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THE LEGAL STATUS OF SHARE CLASSES OF COLLECTIVE INVESTMENT FUNDS IN THE EUROPEAN LEGISLATIVE FRAMEWORK

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A chi mi ha indicato la strada,
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Executive Summary (Italiano)

La possibilità di articolare la struttura di un fondo di investimento in diverse classi di quote può essere considerata uno degli sviluppi più significativi per l'industria della gestione collettiva che ha comportato una profonda rivoluzione nel modo in cui i fondi di investimento vengono commercializzati agli investitori. Per comprenderne l'impatto, basti pensare che, nel dicembre 1991, il *database* Morningstar dei fondi statunitensi comprendeva 2.373 diverse quote mentre, nel dicembre del 2000, lo stesso *database* ne indicava più di 12.029, un incremento di più del 500% in soli 9 anni, il 69% del quale fu dovuto alla diffusione della prassi di strutturare i fondi in più classi di quote, possibilità ammessa dalla SEC nel 1995[1].

Le classi o categorie di quote ("*share classes*" o "*classes of units*") possono essere considerate come diverse "tipologie" di quote appartenenti allo stesso fondo, conferenti ai propri sottoscrittori diritti parzialmente diversi le une dalle altre, nonostante tutti gli investitori continuino comunque ad investire nello stesso patrimonio comune (*pool of assets)*. La possibilità di offrire più classi di quote comporta diversi benefici per i gestori, soprattutto in considerazione del fatto che tramite l'utilizzo di quest'ultime è possibile fornire agli investitori un prodotto maggiormente allineato alle loro specifiche esigenze senza la necessità di dover provvedere alla creazione di un diverso comparto di investimento, processo nettamente più costoso della semplice creazione di una diversa categoria di quote[2].

Nonostante la dimensione e la rilevanza economica del fenomeno, il legislatore europeo non si è curato di adottare una disciplina organica sulle classi di quote, la cui regolamentazione è stata pertanto lasciata ai singoli Stati Membri, ciò comportando la diffusione di prassi nazionali divergenti in merito alle tipologie di classi permesse. Oltretutto, la dottrina ha mostrato poco interesse in relazione allo studio delle problematiche inerenti alla strutturazione di un fondo in diverse classi di quote e, in

[1] Lo studio è stato svolto da MOREY, M. (2003). La correlazione tra l'enorme aumento nella dimensione dei fondi comuni e l'introduzione della possibilità di offrire diverse classi di quote è stata messa in evidenza anche da by NANDA, V., WANG. Z. & ZHENG, L. (2009).

[2] Secondo l'EFAMA il costo per la strutturazione di una classe di è pari 10-20% del costo necessario per la strutturazione di un nuovo OICVM o comparto.

generale, nei confronti del tema della diversificazione dei diritti attribuibili agli investitori di un veicolo di investimento collettivo. Alla luce di quanto detto, non sorprende quindi rilevare come non esista ancora una visione comune circa il trattamento delle classi di quote e, in particolare, circa i limiti alla personalizzazione dei diritti degli investitori realizzabile tramite l'utilizzo di questi strumenti.

Questo studio si pone come obiettivo quello di affrontare le problematiche connesse con la creazione di diverse classi di quote, anche nell'ottica di riuscire ad individuare degli orientamenti operativi in grado di guidare gli operatori di mercato nella strutturazione dei diritti incorporabili nelle diverse classi. In particolare, verrà dimostrato come, anche in assenza di previsioni di dettaglio in materia nel contesto legislativo europeo, è nondimeno possibile rinvenire un quadro giuridico comune per le classi di quote, attraverso la ricostruzione di uno "statuto normativo" della partecipazione ai fondi di investimento, ossia tramite l'individuazione delle caratteristiche fondamentali che connotano la situazione giuridica dei partecipanti al fondo e tramite la lettura interpretativa dei principi generali che regolano la disciplina della gestione collettiva del risparmio.

Nel fare ciò, il lavoro è stato suddiviso in tre capitoli. Il Capitolo I è volto alla ricostruzione dello "statuto normativo" della partecipazione ai fondi di investimento, tramite l'individuazione delle caratteristiche fondamentali del rapporto giuridico che, in seguito alla sottoscrizione delle quote, si instaura tra gli investitori ed il gestore, e che vede anche il coinvolgimento di una pluralità di altri soggetti che partecipano a diverso titolo nelle attività di un fondo di investimento. Per poter procedere in questo senso è tuttavia preliminarmente necessario procedere all'analisi della nozione di "Organismo di Investimento Collettivo del Risparmio" ("**OICR**") che consentirà di poter definire i principali elementi costitutivi della fattispecie.

Successivamente verranno esaminati i principali aspetti del "rapporto fondo-investitore" (per tale intendendosi la relazione giuridica che si instaura, in seguito alla sottoscrizione delle quote del fondo, tra gli investitori, il gestore e tutti gli altri soggetti che partecipano a diverso titolo a tale rapporto), tramite l'analisi delle principali fonti di diritto europeo in materia, ed in particolare della Direttiva OICVM, la quale reca la disciplina applicabile agli organismi qualificabili come "Organismi di Investimento Collettivo in Valori Mobiliari" ("**OICVM**"), i quali sono caratterizzati da una struttura di tipo aperto e dal fatto che possono essere commercializzati a tutti gli investitori (indipendentemente dalla loro qualifica come investitori al dettaglio o professionali) e, dall'altro lato, della Direttiva GEFIA, la quale reca le previsioni applicabili a tutti gli organismi non rientranti nella nozione di OICVM, e ai loro gestori. Si evincerà che il rapporto fondo-investitore si compone di molteplici diritti di natura economica, amministrativa e informativa. In breve, nella categoria dei diritti economici rientrano, principalmente, il diritto dell'investitore di ricevere la liquidazione di un *quantum* corrispondente al valore delle quote possedute e, dall'altro lato, il diritto del gestore a percepire una commissione per il proprio servizio. Gli investitori vantano inoltre il diritto (che si sostanzia nel corrispettivo obbligo per il gestore) di ricevere adeguata informativa pre-contrattuale e post-contrattuale affinché possano essere messi in grado di comprendere i rischi e costi associati con il relativo investimento. Infine, le legge consente di attribuire ai quotisti diritti partecipativi analoghi a quelli dei soci di società di capitali, come ad esempio il diritto di partecipare all'elezione dei componenti dell'organo amministrativo o il diritto di partecipare alle assemblee dei sottoscrittori e di esprimere il proprio voto in tale sede.

Il secondo Capitolo è dedicato ad un più accurato trattamento delle problematiche inerenti all'emissione di diverse classi di quote. La pratica di suddividere l'offerta del fondo in diverse classi nasce e si sviluppa nella prassi di mercato dei Paesi di *common law* come un mezzo efficace per rispondere alla richiesta, da parte degli investitori, di prodotti maggiormente allineati con le loro esigenze.

I fattori che hanno portato alla diffusione delle *share classes* sono principalmente di natura economica. Tramite la creazione di diverse classi di quote i gestori sono infatti in grado di offrire soluzioni personalizzate ai propri investitori senza la necessità di strutturare diversi comparti di investimento. Inoltre, allargando in questo modo la platea dei potenziali sottoscrittori, e di conseguenza le dimensioni del fondo, si possono anche generare economie di scala riuscendo così ad ottenere una diminuzione dei costi di amministrazione e transazione.

Verrà inoltre fornita una descrizione sommaria delle principali tipologie di classi attualmente presenti nei mercati, tra le quali si possono annoverare sia strutture più semplici (come ad esempio, classi differenziate sotto il profilo commissionale o denominate in valute diverse), che anche classi molto più complesse, come nel caso delle classi incorporanti strumenti di copertura (*hedging overlays*), le quali offrono agli investitori la possibilità di ridurre l'esposizione su alcuni rischi di mercato (e.g. rischio di cambio, rischio di volatilità, etc…).

Si procederà quindi ad un esame del contesto normativo nazionale per le classi di quote, nonché all'analisi delle disposizioni interne in materia di *share classes* rinvenibili negli Stati Uniti – ove il fenomeno è stato inizialmente regolamentato –, Irlanda e Regno Unito.

Il *focus* si sposterà successivamente sull'analisi delle disposizioni che a livello europeo regolano il fenomeno della creazione di diverse classi di quote. Si evincerà che, nonostante sia possibile ritenere ammissibile, ai sensi delle Direttive OICVM e GEFIA, la possibilità di operare una differenziazione dei diritti degli investitori, nella normativa europea non sono rinvenibili disposizioni in merito a quali debbano essere i parametri ed i limiti della personalizzazione della partecipazione realizzabile tramite la strutturazione di diverse classi di quote. Verrà fatto notare, tuttavia, come sia nondimeno possibile individuare un quadro normativo comune per la creazione di classi di quote derivando alcune previsioni operative dalla lettura ermeneutica di alcuni dei principi fondamentali della disciplina della gestione collettiva del risparmio. In particolare, dal principio di parità di trattamento (*fair treatment*) può essere dedotto che le caratteristiche di una classe dovrebbero essere strutturate in modo da non recare un pregiudizio per i sottoscrittori di altre classi. Inoltre, si può rinvenire un limite generale alla diversificazione dei diritti amministrativi dei quotisti nel principio di autonomia del gestore rispetto ai singoli investitori, secondo il quale, nonostante sia possibile prevedere in via generale un coinvolgimento di questi ultimi nella vita del fondo, ai sottoscrittori non potrà essere concesso il diritto di influire nella gestione operativa dello stesso. Infine, poiché l'esistenza di una comune "politica di investimento predeterminata" può essere considerata come la caratteristica maggiormente qualificante la nozione di OICR, si può ritenere che non dovrebbe considerarsi ammissibile la creazione di classi che, direttamente o indirettamente, risultino nella predisposizione di politiche di investimento personalizzate, in quanto ciò risulterebbe nella creazione di un differente fondo di investimento. È possibile inoltre dedurre che il requisito di una politica di investimento comune richieda anche l'esistenza di un profilo di rischio comune all'intero OICR. Tale implicazione tuttavia potrebbe avere un impatto negativo circa l'ammissibilità di quelle classi recanti *hedging overlays* in quanto, in assenza di una segregazione patrimoniale tra le varie classi, gli strumenti derivati utilizzati a fini di copertura diverrebbero parte del patrimonio comune, incidendo quindi sul profilo di rischio comune

Il Capitolo finale è volto al trattamento di un recente presa di posizione dell'ESMA, in merito al trattamento delle classi di quote. Avendo rilevato che, in assenza di un quadro regolamentare comune, si sono sviluppate nei vari Stati Membri prassi divergenti in merito alle tipologie di classi permesse, l'ESMA ha formulato nel 2017 un *Opinion on share classe of UCITS*, volta ad introdurre un'armonizzazione delle prassi di vigilanza in materia di *share classes.* In particolare, l'ESMA ritiene che la legittimità delle classi di quote dovrebbe essere valutata sulla base di quattro principi: (i) *common investment objective*; (ii) *non-contagion*; (iii) *pre-determination*; e (iv) *transparency*. Nel documento vengono anche fornite alcune previsioni di dettaglio il cui rispetto, ad avviso dell'Autorità, assicurerebbe la *compliance* con i principi di alto livello.

L'*Opinion* dell'ESMA è in particolar modo rivolta al trattamento delle classi incorporanti degli *hedging overlays*. Su questo versante l'Autorità, sostenendo che vi sia una stretta relazione biunivoca tra l'esistenza di un *common investment objective* e un profilo di rischio comune (*common risk profile*), di modo che le classi recanti diversi profili di rischio non risulterebbero avere un *common investment objective,* ha ritenuto che la strutturazione di *hedged share classes* non sarebbe conforme ai principi fondanti la legittimità delle classi di quote. L'ESMA tuttavia non ha ritenuto di dover spingere la propria posizione sino a ritenere inammissibili anche classi con *currency hedging* le quali, nonostante apparentemente in contrasto con il principio precedentemente riportato, dovranno essere considerate come un'eccezione (intenzionale) allo stesso.

Nonostante sia possibile notare come alcune delle conclusioni dell'ESMA non siano sorrette da sufficienti argomentazioni, e possano sembrare anche parzialmente incompatibile con alcune delle stesse considerazioni preliminari dell'Autorità, le indicazioni dell'*Opinion* dell'ESMA possono essere generalmente accolte, in quanto largamente compatibili con le indicazioni operative individuate nel Capitolo II. L'*Opinion* infatti, sebbene attraverso un diverso (e meno chiaro) percorso ermeneutico, ha confermato la validità di molte di quelle previsioni che sono state dedotte attraverso la lettura interpretativa dei principi di parità di trattamento e politica di investimento comune. In primo luogo, è stato infatti confermato come la caratteristica essenziale delle classi sia quella di avere la stessa politica di investimento comune (o *common investment objective* nella formulazione dell'ESMA). Inoltre, i principi del *non-contagion*, *pre-determination* and *transparency*, confermano molte delle indicazioni operative derivate dal principio del *fair treatment*. In particolare, il *non contagion* può essere individuato come principio fondante della materia, il quale comporta il dovere per il gestore del fondo di adottare tutte misure appropriate per minimizzare il rischio che le caratteristiche peculiari di una determinata classe di quote possano avere un potenziale o effettivo impatto negativo su altre classi del medesimo fondo.

Le indicazioni dell'*Opinion,* il cui oggetto è espressamente limitato ai soli OICVM, non potranno avere un impatto diretto sull'industria dei fondi Alternativi. Per questi ultimi rimarranno quindi valide le indicazioni operative rinvenute nel Capitolo II, la cui legittimità può ritenersi rafforzata dal fatto che molte delle previsioni ivi individuate sono state riconosciute da un atto di particolare rilevanza della *European Securities and Markets Authority*.

Executive Summary (English)

One of the most significant developments in the mutual fund industry has been the rise of multiple-share-class funds which dramatically changed the way in which investment funds are marketed. To understand the impact these structures had on the collective investment industry, it can be noted that at the end of December 1991, the Morningstar U.S. mutual funds database indicated that there were 2.373 different fund shares. By the end of December 2000, the same database indicated that there were 12.029 different shares, a more than 5-fold increase in 9 years, about 69% of which was a result of the rise of multiple share classes, whose offering was allowed by SEC in 1995[3].

Share classes can be considered as different "types" of units or shares belonging to the same fund. Even though all investors in a fund invest in a common pool of assets, share classes attribute different rights or features to sub-sets of investors in relation to their investment. Share classes can be extremely beneficial for asset managers as they can allow more flexibility and cost reduction in structuring investment funds. By using share classes investors' needs can be easily accommodated, generating at the same time economies of scale without the need of going through the - more expensive - process of setting up a new fund or compartment[4].

Notwithstanding the scale and the economic importance of the phenomenon the European legislator has yet adopted no organic provisions on the creation of share classes, leaving the development of the regulation of the matter to national legislators and supervisory authorities. As a consequence, a number of different national practices developed in the European Union as to the types of share classes that are permitted. Moreover, scholars showed little interest in the issues connected with the creation of share classes, and in general with the matters related to the possible differentiation of the economic and administrative rights of investors in collective investment schemes. As a result, there is still no common understanding in relation to the legal treatment of share

[3] The analysis has been carried out by MOREY, M. (2003). The correlation between the massive rise in the size of the investment fund industry and the introduction of multiple share classes has been highlighted also by NANDA, V., WANG. Z. & ZHENG, L. (2009).

[4] According to EFAMA, the cost of launching a new share class is between 10 to 20% of the cost of creating a new UCITS or compartment for the same purpose.

classes and, in particular, on the scope of the differentiation of the investors' rights achievable through the use of these structures.

This dissertation is aimed at tackling the issues connected with the structuring of multiple share classes. With an aim of providing some minimal practical guidance to market operators, it will be shown that it is possible to build a legal and operative framework for share classes through the individuation of a "legal status" of the shareholding in investment funds in the European legislative context, by individuating the key features characterising the investors' participation in European investment funds and through the interpretation of some of the fundamental principles governing the European collective asset management law.

In doing so, the work has been divided into three Chapters. Chapter I is aimed at reconstructing the "legal status" of fund shares, by providing an insight of the main characteristics of the legal relationship that establishes between the fund's investors and its manger and that sees also the involvement of a number of other different subjects that participate to different extents in the activity of a collective investment undertaking (that will be referred to as the "fund-investor relationship".

To this end, the first necessary step will be the framing of a definition of what constitutes an investment fund, or "undertaking for collective investment" (as referred to in the relevant European legislative texts) under European law, as to point out the key elements characterising that qualify collective investment undertakings.

The study will then focus on the individuation of the main aspects of the "fund-investor relationship" through the analysis of its main European-level sources of regulation, that are constituted by the UCITS Directive, providing the framework for investment funds that qualify as "Undertakings for Collective Investment in Transferable Securities" ("**UCITS**"), which are characterised as being open-end in their nature and eligible to be marketed to any investor (whether institutional or retail) and the AIFM Directive, on the other, which contains provisions related to all investment funds that do not qualify as UCITS. It will be found that the fund-investor relationship is composed by a complex number of economic, information, and administrative rights. In summary, the economic rights comprise the right of the investors to profit from the manager's investment activity by redeeming the shares or receiving a dividend distribution and the right for asset managers to charge a fee for their services. Investors are also entitled with the right (which vice versa constitutes a duty for asset managers) of receiving proper pre-contractual and ongoing disclosure to make sure they are properly informed with the risks and costs associated with the relevant financial products. Finally, unitholders are usually provided by law with investors' rights similar to those of stock owners in companies which may include the right to vote for the election or removal of the board, to participate and vote in investors' meetings, to place items on the agenda and to ask questions to the manager.

The second Chapter is instead dedicated at addressing more specifically the issues related with the issuance of multiple share classes. Share classes firstly developed as a market practice in common law countries as an effective means to respond to demand-side pressures, allowing collective asset managers to reflect to some extent individual investors' preferences. The drivers behind the offering of multiple share classes are fundamentally economic by nature. Share classes in fact allow fund managers to provide better customised solutions to investors needs without the necessity of setting up different compartments. By allowing more investors to participate in the fund, and thus potentially increasing the find size, with share classes economies of scale can also be generated thus lowering administration and transaction costs.

Subsequently, an insight of the most widespread types of share classes will be given, which range from very simple arrangements (e.g. classes providing different levels of fees or denominated in different currencies), to much more complicated share classes, such as those providing different hedging overlays which are aimed at reducing the investors' exposure over some generic market risks (e.g. foreign exchange risk, duration risk, volatility risk…).

Furthermore, an overview will be provided of the national regulatory framework for share classes, as well as for that of other jurisdictions whereas an extensive regulation of the matter exists: namely the United States, where the phenomenon was firstly regulated, Ireland and the United Kingdom.

The focus will then shift to the analysis of the European-level provisions regulating the structuring of share classes. It will be noted that under European law, although the possibility to provide a differentiation of investors' rights is recognised in the UCITS and AIFM Directives, no provision is given in relation to the scope of customisation achievable through the setup of multiple share classes. In this respect however it is nonetheless possible to develop a common legal framework for share classes through the interpretation of some of the fundamental principles governing the provision of collective asset management. In particular, from the principle of fair treatment it can be derived that the setup of a share class shall in no case result in prejudice to shareholders of any other class. Furthermore, in compliance with the principle of separation between fund and managers, notwithstanding it can be deemed generally possible to provide investors with different administrative rights, allowing certain groups of shareholders to participate more actively in the fund's life, this shall not result in an actual involvement in the operational management of the fund. Finally, since the existence of a common "defined investment policy", is the element that ultimately qualifies the legal notion of collective investment undertaking, it shall be deemed that arrangements at a share class level providing investors with tailored investment policies shall not be allowed, as this would result in the creation of different investment funds. It can be also considered that the requisite that all investors should share the same investment policy also requires a common risk profile within the fund. This implication, however, may have an adverse impact on the admissibility of share classes providing hedging overlays, since, in the lack of legal segregation between share classes, the derivatives entered into for the hedging purposes will become part of the common pool of assets thus affecting the common risk profile.

The final Chapter deals instead with a recent intervention of the European Securities and Markets Authority in relation to the legal treatment of share classes. Having acknowledged that in the absence of a common legal framework on share classes a number of diverging national practices arose on the types of share class that are permitted, ESMA issued in 2017 the *Opinion on share classes of UCITS,* aimed at introducing a common supervisory approach to share classes. In particular, ESMA is of the view that a series of high-level principles, namely "common investment objective", "non-contagion", "pre-determination" and "transparency", should be followed ub assessing the lawfulness of multiple share class structures. The envisaged principles are also accompanied by a number of operational implications that, according to ESMA, would ensure compliance with the high-level principles.

The ESMA Opinion deals in particular with hedged share classes. In this respect, by stating that a strict biunique relationship exists between a "common investment objective" and a "common risk profile", so that share classes providing a differentiation in the latter cannot be considered compliant with the principle of having a "common investment objective", ESMA concluded that the setup of hedged share classes has to be considered not in line with the principles of the Opinion. The ESMA's view did not however push as far as to ban the creation of currency hedged share classes that, although apparently not compatible with said principle, are nonetheless regarded as the only allowed (intentional) exception

Although it is nonetheless possible to note that some of the ESMA's conclusions lack of a proper justification and also seem somewhat inconsistent with some of the considerations expressed by the Authority, the provisions of the ESMA *Opinion on share classes of UCITS* can generally be welcomed since they are highly compliant with the legal framework envisaged in Chapter II. The Opinion, in fact, although through a different (and also smokier) line of interpretation, has generally confirmed the validity of many of the indications that have been deduced from the analysis of the principles of fair treatment and common investment policy. In the first place the existence of a common investment policy (or "common investment objective" in ESMA's wording) has been confirmed as the qualifying characteristic of share classes. Furthermore, the principles of "non-contagion", "pre-determination" and "transparency" confirm the high-level operational indications implied from the reading of the principle of fair treatment. In particular, the "non-contagion" stands out as the leading principle regulating the matter, which entails the duty for the asset manager to take all the necessary measures to minimise the risk that the characteristics of a given class may result in an actual or potential prejudice for shareholders of other classes.

By way of conclusion, it can be noted that the ESMA Opinion won't have any direct impact on the industry of Alternative funds, as its object is expressly limited to UCITS. In respect of AIFs the considerations of the legal framework envisaged in Chapter II will thus remain valid, whose legitimacy has also been strengthened by the fact that many of the operational indications thereby provided have been acknowledged in a particularly relevant regulatory act of the European Securities and Markets Authority.

CHAPTER I - THE FUND-INVESTOR RELATIONSHIP

1.1. THE NOTION OF "UNDERTAKING FOR COLLECTIVE INVESTMENT"

Scope of this Chapter is to provide a reconstruction of the "legal status" of the participation in common investment funds through the individuation of what can be considered the fundamental characteristics of the complex legal relationship (that will be referred to as the "fund-investor relationship"), which, following the subscription of the fund's shares, comes into existence between the fund's unitholders, its manager and a number of other subjects that are involved in different ways in the activity of collective investment schemes.

In this respect the first necessary step to further investigate such relationship will be however the framing of a definition of what under European law constitutes an investment fund, or "undertaking for collective investment", as referred to in the wording of the relevant legislative texts. This is not without practical implications, as the individuation of the fundamental characteristics of an investment fund will come in handy when dealing with the issue of the scope of differentiation of investors' rights achievable through the setup of multiple share classes since, if an element can be deemed as defining the fund as a whole, it should be thus reflected in any of its parts.

