



ESMA

Paris, 27 March 2015

THEAM response to the ESMA's discussion paper on share classes of UCITS

General comments

THEAM welcomes ESMA initiative to answer the ESMA first consultation on UCITS share classes.

THEAM is a partner of BNP Paribas Investment Partners and specializes in Capital Protection, Indexing and Model-driven investments. Managing €40 billion in assets and boasting 101 staff (of which 40 fund managers), THEAM is an expert in risk-managed, transparent and innovative solutions applied to equity, bond and multi-asset class portfolio management. THEAM manages UCIs under French, Luxembourg, Italian, Belgian, Dutch and British law.

From THEAM perspective, we would like to stress that the clear and shared definition of an “investment strategy” for a UCITS (including a sub-fund if the case may be) is key to position a share class into a UCITS, and we want to underline that this notion is not interpreted the same way all over the EC. Therefore please let us clarify our understanding of what is an investment strategy for a UCITS.

A UCITS is as an investment vehicle allowing an investor to be exposed to financial markets. This exposure is materialized through the investment strategy of the UCITS. Fundamentally, the description of the investment strategy is the way to explain how an investment performs in relation to the risks taken.

By detailing this approach, the investment strategy of a UCITS detailed as the sum of two parts:

- The underlyings the UCITS is invested in or exposed to; and
- The exposure to these underlying (either long, short or neutral, this choice being described in the prospectus).

For example, an investment strategy could be “having a *long* exposure to *[such]* *European equities index*” (to profit of the performance of European equities); another one could be “having a *short* exposure to *US treasury bonds*” (to profit of the raise of interest rates in the USA).



Answers to the question of the discussion paper:

Question 1: what are the drivers for the creating different share classes ?

- A: There are various drivers for creating different share classes. In addition to the drivers mentioned in point 8, there are other drivers as detailed below: reducing costs through the 'pooling' of assets within the same UCITS
- Increasing the size of the UCITS (and therefore the liquidity in most of the cases) by gathering investors wishing to be exposed to the same investment strategy
- Offering different exposure levels to the investment strategy. Investors can seek the same investment strategy but offering different exposure levels.
- And more generally, to mitigate , to an extent, some definite risks embedded within the investment strategy

Question 2: why do certain UCITS decide to create share classes instead of setting up a new UCITS?

The main reasons behind creating new share classes instead of setting up a new UCITS are the following:

- Reducing the costs: creating and operating a separate UCITS is more expensive than creating a new share class, and thus the investor will bear more expensive costs without added value.
- Reducing the operational load: managing a separate UCITS implies making the same work twice at all levels (custodian, valuation, administration, management...) while managing an additional share class reduces the operational load at all levels. More specifically, creating a new share class implies an additional valuation at the UCITS level while mutualising the custodian, management, administration and the asset manager operational load.
- Increasing the size of the UCITS: (i) facilitating investments for investors who may have internal constraints preventing them from investing in small UCITS, and (ii) more globally, minimizing the impact of in- and outflows on them.

Question 3: what are the costs of creating and operating a new share class compared to the cost of creating and operating a separate UCITS?

Depending on the complexity of the new share class, costs of creating and operating a new share class are in the range comprised between 10% to 20% of the cost of creating and operating a separate UCITS.

Question 4: what are the different types of share class that currently exist?

In addition to the share classes mentioned in point 8, other types of share class should be mentioned such as:

- Share classes which differ in terms of benchmarks (price return, total return...);
- Share classes which differ in terms of capital protection or guarantee levels;
- Share classes which differ in terms of risk hedging levels (total or partial hedging of risk factors embedded within the investment strategy (volatility, duration, rates...));
- Share classes which differ in terms of level of exposure to the markets.



Question 5: How would you define a share class?

We propose to define a share class in the following terms:

Considering a given UCITS, a share class is a category of shares which give specific rights under specific constraints to their holder. These rights and constraints should not modify the investment strategy.

The sets of specific rights and constraints can affect revenues distribution policy, the fees level, the entry and/or exit fees, investor's categories, the distribution intermediaries, the currency of accountancy, the voting rights... (cf. point 8 of the consultation), and the mitigation of any risk linked to the investment strategy as defined in the prospectus. Concerning the latter, the main ways to mitigate a risk is to control volatility, to control duration, to limit the maximum loss (at any time or between two dates), to avoid some currency exposure, to limit the maximum exposure to the strategy.

Let us take the example of an investor wishing to invest into a UCITS which investment strategy is to be long the US market. Different exposure levels can be proposed, each of it in a different share class:

- Exposure to the investment strategy (being long the US market);
- Exposure to the investment strategy (being long the US market) with an investment in order to hedge the variations of the USD for an euro investor;
- Exposure to the investment strategy while being sure that the volatility of his/her investment will remain around a certain level (iso-volatility mechanism);
- Exposure to the investment strategy while being sure that the investment will never lose more than 10% over one year...

Question 6: Do you agree that share classes of the same UCITS should all share the same investment strategy? If not please justify your position

As stated in our document introduction, an investment strategy can be detailed as the sum of two parts:

- The underlying the UCITS is invested in or exposed to (whether it is through direct or synthetic investment); and
- The exposure to these underlying (either long, short or neutral, this choice being described in the prospectus.

Based on this definition, we agree that share classes of the same UCITS should all share the same investment strategy. We insist on the fact that according to our definition of a given investment strategy, share classes can differ by mitigating risk levels linked to the investment strategy. For each share class, mitigating risk levels goes through varying exposure levels which are, without limitation, (i) the volatility exposure levels (ii) the capital protection levels (iii) currency level exposure....



