AGA – n°4351/Div

ESMA
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Paris, March 27 2015

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

General comments

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity to answer to the ESMA's first consultation on share classes of UCITS.

Responses to the questions of the discussion paper

1. *What are the drivers for creating different share classes?*

Share classes are now developped extensively in all major European fund issuing countries. Share classes are created as they offer a certain number of advantages, in particular in terms of best cost/benefit for worldwide investors and for the competitiveness of the EU fund and asset management industry, as they:

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. More than 630 management companies are based in France. AFG members manage more than 3,000 billion euros, making in particular the Paris fund industry a leader in Europe for the financial management of collective investments (with 1,500 billion euros managed from France, i.e. 19% of all EU assets managed in the form of investment funds). In the field of collective investment, our industry includes – beside UCITS – the whole range of AIFs, such as: employee savings schemes, regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment funds. AFG is an active member of the European Fund and Asset Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

- Permit to increase the size of European funds (comparatively to US funds whose mean size is far above European funds' one[2]) and thus limit problems of concentration ratio encountered by institutional investors and fund of fund managers;
- Permit to pool the management of assets and thus benefit from reduced operating costs for the end investor;
- Permit to export European asset management wrapped in European vehicles (UCITS) – including beyond Europe - instead of creating local funds;
- Allow diversifying the investors' base favouring better liquidity risk management;
- Allow to reserve a share class to one or several commercial networks;
- Allow for different mininum initial investment amounts;
- Allow for different tarifications: management fees or entry/exit fees;
- Benefit from different revenue distribution regimes;
- Permit clients to invest in local currency without bearing an additional currency risk;
- Give investors choice to switch from one share class to another while continuing to be invested on the same investment strategy;
- Permit to propose to clients that are insurance companies, investments adapted to Solvency II Directive;
- Permit benefiting from the expertise of a fund manager (in terms of alpha generation, investment objective and strategy) while having the added value of the implementation of an overlay of systematic hedging, partial or total, associated with the occurrence of a market risk (for example: risk of equity market drawdown, risk of interest rate increases, risk of widening of credit spread, risk of inflation increase..);
- Allow investors benefiting from a cost and time efficient way to switch amongst share classes (such switch orders between share classes not triggering swing pricing mechanism and being easier to manage form an operational perspective). For instance, it is usual for the same investor to allocate its assets between the different share classes for a given fund according to the market conditions and environment.

In light of the above considerations around investment products to better respond to demand-side pressures, as well as around economic efficiencies, AFG members would more broadly invite ESMA to consider the link between these considerations and the objectives of the European Commission's recent cornerstone initiative of a European Capital Market Union (CMU). Visibly, there are clear synergies between a diversified UCITS product offer - as customised to meet client demands - and the need to increase investors' participation by committing more of their savings to capital markets. Worthy of notice is also the fact that the economic efficiencies additionally remove the regulatory cost of setting up new funds, while allowing existing funds to grow sufficiently so as to reap the advantages of scale, as well as to boost the European asset management industry's competitiveness abroad.

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

Creating share classes benefits investors, especially institutional investors and managers of funds of funds, as they allow limiting problems with the concentration ratio encountered because of the modest size of the fund compared to the investor's minimum ticket size.

[2] EFAMA figures show that for the fourth quarter of 2014, the average size of a UCITS fund compared to the average of a U.S. mutual fund was of € 245 million against € 1.8 billion respectively. After a further break-down, for equity funds the respective difference is € 239 million vs. € 1.5 billion; for bond funds € 315 million vs. € 2 billion, and for money market funds € 918 million vs. € 4.3 billion.

Creating share classes allows pooling the portfolio management and thus profiting from the mutualisation of the operational costs of a fund. This mutualisation is also an obvious advantage in the management of the liquidity risk.

Share classes permit to give access to management expertise (track record) with fully taking advantage of economies of scale while permitting choice in terms of hedging parameters.

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

It should be mentioned that share classes allow managing funds with overall reduced costs which forms a key advantage for the exportation of the European vehicle out of Europe. Indeed, in terms of exportation capacity, if costs were higher, a new fund would be set up instead, but directly on the local market.

