DILLON EUSTACE

Our Ref: JF
Your Ref:

03 June, 2016

European Securities and Markets Authority (ESMA)
103 Rue De Grenelle
Paris 75007
France
Submitted via the ESMA Website

Re: Discussion Paper UCITS Share Classes (ESMA/2016/570)

Dear Sirs,

We refer to the discussion paper and to the invitation to stakeholders to receive feedback.

Dillon Eustace is an Irish law firm which advises many international sponsors and managers of UCITS schemes. We have reviewed ESMA's Discussion Paper and wish to participate in the feedback process. Please find attached in the Appendix to this letter, our responses to each question in the Discussion Paper. Please note that our responses focus exclusively on interest rate risk hedged share classes.

We have no objection to the public disclosure of our response or any part thereof.

Please do not hesitate to contact us in the event that you require further clarification of you have any questions arising from our response.

Yours faithfully,

Dillon Eustace

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APPENDIX

Response to ESMA'S Discussion Paper – UCITS Share Classes (ESMA 2016/570)

Dillon Eustace is an Irish law firm which advises many international sponsors and managers of UCITS schemes. We have considered the ESMA Discussion Paper on UCITS Share Classes (the "**Discussion Paper**") and wish to take the opportunity to respond to the Discussion Paper taking into account input from our clients.

Our responses focus exclusively on the subject of interest rate risk hedged share classes for UCITS funds in respect of whom we advise. In particular, our response focuses on funds where the interest rate risk exposure of all investors in the fund is hedged to a predetermined target in accordance with the principals of predetermination. In this submission, we explain:-

1. how interest rate hedged share classes are consistent with ESMA's view on the principle of share classes sharing a "common investment objective";

2. how interest rate hedged share classes can operate within the operational framework and parameters set out in the Discussion Paper which is designed to minimise cross-contagion risk and establish a level of operational segregation; and

3. how interest rate hedged classes can comply with the principle of predetermination.

We have set out below our responses to the questions raised in the Discussion Paper.

Question 1: Would you agree with the description of share classes?

Yes, we are broadly in agreement with the description of share classes as set out in the Discussion Paper.

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

We consider that the Discussion Paper sets out a comprehensive description of the reasons for setting up share classes.

Question 3: What is your view on the principle of "common investment objective"?

We agree with the principle of "common investment objective", namely that share classes of the same UCITS fund share in the same common pool of assets and that such assets are invested pursuant to the same investment objective. However, this principle should not prevent UCITS from having the flexibility to provide share classes with variations (specifically interest rate hedging overlays) with respect to risks that are inherent in the pool of assets of the fund as a whole (e.g. currency and interest rate risk) and which are systematically hedged to pre-determined profiles for all investors (e.g. currency and interest rate risk). That is, of course, provided that such hedging techniques and any risks associated therewith are clearly managed according to a set of rules disclosed in the fund documents, that they comply with the principle of predetermination, and provided further that the costs and liabilities of such hedging are attributed only to the hedged share classes.

Question 4: What type of hedging arrangements would you consider to be in line with this principle?

We are of the view that for funds where the interest rate risk is hedged for all investors to a predetermined risk profile, appropriately implemented interest rate/duration hedged share classes are compatible with this principle.

We note the statement made by ESMA in the Discussion Paper that "*currency risk hedging is therefore a means to ensure that investors participate to the maximum extent possible and the same performance of the common pool of assets as other investors even though their exposure to the fund is obtained through a different currency from the base currency of the fund*". We have illustrated below how interest rate hedged share classes are also consistent with the principle.

Interest Rate Hedged Classes: Predetermination Principle

In the case of a credit focused UCITS portfolio, where the interest rate risk of the investment portfolio is managed not as an active risk, but, rather, is hedged to a predetermined target for all investors in accordance with the principle of predetermination, the UCITS is providing the same active investment return (the credit return) to all investors. In other words, it is a single portfolio of assets and the portfolio level credit return is the same for all investors. The value of the investment is also impacted, however, by the predetermined interest rate risk of the investment – analogous to the 'base currency' exposure of a fund. Interest rate risk hedged share classes simply offer investors predetermined reduced interest rate risk exposures to hedge against risk that is not part of the active investment risk of the strategy and to which they do not want exposure. In the case of a credit focused UCITS with a predetermined interest rate risk profile, Interest rate hedged share classes enable an investor to limit the interest rate risk associated with its investment in the common credit portfolio, the same way as offering currency hedged share classes for an investor to manage currency risk and fluctuations in the value of their return.