Investment funds can generally be regarded as a popular form of investment vehicle which allows investors with limited funds to access the capital markets through a collective investment scheme which pools investors' funds and spreads risks across a range of investments according to defined asset-allocation criteria[5]. The success of investment funds is mainly due to the fact that they "*make it easy*" for investors to access the capital markets, and to pursue professional investment strategies that would otherwise be unavailable[6].

The legal notion of collective investment undertaking finds today its roots in European law, which, as widely known, is nowadays structured in two sets of disciplines:

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[5] Such definition is provided by MOLONEY, N. (2008), p. 247.

[6] POZEN, R. & HAMCHER, T. (2011), p. 3.

on one side the discipline arisen from Directive EC/85/611 ("UCITS I")[7] - that following its subsequent amendments and implementations is nowadays incorporated in the text of the so called UCITS IV Directive[8] - which contains the regulation of those collective investment vehicles that qualify as "Undertakings for Collective Investments in Transferable Securities" ("**UCITS**"), and on the other hand the more recent Directive EU/2011/61 (hereinafter referred to as "**AIFM Directive**" or "**AIFMD**"), regulating the so called "Alternative Investment Funds ("**AIFs**") and their managers ("**AIF Managers**" or "**AIFMs**"). The scope of the UCITS discipline has historically been, and still is, limited only to open-end funds, and in particular only to those specific types of open-end funds that meet the additional requirements provided by the UCITS Directive[9].

Different is, instead, the framework provided in the AIFMD, which was born from the ashes of the 2007-2008 financial crisis as one of the many acts of the legislative wave that flooded the financial markets regulation. The approach taken in the AIFMD is reversed compared to that historically followed by the UCITS Directive as the discipline laid down in the AIFMD is mainly referred to the managing entity providing, in contrast, only limited provisions relating to the product which is, indeed, identified by way of negation with respect to the notion of UCITS[10]. Furthermore, in defining its scope, the AIFM Directive follows a broad, functional approach, setting out a definition of investment undertaking which is totally independent from the operational or legal structure of the specific undertakings but that rather focuses on the substantial economic phenomenon underlying the provision of the collective asset management service[11].

In this sense, the AIFM Directive, perhaps unintentionally, ended up introducing a general definition of "undertaking for collective investment" which fully absorbs that provided for in the UCITS Directive[12]. As a result, it can nowadays be excluded that,

[7] Directive EC/85/611 has received, over time, four different updates the last of which with Directive EU/2014/91 ("UCITS V").

[8] Directive EC/2009/69, hereinafter also referred to as "**UCITS Directive**" or "**UCITSD**".

[9] See *infra* section 1.2.

[10] Article 4(1)(a)(ii) AIFMD defines in fact alternative investment funds as those collective investment undertakings that "*do not require authorisation pursuant to Article 5 of Directive 2009/65/EC*".

[11] In this sense. ANNUNZIATA, F. (2017a), p. 2.

[12] The UCITS Directive actually offers few indications to the interpreter as to the features characterising the notion of undertaking for collective investment. The definition provided in Article 1(2) in fact only clarifies the object of the activity, identified as the "*collective investment of capital raised from the public*

notwithstanding the differences between the two legal regimes, European law provides two notions of "undertaking for collective investment", one related to UCITS funds and the other to AIFs as, with the introduction in 2011 of the AIFM Directive, it can be considered that the definition is now unified[13].

In conclusion, the common definition of undertaking for collective investment is nowadays provided by Article 4 of the AIFMD, according to which undertakings for collective investment can be considered as entities that: "*raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors*".

1.2. The qualifying elements of the notion of undertaking for collective investment according to the ESMA Guidelines on key aspects of the AIFMD

With a view to ensure the uniform application and interpretation of the provisions of the AIFM Directive, the European Securities and Markets Authority (hereinafter "**ESMA**") delivered a document containing *Guidelines on key concepts of the AIFMD* (hereinafter also referred to as "**ESMA Guidelines**")[14]. These guidelines can be regarded as constituting a typical example of "soft law" instrument available to ESMA to pursue its task of ensuring the common and consistent application of the financial single rule book[15].

The ESMA Guidelines on key concepts of the AIFMD fulfil the purpose of ensuring the uniform interpretation of the provisions of the Directive and in particular of the elements that constitute the notion of Alternative Investment Fund. In this respect, the ESMA Guidelines are of particular importance since they address a fundamental issue, namely the identification of the same scope of application of the AIFMD.

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in transferable securities or in other liquid financial instruments", that UCITS need to act in accordance "*principle of risk spreading*". It is also further provided that "*shares are, at the holders' request repurchased or redeemed, directly or indirectly, out of the assets of these bodies"*. See in more detail Section 1.3.1.

[13] This vision is shared by authoritative doctrine and in particular by ANNUNZIATA, F. (2017b), p. 12.

[14] ESMA, *Guidelines on key concept of the AIFMD* of 13 August 2013, ref. ESMA/2013/611.

[15] On the effects of ESMA soft law see *infra* Section 3.5.

With its Guidelines ESMA clarifies the content of the key elements that pursuant to Art. 4, paragraph 1, of the AIFMD constitute the notion of undertaking for collective investment. According to paragraph 12 of the ESMA Guidelines "*The following characteristics, if all of them are exhibited by an undertaking, should show that the undertaking is a collective investment undertaking mentioned in Article 4(1)(a) of the AIFMD. The characteristics are that: (a) the undertaking does not have a general commercial or industrial purpose; (b) the undertaking pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and (c) the unitholders or shareholders of the undertaking – as a collective group – have no day-today discretion or control*".

Moreover, the Guidelines further qualify the meaning of what have been identified as the key elements of an investment fund, namely: the financial purpose; the absence of "day-to-day" discretion of control; the pooling of capitals from a number of investors; and the defined investment policy aimed at generating a pool return.

1.2.1. Absence of day-to-day discretion or control

Among the qualifying elements of the notion of collective investment undertaking figures that of the absence of *day-to-day discretion or control* of unitholders over the fund a management. As a result, the fact that unitholders are granted *day-to-day discretion or control* should be considered as an element to exclude that an entity is an undertaking for collective investment.

In referring to this principle the Guidelines add an element which is however not expressly mentioned in the Level 1 text but that is nonetheless one of the features that have historically characterised the idea collective investment schemes, which is the separation between investors and fund managers[16].

[16] According to MORLEY the separation of funds and managers is the qualifying characteristic of each investment fund. In the Author's view "*Every type of investment fund adopts a pattern of organization that I am calling the "separation of funds and managers." I choose this phrase partly to evoke the infamous "separation of ownership and control" in ordinary companies," while making it clear that investment fund organization involves something different from and more extreme than the simple delegation of decision-making authority that occurs in ordinary companies*". See MORLEY, J. (2014), p. 1232. The theory however is not convincing considering that, despite its relevance in the context of collective asset management, the autonomy of the fund manager can be declined in various forms and therefore cannot be considered as an element that, if taken in isolation, is capable of differentiating undertaking for collective investments from other industrial or commercial entities or from other financial services providers.

The separation of fund and managers lies at the basis of the standardised nature of the activity of collective investment schemes. Investment funds are in fact characterised by the fact that they offer investors the possibility to entrust their money to a professional manager, which consequently works on behalf of a number of investors that are all equally exposed to the profits or losses resulting from its investment decisions. The fact that investors should be prevented from having a say on the investment decisions is therefore a consequence of both the professional nature of collective asset management and a means to ensure equality among investors.

The meaning of day-to-day discretion or control is clarified in Section II of the Guidelines whereas it is intended as "*a form of direct and on-going power of decision – whether exercised or not – over operational matters relating to the daily management of the undertakings' assets and which extends substantially further than the ordinary exercise of decision or control through voting at shareholder meetings on matters such as mergers or liquidation, the election of shareholder representatives, the appointment of directors or auditors or the approval of annual accounts*".

The practical implications of this principle will be further discussed in Section 2.6.3.

1.2.2. Pooling of capitals from a number of investors

According to the Guidelines the raising of capital mentioned in Art. 4(1) AIFMD has to be intended as the activity "*to procure the transfer or commitment of capital by one or more investors to the undertaking for the purpose of investing it in accordance with a defined investment policy*"[17].

The formulation is very wide and could potentially embrace any activity which would result in a transfer of resources from one or more investors to the collective investment scheme, regardless of whether the cash pooling is only carried out once or on a continuous basis and of the form of the contribution.

The collection of capital is however defined by ESMA in a functional basis, as it stated that the capital raising has to be finalised to the investment in accordance with a defined investment policy. The mere collection of capital is in fact a feature not capable,

[17] Paragraph 13 of the ESMA Guidelines.

per se, of characterising the activities of collective investment schemes as it is a recurring element in any corporation or entity which seeks access to the capital markets. What is determinant is instead the finalisation of the capital pooling, which has to be carried out with a view to invest the gathered resources on the basis of a defined investment policy. In this sense however the "capital raising" requirement loses any descriptive characteristic as it becomes included in the element represented by the defined investment policy[18].

The requirement of a "number of investors", in ESMA's view, is instead satisfied in case the entity is not forbidden to raise capital from a plurality of investors under the relevant national laws, its constitutional documents or any other binding provision[19]. The Guidelines however also consider some exceptions to the above principle, providing that in a number of cases, that include in general those arrangements where a sole investor is acting as an agent for more than one investor, the fact that an undertaking may be prevented from raising capital to the public does not imply non-compliance with the principle of having a "number of investors" [20].

The requisite of the plurality of investors further implies that investment funds should be structurally designed to include more than one participant. As a result, situations that *ex ante* exclude the presence of a plurality of unitholders cannot be considered compliant with this principle. However, it does not seem in contrast with the notion of collective investment undertaking a situation where the lack of the plurality requirement is not met as a result of an accidental issue, provided that the undertaking was originally intended to pursue the fulfilment of this requirement[21].

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[18] ANNUNZIATA, F. (2017b), p. 23.

[19] See paragraph 17 of the ESMA Guidelines whereas it is stated that "*an undertaking which is prevented by its national law, the rules or instruments of incorporation, or any other provision or arrangement of binding legal effect, from raising capital from more than one investor should be regarded as an undertaking which raises capital from a number of investors in accordance with Article 4(1)(a)(i) of the AIFMD if the sole investor: (a) invests capital which it has raised from more than one legal or natural person with a view to investing it for the benefit of those persons; and (b) consists of an arrangement or structure which in total has more than one investor for the purposes of the AIFMD*".

[20] *Ibid.* paragraph 18.

[21] In this sense, ANNUNZIATA, F. (2017a), p. 6.

1.2.3. Defined investment policy

The defined investment policy can be considered the element that most effectively characterises the notion of undertaking for collective investment both from a legal and an economic point of view. It is in fact the element that mostly reflects the standardised nature of the collective asset management activity, which is carried out for the benefits of the investors as a group and independently from the needs of the single unitholders[22]. In this sense the defined investment policy is also the element that mostly distinguishes collective asset management from other investment services where the investment strategies are arranged on the basis of the needs and preferences of the single investors, which may be as well able to provide binding instructions to the investment manager. On the contrary, in investment funds the provision of different investment policies, besides being difficult to implement from an operational point of view, would be in contrast with the standardised nature of collective asset management, ultimately resulting in the provision of a different investment service, such as the individual portfolio management.

In ESMA's view the common investment policy has to be *defined,* which seems to indicate that it should exist before, or at the latest, come to existence at the same time of the investment operation. In this sense in fact the ESMA Guidelines provide that "*the investment policy* [should be] *determined and fixed, at the latest by the time that investors' commitments to the undertaking become binding on them*"[23].

The predetermined nature of the investment policy also suggests a certain stability over time. This does not imply however that it would not be possible to modify the

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[22] This view is supported by different scholars. See, amongst the others, ANNUNZIATA, F. (2017c), p. 211-215. According to the Author in fact the other elements constituting the notion of undertaking for collective investment (namely, the pooling of capital raised from a number of investors and the absence of day-to-day discretion or control) "*cannot be considered,* per se*, as a true distinctive element of the notion of UCI*" as these elements "*can be also found in other organisational structure which do not qualify as undertakings for collective investment*" (i.e.: these elements can be also found in other business corporations notwithstanding the nature of the activities carried out, whether entrepreneurial or financial). Of a similar view seems to be SANDRELLI G. (2015), which also considers the defined investment policy an essential element for any collective investment scheme, as "[i]*t appears difficult that a professional asset management service may be carried out in the total absence of a prior identification of the minimum risk-rewards parameters on the basis of which potential investors may base their decision whether or not to invest their savings in the collective investment undertaking".*

[23] Paragraph 20(a) of the ESMA Guidelines. This further implies that all the all the arrangements in which the definition of the investment policy takes place subsequently from the completion of the share subscription by the investor cannot be considered as undertakings for collective investment.

investment policy at a later stage, but rather that this possibility should be subject to appropriate safeguards and should be made only in compliance with the applicable laws and regulations and also with the fund instrument[24].

In ESMA's view the investment policy should also be set out in a document which becomes part of or is referenced in the constitutional documents of the fund. This clearly suggests that the investment policy should be provided in an appropriate support to allow investors to consult its content.

Besides being predetermined the investment policy must also be binding. In this sense ESMA requires that the undertaking should have an "*obligation (however arising) to investors, which is legally enforceable by them, to follow the investment policy*"[25].

The ESMA Guidelines do not provide a precise understanding of what should be the minimum specification requisites in order to consider the requirement of the defined investment policy fulfilled. In ESMA's view, however, the main purpose of the investment policy seems to be the delimitation of the activities of the investment manager by setting a limit to its discretion. Furthermore, it can be intended that the investment policy should refer, rather than on the object of the investment program, on the modalities on the basis of which the investment objective should be achieved.

Finally, it can be also considered that the investment policy must be detailed at least to some extent given that the absence of any specific indications in relation to the direction that the investment activity may follow cannot be considered as fulfilling the requirement of having a defined investment policy[26]. In the lack of an ESMA position of the matter however, more detailed indications on the level of detailed expected in the definition of the investment policy can be found in national supervisory practices. By way of example, with respect to the Italian jurisdiction, the Bank of Italy, in its Regulation on Collective Asset Management[27], considered that the mere indication of a "business strategy" identifying only general sectors or areas of activity without any further

[24] ANNUNZIATA, F. (2017b), p. 27-28.

[25] Paragraph 20(c) of the ESMA Guidelines.

[26] In this sense, ANNUNZIATA, F. (2017b), p. 30.

[27] Regulation of the Bank of Italy of 19 January 2015 as subsequently amended and supplemented.

specification of more elements (such as concentrations, or investment limits) cannot be qualified as a proper "investment policy"[28].

1.2.4. <u>Pooled return for investors and financial nature of the activity</u>

The ESMA Guidelines provide that the common investment policy should be further characterized by the fact that it should be aimed at generating "*a pooled return for the investors from whom* [the capital] *has been raised*". The notion of pooled return is further specified in the Guidelines as "*the return generated by the pooled risk arising from acquiring, holding or selling investment assets – including the activities to optimise or increase the value of these assets – irrespective of whether different returns to investors, such as under a tailored dividend policy, are generated*"[29].

This element gives further specification of another requirement that in ESMA's view should characterise the definition of "undertaking of collective investment" which is the financial nature of its activity. In this respect, even though ESMA provided in its Guidelines insufficient elements to frame a distinction between financial activities, on the one hand, and commercial and industrial activities, on the other, the pursue of a pooled return generated from the management of the risks inherent the managing activity can be considered the element that ultimately qualifies the financial nature of the activity of an investment fund[30]. The "nature" of a given activity is not in fact reflected in the modalities in which it is carried out but instead in the objectives it pursues. In this respect a financial

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[28] On the differences between "investment policy" and "investment strategy" see *infra* Section 2.6.3.

[29] Section II of the ESMA Guidelines.

[30] According to the definition contained in Section II of the Guidelines the commercial or industrial purpose is "*the purpose of pursuing a business strategy which includes characteristics such as running predominantly i) a commercial activity, involving the purchase, sale, and/or exchange of goods or commodities and/or the supply of non-financial services, or ii) an industrial activity, involving the production of goods or construction of properties, or iii) a combination thereof*". The wording of the Guidelines, however, does not seem to draw a precise dividing line between financial and non-financial activities. As pointed out by ANNUNZIATA (2017b) "*the wording of the Guidelines follows a circular approach which lead the interpreter to the same starting point. It is said, in fact, that "the commercial or industrial purpose" consists of running a business which is (again) commercial (sub. i) or industrial (sub. ii)*". Furthermore, the Authority refrained from providing a principle-based indication of what can be regarded as either a commercial or industrial activity, only providing a few examples of activities that, although traditionally associated to industrial and commercial enterprises, are nonetheless actually neutral for the qualification of the "nature" of the purpose followed by the entity. It is in fact possible to note that the sale or exchange of goods or commodities and even the production of goods or the construction of properties are features that can be also found in financial activities such as in real estate funds.

activity should not be aimed at pursuing the mere intent of providing investors with the distribution of profits – as in any commercial or industrial corporation – but rather at generating a return which is financial in its nature and hence obtained through an investment process based on the principles of risk diversification and risk management[31]. According to the economic theory an activity can in fact be deemed to be financial in its nature whenever capitals are invested in order to obtain a profit which is the result of the bearing of a risk that is correlated with the expected return of the investment[32].

1.3. REGULATORY FUND CATEGORIES

There are currently two different regulatory fund categories under European law, namely UCITS and AIFs. The UCITS regime is discretionary, and only covers those undertakings that meet all of the requirements provided for in the UCITS Directive. In contrast, AIFs represents a non-homogeneous group of different types of collective investment schemes joined together by the fact that they are not UCITS compliant. From this point of view, it can be considered that at EU level, *tertium non datur*, given that each investment fund can be established as a UCITS or as an AIF at the discretion of its manager but whatever is not a UCITS, is an AIF[33].

1.3.1. UCITS

The UCITS regime represents one of the first initiatives of the European Union to create a single market for financial products. In this respect the UCITS Directive was designed, through the harmonization of the EU Member States' internal rules on investment funds and their managers, to promote the free movement of collective investment products and in particular to make it easier for European collective asset managers to market fund units or shares in other Member States[34].

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[31] In this sense ANNUNZIATA, F. (2017c), p. 217. For a better reconstruction of the relevance of the risk profile in the context of the common investment policy see *infra* Section 2.6.4.

[32] In this respect see, among the many others, ROSS, A., WESTERFIELD, R., & JORDAN, B. (2011), pp. 401 ff.

[33] In this sense BODELLINI M., (2016), p. 589.

[34] For further specification of the principles see MOLONEY, N. (2008), pp. 247 ff.

At the heart of the UCITS Directive are the two principles of "mutual recognition" and "home-country-control". The first principle prevents Member States from implementing additional requirements other than those provided in the Directive[35]. Under the second principle the jurisdiction over the supervision of the UCITS is granted to the competent authorities of the Member States in which it was firstly authorised[36].

The UCITS Directive encouraged greater interpenetration of securities markets by granting UCITS management companies a regulatory passport allowing them to provide in other Member States the activities for which they have been authorised in their home country without the need to apply for a further authorisation, only requiring a notification procedure. In fact, after having obtained its passport a UCITS may be marketed freely to any type of investor throughout the EU.

In order to be granted the authorisation to be passported, undertakings must meet all the necessary requirement to be qualified as an "Undertaking for Investment in Transferable Securities", which, according to Article 1(2)(a) is an undertaking with "*the sole object of collective investment in transferable securities or in other liquid financial assets* […] *of capital raised from the public and which operate on the principle of risk-spreading; and with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets*".

It follows from the given definition that the UCITS regime is restricted only to specific types of investment funds that are open-ended in their nature and that further respect all the other requisites provided in the Directive. As a consequence of being open-ended, UCITS funds should be always be able to meet sudden redemptions. As a result, the UCITS Directive provides that UCITS may only invest in "*liquid financial assets*", which include, *inter alia,* transferable securities, deposits, money market instruments, other UCITS shares and financial derivatives (provided that the underlying of the derivative consists of instruments covered in the Directive), financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS may invest according to its investment objectives[37].

[35] Recital 8 of the UCITS IV Directive.

[36] *Ibid.* p. 253.

[37] Art. 50(1) UCITSD. OTC derivatives are only allowed if subject to reliable and verifiable valuation on a daily basis and only in case the counterparties to the transaction are subject to prudential supervision. It has

UCITS funds investment strategies must be based on the principle of risk spreading. In this respect the UCITS Directive provides a number of concentration limits with an aim of reducing the vulnerability of UCITS to the performance of a small number of assets, by also setting individual exposure limits in relation to different cathegories of assets[38]. Notwithstanding the individual limits, it is also provided that a UCITS shall never combine multiple investments within the same individual body where this would lead to an exposure of more than 20% of its assets[39]. Furthermore, the UCITS Directive imposes a hard limit to the recourse to leverage by providing that a UCITS global exposure relating to derivative instruments shall not exceed the total net value of its portfolio[40].

1.3.2. AIFs

With the adoption of the AIFM Directive the European legislator sought to provide for an internal market for non-UCITS funds, that prior to its introduction, were not subject to any common regulation, and also to introduce a harmonised and stringent regulatory and supervisory framework for the activities of all AIFMs within the Union[41].

The AIFMD was a response to the financial crisis that hit markets in 2007 which drew the attention to several weaknesses in the financial system and called for an

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also to be noted that in consideration of the increase in the variety of financial instruments traded in financial markets the European Commission adopted Directive EC/2007/16 (also called "UCITS Eligible Assets Directive") providing further clarification on the notion and characteristics of UCITS eligible assets. In addition, CESR published guidelines concerning eligible assets for investment by UCITS. Recently the CESR guidelines were reaffirmed an expanded by ESMA with the publication in 2014 of *Guidelines on ETFs and other UCITS issues* (ref. ESMA/2014/937), which, *inter alia*, provide a clear definition of the characteristics required for an instrument to be considered as a "*financial index*" for the purposes of the UCITS Directive.

[38] As a general rule UCITS cannot invest more than 10% of their assets in transferable securities or financial instruments other than those referred to in Art. 50(1) (so called "trash quota"). Furthermore, no more than 5% of the UCITS assets should be invested in transferable securities or money market instruments issued by the same body (this limit can be raised by Member States). Further limitations also require UCITS not to invest more than 20% of their assets in deposits made with the same body. The use of derivatives is also restricted, being provided that the maximum exposure to a single OTC derivative counterparty cannot exceed 5% of the UCITS assets, increasing to 10% for certain credit institutions.

[39] Art. 52(2) UCITSD.

[40] Art. 51 UCITSD. As a result, the total risk exposure of an UCITS cannot exceed 200% of its NAV, which could be increased by an additional 10% by means of a temporarily borrowing.

[41] Recital 4 of the AIFMD.

enhancement of supervisory arrangements and regulations involving all the major players in European financial markets. Through the application of its principles, the AIFM Directive in fact also aims at limiting some important classes of macroprudential risks, with the purpose to protect not only the interests of investors, but also the interests of other stakeholders such as creditors, counterparts and the entire European financial markets[42].

The provisions of the AIFMD, which are mainly principle-based, in many cases delegate to the Commission the possibility to adopt implementing legislative acts, which eventually resulted in the adoption of the Commission Regulation EU/2013/231 ("**AIFMD Implementing Regulation**") supplementing many of rules of the Directive. Furthermore, ESMA further issued a number of guidelines, Q&As and other soft law acts providing clarification and operating provisions in relation to many aspects covered in the AIFMD.

