# Discussion Paper

**UCITS share classes**

6 April 2016 | ESMA/2016/570

## Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex I. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **6 June 2016.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Open consultations'.

### Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

### Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal notice.

### Who should read this paper

This document will be of interest to UCITS management companies and their trade associations, as well as institutional and retail investors investing in UCITS.

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# 1 Executive Summary

## Reasons for publication

The UCITS Directive recognises the possibility for UCITS to offer different share classes to investors but 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 class that are permitted, ranging from very simple share classes (e.g. with different levels of fees) to much more sophisticated share classes (e.g. which may potentially have different investment strategies).

Following the discussion paper which was issued in December of 2014, this discussion paper seeks stakeholders' views on ESMA's current thinking with respect to the development of a framework for UCITS share classes throughout the EU. The paper centres on a set of high-level principles regarding share classes, which are further detailed, where necessary, by a set of operational principles. This consultation seeks detailed feedback on whether and how share classes can actually work under the principles outlined in this discussion paper.

## Contents

The paper describes the nature of share classes, the reasons for their existence, and the key elements of share classes. Furthermore, it establishes common principles, both from a high-level and operational perspective, which could form the basis of a regulatory framework that all share classes should comply with. This discussion paper builds on the feedback received to the first discussion paper published last year, as well as on further input provided through engagement by ESMA with relevant stakeholders.

## Next Steps

ESMA will consider the feedback it receives to this consultation in Q2 2016 and expects to take further steps on share classes of UCITS by the end of 2016.

# 2 Background

1. In December 2014, ESMA published a discussion paper (DP) on UCITS share classes.[1] ESMA noted in the DP that it had identified diverging national practices as to the types of share classes that are permitted, ranging from very simple share classes (e.g. with different levels of management fees) to much more sophisticated ones (e.g. with potentially different investment strategies). ESMA saw merit in exploring whether a line can be drawn between the activities which could be permitted at share class level and the ones which should only be limited to the level of the UCITS or compartment. The publication of the DP was seen as the first step towards the development of a common understanding of what constitutes share classes of UCITS and of the ways in which they may differ from one another.

2. Responses to the DP generally stated that the main drivers for creating and operating share classes, in comparison to setting up new UCITS or new compartments of existing UCITS, were flexibility and lower cost. Respondents to the consultation generally saw the need for ESMA to develop a common position, but expressed differing views of the criteria which define a share class. A summary of the feedback to the DP can be found in Annex II.

3. Following up on the responses to the DP, ESMA held a roundtable attended by industry representatives, institutional investors and depositaries. Feedback given mostly mirrored that given on the DP. Participants expressed their desire for a framework for share classes throughout the EU and remarked that too many restrictions on share classes might limit the options for investors as well as the flexibility presently allowed for by share classes. Regarding share classes with hedging arrangements, there was general acceptance that the use of derivatives at the level of the share class could introduce additional risk exposure to the fund, which nonetheless could be monitored and mitigated by risk management and accounting regimes. Attendees underlined their support for allowing hedging arrangements other than currency risk hedging, arguing that the risk profiles were not substantially different.

4. The various issues around share classes have been further discussed over the last months, both within ESMA and by way of an exchange of views with external stakeholders. While the first discussions on share classes, leading to the original DP issued in 2014, focused on actual examples of share classes deemed compatible or non-compatible with the UCITS framework, further discussions held at ESMA level showed the importance of reaching a common view on the elements and the scope of share classes in general, shifting the focus from the examples-based approach of the original DP to the development of a more general, principles-based framework of share classes. The core of this discussion paper reflects on the revised approach and sets out ESMA's current thinking.

[1] Available online at https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1577_dp_on_share_classes_for_publication.pdf

5. This discussion paper therefore centres on a set of high-level principles regarding share classes, focused on investor protection. These high-level principles are further detailed, where necessary, by a set of operational principles. This consultation aims to elicit feedback on whether and how share classes can actually work under the principles outlined in this discussion paper.

