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ESMA issues common principles for UCITS share classes

The European Securities and Markets Authority (“ESMA”) published on 30 January 2017 an [opinion](#) on the use by EU UCITS funds of share classes, outlining four key principles that all UCITS funds must follow when setting up different share classes, and considering whether certain existing share class hedging techniques comply with such principles. The opinion particularly impacts share classes that use a derivative to hedge against a particular risk.

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The opinion is addressed to national regulators. It does not bind funds or national regulators, but it is expected that the FCA and other regulators will follow it, to the extent their existing practice diverges.

ESMA sets out the following high-level principles:

- **Common investment objective:** share classes of the same fund should have a common investment objective reflected by a common pool of assets. In ESMA’s view, hedging arrangements at share class level (with the important exception of currency risk hedging) are not compatible with this requirement.
- **Non-contagion:** UCITS managers should put in place appropriate procedures to minimise the risk that features specific to one share class could have an adverse impact on other share classes of the same fund.
- **Pre-determination:** the manager should determine all features of the share class before the fund is set up.
- **Transparency:** managers should clearly disclose to investors the differences between share classes of the same fund.

Common investment objective

In accordance with the principle that share classes of the same fund should not have different investment objectives, ESMA states that share classes identified by a derivative used to hedge against a particular risk could lead to that share class having a different risk profile and investment objective and are therefore incompatible with this principle. As a general rule, such share classes should be set up as separate funds or sub-funds.

Importantly, ESMA has concluded that currency risk hedging at share class level (which is extremely common with UCITS funds) is compatible with the principle of a common investment objective. UCITS that offer different types of derivative overlays within share classes to hedge risks (such as volatility risk) will not be permitted.

Non-contagion

Derivatives used at share class level are part of the common pool of fund assets, and thereby introduce counterparty and operational risk to all investors in the fund. In theory, an obligation associated with a derivative that is incurred by one class might need to be met by another class (contagion risk). ESMA states that any additional risk introduced to a fund by use of the currency hedge for a share class should be monitored and mitigated appropriately, so that it is only borne by investors in the relevant share class, and that any additional cost necessitated by additional risk management should be attributed to and borne by the relevant share class. To this end, ESMA sets out a number of operational principles:

- The notional of the derivative should not lead to a payment or delivery obligation with a value exceeding that of the share class. Therefore, the manager should assess the maximum potential amount of cash that can be paid to the counterparty (or collateral that can be posted to the counterparty) and ensure that it does not exceed the maximum pool of cash and eligible collateral available to the share class.
- The manager should put in place operational and accounting segregation that ensures that the values of assets and liabilities and profit and loss in the respective share classes are clearly identified on an ongoing basis, and, at the least, at the same valuation frequency of the fund.
- The manager should put in place stress tests to quantify the impact of losses on all share classes that are due to losses relating to assets specific to a share class that exceed the value of that share class.
- The manager should implement the derivative overlay according to a detailed, pre-defined and transparent hedging strategy.

Pre-determination

ESMA states that a manager should determine all features of a share class before it is set up, to give the investor a full overview of the share class's features, including specifying the currency risk that will be hedged in share classes with a currency hedge. ESMA confirms that this does not limit the manager's discretion as to the type of derivative instrument used to hedge currency risk, or how it is implemented operationally.

Transparency

ESMA lays down a number of principles to ensure a common level of investor disclosure, requiring funds to provide information about existing share classes in the prospectus and to make available to investors a current list of share classes with a contagion risk.

Transitional arrangement

ESMA has introduced a transitional arrangement, requiring share classes that do not meet the new conditions to be closed to investment from new investors within six months of the date of the opinion, and to be closed for additional investment for existing investors within 18 months. Managers will need to restructure such classes as new funds or sub-funds to keep them open for investment.





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