For our members, for instance creating a new Fixed Income sub-fund or fund which is UCITS compliant below a size ranging from 30 to 50 million euros is deemed inefficient for investors; while share classes can be set-up without the need of a minimum initial investment or with a limited size of initial investment (from 1 to 5 million euros, depending on the overlay management performed).

Costs of account/conservation administration and custody are identical between a share class and a fund (because generally expressed in % of AUM) or somewhat lower for a share class (because of the effect of favorable thresholds in the case of a decreasing cost % by increasing AUM).

Costs of valuation/administration are definitely lower in the case of a share class (marginal cost for an additional share class) compared to a fund (minimum fixed price on valuation and production of the financial reports).

There are no additional auditor costs in the case of an additional share class.

Furthermore, the launch of a new class does not require, most of the times, seed money to be provided.

4. ***What are the different types of share class that currently exist?***

We are aware of:

- Share classes that differ according to the maximum or minimum investment amounts, or values of holdings allowed to be retained;
- Share classes that differ in terms oftypes of investors (e.g. institutional investors vs. retail investors);
- Share classes that differ according to the currency in which they are denominated;
- Share classes that provide currency hedging when share classes are denominated in different currencies from the base currency;
- Share classes that provide a systematic hedging (total or partial) against a generic market risk (such as risk of equity market drawdown; risk of interest rate increase; risk of widening of credit spread; risk of inflation increase; risk of volatility increase...);
- Share classes that differ according to the types of charges and fees that may be levied and their amount (on-going charges; subscription and redemption fees; performance-related fees);

- Share classes that differ according to the allocation of revenues to investors (by capitalisation or distribution, either subject to or exempt from withholding tax);
- Share classes that differ in terms of voting rights;
- Share classes that differ according to the currency exposure;
- Share classes that are exposed to the same pool of assets but with different levels of capital protection/guarantee and/or payoff;
- Share classes whereby the same underlying portfolio is swapped against a different portfolio of assets (i.e. the final exposures of the share classes are different);
- Share classes whereby the underlying portfolio is hedged with a short portfolio the composition of which entirely differs from the long portfolio (i.e. replicating a long short strategy).

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

Our members strongly believe that the lowest common denominator between two share classes should be the existence of a common pool of assets, meaning that all share classes in a fund share the same investment strategy. Indeed, a same investment strategy means a common pool of assets. Then, each share class has the possibility to implement distinctevely an overlay of systematic hedging, partial or total, on one or several market risks (for exemple equity, duration, credit spread, inflation, volatility risk). These hedging features do not depart a class from the common investment strategy defined at the fund level.

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

It should be reminded that currently the concept of investment strategy does not have the same definition from one country to another. If ESMA retains the notion of investment strategy to define the common denominator, it should be clearly stated so that it means the same thing in every Member State. AFG strongly believes that a same investment strategy is based on a common pool of assets. Hedging a market risk that stems form the assets of the common pool on one share class preserves the same investment strategy.

Share classes share the same investment strategy while allowing for customisation through market risk hedging. Far greater efficiencies can be achieved by allowing more investors into one single fund with several customised share classes based on the same "engine", i.e. the fund manager's expertise in delivering the same strategy. The core portfolio and its investment management strategy remain unaffected by the hedging activity at a share class level.

We recall that a same investment strategy does not imply getting an identical performance, for instance the performance of a portfolio of Japanese equity that is currency hedged may differ by 15% on one year from the same but unhedged portfolio.

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

Technically, share classes in a same fund are differentiated by the fact that a part of the derivative financial instruments in the fund are reserved to them. A "reserved" derivative should not influence/contaminate the net asset value per share of other share classes. It should only impact the income/revenue of the concerned share class, i.e. for which the derivative was reserved. This operating process is similar to that of the management of differentiated fees or entry levys for instance.

