European Securities and Markets Authority

Reply form for the Discussion Paper on Share Classes

6 April 2016

European Securities and Markets Authority

Date: 6 April 2016

Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Discussion Paper on Share Classes (SC), published on the ESMA website.

Instructions

Please note that, in order to facilitate the analysis of the large number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, ESMA will only be able to consider responses which follow the instructions described below:

- use this form and send your responses in Word format (pdf documents will not be considered except for annexes);
- do not remove the tags of type < ESMA_QUESTION_DP_SC_1> - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- if they respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives that ESMA should consider

Naming protocol

In order to facilitate the handling of stakeholders responses please save your document using the following format:

ESMA_DP_SC _NAMEOFCOMPANY_NAMEOFDOCUMENT.

E.g. if the respondent were XXXX, the name of the reply form would be:

ESMA_DP_SC _XXXX_REPLYFORM or

ESMA_DP_ SC _XXXX_ANNEX1

Deadline

Responses must reach us by **6 June 2016.**

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that 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 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 headings 'Legal notice' and 'Data protection'.

Introduction

Please make your introductory comments below, if any:

<ESMA_COMMENT_ DP_SC_1>
CFA Institute appreciates the opportunity to respond to ESMA's Discussion Paper on UCITS Share Classes (ESMA/2016/570).

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. CFA Institute has more than 136,000 members in 145 countries and territories, including more than 129,000 Chartered Financial Analyst® charterholders, and 147 member societies.

CFA Institute welcomes ESMA's work and analysis regarding UCITS share classes and supports the need for principles to establish clarity and consistency in the use of UCITS share classes within the European Union. We agree with the key elements of share classes, including the principle of a common investment objective reflected by a common pool of assets, as well as the principles of non-contagion, pre-determination, and transparency.

CFA Institute believes that UCITS management companies seeking to pursue different investment objectives should create different funds (or UCITS sub-funds/compartments) for that purpose, rather than creating different share classes within the same fund or compartment.
<ESMA_COMMENT_ DP_SC_1>

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

<ESMA_QUESTION_DP_SC_1>
CFA Institute agrees with the description of share classes as presented by ESMA in paragraph 9 of the DP, namely that share classes are different types of shares or units belonging to the same fund or sub-fund / compartment that allow for the attribution of certain investment outcomes or features only to investors in the given share class.
<ESMA_QUESTION_DP_SC_1>

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

<ESMA_QUESTION_DP_SC_2>
In paragraphs 11-12 of the DP, ESMA notes that the main reasons for setting up different share classes are reduced cost (for firms); customisation for investor needs; economies of scale; fund sizes (allowing large investors to invest in European UCITS funds without breaching their holding ratio); time to market; and brand capitalisation. We do not see any other reason for setting up share classes.

We wish to underline that among these reasons, those benefitting investors first and foremost – specifically, customisation, economies of scale, and fund sizes – should be the primary considerations for setting up a share class. Issues such as reduced cost, time to market and brand capitalisation are somewhat secondary as these considerations are primarily for the benefit of firms rather than investors. We also caution against the creation of share classes as a way to circumvent administrative concerns.
<ESMA_QUESTION_DP_SC_2>

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

<ESMA_QUESTION_DP_SC_3>
CFA Institute agrees with the "common investment objective" principle as presented by ESMA (in paragraph 13), whereby share classes of the same fund should have a common investment objective reflected by a common pool of assets, along with the principles of "non-contagion", "predetermination", and "transparency".

We also agree (paragraph 16) that while some share classes have been set up to differentiate between different groups of investors (e.g. regarding minimum investment amounts) or means of investment (e.g. regarding treatment of management fees, capitalisation or distribution of income, base currency, etc.), the performance of the investment is not modified by the characteristics of these types of share classes. Therefore they satisfy the criterion of sharing a common investment objective.

As a matter of principle, CFA Institute believes that UCITS management companies seeking to pursue different investment objectives should create different funds (or UCITS sub-funds/compartments) for that purpose, rather than creating different share classes within the same fund or compartment.
<ESMA_QUESTION_DP_SC_3>

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

<ESMA_QUESTION_DP_SC_4>
In paragraph 18, ESMA notes that some stakeholders have argued that only share classes with "increased" risk factors, or with "additional" or "different" risk factors compared to the common pool of assets, should not be considered as complying with the principle of having the same investment objective. CFA Institute broadly agrees with this notion; we consider the addition of strategic risk factors to alter the investment objective.

We agree with ESMA (paragraph 20) that currency risk hedging at the level of share class is compatible with the principle of a common investment objective. Currency-hedged share classes are consistent with this notion because they enable investors whose currency of domicile differs from the currency of the fund to obtain the same risk exposure to the fund as investors whose currency of domicile is the same as that of the fund (i.e. it supports the level playing field argument noted by ESMA).

However, we would add that any currency hedging strategy should be conducted systematically with a pre-defined hedge target (pre-determined). Otherwise, it may be possible for the manager to take tactical currency bets, which may not be in line with the principle of a “common investment objective”. We also note that while currency hedging is consistent with the principle of a common investment objective, it cannot be disassociated from the principle of non-contagion.