Question 7: Could you explain how the operational segregation between share classes works in practice?

From our point of view, operational segregation is a key feature to avoid contagion risk between the various share classes and to ensure that the characteristics of each share class are well identified.

If derivatives instruments are used to implement the customization made in respect of the various share classes, one possible way is to limit at maximum the contagion risk thanks to adequate collateral parameters.

First of all, we want to stress out that investors of a UCITS, as it is primarily a “Collective Investment” scheme, are dependent on other investors as on their behaviour. This dependence is observable even if the UCITS is made up of one share class.

For example, a long-term investor will often suffer from neighbouring tactical investments with frequent in- and outflows, which would imply more extra costs. It is well-known that an investor position is not the same upon the size of the AUM of the UCITS, and upon the strategy of the UCITS. Therefore, the organization and regulation of the UCITS cannot prevent totally an investor from some contagion implied by a co-investor choice: the reasonable reachable objective is only to limit and control the risk of such contagion, and to provide a service that justifies the risk taken.

As afore-mentioned (Question 1), we think that any investor can find advantages to multiple share classes in a given UCITS: greater AUM helps to increase the liquidity of the UCITS, minimizes the impact of co-investors behaviour, and increases its competitiveness and aggressiveness. We think these advantages may justify adding small supplementary contagion risk between these different share classes.

Practically speaking, the risk of contagion appears when a share class aims to mitigate a certain risk of the strategy. As the assets are collective in a UCITS, this aim can only be reached with a derivative tool and therefore a counterparty risk. Therefore, the risk of contagion is the risk of a counterparty dedicated to the derivative of a given share class defaulting. As a physical segregation seems to be not compliant with the principle of a UCITS, it is necessary to set up dedicated constraint on the size of the risk generated by the counterparty risk which does not directly profit to each shareholder.

When a counterparty risk benefits to each shareholder, the maximum exposure is 10% of the AUM.

Depending on its operational capability and after giving some precision in the prospectus, we suggest that the UCITS chooses one of the operational solutions below,

- 1) Being able to affect any loss to the concerned share class, while never exposing its NAV to lose more than 10% (effective full segregation)
- 2) Being able to limit the loss of any shareholder of any share class to a certain level lower than 10% [for example 2%) (pragmatic partial segregation)

Please note however that the case considered here is the counterparty default of a given share class.



Question 8. Do you agree that the types of share class set out in paragraph 8 are compatible with the principle of having the same investment strategy? In particular do you agree that currency hedging that is described in paragraph 8 complies with that principle? If not, please justify your position.

Yes, the types of share classes set out in paragraph 8 are compatible with the principle of having the same investment strategy. Moreover, in our opinion, the different levels of exposure, providing that they respect the same investment principle, would be compatible with the same principle.

Question 9. Do you believe that other types of share class that comply with the principle of having the same investment strategy exist (or could exist) and should be allowed? If yes, please give examples.

Yes, we believe that other type of share class do comply with the principle of having the same investment strategy as mentioned in the preliminary comment as well as in the answers to Q1 and Q5.

- For example, if an investor invests into a Euro denominated UCITS which strategy offers an exposure to a US denominated index, here is a non-comprehensive example of the various levels of exposure to the same investment policy that may take place :
 - o The so called « simple » exposure, meaning an exposure to the index as well as a FX hedge to prevent the investment to be subject to the EUR/USD movements in order to benefit only from the index variations;
 - o An exposure without any FX hedge will lead to an exposure both into the index movements as well as the EUR/USD movements;
 - o An exposure to the index with different levels of risk protection (through volatility control for example...);
 - o An exposure to the index with different levels of capital protection

Question 10. Do you agree that the types of share class set out in paragraph 10 above do not comply with the principle of having the same investment strategy? If not, please justify your position.

We believe that certain types of share class set out in paragraph 10 may comply with the principle of having the same investment strategy (as described above), but offering various exposure, hence:

- The third example of share class which offers different degrees of protection against some market risks as each one will still be following the same investment principle, but with different exposure levels.
- The fourth one being exposed to the same pool of assets but with different levels of capital protection again will be following the same investment principle, but with different exposure levels.
- The fifth one offering different leverage will be following the same investment principle.



However, the first and second example being exposed to different pools of assets or being swapped against different portfolio will not respect the same investment policy, and therefore will not be compatible with the principle of having the same investment strategy.

Question 11. Please provide information about which existing UCITS do not comply with the criteria laid down in paragraph 6 as well as an indication of the assets under management and the number of investors of these UCITS.

We are not aware of any existing UCITS which does not comply with the criteria laid down in paragraph 6.

Question 12. Do you see merit in ESMA clarifying how regulatory ratios such as the counterparty risk limit should be calculated (e.g. at the level of the UCITS or share classes)?

We do see merit in ESMA clarifying such regulatory ratio. This clarification will help to avoid regulatory distortion between countries and consequently benefit the investors.

Question 13. Do potential and current investors get adequate information about the characteristics, risks and return of different classes in the same UCITS? If not, what else should be provided to them?

Thanks to the introduction of the standardized KIID which covers the various characteristics of each available share class, the investors do get a generic level of information.

Moreover, should the investor need more specific information, the investor is allowed to require specific additional information. However, we do not think that this should be standardized as it is set to detail each characteristic attached to the various share classes of the UCITS.

Question 14. Do you agree that ESMA should develop a common position on this issue? If not, please justify your position.

Yes, as mentioned in the answer to question 12, any common position will benefit the investors and the industry.

Yours sincerely,

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