Alternative Investment Management Association

European Securities and Markets Authority
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Submitted electronically via the ESMA website at: http://www.esma.europa.eu/

6 June 2016

Dear Sir/Madam,

AIMA's response to the ESMA Discussion Paper ESMA/2016/570

The Alternative Investment Management Association Limited[1] (AIMA) is grateful to the European Securities and Markets Authority (ESMA) for the opportunity to comment on its Discussion Paper regarding UCITS share classes (ESMA/2016/570) (the 'Discussion Paper'). AIMA welcomes ESMA's consideration of the merits of developing a common understanding of what constitutes a share class of a UCITS. However, we have some concerns in relation to the types of hedging arrangements that should be permitted in different share classes and the transition period for share classes that will be required to be closed down by firms seeking to come into compliance. We set out our detailed comments on these points in the annex to this letter as responses to the questions posed by ESMA in the Discussion Paper.

We hope you find our comments useful and would be more than happy to answer any questions you may have in relation to this letter.

Yours sincerely,

Jiří Król
Deputy Chief Executive Officer
Head of Government & Regulatory Affairs

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,600 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

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Annex

AIMA's response to the questions posed by ESMA in the Discussion Paper

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

No comment.

Q2. Do you see any other reasons for setting up share classes?

No comment.

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

No comment.

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

ESMA states in the Discussion Paper that the term "hedging" should be understood as follows:

> **Box 8**
>
> **Hedging**
>
> 1. 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 :
>
>   (a) investment strategies that aim to generate a return should not be considered as hedging arrangements;
>   (b) there should be a verifiable reduction of risk at the UCITS level.
>   (c) the risks linked to financial derivative instruments, i.e., general and specific if any, should be offset;
>   (d) they should relate to the same asset class; and
>   (e) they should be efficient in stressed market conditions.
>
> 2. Notwithstanding the above criteria, financial derivative instruments used for currency hedging purposes (i.e. that do not add any incremental exposure, leverage and/or other market risks) may be netted when calculating the UCITS global exposure.
>
> 3. For the avoidance of doubt, no market neutral or long/short investment strategies will comply with all the criteria laid down above.

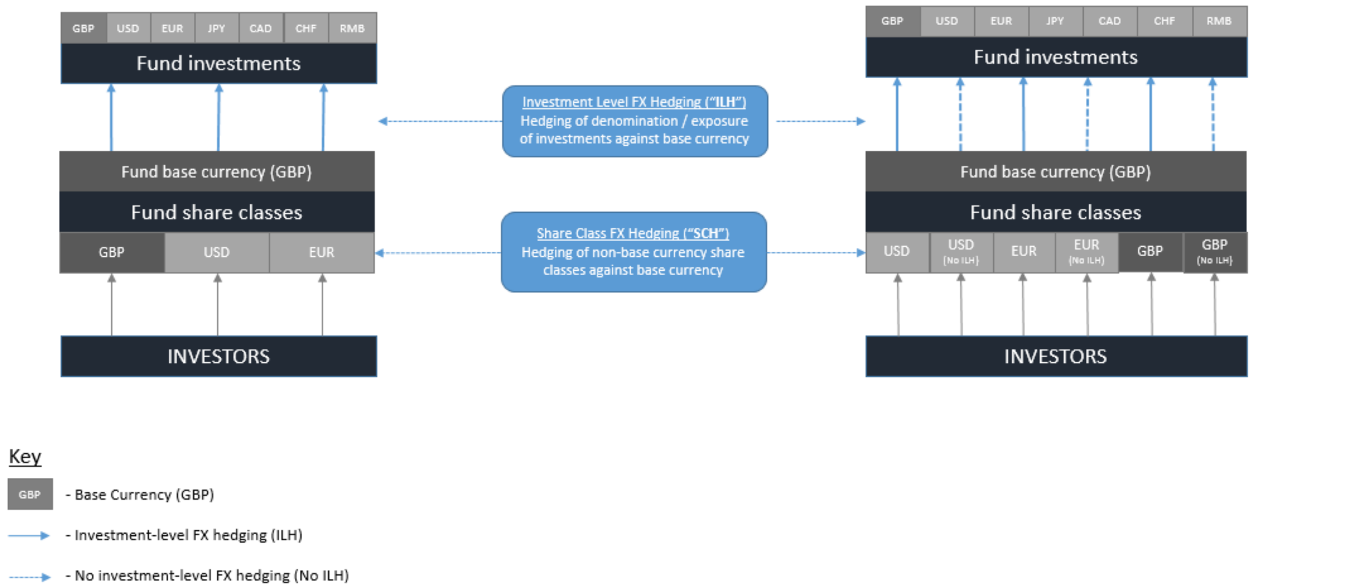
Source: CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788 at http://www.cysec.gov.cy/CMSPages/GetFile.aspx?guid=5774894c-b81e-4fab-afbe-b6580cdced51