6. A list of points for discussion, together with specific questions, is set out in Section 3 below. When considering these issues, it is important to bear in mind that ESMA has not taken any final decision yet on the type of instrument that it might issue on the topic of share classes. While ESMA has a number of regulatory instruments at its disposal, it seems probable that the work on share classes could lead to ESMA issuing an opinion, most likely under Article 34 of the ESMA Regulation.[2]

# 3 Issues for discussion

## 3.1 What is a share class?

7. A UCITS or one or more of its compartments can be sub-divided by share classes.

8. Compartments (or "sub-funds") are separate parts of a common fund vehicle, subject to fund rules in their own right, and having their own investment objective, in accordance with Arts. 49 ff. of the UCITS Directive. Assets of one compartment are kept separate from assets of other compartments. Furthermore, compartments are usually legally segregated from other compartments, meaning that a liability arising in one compartment cannot be offset by the assets in other compartments of the fund. While asset segregation between sub-funds is not mandatory in some jurisdictions, ESMA is of the view that the UCITS Directive should be interpreted in such a way that it requires the segregation of assets between compartments.

9. Share classes, in contrast, are not compartments but different types of units or shares belonging to the same UCITS (or compartment[3], if set up). Even though all investors in a fund invest in a common pool of assets, share classes attribute different rights or features to sub-sets of investors in relation to their investment. Thus, share classes allow for a certain level of customisation for investors with special characteristics or requirements, e.g. the distribution of revenues, a particular tax treatment under national law, or a different minimum investment amount. There is no legal segregation of assets between share classes. However, any costs arising in a given share class are attributed to the investors in that share class only. Any investment outcome relating to specific arrangements in a given share class is credited to that share class only.

[2] Another option could be to issue an opinion under Article 29 of the ESMA Regulation.

[3] For the purposes of this paper, the term "fund" should be understood to refer to a UCITS fund or one or more of its compartments.

10. While the UCITS Directive covers UCITS funds and compartments, it stays silent on the definition and scope of share classes, only recognising their existence in passing[4]. There is therefore as yet no common legal or regulatory framework for share classes throughout the EU. In some jurisdictions share classes cannot be set up at all; in others they are allowed, but the degree of flexibility varies, both in regard to their features and whether they need to be pre-approved by NCAs.

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

## 3.2 Why do share classes exist?

11. Following the recent consultations regarding share classes, respondents stated a number of reasons for offering share classes to investors instead of separate funds or investment compartments. While some of these reasons are of more benefit to the investor, especially to the one in the new share class, others may overall be more advantageous to the promoter, investment manager or distributor.

12. Respondents identified the following reasons:

    a. Reduced cost: the cost of setting up a share class is approximately between 5% and 20% of the cost of setting up an investment compartment with a similar portfolio of assets;

    b. Customisation for investor needs: investors may wish to invest in an existing fund on terms which are bespoke to their specific preferences, based for example on (i) currency, (ii) fees, (iii) voting rights, (iv) mitigation of certain investment risks, etc.;

    c. Economies of scale: similarly to compartments, which already benefit from economies of scale, share classes of a large fund could benefit in terms of the administration, custody, management and ongoing advisory costs;

    d. Fund sizes: setting up share classes allows funds to reach a size which allows large investors to invest in European UCITS funds without breaching their holding ratio;

    e. Time to market: while, in some jurisdictions, it currently may take a matter of weeks or months to set up a new investment compartment, it may take only a few days to set up a share class;

[4] The UCITS Directive contains four references to the term “share class”, all of them in the context of marketing to investors.

f. Brand capitalisation: it is easier to attract new investment mandates by launching new share-class based fund products as part of an existing successful fund complex than by starting afresh with a new fund.

