Date 27 March 2015

RE: Discussion Paper on Share Classes of UCITS (ESMA/2014/1577) (the "Paper")
        Your input – Consultations

We refer to the Paper and the invitation to receive feedback responses.

The IFIA and the Irish UCITS industry

The Irish Funds Industry Association (IFIA) is the representative body for the international investment fund community in Ireland. Founded in 1991, the IFIA represents custodian banks, administrators, investment managers, transfer agents, fund promoters and professional advisory firms involved in the international fund services industry in Ireland.

Ireland has been a leading cross-border domicile for UCITS since their introduction in the late 1980s. As at December 2014, Irish UCITS represented approximately €1.27 trillion in assets, across 3,561 funds.

Our response

The IFIA read the Paper with interest and has considered it in detail. We wish to participate in the feedback process and set out below are our responses to the questions raised in the Paper. Given the volume and number of UCITS funds authorised and regulated by the Central Bank of Ireland and serviced by industry companies, we believe we have significant experience to bring to this discussion and ask ESMA to give appropriate consideration to our response.

We do not object to this response being publicly disclosed.

Introductory Remarks

There are two key points, expressed in more detail in our responses below, that we wish to focus on at the outset.

1. Principles underpinning separate share classes

We consider there are two fundamental principles that underpin the model of separate share classes within a UCITS, as follows:

(i) the UCITS must still represent a collective investment in a single pool of assets (consistent with the sole object of UCITS as outlined in Article 2(1) of the UCITS IV Directive (2009/65/EC));
(ii) investors in one class shall not be prejudiced vis-à-vis investors in another class.

It distorts this analysis to also propose a principle that share classes of the same UCITS should have the same “investment strategy”. UCITS legislation makes no reference to a principle of "a unique investment strategy" (as mentioned in the Paper).
2. Customisation at share class level promotes the concept of collective investment - to investors' benefit

In its Impact Assessment Paper accompanying UCITS IV\(^1\), the European Commission highlighted four key problem areas it sought to address with the measures introduced under UCITS IV. One of these areas was the "proliferation of funds of a sub-optimal size". It was thus recognised that economies of scale that come with collective investment reduce costs for investors and therefore bring empirical benefits for investors in UCITS.

Any proposals from ESMA that restrict the scope for share class customisations will inevitably result in a proliferation of funds of a sub-optimal size – in conflict with a key European Commission objective for UCITS – and should therefore be considered carefully, perhaps with the European Commission's input.

We respond below to the questions presented in the Paper. For ease of reference, we have included the questions and addressed each in turn.

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

As noted in the Paper, share classes are categories of interest in a UCITS that allow subsets of investors to achieve some specific customisation aspects to their investment.

Share class customisation in UCITS can cover a range of elements. Some examples are as follows: varying dividend models; different investor focus; different minimum holding amounts; differences in terms of where they are listed and/or registered for sale; range of denominated currencies and variation of exposure to such currencies; varying fee levels; variation of exposure to interest rates; variation of level of participation in the performance of the fund; variation in levels of capital protection.

Having these customisations at share class level enables UCITS to offer these specifications at a lower cost than may otherwise be possible and therefore increase investor choice and meet investor demand. Low costs are critically important to preserve and/or grow investments. The cost of creating new funds for such specifications is extremely prohibitive relative to the level of assets they can generate in most cases.

UCITS which genuinely aspire to raise capital from multiple investors – particularly on a cross-border basis - will inevitably require the capacity to offer share class customisations. Share classes are therefore a fundamental aspect of constructing a successful cross-border collective investment scheme and should be protected and supported in UCITS.

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

In addition to the key reason of cost efficiency (see response 3 below), there are a range of additional operational challenges to manage when considering running multiple funds with a single common strategy rather than managing the assets within a single pool – some examples are as follows: order allocation issues and other potential conflicts of interest; restricting access to investment opportunities; reduction in scale and volume opportunities; higher trading costs of running multiple trade books. These are strong reasons for collective investing generally. Preventing share class customisation essentially undermines the concept of collective investing and undermines the efficiencies and controls such collective investing brings.

