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Online to: www.esma.europa.eu

Dear Sirs,

Discussion Paper on the Share Classes of UCITS (ESMA/2014/1577)

The Investment Association represents the UK asset management industry. Our members manage over £5 trillion in the UK of assets on behalf of UK, European and international clients, both retail and institutional. Our aim is to make investment better for clients so they achieve their financial goals, better for companies so they can get the capital they need to grow, and better for the economy so that everyone prospers.

We support ESMA in developing a common position for share classes of UCITS. UCITS is the EU's flagship investment product for retail investors.

As ESMA recognises, the UCITS Directive does not prescribe what is and is not allowed at share class level. Given that there is no such prescription and given the benefits of pooling, it is in the interests of investors to provide as much flexibility as possible as regards the ability to create share classes within a single UCITS subject to robust management of any residual risks and appropriate disclosure.

As ESMA notes, the driver for creating different share classes is to allow subsets of investors in a UCITS to achieve a level of customisation which accommodates their specific needs in a way which is cost effective for investors. Share classes are significantly more cost effective than sub funds.

We therefore support a principles-based approach to UCITS share classes, with those principles recognising both the importance of robust risk management and appropriate disclosure.

It is equally important that the same range of share classes should be available to investors throughout the EU regardless of the domicile of the UCITS; investors have a legitimate right to expect to be able to access to the same range of share classes in a European product.

The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

Given too that the UCITS of any European domicile can be freely sold throughout the European Union, if any national regulator is unduly restrictive of locally domiciled UCITS, which will hamper the ability of that Member State's UCITS to meet investor needs.

We attach our answers to the questions asked in the Discussion paper. If you require any further information, please do not hesitate to contact me at karen.bowie@theinvestmentassociation.org or on +44 207 269 4680.

Yours faithfully,

Karen Bowie

Senior Adviser – Product Regulation

ESMA Discussion Paper - Share classes of UCITS

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

The driver for creating different share classes is, as noted by ESMA in its Discussion Paper, to allow subsets of investors in a UCITS to achieve a level of customisation which accommodates their specific needs in a way which is cost effective for investors. Our answer to question 3 identifies the cost savings.

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

As mentioned in response to Question 1, the creation of share classes permits a level of customisation in a way which is cost efficient for investors and avoids the situation of having a plethora of small UCITS each having the same underlying portfolio of investments and investment strategy but of interest only to a particular set of investors.

As was noted in the Commission's White Paper on enhancing the single market framework for investment funds, there is a proliferation of small funds and the larger a pool of assets, the more likely is the opportunity to achieve economies of scale. Such economies can in turn lead to a reduction in charges or better performance for the investor as a result of scale savings. Whilst the focus of that White Paper (and in turn the updating of the Directive to UCITS IV) was on other methods of achieving larger pools – master-feeder arrangements and merging funds- the ability to create share classes within a single UCITS fund also delivers such an outcome- the pooling of assets of investors who all desire the same underlying portfolio of investments but with a degree of customisation.

By way of example of customisation, there might be an underlying portfolio which invests in European securities where there are the following subsets of investors (or any combination of these):-

- those who want income paid out
- those who want income accumulated
- those who want gross or net interest distributions
- those who pay different charges
- those who want different currencies
- those who want to hedge currency risk
- those who want to hedge interest rate risk

If a UCITS needed to be set up to meet the customised requirements of each group of investor, economies of scale would be lost. There would be a replication of funds with similar underlying portfolios. If, in the above example, seven individual UCITS had to be set up instead of one, economies of scale are lost to the detriment of all investors.

The ability to have share classes means that each subset of investors has an interest in the same underlying pool of assets but has outcomes tailored to the needs of that subset.

As ESMA rightly notes, the UCITS Directive does not prescribe what is and is not allowed at share class level. Given that there is no such prescription and given the benefits of pooling, it is in the interests of investors to provide as much flexibility as possible as regards the ability to create share classes within a single UCITS subject to robust management of any residual risks and appropriate disclosure.