Common Investment Objective

In a credit focused UCITS, all investors have the same level of exposure to the credit return of the portfolio (i.e. the common investment objective of the fund). Investors have the same exposure to the common pool of assets and receive the same credit returns. Interest rate hedging at the share class level simply aims to reduce the investor's exposure to the risks associated with the 'base' predetermined interest rate risk of a fund.

We have set out below examples which illustrate how we consider interest rate duration hedging at share class level is consistent with the common investment objective principle.

Examples

Interest rate hedged share classes offered by a credit focused UCITS allow an investor to manage the interest rate risk associated with its investment in the UCITS. Corporate bond prices are sensitive to movements in interest rates and many investors are concerned about the effects of rising interest rates on their fixed income portfolios. For example, as USD interest rates rise, the value of the corporate bonds in a UCITS portfolio would be expected to decline and *vice versa*.

The portfolio of a corporate credit UCITS fund would have a natural sensitivity to interest rates or a natural interest rate profile as a consequence of the corporate bond investments in the portfolio. For the fund in this example, this sensitivity to interest rate risk is hedged to a predetermined interest rate risk profile *for all investors*. The only question at hand is whether different investors can choose to further reduce that risk by electing to invest in a share class with a predetermined reduced interest rate risk profile.

Choice for investors

Different investors desire different interest rate exposures and profiles, just as different investors desire different currency exposures. Accordingly, offering interest rate hedged share classes and different currency hedged share classes allows investors to determine which share class meets their desired profile such as, for example, a US Dollar index duration interest rate profile share class or a Euro index duration interest rate profile share class. The aim of interest rate hedging at the share class level is to give choice and to allow the investors to have the benefit of exposure to the credit returns of a corporate bond portfolio (i.e. the UCITS' single investment objective) whilst mitigating against interest rate risk relative to the investor's target profile.

Actual Client Experience

To illustrate this further with an example, a UCITS client of ours aims to make the source of it UCITS investment returns relative to its interest rate profile transparent by hedging all interest rate risk to pre-determined profiles, and by creating interest rate hedged share classes that allow investors to invest in a share class with a pre-determined interest rate profile which matches their desired interest rate profile. In the case of these funds, the profile is either 'index duration', which is a predetermined profile based on an index, or 'zero duration', which systematically, in a predetermined fashion, hedges the duration risk for the investor.

This UCITS aims to achieve this by setting a pre-determined interest rate profile for each share class and by then hedging the interest rate risk of the UCITS' portfolio into cash flows to match the cash flow profile of the hedged share class.

Other examples

To further illustrate, we have set out the following examples:

Assume a UCITS is invested in a USD denominated corporate bond portfolio with a duration profile that does not match the duration or cash flow profile of a corporate bond index (the "**Index**"):

(a) for investors that require interest rate risk to match that of the Index, the investor invests in a USD Index duration share class. The fund uses cleared USD interest rate swaps and treasury futures to tailor the interest rate risk profile of the USD Index duration share class to match the interest rate risk exposure of the Index. Differences in returns between the USD Index duration share class and the Index should therefore not be due to interest rate risk/return differences, but should be due to the benefit of the credit portfolio asset selection relative to the credit exposures of the Index. This profile is the 'base' profile of the fund, equivalent to the base currency of a fund;

(b) other investors will, depending on their desired interest rate sensitivity, want to invest in a hedged interest rate duration profile, such as a USD three-month duration share class. The shorter duration share class investors want to 'hedge' the interest rate risk associated with the fund's corporate bond exposure (i.e. they do <u>not want</u> the interest rate risk in the Index);

(c) Note that in this example, the investments of all investors in the fund are subject to interest rate risk hedging to a predetermined cash flow profile. The only question is whether more than one such profile can be offered to investors, which, we believe, is appropriate.

Therefore, for the three-month duration share classes, the interest rate risk is hedged back to 3 month LIBOR, and the difference between the short duration share class returns and the returns of the short duration interest rate profile should, again, be the credit return of the investment portfolio. Absent the interest rate hedging, it would not be possible for the investor to have their desired corporate bond exposure within the fund without also having exposure to unwanted interest rate risk.