In introducing the new framework for a common market for AIFs, the European legislator decided not to regulate the characteristics of the investment product offered to investors, which continue to be subject to the internal rules of each Member States, but instead only to provide common rules regarding the managing entities and the marketing of alternative funds[43].

The AIFMD introduced a passporting regime which is inspired by that of the UCITS Directive. Pursuant to Art. 31(1) of the Directive, an authorised EU AIFM may market shares of an EU AIF, either by providing cross-border marketing services or to a branch, to professional investors in any of the Member States[44]. The scope of the AIFMD

[42] In this sense, STEFANINI F. [ed.], DEROSSI T., MEOLI M., & VISMARA, S, (2010), p. 31.

[43] The regulatory solution adopted in the AIFMD to regulate the activities of AIFMs and not to provide explicit rules applicable to the AIFs is mainly a consequence of the difficulty of finding an appropriate harmonised definition of AIF, in relation of their heterogeneity. Furthermore, the AIFMD, which was adopted as a result of the 2007-8 financial crisis, is primarily aimed at pursuing financial stability and at avoiding systematic risks. In consideration of the fact that the major threats to the market integrity are posed by the activities of the managing entities of AIFs, and not by the structure of the AIFs themselves, the European Commission shared the view that "*the most effective way to tackle the risks is therefore to focus on these entities which are decisive in terms of the risks associated with the management of AIF*" (EUROPEAN COMMISSION (2009), *Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*, ref. COM(2009) 207 final, p. 7).

[44] Art. 31 and 32 AIFMD. The definition of "professional investor" is provided in Annex II of the MiFID II (Directive 2014/65/EU) as an investor "*who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs*". These include credit institutions,

passport is therefore more limited than that of the UCITS Directive, as AIFs are only eligible to be sold to professional investors. However, the AIFMD also authorises Member States to permit the marketing of units or shares of alternative funds to retail investors, albeit in this case Member States can impose stricter requirements than those applicable to professional investors. The additional requirements imposed to cross-border AIFs however cannot be stricter than those applicable to AIFs marketed domestically[45].

The AIFM Directive provides no restriction on the eligible assets nor to the discretion of managers in delineating and implementing the investment policy. As a result, AIFs have no limitations on the use of derivatives, leverage or short selling and can set their own desired risk exposure even though restrictions may be demanded by national laws. However, AIFMs are subject to reporting requirements on their liquidity level, risk exposure and use of leverage[46].

The provisions of the Directive apply to both EU and non-EU AIFMs which manage or market one or more AIFs in the European Union irrespective of whether such AIFs are EU AIFs or non-EU AIFs[47]. The scope of the AIFMD is also further defined by a size-based threshold referred to the AIFM's asset under management. The AIFMs below this threshold are not subject to the provisions of the Directive except for the registration requirement[48]. In order to qualify for the size-based exemption from the AIFMD, the total assets under management must not exceed EUR 100million if the AIFM manages open-ended funds or funds which do not employ leverage. In the event the AIFM manages only closed-ended funds and renounces to the use of leverage, the limit is set to a maximum of EUR 500million[49]. The AIFM must fully comply with the AIFMD in the event the limit is exceeded over three months. Once this happens the fund manager must inform the national supervisory authority immediately.

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investment firms, collective investment schemes, institutional investors and other authorised or regulated financial or insurance companies.

[45] Art. 43 AIFMD.

[46] See *infra* Section 1.8.

[47] Art. 2(1) AIFMD.

[48] Art. 3(2)-(4) AIFMD.

[49] The calculation of the values is subject to Arts. 2 ff. of the AIFMD Implementing Regulation.

A further exemption is also granted to "intragroup undertakings"[50], while a series of other entities such as holding companies, pension schemes, family offices supranational institutions and securitisation special purpose vehicles are explicitly excluded from the scope of the Directive[51].

1.4. LEGAL STRUCTURES

The legal structure of a fund forms the main basis of the governance framework under which the which the fund operates.

Notwithstanding the differences in their organisational structures, the fact that investment funds may be organised according to different models does not impact their submission to a common discipline. In the view of the harmonisation of the European law, the UCITS Directive first, and subsequently the AIFM Directive, have in fact introduced a common legislative framework which is applicable to different kinds of legal undertakings, all sharing the same economic function but deeply different in regard of their legal structure[52].

The AIFMD in fact is applicable to any entity that qualifies as an Alternative Fund Manager, whose definition does not take into account the legal form of the undertaking[53]. The undertakings falling within the scope of the UCITS Directive may instead be constituted "*in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies)*"[54].

As of today, the most widespread arrangements under which the collective asset management service is carried out are generally organised following either the unit trust model, the contractual model or the corporate (or statutory) model[55]. These three different

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[50] According to Art. 3(1) the intragroup exemption applies to "*AIFs whose only investors are the AIFM or the parent undertakings or the subsidiaries of the AIFM or other subsidiaries of those parent undertakings, provided that none of those investors is itself an AIF*".

[51] See Art. 2(3). On the definition of "holding companies" and "family offices" see WEGMANN, H. (2015) Chapter 3.3.2.

[52] In this sense LENER, R. (1989), p. 226.

[53] See also Sections 1.1 and 1.2 above.

[54] Article 1(3) of the UCITS Directive.

[55] According to WEGMANN, H. (2015), there are only "*two basic legal models in which investment funds are organised, (1) the contractual model; and (2) the corporate model*". This view however raises some

legal structures appear, at a first glance, substantially different. It is therefore worth analysing these models separately.

1.4.1. Unit trust

The unit trust model, which can be considered the archetype of the general class of collective investment schemes, can be described as a "*relationship in which the trustee is held to deal with the trust property for the benefit of the beneficial owners of the trust*"[56].

The trust originated from the English medieval law and is now mainly diffused in common law jurisdictions (especially in the UK) whereas it is rarely found in civil law systems since they usually do not recognise the its typical ownership structure. At the basis of the concept of the trust scheme is in fact the division of ownership between "legal" and "equitable" which is in sharp contrast with the unique and absolute conception of ownership of civil law jurisdictions[57].

The trust can be described as an "aggregation of property", where the rights and duties are divided among the trustee (or legal owner) and the beneficiaries (or equitable owners) in the trust[58]. Whilst the legal owner of the property (trustee) has the right to possession, the privilege of use, and the power to convey those rights and privileges the benefits of the property are all entitled to another subject (beneficial owner). The trustee has a fiduciary duty to the beneficial owner to exercise his legal rights, privileges, and powers in such a way as to benefit not himself but the beneficiary[59]. The trust scheme therefore provides that separation of management which is now a qualifying element of the very concept of investment fund.

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concerns in relation to the qualification of unit trusts and partnership structures. The Author also assumes that unit trusts can be assimilated to the contractual model as "*a trust fund is essentially created by contract (i.e. the trust agreement)*" and that contractual structures can be more generally classified as *"partnership structures, which include all contractual structures that are not separate legal entities under which each investor is a co-owner of the assets funds can be organised"*. This view however is not reflected in the UCITS Directive which identifies at least three different organisational forms for UCITS (see *infra* footnote no. *54*).

[56] WEGMANN, H. (2015), p. 104.

[57] For an overview of the legal and historical origins of the trust and for the similarities and differences between the English trust and German private law schemes, see MAITLAND, F. W. (1904).

[58] In this sense WEGMANN, H. (2015), p. 108.

[59] For an in-depth overview of the general trust structures and of the duties of the trustee see DONAHUE C. & ALEXANDER G. (1999).

For the purposes of the AIFM and UCITS Directive the trustee, next to being the legal owner, also performs the role of depositary. In case of UCITS funds however, since it is required that the depository cannot be the same entity as the manager, it will be required to appoint a separate manager[60].

1.4.2. Contractual model

The contractual model is the most widespread legal form in Italy and in Continental Europe, being it the form that has been usually used to firstly implement the regulation of investment funds in the national systems of civil law countries, reflecting part of the qualifying characteristics of the unit trust, and in particular its peculiar arrangement of ownership and management, into a legal scheme (the contract) which was deeply rooted in these jurisdictions.

In this model the contributions provided by the investors converge in a pool of assets whose management is entrusted to a separate legal entity, the management company. The contractual investment fund is therefore represented by a pool of assets which is different from the investors' and the management company's own assets, that has to be kept in custody by a third party (the depositary)[61]. The contractual investment fund is usually described as not constituting a legal entity in its own rights and the fund investors are usually qualified as co-owners of the fund's assets[62].

The legal nature of contractual funds, however, has been, and to some extent still is, the focus of an intense doctrinal debate, which has been particularly alive in the first years following the introduction investment fund laws in Italy and in other civil law jurisdictions. Historically, the crucial point of the debate has always been represented by the problem of the "ownership" of the common pool of assets and therefore of the formal characterisation of the relationship between the investors, the fund and the management

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[60] See *infra* Section 1.6.2.

[61] See also Section 1.6.

[62] In several legal systems in fact contractual funds are expressly regarded as pool of assets co-owned by investors and managed by a separate management company on the basis of a mandate contract with investors. It has to be noted however that the national laws usually provide numerous derogations to the legal regime of the co-ownership so that many scholars conclude that the fund-investor relationship is a "special legal framework" that differs from the traditional notion of property and reflects "*the interaction between traditional property law and the law governing UCIs"* (KREMER, C. & LEBBE I. (2009), p. 47.).

company. Different theories regarding the nature of the fund-investor relationship in contractual funds arisen from time to time[63]. In particular, in the Italian legal literatures, investment funds have been characterised as a mere contract, as a co-ownership between the investors, as a mandate scheme between the management company and investors, and also, according to a more recent theory as a separate legal entity with its own legal personality[64].

With the evolution of the asset management legislation and with the introduction of an increasingly detailed and complex regulation, however, the argument lost most of its relevance as the legislator intervened to solve many of the practical problems connected with the debate around nature of investment funds.

1.4.3. Statutory model

The statutory or corporate model is popular both in common and civil law jurisdictions, in which it does not raise the same concerns of the contractual model.

Under the corporate model the investment fund is structured as an investment company whose sole object is the management of a pool of assets[65]. As a result, corporate funds are structured as separate legal entities having their own legal personality.

As a consequence of being a company the fund's organisational structure mirrors the typical corporate organisation that provides for the presence of different corporate bodies. As a result, the fund is managed by its board of directors while a supervisory body is supposed to fulfil oversight and monitoring functions[66]. The fund may also be either internally or externally managed, in which case the board of directors will appoint a separate manager.

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[63] For an in-depth overview of the different theories see SEMINARA, L. (2016), 1115 ff.

[64] This theory has been put forward by the most recent Italian doctrine and found confirmation in a recent Ruling of the Tribunal of Milan. See in this respect BASILE, M. (2017).

[65] In this sense, LENER, R. (1989), p. 228.

[66] Depending on the different corporate structures the supervisory body may be constituted as a separate body from the board of directors. This is the case in the German "two-tier" structure whereas corporation have two boards: the management board and the supervisory board. The supervisory board (which is elected by shareholders) appoints and dismisses the management board and monitors its operate. According to the UK "one-tier" model instead, only one single board exists, whose members are elected by shareholders, which carries out both the management and the supervision of the company.

Another implication of the statutory model is that fund investors are also qualified as shareholders. Being shareholders of the company, investors, are, theoretically, be granted far more reaching powers than in the other two models as they will be able to participate to investors' meetings and thus potentially influence the fund activity or at least express their disagreement for the current management.

1.4.4. Impact of the legal structure on the fund-investor relationship

As shown the trust, contractual and statutory structures are catachresis by totally different organisational models. The rules governing the provisions of the collective asset management activity however have an impact on the typical organisational frameworks adapting them to the operating mechanics of collective investment[67]. At a deeper look, it can be noted that the traditional organisational models for collective investment schemes actually tend to present some sorts of "contaminations" with each other and seem to move towards converging lines.

It has been in fact shown that the contractual structure has been inspired by the rules typically characterising the unit trust. Furthermore, contractual undertakings present a clear organisational framework, which is shaped on the basis of corporate structures. Finally, the national discipline of corporate funds usually provides significant deviations from the standard corporate models, which originate from the influence on this structure of the common law trust rules[68], as the separation of investors and management provided in most corporate fund is far more evident than the simple delegation of decision-making authority that occurs in ordinary companies[69].

In the view of an authoritative legal doctrine, the reasons for the above considerations may be traced to the fact that the European regulations of investment funds follows a "*typically functional approach by virtue of which* […] *the pursue of its major objectives* [i.e. the harmonisation of the European capital markets and investor protection] *significantly outweighs the consideration of the formal and organisational schemes*"[70].

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[67] ANNUNZIATA, F. (2017b), p. XIII.

[68] *Ibid.* p. XIV.

[69] See in this respect footnote no. 16.

[70] ANNUNZIATA, F. (2017b), p. XV.

The core provisions of the European collective asset manager regulation apply horizontally and without distinction to the single legal forms. These latter can be therefore considerate as different "envelopes" for the provision of the collective asset management activity, whose differences in the relevant sectoral disciplines do not impact the substantial underlying legal relationship between funds and investors.

1.5. FUND SHARES AND PARTICIPATION RIGHTS

One of the defining features of investment funds is the fact that in order to raise capital they need to issue securities or other financial instruments to investors, which are usually referred to as shares, in case of corporate funds, or units, in case of contractual funds or investment trusts.

Units or shares represent the rights of the participants in a collective investment undertaking and also act as a measuring unit for the evaluation of the pro rata interests of each investor. As a result, all the rights and obligations characterising the fund-investor relationship are embedded in the fund's participation rights.

Fund units also qualify as financial instruments for the purpose of the MiFID discipline and are therefore subject to the provisions therein contained[71].

Fund shares are usually of the "equity type", representing the pro rata interest of an investor in the fund's assets, which is reflected in the Net Asset Value ("**NAV**") of each share[72]. A fund's Net Asset Value reflects the difference between the fund's assets and the fund's liabilities, divided by the number of shares outstanding. The NAV's key feature is that it does not reflect expectations about future fees or future portfolio changes being it based simply on the value of the securities in a fund's portfolio on any given day. As a result, any profit or loss will always be reflected in the fund's NAV.

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[71] See Section C of Annex I to the MiFID II, which provides a list of instruments which are considered to be "financial instruments" for the purposes of the directive which include transferable securities, money-market instruments; units in collective investment undertakings; options, futures, swaps, forward and other derivatives.

[72] It is possible however that funds may issue shares which are "debt in nature" so that investors' rights are based on a fixed interest rate of the fund's assets. By way of example, investors entering into a pension scheme are usually not granted a share in the profit made by the pension scheme but instead they receive payments upon retirement or upon a specific event occurring. See further WEGMANN, H. (2015), p. 60-62.

Investors can profit from an investment fund by having their shares redeemed or bought back by the fund itself which is under an obligation to do so. Depending on the frequency of redemptions and buy backs provided in its constitutional documents, investment funds can be categorised either as being either open-ended or closed-ended.

Open-end funds redeem shares on a regular basis at their NAV, which, as a result, should be assessed at least with the same frequency of redemption.

In order to qualify as open-end for the purpose of the UCITS Directive a fund should allow investors to redeem their shares against the NAV (or, in case of listed UCITS, at a price not significantly different from their NAV) at least twice a month[73]. Member States however may allow UCTIS to redeem shares only once a month[74].

An AIF shall be considered to be of an open-end nature if it repurchases shares, at the request of its shareholders, prior to the commencement of its liquidation phase or wind-down out of the assets of the AIF and in accordance with the procedures and frequency set out in its rules or instruments of incorporation, prospectus or offering documents[75]. No criterion is imposed in relation to the frequency of redemptions. Furthermore, any restrictive powers in the AIF instruments, such as lock-up periods or suspensions, are not taken into account in determining the open-end nature of the AIF[76].

In addition to a portion of the fund's return unitholders are usually provided by law with investors' rights similar to those of stock owners in companies. These rights may include the right to vote for the election or removal of the board, to participate and vote in investors' meetings, to place items on the agenda and to ask questions to the manager.

At a European level the exercise of shareholders' rights is mainly disciplined by the Shareholders Rights Directive[77] which establishes requirements in relation to the

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[73] Art. 1(2)(b) UCITSD. The UCITS' constitutional documents however may, in accordance with the applicable national law, provide for a provision allowing the management company to temporarily suspend the repurchase or redemption of its units in exceptional circumstances if the interests of investors are at stake (Art. 84 UCITSD).

[74] Art. 76 UCITSD.

[75] Article 1(2) of the Commission Delegated Regulation EU/2014/694 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to regulatory technical standards determining types of alternative investment fund managers.

[76] In this sense WEGMANN, H. (2015), p. 75.

[77] Directive EC/2007/36, as subsequently amended and supplemented.

exercise of certain shareholder rights attached to voting shares in general meetings of companies. The scope of application of the Shareholder Rights Directive is however limited to companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market and Member States are further allowed to exempt both UCITS and AIFs from the provisions of the Directive[78]. As a result, there is as yet no common framework on fund investors' voice rights, whose regulation is basically left to national laws.

Generally speaking, investment funds structured as investment companies (if not issuing non-voting shares) usually provide at least the possibility for shareholders to attend shareholders' meetings, while the possibility for contractual funds to hold general assemblies, if not prevented at all, will usually depend on the fund's instrument[79].

The lack of binding provisions regulating the involvement of investors in the fund's administrative life is not surprising. The clear separation between investors and the fund management can be in fact considered a feature historically characterising investment funds, being also a consequence of the standardised nature of their activity. This is also reflected in the legislative definition of undertaking for collective investment which actually provides that investors should not be granted a "day-to-day" control on the fund's activities[80].

Furthermore, the traditional legal and economic theory considers that sufficient protection is already granted to investors since they always have the possibility to "vote with their feet" by selling or redeeming their shares. For mutual fund investors exit is in fact usually more efficient and less costly than the exercise of a collective action against the manager, it is therefore held that fund's investors usually "*do not value control, because if they are unhappy, they can simply remove their money and take it elsewhere*"[81].

[78] Art. 1(1) of the Shareholders Rights Directive.

[79] By way of example common contractual funds in Ireland should not hold investors' meetings while in other jurisdictions such as Italy or Luxembourg, in the lack of explicit legal provisions preventing this possibility, the consolidated doctrine is in the sense of considering it possible for contractual funds to envisage a general assembly in their constitutional documents. For a better insight of these issues see ANNUNZIATA, F. (2017b), p. 139ff.

[80] In this respect see Section 1.

[81] In this sense MORLEY, J. (2014), p. 1246ss. The Author also goes as far as to state that any arrangement restricting the discretion of the manager should not be considered appropriate for investment funds as exit rights constitute the most effective form of investor protection. The view of the Author however is justified by the consideration that "[e]*xit rights cause fund investors to resemble product buyers. Just as product*

The provision of voice rights for investors is in fact a more typical feature in private equity and hedge funds, and in other types of closed-end funds where the possibility for investors to exercise their exit is much more limited or costly than in open-end funds[82].

However, there not seem to be any incompatibility between exit and voice rights, and even in open-end fund the institution of a general assembly can be utilised as an useful tool to complement the investor protection framework[83]. It can be also noted that, even though it is true that investors may always exercise their right to ask for a redemption or repurchase of their shares as a reaction to their disagreement with the manager's activity, the possibility to redeem shares at any time may be precluded even in open-end funds, since the UCITS Directive expressly allows fund managers to limit the frequency of redemptions to once a month.

The potential scope of the investors voice rights in open-end and closed-end funds, however, should reflect, as appropriate, the difference in the interests involved, so that for closed-end funds it should be possible to attribute more pervasive voice powers to investors, also in consideration of the greater sphere of discretion the AIFMD left to the parties in defining the characteristics of their relationship.

Without prejudice to the above, the freedom of the parties in arranging the voice rights of investors and in particular the competences of the general assembly encounter a limit in the principle of the separation between fund and managers, which characterises the very notion of "undertaking for collective investment". As a result, in no event shall the powers granted to investors result in the possibility to exert an actual influence over operational matters relating to the daily management of the undertaking[84].

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buyers can sever their relationships with suppliers by refusing to buy the products any longer, so too can fund investors sever their relationships with management companies by removing their assets and refusing to pay the managers' fees any longer." The assimilation between product buyers and fund investors, however, raises some concerns, as, even in open-end collective investment schemes, share redemption are not always allowed on a daily basis. Furthermore, the same Author also recognises that "[t]*he separation of funds and managers is thus most problematic in closed-end funds and private equity funds, where exit is relatively limited*".

[82] *Ibid.* p. 1255.

[83] In this sense, ANNUNZIATA, F. (2017b), p. 142.

[84] See in more detail Sections 1.2 and 2.6.3.

1.6. PARTIES TO THE FUND-INVESTOR RELATIONSHIP

One of the fundamentals of European investment funds law is the so-called investment triangle. Both the UCITSD and the AIFMD require a general structure of investment activities which can legally be characterised as a triangle the corners of which constitute (i) the investor; (ii) the external or internal asset manager; and (iii) the depositary/custodian[85].

The manager oversees the investment activities and the depositary holds the assets in custody on behalf of the fund thus functioning as the point of contact for money flowing to and from the investors. Moreover, both the manager and the depository, oversee each other activities[86].

In addition to these subjects there are several other parties that provide (or may provide) services, including additional control functions, such as the independent auditor, administrator, principal underwriter, transfer agent and investment adviser. The auditor has the duty to review the fund's financial statements included in the annual report. It is also responsible for assessing the compliance of the fund's activities in relation to certain regulations, mainly related to the correct valuation of the fund's shares and the validation of the fund's income and costs, thus providing *ex-post* protection against the reporting of incorrect information. The fund administrator provides administration services to the fund, including accounting and pricing or valuation services. In many cases the manager is also the fund's administrator. The principal underwriter is a broker-dealer engaged in the purchasing and reselling of the fund's shares to the public, directly, or indirectly through other financial institutions. The principal underwriter usually prepares sales material in order to market the fund. The transfer agent is a financial institution that maintains records of investors and account balances. In exchange for a fee, it records transactions, issues and cancels certificates, processes investor mailings and deals with other investor problems[87].

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[85] In this sense ZETZSCHE, D. (2017), p. 26.

[86] *Ibid.* See also Arts. 22 ff. of the UCITSD and Arts. 21 ff. AIFMD.

[87] For a better overview of the activities of the different subjects that, together with the fund manager and depositary, are involved in the activities of common investment funds see WEGMANN, H. (2015), p. 58-59.

1.6.1. Fund Manager

Fund managers are professional investment services providers that offer investment portfolio management and risk management services to investment funds. An investment fund can be managed either externally by a separate entity (as is the case for contractual funds) or internally by its internal board (as is often the case for corporate funds).

Fund managers are usually the subjects that establish the fund in the first place and most fund managers manage multiple investment funds with different features and investment strategies.

From a regulatory perspective, a fund manager can be defined as a legal person that qualifies either as a "management company" under the UCITS Directive[88] or "alternative fund manager" under the AIFM Directive[89]. As such, it will usually be subject to a registration requirement with the relevant supervisory authority and thus comply with several investor protection rules that may include, amongst the others, anti-fraud and fiduciary obligations and capital and internal control requirements. In order to provide their services fund managers must apply for authorisation to the relevant national supervisory authority which will also exercise an ongoing supervision over their activities[90].

[88] See Art. 2(1)(b) of the UCITSD according to which management company "*means a company, the regular business of which is the management of UCITS in the form of common funds or of investment companies (collective portfolio management of UCITS)*".

[89] According to Art. 4(1)(b) of the AIFMD alternative investment fund managers ("AIFMs") "*means legal persons whose regular business is managing one or more AIFs*".

