



ASSOGESTIONI

associazione del risparmio gestito

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ESMA – European Securities and Markets Authority
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Assogestioni Reply to ESMA Discussion Paper on UCITS share classes (ESMA/2016/570)

Assogestioni¹ welcomes the opportunity to respond to ESMA Discussion Paper on UCITS share classes (ESMA/2016/570).

In general, as already expressed in our reply to the former Discussion Paper, Assogestioni globally agrees and supports ESMA's intent to create common minimum standards for the set up and operation of share classes.

We appreciate and see merit in the approach adopted by ESMA in this Discussion Paper that, shifting from the 2014 list-oriented approach, now attempts to identify a principle-based framework for UCITS share classes in the EU.

Given our understanding of the “common investment objective”, we also appreciate that the different principles stemming from ESMA general guidelines also allow hedging arrangements different from FX contracts. Non-discretion, predetermination and transparency are principles that share classes aiming to reduce risks different from FX can still well comply with. We are therefore confident that duration, volatility and other factors may very well respect the proposed operational principles as long as the aim is to obtain a reduction of risk on a systematic and transparent basis.

Nevertheless, we believe that certain specifications are necessary to better frame the work in this regard. In particular, we refer to the notion of “hedging” linked to *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and*

¹ Assogestioni represents the interests of the Italian fund and asset management industry. Its members manage funds and discretionary mandates around EUR 1.854 (as of April 2016).



Counterparty Risk for UCITS (paragraph 21). Indeed, we recommend linking the definition of “hedging” to the general principles and risk mitigation objective of the CESR’s guidelines, rather than to the specific rules/discipline covering the hedging arrangements under its methodology.

Overall, we are of the view that any work on this subject should not have the unintended consequence to undermine both the benefits and the level of competitiveness that these arrangements give to the UCITS asset management industry, especially vis-à-vis non-EU competitors. In this sense, we urge ESMA to carefully consider any unjustified restriction on the principle of common investment objective for certain types of arrangements. As correctly pointed out by ESMA itself, the reasons driving the creation of share classes are also linked to brand capitalization and fund size, in addition to costs and time to market, and it is important that any regulatory policy decision in this sense does not hamper the benefit of economies of scales connected to their set up.

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

Assogestioni agrees with the description of share classes provided by ESMA. We share ESMA’s distinction between compartments and share classes based on the different discipline on segregation. We also agree with the stress put by ESMA on the customization of features and rights which share classes aim to achieve.

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

In line with our response to ESMA first Discussion Paper on UCITS share classes (ESMA/2014/1577), Assogestioni believes that the listed reasons in paragraph 12 for setting up share classes are comprehensive, well encompassing the different drivers that can lead asset managers to create share classes.

Q3: What is your view of the principle of “common investment objective”?

We agree with ESMA’s approach to consider the “common investment objective” as investment in one common pool of assets. Indeed, the investment choices at the level of fund/compartment, which determine the investment objective, are realized by the asset managers in a way that is independent from the hedging choices at the level of the share class. The portfolio composition, common to all share classes, is realized based on a predefined investment policy.

Differently from ESMA, however, we believe that derivatives overlays do not undermine the compliance of share classes using such overlays with the principle of “common investment objective”, as long as certain requirements are met.

Along the same line, we do not share the reported approach by some respondents in paragraph 19, stating that a common investment objective requires a common risk profile. A common risk profile should not be considered as a criterion to identify the common investment objective. A derivative overlay only proposes more choice to investors to find adapted solutions to their own risk profile, risk tolerance, investment horizon and is not intended to alter the investment objective of the



common asset pool. Hedging realized through different techniques allows reducing the risk of the pool of assets, a risk that is available in the fund's documents and well captured by the SRRI. While currency risk hedging is considered compatible with the principle of common investment objective, we do not see any reason to treat risk hedging other than currency hedging differently.

In addition, the reference in paragraph 21 to the notion of "hedging" linked to the *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* is not clear. We advise ESMA to only refer to the general principles underlying the CESR's methodology foreseen for the commitment approach. These principles could be as follows:

- (a) the Investment strategies should not aim to generate a return;
- (b) there should be a verifiable reduction of risk;
- (c) risk mitigation strategies should be efficient in stressed market conditions.

Such a change would indeed allow an appropriate application of the rules to all investment funds and not circumscribe it only to those that use the commitment approach. In addition, it would also avoid doubts on the possibility to implement total hedging techniques (i.e. pure replication currency hedging when it is used to hedge the fund base currency to the currency of the class without hedging the underlying portfolio currencies) and partial hedging, including that on specific financial instruments. We are also of the view that the over-hedging arrangements, as per paragraph 29(b), are also compatible with such principles. The same considerations go for duration-hedged share classes and those hedging other risk factors.

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

In line with our reply to Q3, we are of the view that there are multiple hedging techniques aiming to obtain risk reduction that are compatible with the principle of common investment objective. In addition to currency risk hedging, other types of hedging should also be considered, such as duration hedging and volatility hedging.

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

We share the view that additional risk introduced through the application of a derivative overlay at the level of a share class should be mitigated and monitored so not to create spill-overs affecting those investors that did not choose to subscribe share classes with a specific derivative overlay. In order to achieve this purpose, exposures are duly collateralized and managed and the hedge is periodically readjusted to factor in changes in the risk factors. Also, the costs of such overlays are correctly borne only by those investors choosing the overlay.



Q6: Are you aware of any material evidence of investors in one share class suffering losses as a result of the crystallization of risk in another share class?

Assogestioni is not aware of any such evidence.

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)

As there is no evidence on losses, even in case potential risk contagion can *theoretically* occur, ESMA should not discriminate among share classes purely on this basis, as the risk of contagion is intrinsic to every type of factor hedging strategy, including currency hedging.

