members.

- Do you object to publication of personal data on the grounds that such publication would harm your legitimate interests?

  No.

- Do you agree to having your response to the consultation published along with other responses?

  Yes.