[90] The authorisation requirements for UCITS Management Companies (or self-managed UCITS) and AIFMs, which are largely similar, are laid down in Article 7 of the Directive and in article 8 AIFMD. It is required that the request for authorisation must be accompanied by a programme of activity setting out, at least, the organisational structure of the undertaking. It is also required that management companies (or self-managed undertakings) must comply with the relevant capital requirements and that the head office and the registered office should be located in the same Member State where the authorisation is requested. In evaluating the applications, the relevant supervisory authority must also asses that the persons who effectively conduct the business are of sufficiently good repute and are sufficiently experienced also in relation to the type of fund managed. Furthermore, the authorisation may be refused in case of connections to a natural or legal third party which are deemed to prevent effective supervision. In addition, AIFMs are also required to provide information in relation the investment strategies the risk profiles and other characteristics of the AIFs it manages or intends to manage. Given that the AIFM Directive does not (directly) regulate the product but only managers, this information provides the competent authority with the information needed to assess the suitability of the AIFs. Finally, unlike UCITS, AIFMs must either have a professional indemnity insurance or have additional own funds appropriate to cover risks arising from professional negligence.

Fund managers are permitted by law to delegate some of their activities to an external third party ("delegated manager" or "sub-manager"). The European regulations however place some restrictions on the delegation of key functions to a third party requiring that the subject to which the activities will be delegated must be qualified and capable of undertaking the delegated functions, that the mandate does not prevent the effectiveness of the supervision of competent authorities over the management company and that conflicts of interest are prevented (in particular, the function of investment management cannot be delegated to the depositary of the fund)[91].

UCITS management companies and AIF Managers cannot however delegate so much of their functions and responsibilities to the extent that, in essence, they become a "*letter-box entity*". The meaning of the wording, which is set out in Article 13(2) UCITSD and in Article 20(3) of the AIFMD, has been clarified, although only in relation to alternative funds, by ESMA, which has identified two circumstances under which the fund manager would be considered as a letter-box entity: *"(i) the AIFM no longer retains the necessary expertise and resources to supervise the delegated tasks effectively and manage the risks associated with the delegation; or (ii) the AIFM no longer has the power to take decisions in key areas which fall under the responsibility of the senior management or no longer has the power to perform senior management functions, in particular in relation to the implementation of the general investment policy and investment strategies*"[92]. Considering that Art. 20 AIFMD is based on Art. 13 of the UCITS Directive it is possible to conclude that the clarification of the term "letter-box entity" given for alternative funds is also valid for UCITS funds[93].

1.6.2. Depositary

Under Art. 22 of the UCITS Directive and Art. 21 of the AIFM Directive, management companies are required to appoint a depositary for each of the funds they manage that needs to be independent from the fund's manager.

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[91] See Art. 13 of the UCITSD and Art. 20 of the AIFMD.

[92] ESMA, Final Report - *ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive*, ref. ESMA/2011/379, p. 135.

[93] This view is in particular shared by WEGMANN, H. (2015), p. 44.

The depositary is a credit institution or other category of institution subject to prudential regulation that ensures the proper safekeeping of the fund's assets and also exercises certain supervisory tasks[94]. In order to avoid conflict of interest, fund managers cannot act as depositories and the depository should act in the sole interests of investors and independently from the manager[95].

The safekeeping duties of the depositary include the duty to hold in custody or maintain records of the fund's financial instruments and other assets, arrange the settlement of transactions and administer corporate actions. The custody duty further requires the depositary to ensure proper segregation of the fund's assets from the depositary's own assets so that any book held on behalf of the UCITS or AIF can be clearly identified as belonging to that UCITS or AIF at all times[96]. In case the assets cannot be held in custody the depositary's obligation is to maintain up-to-date records and verify ownership.

The depositary also performs an oversight role which mainly consists in the monitoring of the fund's cash flows and on the supervision of certain aspects of the fund's activity. In regard of the first task, the depositary has the duty to ensure that that all payments made by, or on behalf of, investors upon the subscription of units or shares of the fund have been received, and that all of the fund's cash has been booked in one or more cash accounts[97]. The UCITS and AIFM Directives also assign to the depositary the duty to ensure that operations related to the transaction of units or shares (*i.e.* sale, issue, repurchase, redemption and cancellation), the calculation of the value of the fund's participation rights and the calculation of the fund's income are performed in compliance with all the relevant laws and with the fund's constitutional documents[98].

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[94] Art. 23(2) UCITSD and Art. 21(3) AIFMD.

[95] Art. 25(1) UCITSD and Art. 21(4)(a) AIFMD.

[96] Art. 22(5)(a)(ii) UCITSD and Art. 21(4)(a) AIFMD. Art. 22(8) of the UCITS Directive also provides that "*Member States shall ensure that in the event of insolvency of the depositary and/or of any third party located in the Union to which custody of UCITS assets has been delegated, the assets of a UCITS held in custody are unavailable for distribution among, or realisation for the benefit of, creditors of such a depositary and/or such a third party*".

[97] Art. 22(4) UCITSD and 21(7) AIFMD.

[98] Art. 22(3) UCITSD and 21(9) AIFMD.

The monitoring duties of the depositary cannot be delegated to a third party, however it is possible to delegate the custody duties to a separate entity, different from the fund manager, provided that the depositary is able to demonstrate that there is an objective reason for the delegation and that certain conditions mainly related to prudential and asset segregation requirements are met[99].

In performing its activities, the depositary is under a special liability which sums up with the obligation usually related to the custody of financial instruments[100]. The depositary is, in fact, liable to the UCITS or AIF, and to their investors, for all losses suffered as a result of the depositary's negligent or intentional failure to properly fulfil its obligations. The liability of the depositary may be directly invoked by both the management company and the fund's investors[101].

1.7. OBJECT OF THE FUND-INVESTOR RELATIONSHIP: THE COLLECTIVE ASSET MANAGEMENT SERVICE

The provision of a professional investment management service standardised for all investors (or "collective asset management service"), is the main object of the fund-investor relationship. The legal definition of the collective asset management service is provided in the AIFM Directive as the performance of the activities of portfolio management and risk management[102]. The two profile are closely related, so that one cannot exist without the other. This is further stressed in Article 6(5)(d) AIFMD which provides that AIF Managers cannot be authorised to provide portfolio management services without also providing a risk management activity.

The given legal definition, which highlights the tight connection between portfolio and risk management, captures the economic and historical conception of investment funds. As professional investors that gather considerable amounts of capital from the public, collective asset managers are able to implement different investment strategies,

[99] Art. 22a UCITSD and 21(11) AIFMD.

[100] In this sense ANNUNZIATA, F. (2017c), p. 229.

[101] Art. 24 UCITSD and 21(12) AIFMD.

[102] According to Annex I to the AIFMD "i*nvestment management functions which an AIFM shall at least perform when managing an AIF* [are]*: (a) portfolio management; (b) risk management*".

gaining exposure on multiple underlying assets. The portfolio of an investment fund, being composed of different varieties of assets with different degrees of risks, will be therefore less exposed to the ups and downs of single securities. As a result, investment funds allow investors with limited capital resources to invest in a risk-diversified pool of assets. Since the portfolio of an investment fund is diversified, its management implies both a choice of capital allocation as well as its risk management. The risk management is in fact an activity that is inherent to any financial service since, according to the economic theory, the bearing of a risk is what ultimately justifies any financial return.

The conception of risk management has however changed over time[103]. Whilst the traditional vision assigned risk management with the task to reduce or even eliminate the risks associated with the management of a diversified investment portfolio, the evolution of the markets has seen investment funds used for more speculative purposes so that, as of today, risk management can be seen as a technique to ensure the attainment of a certain risk-yield profile, not necessarily aimed at reducing the risk inherent of the portfolio[104].

Given its importance for the provision of the collective asset management service both the UCITS and the AIFM Directives provide extensive rules on risk management and also ascribe this function a key role in the context of the internal control systems[105].

As what regards the other component of the notion of collective asset management, namely portfolio management, it can be considered an activity discretionary in its nature: managers have in fact wide freedom of action in arranging the investment objectives and the strategies to pursue them. Furthermore, investors have tendentially no say over the investment decisions of the manager given that the absence of "day to day discretion or control" over the asset manager's activity is one of the main requisites laid down in European law in order to qualify an entity as "undertaking for collective investment". This general discretion of the asset management does not however mean that investors should be subject to a completely arbitrary power. In creating an investment

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[103] According to SZYLAR S. (2010) risk management can be described in general as a "*situation in which an individual or a firm makes decisions to alter the risk/return profile of future cash flows*", p. 34.

[104] In this sense, ANNUNZIATA, F. (2017b), p. 31-34.

[105] Pursuant to Article 51 UCITSD and 15 AIFMD, European investment funds managers are required to implement adequate risk-management systems in order to identify, measure, manage and monitor appropriately all risks relevant to each investment strategy and to which each managed fund is or may be exposed.

fund, asset managers must in fact self-limit their discretion by setting down the defined investment policy, thus disclosing the general guidelines for their investment activity[106].

Furthermore, in case of UCITS funds, needs of investor and market protection, led the European legislator to regulate many aspects of the investment process. The UCITS Directive, in fact, circumscribes the category of assets eligible for investment, providing that UCITS may only invest in liquid financial assets, also in further respect of strict concentration and exposure limits. The UCITS Directive also limits the recourse to certain investment strategy such as short selling and use of leverage[107].

To compensate their services fund managers are usually paid by a management fee and an incentive fee. The management fee is typically based on a fixed percentage of the average annual size of the fund while the incentive fees are usually based on the amount of increase of the net profits.

Fund managers have a general discretion in arranging the fee they charge, however, in consideration of the fact that inadequate fee structures may encourage excessive risk taking and additional conflicts of interest, the European legislator placed several restrictions intervened to place a number of restrictions to such discretion, requiring fund managers to respect additional safeguard requirements. In particular, fund managers shall adopt remuneration policies which are in line with the business strategy and that promote sound and effective risk management that should consist both of a fixed and a variable component which should reflect the fund performance. It is also provided that such components should be properly balanced, that a consistent part of the variable remuneration should consist of fund shares, and that a portion of the variable remuneration shall be deferred for a minimum period of time[108].

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[106] See in more detail Sections 1.3.1, 1.2.3 and 2.6.4.

[107] It has to be noted that although short selling is effectively prevented, following the introduction with UCITS III of the possibility for UCITS Management Companies to enter into derivative transactions, UCITS funds gained the ability to synthetically shorten their exposures and thus allowing for the creation of long-short products and enhanced investment strategies. In synthetic short selling, the security is not actually sold, a share position is created through financial derivative instruments that create an exposure to the price of the security, rather than through the actual sale of the security. UCITS recurring to these strategies are usually referred to as “NEWCITS”. For complete overview of the phenomenon see STEFANINI F. [ed.], DEROSSI T., MEOLI M., & VISMARA, S. (2010).

[108] See Art. 14(b) of the UCITS Directive and Annex II of the AIFM Directive.

In carrying out their activities European collective asset managers are also subject to specific conduct of business rules. In the investment services landscape, the concept of "conduct of business rules" firstly develop within the framework of the MiFID (Directive 2004/39/EC) with the aim to "*provide for the degree of harmonisation needed to offer investors a high level of protection*" [109] and later applied to UCITS under the UCITS III Management Company Directive[110]. In doing so the European regulators codified the general fiduciary obligations that originally developed as part of the law of agency in common law jurisdictions[111].

According to the consolidated common law doctrine, the fiduciary obligation divides neatly into the duty of loyalty and the duty of care. This division is based in part on the risks to which the principal is exposed in a fiduciary relationship which can be generally categorised as the risk of malfeasance (such as in case of misappropriation), and the risk of nonfeasance (such as in case of neglect)[112]. The duty of loyalty addresses the first risk; the duty of care addresses the risk of the second. The duty of loyalty, therefore, is largely negative. It is a duty to prevent misconduct, refrain from self-interested, and avoid conflicts of interest. By contrast, the duty of care is largely positive. It is a duty to pursue the beneficiary's interests with diligence and skill, and it mandates a positive behaviour[113].

The duty of loyalty is codified in Articles 14(1)(a) of the UCITS Directive and in Art. 12(1)(a) of the AIFM Directive as a duty of the manager to act honestly, fairly and in the best interest of the UCITS or AIF and the integrity of the market. In addition, it is stated that managers should "*avoid conflicts of interests*" and "*employ effectively the resources and procedures that are necessary for the proper performance of its business activities*"[114].

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[109] Recital 2 of the MiFID.

[110] Directive EC/2001/107.

[111] According to the common law consolidated doctrine a fiduciary is a person who "*acts for another in situations that give rise to a relationship of trust and confidence, giving rise to the* 'obligation of loyalty'" (SPANGLER, T. (2012), p. 90).

[112] In this sense LABY, A. (2017), p. 4.

[113] *Ibid*.

[114] Art. 14(1)(c) and (d) UCITSD and Art. 12(1)(c) and (d) AIFMD.

In essence, the duty of loyalty includes a number of sub-duties, including the duty to act in the best interest of investors (which also includes the duty of "fair treatment)[115], the duty of confidentiality and the duty to avoid conflicts. With, respect to the latter, the two Directives require fund managers to provide investors with immediate disclosure of potential conflicts and to implement conflict of interest policies containing the necessary provisions to identify, prevent and manage any conflict of interest.

The duty of care is different from the duty of loyalty and somewhat smokier in its conception, it is, in fact, generally positive, and focuses on the process and diligence a fiduciary must undertake[116].

The duty of care has been codified in the UCITS and AIFM Directives as the duty, for fund managers, to act with "*due skill, care and diligence*"[117]. The requisite to act with due skill and care sets the standard of professional judgement and skills required to the manager in making its investment decisions. In respect of the latter both the UCITSD and the AIFMD require that the persons that effectively conduct the business of the management company must be of "*sufficiently good repute"* and of "*sufficiently good experience*"[118].

The implications of the duty to act with due diligence are however more uncertain. It can be broadly intended as the duty to make "*reasonable efforts to achieve a result*"[119]. This however does not imply that there is a duty to achieve a profit on the investment made by the manager. It is instead an obligation to perform an effort to invest the capital with a view to obtain an expected result and to refrain from negligence. As a consequence, a loss resulting in the realisation of financial risks and not due to the manager's negligence would not determine a liability[120].

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[115] An extensive overview of the duty of fair treatment is provided in Section 2.6.2.

[116] In this sense LABY, A. (2017), p. 7.

[117] Art. 14(1)(b) UCITSD and Art. 12(1)(a) AIFMD.

[118] See also Section 1.7 above.

[119] *Ibid.*

[120] According to SPANGLER, T. (2012) "[t]*he general rule in negligence is that pure economic loss is not recoverable for a variety of historical reasons, including concerns over unlimited liability and a desire to foster a competitive market with certainty for participants*", p. 88.

As a general rule, an investment manager would be held to have acted negligently where no reasonable entity, in the same position and possessing the same skill and competence, would have acted in such a way[121]. The European legislator has however intervened to further specify the level of due diligence to be expected from fund managers. In particular, the UCITS IV Implementing Directive[122] demands the implementation of a high level of diligence in the selection and in the monitoring of investments, also requiring management companies to establish written policies and procedures on investment and risk management due diligence.

For AIFs the AIFMD Implementing Regulation requires the implementation of detailed due diligence rules, with particular reference to the management of illiquid assets. In case an AIFM manages assets with limited liquidity it must prepare a business plan, to be kept updated on an ongoing basis, laying down the envisaged investment strategy for these assets. Transactions must be conducted in accordance with the plan and the performance of the AIF must be monitored constantly[123].

Further due diligence requirements for AIFs are also requested in the selection and appointment of prime brokers and other third-party providers[124].

1.8. TRANSPARENCY AND DISCLOSURE RULES

Transparency and disclosure are fundamental tools in the context of investor protection. Adequate disclosure allows investors to make an informed investment decision by providing information on the risks and costs associated with the relevant financial products. Disclosure plays also an important role in providing investors with the necessary information to exercise their rights. Furthermore, there is also empirical evidence that an adequate disclosure framework reduces the moral hazard problem of manager and thus ultimately may lead to an enhancement of the fund's performance[125].

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[121] In this sense SPANGLER, T. (2012) which further considers that "[r]*egulations can provide evidence of what is expected of a regulated firm in many* circumstances" p. 88.

[122] Commission Directive EU/2010/43 implementing Directive EU/2009/65.

[123] See Art. 19 of the AIFMD Implementing Regulation.

[124] Art. 23 of the UCITS IV Implementing Directive and Art. 23 of the AIFMD Implementing Regulation.

[125] According to ÖSTBERG, P. (2005) "[t]*here is extensive evidence that increases in disclosure leads to greater shareholder value*", and that "*disclosure level determines the verifiability of the firm's assets and therefore reduces the insider's moral hazard problems*".

Both the UCITS and the AIFM Directives contain an extensive disclosure and transparency framework, requiring funds to provide multiple information to investors. As a general rule, it is possible to identify two category of investor disclosure: (i) pre-contractual information, which may be disclosed prior to the initial investment; and (ii) ongoing information, which is disclosed after the share purchase. While ongoing information is provided on a continuous or periodic basis, pre-contractual information is normally provided once, before the subscription of the fund's units or shares.

The pre-contractual disclosure requirements for UCITS include the UCITS prospectus and the Key Investor Information Document ("**KIID**"). Being exempted from the provisions of the Prospectus Directive[126] the regime for the prospectus disclosure requirements for UCITS is provided in the UCITS Directive which, according to Art. 69(1) requires UCITS management companies to publish a prospectus containing "*the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto*"[127].

The extensive detail in the disclosure requirements for the UCITS prospectuses eventually resulted in making the document too complex for the average retail investor and therefore unsuitable for guiding them in their decisions. For this reason, the UCITS IV Directive introduced the obligation for UCITS management companies to provide investors with a KIID, a short document containing only the most important information in order to facilitate the retail investor's understanding of the product[128]. The KIID also

[126] Directive EC/2003/71. Article 2(a) of the Prospectus Directive exempts "*units issued by collective investment undertakings other than the closed-end* type" from the scope of the Directive.

[127] A list of minimum information requirements to be included in the prospectus is provided in Schedule A of Annex I to the UCITS Directive which includes information about the UCITS name and date of establishment, key characteristics of the UCITS shares, its investment objectives, risks and costs, valuation and redemption policies, performance and remuneration policies of key personnel. Information regarding the depositary and advisers, including material provisions which may be of relevance for investors, must be further provided. In addition, it is required that the UCITS prospectus must also mention the categories of assets in which the investment is authorised, whether transactions in financial derivative instruments are authorised and a prominent statement regarding its investment policy in case its portfolio is characterised by a high level of volatility or in case the UCITS replicates a financial index.

[128] Article 78 of the UCITS Directive. The KIID came to replace the "simplified prospectus" introduced by the UCITS III that was, in turn, deemed not simple enough for the more complex products that arose as a result of the financial innovation.

allows investors to compare more easily different investment products as it is provided in a short and standardised fact sheet[129].

The ongoing disclosure requirements applicable to UCITS require them to publish an annual report for each financial year plus a half-yearly report covering the first six months. The annual report shall include a balance-sheet or a statement of assets and liabilities, a detailed income and expenditure account for the financial year, a report on the activities of the financial year, as well as any significant information which will enable investors to make an informed judgement on the development of the activities of the UCITS and its results[130]. The half-yearly report is less detailed although it still contains information such as the balance sheet, the number of circulating shares, the NAV per share and another portfolio information.

The UCITS Directive also provides some rules applicable to marketing material. Although it does not prescribe any fixed form or content for the provision of such information (whose regulation is therefore left to Member States) Article 77 requires that all marketing communications to investors shall be clearly identifiable as such and that they shall be fair, clear and not misleading and also consistent with the information disclosed in the prospectus and KIID.

The pre-contractual requirements for Alternative funds are laid down in Article 23 of the AIFMD which provides a set of information requirements largely similar to, although far less detailed than, those contained in the UCITS prospectus[131]. The

[129] The Commission Regulation EU/2010/583 which, together with the CESR's template for the Key Investor Information Document , contains the implementing provisions regarding the form and content of the KIID, provides in fact that the information in the KIID shall be written in a comprehensible and non-technical language and that the total length of the document shall not exceed two A4 pages. The CESR's template further indicates that the KIID should consist of five sections, put in separate boxes, namely (1) *objectives and investment policies;* (2) *risk profile*; (3) *charges*; (4) *past performance*; and (5) *practical information*. Moreover, the KIID must include a Synthetic Risk and Reward Indicator (SRRI) which in essence assess the risk of the potential investment on a scale from 1 (minimum risk) to 7 (high level of risk).

[130] Article 69(3) UCITSD. Detailed information to be included in the financial report are set out in Schedule B of Annex I.

[131] AIFMs are required to disclose information related to their investment strategy and objectives, the assets eligible for investment, the relevant risk profile, the types and sources of leverage and the leverage cap and also other information related to fees and expenses[131]. "*Material changes*" to this information must be stressed in the annual report[131].Pursuant to Art. 106(1) of the AIFMD Implementing Regulation "*any changes in information shall be deemed material* […] *if there is a substantial likelihood that a reasonable investor, becoming aware of such information, would reconsider its investment in the AIF.*

disclosure shall only be done to perspective investors, as public disclosure is not required. Neither Article 23 nor any other provision in the Directive however prescribe a format for the disclosure, although Member States may impose certain format requirements[132]. AIFMs are also allowed to provide the required information on their website as long as the information is "*clear, reliable, readily understandable and clearly presented*"[133].

In any case, since AIFs are not granted any exemption, in case of a public offering, AIFMs will be required to provide a prospectus pursuant to the provisions of the Prospectus Directive. Furthermore, AIFMs wishing to sell their products to retail investors may be required to provide them with a KID in accordance with the PRIIPs Regulation[134].

The ongoing disclosure requirements for AIFs are instead provided in Article 22 AIFMD, according to which AIFMs are required to publish, for each fund they manage, an annual report (half-yearly reports are not required). The annual report shall at least contain a balance-sheet or a statement of assets and liabilities; an income and expenditure account and a report on the activities for the financial year; the total amount of remuneration for the financial year, split into fixed and variable remuneration and the aggregate amount of remuneration broken down by senior management and other key personnel[135]. The AIFMD Implementing Regulation further provides additional minimum rules related to the information to be included in the annual report[136].

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[132] For a brief overview of the formats required in different Member States see WEGMANN, H. (2015), p. 178.

[133] See Art. 36 and recital 124 of the AIFMD Implementing Regulation.

[134] Regulation 1286/2014/EU ("**PRIIPS Regulation**"), required to provide investors with another pre-contractual information document, the so called "Key Information Document" ("**KID**"). The KID, in a similar way than the KIID, is aimed at providing investors with easy-to-understand information on complex financial products eligible to be sold to retail investors (so called "PRIIPs"). The information provided in the KID are in line with those in the KIID, except from a more in depth disclosure of the different categories of costs associated with the investment and of a different risk indicator which is calculated on the basis of future market scenarios rather on the past volatility of the NAV. The KID structure is provided in the Commission Delegated Regulation EU/2017/653.

[135] This last category comprises, according to Article 22(2) AIFMD, "*members of staff of the AIFM whose actions have a material impact on the risk profile of the AIF*".

[136] See Arts. 104-106 of the AIFMD Implementing Regulation.

Aside for the annual report, AIFMs are also subject to a number of periodic disclosure requirements related to liquidity, risks, leverage and conflict of interests[137].