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

## 3.3 Key elements of share classes

### 3.3.1 Overview

13. As a basis for discussion, and taking into account input given by stakeholders, ESMA has identified the following high-level principles that should be followed 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;

- "Non-contagion": UCITS management companies should implement appropriate procedures to minimise 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;

- "Pre-determination": All features of the share class should be pre-determined before it is set up;

- "Transparency": Differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes.

14. In addition to the above principles, ESMA is of the view that share classes should never be set up to circumvent the rules of the UCITS Directive on diversification, derivative eligibility and liquidity.

### 3.3.2 Common Investment Objective

15. Share classes of the same fund are linked by a common investment objective which is realised through the investment in a common pool of assets.

16. There are currently several types of UCITS share classes set up throughout the EU, which provide investors with different features. Some share classes have been set up to differentiate between groups of investors (e.g. retail vs. institutional investors) or means of investment (e.g. in regard to management fees, minimum investment amounts, voting rights or currency). As the performance of the investment as such is not modified by the characteristics of these types of share classes, they share a common investment objective.

17. As set out in the summary of responses in the annex, stakeholders generally agreed with the principle that share classes of the same fund should all have the same investment objective in the sense that all share classes share a common pool of assets.

18. Stakeholders also emphasised that some share classes are identified by a derivative hedge (also called a 'derivative overlay' or simply 'overlay') aiming to hedge out some risk factors of the common pool of assets. These stakeholders have argued that such share classes should not be considered to have a different investment objective. In their view, only share classes with increased risk factors, or with additional or different risk factors compared to the common pool of assets, should be considered as not complying with the principle of having the same investment objective. In this sense, investment in the share class would aim to improve the value of an investment (relative to the investor's expectations) as compared to a situation where the investor would invest in the common pool of assets without the level of customisation provided by the share class.

19. However, a number of different approaches can be envisaged to the meaning and scope of ‘common investment objective’. Some stakeholders have argued that the common investment objective of a fund also requires a common risk profile within the fund, stating that the UCITS Directive does not specifically refer to share classes within the context of investment policies (Articles 49 ff. of the UCITS Directive). As a result, there is some concern that the use of derivative overlays within a share class could lead to that class having a risk profile, and therefore an investment objective, which would no longer be in line with the overall investment objective of the fund.

20. While ESMA shares this concern, it regards currency risk hedging at the level of a share class as compatible with the principle of a common investment objective. As not all EU Member States currently share a single currency, currency risk hedging is seen as a way to support a single market, as well as to level the playing field for investors from across the EU, by allowing them to invest in funds while mitigating the currency risk involved. Currency risk hedging is therefore 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, even though their exposure to the fund is obtained through a different currency from the base currency of the fund.

21. In the context of share classes, ESMA is of the view that the term “hedging” should be understood as defined in box 8 of *CESR’s Guidelines on Risk Measurement*[5]. ESMA is of the opinion that UCITS management companies which seek to offer different investment objectives to investors should set up separate funds or compartments.

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[5] CESR’s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788

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

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

### 3.3.3 Non-contagion

22. Share classes which are defined by a specific derivative overlay to systematically hedge out a given risk (such as currency risk) allow an investment manager to better align the characteristics of the common investment pool to the preferences of a class of investors, so they could be seen as an appropriate and proportionate solution to the need to provide efficient levels of customisation to investors. However, derivative overlays could also cause a disadvantage to investors in other share classes.

23. In general, the use of derivatives means that the fund enters into derivative contracts which may generate payment/delivery obligations at the level of the fund that it should be able to meet (e.g. in case of cash settlement of currency forward contracts, collateral arrangements). Due to the lack of asset segregation between share classes, the derivatives used in the overlay of a given share class become part of the common pool of assets. The application of a derivative overlay in a share class therefore introduces potential counterparty and operational risk for all investors in the fund. This could lead to a risk of contagion (also known as spill-over) to other share classes, some of which might not have any derivative overlays in place. Spill-over risk could disadvantage investors in those classes with no derivative overlay, as well as those participating in the share class that benefits from the overlay.