In short, all investors have the same level of exposure to the UCITS' credit portfolio and receive the same credit returns based on the investment objective of the UCITS. The interest rate hedging techniques at share class level aim to reduce the volatility of the investor's returns (i.e. in respect of interest rate risk) versus their desired risk profile.

Summary

Accordingly, interest rate hedging at share class level is consistent with the common objective principle. The interest rate hedging programme does not modify the investment strategy or policy of the UCITS. An interest rate hedged share class does not alter, change or affect the UCITS' strategy which, in the case of this credit fund, would be to invest in a portfolio of bonds/credit exposures.

We note ESMA's statement that there are some concerns "*the use of derivative overlays within a share class could lead to that class having a risk profile and an investment objective which would no longer be in line with the overall investment objective of the fund*". We do not believe that this is the case.

All investors have the same objective and exposure to the objective – to capture the credit return of the investment portfolio. For each investor, their interest rate risk hedged to a pre-determined interest rate risk profile the only question is whether more than one such predetermined profile can be offered by the fund which we believe it can.

Question 5: What is your view on the principle of non-contagion?

We agree with the principle of non-contagion as set out in the Discussion Paper. Specifically, we agree that although such a contagion cannot be fully eliminated, it can be mitigated by putting in place a set of operational procedures. As more fully described in our response to Question 11 below, most of the operational principles outlined in paragraphs 28 and 29 of the Discussion Paper are applied in practice today in respect of currency and interest rate hedged share classes for Irish UCITS.

Question 6: 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, we are not aware of any such instance. Our UCITS client has managed UCITS funds for over 10 years which hedge interest rate risk predetermined interest rate risk profiles and no such instances of loss have arisen.

Question 7: 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)

We note that ESMA has, in Paragraph 23 of the Discussion Paper highlighted contagion risk arising from liquidity stress related to margin requirements and the failure of counterparty. We are of the view that these risks are low and manageable. The risk in respect of margin requirements is manageable by the adoption of a set of operational and risk procedures such as the stress testing of margin requirements and setting minimum liquid asset requirements accordingly.

The potential risk arising from the failure of counterparty has essentially been eliminated with respect to interest rate hedging which in practice uses futures and cleared interest rate swaps, both of which are now traded using a Central Clearing Counterparty pursuant to Regulation 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories ("EMIR"). This is in contrast to FX Forwards in the case of currency hedged share classes which face a larger risk of counterparty default risk as they are trade on a bilateral basis.

In addition, the hedges are implemented in major currencies as opposed to emerging market currencies where discontinuous risk is more prevalent.

Risk is further minimised as interest rate hedged classes utilise highly liquid, low cost derivatives available on either exchange or over the counter, for example, interest rate swaps and futures. Such derivatives are always cash settled. Interest rate swaps are now centrally cleared through a CCP removing the risk of a single counterparty default, IRS trades are cleared under standardized terms, exchange traded and OTC derivatives are fully collateralized and any bilateral trades take place under standardised ISDA/CSA arrangements.

Question 8: Do you agree with the operational principles set out in paragraphs 28 and 29?

We are broadly in agreement with the operational principles as outlined in the Discussion Paper and, as previously stated, the majority of them are applied in practice by Irish UCITS funds using interest rate hedged classes and currency hedged share classes. We have elaborated in further detail in our response to Question 11 below.

We would however query paragraph 29 (a) (i.e. that exposure to an counterparty is in line with the UCITS Directive in respect of the net asset value of the share classes). Is ESMA suggesting that the UCITS counterparty exposure limits be applied at share class level? We believe this should simply be stated as a limit applicable to the fund because, as ESMA have pointed out in paragraph 23, there is no legal segregation of assets within classes of a UCITS. Furthermore, there are jurisdictions (including Ireland) where segregated liability between share classes of a fund does not have any legislative basis.

Question 9: Do you consider the exposure limits in paragraphs 29.b and 29.c to be appropriate?

A client who operates an interest rate share class hedging programme for its UCITS has confirmed that it operates in accordance with the principles set out in paragraph 28 and within the limits set out in paragraph 29.