Further details on the benefits of launching a new share class for an existing fund rather than a new fund:

- Lower costs to investors.
- The lower set-up and running costs of setting up a new share class for an existing fund compared to setting up and running a new fund.
- Time to market.
- Less operational complexity.
- Lower transaction costs in respect of underlying securities, i.e. there would be no need for a fund to sell the underlying assets if an investor opted to switch into the new share class.
- Viability – a new share class of an existing fund would require significantly less investment to be viable than a new fund.
- Seed capital requirements – this would be significantly lower for a new share class of an existing fund than a new fund.
- KIID production – although a separate KIID would normally be required for the new share class, KIIDs for share classes within the same fund would generally share the same wording.
- Generally, share classes can be legally established within the instrument of the fund so they are ready to launch without further regulatory approval.[1]
- Cost of global distribution is higher for a new fund than a new share class of an existing fund.
- Increase in demand by international investors for share classes which hedge local currency risks.
- Increase in demand by international investors for share classes which hedge interest rate risk.
- Availability of performance record from existing share classes, whereas a new performance record would have to be established for a new fund.

It is also worth drawing out the specific benefits of having an interest rate hedging share class as opposed to setting up a new fund from a liquidity management perspective - as it brings tangible benefits to investors and the market. As a typical bond fund is susceptible to high levels of redemptions in rising interest rate environments, the availability of an interest rate hedging share class can be a powerful tool in helping to mitigate the potentially detrimental impact on the fund and its investors of significant outflows. A switch between share classes is

[1] In the UK, for hedged share classes, this is the case only when adding a new hedged share class to a fund where hedged share classes already exist (and potentially where the hedging method is not new).

a more cost effective option for investors than switching funds. If investors had to sell out of one fund with a long duration and into another fund with a short duration, with the consequent need for one fund to sell assets and another one to buy assets, the investors suffer those underlying selling and buying costs[2]. Costs which would not be incurred if the investor could move within share classes within the same fund. The ability to offer share classes with different duration levels would mean that the impact of changes in interest rates on the value of an investor's capital would be limited and the scale of outflows from bond funds in general correspondingly reduced. Reducing the scale of bond fund outflows minimises the impact on the wider market of investor activity in a rising interest rate environment.

Finally, interest rate-hedged share classes attract investment to UCITS (and Europe) from outside the EEA.

The ability to hedge currency and interest rate risk (and potentially hedging systematically other market risks) at share class level provides investors a way of meeting their needs at a lower cost than would be the case if a new fund were set up to meet those needs. Indeed, there may also be less choice available to investors as, with the loss of economies of scale that being a part of a large fund brings to investors, it may not be possible to offer a hedged fund that is cost effective for investors. One manager estimated that on a €16m fund, a new share class would add approximately 2bps of expenses to the OCF, whilst creating a new sub fund would add an additional 27bps to the OCF. At that level, the latter would not be economically viable and so would be unlikely to be offered as it would not be a cost effective method of achieving the investors' desired outcome. One of the key advantages of share class hedging is that it can be provided at a much lower level of AUM compared to a sub fund. As a rule of thumb, the manager estimated that a sub fund needs to be around €160m to be viable, but as a share class it can be viable at €8m.

In short, allowing the hedging at share class level increases investor choice and disallowing it reduces investor choice.

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

It is difficult to quantify costs precisely but the creation of new sub funds rather than new share classes costs investors more. This can vary according to business model, service providers, and size of fund/share class.

We have received rough estimates from a number of managers. Different aspects have been focused upon but in the interests of providing ESMA with a range of views, considerations and estimates, we provide the input we have received in the Annex.

For the purposes of providing a high level estimate, however, we understand that launching a sub fund can be at least two to six times that of launching a share class and the difference in ongoing costs of supporting a sub fund as opposed to a share class can be as much as ten to fourteen times higher.

[2] By way of example, one manager has advised that its average transaction costs for large subscriptions or redemptions in its global bond and credit funds are 30bps, ie. For a subscription in a new short duration fund, and a redemption from a long duration fund, the aggregate would be 60bps. 60bps is clearly a huge cost for these types of funds.