24. ESMA sees this contagion risk as stemming from a number of sources including: (i) market movements which lead to a draw-down of fund liquidity to meet mark-to-market margin requirements and (ii) the failure of a derivative counterparty leading to a delayed (or failed) recovery of fund assets. Although this contagion risk may be mitigated, it cannot be fully eliminated, as the possibility of an adverse tail event materialising will persist, e.g. through the default of a derivative counterparty or through the losses relating to share class specific assets exceeding the value of the respective share class.

25. While ESMA is currently not 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, the use of share classes with derivative overlays in several Member States raises the prospect that such a risk may materialise in the future.

26. It is therefore 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. Equally, if the introduction of additional risk through using

derivative overlays for hedging purposes at share class level leads to a rise in administrative costs due to the necessity for additional risk management, these costs should only be attributed to (and borne by) the respective share class.

27. To ensure that the derivative overlay does not lead to spill-over risk, it is important for the overlay to be scaled and managed appropriately in accordance with a set of minimum operational requirements.

28. With this in mind, the following operational principles should be observed:

    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.

29. ESMA is aware that daily subscriptions and redemptions lead to conditions where it is difficult to attain a perfect hedge within a fund or share class. To nonetheless ensure that the above operational principles are met, the UCITS management company should, at the level of the share class with a derivative overlay:

    a. Ensure that the exposure to any counterparty of a derivative transaction is in line with the limits laid down in Article 52 of the UCITS Directive in respect to the net asset value of the share class;

    b. Ensure that over-hedged positions do not exceed [105] per cent of the net asset value of the share class;

c. Ensure that under-hedged positions do not fall short of [95] per cent of the net asset value of the share class, unless it has been explicitly stated in the investment strategy of the share class;

d. Keep hedged positions under review to ensure that over-hedged or under-hedged positions do not exceed/fall short of the permitted levels stated above at any time; and

e. Incorporate a procedure in said review to reset the hedging arrangement on a regular basis to ensure that any position stays within the permitted position levels stated above and is not carried forward from month to month.

30. ESMA is of the view that the operational principles outlined above should be seen as the minimum standard for share classes with a derivative overlay. ESMA considers that there could be hedging arrangements which can be managed within these principles. However, ESMA has doubts about whether all derivative hedging strategies can be managed according to these operational principles. More specifically:

a. In line with paragraph 19, ESMA believes that since currency share classes which are currency-hedged may be delivered through an FX forward or FX swap with a notional amount (which is calibrated to the value of the underlying fund portfolio which aligns to the unit-holders of the relevant share class) and rolled over systematically as necessary, such share classes could be operated according to these principles; and

b. ESMA doubts whether share classes with overlays that are not linked to FX hedging, such as, duration-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.

**Q5. What is your view on the principle of “non-contagion”?**

**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?**

**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)**

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

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

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

**paragraph 28.c)**

**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.**

**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?**

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

### 3.3.4 Pre-determination

31. As outlined above, share classes attribute different rights or features to sub-sets of investors in relation to their investment. Depending on how the share class is designed, it could be set up so that the management company would have a certain amount of discretion in regard to the features of the share class, such as the hedging arrangement.

32. Derivatives used in hedging arrangements pose a potential contagion risk for the fund as a whole, due to the lack of segregation between share classes. A share class in which the risk to be hedged is at the discretion of the management company could lead to a situation where it was unclear to other fund investors which specific risk was being hedged at a given point in time. This could have a potentially adverse effect on investors in the fund, as they would lack information about the hedging arrangements in place and their potential effect on the common pool of assets.

33. ESMA is therefore of the view that all features of a share class should be pre-determined before the share class is set up, in order to allow the potential investor in the fund to gain a full overview on the rights and/or features attributed to his investment. In share classes with hedging arrangements, this pre-determination should also apply to the kinds of risk which are to be hedged out systematically. If the share class is created after the fund in which the share class is included has been authorised, the new share class should not affect the features and characteristics of the fund for the investors already invested in other classes of the fund.