FX currency hedging

Foreign exchange ('FX') currency hedging can take many forms in a fund context, including "share class FX hedging" and "investment-level FX hedging". Investment-level FX hedging, which fulfils the above definition of "hedging", is the hedging of the currencies in which the fund's investments are denominated/exposed against the base currency of the fund, and is generally applied in tandem with share class FX hedging to fully (or near-fully) hedge an investor's FX exposure to the fund and its underlying investments. In both instances, the objective of hedging would be the same and the investor would be making a choice about how they wished to hedge their currency risk. Investment level hedging seeks to provide an economically efficient way of hedging currency risk associated with investments in different currencies. This is shown by the diagram below:

Fund 1 – application of investment-level FX hedging to all share classes

Fund 2 – investor option to switch off investment-level FX hedging



ESMA states in its Discussion Paper that it considers share class FX hedging could operate in accordance with the principles outlined in the Discussion Paper, including the need for different share classes to have a common investment objective.[2] We strongly agree that share class FX hedging can operate in such a way. However, we note that ESMA appears to single out currency risk hedging at the level of the share class (i.e. "share class currency hedging") as being compatible with the principle of a common investment objective on the basis that it is "…a way to support a single market, as well as to level the playing field for investors across the EU, by allowing investors to invest in funds while mitigating the currency risk involved" and "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".[3] In the same way, AIMA considers that currency risk hedging at the level of a UCITS's investment portfolio (i.e. "investment-level currency hedging") is also compatible with the principle of a common investment objective,[4] as it is simply an extension of share class currency hedging and its purpose is to remove the impact of currency movements between the UCITS's currency exposure and the investor's chosen currency, leaving only the investor's desired exposure to the performance of the underlying portfolio (for example global equities)."

Interest rate hedging and duration hedging

AIMA also considers that employing interest rate hedging or duration hedging could operate in accordance with the principles outlined in the Discussion Paper, including the need for different share classes to have a common investment objective.[5] Employing interest rate hedging or duration hedging does not alter the investment strategy of the share class any more than employing a currency hedge would. From a structural and operations perspective, interest rate-hedged share classes are similar to currency-hedged share classes; both hedges are created by using highly liquid, low-cost derivatives available from counterparties with little counterparty risk. Allowing interest rate-hedged share classes within UCITS permits firms to offer hedges against these risks to investors at a lower cost.

[2] See Paragraph 30 of the Discussion Paper.

[3] See Paragraph 30 of the Discussion Paper.

[4] Provided it is carried out for bona fide "hedging" purposes (as defined in box 8 of CESR's Guidelines on Risk Measurement, set out above.)

[5] See Paragraph 30 of the Discussion Paper.

Furthermore, the UCITS will still employ the same strategy for both the share class that does not have the interest rate/duration hedge and the share class that does. Both a hedge and an unhedged class would be exposed to the same portfolio of investments with the exception of the interest rate or duration hedge itself. Exposure to and the costs of interest-rate hedging are primarily limited to the investors in the applicable share class, just as it is for currency hedging. This is the same as what occurs for currency classes. Conceptually, there is not a fundamental difference between a currency class which removes currency risk and an interest rate or duration hedged class that removes the interest rate or duration risk.

