ESMA publishes its Opinion on UCITS Share Classes

Overview

On 30 January 2017, ESMA published its long awaited opinion on the use of share classes in a UCITS investment fund in response to the ESMA Discussion Paper on Share Classes of UCITS (the **Opinion**). The Opinion was issued due to diverging approaches taken by regulators across the European Union and focusses on the extent to which different types of share classes of the same UCITS sub-fund may differ from one another.

ESMA, in line with the current Central Bank of Ireland (**CBI**) position, has acknowledged the potential to have differing share classes (referred to as 'technical share classes') with special characteristics or requirements which may vary on matters such as dividend policy, fee structures, minimum investment amounts or particular tax treatments under national law. The Opinion has no impact on such share classes, which will remain available.

The most notable aspect of the Opinion is the determination by ESMA in relation to what they refer to as "derivative overlays" at share class level. A number of derivative overlay share class constructs have been permitted to date. However, ESMA has stated that, in its view, only currency risk hedging share classes are compatible with the requirement for a UCITS sub-fund to have a common investment objective. This determination means that, despite industry submissions, only currency risk hedging share classes will be permitted at share class level in the future. A transitional period has been provided for to permit any other existing derivative overlay share classes which do not comply with the ESMA Opinion's principles to be closed to new and additional investment over time (see below).

The determination to restrict the derivative overlay to currency risk hedging at share class level necessitates a shift in the current practice in Ireland and is contrary to the current CBI interpretation which permits interest rate hedging at share class level and other derivative overlay share classes. Investment managers and fund boards should be aware of this determination and act on it as necessary.

ESMA's Opinion high-level principles

ESMA's Opinion sets out four high-level principles that should be followed when establishing different share classes within a UCITS, which include:

- share classes of the same UCITS should have the same common investment objective which is realised through investment in a common pool of assets;
- UCITS (SMIC or with a management company) 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;
- all features of the share class should be pre-determined before it is set up; and
- transparency of disclosure to investors where more than one share class exists and where new share classes which utilise derivatives are established and introduce counterparty and operational risk, that both new and existing holders be informed in a timely manner.

Common investment objective

A key aspect to come from the Opinion relates to share classes which engage in derivative based hedging arrangements at share class level. ESMA has confirmed that, in relation to derivative based hedging at share class level, it is of the opinion that only currency risk hedging share classes are compatible with the requirement for a UCITS sub-fund to have a common investment objective. ESMA believes that currency risk hedging supports the single EU market, provides a level playing field for investment to investors across the EU and allows all investors to participate to the maximum extent possible in the same performance of the relevant UCITS sub-fund.

As a result, share class hedging arrangements with derivative overlays, which are not currency risk hedging share classes, are deemed to be incompatible with the requirement for a UCITS sub-fund to have a common investment objective amongst its share classes. An unfortunate result of this position is that UCITS which aim at protecting the investor from certain types of risk, such as interest rate risk or duration hedging or beta hedging, should be set up as separate UCITS or as separate sub-funds within the umbrella and cannot avail of the share class structure.

A further impact of the position taken by ESMA will be felt by UCITS sub-funds using derivatives at a share class level to adjust levels of exposure to common underlying assets and setting differing trigger, autocall and barrier levels, and caps and floors on a per share class basis. This approach was taken by a very small number of investment fund promoters, however the novel and innovative use of derivatives to modify risks, other than currency, at share class level (whilst retaining exposure to a common underlying asset) has now been restricted and arguably leaves a gap in the development and advancement of the UCITS product.

Appropriate procedures to minimise the risk

ESMA has stated in the Opinion that currency risk share classes permit the investment manager to better align the characteristics of the common pool of assets to the preferences of investors in specific share classes and provide for efficient levels of customisation.

As the use of derivatives means that the UCITS on behalf of its sub-fund enters into derivative contracts, ESMA has stated in the Opinion that where additional risk is introduced to the UCITS sub-fund through the use of derivatives, for a specific share class, such risk should be mitigated and monitored and if realised, only borne by the investors in the relevant share class. ESMA further that, where a share class engages in hedging or has specific costs or benefits attributable solely to a single share class, such costs and benefits may be credited to the relevant share class only.

ESMA has detailed a number of minimum standardised operational principles to be observed where a share class engages in derivative transactions, which include: (i) that the notional of any derivative contract does not exceed the value of the share class; (ii) the implementation of a level of operational and accounting segregation which, at a minimum, ensures 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 UCITS sub-fund; (iii) the implementation of stress tests to quantify the impact of losses on all investor classes; and (iv) that derivative currency risk hedging should only be implemented in accordance with a detailed, pre-defined and transparent hedging strategy.

To ensure the minimum standardised operational principles to be observed are met, ESMA has provided further guidance on the restrictions that should be followed. The guidelines provided for in the Opinion are broadly similar to those currently imposed by the CBI pursuant to Regulation 26 (c)(3) of the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2015. In addition to the current requirements imposed by the CBI, ESMA also introduces a requirement 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 to mitigate currency risk and comply with the stress test requirements as outlined above.

All features of the share class should be pre-determined

ESMA has stated its concern that should there be a lack of information, particularly in relation to hedging arrangements, this may have an adverse effect on investors. ESMA is of the view that all features of a share class, including currency risk which is to be hedged out, should be pre-determined before the share class is set up, in order to allow a potential investor in the UCITS sub-fund to gain a full overview on the rights and/or features attributed to his/her investment.

Transparency of disclosure to investors

ESMA is of the opinion that it is important that the existence and nature of all the share classes of the UCITS sub-fund are disclosed to all investors of the UCITS sub-fund and as share classes which engage in derivative transactions 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. Questions remain as to how this should be done operationally and whether notification via a website update would be sufficient, however, we anticipate that these matters will be resolved through a Q&A process with the CBI in due course.

ESMA sets out a requirement in respect of the common level of transparency for share classes which includes providing information about existing share classes in the offering documents and to provide a list of share classes which engage in derivative transactions in a form readily available which should be kept up-to-date. ESMA has also stated that, in accordance with the stress testing requirements outlined above, stress test results should be made available, on request, to competent authorities.

Next Steps and transitional arrangements

Investment funds which have share classes that do not comply with the provisions of the ESMA Opinion will be required to take action. ESMA has provided for a transitional period for the implementation of the outcomes of the Opinion noting the potential impact that this may have on certain funds.

A fund may retain existing share classes that have been permitted by local regulators but which would fall foul of the ESMA Opinion, however such share classes must be closed to investment by new investors by 30 July 2017 and closed to additional investment by existing shareholders by 30 July 2018.

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