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

The UK permits the following:

accumulation and income paying share classes,

classes with different charges and expenses,

classes with different currencies,

hedged currency classes.

In addition, Net and Gross interest distributions are also common.

In the UK, the rules governing the type of share classes of UK Authorised Funds (which includes UCITS) are set out in Section 3.3 of the FCA's Collective Investment Schemes Handbook. This requires that an Authorised Fund cannot provide for a class of share in respect of which:

(a) the extent of the rights to participate in the capital property, income property or distribution account would be determined differently from the extent of the corresponding rights for any other class of shares; or

(b) payments or accumulation of income or capital would differ from those of any other class of shares.

If any class of shares in an Authorised Fund has different rights from another class of share in that fund, the Instrument constituting the scheme must provide how the proportion of value of the scheme property and the proportion of income available for allocation attributable to each such class must be calculated.

By way of guidance, the FCA indicates that in considering proposals for new share classes it takes into account three principles as listed below:-

(a) a share class should not provide any advantage for that class if that would result in prejudice to shareholders of any other class;
(b) the nature, operation and effect of the new share class should be capable of being explained clearly to prospective investors in the prospectus; and
(c) the effect of the new share class should not appear to be contrary to the purpose of any part of the sourcebook.

5. How would you define a share class?

Broadly, as a type of share which provides a level of customisation which accommodates the needs of investors holding that type of share whilst sharing the same underlying pool of assets as other share classes in the UCITS. We welcome ESMA's recognition of the ability to offer investors share classes that provide currency hedging. Currency risk hedging at share class level has long been possible in a number of jurisdictions and was only fairly recently introduced in the UK (in 2007). To safeguard interests of investors in unhedged share classes, the FSA took a two pronged approach; namely, it had regard to the responsibilities of

management companies to operate effective systems and controls and to explain product risks clearly to investors. It noted *"The fact that such arrangements are operated effectively in other jurisdictions, indicates that the risks can be managed effectively in that way"*. We believe that any principles need to make reference to having in place effective risk management systems and controls to mitigate risk, however small, to other investors.

Specific comments on the three bullets listed in paragraph 6:

Bullet 1 – We agree that share classes should have the same investment strategy. For further views on how this sits with the hedging of market risks at share class level, please see response to Question 6.

Bullet 2 – We disagree with this statement as it would prohibit hedging at share class level because it requires that a class 'should not have **a potential (or actual) adverse impact** on other share classes..'. This is reiterated in paragraph 9 which states that 'currency hedging should **only be possible if it cannot have an adverse impact** on the share-holders of the other share classes…'

As ESMA recognises, there is no legal segregation of assets between share classes. Therefore, as a matter of fact, there will always be the potential (however unlikely it is to happen) for an adverse impact on other share classes. Unless amended, the draft principle would therefore have the practical effect of prohibiting hedging at share class level since it is expressed in absolute terms. Such a prohibition would result in detriment to investors in the hedged and in other share classes of the UCITS as economies of scale would be lost as would the ability of the industry to meet investor demand given the time and costs of establishing new and largely undifferentiated funds for this purpose.

The fact that there is no legal segregation at share class level has always been recognised and gives rise to the need to manage risk appropriately and in the interests of all investors in a UCITS.

As mentioned above, in the UK, the ability to hedge currency risk is relatively new compared to other jurisdictions. In its 2006 consultation paper (FSA CP 06/22), the UK Financial Services Authority explicitly recognised this potential risk and took it into account in laying down its rules.

"For class-specific hedging to be permitted, firms would have to provide an appropriate level of protection for all unitholders, and address the risk that the rights conferred by the hedged class might cause prejudice to holders of other classes of units in the same fund." (section 6.9).

Recognising this risk, the FSA proposed reliance on the existing safeguards within the regulatory regime; namely, the management company's systems and controls, the independent oversight provided by the depositary, and adequate disclosure.