Interest rate-hedged share classes may reduce the risk of the share class and the fund that they are attached to in terms of reducing the average value-at-risk indicator for the class and fund under normal market conditions. Even in stressed conditions, the loss to investors of interest-rate hedged classes would be limited. Allowing interest rate-hedged share classes in UCITS will give investors greater choice and the characteristics of the interest rate hedge are appropriately disclosed to investors in the offering documents. For certain investors who wish to lower their exposure to interest-rate risk, these types of share classes can offer an attractive investment.

In terms of operational risk, interest rate-hedged share classes do not jeopardise any investors in any other classes assuming proper risk management and segregation of liabilities is in place as it is for funds that have currency hedged share classes. All hedges put in place can be non-recourse so that the assets of any other classes are protected which is similar to the protections applicable to a currency-hedged share class.

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

No comment.

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 comment.

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)

No comment.

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

No comment.

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

We would note that the wording of these exposure limits are suited for share class NAV hedging (i.e. the hedging of the share class currency against 100% of its NAV value in fund currency) but not for look-through hedging (i.e. the hedging at share class level of the FX assets inside the portfolio).

As look-through hedging is aimed at reducing 100% of the FX risk directly embedded in the investments of the share class investors, the wording could be changed to target "95%-105% of the FX exposures of the share class". This would make both type of hedging compliant with the operational rule.

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

No comment.

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.

In paragraph 28 of the Discussion Paper, ESMA states that share classes which are defined by a specific derivative overlay to systematically hedge out a given risk (such as currency risk) should observe the following operational principles:

> "a. The notional of the derivative should not lead to a commitment to deliver or receive securities with a value which cannot be serviced by that portion of the common pool of assets on which the share class unit-holders have a claim, i.e. the maximum potential amount of collateral that could be posted to the derivative counterparty should be prudently assessed by the management company and not exceed the maximum pool of eligible collateral on which share class unit-holders have a claim;
>
> b. The UCITS management company should put in place a level of operational segregation which, at a minimum, ensures that there is a clear identification of assets, liabilities and profit/loss to the respective share classes on an ongoing basis, and, at the very least, at the same valuation frequency of the fund;
>
> c. The UCITS management company should implement stress tests to quantify the impact of losses on all investor classes of a fund that are due to losses relating to share class-specific assets that exceed the value of the respective share class;
>
> d. The UCITS management company should be able to evidence, ex ante, that the implementation of a derivative overlay will lead to a share class which better aligns with the specific risk profile of the investor; and
>
> e. The derivative overlay should be implemented according to a detailed, pre-defined and transparent hedging strategy."

We note that ESMA's proposed operational principles potentially apply differently to share class and investment-level FX hedging. This is particularly the case in relation to point (e) above, as investment-level FX hedging is, by its nature, more discretionary and therefore less pre-defined, than share class FX hedging. For example, as a matter of investment discretion the investment manager may decide not to hedge 100% of the relevant investment's denominational currency against the fund's base currency. We consider that share class and investment-level FX hedging should both be possible in the same UCITS.

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?

No comment.

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

No comment.

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

No comment.

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

No comment.

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

No comment.

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

No comment.

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

No comment.

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

No comment.

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?

No comment.

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?

In paragraphs 38 - 39of the Discussion Paper, ESMA notes that:

> "[a] framework for share classes, based on the principles as outlined in this discussion paper, could therefore have a considerable impact on the investment fund markets in
>
> Member States where share class arrangements can currently be set up which might contravene the above principles… ESMA is of the view that for share classes not complying with the principles, transitional provisions would have to be introduced. Possible provisions for non-complying share classes could address the topics of maintaining existing share classes and allowing new investment in existing share classes."

AIMA strongly believe grandfathering of existing "non-compliant" share classes should be introduced, as the relevant investors knowingly invested in those classes on an informed and transparent basis. However, if ESMA finds grandfathering to be inappropriate then transitional arrangements will need to be introduced, and AIMA requests that UCITS with share classes that do not comply with any of the principles ultimately adopted are given a sufficient amount of time to change their structure and their arrangements with current investors.