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

We generally agree with the operational and organizational principles established in paragraphs 28 and 29. However, we would like to emphasize the following aspects, which we think should be adjusted:

- paragraph 28(a): we ask to clarify what is meant by “notional” of the derivative and to specify how this provision should be coordinated with the following 29(b) on over-hedging.
- paragraph 28(c): we believe that the available controls and risk monitoring procedures, as required by the UCITS directive, are sufficient. In case they are nevertheless required, we advise ESMA to clarify what types of stress tests should be implemented, especially whether additional stress tests are needed on top of those already performed.
- paragraph 28(d): we believe that this provision should be emended to consider “**potential investor**”, as any *ex ante* evidence can only be carried out considering possible future investors.
- paragraph 28(e): it is important to clarify that transparency should be implemented on the hedging strategy, but not on the specific techniques and derivative instruments used to implement it. For example, the level of the risk reduction should be specified in the fund documents.
- paragraph 29(a): in line with the UCITS directive, we believe that the exposure should be measured in respect to the net asset value of the portfolio, not of the share class;
- paragraph 29(b) and (c): share classes can implement total or partial risk reduction and we understand that partial hedging is rightly allowed, as described in the fund’s documents.
- paragraph 29(e): we deem such a provision useful to cope with possible passive breaches of the thresholds. However, we suggest replacing the term “reset” with the term “**rebalance**”, as reset implies a total unwinding of the positions.



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

N/A.

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

As per our reply to Q8, we believe that the already available control, such as implementation of operational segregation, monitor of hedging and collateralization, are already sufficient to monitor the risk. In case stress tests will nevertheless be required, we advise ESMA to be more specific on the types of the stress tests to perform, in particular whether there should be any need for additional stress tests on top of those already performed by asset management companies.

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.

The operational principles in paragraph 28 and 29 (considering the adjustments illustrated in our reply to Q8) are compatible with other types of hedging strategies not linked to FX contracts, such as duration and volatility. In this sense, we do not agree with paragraph 30(b): we believe that also such other types of share classes should and can be compatible with the principle of having a detailed, pre-defined and transparent hedging strategy. In our understanding, ESMA itself seems to consider other hedging arrangements compatible with the principles established. If not, we do not understand the purpose of the whole exercise, which would strictly confine the applicability of the principles to currency hedging only.

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?

No, we do not think that additional operational principles are necessary to address non-contagion. Please also refer to our reply to Q8 and Q9.

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

N/A.

Q14: What is your view on the principle of “predetermination”?

We agree with ESMA’s consideration that the principle of “predetermination” should apply to rights and/or features attributed to the investment, as well as to the risks which are to be hedged *systematically*. In this sense, we share ESMA’s policy choice



to put attention on the “systematic character” of the use of derivative, not allowing asset managers to discretionally choose the type of risk to be hedged time to time.

However, it is important to stress that this does not equal to exclude a certain level of discretion when it comes, for example, to operationally implement the hedging arrangement (i.e. use of more liquid futures or OTC forward contract or swaps, and choice of their terms). For this reason, we do not agree with the statement in paragraph 34 of the Discussion paper that does not recognize any level of discretion to asset managers.

In addition, we do not agree with the last sentence of paragraph 33. According to this statement, it seems that, unless share classes are set up at the very moment the fund is launched, it will not be possible to offer any other share classes at a later stage. As described in our reply to Q5, the risk of non-contagion may not be completely eliminated, even if share classes have operational segregation, as it is not possible to legally segregate liability. In addition, such provision would unduly restrict the possibility to set up time to time new share classes to meet specific investors’ need. We therefore recommend ESMA to remove such sentence.

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

No, we see no need for additional provisions.

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

As mentioned in our reply to the first Discussion paper, we believe that an adequate level of information is already available to investors. In particular, we refer to what foreseen both in UCITS L1 and L2 measures: art. 78(7)(b)(ii) of the UCITS Directive and art. 25 of Regulation no. 583/2010 provide appropriate level of disclosure for investors to allow them understand the main characteristics of the different share classes, together with their risk, return profile and related costs.

We believe that the requirement foreseen in paragraph 36(b) (*“in regard to share classes with a contagion risk, the management company should provide a list of share classes in the form of readily available information which should be kept current”*) should be dropped. We do not see the reason for such a disclosure, given the fact that not only sufficient information is already contained in relevant investor documentation (prospectus and annual reports) but also that such a risk is already monitored through the procedural and operational requirements set in previous paragraphs. Moreover, in case there is more than one hedged share class, there would be no sense in providing such a list, as all the existing share classes would be deemed at risk of contagion.

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

Please, refer to our previous answer.



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

We believe the indications prescribed in paragraph 36 of the Discussion paper are not necessary, given the bulk of reporting requirements and documentation already provided by asset managers to investors according to the UCITS discipline. Please also refer to our reply to Q16.

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

No, we do not see merit in further disclosure vis-à-vis investors. As indicated before, UCITS requirements already provide a wealth of information to investors via the existing requirements.

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?

We see a significant impact on the EU fund market in case ESMA maintains its position on certain types of hedged classes. If considered not compatible with its guidelines/standards, these hedging would indeed need to be performed via different ways, e.g. the offer of a stand-alone product, and sometimes much more operationally complex, as in case of master-feeder. This switch to different products would cause significantly high costs and determine higher time-to-market. It will also outweigh the benefit of economies of scale of larger UCITS funds, which is at odds with the objective of the CMU, aiming at increasing the role and contributions of both the asset management industry as a whole and these important investment vehicles to the EU economy.

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?

Transitional provisions would be appropriate in case certain types of hedging will still not be deemed compatible with future principles.

THE DIRECTOR GENERAL