The changes to the FSA rulebook, introducing the ability to hedge currency classes contains detailed guidance setting out the regulator's expectations at COLL 3.3.5B. This explicitly recognises the fact that there may be a potential adverse impact in that it requires that an AFM (authorised fund manager) should:

"ensure that the relevant prospectus clearly:
(i) states that such a transaction may be undertaken for the relevant class of units[4]*; and*
(ii) explains the nature of the risks that such a transaction may pose to investors in all classes;"

It also requires that the management company consult with the depositary and the auditor on a number of matters (adequacy of systems and controls, treatment of transactions in the scheme's accounts and how any consequential tax liability will be met).

Recognising that there is a risk to which hedged share classes gives rise and the need for that risk to be mitigated, we recommend that there should be a principle which revolves around the need for the management company to have robust systems and controls, and for the depositary to be satisfied as to the adequacy of those systems and controls.

Bullet 3 – The information on share classes disclosed to investors should be proportionate and relevant to their investment requirements. We agree that, where an investor enquires or invests in a UCITS with more than one share class, the fact that other share classes exist for the same UCITS should be disclosed to investors, who should also be advised where they can obtain more information on other share classes in the UCITS. This is, as we note in our response to Question 13, already a requirement of the existing Key Investor Information Regulation (KII Regulation). Information on all available share classes of the UCITS and the differences between these share classes will be disclosed in the prospectus, and also in many cases a webpage or other literature produced by the management company, such as factsheets, which should be readily available to investors on request. This information should clearly explain the characteristics of each share class, how these are distinguished from other share classes and any restrictions on certain groups of investors accessing a share class.

However, as share classes are customised to meet the needs of particular investor groups, for most investors many of the other share classes available are likely to be irrelevant. Disclosing all available share classes of a UCITS and the differences between these to all investors is not likely to be useful for the majority of investors and could cause confusion. For example, where a fund offers a share class with a lower annual management charge in return for a higher initial investment requirement, routinely providing details of this share class to investors who cannot meet the higher initial investment requirement could confuse those investors into thinking that a cheaper share class is available to them when in practice this is not the case.

As mentioned, these disclosure requirements are already covered by the existing KII Regulation. Given these current disclosure requirements which are directly applicable, we query the need to have a specific principle on disclosure. If there were to be one, we believe it should clarify that the key characteristics of the share class chosen by the investor should be clearly disclosed to the investor, that the existence of other share classes in the UCITS should be disclosed to the investor, and that information on the other share classes of the UCITS and the differences between share classes should be made available to investors on their request.

6. Do you agree that share classes of the same UCITS should all share the same investment strategy? If not, please justify your position.

Yes. We do not consider that hedging specific risks at share class level prevents there being a common investment strategy.

One of the most common examples of this, at share class level, is the ability to hedge currency risk.

The discussion paper seeks to draw a distinction between hedging for currency risk and hedging for interest rate risk (Paragraphs 9 and 11). The distinction is a very fine one and we question the rationale for treating these examples of hedging at share class level differently. It appears to be based upon equating having 'the same investment strategy' with 'ensuring that investors receive as nearly as possible the same results'. We disagree with this equation.

There is nothing in the UCITS Directive which requires this equation. What the UCITS Directive does require is that a UCITS should have an investment strategy (or using the terminology in the Directive 'investment objectives and investment policy'). A share class which hedges a particular risk can still be viewed as having the same investment strategy as other classes. It is simply hedging a particular risk to which the UCITS' investment strategy gives rise. There is nothing in the Directive which bases allowable share classes on outcomes.

To take a simple example, a manager launches a UCITS investing in the fixed income instruments issued by companies in both the UK and Europe. Investors like the manager's approach to selecting individual portfolio holdings and the income being paid by companies held in the portfolio, in other words, the UCITS investment strategy. The UCITS has a Sterling currency class and a Euro currency class. Whilst investors like the investment strategy of the UCITS, some investors wish to hedge the currency risk to which the investment strategy gives rise. Other investors wish to hedge the interest rate risk to which the investment strategy gives rise. Hedged classes thus enable all investors to have an interest in the same pool of assets that underlie the UCITS investment strategy, whilst addressing specific market risks (such as currency risk and interest rate risk) at the share class level.