[137] With respect to liquidity disclosure, the AIFMD Implementing Regulation requires that AIFMs must provide investors with the percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature (Art. 108(2)). The risk disclosure requires instead AIFM to provide information related to the measures adopted to assess the sensitivity of the AIF's portfolio to the most relevant risks to which the AIF is or could be exposed, including where risk limits set by the AIFM have been or are likely to be exceeded (Art. 108(4)) . In relation to the leverage disclosure AIFMs must disclose any changes to the maximum level of leverage (Art. 109). Lastly, AIFMs are required to disclose material conflict of interest that arise in the course of the managing activity (Art. 36).

CHAPTER II – SHARE CLASSES OF COLLECTIVE INVESTMENT FUNDS

2.1. INTRODUCTION TO SHARE CLASSES

For a long time, the substantial uniformity of the legal status of funds' subscribers has been a milestone of the collective asset management discipline. The very nature of the economic operation that qualifies collective investment schemes is characterised by the homogeneity of the subscribers' positions and thus of the rights and duties related to the status of fund shareholder. The standardisation of the activity of the asset manager, which is conducted on the basis of a predetermined investment policy, implies in fact the adherence for investors to a defined investment program, whose realisation does not take into account their specific individual needs[138].

The evolution of financial markets and of the relevant regulations introduced numerous elements of complexity that eventually resulted in an increasing demand from institutional investors of arrangements better tailored to their needs.

The creation of classes of shares (or units) is a somewhat recent trend affecting the way in which collective asset management products are marketed in Europe and other countries, that developed as an answer to the increased investors' needs for product diversification. Share and unit classes can be considered as different "varieties" of shares or units which differentiate the ways in which investors participate in the same fund or investment company.

Share classes[139] firstly developed as a market practice in common law countries as an effective means to respond to demand-side pressures, allowing collective asset managers to reflect individual investors' preferences related to the distribution policy and the load structure of the fund and in particular to provide different administrative systems for investors opting for the distribution or reinvestment of the income generate by their investment[140].

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[138] In this sense, ANNUNZIATA, F. (2017b), p. 45.

[139] In the prosecution of this Chapter the term "share" and "share class", unless otherwise intended, will be used to cover all participation rights issued by common investment schemes, whether they take the form of common funds and unit trusts that issue units or investment companies that issue shares.

[140] In this sense, BRACALONI, C., et al. (2006), p. 5.

The introduction of new categories of shares belonging to the same investment fund was later used for different purposes allowing subsets of investors to achieve some level of customisation in order to accommodate their specific needs, without detracting them from the common underlying investment objective and also avoiding the expenses connected with setting up new investment funds.

As many commentators pointed out, the rise of multiple share classes can be considered one of the most significant developments in the investment fund industry. To understand the impact of multiple share classes it can be noted that at the end of December 1991, the Morningstar mutual funds database indicated that there were 2.373 fund shares. By the end of December 2000, the same database indicated that there were 12.029 shares, a more than 5-fold increase in 9 years, about 69% of which was a result of the rise of multiple share classes[141].

This massive rise in the number of multiple share classes was mainly due to the adoption of rule 18f-3 by the United States Securities and Exchange Commission ("**SEC**") in 1995 which acknowledged the positive impact of a certain customisation of investors' rights and introduced a first regulatory background for the creation of multiple share classes[142].

Notwithstanding the scale and the economic importance of the phenomenon however, the European legislator has yet adopted no organic provisions on the creation of share classes, leaving the development of the regulation of the matter to national legislators and supervisory authorities[143]. As a consequence, a number of different national practices developed in the European Union as to the types of share classes that are permitted (if permitted at all), ranging from very simple share classes (e.g. with different levels of fees) to much more sophisticated arrangements comprising, *inter alia*, different investment strategies[144.] Moreover, scholars showed little interest in the issues connected with the creation of share classes, and in general with the matters related to the

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[141] The analysis has been carried out by MOREY, M. (2003). The correlation between the massive rise in the size of the investment fund industry and the introduction of multiple share classes has been highlighted also by NANDA, V., WANG. Z. & ZHENG, L. (2009).

[142] In this sense, MOREY, M. (2003).

[143] The lack of a common framework for the creation of share classes has been however recently addressed by the ESMA that provided a principle-based framework in its 2017 *Opinion on share classes of UCITS,* ref. ESMA34-43-296. The ESMA Opinion will be discussed in Chapter III.

[144] This is acknowledged by ESMA in its 2014 *Discussion Paper on Share Classes of Ucits*, p. 4.

possible differentiation of the economic and administrative rights of investors in collective investment schemes. As a result, there is still no common understanding in relation to the legal treatment of share classes and in particular to the scope of the differentiation of the investors rights achievable through the use of these structures.

Purpose of this Chapter is to provide a better insight of the phenomenon of multiple share classes. The analysis will start by taking in consideration the benefits provided by the creation of multiple share classes and the different types of classes currently marketed in Europe. Subsequently the national regulatory framework of Italy, and other jurisdictions in which an extensive regulation of the matter is provided, will be examined. Finally, in the lack of detailed legal provisions, a common framework for the creation of share classes will be defined by deriving operating indications from the interpretation of the general principles of the European collective asset management regulation. The envisaged framework should be useful to provide guidance, to some extent, to market operators in creating share classes.

2.2. DRIVERS BEHIND THE CREATION OF SHARE CLASSES[145]

The drivers behind the creation and the customisation of different share classes are fundamentally economic by nature. Share classes developed as a means to provide better customised solutions to investors' needs. As a matter of fact, different investors' groups often have different requirements about the features of their investments which can relate, by way of example, to maximum/minimum investment amounts, types of fees and charges, denomination of currency, allocation of revenues, holding periods and many other specificities. In this context, share classes are a useful tool for asset managers

[145] The majority of the information provided in this section has been mainly gathered by the stakeholders responses to the 2014 and 2016 ESMA Discussion Paper on Share Classes of UCITS (respectively, ref. ESMA2014/1577 and ESMA2016/570) in which the Authority expressly questioned the stakeholders to provide, amongst the others, feedback on the main drivers for creating different share classes. The content of the Discussion Papers is further discussed in Chapter III.The responses to the consultations are available online at (for the 2014 Discussion Paper) https://www.esma.europa.eu/press-news/consultations/discussion-paper-share-classes-ucits; and (for the 2016 Discussion Paper) https://www.esma.europa.eu/press-news/consultations/discussion-paper-ucits-share-classes#TODO

operating at a European or global scale to promptly respond to the different investors demands while maintaining a common investment strategy[146].

Another significant advantage, both from an investor's and an asset manager's perspective, comes from the economies of scale tied to the management of a larger pool of assets, which generates lower administration and transaction costs. The increase in the fund size also lessens the risk from concentration, ultimately benefitting the investors, especially large institutional ones. Moreover, by offering different share classers fund managers can increase the number of investors within one fund without the need to launch several separate investment funds, each customised to meet the specific investor's needs, despite sharing the same investment policy. Far greater efficiencies can instead be achieved by gathering more investors into one single fund with several customised share classes. Launching new share classes, in fact, does not require new authorisation and involves far lower supervisory fees and set-up costs compared to the launch of a new investment fund or compartment. Indeed, according to the European Funds and Asset Management Association ("**EFAMA**") the costs of setting up new share classes ranges between 10-20% of that to create a separate fund or compartment for the same purpose[147]. Furthermore, operating costs of large funds are generally lower than those of funds with lower levels of asset under management[148].

The cost mutualisation achievable through the use of share classes allows European asset managers to manage larger funds and thus face of more effectively the competition from non-European providers, also in consideration of the fact that scale savings can lead to tangible advantages for end-investors such as a reduction in charges or higher returns[149]. Moreover, a broader array of share classes provides significant

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[146] See, amongst the other respondents, the GERMAN INVESTMENT FUNDS ASSOCIATION's ("*Bundesverband Investment und Asset Management* e. V.", or "**BVI**") Reply to the ESMA's 2014 Discussion Paper on Share Classes of UCITS.

[147] This in accordance with the EFAMA Reply to the 2014 ESMA's Discussion Paper on Share Classes of UCITS, p. 1.

[148] This is stressed out by many respondents to the 2014 ESMA's consultation. By way of example see, amongst the many others, BVI's and EFAMA's Replies.

[149] In this regard see the European Commission's 2006 *White Paper on Enhancing the Single Market Framework for Investment Funds* (ref. COM(2006) 686) whereas it is stressed that European collective asset management market is characterised by a proliferation of small funds thus suffering the competition of larger non-EU undertakings. The White Paper also stresses the tangible improvements that economies of scale may bring to end-investors, such as enhancements in product performance and cost-savings. Although not expressly related to share classes, these are a significant tool in order to gather numerous

advantages in drawing more non-European investors towards European investment funds[150].

In addition to these economic considerations the structuring of separate share classes results in considerable operational advantages such as a noticeable reduction in time to market, as share classes can be set-up on an as-need basis in order to swiftly respond to investors' needs, without going through prior authorisation of the national competent authorities (as usually only a notification is needed) and without the need for the creation of new offering materials or legal documentations and service contracts. Moreover, share classes usually require less seed capital to launch if compared to the opening of a new fund or compartment and can also benefit from the availability of a performance record from existing share classes, whereas a new performance record would have to be established for a new fund[151].

Funds offering multiple share classes also allow investors more flexibility in pursuing their investment strategies and also a better alignment of their desired risk profile with the one of the common investment policy as share classes may be also set up in order to offer protection against some kind of generic market risk to which investors may be particularly exposed (e.g.: risk of equity market drawdown, risk of interest rate increases, risk of inflation increases and many others). Moreover, in case of variation of the market conditions, switches between share classes are operationally easier to manage than switches between investment funds, which actually imply a divestment and reinvestment activity.

Finally, many stakeholders pointed out that the possibility to create share classes, facilitating the participation of investors in the capital markets, responds to the objectives

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investors under the same investment policy, albeit with some level of customisation, also in the view of drawing non-European investors towards European UCITS and AIFs.

[150] In particular, in many Asian countries sub-funds may only be launched subject to certain conditions, including the size of the assets under management and NAV track record. This is particularly stressed in the ASSOCIATION OF THE LUXEMBOURG FUND INDUSTRY ("**ALFI**") Response to the 2014 ESMA's Discussion Paper on UCITS share classes.

[151] In this respect see further the EFAMA Reply to the 2014 ESMA's Discussion Paper on Share Classes of UCITS.

of the recent initiative of the European Commission of a European Capital Markets Union[152].

2.3. MOST WIDESPREAD TYPES OF SHARE CLASSES

Share classes offerings are fundamentally demand-side driven, reflecting the different individual investors' preferences arising from time to time. As such, a wide range of share classes has been created to enable investors to better tailor investment outcomes to their needs. Below is a non-exhaustive list of the main characteristics of the share classes that are currently available on the markets[153]:

2.3.1. Classes differentiated by fee structure

These classes differ according to the types of charges and fees that may be levied and their amount. They provide investors with different types (e.g. front-end vs. ongoing) and/or levels of fees, mainly depending on the amounts invested and on the holding period.

These classes are historically the most standardised and usually take the denomination of Class A, B, and C Shares (this is mainly in the U.S.).

Class A shares provide front-end charges and are typically offered to individual investors through intermediaries. Front-end charges are based on a fixed percentage and paid upon the first purchase of shares. Many investment funds may wave these charges or offer discounts in consideration of the amount invested and of the type of investor

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[152] The Capital Markets Union is a plan of the European Commission to mobilise capitals in Europe for the creation of a true single capital market for the EU and to develop a more diversified financial system capable of complementing bank financing. In order to unlock capitals around Europe the Commission is planning on establishing a genuine single capital market in the EU where investors are able to invest their funds without hindrance across borders and businesses can raise the required funds from a diverse range of sources, irrespective of their location. Investment funds play a fundamental role in this plan as they are a means to channel investors' money – especially with reference to retail investors - towards European equity. See in more detail the European Commission's 2015 Green Paper, *Building a Capital Markets Union* (COM(2015) 63 final) and also the 2015 *European Action plan on building a capital markets union* ("Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, COM(2015) 468 final").

[153] It has to be noted that it is also possible to find share classes characterised by a combination of the listed features.

(retail vs institutional). Most of these classes also incur in some ongoing servicing fees that are usually charged annually. These classes may be more attractive to long-term investors, because, over a long period of time, the ongoing fees charged on other share classes will become more costly, especially for those investors that qualify for a reduction or waiver of the initial front-end charges which are only one-time fees paid on the investor's initial subscription[154].

Class B shares usually do not impose front-end sales charges but instead provide fees that are charged to shareholders on an ongoing basis (usually annually) to support the fund's distribution and operational costs. Class B shares usually also include a back-end charge or contingent deferred sales charge that is typically imposed upon redemption in case the shares were held for less than a specified period of time. This load often declines to zero within a fixed time[155].

Class C shares are often called "level load" shares. They usually have small deferred charges that reduce to zero after a short period of time (1 year usually). These classes also charge ongoing fees higher than A shares but do not require front-end charges[156].

2.3.2. Classes differentiated by investor category

These share classes differ in terms of the types of investor they are eligible to be sold (retail vs. institutional). The main characteristics of these classes is that they provide a more favourable fee structure for institutional investors than for retail investors. This is usually due to the greater investment volumes that institutional investors may grant to the fund, combined with their grater contractual power and economic stability[157].

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[154] This consideration is expressed by PURETZ, J., et al. (2018), p. 50.

[155] For an overview of a number of different load structures see O'NEAL, E. (2003), p. 7.

[156] *Ibid.* p. 7.

[157] In this sense BRACALONI, C. et al. (2007), p. 16.

2.3.3. Classes differentiated by the allocation of revenues

This type includes classes differentiated by a different income distribution policy, allowing asset managers to provide different administrative systems for investors opting either for the distribution (so called "distribution" or "income" classes) or reinvestment in the fund (so called "accumulation classes") of the revenues generated[158].

2.3.4. Classes differentiated in term of voting rights

It is a common practice to assign more voting rights to a class of shares than to another. The purpose of these classes is to give key company insiders greater control over the company's actions by allowing them to exercise greater influence through its general meeting and board. In many cases voting shares (or shares providing multiple voting rights) are only allocated to seed or institutional investors while retail investors are only allowed to purchase non-voting shares.

2.3.5. Bearer and registered share classes

A bearer share is a security wholly owned by whoever holds the physical share certificate. The security is issued without record of the owner's name nor track is kept of the transfers of ownership. Because the share is not registered to any authority, transferring the ownership simply involves the delivery of the physical document. Payment is made to whomever holds the share.

Registered shares are securities whose ownership is kept on file with the issuer. Transfer of ownership can only occur when names are changed in the ledger. Payments are made directly to the owner of record.

In many cases investment funds issue both bearer and registered shares and attribute voting rights only to the latter. Retail investors are usually prevented from subscribing registered shares.

[158] *Ibid.* p. 21.

2.3.6. Classes denominated in different currencies

These classes are denominated in a currency which is different from the base currency of the fund. In case they are not hedged, investors purchasing these classes are exposed to foreign exchange risk (i.e.: the risk that the investment's value may change due to changes in the value of the two different currencies).

2.3.7. Classes providing different hedging overlays

These classes aim at providing investors with a reduction in the exposure over some generic market risk. Hedged share classes work by holding hedging instruments whose performance is intended to offset the effect of the specific market risk against which the investor intends to seek protection.

The management of the specific class hedging overlay is usually separated from the management of the common pool of assets: the investment manager implementing the general investment policy will manage the portfolio as a whole, taking decisions without looking at a share class level whilst the hedging strategy will operationally be implemented separately and on a systematic basis, with no discretion in determining whether or not to apply the hedge[159].

As there is usually no legal segregation between the different share classes the derivative instruments entered into for pursuing the hedging strategy will become part of the common pool of assets. This, however, may cause some adverse impact on the shareholders of the un-hedged shares as the derivative contracts are traded at fund level[160]. This contagion (or "spill-over") risk, which can be defined as the risk of one share class impacting the net asset value of other classes, may come from different sources. In the first place, there is a risk linked with the event of insolvency of the counterparty of a derivative transaction, that would be unable to meet its contractual requirements under the contract when they become due (so called "counterparty risk"). Furthermore, the deposits and margin calls linked to the derivative overlay may adversely impact the

[159] A comprehensive understanding of the functioning of the implementation of systematic hedging overlays is provided in the EFAMA Responses to the 2014 and 2016.

[160] This is due to the risk that the fund manager enters into commitments which cannot be met out of the property attributable to the hedged share class, with the result that all the other classes might suffer a loss as a consequence to the class-level hedging.

liquidity of the class assets so that they cannot be sold in time to meet redemptions ("liquidity risk"). Finally, there is also the possibility that in case of over-exposure an insolvency event materialising at a share class level may actually cause the default of the entire fund[161].

In order to protect shareholders against the spill-over risk, asset managers usually put in place an "operational" segregation of share classes, by booking the instruments for hedging purposes separately at a share class level. This means that from an accounting perspective the costs, as well as any benefit, of the hedging overlay will be allocated to each share class based on that specific class percentage of the total assets under management[162]. As a result, it is possible that hedged classes will have a separate NAV. It is worth nothing, however, that it would be impossible to completely eliminate any theoretical risk of contagion since, from a legal perspective, it is usually not possible to separate liabilities between share classes.

Some of the most common hedging overlays include:

(i) <u>Currency hedged share classes</u>

Designed for investors who want exposure to assets denominated in foreign currencies without the associated currency risk of the base currency of the fund. These classes limit the exposure on foreign exchange risk by reducing the effect of exchange rate fluctuations between the fund's base currency and the currency to which the investor wishes to be exposed.

(ii) <u>Duration-hedged share classes</u>

Duration is the sensitivity of the price of an underlying portfolio of assets to changes in the level of the interest rates. Yields of corporate bonds are

[161] For further description of the risk associated with derivative transactions see GREGORY, J. (2014). It has also to be noted that the UCITS and AIFM Directives and implementing provisions require management companies to put in place sound risk management procedures in order to monitor and limit the materialisation of such risks. In particular the UCITS rules highly confine the risk exposure of UCITS funds in relation to derivative transactions by providing, *inter alia*, limitations on the recourse to leverage and cash borrowings, concentration limits, counterparty selection requirements and the ban on the re-use of collateral received. In this respect see the ESMA (2014), *Guidelines on ETFs and other UCITS issues*, ref. ESMA/2014/937.

[162] In this respect see further the EFAMA (2014) Reply to the 2014 ESMA's Discussion Paper on Share Classes of UCITS, p. 5.

made up of two components: (i) the "risk-free" yield, which is driven by government bonds and other changes in the macroeconomic environment; and (ii) the credit spread, which is the perceived ability of the issuer to meet its repayment obligation[163]. The aim of duration-hedged classes is to reduce the risks associated with the "risk-free" rate, isolating the credit spread component.

(iii) Volatility-hedged share classes

Volatility is the sensibility of a security to the ups and downs of the market[164]. Investment strategies can be deployed with different levels of volatility, through the use of these share classes investors can opt for a level of volatility below that implied by the common strategy.

(iv) Equity protection share classes

For these classes a derivative overlay is implemented to partially offset the impact of significant declines (drawdown) of a main equity index. According to EFAMA these classes emerged "*to satisfy investors' needs for equity exposure with risk hedging features, combining volatility and drawdown mitigation strategies, in an integrated single approach*"[165]. These classes are popular within insurance companies as they allow them to combine an equity investment with their Solvency II[166] requirements[167].

Investors subscribing hedged share classes are exposed to additional costs and risks inherent the overlay, such as the underperformance of the class compared to other un-hedged classes in case the risk factors from which protection is sought do not materialise or worse materialise in the opposite sense as foreseen by the overlay.

[163] For an in-depth description of the duration risk see POZEN, R. & HAMCHER, T. (2011), p. 127.

[164] *Ibid.*

[165] Quoted from the EFAMA's Reply to the 2016 ESMA's Discussion Paper on Ucits share classes, p.8.

[166] Directive EC/2009/138, which requires European insurance companies to respect strict capital requirements to make sure they are able to meet their obligations to policyholders.

[167] This view is put forward by EFAMA in its Reply to the 2016 ESMA's Discussion Paper on Ucits share classes, p.8

2.4. REGULATORY FRAMEWORK IN THE UNITED STATES

The United States were one of the first countries to introduce a framework for the issuance of multiple classes of share representing interest in the same portfolio of assets. With the adoption of Rule 18f-3 in 1995 the Securities and Exchange Commission introduced a relatively flexible framework for the issuance of multiple share classes, allowing funds to tailor product offerings to meet their investors' preferences without the need for an individual exemptive order. The enhanced capability for US funds to differentiate their products allowed them to easily attract more capital thus also spurring the growth of the US collective asset management industry.

Prior to the adoption of the rule, funds seeking to issue multiple classes were required to apply for an exemption from Sections 18(f)(1) and 18(i) of the Investment Companies Act which preclude the issuance of senior securities by open-end investment companies[168]. Between 1985 and 1995 the Commission issued approximately 200 exemptive orders allowing funds to offer multiple share classes, typically with different distribution arrangements. In its orders the SEC also imposed conditions that addressed some investor protections constraints[169].

With the adoption of Rule 18f-3, the SEC sought to reduce the amount of time and expense for funds involved in offering multiple classes and also reduce the SEC's burden of reviewing applications for exemptive orders while providing funds with the possibility to differentiate the features of their shares to meet investors' demands and at the same time preserving investor protection conditions.

Funds offering multiple share classes pursuant to Rule18f-3 must provide that each class have the same rights and obligations, except in respect of:

(i) <u>Distribution arrangements:</u> classes can have a different arrangement for shareholder services or the distribution of securities (or both) provided they pay all of the expenses of that arrangement;

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[168] According to Section 18(f)(1) of the Investment Companies Act of 1940, it is "*unlawful for any registered open-end company to issue any class of senior security*". Section 18(g) defines senior security to include any stock of a class having a priority over any other class as to distribution of assets or payment of dividends. Section 18(i) requires that every share of stock issued by a registered investment company be voting stock, with the same voting rights as every other outstanding voting stock.

[169] SECURITIES AND EXCHANGE COMMISSION (1995), p. 11876.

(ii) Expense allocation: different classes may pay a different share of other expenses (other than advisory or custodial fees or other expenses related to the management of the fund's assets) to the extent these expenses are actually incurred in a different amount by that class or to a different degree than other classes;

(iii) Voting rights: different classes can have exclusive voting rights on any matter submitted to shareholders that relates to the class's servicing or distribution arrangement or in which the interests of the class differs. On the contrary voting rights that affect all investors in the fund must be allocated equally to all shareholders;

(iv) Exchange privileges and conversions: separate classes may provide for different exchange privileges or conversion features, provided that the conversion is effected on the basis of the relative NAV of the two classes, without the imposition of any sales, fees, or other charge and the fees paid by the new class are not higher than the expenses of the old class.

The SEC Rule gives significant responsibility to the board of directors, and in particular to independent directors, as Paragraph (d) requires the fund to adopt a written plan detailing the various differences among the multiple share classes, including the different services or distribution arrangements offered to shareholders, the methods for the allocation of expenses and any conversion feature or exchange privilege. The rule also requires that a majority of directors and a majority of independent directors find that the plan is in the best interest of each class individually and of the fund as a whole. According to the SEC "*the board should focus, among other things, on the relationship among the classes and examine potential conflicts of interest among classes regarding the allocation of fees, services, waivers and reimbursements of expenses, and voting rights. Most significantly, the board should evaluate the level of services provided to each class and the cost of those services to ensure that the services are appropriate, and that the allocation of expenses is reasonable*"[170]. The board is also requested to monitor conflict of interests among classes and take any action necessary to eliminate potential conflicts.