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

The feedback we have received is that establishing a new class can cost between 10% and 20% of the cost of establishing a new sub-fund. Some further sample detail is set out below for illustration purposes.

There are necessarily incremental costs associated with servicing multiple classes. However these are approximately 10-20% of the cost of running an additional sub-fund for every specification (based on very

basic estimates). The example below assumes 10 customised variations, so compares: (i) 10 sub-funds with no class customisation; and (ii) one sub-fund with 10 customised classes.

In the example, for (i): ongoing fees and expenses are estimated at €100k per sub fund. For (ii): it will be €100k + €20k per class = €300k. This amounts to three times the costs (with ten times the asset levels). This represents a saving of approximately 70% utilising the multi-class option versus the multi-fund option - or 7 basis points.

Example case:

<table>
<thead>
<tr>
<th>Number of sub funds/number of share classes</th>
<th>Assets with relevant customisation</th>
<th>Assets in aggregate at sub-fund level*</th>
<th>Ongoing fees and expenses (excluding management fees) as percentage of sub-fund NAV (including amortised portion of establishment expenses)</th>
<th>Cost per €1000 investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) multi-fund option (sub-fund for each customisation)</td>
<td>€10,000,000</td>
<td>€10,000,000</td>
<td>1.00%</td>
<td>10</td>
</tr>
<tr>
<td>(ii) multi-class option (share class for each customisation)</td>
<td>€10,000,000</td>
<td>€100,000,000</td>
<td>0.3%</td>
<td>3</td>
</tr>
</tbody>
</table>

*Assumes 10 different customisations

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

See examples outlined in response 1 above.

5. How would you define a share class?

We note the objective of the Paper is to develop a common understanding of what constitutes a share class. We consider there already is a common understanding of what constitutes a share class. Firstly, as acknowledged in the Paper, we note that share classes are categories of interest in a UCITS that allow subsets of investors to achieve some specific customisation aspects to their investment. Further, we consider there are two fundamental principles that underpin this model of separate share classes within a UCITS, as follows:

(i) the UCITS must still represent a collective investment in a single pool of assets (consistent with the sole object of UCITS as outlined in Article 2(1) of the UCITS IV Directive (2009/65/EC);

(ii) investors in one class shall not be prejudiced vis-à-vis investors in another 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.

In the absence of a more precise definition of this concept we feel it is overly simplistic to propose all share classes share the same investment strategy. We would be concerned that such a simplistic statement could suggest that a level of customisation that would allow for different investment outcomes while maintaining the same investment objective could be construed as a different investment strategy, we do not believe this should be the case. Once it is acknowledged that a fundamental principle is that there shall be a single pool of assets, it distorts the analysis to also propose a principle that share classes of the same UCITS should have the same investment strategy. We do not agree that UCITS legislation advocates a principle of “a unique investment strategy” (as mentioned in the Paper). Rather, it is more appropriate to consider whether the specific customisation aspects of a share class undermine the principle of collective investment in a single pool of assets or could prejudice the interests of investors in another share class.

It is accepted that different levels of fees can be applied to different share classes. The impact of this is that investors receive different levels of investment returns while ultimately being exposed to the same underlying pool of assets.
The same analysis applies if it is accepted that different dividend models may be applied (as distributing share classes mean an investor’s total investment is reduced thereby giving a different overall investment return to an accumulating share class).

Further, if it is accepted that different share classes can be denominated in different currencies, then the impact will be that investors receive exposure to different commercial and operational risks while ultimately being exposed to the same underlying pool of assets (irrespective of whether or not there is currency hedging).

In each of these examples, the share class elements will necessarily involve a customisation that is applied to the class, effectively as an overlay technique. This should be permitted, provided that any such technique does not undermine the two fundamental principles, namely that (i) the UCITS represents collective investment in a single pool of assets; and (ii) the investors in one class are not prejudiced vis-à-vis investors in another class.

