Frankfurt am Main,
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BVI's response to ESMA's Discussion Paper on share classes of UCITS (ESMA/2014/1577)

BVI[1] gladly takes the opportunity to contribute its views to the envisaged common approach to the use of share classes under the UCITS Directive.

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

BVI members perceive share classes as an essential tool for cost-efficient fund management in the European and global context. The main advantages and economic drivers for creating different share classes are the following:

- Customised solutions to investors' needs: Different investors' groups often have different requirements with regard to the features of their investments. This pertains e.g. to maximum/minimum investment amounts, types of fees and charges, denomination of currency, allocation of revenues and many other specificities. Asset managers operating on a European or global scale need share classes in order to respond to these varying investors' needs in a prompt and cost-efficient manner while maintaining a common management solution and offering the expertise of a particular fund manager. One of our members has mentioned the example of a monthly distributing share class which is in great demand in the Hong Kong retail market where retail investors appreciate monthly income to cover their costs of living.

- Cost-efficient way of managing a fund: Operation of different share classes allows for mutualisation of costs within one fund. By offering investors different share classes instead of different funds, fund managers can increase the number of investors within one fund and offer one single engine of investment strategy and fund management expertise. This generates economies of scale to the benefit of investors and improves the international competitiveness of UCITS managers. In particular, it is worth noticing that creation of new share classes does not require new authorisation and thus involves no supervisory fees and lower set-up costs as compared to launching a new fund. Also, operating costs of large funds with different share classes are generally lower than costs of funds with low levels of assets under management (e.g. in terms of transaction costs).

- Time-to-market: Share classes can usually be launched on an as-need basis and thus enable fund managers to respond swiftly to the bespoke needs of investors. The launch of a new UCITS always requires prior authorisation by the competent NCA.

- Enhanced risk allocation: Switches between share classes are operationally easier to manage than switches between different funds. It is quite common for investors to switch their allocation of assets between different share classes in order to react to varying market conditions.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 88 members manage assets in excess of EUR 2.5 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

BVI
Bundesverband Investment
und Asset Management e.V.
Contact
Phone +49 69 15 40 90 0
www.bvi.de
BVI Berlin
Unter den Linden 42
10117 Berlin
BVI Brussels
Rue du Trône 14–16
1000 Bruxelles
BVI Frankfurt
Bockenheimer Anlage 15
60322 Frankfurt am Main
Executive Board
Thomas Richter CEO
Rudolf Siebel MD

- Systematic hedging: Many investors value the expertise of a particular fund manager, but wish to benefit from systematic hedging against realisation of some market risks (e.g. risk of equity market drawdown, risk of interest rate increases, risk of widening credit spreads, risk of inflation increase). The instrument of share classes is capable of offering customised solutions to these demands.

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

Please refer to our answer to Q1 above. Creation of different share classes is generally prompted by investors' demand for specific solutions and efficiency considerations. If implementation of a variable is possible within an existing fund, it is far more efficient both from the cost and time perspective to create a new share class than a new fund.

In addition, it should be borne in mind that share classes help to create a more efficient fund landscape in Europe by reducing the number of UCITS and increasing their assets under management. Hence, the use of share classes contributes to realization of one of the key objectives of the UCITS IV reform which aimed at reducing the fragmentation of the EU fund market. Share classes should be also perceived as an instrument helping to promote the Capital Markets Union in line with the Commission's thrust for reducing costs for setting up funds and enhancing economies of scale[2].

From investors' perspective, share classes significantly expand the choice of investment solutions available for investors. There are no negative implications for investors, since operations within one share class such as e.g. risk hedging have no impact on other fund investors due to the applied operational segregation and strict risk management.

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

We estimate the costs of launching and maintaining of a separate UCITS ten to fifteen times higher than costs of creating and operating a new share class. Furthermore, creation of separate funds instead of share classes on a wider scale would cause a significant fragmentation of the EU fund market and noticeably increase the general costs of fund management.