34. ESMA is further of the opinion that a share class offering any form of discretion to the UCITS management company with regard to hedging mechanisms would therefore contravene the principle of pre-determination.

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

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

### 3.3.5 Transparency

35. As share classes introduce a level of customisation which attributes different kinds of benefits to various groups of investors in a common pool of assets, it is important that the existence and nature of all the share classes of the fund are disclosed to all investors of the fund, whether they are participants in the share class or not. Furthermore, since some kinds of share classes, namely those with derivative overlays introduce counterparty and operational risk, new and existing investors should be informed about the creation and existence of such share classes in a timely fashion, including updates in periodic reports.

36. ESMA is of the view that the following operational principles, considered to be minimum requirements, should be observed by a fund with share classes to ensure a common level of transparency vis-à-vis all its investors:

    a. The information about existing share classes should be provided via the fund prospectus as part of the details of the types and main characteristics of the units;[6]

    b. In regard to the share classes with a contagion risk, the management company should provide a list of share classes in the form of readily available information which should be kept current; and

    c. The stress test results should be made available to national competent authorities on a regular basis.

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

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

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

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

[6] Cf. UCITS Directive, Annex I, Schedule A, 1.10

## 3.4 Impact on existing share classes and transitional provisions

37. As noted above, there are currently divergent approaches to share classes throughout the EU. While share classes cannot be set up at all in some Member States, the creation of share classes is not regulated at all or only to a certain extent in other jurisdictions, resulting in a wide array of share classes currently available to investors, which might not comply with the above principles.

38. 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.

39. 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. Furthermore, transitional provisions governing the closure of non-complying share classes would have to include a provision in regard to the cost arising from the closure.

40. As previously stated, ESMA has not taken any decision yet on the type of instrument that it might issue on the topic of share classes. While ESMA has a number of regulatory instruments at its disposal, it seems probable that the work on share classes could lead to an ESMA opinion addressed to the EU institutions or national competent authorities.

**Q20. 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?**

**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?**

# Annexes

## Annex I: Summary of questions

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

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

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

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

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

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?

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)

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

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

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

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.

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?

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

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

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

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

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

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

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

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?

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?

# Annex II: Summary of the feedback to ESMA's Discussion Paper on share classes of UCITS (ESMA/2014/1577)[7]

### Q1. What are the drivers for creating different share classes?

1. According to all respondents to the consultation, the key drivers behind the use of share classes are flexibility and costs. Through the use of share classes, asset managers can easily accommodate investors' needs and at the same time generate economies of scale. Sometimes share classes are also the only solution for marketing UCITS to certain categories of investor that can only invest in UCITS with a minimum size or minimum track-record.

### Q2. Why do certain UCITS decide to create share classes instead of setting up a new UCITS?

2. In line with question 1 above, the reasons for creating a share class instead of setting up a new UCITS are the costs of creating a new UCITS and also constraints from investors.

### Q3. What are the costs of creating and operating a new share class compared to the cost of creating and operating a separate UCITS?

3. All respondents to the consultation reported that the costs of creating and operating a new share class were lower than the costs of creating a separate UCITS, but that the costs vary across providers and jurisdictions. According to EFAMA, the cost of launching a new share class is between 10 to 20% of the costs of creating a new UCITS from the same purpose.

### Q4. What are the different types of share class that currently exist?

4. Respondents provided the following non-exhaustive list of existing share classes:

   - Retail client
   - Institutional client
   - Investment management agreement only client
   - Income (distributing share class)
   - Limited issue (share class with offer limited to AUM size or date)
   - Seed investor

[7] Available online at http://www.esma.europa.eu/system/files/2014-1577_dp_on_share_classes_for_publication.pdf

- Performance fee
- Smoothed income (regular, standardised income payments)
- Defined distribution
- Tax efficient wrapper (UK ISA)
- Systematic hedging (total or partial) against a generic market risk (currency, equity, interest rate, credit spread, inflation, volatility).
- Minimum investments vs. minimum holding amount.
- Fixed vs. variable service cost.
- Fixed vs. variable management fees.