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

In the example of share class hedging, there will not be any legal segregation of assets between classes within a UCITS. Accordingly, in an Irish context, a number of controls are applied in compliance with the regulatory conditions of the Central Bank of Ireland, as outlined in Guidance Note 3/99 (Share Classes – Hedging Against Exchange Rate Movements)\(^2\). For examples, the extent to which a hedging arrangement may lead to an over-exposure must be kept under review and not permitted to exceed specified threshold levels. The transactions must be clearly attributable to the class. Gains/losses of the hedging transactions (as well as the costs thereof) will accrue solely to the relevant class.

The hedges are created by using highly liquid, low-cost derivatives (typically futures) available on exchange or over-the-counter (OTC). Generally with OTC transactions, the hedges put in place are non-recourse so that the assets of any other classes are protected.

The parameters of what is permitted for Irish UCITS in terms of share class customisations are clearly set out in policy papers/guidance notes issued by the Central Bank of Ireland. There are detailed and considered conditions that must be adhered to depending on the types of characteristics being used. In addition to Guidance Note 3/99 mentioned above, we refer you also to Policy Update 1/2010 (Multiple share classes within a single collective investment scheme)\(^3\). Each of these papers is publicly available on the website of the Central Bank of Ireland (as referenced in the footnotes below).

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.

As stated in response 6 above, we do not agree that UCITS legislation advocates a principle of “a unique investment strategy” (as mentioned in the Paper). Rather, it is more appropriate to consider whether the specific customisation aspects of a share class undermine the principle of collective investment in a single pool of assets.

The Paper states that currency hedging arrangements at share class level “are intended to ensure that investors receive as nearly as possible the same results of the investment strategy, even though their exposure is obtained through a different currency”. As a point of clarification, currency hedging (in its most simple form) is intended to give the investor exposure based on the return of the single pool of assets, but with the elimination of any foreign exchange rate fluctuations that would otherwise be factored into the investment due to the investment being made in a currency other than the currency of denomination of the fund. There are two share class customisation elements here. The first is that the class is denominated in a class other than the currency of denomination of the fund. The second is that the fund engages in an investment technique for the class to screen out the currency risk that the investment would otherwise be

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subject to. While the net effect is to try to give the investor a return corresponding with that of investors in classes denominated in the currency of denomination of the fund, the actual mechanics of this transaction are such that currency risk has been isolated and extracted. (This assumes the hedge is successful but, of course, perfect hedging is not an exact science.)

We consider that currency hedging arrangements at share class level, applied in accordance with the regulatory conditions of the Central Bank of Ireland, (i) do not undermine the principle that UCITS must represent a collective investment in a single pool of assets; and (ii) do not result in investors in one class being potentially prejudiced vis-à-vis investors in another class.

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.

It is accepted that you can screen out currency risk that arises at class level. It is therefore logical that you should be able to screen out some aspects of currency risk rather than all (particularly as full hedging is not an exact science anyway). This would justify partially hedged classes or classes screening out particular currency exposures only.

Further, as it is accepted that you can screen out currency risk, it is therefore also logical that you should be able to screen out some other objective aspects of risk from the market exposure of the assets in the common investment pool – for example, interest rate risk or volatility risk. Based on objective analysis, each takes an identifiable aspect of risk that can be isolated and extracted from the market exposure of the assets in the common investment pool. Each gives investors in the class exposure to different commercial and operational elements (with necessary controls being applied) while ultimately being exposed to the same underlying pool of assets.

It would be arbitrary to "draw a line" and permit certain share class customisation techniques and prohibit others when they all comply with the two fundamental principles namely that (i) the UCITS represents collective investment in a single pool of assets; and (ii) the investors in one class are not prejudiced vis-à-vis investors in another class.

