European Securities and Markets Authority

Date: 30 January 2017
ESMA34-43-296

OPINION

Share classes of UCITS

1 Legal basis

1. ESMA's competence to deliver an opinion is based on Article 29(1) of Regulation (EC) No 1095/2010 of the European Parliament and of the Council[1] (the 'Regulation'). In accordance with Article 44(1) of the Regulation, the Board of Supervisors has adopted this opinion.

2 Background

2. 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).

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

4. 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 legally required 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.

5. Share classes, in contrast, are not compartments but different types of units or shares belonging to the same UCITS (or compartment[2], 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.

[1] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.
[2] For the purposes of this opinion, the term "fund" should be understood to refer to a UCITS fund or one or more of its compartments.

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.

6. 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[3]. 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.

7. There are 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.

8. The main reasons for setting up share classes are:

   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: in a similar way 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;

   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.

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

3 ESMA opinion – Key elements of share classes

3.1 Overview

9. ESMA is of the view that the following high-level principles 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.

10. 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, particularly those on diversification, derivative eligibility and liquidity.

3.2 High-level Principle: Common Investment Objective

11. 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.

12. There are currently several types of UCITS share classes set up throughout the EU, which provide investors with different features.

13. Some share classes, which could be classified as "technical share classes", have been set up with an administrative and/or accounting impact in mind. They 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.

14. Other share classes could be classified as "overlay share classes". These share classes are identified by a derivatives-based hedging arrangement at share class level (also called a 'derivative overlay' or simply 'overlay'). This arrangement aims at mitigating ("hedging out") one or more of the risk factors of the common pool of assets for the investors belonging to the share class.

15. In terms of the meaning and scope of 'common investment objective', a number of different approaches can be envisaged. Some stakeholders believe that a common investment objective, realised through the investment in a common pool of assets, does not call for a common risk profile of the fund and its share classes, as long as a share class with a derivative overlay does not have a risk profile which is higher than the overall risk profile of the fund.

16. Other stakeholders argue 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.

17. ESMA shares this concern. The Authority is of the opinion that hedging arrangements at share class level are not compatible with the requirement for a fund to have a common investment objective. ESMA holds the view that UCITS which aim at protecting the investor from certain types of risk should be set up as separate funds or sub-funds.

18. As an exception to the above, ESMA is of the view that *currency risk hedging* at the level of a share class is compatible with the principle of a common investment objective. As not all EU Member States share a single currency, ESMA sees currency risk hedging as a way to support a single market, as well as a means 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. As such, all references to derivative overlays and hedging in this opinion should be understood as referring to currency risk hedging arrangements.

3.3 High-level Principle: Non-contagion

19. Share classes which are defined by a specific derivative overlay to systematically hedge out currency risk allow an investment manager to better align the characteristics of the common pool of assets 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, these derivative overlays could also cause a disadvantage to investors in other share classes.

20. 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.

21. The application of a derivative overlay in a currency risk hedged 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.

22. 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.

23. ESMA therefore believes 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.

24. 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, ESMA is of the view that these costs should only be attributed to (and borne by) the respective share class. ESMA is further of the opinion that the accounting methodology of the fund has to ensure that profit and loss (realised and unrealised) of the derivative assets used for hedging purposes in an overlay share class are only applied to the respective share class.

25. To ensure that the derivative overlay used to hedge the currency risk 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. With this in mind, ESMA is of the view that the following operational principles should be observed:

    a. The notional of said derivative should not lead to a payment or delivery obligation with a value exceeding that of the share class. To that end, the maximum potential amount of cash that could be paid to the counterparty or collateral that could be posted to the derivative counterparty should be prudently assessed by the management company and should not exceed the maximum pool of cash and eligible collateral corresponding with the value of the share class;

    b. The UCITS management company should put in place a level of operational and accounting segregation which, at a minimum, ensures that there is a clear identification of the values of assets and liabilities as well as of profit and loss (realised and unrealised) in 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; and

d. The derivative overlay should be implemented according to a detailed, pre-defined and transparent hedging strategy.

26. 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% of the net asset value of the share class;

    c. Ensure that under-hedged positions do not fall short of 95% of the portion of the net asset value of the share class which is to be hedged against currency risk;

    d. Keep hedged positions under review on an ongoing basis, at least at the same valuation frequency as the fund, to ensure that over-hedged or under-hedged positions do not exceed/fall short of the permitted levels stated above; and

    e. Incorporate a procedure in said review to rebalance 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.

27. 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.

3.4 High-level Principle: Pre-determination

28. 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 UCITS management company would have a certain amount of discretion in regard to the features of the share class, such as the hedging arrangement.

29. 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.

30. 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 currency risk which is to be hedged out systematically. Notwithstanding this, ESMA is of the opinion that this requirement neither limits the discretion of the UCITS management company as to the type of derivative instrument used to hedge the currency risk, nor its operational implementation.

3.5 High-level Principle: Transparency

31. 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.

32. 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;[4]

    b. In regard to the share classes with a contagion risk, the UCITS 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 request.

3.6 Impact on existing share classes, transitional provisions

33. 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 do not comply with the above principles.

34. ESMA is aware that the above principles will have a considerable impact on the investment fund markets in Member States where share class arrangements can currently be set up which do not comply with these principles.

[4] c.f. UCITS Directive, Annex I, Schedule A, 1.10

35. To mitigate negative effects for investors in share classes which were established prior to the issuance of this opinion and which do not comply with these principles, ESMA is of the view that these share classes should be allowed to continue to operate. However, in order to level the playing field across the EU, ESMA is of the opinion that these share classes should be closed for investment by new investors within six months of publication of this opinion, and for additional investment by existing investors within 18 months of publication of this opinion.