[170] SECURITIES AND Exchange COMMISSION (1995), p. 11880.

Finally, proper disclosure of the salient features of the multiple class structure shall be given in the prospectus, in a format designed to facilitate the comprehension by investors[171]. In case the arrangement provides for conversion or exchanges of shares, the disclosure shall cover all other classes into which the classes in question may be converted or exchanged[172].

2.5. NATIONAL REGULATORY FRAMEWORKS IN THE EUROPEAN UNION

Under European law there is currently no organic legal or regulatory framework regarding the definition and scope of share classes, even though the practice is widely spread in most European markets. As a result, in the European Union there are currently a number of diverging national practices as to the types of share classes that are permitted and as to the necessary procedures to set up share classes.

In the prosecution of this Section a brief overview of the national regulatory framework for share classes in Italy and in other European countries where a legal framework for share classes has been developed (namely Ireland and the United Kingdom) will be given.

2.5.1. Italy

The use of multiple classes of shares is not common among Italian-domiciled funds, which mainly utilise these arrangements to provide different fee levels. Many share classes of cross-border funds are nonetheless currently marketed in Italy.

Italian funds can be established as common contractual funds, open-end investment companies with variable capital ("**SICAVs**")[173] or closed-end investment companies with fixed capital ("**SICAFs**"). UCITS funds can only take the form of contractual funds or SICAVs while SICAFs, in turn, necessarily qualify as AIFs.

Historically, Italian funds were prevented from creating classes of shares attributing different rights to investors as it was expressly provided that all shares had to

[171] *Ibid.* p. 11881-11884.

[172] See Item 12(c) of SEC Form N-1A.

[173] It has to be noted however that, as of today, very few Italian-domiciled SICAVs have been created. Currently (June 2019) no operating Italian SICAV exists.

be "*of equal value and of equal rights*"[174]. However, the Bank of Italy introduced by way of interpretation the possibility for Italian funds to create share classes with different fee structures. The Authority was in fact of the view that the rule laid down in Art. 36, para. 8 TUF had to be intended as a "*general provision aimed at ensuring that all investors equally benefit from the outcome of the investment activity*"[175]. As such, the Bank of Italy deemed that the envisaged provision did not exclude the possibility to set-up share classes with different levels of charges, provided that in the fund rules the different classes and criteria on the basis of which the fees should be paid are clearly described and that the conditions to access the relevant classes are objectively defined[176].

The provision of Art. 36, para. 8 TUF was eventually deleted in 2003 with the transposition of the UCITS III Directive[177], thus resulting in the full recognition of the possibility to issue multiple classes of shares by the Italian law[178].

However, probably due to the lack of interest from the market participants, no extensive legal nor regulatory framework has yet been developed in relation to the creation of multiple share classes. Moreover, the actual system is not perfectly coordinated as, while there is currently no apparent limitation to the issuance of share classes for common funds (so that the matter of share classes is totally left to the parties' contractual freedom[179]), the same possibility for SICAVs and SICAFs is subject to some limitations.

The creation of multiple classes of shares is apparently precluded for SICAVs as Art. 35-*quarter,* para. 7, TUF expressly provides the non-applicability of Art. 2348 of the Italian Civil Code which regulates the creation of multiple share classes for commercial and industrial corporations[180]. Such reference is instead not included in Art. 35-*quinquies*,

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[174] See art. 36, para. 8, of the 2002 version of Legislative Decree No. 58 of 1998 ("Italian Consolidated Financial Act" or "**TUF**").

[175] BANK OF ITALY (2000), Communication on "Contractual Funds. Management Fees". In *Supervisory Bulletin*, no. 8 of 8 August 2000, p. 5.

[176] *Ibid.* p. 5.

[177] The provision of the UCITS III were implemented by Legislative Decree No. 274 of 2003.

[178] In this sense DESIDERIO, M. (2004), p. 160.

[179] This view is shared by ANNUNZIATA, F. (2017b), p. 158.

[180] However, the secondary regulation allows for the creation of multiple share classes for SICAVs whose shares are only eligible to be marketed to institutional investors. See Title III, Chapter 1, Section III.1.3,

containing provisions relating to SICAFs' shares and capital structure, which are instead expressly aloud to issue multiple share classes although only in conjunction with the setup of different compartments[181].

This lack of coordination is a result of the differences in the legal status of SICAVs and SICAFs (and of the difficulties of the Italian legislator in conceiving these undertakings), which, although formally adopting the legal structure of a share company present at the same time a number of characteristics which heavily deviate from the traditional legal archetype of ordinary business corporations. In particular, the non-applicability for SICAVs of many of the provisions related to the capital structure of share companies, including that governing the creation of multiple share classes, is a result of the profound differences in the conception of the role of legal capital in SICAVs in respect to that in ordinary corporations.

The distinctive trait of SICAVs, which is provided in Art. 35-*quarter* TUF, is, in fact, that the SICAV's legal capital shall be at any time equal to its net worth, which implies a variable nature of the SICAV's legal capital[182]. As a result of this principle of equivalence the two concepts of legal capital, on the one hand, and net worth, on the other, which are instead well distinguished for traditional share companies[183], are brought together so that for SICAVs the term "legal capital" indicates from time to time the amount of the net asset value of the company. Given its variable nature, the legal capital of SICAVs is not capable of serving those functions which are traditionally attributed to that of industrial and commercial corporations, which are a consequence of the fixed

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footnote no. 1 of the Collective Asset Management Regulation (Bank of Italy Regulation of 19 January 2015 as subsequently amended and supplemented).

[181] Art. 35-*quinquies*, para. 4, let. c) TUF. The difference between share classes and compartments is given in Section 2.6.1.

[182] In this sense, GHISALBERTI, M. & NAVARRA, B. (2012), p. 663. The variable nature of the SICAV's legal capital is a consequence of the fact that these undertakings are open-ended in their nature and thus shall at any time allow share issuances or redemptions. LENER, R. (1994) also shows that in other jurisdictions, although SICAVs are similarly qualified by the variable nature of their legal capital, a principle of equivalence between the SICAVs capital and net worth is not provided.

[183] For traditional industrial and commercial corporations, the net worth represents the difference between current assets and liabilities. The legal capital instead corresponds to a stated value, disclosed in the company's Articles of Association, expressing of the sum of the assets contributed to the company by shareholders and that cannot legally be allowed to leave the business. For a better understanding of the notion of legal capital under Italian law see CAMPOBASSO, G. F. (2014), p. 6 ff. and also STAGNO D'ALCONTRES, A. & DE LUCA, N. (2017) p. 334 ff.

nature that this element has in those structures. In particular, the legal capital of SICAVs cannot be conceived as a means to protect creditors' liabilities, function which is instead traditionally ascribed to the legal capital of ordinary share companies[184], since SICAVs creditors do not dispose of a fixed amount that cannot be detracted from the companies' assets. Instead, it is deemed that the legal capital of SICAVs performs a shareholder/investor protection function, since it provides these latter with a continuous updating of the value of their shareholding, allowing them to decide at any time whether to increase or to reduce their investment in the company[185].

On the basis of the legal framework for SICAVs the Italian legislator subsequently built the regulation applicable to SICAFs[186]. However, an explicit reference to the principle of equivalence between legal capital and net worth is not made in Art. 35-*quinquies* TUF which regulates the capital and share structure of SICAFs[187]. As a consequence, it could be considered that this lack of reference may encompass the reinstatement of the ordinary legal framework for the capital structure of share companies[188]. The non-applicability of the principle of equivalence is also suggested by the fact that in the Explanatory Memorandum it is expressly stated that "*the share capital*

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[184] The creditor protection function of the legal capital is a staple in European Company Law. Representing an amount set aside that shareholders could not pay out to themselves in dividends, the legal capital serves as a "cushion" for the protection of creditors in the event the corporation encountered financial problems. In this sense the legal capital regime is also often thought as a balance to the limited liability of shareholders. For an overview of the creditor protection role of legal capital (and a critique to its effectiveness) see ENRIQUES, L. & MACEY, J. (2001).

[185] In this sense, GHISALBERTI, M. & NAVARRA, B. (2012), p. 664.

[186] This is confirmed in the Explanatory Memorandum of Legislative Decree No. 44 of 4 March 2014 (which implemented the provisions of the AIFMD and also introduced the regulation for SICAFs) (hereinafter "**Explanatory Memorandum**) whereas it can be read that "*the regulation of SICAFs has been built on the basis of the current rules applicable to SICAVs and the differences between SICAFs and SICAVs are limited*" (p. 17).

[187] As noted by CARRIERE, P. (2014) in the first drafts of their envisaged legal framework the principle of equivalence between legal capital and net worth was initially conceived also for SICAFs. However, in the - *acritical*, in the Author's view - acceptance of some concerns raised by stakeholders, which complained that many forms of shareholder financing (especially those common in private equity) would have resulted as not compliant with said principle, the Italian legislator amended the envisaged framework for SICAFs, omitting for these undertakings the reference to the principle of equivalence (p. 473-475).

[188] In this sense CARRIERE (2014), p. 475. It has to be noted that the Author is however in fundamental disagreement with the practical implications of this approach. He deems in fact that the omission of the principle of equivalence between legal capital and net worth is the result of the legislator's misunderstanding of the nature of this principle and of the acritical acceptance of the concerns raised by stakeholders (p. 473-476),

of SICAFs cannot be always equal to its net worth, since investment schemes adopting the legal form of corporations are usually structured with a small amount of capital and one or more reserves in which the shareholders' deposits are accounted […]*"*[189]. It has to be noted, however, that the application to a collective investment undertaking, such as SICAFs, of the rules for the legal capital of ordinary corporations may result in adverse consequences, given that this discipline is inspired by a different purpose than that of collective asset management regulations. While the latter is primarily aimed at the protection of the investors' interests, the former is instead inspired, through the preservation of the integrity of the legal capital, at the protection of the interests' of the company's creditors, which are instead not (at least directly) taken into consideration in the discipline of collective investment undertakings[190].

Furthermore, against the argument of the non-applicability for SICAFs of the principle of equivalence between legal capital and net worth, it can be noted that Art. 35-*quinquies* TUF, although entitled "*Capital and shares of SICAFs*", does not actually contain any rule referred to the share capital of SICAFs[191]. As a result it can be deemed - in contrast with what was envisaged in the Executive Summary, which in any case does not have a particularly relevant hermeneutical relevance - that the same capital regime envisaged for SICAVs is also applicable to SICAFs, so that the principle of equivalence is valid also for the latter, in consideration of the fact that the legal framework for SICAFs was built on the basis of that for SICAVs[192].

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[189] Executive Memorandum, p. 17. However, it has to be noted, that, notwithstanding the wording of the Executive Summary seems to imply so, forms of capital collection different than the subscription on behalf of investors of shares or units (such as forms of shareholders' financing) might be in contrast with the notion of "Undertaking for collective investment" ("*Organismo di investimento collettivo del risparmio*") provided under Italian law, which requires that the capital pooling shall be made "*through the offering of units or shares*" (see Art. 1, para. 1, let. k) TUF). In this sense see also CARRIERE (2014), p. 477.

[190] In this sense, CARRIERE (2014) considers that the omission in Art. 35-*quinquies* TUF of the reference to the principle of equivalence, which in his view results in the application to SICAFs of the rules on the legal capital for ordinary corporations, resulted in a proper "*heterogony of purposes*" (p. 473).

[191] In this respect it can be also noted that also in the Executive Summary no reference is made in relation to the possibility to apply the discipline of the legal capital for ordinary share company to that of SICAFs. Instead, the application to SICAFs shares of many of the provision regulating shares of ordinary corporations is expressly envisaged (p. 18).

[192] In this sense, the fixed nature of SICAFs should be assessed not with reference to its legal capital but instead to the fact that, as opposed to SICAVs, these undertakings do not have the duty to redeem existing shares or issue new shares at any time, at the request of investors.

In spite of the above, the creation of multiple share classes differentiated in terms of voting rights is expressly allowed for both SICAVs and SICAFs. According to the relevant provisions it is in fact possible to issue bearer shares which assign one single vote to the owner, regardless of the number of shares of such category held[193].

With regard to the disclosure requirements, the Collective Asset Management Regulation provides, as general rule applicable to any fund structure, that the funds' constitutional documents, in the context of the definition of the investment policy, should contain the indication of "*the characteristics of the share classes eventually created and of the envisaged conditions, defined objectively, required to access the relevant share class*"[194].

2.5.2. Ireland

Being a leading cross-border domicile for investment funds since their first introduction, Ireland has an extensive framework regulating the setup of multiple share classes. The creation of multiple share classes is generally allowed for both UCITS and AIFs even though the specific provisions related to the limits encountered in the structuring of the arrangement vary.

According to Irish law UCITS funds, which may be established as unit trusts, common contractual funds, variable or fixed capital companies or Irish Collective Asset-management Vehicles ("**ICAVs**"), need to comply with the provisions set forth in the Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1)) (Undertakings for Collective Investment in Transferable Securities) Regulations 2015 ("**Central Bank UCITS Regulations**").

The possibility for a UCITS funds to offer multiple share classes is set forth in Chapter 5 of the Central Bank UCITS Regulations, according to which it is possible for "*a responsible person*" to create a "*share class, or more than one share class, within the relevant UCITS, or within a sub-fund of an umbrella UCITS*[195]".

[193] See Art. 35-*quarter,* para. 4 and 35-*quinquies*, para. 2 TUF.

[194] Title V, Chapter 1, Section V.1.6 of the Collective Asset Management Regulation.

[195] Central Bank UCITS Regulations, Chapter 5, 26.

Alternative funds under Irish law can instead be established as open-ended, closed-ended or limited liquidity structures and offered for sale to Retail investors ("**RIAIF**") or Qualifying investors ("**QIAIF**")[196]. The applicable provision related to AIFs are mainly contained in the Bank of Ireland's AIF Rulebook which supersede all requirements set out in previous Non-UCITS Notices.

The fundamental principles, which govern the creation of one or more classes within a single investment fund, are set out in Regulation 26 of the Central Bank UCITS Regulations and in the "General Rules" section of the Retail Investor AIF (section 1.ix of Part I) and Qualifying Investor AIF (section 1.v of Part I) Chapters of the AIF Rulebook.

In the first place, it is provided that collective investment schemes must consist of a single common pool of assets. As such, assets may not be allocated to individual share classes (even though, subject to that certain conditions, it is possible for QIAIF to allocate assets to individual share classes[197]). It is also required that the capital gains or losses and the income arising from the common pool of assets must be distributed or must accrue equally to each unitholder. Furthermore, as a general rule, it is provided that unitholders in a share class, must be treated equally and fairly, or where there is more than one share class all unitholders in the different share classes must be treated fairly. Finally, the fund's constitutional documents shall disclose the characteristics of each share class.

Historically the Central Bank only permitted the creation of share classes differentiated on the basis of subscription or redemption procedures or that provided different distribution policies or charging structures. However, after receiving multiple requests to allow currency hedged share classes, the Central Bank of Ireland changed its practice and with the issuance of Guidance Note 3/99 provided a framework for the creation of hedged share classes. The Central Bank, following the considerations of the submissions, accepted that "*subject to a clear disclosure in the prospectus and an unambiguous valuation and allocation provisions in the constitutional document of the*

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[196] AIFs can be established as unit trusts, designated investment companies (i.e. investment companies which may raise capital by promoting their shares to the public), investment limited partnership, or common contractual funds; and ICAVs.

[197] In particular it is required that the arrangement (i) is not made for the purpose of pursuing a separate investment objective by the share class; (ii) does not result in a share class operating *de facto* as a separate sub-fund; or (ii) is not created in order to circumvent the general requirements for the creation of share classes. See Chapter 2, Part I sections v.2, of the AIF Rulebook.

CIS ["Collective Investment Scheme"]*, the creation of a hedged currency share class (i) may be viewed as an acceptable efficient portfolio management technique and not an investment asset of the CIS; (ii) creates positive benefits to shareholders; (iii) does not prejudice holders of other share classes*[198]"

According to the provisions laid down in the Guidance Note 3/99, exchange rate hedging overlays were permitted at a share class level provided that the constitutional documents contained clear provisions for the charging of the resultant costs and gains/losses to the relevant share class and that the general hedging strategies are clearly described in the prospectus. Furthermore, the fund is required to set up proper administration system and produce periodic reports indicating how the hedging transactions have been utilised[199].

More operating principles regarding, *inter alia*, the admissible levels of over-exposure and further disclosure requirements are also set forth in Regulation 26 of the Central Bank UCITS Regulations and in the AIF Rulebook.

Following submissions on similar grounds, the Central Bank of Ireland subsequently allowed interest rate hedge classes for UCITS and non-UCITS by issuing a Policy Update that made it clear that investment funds may engage in interest rate hedging at a share class level provided that the benefits and costs of the hedging are accrued and attributed solely to unitholders in the hedged share class and that such arrangements are structured in accordance with the principles established in Guidance Note 3/99.

Following the publication of the ESMA 2017 *Opinion on share classes of UCITS* the Central Bank of Ireland released a statement in which declared the intention to comply with the principles laid down by ESMA which, *inter alia,* considered that hedging overlays other than exchange rate hedging should not be allowed to be set up at a share class level for UCITS funds. The Central Bank has thereby amended all the relevant regulatory provisions by making it no more possible for UCITS funds to provide investors with interest rate hedged share classes. As a result, nowadays the issuance of interest rate hedged share classes is allowed only for AIFs.

[198] Central Bank of Ireland Guidance Note 3/99, *Share classes – hedging against exchange rate movements* of July 2007, p. 3.

[199] *Ibid.* p. 4-5.

2.5.3. United Kingdom

The practice of issuing multiple share classes can be considered a staple in the British asset management industry. Over time the authorities developed a detailed legal and operational framework related to the creation and functioning of share classes.

The main legislative and regulatory sources regulating the activity of collective investment schemes in the United Kingdom are constituted by the Financial Services and Markets Act 2000 ("**FSMA**") and by the Financial Conduct Authority ("**FCA**") rules laid down in the FCA Collective Investment Schemes Handbook ("**COLL**").

The relevant provisions make a distinction between "Regulated CIS [Collective Investment Schemes][200]" and "Unregulated CIS". The latter notion comprises all entities that are not "Regulated CIS", provided they still qualify as collective investment schemes pursuant to Section 235 FSMA[201]. Registered CIS are authorised by the FCA and can be established as Authorised Unit Trusts, Authorised Contractual Schemes[202] or Open-end Investment Companies. Unregulated CIS are not subject to the same restrictions as a Regulated CIS and can be established in any legal form. Although these schemes are not authorised or recognised, persons carrying on regulated activities in the UK in relation to Unregulated CIS are subject to the FCA supervision. In accordance with Section 21 FSMA Unregulated CIS cannot be promoted to the general public.

The general rules governing the creation of share classes for UK Authorised Funds are set out in Section 3.3 COLL. The leading principle governing this matter is that the creation of a share class is only allowed on condition that it does not provide any advantage for that class that would result in prejudice to unitholders of other classes[203]. Furthermore, it is also required that the "*nature, operation and effect of the new unit class*

[200] Regulated CIS include Authorised Funds established in the UK and Recognised funds established outside the UK.

[201] "*'Collective investment scheme' means any investment arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income*".

[202] Authorised Contractual Schemes can be established either in the form of a co-ownership scheme or as a limited partnership.

[203] COLL Section 3.3.2, para. 2, let a), which provides that "*a unit class should not provide any advantage for that class if that would result in prejudice to unitholders of any other class*"

should be capable of being explained clearly to prospective investors in the prospectus"[204]. Moreover, the effect of the new class has not to be contrary to any other provision laid down in the COLL[205].

COLL Section 3.3.5 disciplines the permitted arrangements of the rights embedded in share classes. It is provided that funds cannot create a class of share in respect of which the extent of the rights to participate in the capital property, income property or distribution account are determined differently from the extent of the corresponding rights for any other class of share or that payments or accumulation of income or capital differ in source or form from those of any other class of unit[206].

Moreover, if any class of shares in an authorised fund has different rights from another class in that fund, the constitutional documents of the fund must provide "*how the proportion of the value of the scheme property and the proportion of income available for allocation attributable to each such class must be calculated*"[207].

The COLL also lists the permitted types of share classes which include accumulation or distribution classes, classes differentiated by the level of charges and expenses, classes denominated in different currencies and currency hedged share classes.

In consideration of the risks associated with hedged share classes the structuring of these arrangements requires the establishment of additional safeguards. Management companies wishing to issue currency hedge classes shall ensure that the relevant prospectus clearly states that transactions for hedging purposes may be undertaken for the relevant class of shares and also explain the nature of the risks that such a transaction may pose to investors in all classes[208].

It is worth noting that, recognising that there is a need to mitigate the risk to which hedge classes give rise, the FCA also requires the involvement of third parties in assessing the suitability of the operational safeguards put in place. It is in fact provided that the management company shall consult with the depositary and the auditor about the

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[204] COLL Section 3.3.2, para. 2, and b).

[205] *Ibid.* let. c).

[206] COLL Section 3.3.5, para. 2.

[207] *Ibid.* paragraph 1.

[208] COLL Section 3.3.5B para. 1, let. a).

adequacy of the control systems used in order to ensure compliance with the relevant rules set out in the COLL[209].

2.6. BUILDING A COMMON FRAMEWORK FOR SHARE CLASSES IN THE EUROPEAN UNION

2.6.1. Existing legal provisions regulating share classes under European law

As anticipated, even though the practice is widely spread in most European countries, under European law there is currently no organic legal framework regarding the definition and scope of share classes. In general, the UCITS and the AIFM Directive allow for a possible customisation of investors' rights without however providing any information in relation to the limits of the level of customisation achievable.

The UCITS Directive expressly recognises the existence of share classes in passing by, containing four reference to the term "share class", all of them in the context of marketing to investors[210], without however providing any operational provision regarding the setting up of share classes.

No reference to share classes is instead contained in the AIFM Directive. This shall come as no surprise, since the scope of application of the AIFMD is mainly referred to the fund's managing entities and their activities, while only limited provisions are related to the structure of AIFs, which are only regulated indirectly.[211] In this respect the consideration that share classes are not referred to in the AIFMD is clearly not relevant for excluding the admissibility of such structures for AIFs, also in consideration of the fact that the offering of multiple AIF share classes is a well consolidated market practice in the European Union.

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[209] *Ibid.* let. b) and c).

[210] See Articles 78(7)(b)(ii), 93(1), and 93(8) UCITSD.

[211] For the reasonings behind the regulatory solution adopted in the AIFMD to regulate the activities of AIFMs and not to provide explicit rules applicable to the AIFs see Section 1.3.2 and in particular footnote 43. The fact that AIFs are not directly regulated in the AIFMD, however, shall not lead to the conclusion that AIFs are totally excluded from the scope of the Directive's rules as they can be drawn in the ambit of the regulation in a number of ways, so that, as pointed by ZETZSCHE, D. & MARTE, T. (2015), "*rules that are apparently manager regulations are in fact product regulations through the back door*". (Ch. 6, paragraph 4.6) In this respect DELL'ERBA, M. (2017) also considers that in providing the rules on AIFMs operational requirements (Arts. 12ff.) "*the aim of the European Regulators was to model a sort of mandatory structure for AIFs*" (p. 345).