We note additionally that the Discussion Paper proposes a procedure to reset the hedging arrangement regularly. In fact, our client systematically adjusts the hedges daily to reflect net asset value changes in each share class.

Question 10: Which stresses should be analysed as part of the stress tests?

In order to address the risk of contagion, stress testing should cover counterparty risk and market risk. A counterparty stress test should simulate the failure of the counterparty to which the share classes or fund has the highest exposure.

Market risk stress testing should include tests that shock the relevant positions in order to determine loss to a share class as well as impacts to liquidity resulting from margin calls. For example, interest rate hedged share classes could be stress tested with a standard set of shocks based on sudden parallel shifts of the yield curve and shocks of specific points on the curve. In determining the scenarios used for ongoing stress testing purposes, emphasis should be placed on adequately identifying all material interest rate risks.

Our UCITS client who operates an interest rate share class hedging programme already has in place a robust suite of stress testing that is reporting to the board of the UCITs and the Central Bank.

Question 11: 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.

In response to Questions 8 - 11, we are broadly in agreement with the operational principles and exposure limits outlined in the Discussion Paper. Further, we would like to point out the fact that the Central Bank has rules in place for share class hedging (both currency and interest rate) which are consistent with such principles and these rules have been in place in Ireland for some years. Our UCITS clients offer both currency hedged share classes and interest rate duration hedged share classes which operate according to such rules and within a well-established risk management framework. On this basis, we see no issue with continuing to allow interest rate/duration hedged share classes.

These rules are set out in Regulation 26 (3) of the Central Bank UCITs Regulations and which is further elaborated upon in the Central Bank of Ireland's guidance "*UCITS and AIF Share Class Hedging*" available on its' website. These conditions have been in place for many years[1] as follows:-

(i) the extent to which a hedging arrangement may lead to an over exposure must be kept under review and are not permitted to exceed specified threshold levels (i.e. over-hedged positions cannot exceed 105% of the net asset value of the share class;

(ii) a review procedure is in place that where the hedged arrangements are reset on a regular basis to ensure that position levels stay within the permitted threshold levels and are not carried forward from month to month;

(iii) hedging transactions must be clearly attributable to a specific class; and

(iv) the costs/benefits of the hedged transaction must be allocated to the share class rather than the pool of assets of the UCITS fund as a whole.

Interest rate hedged classes are consistent with the non-contagion principles set out in Paragraph 28 (a-e) of the discussion paper as follows:

(a) the notional of the derivative should not lead to a commitment to deliver or receive securities with a value that cannot be serviced by that portion of the portfolio represented by the share class;

Note that interest rate hedged classes for Irish UCITS are already required to comply with this principle as the Central Bank rules provide participation rate of the share class cannot exceed 100% of the relevant share classes performance of the portfolio.

(b) a level of operational segregation should be put in place to ensure a clear identification of assets/liabilities and profit and loss to the respective share class(es) on an ongoing basis and at the very least, at the same valuation frequency of the fund;

[1] i.e. previously in its Central Bank's Guidance Note 3/99 "Share Classes – Hedging against Exchange Rate Movements"

This level of accounting segregation is already imposed by the Central Bank for share classes, included interest rate/duration hedged classes. Note in particular, the following from the Central Bank's guidance: "*valuation systems operated by the management company, investment company or administration company should be capable of processing and identifying the relevant hedge transactions at share class level. Systems should also be in place to enable a review of the hedge to be undertaken in the light of ongoing flows into and out of the share class*". As previously mentioned, UCITS funds operating hedged currency and interest rate share classes have abided by the principle to maintain accounting and operational segregation for several years.

Further as set out abovethe Central Bank requires that transactions are solely attributable to the relevant share class and the gains/losses of the hedging transactions as well as the costs thereof, accrue solely to the relevant (hedged) class. In practice, operational or accounting segregation is applied so that hedging trades are booked to the assets attributable specifically to the hedged classes specifically and not the UCITS common pool of assets as the rest of the portfolio's trading activity would be. These ensure that the costs/liabilities relating to a hedged share class are separated from the rest of the portfolio.