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

Each UCITS compartment has a single pool of assets, and there is no segregation of these assets between share classes. The value of each share class is determined by an apportionment of the value of the pool of assets.

The management of the common pool of assets in which all share classes have an interest is functionally separated from the management of characteristics of individual share classes. As such, the investment manager making decisions on how the assets of the UCITS will be invested will not look at each share class, but will manage the portfolio as a whole, ensuring subscriptions are invested in the portfolio and assets sold from the portfolio in order to meet redemption requests, but without any reference to the particular share class into which the subscription or redemption was made.

For hedged share classes, the hedging strategy will be implemented separately from the investment strategy and independently of any hedging strategy employed by the investment manager for the portfolio as a whole. The hedging strategy will normally be performed by a function that is independent of the investment team managing the portfolio, and will overlay the investment portfolio. The hedging strategy will be applied systematically to hedge the defined risk. The process typically does not allow the management company discretion in determining whether or not to apply the hedge, although typically the systematic process allows for a small tolerance on the hedge exposure to avoid the management company having to place small adjustments to the hedge positions. As such, the management company will merely purchase the necessary derivative instruments (eg. forward currency contracts for currency hedging or exchange-traded futures on sovereign interest rates for interest-rate

hedging) required to hedge the identified risk and adjust these when the risk exposure moves outside the permitted tolerances.

For all share classes, a valuation will be performed for each share class separately. Valuations are performed by a function that is independent from the investment manager making decisions on the portfolio. Initially, each asset in the portfolio will be valued, and liabilities relating to the entire UCITS will be deducted. This valuation will form the basis of the valuations for each share class. For each share class, any hedging instruments specific to that share class will be valued, costs specific to that share class and any differing tax treatment will be accrued, and the conversion factor for any income previously reinvested in the UCITS for that share class (in the case of accumulation shares) will be applied in order to value each share class.

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.

Yes. As regards the particular question on currency hedging, we believe that it is compatible with the principle of having the same investment strategy for the reasons given in response to Question 6. We similarly believe that the same can be said for interest rate hedging and potentially other types of hedging at share class level.

With regard to share class currency hedging, we understand that there are at least two different forms: the first, commonly referred to as "TA" or "NAV" hedging, involves a single currency hedge covering the entire share class NAV; the second, commonly referred to as "look through" hedging, involves hedging proportionately the currency risk that may arise at a portfolio level within a share class. This distinction was not featured in the ESMA Discussion Paper. Any harmonised approach should be flexible enough to recognise the various approaches to currency hedging.

It is also important to bear in mind the fact that hedging at share class level is designed to meet the needs of investors in a way that is cost-effective for investors. If such hedging were to be prohibited, it would adversely affect both the investors in the hedged class but also in the other share classes. If two separate UCITS were required to be set up, the pooling benefits which a single pool of assets brings is lost, with potential higher costs for all investors. At its most extreme, it might result in hedging not being available. This may be the case if there are insufficient investors to make setting up a separate UCITS a means of meeting investors' needs in a cost-effective way for those investors.

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.

Yes. For the reasons given in our response to Question 6, we believe that interest rate risk share classes still meet the principle of having the same investment strategy; the share class, along with all other share classes, has an interest in the same underlying pool of assets (and therefore investment strategy) but has outcomes tailored to the needs of that subset. There may be other types of hedging that should be permitted for similar reasons.

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.

To our knowledge there are currently no UK UCITS which have these types of share class.

For the reasons given in our response to Question 6, we believe that interest rate risk share classes still meet the principle of having the same investment strategy; the share class, along with all other share classes, has an interest in the same underlying pool of assets (and therefore investment strategy) but has outcomes tailored to the needs of that subset. There may be other types of hedging that should be permitted for similar reasons. We understand that a number of other jurisdictions permit hedging of other market risks where it is done on systematic basis. It is done to meet investors' needs for risk reduction in a cost effective way.