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

In general, share classes may be assigned to the following most common categories:

- Differing according to the maximum or minimum investment amounts
- Differing in terms of the types of investors
- Differing regarding the types and/or amounts of charges and fees
- Differing in terms of currency denomination
- Differing according to the allocation of revenues to investors
- Differing in relation to the distribution frequency (weekly, monthly, quarterly, semi-annual and annual)
- Currency hedged share classes

[2] Cf. Commission's Green Paper „Building a Capital Markets Union“ from 18. February 2015, page 17.

- Duration hedged share classes
- Share classes with systematic hedging against other elements of market risks (e.g. volatility)

5. How would you define a share class?

The German Capital Investment Code (KAGB) provides for a definition and non-exhaustive criteria for classification of share classes[3]. In our view, this provision is broad enough to accommodate both the current practice and possible future trends in share class based solutions and hence, could be used as a basis for the envisaged common understanding at the EU level.

If applied to the UCITS level, the provision would read as follows:

> *"Units or shares of UCITS may be classified according to different features, <u>in particular</u> with regard to the appropriation of income, front-end load, redemption fee, currency denomination, management fee, minimum investment amount or a combination of these (unit/share classes). […] The value of UCITS units or shares shall be calculated separately for each unit/share class."*

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

We agree with the principle that all share classes of the same UCITS should have the same investment strategy. This is generally ensured by the fact that all investors remain invested in the same portfolio of assets. In contrast, exposure to the same performance pattern should not be perceived as a necessary element of a common investment strategy. Indeed, the exposures of different share classes may vary due to e.g. the impact of hedging arrangements or different currencies of denomination.

On this basis, we think that share classes offering different degrees of protection against some elements of market risk such as interest rate or volatility risk also share the same strategy with other share classes of the same fund. Hedging operations in a share class provide an overlay which systematically reduces certain risks of a portfolio. Hence, hedged share classes offer investors the choice to eliminate or reduce certain risk factors of an investment according to market conditions and/or their own constraints (stemming e.g. from capital requirements under Solvency II). The reduction of risk is generally implemented in a systematic manner meaning that no discretionary management takes place with regard to the risk hedging and no additional investments are involved.

Hence, provided that the costs and risks of hedging operations can be operationally allocated to a specific share class, fund managers should be allowed to respond to the investors' demand for a risk-minimised profile in relation to a specific investment strategy by setting up a customised share class of a UCITS instead of being required to launch a new fund. As explained in our reply to Q1-3 above, realisation of investment solutions via share classes is much more efficient in terms of costs and time-to-market and enhances the competitiveness of the EU fund industry.

[3] Cf. § 96 para. 1, 1st sentence of KAGB.

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

Generally, the investment manager taking decisions on how assets of a UCITS are to be invested will not look at each share class, but will manage the portfolio as a whole, ensuring that subscriptions are invested in the portfolio and assets sold from the portfolio in order to meet redemption requests, but without any reference to the particular share class into which a subscription or redemption was made. For hedged share classes, the hedging strategy will be implemented separately from the investment strategy and independently of any hedging strategy employed by the investment manager for the portfolio as a whole. The hedging strategy will normally overlay the investment portfolio. It 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 management team will merely purchase the necessary derivative instruments (e.g. forward currency contracts) required to hedge the identified risk.

The operational segregation between share classes as such may be best explained by way of an example, e.g. by considering a duration hedged share class. In this case, the instruments held for hedging purposes at the share class level are separated in a technical account, whereas the portfolio assets are booked into the general fund portfolio. The performance of the fund portfolio is reflected in the NAV of all share classes, whereas the profits and losses of the hedging instruments are only reflected in the share value of the hedged share class. Also, any margin requirements relating to the hedging instruments are allocated to the hedged share class for accounting purposes and thus reflected in the relevant share value.

The operational segregation should be accompanied by a rigorous risk management in order to minimize the “spill over” risk of transactions booked for individual share classes. However, since such risk cannot be fully eliminated, especially with regard to the potential default of a counterparty to a derivative transaction entered into on account of a share class, but legally concluded for the entire UCITS, all investors should be properly informed about the associated counterparty risks.

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.