The portfolio of the fund is composed of :

- common assets which impact in the same manner all share classes. These assets are recorded in the accounts with an allocation between all share classess according to a coefficient of distribution. The exposure can be also achieved synthetically;

- a hedging strategy made up of derivative financial instruments dedicated to one or more share classes whose variations affect only those share classes. The manager adjusts the amount of his hedging to the net asset value of the hedged share shares.

The manager implements risk controls specific to the hedging overlay in order to manage/follow up potential contagion effects (please see Q9).

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, but the list is not exhaustive. For instance, share classes that differ in terms of market risk hedging (full or partial ; duration risk, equity risk, inflation risk) are also compatible with the principle of having the same investment strategy.

AFG considers that all share classes of the same sub-fund share the same investment strategy provided that:

- the overlay implemented on the top of the investment strategy is managed without having an impact on the investment strategy of the fund,

- the overlay is systematically reducing the risk of a given risk factor that stems from the common pool of assets, partially or totally,

- the overlay share class is just facilitating the investment of a given investor who can choose to reduce or not a specific risk factor according to market conditions and its own constraints (i.e. such as capital requirements under Solvency II).

The fact that the reduction of a risk is implemented on a systematic basis is a key element to consider, as it means that there is no discretionary management performed of the hedging strategy.

In addition, this option of being able to choose a share class with a systematic risk hedging is **announced to investors** in the fund share class description: it provides to investors a very clear and transparent level of information on the objective risk mitigation. **On this basis of ex ante information, the investor is free to choose to invest or not in the relevant share class.** Each share class has a distinct KID.

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.***

A same investment strategy shall not be understood as restrictive as to exclude hedging of market risks from the accepted framework of shares classes. AFG strongly believes that the principle of having the same investment strategy is respected as long as the fund benefits from a unique pool of common assets and the dedicated overlay is systematically reducing the risk of a given risk factor, partially or totally, on a given share class.

Hereafter, we define the share classes' perimeter which should be authorized:

- Shares classes can implement strategies of hedging one or more risks. The concept of hedging is appreciated at the level of the overall strategy implemented. Indeed, this does not exclude the use of financial contracts presenting a positive exposure at a risk if the overall strategy implemented leads to a reduction in the overall risk of the share class.

1. Risk factors authorised for hedging (non exhaustive)

a) group 1: "Classic-type" risk factors

- Equity risk
- Duration risk
- Credit risk
- Exchange rate risk (between the currency of the instruments on the asset side and the base currency of the fund)

b) group 2: "Technical-type" risk factors

- Inflation risk
- Dividend risk
- Volatility risk

2. Hedging techniques authorised

a) Directional hedging (linear profile)

b) Optional hedging (convex profile)

Options are essential to the control of extreme risks both for natural persons and institutional investors, in particular those subject to the Solvency II Directive. In this respect, the implementation of a systematic optional strategy of hedging of extreme risks makes it possible to limit to a significant degree the use of capital (SCR).

There are as many optional strategies as there are different profiles of target risks. These strategies can hedge or not the delta according to the exposure that is sought.

c) Protection mechanism having for objective to protect the net asset value of the share class on a given horizon, by a technique of portfolio insurance.

3. Hedging instruments authorised (non exhaustive)

Hedging strategies can be based on the use of one or more of the following instruments:

a) Swap
b) Future/forward
c) Options/Hedged options
d) CDS

Derivatives can be either traded on regulated/organised markets or OTC.

4. Micro hedging/ macro overlay

The risk reduction objective can relate to overall market risks (macro overlay) and/or to the specific risks (micro hedging):
- In the case of specific risks' hedging, the underlying(s) of the hedging instruments should be an asset of the fund;
- In the case of one or more market risks hedging, the hedged share class should preserve an exposure to the specific risks of the fund.

5. Systematic hedging

Hedging strategies are systematic because there is a systematic and permanent reduction of a given risk. The hedging strategy will be applied systematically to hedge the defined risk, with no discretion by the manager in determining whether or not to apply the hedge. For this purpose, the fund will purchase the necessary derivative instruments required to hedge the identified risk. However that does not mean that the asset manager will not have the technical choice of the instruments to use in order to implement the hedge: type of derivative, maturity…

6. Total/partial hedging

Share classes can implement total or partial hedging. The global level of hedging or risk reduction should be specified in the fund's official documents. When it is possible to specify a target level of hedging (for example 95%), there should be some leeway recognized around the target level (ex: residual exposure of 5% for a total hedge).