In addition, CFA Institute is supportive of ESMA’s opinion (paragraph 21) that UCITS management companies which seek to offer different investment objectives to investors should set up separate funds or compartments.
<ESMA_QUESTION_DP_SC_4>

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

<ESMA_QUESTION_DP_SC_5>
CFA Institute broadly agrees with ESMA’s principle of “non-contagion” (section 3.3.3 of the DP – preventing a derivative overlay from creating spillover risk that could disadvantage investors in other share classes). In particular, we agree with the notion (paragraph 26) 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 materialisation.

Nonetheless, we understand that the risks could spill over to other classes as there is no legal segregation between the asset classes, only an accounting segregation. We are thus in favour of certain safeguards as further elaborated in our response to Question 8 on “operational principles”.

An additional consideration not made explicit in paragraph 26 of the DP is that the “introduction of additional risk through using derivative overlays” should refer only to counterparty and operational risk considerations. As noted in our response to question 4, the addition of strategic risk factors (i.e. derivative overlays designed to increase the risk profile of the share class) would not be consistent with the principle of a “common investment objective”.
<ESMA_QUESTION_DP_SC_5>

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?

<ESMA_QUESTION_DP_SC_6>
We are not aware of any evidence of investors in one share class suffering losses as a result of the crystallisation of risk in another share class.
<ESMA_QUESTION_DP_SC_6>

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)

<ESMA_QUESTION_DP_SC_7>
CFA Institute believes that potential contagion risk arises from the fact that derivative hedging arrangements are segregated only in accounting terms (apportioning any gains/losses or income/expenses to the applicable share classes). These derivatives belong to the common pool of assets and thus are not legally segregated, raising the potential for spillover risk. We agree with ESMA (paragraph 24) that the contagion risk can stem from a number of sources, including market movements which lead to a draw-down of fund liquidity, and the failure of a derivative counterparty leading to a delayed/failed recovery of fund assets.
<ESMA_QUESTION_DP_SC_7>

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

<ESMA_QUESTION_DP_SC_8>
CFA Institute agrees with the operational principles set out in paragraph 28 to manage the contagion risk associated with the inclusion of derivative overlays. These principles should be considered minimum requirements to mitigate potential spillover risk associated with hedging arrangements.

Regarding paragraph 29, the principles to keep the hedged positions under review and within the specified limits seem reasonable.
<ESMA_QUESTION_DP_SC_8>

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

<ESMA_QUESTION_DP_SC_9>
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<ESMA_QUESTION_DP_SC_9>

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

<ESMA_QUESTION_DP_SC_10>
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<ESMA_QUESTION_DP_SC_10>

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.

<ESMA_QUESTION_DP_SC_11>
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<ESMA_QUESTION_DP_SC_11>

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?

<ESMA_QUESTION_DP_SC_12>
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<ESMA_QUESTION_DP_SC_12>

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

<ESMA_QUESTION_DP_SC_13>
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<ESMA_QUESTION_DP_SC_13>

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

<ESMA_QUESTION_DP_SC_14>
CFA Institute broadly agrees with the principle of “pre-determination” (as noted in section 3.3.4). In particular, we agree with paragraph 33, according to which all features of a share class should be predetermined 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 the investment. As noted by ESMA, predetermination should also apply to the kinds of risks which are to be hedged out systematically.

Moreover, we believe that if a new derivative overlay is to be created for the share class, that should be communicated to all current investors in a timely and transparent fashion (please see our response to question 16 on “transparency”).
<ESMA_QUESTION_DP_SC_14>

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

<ESMA_QUESTION_DP_SC_15>
Please see our response to question 16 (below) on transparent communication.
<ESMA_QUESTION_DP_SC_15>

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

<ESMA_QUESTION_DP_SC_16>
CFA Institute agrees with the “transparency” principles laid down in paragraph 35. For example, we agree with ESMA that new and existing investors should be informed about the existence and features of different share classes as part of the pre-contractual disclosure information, specifically the prospectus. The information on share classes should also be made available on an ongoing basis in the statutory fund reports and financial statements.

As noted by ESMA in paragraph 35, we also believe that the information needs be made available to all investors, not merely to investors in that particular share class.
<ESMA_QUESTION_DP_SC_16>

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

<ESMA_QUESTION_DP_SC_17>
CFA Institute broadly considers the disclosure requirements to be sufficient.
<ESMA_QUESTION_DP_SC_17>

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

<ESMA_QUESTION_DP_SC_18>
We consider the operational principles listed in the DP as sound minimum requirements on transparency and have no further comments.
<ESMA_QUESTION_DP_SC_18>

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

<ESMA_QUESTION_DP_SC_19>
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<ESMA_QUESTION_DP_SC_19>

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?

<ESMA_QUESTION_DP_SC_20>
CFA Institute believes that the potential impact of the principles outlined in this Discussion Paper will largely depend on the potential legal instrument used (e.g. opinion, guidelines, Regulation, etc.). The impact will also depend on the scale of funds that are currently non-compliant with these principles. Absent data on the current scale and degree of non-compliance with these principles among UCITS funds in the European Union, we are not able to opine further.
<ESMA_QUESTION_DP_SC_20>

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?

<ESMA_QUESTION_DP_SC_21>
CFA Institute broadly agrees with the principles on transitional provisions as set out in paragraph 39. We would welcome a clear policy on transitional provisions, including adequate transitional periods, to allow the fund industry (and investors in the affected share classes) to make the necessary operational changes.
<ESMA_QUESTION_DP_SC_21>