

ESMA Publishes Discussion Paper on UCITS Share Classes

The European Securities and Markets Authority (“**ESMA**”) has published a second discussion paper on the topic of UCITS share classes (the “**Discussion Paper**”), proposing a number of high-level and operational principles to form the basis of a regulatory framework for all UCITS share classes.

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 First Discussion Paper

ESMA’s first discussion paper was published in December 2014. ESMA has 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 December 2014 discussion paper proposed non-exhaustive lists of permissible and prohibited differentiation at share class level. Moving on from the examples-based approach, the Discussion Paper proposes a principles-based approach and requests feedback on whether and how share classes could work in practice under the principles outlined in the Discussion Paper.

The Principles-Based Approach

ESMA’s current thinking, as expressed in the Discussion Paper, is that UCITS should follow the following high-level principles when setting up share classes:

- share classes of the same fund should have a common investment objective reflected by a common pool of assets (the **common investment objective** principle);
- UCITS management companies should implement appropriate procedures to mitigate and monitor the risk that features that are specific to one share class could have a potentially adverse impact on other share classes of the same fund (the **non-contagion** principle);
- all features of a share class should be pre-determined before it is set up (the **pre-determination** principle); and

- 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, 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. However, ESMA 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.

Non-contagion

ESMA notes that derivatives used at share class level become part of the common pool of funds assets, thereby introducing potential counterparty and operational risk to all investors in the fund and not just to the investors in that specific share class. The Discussion Paper refers to this as contagion risk or spill-over risk. ESMA states that it is “*paramount that any additional risk introduced to the fund through the use of a derivative overlay 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, 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 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;
- 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;
- there must be evidence 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
- the derivative overlay 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 unless this has been expressly stated in the investment strategy of the share class; and that hedged positions are kept under review and re-set, as necessary, to ensure that they remain within the permitted levels.

ESMA considers that certain hedging arrangements can be managed within these principles, including currency hedging. However, ESMA doubts whether share classes with overlays that are not linked to currency hedging, such as duration risk (also referred to as interest rate risk) hedged or volatility risk hedged share classes, could be seen as compatible with these operational principles, as they might not be implemented according to a detailed, pre-defined and transparent hedging strategy.

In relation to the operational segregation, the Central Bank of Ireland currently requires a UCITS which proposes to invest in financial derivative instruments at share class level to obtain a legal opinion that the counterparty's recourse to the fund's assets is limited to the relevant share class's participation in the overall fund assets.

Pre-determination

ESMA is of the view that all features of a share class should be pre-determined before a share class is launched 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 derivative overlay, this pre-determination should also apply to the kinds of risks being hedged systematically. The Discussion Paper sets out ESMA's view that share classes offering any form of discretion to the UCITS or UCITS management company with regard to hedging mechanisms would contravene the principle of pre-determination.

Transparency

ESMA proposes 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

The Discussion Paper does not propose specific transitional provisions which would apply to existing share classes that are not in compliance with the principles proposed by ESMA, but invites stakeholders' views as to what transitional provisions may be deemed necessary, to possibly include provisions addressing maintaining existing share classes, allowing new investment in existing share classes and the costs of closure of non-compliant share classes.

Next Steps

The consultation closes on **6 June 2016**. ESMA expects to take further steps, possibly in the form of an ESMA opinion addressed to the EU institutions or national competent authorities, by the end of 2016.

The principles-based approach set out in the Discussion Paper appears to be more considered than an arbitrary prohibition of specified types of share class, as proposed in the December 2014 consultation. However, if the principles-based approach is to be adopted, it is hoped that the principles will be applied in a fair and consistent manner. In this regard, ESMA's comments regarding duration and volatility share classes may cause concern as potentially indicating that a decision has already been made regarding these share classes in advance of receipt of feedback on the consultation. ESMA's suggestion in the context of applying the transparency principle that new and existing investors should be informed about the creation and existence of share classes with a derivative overlay in a timely fashion, including updates in periodic reports, may impose a significant burden on asset managers that operate a large number of share classes and could result in investors

being provided with a large volume of information of little relevance to them. It is also hoped that the transitional provisions will be proportionate, so that, given that we expect there to be a relatively small number of non-compliant share classes, the option to grandfather and retain existing classes should remain available.











The partners at Matheson intend to submit a response to the Discussion Paper to ESMA and we will be contributing at an Irish and European level to industry feedback and responses. We would be delighted to speak with you should you have any queries in relation to the proposals, or to discuss your viewpoint regarding any aspect of the Discussion Paper.

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

Please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

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.

Contacts

 <p>Tara Doyle PARTNER T +353 1 232 2221 E tara.doyle@matheson.com</p>	 <p>Michael Jackson MANAGING PARTNER T +353 1 232 2000 E michael.jackson@matheson.com</p>	 <p>Dualta Counihan PARTNER T +353 1 232 2451 E dualta.counihan@matheson.com</p>
 <p>Joe Beashel PARTNER T +353 1 232 2101 E joe.beashel@matheson.com</p>	 <p>Anne-Marie Bohan PARTNER T +353 1 232 2212 E anne-marie.bohan@matheson.com</p>	 <p>Shay Lydon PARTNER T +353 1 232 2281 E shay.lydon@matheson.com</p>
 <p>Liam Collins PARTNER T +353 1 232 2195 E liam.collins@matheson.com</p>	 <p>Philip Lovegrove PARTNER T +353 1 232 2538 E philip.lovegrove@matheson.com</p>	 <p>Elizabeth Grace PARTNER T +353 1 232 2104 E elizabeth.grace@matheson.com</p>
 <p>Oisín McClenaghan PARTNER T +353 1 232 2227 E oisín.mcclenaghan@matheson.com</p>	 <p>Michelle Ridge PARTNER T +353 1 232 2758 E michelle.ridge@matheson.com</p>	

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