



## ESMA Publishes Opinion on UCITS Share Classes

On 30 January 2017, the European Securities and Markets Authority ("ESMA") published an opinion on the topic of UCITS share classes (the "**Opinion**"), confirming the four high-level principles which a UCITS must follow when setting up different share classes and considering the manner in which certain share class hedging techniques comply with such principles.

### Background

While the UCITS Directive recognises the ability of UCITS to offer different share classes to investors, it does not prescribe whether, and to what extent, share classes of a given UCITS can differ from one another. ESMA has identified diverging national practices as to the types of share classes that are permitted, ranging from very simple share classes (eg, with differing levels of fees) to much more sophisticated share classes (which, according to ESMA, may have different investment strategies).

### The Discussion Papers

ESMA's Opinion follows on from two discussion papers published on the topic (the "**Discussion Papers**"). ESMA's first discussion paper was published in December 2014 (the "**2014 Discussion Paper**"). ESMA used the feedback received, together with input provided through engagement by ESMA with relevant stakeholders, to further develop its proposals to establish a framework for UCITS share classes throughout the European Union ("EU"). The 2014 Discussion Paper proposed non-exhaustive lists of permissible and prohibited differentiation at share class level. ESMA's second discussion paper was published in April 2016 (the "**2016 Discussion Paper**") and moved on from the examples-based approach of the 2014 Discussion Paper. The 2016 Discussion Paper proposed a principles-based approach and requested feedback on whether and how share classes would work in practice under the principles outlined in the 2016 Discussion Paper.

Following on from the Discussion Papers, ESMA's Opinion builds on the principles-based approach of the 2016 Discussion Paper and confirms the four principles which UCITS must follow when setting up different share classes. ESMA states that the purpose of these principles is to ensure a harmonised approach across the EU.

### The Principles-Based Approach

In its Opinion, ESMA sets out four high-level principles which UCITS must follow when setting up different share classes:

- *Common Investment Objective*: share classes of the same fund should have a common investment objective reflected by a common pool of assets (the **common investment objective** principle). Significantly, ESMA considers that hedging arrangements at share class

level – with the exception of currency risk hedging – are not compatible with the requirement for a fund to have a common investment objective;

- **Non-contagion:** UCITS management companies should implement appropriate procedures to minimise the risk that features specific to one share class could have a potentially adverse impact on other share classes of the same fund (the **non-contagion** principle);
- **Pre-determination:** all features of a share class should be pre-determined before it is set up (the **pre-determination** principle); and
- **Transparency:** differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes (the **transparency** principle).

### **Common Investment Objective**

In elaborating upon these principles in the Opinion, ESMA focuses on the use of derivatives at share class level to allow for customisation for a sub-set of investors. ESMA states that share classes identified by a derivative hedge or “*derivative overlay*” used to hedge against specific risks could lead to that share class having a risk profile, and therefore an investment objective, that differs to the overall investment objective of the fund. In this regard, ESMA states that it is of the opinion that hedging arrangements at share class level are not compatible with the requirement for a fund to have a common investment objective. ESMA states that UCITS which aim to protect investors from certain types of risk should set up separate sub-funds rather than separate share classes.

However, ESMA provides for one exception and states that it regards currency risk hedging at share class level as compatible with the principle of a common investment objective, as it is seen as a way to support a single market, as well as to level the playing field for investors from across the EU.

Unfortunately, ESMA has taken the position that derivative overlays at share class level to hedge out other risks, such as volatility risk and duration risk, do not meet the common investment objective principle and therefore will be deemed non-compliant at the end of the transitional period (discussed in further detail below).

### **Non-contagion**

ESMA notes that derivatives used at share class level for currency hedging become part of the common pool of funds assets, and thereby introduce potential counterparty and operational risk to all investors in the fund and not just to the investors in that specific share class. The Opinion refers to this as contagion risk or spill-over risk. ESMA believes that any additional risk introduced to a fund as a result of the use of a currency hedge for a given share class “*should be mitigated and monitored appropriately and only be borne by the investors in the respective share class in the event of its materialisation.*” Furthermore, ESMA states that any additional cost necessitated by additional risk management should be attributed to and borne by the respective share class.

In order to ensure that the use of derivatives does not lead to contagion risk, ESMA states that currency hedging at share class level must be scaled and managed appropriately and enumerates a number of operational principles that UCITS and UCITS management companies ought to observe as a minimum standard:

- 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 investors have a claim;

- there should be a level of operational segregation which ensures, at a minimum, that there is a clear identification of the assets, liabilities and profit or loss to the respective share classes on an ongoing basis, and, at the very least, at the same valuation frequency of the fund;
- stress tests should be implemented 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; and
- the share class currency hedge should be implemented according to a detailed, pre-defined and transparent hedging strategy.