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.

No, we think that share classes which offer various levels of protection should be accepted, as well as shares classes which offer a hedge against a market risk factor present in the fund portfolio.

On the other hand, the mechanism of the hedged share classes should be limited to the reduction of risk.

We thus strongly advocate for instance that the last three examples of the list are fully complying with the priciple of having the same investment strategy as we have defined in our reply at Q9. Indeed, the principle of having the same investment strategy is respected as long as the fund benefits from a unique pool of commun assets and the dedicated overlay is systematically reducing the risk of a given risk factor, partially or totally, on a given share class. Thus, the following examples are having the same investment strategy:

- Share classes that offer differing degrees of protection against some market risks such as interest rate risk or volatility risk;
- Share classes that are exposed to the same pool of assets but with different levels of capital protection and/or payoff. For example, a UCITS offers two share classes. One share class protects 80% of the initial NAV and delivers 100% of the performance of an index after a fixed term (5 years) and the other share class protects 100% of the initial NAV and delivers 50% of the performance of the same index after the same 5 year term;
- Share classes that differ in terms of **exposure**.

It should be noted that there are synthetic management techniques which have recognised advantages for investors in shares classes that we exclude from the current debate that focuses exclusively on UCITS.

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.***

In France, all cases described in paragraph 8 are authorized.

Regarding the criteria laid down in paragrapg 6, AFG strongly advocates that there should be no ambiguity on the definition of a same investment strategy, which is respected as long as the fund benefits from a unique pool of commun assets and the dedicated overlay is systematically reducing the risk of a given risk factor, partially or totally, on a given share class.

Also, we believe that the second criterion should be specified so as to state that "Features that are specific to one share class are specifically monitored so as to adress potential (or actual) adverse impact on other share classes of the same UCITS." We all agree to the objective to avoid contagion risk and on a more operational standpoint, we would like to clarify the fact that tight risk management means should be employed so as to manage/mitigate this risk.

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)?***

Provided that there is a possibility to open the list of authorised types of share classes like in the framework AFG proposes (see our reply at Q9), we believe that only the calculation of the counterparty risk (or other risk management means implemented so as to control/follow up the contagion risks) per share class may be justified in order to limit contagion risks from a hedged share class on the other share classes. The calculation of the global risk and diversification risks at the level of each share class is not necessary since complying with the ratios at the fund level (common asset pool) makes possible to limit risks at the level of each share.

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?***

In order to minimize operational risks and to ensure the transparency to investors, a Position - Recommendation of the AMF (n° 2011-05) provides that funds implementing this kind of method must:

- indicate the risk hedging policy in the summary table of the fund offering (by presenting the entire spectrum of share classes that are offered); the risk heding policy is necessarily a systematic one;

- clearly mention the risk hedging policy related to each share class within the investment strategy;

- ensure consistency between the fund objective, the benchmark, the classification and, if relevant, the threshold of the performance fee with the management put in work for each share, by adapting it to each share class, if needed;

- to explicitly specify within the profile of risk (except permanent total hedging of the risk for all share classes) the residual risk suitable for each share class – and not the methods of hedging for this risk.

This framework appears to us necessary and sufficient to ensure a good level of transparency for investors.

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

Beyond the commonly allowed use by the European regulators, the framework of use authorized for the share classes differs in an important way from one country to another.

Yes, it appears important to us to develop a common framework at European level making it possible to align the authorized practices from one country to another. **Ultimately, it should be recalled that share classes are a valuable competitive tool for European asset managers; it would be detrimental both for worldwide investors and for the European fund and asset management industry to curb share classes possibilities beyond reasonable boundaries.**

If you need any further information, please don't hesitate to contact myself, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

Eric PAGNIEZ