Furthermore, the AIFMD seems to allow AIFs to provide a certain differentiation in the treatment of investors as it expressly prescribes that it is possible to provide certain shareholders with a "*preferential treatment*", on condition that such preferential treatment is properly disclosed in the funds' rules or instrument of incorporation, thus implicitly allowing for the possibility to customise, to some extent, investors' rights[212].

The possibility to provide a preferential treatment pursuant to Art. 12 AIFMD, although effectively constituting one of the possible ways in which AIFMs may grant a level of customisation to the rights granted to different groups of investors, has to be distinguished from the creation of share classes that, although achieving a similar result, relates to a different legal situation.

Although it has not been extensively analysed with relation to investment funds, the differentiation between the creation of different share classes and the provision of a preferential treatment is a well-known topic among Italian corporate law scholars. For Italian share companies[213] applies in fact the principle that all shares must attribute equal rights to their holders, save for the possibility to create different "categories" (or "classes") of shares which can grant different rights (in comparison to ordinary shares) to their holders provided that shareholders within the same class are granted an equal treatment[214]. This implies that it is not possible for share companies to differentiate the treatment provided to certain shareholders, if such different treatment is not reserved to a class of shares.

On the other hand, in relation to Italian limited companies[215], the Italian legislator expressly provided for the possibility to confer single shareholders "*particular rights*"

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[212] See Art. 12(1) AIFMD, whereas it is stated that "[n]*o investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's rules or instruments of incorporation*". Moreover, Art. 23(1)(j) provides that, in case an investor obtains preferential treatment, proper disclosure of that preferential treatment, of the subjects that obtain such preferential treatment, and of their legal and economic links with the AIF, shall be given to investors.

[213] *Società per azioni* pursuant to Art. 2325ff. of the Italian Civil Code.

[214] Art. 2348 of the Italian Civil Code.

[215] *Società a responsabilità limitata* pursuant to Art. 2462 ff. of the Italian Civil Code. The share capital of Italian limited companies is not divided into standardised participation units (i.e. it is not represented by shares) but instead it is subdivided into a number of parts ("quotas") in relation to the number of shareholders (or, better, "*quotaholders*") so that the number of quotas always matches with the number of *quotaholders*. For a better overview of the legal structure of Italian limited companies see further CAMPOBASSO, G. F. (2014), p. 574 ff.

related to the administration of the company or the income distribution (i.e. administrative or economic rights)[216]. Such provision grants more freedom to the statutory autonomy of limited companies, in respect to share companies, for which the differentiation of shareholders' rights must necessarily go through the creation of a different class of shares. In limited companies instead, it is allowed to attribute particular rights, and hence to provide a preferential treatment, to single shareholders "as such", without prejudice to the fact that for these companies the possibility to create different classes of participation rights, attributing different sets of rights to their holders, has to be deemed admissible as well[217].

In light of the above, it can be concluded that in order to create "special" shares, conferring different rights to certain groups of investors, it would be necessary to create a different class of shares, while it is controversial whether a class may consist of only one share, thus substantially designating a single shareholder to which a different treatment is provided, in a similar way as what happens in limited companies[218].

Similar considerations can be also applied to investment funds, since, as noted in Section 1.4, notwithstanding they can be structured either as unit trusts, contractual funds or investment company, all funds share an organisational pattern that is largely similar to that of share companies. According to European law in fact (in a similar way as what is provided for share companies), all the rights attributable to funds' shareholders, whether they are investing in UCITS or AIFs, must necessarily be objectivised and securitised in

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216 Art. 2468, paragraph 5, of the Italian Civil Code. On the scope of the "particular" administrative and economic rights attributable to shareholders of Italian limited companies see STAGNO D'ALCONTRES, A. & DE LUCA, N. (2017) p. 418 ff.

217 The possibility to create different "classes of quotas" in Italian limited companies is an issue currently disputed in the Italian legal literature. In opposition to the traditional doctrine which deems that the creation of classes of quotas is not compliant with the general principles of Italian corporate law (see, among the others CAMPOBASSO, G. F. (2014), p. 575), more recent theories tend to consider such arrangements admissible (in this respect see, among the others, STAGNO D'ALCONTRES, A. & DE LUCA, N. (2017), p. 421). It has also to be noted that, following the introduction of these structures in Italian law, limited companies qualifying as start-ups or SMEs are expressly allowed to create different classes of quotas (see Art. 26 of Decree Law No. 179/2012).

218 For a better insight of these issue see STAGNO D'ALCONTRES, A. & DE LUCA, N. (2017), p. 400-401. Notwithstanding some scholars tend to negate that a share class may be composed of a single share, the Authors deem such situation not in contrast with the rules regulating the creation of multiple share classes and therefore admissible. The Authors note in fact that, from a substantial standpoint, the fact that a class may be composed of one, two, or more shares is irrelevant since it does not alter the application of the relevant rules on share classes and their special meetings (this concept is clearly explained through the example provided on page 401).

an investment certificate, namely the fund's units or shares, which will therefore embed all the rights and duties characterising the fund-investor relationship[219]. As a consequence, any differentiation in the investors' entitlements would have to be reflected in the structure of the fund and thus inevitably go through the creation of "special" shares, embedding all the relevant features of such different treatment. This would eventually result in a situation where, within the same fund, multiple "classes" of shares would be present, with different features from one class to another, but, in accordance with the principle of fair treatment, equal characteristics within the same class[220].

The provision of Art. 12 AIFMD, which allows AIFMs to provide certain investors with a *preferential treatment*, resembles instead what is provided under Italian law for limited companies, and can be therefore read as allowing AIFMs to derogate from the abovementioned general principle. AIFs are therefore granted more freedom, with respect to UCITS for which no similar rule is provided, in shaping their relationship with investors, as it will be possible for them to provide a different, and also a more favourable, treatment to an investor "as such" without the need to go through the creation of a different class of shares, notwithstanding that the possibility to structure multiple share classes remains in any case a valuable option also for AIFs. In order to do so AIFMs may provide in the fund instruments that preferential rights may be attributed to certain shareholders or enter into side agreements[221] *vis-à-vis* single investors to regulate certain aspects of their relationship, supplementing or modifying the terms of the offering memorandum, provided that such preferential treatment is properly disclosed and that it causes no prejudice to other investors[222]. It has to be noted however that in this case, since

[219] See in this respect Section 1.5.

[220] The principle of fair treatment and its implications on the structuring of multiple share classes is further discussed in Section 2.6.2.

[221] The reference is, in particular, to the so-called "side-letters" which can be defined as "*separate agreements that supplement or modify the terms of the governing documents of a private fund*" (MANNON, J. & BLATHERWICK, N. (2012), p.1). The use of side letters has become a common theme amongst investors and managers, but their use has recently been under intense scrutiny by regulators in consideration of the investor protection concerns they raise. In particular, different national regulators have expressed their disapproval for the use of side letters, also calling for a more extensive disclosure framework for these arrangements (In this respect see further MANNON, J. & BLATHERWICK, N. (2012), p. 7ff).

[222] Art. 23(2) of the AIFMD Implementing Regulation provides that "[a]*ny preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors*".

the different rights are attributed to the *persona* of the investor and are not embed in the securities representing the participation rights in the fund, in case of a share transfer the preferential rights will not automatically transfer to the buyer, being to this end necessary a consequential amendment of the fund's instrument or the entering into a new separate agreement with the buyer[223].

Some more information regarding the legal qualification of share classes under European law can be derived by comparison with another arrangement that allows for the differentiation of investors' rights and that is expressly regulated in the UCITS Directive. That is the possibility to sub-divide an investment fund into different compartments (or "sub-funds"). Pursuant to Art. 49 of the UCITS Directive "*where a UCITS comprise more than one investment compartment, each compartment shall be regarded as a separate UCITS*". Compartments can be therefore considered as separate parts of a fund having their own investment objective and subject to fund rules in their own right. The assets of a compartment are legally segregated from the others so that a liability arising in one compartment cannot be offset by assets in other compartments of the fund[224].

The creation of multiple share classes should not require the setup of a new compartment in relation to each class[225]. Therefore, since they do not qualify as sub-funds, it can be derived that all share classes should share a common investment policy, although providing a certain level of customisation to investors' rights. Moreover, legal segregation of assets between share classes should not be considered required by the European law. As a result, allocation of assets at a share class level should not be allowed.

Apart for the – few – aforementioned provisions, the European laws provide no other information in relation to the legal framework applicable to share classes. In particular, notwithstanding the fact that the possibility to provide a certain degree of

[223] On similar grounds Italian scholars agree that the *particular rights* which can be attributed to shareholders in limited companies, in case of a partial or total transfer of the *quota* and in the lack of specific statutory rules providing so, do not automatically transfer to the buyer. In this respect see, among the many others, STAGNO D'ALCONTRES, A. & DE LUCA, N. (2017), p. 420, and also CAMPOBASSO, G. F. (2014), p. 574.

[224] The segregation of assets between sub-funds is not expressly required in the UCITSD and as such is not legally required in some jurisdictions, however ESMA is of the view that the UCITS Directive should be interpreted in such a way that it requires the segregation of assets between compartments. In this respect see further Section 3.2.

[225] In fact, the consolidated market practice contemplates the creation of two or more share classes in relation to each sub-fund. In this respect see further GUFFANTI, E. & SANNA, P. (2017), p. 474.

customisation of the investor's rights is recognised in both the UCITS and the AIFM Directive, nothing is said in relation to how far it is possible to push such differentiation[226].

In the absence of any other provision it is nonetheless still possible to build a regulatory framework for share classes in the European Union which can also be useful to guide market operators in the structuring of the economic and administrative rights embedded in share classes, by deriving operational guidelines from the interpretation of the general principles governing the provision of the collective asset manager service.

2.6.2. Fair treatment of investors

The first principle that needs to be taken in consideration when structuring different arrangements of investors' rights through the creation of share classes is the general duty to treat investors' fairly. Such principle is codified under European law in Art. 14(1)(a) of the UCITS Directive, which requires UCITS management companies to act "*honestly and fairly in conducting its business activities in the best interests of the UCITS*", and in Art. 12(1)(f) of the AIFMD which more explicitly requires AIFMs "*to treat all AIF investors fairly*".

Currently there is no harmonized definition about what constitutes a "fair treatment" of investors. The concept of fair treatment, as a matter of fact, contains an element of subjectivity which takes account of the facts of a particular circumstance or case[227]. As a result, fund managers will inevitably deal with fair treatment issues differently. In this respect, however, the consolidated doctrine and the prevailing legal practice is in the sense of considering that for both UCITS and AIF the principle of fair treatment does not necessarily imply the equal treatment of all investors[228]. The principle

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[226] Clearly, many limits to the manager's discretion are posed by the countless number of mandatory rules that apply to the provision of the collective asset management service which obviously cannot be evaded by setting up multiple share classes (e.g.: leverage caps, disclosure requirements, governance requirements, etc…). In this case I am questioning whether it is possible to find some further limits to the residual discretion area left by the applicable laws and regulations.

[227] This view is supported by ESMA (2011), *Final Report - ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directiv*e, ref. ESMA/2011/379, p. 51.

[228] In this sense FRANKEL, T. & LABY, A. (2018), p. 34 ff.

of fair treatment therefore does not prevent the fact that different rights can be attributed to subscribers of different share classes. It seems to imply however that it should not be possible to provide variations of the legal position of shareholders within the context of the same class of shares. According to the consolidated common law doctrine in fact the principle in question implies for the asset manager the duty to "*treat beneficiaries of the same class equally and* [to] *treat beneficiaries of different classes fairly*" [229].

Some more information in relation to the content of this principle has also been provided by ESMA, which is of the view that the concept of fair treatment includes that "*no investor may obtain a preferential treatment that has an overall material disadvantage to other investors"*[230]. Consequently, a differentiation of the rights of a group of investors provided by setting up a different share class does not necessarily encompass an overall material disadvantage to other investors. However, if the differentiation results in such an effect, it would be an unfair treatment and therefore not allowed[231].

The requirement that the use of share classes shall not result in a breach of the principle of fair treatment has been also expressed in an international context by the International Organization of Securities Commissions ("**IOSCO**"), which considered that such provision should be deemed as an international best practice. In its Paper the IOSCO made in fact clear that "*the existence of different share classes should not result in a breach of equality of investors who invest or have invested in the same share class*" and

[229] In this sense SPANGLER (2017). This principle is also clearly expressed in Irish law (See Section 2.5.2.).

[230] ESMA (2011), *Final Report - ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directiv*e, ESMA/2011/379, p. 51. The principle is also codified in Art. 23 of the AIFMD Implementing Regulation (Commission Delegated Regulation EU/2011/231), which provides that "*Any preferential treatment accorded by an AIFM to one or more investors shall not result in an overall material disadvantage to other investors*."

[231] This has been stressed by ESMA (See ESMA (2011), *Consultation Paper - ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directiv*e, ESMA/2011/209) in relation to the preferential treatment that may be provided to some investors according to the AIFMD, however the same reasoning may apply to any differentiation of investors' rights. In fact, as noted in Section 2.6.1, the provision of a preferential treatment to an investors can be considered similar to a situation where a share class is composed of only one share. Furthermore, such principle is explicitly provided, both for UCITS and AIFs, in the UK regulation of share classes (see Section 2.5.3).

that "*no advantage should be provided to a share class that would result in a prejudice to another share class or to the fund*"[232].

The same document also stresses the importance of an *ex-ante* determination of a series of objective criteria upon which the features of share classes should be based. It is in fact stated that "*differences in fee and expenses shall be based on objective criteria disclosed in the fund prospectus*"[233].

It is thus possible to conclude that the principle of fair treatment can be declined in a number of corollaries all capable to provide some fundamental operational indications for the structuring of share classes. It implies, as a general rule, that setting up multiple share classes shall not negatively affect other investors in the fund. Management companies should therefore take all the necessary measures to minimise the risk that the characteristics of a given class may result in an actual or potential prejudice for shareholders of other classes. In this respect, fund managers should at least guarantee that, notwithstanding there is no legal segregation between share classes, any costs arising in a given share class should be attributed to investors in that share class only. Another possible (and stricter, as well as more difficult to implement) implication of this principle would be that any investment outcome (whether positive or negative) relating to specific arrangements in given share class – with particular reference to those of hedged classes - should be credited, at least from an accounting perspective, to such share class only[234]. Finally, from the principle of fair treatment it can be also derived that the creation of share classes should be based on objective criteria that need to be properly disclose to investors.

2.6.3. Absence of "day to day discretion or control" as a limit to the arrangement of administrative rights

Another limit to the discretion of the manager in customising investors' rights, although only referred to the arrangement of administrative and voice rights, is posed by

[232] IOSCO SC5 (2004), *Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, paragraphs 44 "Multiclass funds".

[233] *Ibid.* para. 45.

[234]

the principle of separation of funds and managers which requires that the management activity is carried out separately and independently from investors.

This requirement is codified in the ESMA Guidelines on key concept of AIFMD as the absence of "day-to-day discretion or control", which means "*a form of direct and on-going power of decision – whether exercised or not – over operational matters relating to the daily management of the undertakings' assets*[235]".

As a consequence, notwithstanding it can be deemed generally possible to provide investors with different administrative rights, allowing certain groups of shareholders to participate more actively in the fund's life, this shall not result in the possibility for investors to participate to the operational management of the fund.

The concept of "*operational matters*" however is rather unclear. A possible guiding criterion can be however derived from the ways in which an investment process is usually structured. Generally speaking an investment process is carried out through different phases, that range from the more general definition of the investment objective (which includes the definition of, *inter alia*, the return expectations, time horizons, risk tolerance, etc…), to the delineation of the investment strategies, to increasingly specific investment decisions which eventually end up with the identification of the single investment target[236].

In this respect, it can be intended that the participation of investors in the first part of the investment process, such as in the definition of the general investment policy, should not result in a power of decision over "*operational matters*", while any

[235] Section II of the ESMA Guidelines.

[236] For better insight of the investment process of investment funds see POZEN, R. & HAMCHER, T. (2011), Chapter 4. Furthermore, the difference between investment strategies and the defined investment policy can be well grasped in the Bank of Italy's *Final Report* of the public consultation carried out upon reception of the AIFMD and related to the amendments to the CONSOB-Bank of Italy Joint Regulation of 29 October 2007. According to the Authority, the investment strategy is a component of the investment policy addressing the scope and the limits of the investment activity, of which should also specify the risk profile and the expected returns. In particular, the investment strategy is related to the criteria to be followed when choosing the directions to take in order to meet the risk-return objectives. Therefore, investment strategies can vary from time to time in relation to the evolution of market conditions and ultimately result in a series of investment decisions, such as, the weight of the single components of the portfolio or the level of leverage.

interference in the actual implementation of the investment strategies should be deemed as contrasting with the principle of the absence of "day-to-day control"[237].

As a consequence, it should not be possible to grant shareholders, whether individually nor collectively through shareholders' meetings, the power to decide whether or not (e.g.: through veto powers) to perform single investment transactions or to contribute to the definition of operating investment strategies.

The principle of separation however does not seem to impact on the rules governing the formation and composition of the governing body (e.g. the board of directors) of the fund[238].

2.6.4. Common investment policy and common risk profile as a general limit to the arrangement of economic rights

The above considerations in relation to the principles of fair treatment and on the principle of absence of "day-to-day" control, although providing market practitioners with some effective guidelines, are still however rather vague to serve as an effective tool to lead market operators in the differentiation of the economic rights attributable to different classes of investors.

In the lack of any other applicable provision, it is possible to try to provide more effective indications on the limits asset managers may take into consideration in arranging the different economic rights by way of interpretation, trying to detect those features that can qualify as the "essence" itself of the participation in the fund, which thus must be present in any part thereto (similarly to a sort of "*DNA of the fund invariably imprinted in all shares*"[239]), and those other features that, although contributing to the definition of certain aspects of the participation in the fund, do not serve such purpose and thus can be subject to variations from one share to another.

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[237] This view is shared, in particular by, ANNUNZIATA, F. (2017b), p. 66 and similar considerations are also put forward by SANDRELLI, G. (2015) which however adopts a more restrictive approach.

[238] In this respect some scholars also consider that it is possible for shareholders to be elected as non-executive members of the governing body of the fund (see ANNUNZIATA, F. (2017b), p. 146; and ARDIZZONE, L. (2016)). Other Authors, however, do not share this position and consider that the principle of separation prevents any possibility for shareholders to be elected in the governing body of the fund. For an overview of the more restrictive positions, see SANDRELLI, G. (2015).

[239] The expression is taken from GUFFANTI, E. & SANNA, P. (2017), p. 473.

According to Art. 4, paragraph 1, of the AIFM Directive and of the ESMA Guidelines on key concepts of the AIFMD, which contain the qualifying elements of the notion of "undertaking for collective investment", an investment fund can be defined as an entity raising capital from the public, with a view of investing it in accordance with a defined investment policy and in full autonomy from the shareholders, in order to generate a pooled return for investors[240].

Among the various elements that compose this definition, the feature that most effectively qualifies the legal notion of undertaking for collective investment and that constitutes its distinctive trait in comparison with other arrangements utilised to carry out financial and industrial services, is the existence of a "defined investment policy"[241]. The investment policy specifies the investment guidelines, addressing the limits, the criteria's and the strategies to be followed when performing the investment activity.

The defined investment policy is also the element that characterises the most the economic operation underlying the provision of the asset management service, which consists of the entrustment, from a group of investors, of a pool of assets to a professional manager with the sole purpose of having it invested in a standardised way and in the interest of the investors collectively[242].

Being it the element that ontologically defines, both legally and economically, the very concept of "undertaking for collective investment" it is possible to conclude that it should not be possible to provide investors with different investment policies, as this would result in the creation of separate investment funds. As a result, all share classes within the same fund need to be subject to the same investment policy defined in the fund's constitutional documents.

The principle that investors should all be subject to the same investment policy remains however somewhat smoky, also in consideration of the fact that there is no fixed legal definition on what constitutes an investment policy[243]. As a general rule, it can be

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[240] This definition can be deemed compliant with the requisites of the ESMA Guidelines on key concepts of the AIFMD which are further discussed in Section 1.2 above.

[241]In this respect see also Section 1.2.3 above, and in particular footnote 22.

[242] In this sense ANNUNZIATA, F. (2017b), p. 44.

[243] In this respect the ESMA Guidelines only indicate that "*the investment policy specifies investment guidelines, with reference to criteria including any or all of the following: (i) to invest in certain categories of assets, or conform to restrictions on asset allocation; (ii) to pursue certain strategies; (iii) to invest in*

considered that the principle in question implies that all shareholders should be equally subject to the asset allocation and other investment decision of the asset manager so that the investment outcome for all shareholders should come from the common “engine” they share. Consequently, capital gains or losses and income arising from the common pool of assets should be distributed or should accrue equally to each shareholder in proportion to their individual participation in the fund.

It is not however clear whether the principle of the common investment objective would also imply that all investors need to be subject to the same risk profile, or if it is possible to provide investors with different risk-reward arrangements at a share class level[244].

The risk profile indicates the aggregate level of risk linked with the investment in the fund and can be considered, as such, one of the characterising elements of each fund’s investment policy[245]. Being the activity of a collective investment undertaking financial in its nature, its purpose is in fact the generation of financial returns obtained through a managing activity based on the principle of risk-diversification and on the correlation of risk-yield[246]. In this sense the common investment policy needs to be aimed at generating a pooled return for the investors from whom the capital has been raised, by laying down the guidelines to be followed in the managing of the risk arising from acquiring, holding or selling investment assets in order to optimise or increase the value of these assets.

The common risk profile associated with the investment activity of the asset manager has also a legal and operational relevance as it functions both as a limitation to the general discretion of the manager, by fixing a limit to risk-taking, and as an indication

particular geographical regions; (iv) to conform to restrictions on leverage; (v) to conform to minimum holding periods; or (vi) to conform to other restrictions designed to provide risk diversification”.

244 The issue is not without relevance as the relationship between the common investment policy and the fund’s risk profile is one of the salient points of the ESMA 2017 *Opinion on share classes of UCITS*. The ESMA position on the matter however has been challenged by many market operators giving rise to an intense debate on the matter. These issues are further discussed in Chapter III and, in particular, in Section 3.3.

245 According to the economic literature “risk” can be thought of as the trade-off between risk and return, which is to say the trade-off between earning a higher return or having a lower chance of losing money in a portfolio. See ROSS, A., WESTERFIELD, R., & JORDAN, B. (2011) pp. 377 ff.

246 According to the economic theory an activity can be deemed to be financial in its nature whenever capitals are invested in order to obtain a return which is the result of the bearing of a risk that is correlated with the expected return of the investment. See, amongst the others, ROSS, A., WESTERFIELD, R., & JORDAN, B. (2011), pp. 401 ff.

of the minimum risk-rewards parameters on the basis of which potential investors may base their decision whether or not to invest their savings in the fund[247]. The risk profile is also an element that is reflected in the legal status of the shareholder as the right to receive a proper and sound management of the fund's assets, concept which is necessarily parameterised to the level of potential loss deemed acceptable by the fund participant[248]. As such, a loss which constitutes a consequence of the materialisation of financial risks does not determine a liability for an asset manager that properly managed the fund's assets, only acquiring risks that were coherent with the investment policy disclosed in the constitutional documents. Otherwise, an asset manager which took risks that were inconsistent with the fund's general risk profile would be considered liable for the loss arisen in connection with the improper management of the fund's assets[249]. The economic position of the fund's shareholder is therefore determined by the risk profile that the investor decided to accept upon subscription of the fund's shares: the greater the risk level accepted, the greater the potential profits or losses[250].