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.

As mentioned in response to Question 5, the proposed second bullet point would result in the de facto prohibition of currency hedging share classes. This would result in detriment to investors in the hedged and in other share classes of the UCITS. By way of one example as to outcome if hedged share classes were not permitted, one manager has indicated that it has 24 hedged share classes with a total of 237 investors in those classes. The share classes have a total AUM of £775m. The majority of these would not be economically viable as separate funds.

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)?

No. In accordance with Article 49 of the UCITS Directive, regulatory ratios are to be calculated at the level of the UCITS (or the investment compartment where a UCITS comprises of more than one compartment). In addition, since there is no segregation of assets between share classes, it would not be logical to apply regulatory ratios such as the counterparty risk limit at share class level. The counterparty risk exposure arising from hedging transactions at share class level is included in the calculation of the counterparty risk exposure for the UCITS.

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?

Yes. It is important that investors receive appropriate, meaningful and relevant information in order to make investment decisions, as well as ensuring the information they receive is accurate, clear, fair and not misleading. Over disclosure can be as unhelpful to investors as under disclosure, as this can mean investors being unable to easily identify the information that is relevant to them.

In this regard, we believe the current disclosures in the Key Investor Information Document (KIID), as required by the KII Regulation, strikes an appropriate balance in ensuring that all investors receive key information in relation to the share class of the UCITS they have chosen

to invest in, including any characteristics applicable to that share class, the ongoing charges of the share class, the performance of the share class and material risks that may be associated with that share class. While in theory a risk of contagion exists for UCITS with hedged share classes, in practice this risk should be immaterial for non-hedged share classes provided a robust risk management framework is in place in respect of the hedging strategy applied to the hedged share class. Therefore, we would not ordinarily expect contagion risk to be a material risk to be disclosed to investors in the KIIDs for the non-hedged share classes of the UCITS. There may be limited cases where a management company considers the contagion risk arising from a hedged share class to be a material risk for the UCITS (eg. due to the size of the hedged share class relative to the other share classes of the UCITS), and in these limited examples the contagion risk should be disclosed as a material risk in the KIIDs for the non-hedged share classes of the UCITS.

The Practical Information section of the KIID already requires a disclosure that other share classes exist for the UCITS, and where more information on these share classes can be found. For the same reasons outlined in our response in Question 5 relating to the third principle identified by ESMA, we believe this is sufficient for the majority of investors, for whom many of the other share classes offered are unlikely to be relevant to their financial circumstances or their investment needs. Investors who require information on all available share classes, including the differences between these, are directed in the KIID to the prospectus for the UCITS, the KIIDs for other share classes of the UCITS or other resources provided by the management company (as applicable).

For the majority of investors, further disclosure requirements on other share classes available in the same UCITS and the differences between the share classes are not likely to be helpful and could prove counterproductive. Therefore we would urge that ESMA not recommend additional disclosure requirements be imposed. The KII Regulation already requires disclosure key information on share classes to investors in plain language, and where there are examples of failure in this regard these should rightly be addressed by NCAs, but through appropriate enforcement of the existing KII Regulation.

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

Yes. We support ESMA in developing a common position. UCITS is the European flagship investment product for investors. The same range of share classes should be available to investors throughout the Union regardless of the domicile of the UCITS. What is available to meet the needs of investors should not be restricted simply because those investors happen to buy a UCITS domiciled in one jurisdiction rather than another. This would also meet investor expectations as investors would naturally expect the access to the same range of share classes in a European product.

Given too that the UCITS of any European domicile can be freely sold throughout the European Union, if any national regulator is unduly restrictive of locally domiciled UCITS, that will hamper the ability of local UCITS to meet investor needs and local investors will, if they have sufficient knowledge, look to UCITS of other jurisdictions to meet their needs.