**Q5. How would you define a share class?**

5. According to respondents, a share class is a unit of participation in the collective pool of assets of a UCITS which can be customised such that its right and features can be different to other share classes in the same UCITS.

**Q6. Do you agree that share classes of the same UCITS should all share the same investment strategy? If not, please justify your position.**

6. Most respondents to the consultation generally agreed with this principle provided that this does not prevent the existence of specific overlays that are deemed to provide shareholders with protection against some risk factors of the common pool of assets (currency, equity, interest rates etc.). However, some respondents pointed out that there was no harmonised definition of what constitutes an investment strategy and that it would therefore be more appropriate to refer to a common investment pool of assets.

7. Moreover, most investors declared that financial derivative instruments should not be used to increase the exposure to a certain risk factor or to introduce a new risk factor at the share class level.

**Q7. Could you explain how the operational segregation between share classes works in practice?**

8. Respondents to the consultation confirmed that there was not legal segregation of assets between share classes of the same UCITS. The segregation is an accounting segregation whereby the profit and loss of the overlay are attributed to the relevant share class. This means that in theory there can always be a risk of contagion between share classes but this risk is managed by making sure that the profit and loss of the hedging arrangements are solely attributed to the hedged share classes and by conducting stress tests. Also, in the context of overlays, the contagion risk is mitigated by the nature of the financial derivative instruments used. For example, if put options

are purchased to put in place an overlay, there is no contagion risk because the only 'risk' is the loss of the premium by shareholders of the share class if the put option is never exercised. For other financial derivative instruments such as futures on government bonds used for duration overlays, the risk is that the margin call is bigger than the relevant share classes and that other share classes have to step in, thus affecting their NAVs. However, this risk is mitigated by the fact that the margin calls are on a daily basis which means that it would require a dramatic shock in the market for this situation to happen.

9. Also, in many instances, the management of the overlays is not done by the portfolio managers but by a separate team.

**Q8. 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.**

10. All respondents agreed that the types of share class set out in paragraph 8 were compatible with the principle of having the same investment strategy, in particular share classes with currency hedging. However, a few respondents wanted ESMA to clarify that currency hedging should not be reduced to currency hedging at the level of the UCITS and that currency hedging at the level of individual portfolio's holdings should be allowed too.

**Q9. 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.**

11. For the majority of respondents, other share classes with overlays which provide investors with systematic protection against certain risk factors of the common investment portfolio (interest rates, equity, volatility etc.) also comply with the principle of having the same investment strategy.

**Q10. 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.**

12. Generally, respondents agreed with ESMA except for share classes that offer protection against certain risk factors of the common portfolio of assets which should be considered as complying with the principle of having the same investment strategy.

**Q11. 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.**

13. According to stakeholders existing UCITS that would not comply with criteria laid down in paragraph 6 are the UCITS that have share classes with other forms of hedging such

as interest rate hedging or that are using derivative instruments to increase or introduce new types of risk at the level of share classes. Also, respondents pointed out that, because there is no legal segregation of assets between share classes, there will always be a theoretical contagion risk between share classes that are using derivative instruments even for currency hedging strategies. However, this risk is appropriately managed by UCITS. Therefore, according to respondents the criterion of non-contagion should be replaced by an obligation to manage the risk in an appropriate manner.

**Q12. 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)?**

14. Most of the respondents did the not see merit in clarifying how regulatory ratios such as the counterparty risk limit should be calculated.

**Q13. 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?**

15. According to the vast majority of respondents, investors already get adequate information about the characteristics, risks and return of different share classes of the same UCITS. Therefore, there is no need to provide them with further information.

**Q14. Do you agree that ESMA should develop a common position on this issue? If not, please justify your position.**

16. Respondents to the consultation generally welcomed a common position being developed by ESMA.