(c) The implementation of stress tests to quantify the impact of losses on all share classes due to loss in a hedged share class;

(d) evidence on an ex-ante basis that the implementation of the derivative overlay will lead to a share class which better aligns with the specific risk profile of the investor;

The implementation of interest rate share class hedging by our UCITS client is done in a very systematic fashion. The duration and other interest rate sensitivities of the portfolio are calculated before proposed hedging and after proposed hedging. The hedge positions proposed are then thoroughly reviewed by the portfolio manager before executing on such proposals. We suggest that evidence that the overlay will lead to a share class better aligned with specific risk profile of an investor could be as simple as a report showing the pre hedged duration of the share class.

(e) the derivative overlay should be implemented according to a detailed, pre-defined and transparent hedging strategy.

Please refer to our response to Question 14 below.

Question 12: 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?

No comment. We view the contagion risk as low and the operational principles as sufficient to address such risks.

Question 13: What effect would these additional measures have on the compatibility of the operational principles with further hedging arrangements?

We would consider the effect to be minimal as Irish UCITS operating hedged share classes are already operating in accordance with most of the principles.

Question 14: What is your view on the principle of predetermination?

We broadly agree with the principle that the features of the share class should be determined before it is launched. However, this should allow for fund managers to have the flexibility to change the features of the hedged share class to adapt to market conditions and investor demands upon giving either prior reasonable notice to the affected investors or seeking prior investor consent, as appropriate.

We note that ESMA's statement that they doubt whether share classes with duration risk hedged overlays can be compatible with these operational principles "*as they might not be implemented according to a detailed predefined and transparent hedging strategy*". In the case of our UCITS client who currently operates interest rate hedged classes, the interest rate risk hedging is transparently implemented to a detailed predefined hedging strategy. The investment manager of the fund has no discretion as to the details of the target profile or the risk to be taken in the share class.

We are of the view that interest rate hedged share classes can comply with the principle of pre-determination and have in fact been doing so in the case of Irish UCITS funds for a number of years.

As we have set out in our response to Question 4 above, our UCITS clients offering interest rate hedging and such UCITS determines the desired interest rate profile of the investor at the outset and before the UCITS / relevant share class is launched.

This UCITS manager aims to achieve this <u>by setting a pre-determined interest rate profile for each share class and by then hedging the interest rate risk of the UCITS' portfolio into cash flows to match the cash profile of the hedged share class</u>.

The illustrative examples set out in our response to Question 4 above illustrates how UCITS offering interest rate/duration hedged share classes can and do operate in accordance with a pre-determined hedging strategy which is fully transparent to investors at the outset.

Question 15: Are there and additional requirements necessary to implement this principle?

We do not believe so.

Question 16: What is your view on the principle of "transparency"?

We are in agreement with the principles stated in paragraphs 35-36 of the Discussion Paper.

Question 17: Do you consider the transparency requirements to be sufficient?

Yes.

Question 18: Notwithstanding the fact that ESMA considers the above operational principles on transparency as minimum requirements, which modifications would you deem necessary?

None.

Question 19: Do you see merit in further disclosure vis-à-vis the investor?

We consider the terms of paragraph 36(a) as adequate.

Question 20: 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?

Whilst the cross-border harmonisation of this framework is generally welcome, we wish to reiterate that the offering of derivative hedged share classes should not be limited to currency hedged classes. As set out in our responses above, interest rate hedged share classes should continue to be permitted as they are compatible with the principles outlined above. To the extent that the outcome of the ESMA's opinion is that such share classes are not compatible with the principles as outlined herein, interest rate hedging would need to be performed via separate sub-funds or through master-feeder products. This would inevitably drive up the cost for UCITS investors, increase the time to market and potentially reduce the availability of such products to investors.

Question 21: 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?

To the extent that ESMA determines that interest rate hedged share classes are not consistent with the principles set out in the Discussion Paper, UCITS funds with interest rate share classes should be "grandfathered", i.e. allowed to continue in existence permanently. To require UCITS offering interest rate share classes to discontinue their use over a period of time or at all would be highly disruptive and costly (as it would necessitate either establishing new sub-funds, restructuring to master-feeder arrangements or re-balancing a portfolio) and not be in the interests of existing investors.

Conclusion

For the reasons as set out above we are of the view that interest rate hedged share classes are compatible with the four key principles outlined in the Discussion Paper and can continue to comply with the operational principles and that they should continue to be allowed.