Other comments on matters not covered by specific questions:

Paragraph 6 of the Discussion Paper suggests a number of principles to be used in assessing the 'legality of different share classes.' As a general comment, the Discussion Paper potentially

deals with what constitutes a single CIS as a matter of law. The question of the extent to which share classes in a collective investment scheme can differ and the scheme remain a single collective investment scheme at law is ultimately a matter for the courts. The question therefore arises whether it is within ESMA's gift to provide certainty in this area or whether it would ultimately require a change to the UCITS Directive given that the Directive does not currently set conditions around share classes. ESMA may wish to discuss this with the Commission.

Annex

Manager A:

New Share Class

Set up: £3k
Ongoing pa: £3k

New Fund

Set up £6k
Ongoing pa: £30k (This is primarily the fixed fee for Fund accounting and the cost of an additional audit).

Manager B:

The ongoing cost differential between running a sub-fund rather than a share class could be reasonably significant. There are sub-fund specific costs such as audit (this cost will vary depending on the fund but £7,500 might be a reasonable estimate), regulators authorisation fees, etc. Running separate sub-funds for essentially the same strategy can also lead to greater transaction costs as if you want to implement a stock specific call you would need to execute two transactions rather than the one trade which you could have done if you were just operating one sub-fund. This would certainly apply to custodian transaction charges and may also be an issue on brokerage charges.

However, another potentially more significant consideration is that many fund administration costs work on a tiered basis per sub-fund. Taking a crude example if you are charged 10bps on the first £100m and 5bps on anything over £100m; two £100m funds would pay £100k each whereas a single £200m fund would pay £150k, a saving of £50k to the investors assuming the fund pays for its administration.

It is quite hard to quantify, as it would really depend on the specifics of the fund (e.g. size, turnover and underlying fees) but these are the kinds of things that make more cost effective the operation of currency hedged share classes as part of a wider pooled fund rather than in a separate sub-fund.

Fund administrators charge different fees for administering a share class as opposed to administering a fund. It is about 30% higher.

Manager C

We have 9 funds operating currency hedging in an average of 4 currencies. If these had to be set up as individual funds this would result in 27 new funds (i.e 9x3).

Upfront costs:

Registration: £1,500 x 27 = £40,500
Legal: £5,000 x 27. Assumption that a new prospectus/supplement would be a mirror so we would be charged somewhere between a 'regular prospectus update' and 'a new prospectus' from the lawyers. Total £135,000

Ongoing Costs– per annum

Some identified costs. There may be others.

Legal Costs - +£3,500 x 27. Duplication of annual prospectus updates. It may be possible to get some reductions for economies of scale, but probably not much. Total £94,500
TPA Costs - + £13,000 x 27. Cost of fund versus sub fund. Some additional transaction costs, but these are hard to quantify. Total +£351,000
Audit Costs - +£50,000 as an estimate on top of current bill as workload increases for Auditors. Total +£50,000
Regulator Fees - £20,000
KIIDs - £1,620 (27*£60)

Many data providers will charge a high level fee for a fund, but then a small additional fee for each share class. More funds/less share classes = higher costs.

Soft Costs/Unquantifiable costs:

Impact on fund management staffing requirements: – hard to quantify. You would initially think it would be duplication of positions, but that's just not achievable when cashflows are +ve in one currency and –ve in another. Divergence will occur and the fund manager will be managing 4 portfolios with nearly identical, but not quite, objectives. New hires in the front office would definitely be required.

General Business Costs – There would be project setup costs and ongoing costs from maintaining another 27 regulated vehicles. Again new hires would be required to maintain such additional vehicles – both within operations and in the front office.

Trading/Performance Costs – The fund manager might be able to get the same deal for 4x£25m trades as he would do for 1x£100m, but the divergence in the new sub funds will mean that he trades more often across the individual funds and in smaller batches. This will have an impact on the performance and in transaction costs, both explicit and implicit.

In all, the costs would be considerable and it is likely that it is likely that currency hedging offerings would be reduced.