To comply with these operational principles, the UCITS and UCITS management companies should ensure, for each share class:

- that the exposure to any counterparty is in line with the limits laid down in the UCITS Directive;
- that over-hedged positions do not exceed 105% of the net asset value of the share class;
- that under-hedged positions do not fall short of 95% of the net asset value of the share class which is to be hedged against currency risk; and
- that hedged positions are kept under review on an ongoing basis (at least at the same valuation frequency as the fund) to ensure that positions do not exceed / fall short of the permitted levels stated above.

ESMA also requires UCITS and UCITS management companies to incorporate a procedure in the above review to rebalance hedging arrangements on a regular basis to ensure that any position stays within the permitted levels and is not carried forward from month to month.

#### ***Pre-determination***

In its Opinion ESMA expresses the view that all features of a share class should be pre-determined before a share class is set up, in order to allow the potential investor to gain a full overview of the rights and features attributed to his investment. In share classes with a currency hedge, this pre-determination should also apply to the currency risk which is being hedged out systematically. ESMA goes on to clarify that it does not believe that this requirement limits the discretion of the UCITS or the UCITS management company as to the type of derivative instrument used to hedge currency risk, nor how it is implemented operationally.

#### ***Transparency***

ESMA has laid down a number of operational principles as a minimum standard to be observed by funds with share classes to ensure a common level of transparency for all investors, requiring funds and their management companies to provide information about existing share classes in the prospectus and a current list of share classes with a contagion risk in the form of readily available information.

Stress test results should also be made available to national regulators on a regular basis.

## **Transitional Provisions**

In the Opinion, ESMA notes that there are currently divergent approaches to share classes across the EU. In light of this, and in order to mitigate the impact on investors in existing share classes which do not comply with the Opinion, ESMA states that such share classes should be allowed to continue for the time being.

However, ESMA clarifies that such share classes should be closed to investment from new investors within 6 months of the publication of the Opinion, and for additional investment by existing investors within 18 months of publication.

## **Comment**

While the principles-based approach adopted in the Opinion is preferable to the earlier proposed examples-based approach, ESMA's view that the requirement in relation to share classes having a "common investment objective" prevents the use of derivatives to hedge out risk factors such as interest rate risk may require many existing funds to revise their approach to hedging at share class level.

The Opinion is not legally binding, but it is expected that ESMA's approach will be followed by the Central Bank. In any event, the Central Bank's current requirements regarding UCITS share classes are broadly similar to the principles set out in the Opinion. We will update our clients as to any further developments regarding updates to Central Bank policy.

ESMA's Opinion may be accessed [here](#).

*Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at [www.matheson.com](http://www.matheson.com).*

## **Contacts**

 <b>Tara Doyle</b> PARTNER  <b>D</b> +353 1 232 2221 <b>E</b> tara.doyle@matheson.com	 <b>Michael Jackson</b> MANAGING PARTNER  <b>D</b> +353 1 232 2000 <b>E</b> michael.jackson@matheson.com	 <b>Duala Counihan</b> PARTNER  <b>D</b> +353 1 232 2451 <b>E</b> dualta.counihan@matheson.com
 <b>Joe Beashel</b> PARTNER  <b>D</b> +353 1 232 2101 <b>E</b> joe.beashel@matheson.com	 <b>Anne-Marie Bohan</b> PARTNER  <b>D</b> +353 1 232 2212 <b>E</b> anne.marie.bohan@matheson.com	 <b>Shay Lydon</b> PARTNER  <b>D</b> +353 1 232 2735 <b>E</b> shay.lydon@matheson.com
 <b>Liam Collins</b> PARTNER  <b>T</b> +353 1 232 2195 <b>E</b> liam.collins@matheson.com	 <b>Philip Lovegrove</b> PARTNER  <b>D</b> +353 1 232 2538 <b>E</b> philip.lovegrove@matheson.com	 <b>Elizabeth Grace</b> PARTNER  <b>D</b> +353 1 232 2104 <b>E</b> elizabeth.grace@matheson.com
 <b>Oisin McClenaghan</b> PARTNER  <b>T</b> +353 1 232 2227 <b>E</b> oisinmcclenaghan@matheson.com	 <b>Michelle Ridge</b> PARTNER  <b>T</b> +353 1 232 2758 <b>E</b> michelle.ridge@matheson.com	 <b>Barry O'Connor</b> PARTNER  <b>T</b> +353 1 232 2488 <b>E</b> barry.oconnor@matheson.com

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