If there is a case to draw such a line, this would presumably be on the grounds of public policy rather than based on interpretation of legal principles contained in UCITS legislation. This would only be within the remit of the European Commission on the basis of future primary legislation on the matter. This is particularly the case given the absence of express references to applicable share class rules in the UCITS Directive for ESMA to consider and provide interpretation or guidance on.

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.

As discussed in response 9 above, we consider that any share class customisation technique that does not undermine the principle of collective investment in a single pool of assets and does not result in investors in one class being potentially prejudiced vis-à-vis investors in another class should be permissible. As discussed in response 9 above, this could include some of the techniques set out in paragraph 10 of the Paper.

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.

We are not in a position to comment on this question.

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)?

To the extent UCITS utilise over-the-counter derivatives at share class level, we agree that specifically considered rules in relation to how counterparty exposure limits apply at share class level would be helpful.
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?

We consider the current requirements that apply to Irish authorised UCITS are appropriate. These requirements include that details of share classes may be contained in supplements to the prospectus but not in a separate prospectus. Investors will always be aware of the presence of other classes and are entitled to request additional details (i.e. to receive any separate class supplements other than those relating to their own class). In addition, based on Central Bank of Ireland requirements, conditions are required to be put in place to ensure that the presence of another share class does not potentially result in their interests being prejudiced. Therefore, we would not deem full transparency across classes to be necessary and an obligation to advise of all the characteristics of other classes or analyse various classes to identify differences and explain these to investors would be inappropriate.

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

As mentioned in response 7 above, the parameters of what is permitted for Irish authorised UCITS in terms of share class customisations is clearly set out in policy papers/guidance notes issued by the Central Bank of Ireland. Therefore, in an Irish context, appropriate published rules already exist on share class customisation. These rules are very much directed at protecting the overriding principle of a single pool of assets and aimed at shareholder protection between such share classes.

It would be helpful if ESMA could indicate the precise benefits it envisages arising from this consultation. To the extent there is a disparity in practices in this area across EU member states, this would not in itself appear to merit a review. This is not a case where primary legislation is being interpreted in a number of ways so as to require central guidance or regulatory recommendations. Also, it is not clear what policy position or principle this initiative seeks to protect. It would be helpful to understand what prompted this review, whether concerns have been raised by investors or whether instances occurred where investors have been impacted negatively by existing share class practices. We are not aware of any such issues.

Separately, an adverse outcome to this consultation could result in certain types of share class (i.e. those not considered acceptable to ESMA) having to be reorganised as separate sub-funds. This means additional costs and expense for funds (as considered in response 3 above). These costs are ultimately carried by investors. Another possible outcome (and indeed a more likely one) is a reduction in the product choices available to investors in UCITS.

These outcomes are detrimental to the interests of investors in UCITS both existing and in the future. At present, we perceive no counterbalance in terms of these outcomes being offset by a legal or regulatory issue/concern being rectified.

The Paper refers to taking into account the possible impact of its final position on current market practices. This is a critical point. UCITS currently operating with share classes in compliance with published regulatory guidance could potentially find their characteristics beyond the scope of what ESMA considers, in its opinion, to be acceptable. These may be particular share class characteristics that are fundamental to investors. If they were no longer permitted, this could potentially result in many UCITS having to close and return monies to investors, thus crystallising gains or losses for investors who may not wish to have this situation imposed upon them e.g. from a tax perspective. It is difficult to quantify this potential impact, but there would certainly be billions of Euro in UCITS assets in funds that have share class specifications that, if removed, would fundamentally change the investment proposition.

The Paper refers to a next step of establishing a common position on the use of share classes by UCITS. Noting our concerns above, please indicate whether this will this take the form of a set of guidelines or recommendations (pursuant to Article 16 of Regulation 1095/2010) that are subject in advance to open public consultation and a request for advice from the Securities and Markets Stakeholder Group. We would submit that ESMA should consider in particular our comments in response 9 above whereby it may be more appropriate to refer any unresolved concerns that ESMA may have to the European Commission to consider at a legislative level.

Irish Funds Industry Association