Manager D:

The estimated service provider costs (legal, admin, custody) are the following: unhedged share class – £5,000, hedged share class – £15,000, new sub-fund in existing umbrella – £25,000, new umbrella – £ 40,000

As regards the resultant increase in costs for investors in the remaining UCITS as a result of losing the Funds under Management attributable to those in the existing hedged currency share class, this depends on many factors, such as type of strategy and size of funds. It could in theory double the impact of costs or increase them more than that where service providers have provided break points in their fee schedules or where fixed fees matter to a particular strategy.

Manager E:

The efficiencies from share classes verses funds in the on-going cost base are mainly in the costs of third parties. I believe to replicate the existing range with separate funds we would need 36 funds.

- For fund accounting and pricing the extra cost is difficult to estimate with accuracy as it depends not only on complexity. We have assumed around £50k as an average. This would lead to somewhere around £1.8m pa of extra fund accounting and pricing costs.
- Transfer agency costs would lead to around £3k per fund, so £108k.
- There would also be some other small costs resulting from the need to produce more sets of accounts. Estimate – around £50k in total.
- There would also be additional costs of running multiple 'clone' like funds in the front office. Estimate another £250k pa for this, although this is very much a rough estimate and might need one-off systems development rather than extra on-going costs.

This would lead to around £2.2m pa of extra costs for Manager E.

All the extra funds would need auditing so there would be increased costs to them of £5k per fund, around £180k pa in total payable by the funds.

In addition there are likely to be increased costs (and perhaps more importantly timescales) associated with launching new funds rather than share classes. Seeding and 'small' funds would become a more significant issue. Future changes to funds would also become more complex although this again is not measurable.

Manager F:

Set up Costs (one-off)	**Average Cost – TA**	**Average Cost – Fund Admin**	**Total Cost / Max. Time to Set Up**
New Sub-Fund (typically 10 share classes)	£6000 6-8 weeks	- 4 weeks	£6000 8 weeks max
New Share Class	£4000 4-8 weeks	- 4 weeks	£4000 8 weeks max

The ongoing cost of £30k per annum for a new sub-fund is reasonable. As to costs of setting up a share class, it really depends on the purpose of the share class. If it is a hedged share class then 3k per annum seems reasonable as there are additional hedging costs that are attributed to these share classes. For a standard non-hedged share class once set-up I would expect the ongoing costs to be less.

Manager G:

Cost of a new fund vs new share classes

New fund –

- Set up: one time development of £30-50k for straightforward fund; about £100k for complex fund.

- Annual running costs paid by company of about £35-40k depending on complexity of the fund.
- Annual costs included in the OCF are variable depending on fund size, number of transactions, etc. Rule of thumb is a sliding scale which decreases with fund size, but funds with high shareholder transaction levels will incur higher costs. Estimate £50k for £100m fund (5bps) and £150k for £500m fund (3bps).

New share class –

- Set up: approximately £5-10k to set up a new share class including legal and admin aspects.
- Annual running costs (impact to the OCF) would be an increase by about £10k to the fund. But spread over larger assets, the bps impact would be small.

Manager H:

As requested, here is the high level comparison between fund vs share class level costs. Only included costs that would be different between each. From the analysis below, it would be approximately 14 times more costly to operate a fund vs launching a share class within an existing fund. There are a number of costs that are not quantifiable but would increase this ratio as they would only be applicable to a separate fund. These have also been listed below.

Quantifiable cost	Fund	Share Class
Fund accounting	28,500	4,200
Tax services	10,000	0
1 Jurisdiction of tax cost	4,000	0
Audit	13,100	0
Fair Value Pricing	3,400	0
Middle office portfolio	1,100	0
	60,100	4,200

Cost ratio of Fund / Share Class 14.3

Unquantifiable costs but chargeable at Fund level only	Fund	Share Class
Set up legal fees	x	
Regulatory, Registration & representation costs at fund level	x	
Printing fees	x	
Middle Office and Custody transaction costs for fund rebalances	x	
Other expenses	x	