We agree that the types of share classes described in paragraph 8 of the discussion paper should be deemed as following the same investment strategy. This pertains also to share classes offering currency hedging, duration hedging and in general to other forms of overlay against certain elements of market risk (cf. our answer to Q9 below).

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.

Yes. As explained in our replies to Q6 and 8 above, we believe that share classes offering total or partial protection against other elements of market risk such as e.g. interest rate and volatility risk also comply with the principle of maintaining one single investment strategy within a UCITS. In our opinion, a systematic risk overlay in a share class does not impact the overall investment strategy of a fund.

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.

Referring to our comments made above, we do not agree that share classes offering a systematic overlay against some elements of market risk violate the principle of having the same investment strategy. Additional systematic protection against selected risk factors such as duration or volatility does not change the overall investment strategy of a share class. ESMA itself recognizes that currency hedging operations in a share class are possible without deviating from the common investment strategy. This stance should be accepted in general in relation to hedging operations against market risks which are implemented in a systematic manner in a share class and do not involve additional investment discretion, provided appropriate investor information on the associated risks. Moreover, it should be noted that hedging against currency risk does not display any operational differences from other market risk hedging which is generally performed within a separate technical account (cf. our response to Q7 above).

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.

On the basis of our position as presented above, we do not have any indication of UCITS which do not comply with the criterion of having the same investment strategy or with the other criteria for share classes suggested by ESMA. In particular, appropriate disclosure to investors is generally ensured by information on different share classes provided in the sales prospectus and share-class specific KIID, where applicable, and accompanied by relevant marketing materials.

In more abstract terms, we would assume that share classes taking additional exposure compared to the main share class of the fund e.g. by additional investments or enhanced leverage would not comply with the requirement of maintaining the same investment strategy.

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)?

No, we do not see the need for such a clarification, since the CESR 2010 Guidelines on global exposure and counterparty risk for UCITS provide for sufficient guidance in this regard. In fact, calculation of counterparty risk limits per share class would give investors the false impression that assets are segregated at the share class level. It should also be borne in mind that investors obtain relevant information on general and more specific risks – including counterparty risks – affecting the entire UCITS or specific share classes in particular in the sales prospectus and where applicable, in share-class specific KIIDs (cf. our answer to Q13 below).

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?

As indicated above, investors are currently being informed about different characteristics and risks of share classes in the sales prospectus and KIID. Information on the fund's risk profile to be included in the prospectus in line with Article 69(1) UCITS Directive also requires the description of different risk profiles at the share class level. Moreover, UCITS are generally under the duty to produce separate KIIDs for each single share class in accordance with Art. 26 of the Level 2 Regulation 583/2010. Only if the choice of a representative share class bears no risk of being misleading to investors, the UCITS manager may produce one KIID for the representative share class. In this case, however, material risks applicable to other share classes must be sufficiently explained in the risk and reward section of the KIID.

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

BVI welcomes the prospect of ESMA developing a common position on the use of share classes by UCITS. A common understanding among the ESMA members in this regard could contribute to further harmonisation of the supervisory practices and hence strengthen the Single Market for UCITS.

In this context, however, it is important that the envisaged common position does not hamper the use of share classes for efficient management of various investors' demands. As explained in our comments made above, share classes enable UCITS managers to offer cost-efficient and speedy solutions for different investor profiles while allotting investments to the same portfolio of assets. UCITS should be able to benefit from these efficiency gains also in terms of market risk hedging operations which should be allowed to be conducted via share classes instead of setting up separate funds. Such practically oriented approach to UCITS structuring appears very much in line with the political initiative for enhancing growth and economies of scale in the fund sector recently launched by the EU Commission as part of the Capital Markets Union. Ensuring sufficient flexibility of share class application by UCITS is also crucial for maintaining the competitiveness of the EU fund industry in worldwide terms.

Should the use of UCITS share classes be restricted notwithstanding our recommendations made above, we think that it would be important to allow for proper 'grand-fathering' of existing share classes in order not to undermine investors' confidence in the soundness and reliability of the UCITS framework.