Given its legal and operational relevance, a number of scholars and market practitioners tend to ascribe to the risk profile the same consideration of the common investment policy and therefore to consider it as another defining characteristic of common investment fund and, as such, incapable of being differentiated among different groups of investors[251]. The presence of a unique risk profile equal to all fund shares seems also to be in line with the standardised nature of collective asset management: given that all shareholders should be equally exposed to the same "investment engine" this should imply the acceptance on behalf of each investor of the risk profile linked with the common investment policy.

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[247] The risk profile is in fact one of the main information to be disclosed to investors in the fund's prospectus and KIID According to Art. 69 of the UCITS Directive "*The prospectus shall include, independent of the instruments invested in, a clear and easily understandable explanation of the fund's risk profile*"(emphasis added). The KIID contains a section denominated "*Risk and reward profile*" which contains an indication of a "synthetic risk indicator" which summarizes the risk profile of the UCITS (see Art. 8 of Commission Regulation EU/583/2010).

[248] The right to receive a sound management is a consequence of the duty of the asset manager to act in the best interest of investors, which is codified in Arts. 14(1) UCITSD and 12(1) AIFMD.

[249] In this respect see further GUFFANTI, E. & SANNA, P. (2017) p. 473.

[250] *Ibid.*

[251] In literature this position is supported by GUFFANTI, E. & SANNA, P. (2017), p. 473. This is also the view taken by ESMA in its 2017 *Opinion on share classes of UCITS*, which is further discussed in Section 3.3.

However, a number of market stakeholder challenged this view, pointing out, in particular, that if the fact that all investors need to share the same investment policy would encompass a common risk profile, most existing types of share classes would not comply with this principle[252] (by way of example, one stakeholder pointed out that in case there is a share class where dividends are paid out and another where they are reinvested in the fund, the risk profile regarding these revenues is different)[253]. In the responses the two Discussion Papers that preceded the ESMA *Opinion on share classes of* UCITS many market operators rejected the existence of such a biunique correspondence between investment policy and risk profile. In particular it has been observed that, although the risk profile constitutes a particularly relevant trait of the participation in the fund, there seem not to be enough decisive elements in order to conclude for the necessity to have all investors sharing a common risk profile, in particular in consideration of the fact that no such explicit provision is provided in the UCITS nor in the AIFM Directive, nor in the other relevant sources of law governing collective asset management[254].

Indeed, notwithstanding it is true that there are no explicit provisions requiring investment funds to provide all investors with a common risk profile, the relevance of this element can be nonetheless be derived, as noted, from a number of factors. Furthermore, the need for a common risk profile within the fund seems implied from the standardised nature of collective investment funds and also from the very notion of "undertaking for collective investment" set forth by ESMA. When read in conjunction with the provisions of the ESMA Guidelines on key concepts of the AIFMD the concept of a "common risk

[252] This consideration has been put forward by many of the respondents to the ESMA 2016 Discussion Paper on Ucits share classes. See among the many others the EFAMA's reply which provides a comprehensive explanation of the negative practical implications that would be caused by this restrictive view of the relationship between common investment policy and risk profile.

[253] This has been expressed by BVI in its Reply to the ESMA 2016 Discussion Paper on Ucits share classes, whereas it is expressed that "*most distinctive features of share classes lead to a different risk profile from the point of view of investors. For example, if there is one share class where revenues are paid out to investors and a second share class where they are reinvested in the fund, the risk profile regarding these revenues is different. If the principle of common investment objective would encompass a common risk profile, most existing types of share classes would not comply with this principle*" (p. 5). It will be further noted however that different distribution arrangements do not actually impact the common risk profile since, when this concept is read in compliance with the provisions of the ESMA Guidelines on key concepts of the AIFMD, it does not imply that all investors shall receive the *same* returns.

[254] This view is shared by some of the respondents to the 2014 and 2016 ESMA Discussion papers on share classes. See, for the completion of its argumentations, the EFAMA's Reply to the 2016 ESMA's Discussion Paper on UCITS share classes, p. 6-9.

profile" can be, in fact, conceived as a connatural element to the defined investment policy, which is, as anticipated, the element that ultimately defines the nature of all investment funds. In this sense, however, the common risk profile is relevant only in connection with the fund's common investment policy so that its scope shall be limited to that of this latter concept. In ESMA's view the principle that investors should share a common investment policy is not aimed at providing investors with the same returns but instead at ensuring that they are all equally subject to the fund's performance, intended as the investment outcome generated by the manager's investment decisions over the common pool of assets[255]. This implies that, irrespective of whether different dividend policies are provided, all investors should share the same "investment engine" so that all profits, or losses, arising as a result of the portfolio and risk management choices of the asset manager, equally accrue to all shareholders, in proportion to their holdings[256].

As a result the common risk profile should not be considered as an element implying the equality of all the single subjective positions of shareholders with respect to dividend distributions, so that all investors in the fund should be granted the same returns, but rather intended in an "objective" (or "internal") perspective, as indicating the level of risk associated with the common investment policy and thus that has to be accepted by investors in order to participate in the fund, irrespective of whether tailored dividend policies are provided.

In conclusion, the common risk profile, intended as the risk profile associated with the fund's capability of generating an investment outcome can, therefore, ultimately be conceived as an element capable of defining the nature and the object of the financial activity which is typical to an investment fund, and therefore an element that should be common among all investors, being it one of the key elements that defines the common investment policy which, as noted, is the element that ontologically qualifies investment funds. Furthermore, in defining the characteristics of the different share classes, the

[255] As anticipated in Section 1.2 the common investment policy has to be aimed at providing investors with a "pooled return" which is defined by ESMA as "*the return generated by the pooled risk arising from acquiring, holding or selling investment assets – including the activities to optimise or increase the value of these assets* – [i.e. the common investment outcome generated through the management of the fund's assets] *irrespective of whether different returns to investors, such as under a tailored dividend policy, are generated*" (emphasis added).

[256] As noted in Section 2.5.2, this principle is also expressly provided in the Irish regulations of share classes, both for UCITS and AIFs.

common risk profile should also be intended as a limit, characterising the common investment policy and thus the participation of all investors in the fund, which should not be breached in the structuring of the class features, given that this would result in a prejudice for other investors and thus in an infringement of the principle of fair treatment.

In light of the above considerations, arrangements that do not affect the overall "internal" common risk profile and therefore the "generation" of the investment outcome but only impact on its distribution to the different groups of investors, such as the provision of multiple currency denominations or of different level of fees, should be generally considered allowed at a share class level.

Assessing the compliance of more complex share class structures, such as those providing hedging overlays, is however more cumbersome. These arrangements imply entering into derivative transactions and, since there is no legal segregation between share classes, the financial instruments purchased for hedging purposes will become part of the common pool of assets and thus affect the common risk profile. However, many market stakeholders have outlined that in case the hedging overlay is implemented on a systematic basis (i.e.: independently from the investment decisions and without discretion about whether or not to apply the hedge) and that proper operational segregation is put in place so that the costs and the risks of the overlay are only borne (from an accounting point of view since legally there is no segregation between the fund's assets) by the hedged share classes, the overall common risk profile should not be considered affected by the derivative overlay as the material contagion risk for other investors can be considered minimal[257].

It is impossible not to note, however, that in the lack of legal segregation it would always be impossible to eliminate any "spill-over" risk, as in case a fund enters into commitments which cannot be met out of the property attributable to the hedged share class, this would result in all the other classes suffering a loss in relation to the hedging. In this respect it has to be noted however that, while no restriction is provided for AIFs, the UCITS Directive limits the derivative exposure and the use of leverage for UCITS by providing that the global exposure relating to derivative instruments shall not exceed the

[257] The majority of the respondents to the 2014 and 2016 ESMA Discussion Papers on share classes share this view. See, for the completion of their arguments, the EFAMA's, DILLON EUSTACE's and MATHESON's Replies to the 2016 ESMA's Discussion Paper on UCITS share classes.

total net value of its portfolio[258]. Although the provision is referred to the exposure of the UCITS as a whole and not to its share classes an extensive interpretation of this principle may lead to consider that hedging arrangements at a class level shall not exceed the total NAV of the specific class[259].

Notwithstanding the above, it is a matter of fact that the offering of some types of hedging arrangements are a common market practice and are also allowed in multiple national systems[260]. Furthermore, ESMA in its recent Opinion on share classes of UCITS considered currency hedging allowed at a share class level, provided that a set of operational safeguards are put in place[261].

2.6.5. Additional considerations regarding Alternative Investment Funds

The regulation of AIFs is subject to substantially less rigorous rules in comparison with the provision of the UCITS Directive and as such the spheres of discretion left to AIFMs are far broader than those of UCITS management companies. The level of customisation of investors rights achievable for these types of funds is therefore clearly wider than for UCITS funds.

Moreover, in relation to AIFs the fair treatment rules apply in a less strict way, as it is explicitly provided, both in the AIFMD and in its Implementing Regulation, not only that it is possible to differentiate some features of the investors' participation in the fund, but also that is possible to provide certain investors with a "*preferential treatment*" provided that such treatment is properly disclosed and that it doesn't negatively affect the status of other shareholders[262].

In light of the above, one may ask if the limit of the common risk profile may be still deemed applicable for AIFs since, being it possible to treat certain investors in a

[258] Art. 51(3) UCITSD.

[259] This interpretation has been partially validated by ESMA which in its Opinion on share classes of UCITS considered, in application of the principle of "non-contagion" that over-hedged positions shall not exceed 105% of the NAV of the share class while under-hedged positions shall not fall short 95% of the portion of the NAV of the share class. In this respect see further Section 3.2.2 and in particular footnote 292.

[260] As shown in Section 2.5 currency hedging is currently allowed, *inter alia*, in Ireland and in the U.K.

[261] The ESMA Opinion is further discussed in Chapter III.

[262] See Art. 12(1) AIFMD and Art. 23 of AIFMD Implementing Regulation.

preferential way, it should also be possible to create a share class whose entry or functioning conditions (which should be properly indicated in the fund's constitutional documents) result in a risk profile which is different than the common risk profile of the fund[263].

It is possible to object that the fact that in any investment fund, whether alternative or UCITS, the management of the common pool of assets has to be carried out in a standardised way, is difficult to reconcile with the differentiation of the risk-return profile between share classes. Moreover, it can also be noted that the examples of preferential treatment provided in the AIFMD Implementing Regulation are not related to that aspect, but only refer to the disclosure of information to investors (side letters), different liquidity terms and different levels of fees[264].

However, none of the above observations seem to be relevant and in particular the second one as the AIFMD Implementing Regulation expressly admits the existence of "other cases" of preferential treatment. Moreover, in the current market practice there are several widely spread arrangements that highly differentiate the risk profile of shareholders and that are also expressly regulated by the European regulation. The reference is in particular to those "*special arrangements*[265]", such as gates, side pockets and lock ups[266], which provides for the suspension of redemptions in case of particular market events.

Since it is often the case that these arrangements are waived for certain groups of investors (usually through separate side letters even though nothing seems to prevent the creation of share classes with these characteristics since the practice is widely spread and accepted by the relevant authorities), there can be significant differences in the risk profile of different investors. The possibility to utilise these kinds of arrangements is however

[263] This point is raised by GUFFANTI, E. & SANNA, P. (2017), p. 476.

[264] *Ibid.* p. 476. See also Annex I to the AIFMD Implementing Regulation.

[265] Special arrangements "*means an arrangement that arises as a direct consequence of the illiquid nature of the assets of an AIF which impact the specific redemption rights of investors in a type of units or shares of the AIF and which is a bespoke or separate arrangement from the general redemption rights of investors*". See ESMA (2011), *Final Report - ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directiv*e, ref. ESMA/2011/379, p. 74.

[266] Gates and lock-up provisions limit or halt redemptions or sell of shares. Side pockets are accounts that can be used from time to time to separate illiquid, hard-to-value assets from liquid assets.

restricted by law and should be only limited to exceptional circumstances and properly disclosed to investors[267].

In any case, the possibility for the asset manager to provide a differentiation in the risk profile of different groups of investors should never result in an arbitrary power, as it should be performed in compliance with all the principles governing the creation of share classes and in particular with that of fair treatment. As a result, in no case this should result in a prejudice for shareholders in other classes and the "*preferential treatment*" should be provided on the basis of objective criteria, *ex-ante* identified and properly disclosed to shareholders. Furthermore, it would be appropriate to limit arrangements that may expose certain shareholders to particularly detrimental risks only to exceptional circumstances.

In conclusion, it is however possible to state that although a differentiation in the risk profile attributable to AIF investors can be envisaged, they nevertheless still need to share the same defined investment policy. As a result, arrangements not complying with the requisite that all investors should share a common investment policy, intended, as highlighted in Section 2.6.4, as the common exposure to the profits or losses derived from the common investment engine, (such as, by way of example, arrangements providing that losses shall be borne only by single groups of shareholders), shall be deemed not admissible. The circumstance that the fund is a non-UCITS[268], indeed, does not alter the fact that the defined investment policy is the element that ultimately qualifies the notion of "undertaking for collective investment", it is nonetheless not possible to unquestionably affirm that this implies that all shareholders have to be exposed to the same common risk profile.

[267] IOSCO developed a principle-based framework for suspension clauses. The Authority provided a non-exhaustive list of what could constitute exceptional circumstances which includes market failures, exchange closures, unpredictable operational problems and technical failures and unforeseeable liquidity issues. It also made clear that ex-ante information plays a pivotal role in order to ensure an adequate level of investor protection. See IOSCO (2011), *Consultation Report - Principles on Suspensions of Redemptions in Collective Investment Schemes,* ref. CR 01/11.

[268] Indeed, the fact that the fund can be qualified as an AIF should strengthen the consideration that all investors need to share the same investment policy as it is derived from a provision laid down in the AIFMD.

2.7. APPLICATION OF THE FRAMED PRINCIPLES TO EXISTING TYPES OF SHARE CLASSES

Through the analysis of the – few – existing legal provisions related to share classes under European law and through the interpretation of some of the general principles governing collective asset management, a series of operating indications that are capable to serve, to some extent, as a guide for market practitioners in the structuring of share classes has been framed.

In summary, it has been found that:

(a) the features of a share class cannot negatively affect shareholders in other classes;

(b) since there is no legal segregation between share classes it is not possible to allocate assets at a share class level;

(c) any costs and any investment outcome arisen in connection with a share class arrangement shall be credited to that share class only;

(d) all investors should be equally subject to the fund's defined investment policy;

(e) in light of the above, capital gains or losses arising from the common pool of assets must be distributed or must accrue equally to each shareholder relative to their participation in the fund;

(f) the way in which investors perceive the investment outcome can be varied provided this doesn't negatively affect the common risk profile;

(g) for AIFs it is possible to offer share classes that provide different risk-profiles, provided that certain conditions are met, but it shouldn't be possible to provide variations in the defined investment policy;

(h) if share classes provide different administrative or voice rights the principle of "no day to day discretion or control" must be respected;

In applying these principles to the different types of share classes listed in Section 2.3 it can be also concluded that:

(i) classes differentiated by fee structure or allocation of revenues and by different currency denominations (in case they are unhedged) are always permitted as they do not alter the common risk profile of the fund since they only affect the moment of the distribution of the outcome and not its generation;

(ii) classes differentiated in term of voting rights are usually permitted provided that investors are not capable of influencing the operating management of the fund;

(iii) classes with hedging overlays should not be allowed for UCITS funds as they affect the common risk profile of the fund since, in the lack of legal segregation between share classes, they pose an ineradicable potential spill-over risk. However, notwithstanding such consideration, some types of hedging overlays at a share class level are currently allowed in certain EU jurisdictions. It will also be further noticed that ESMA, although calling for a ban of hedged share classes, considered currency hedging admissible at a share class level. In any case AIFs should be granted more freedom in the structuring of classes with hedging overlays (and, in general, of all share class arrangements) given that in respect to these funds the principle of fair treatment applies in a less rigorous way.

CHAPTER III – THE ESMA OPINION ON SHARE CLASSES OF UCITS

3.1. EVOLUTION OF THE ESMA APPROACH TO SHARE CLASSES OF UCITS

As highlighted in Chapter II The possibility for European investment funds to issue multiple share classes can be foreseen in both the UCITS and the AIF Directives. However, given the scarcity of provisions regulating the matter there is currently no common understanding in the European Union of what constitutes a share class and on the ways on which share classes may differ from each other. As a result, there are currently several different national practices in place throughout the European Union. In some jurisdictions share classes cannot be set up at all, while in others they are allowed[269]. Furthermore, different approaches exist in relation to the range of customisation of investors' rights achievable through share classes.

In a view to introduce a level playing field among the operators of different European countries and hence strengthen the Single Market for UCITS, ESMA saw the merit in assessing the issues related to the creation of share classes of UCITS funds and develop a common understanding on what constitutes a share class.

Before reaching any final assessment ESMA sought the feedback of market stakeholders on a possible first approach to the matter, with the publication in 2014 of a Discussion Paper on Share classes of UCITS (hereinafter also referred to as the "**2014 Discussion Paper**") [270]. In the document, after highlighting the differences between compartments and share classes by stressing that for the latter no asset segregation can be envisaged[271], ESMA laid down a set of principles that were identified as capable of

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[269] This is specified by ESMA in paragraph 6 of the *Opinion on share classes of UCITS.*

[270] ESMA, *Discussion Paper on Share Classes of UCITS* of 23 December 2014, ref. ESMA2014/1577. The 2014 Discussion Paper contained a series of question addressed to market stakeholders seeking their opinion on, *inter alia,* the drivers for creating share classes and the cost for such a creation, the different share classes currently existing and a series of other operational matters.

[271] In this respects see paragraphs 3-5 of the 2014 Discussion Paper whereas it is stated that "[u]*sually, assets of compartments are legally segregated so a liability arising in one compartment cannot be offset by the assets of other compartments*" and that, on the other hand, "[t]*here is no legal segregation of assets between share classes*".

assessing the legality of share classes. In particular, in ESMA's view, share classes were regarded as sharing the same "*investment strategy*", so that UCITS management companies seeking to offer different investment strategies would need to create different UCITS or sub-funds[272]. Furthermore, it was deemed that the specific features of one class "*should not have a potential ('or actual') adverse impact on other share classes of the same UCITS*" and that differences between share classes of the same UCITS should be disclosed to investors[273].

The 2014 Discussion Paper also contained a series of more operational indications as, following an example-based approach, ESMA identified a list of classes deemed compatible or non-compatible with the envisaged principles. The authority in particular considered, *inter alia*, that hedged share classes were not compatible with the principle of having the same investment strategy, with the exception of currency hedged classes, in consideration of the fact that "*such hedging arrangements 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*"[274]. In contrast, other kinds of hedging overlays, such as interest rate hedging, were deemed not compliant with the principles laid down in paragraph 6 of the 2014 Discussion Paper since "*investors in that class are not exposed to the same* [risks] *as investors in the other classes in the fund*"[275].

Market operators welcomed the ESMA's interest in developing a common framework on share classes since this would also eventually result in the harmonisation of the supervisory practices and hence strengthen the Single Market for UCITS[276]. The

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[272] *Ibid.*, paragraph 6-7.

[273] *Ibid.*, paragraph 6.

[274] *Ibid.*, paragraph 9. According to Paragraph 8 of the 2014 Discussion Paper, other classes deemed compatible with the principles laid down by ESMA include classes differing: (i) in the minimum/maximum investment amounts; (ii) in the type of investors; (iii) in the charges and fees that may be imposed; (iv) in the currency in which they are denominated; (v) in the allocation of revenues; (vi) in voting rights; (vii) in other characteristics such as being registered or bearer classes.

[275] *Ibid.*, paragraphs 10-11. The other classes excluded include, *inter alia*, classes offering actual or potential exposure to differing pools of underlying assets, classes that are exposed to the same pool of assets but with different level of capital protection and/or payoff and classes differing in terms of leverage.

[276] For an overview of the responses to the public consultation see Annex II of the 2016 ESMA *Discussion Paper on UCITS share classes,* ESMA/2016/570.

proposed approach was however highly criticised as it was pointed out that in the lack of an harmonised definition of what constitutes an "*investment strategy*" different approaches would eventually be taken from one Member State to another. It was instead proposed to shift the focus from the common investment strategy to the common pool of assets since, in the view of the majority of the respondents, it constitutes the main qualifying feature of investment funds universally accepted in all European Member States. Furthermore, the example-based approach taken in relation to the classes deemed compatible with the leading principles envisaged by ESMA was considered inappropriate since, being the list non-exhaustive, it was incapable of providing an actual guidance in the identification of the admissible features of share classes.

Finally, the fact that the hedging of the currency risk was accepted and that other kinds of hedging arrangements were banned was considered inconsistent. The fact that only the latter was considered compatible with the principle of having a shared investment strategy was not in fact properly explained by ESMA, being the consideration that currency hedging is aimed at providing investors with the same results of the investment strategy irrelevant in the lack of a common understating of this conception[277].

In consideration of the feedback received, ESMA eventually decided to change its approach by developing a more general, high-principle framework, focused on investor protection which was presented to market stakeholders with the publication of another Discussion Paper on share classes of UCITS in 2016 (the "**2016 Discussion Paper**")[278]. With its second consultation ESMA sought the feedback of market operators on how share classes would work under the proposed framework in order to subsequently reach a final assessment on the matter of UCITS share classes with the issuance of its final act.

Since there are only minor differences between the 2016 Discussion Paper and ESMA's final Opinion the description of the newfound principles will be given in the next Section.

[277] This consideration is expressed with particular precision in AMUNDI ASSET MANAGEMENT's Reply to the 2014 ESMA's Discussion Paper.

[278] ESMA, *Discussion Paper on UCITS share classes of 6April 2016*, ref. ESMA2016/570.

3.2. THE ESMA OPINION ON SHARE CLASSES OF UCITS OF 30 JANUARY 2017

The path followed by ESMA eventually led to the issuance on 30 January 2017 of an opinion[279] under Art. 29 of the ESMA Regulation[280]. The ESMA Opinion is the first regulatory provision containing a definition of what should constitute a "share class" and of its difference with fund compartments. In ESMA's view share classes are in fact not compartments but "*different categories of units or shares belonging to the same UCITS*" attributing "*different rights or features to sub-set of investors in relation to their investment decision*", even though all investor in a fund invest in a common pool of assets[281]. The main difference addressed by ESMA between share classes and compartments is the fact that sub-funds require asset segregation between each other. ESMA is in fact of the view that the UCITS Directive should be "*interpreted in a such a way that it requires the segregation of assets between compartments*"[282]. In spite of the lack of legal segregation ESMA however points out that the costs, or investment outcome associated with a given share class should be attributed to that share class only.

The ESMA Opinion also finalises the approach taken by ESMA in its 2016 Discussion Paper by laying down four high-level principles to be followed when setting up different share classes, namely: "*common investment objective*", "*non-contagion*", "*pre-determination*" and "*transparency*".

In addition to the above principles ESMA provided that the creation of share classes should never be used "*to circumvent the rules of the UCITS Directive, particularly those on diversification, derivative eligibility and liquidity*"[283].

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[279] ESMA *Opinion on share classes of UCITS of 30 January 2017*, ref. ESMA34-43-296, hereinafter referred to as the "**ESMA Opinion**" or the "**Opinion**".

[280] Regulation EC/2010/1095 establishing a European Supervisory Authority (European Securities and Market Authority).

[281] See paragraph 5 of the ESMA Opinion.

[282] See paragraph 4 of the ESMA Opinion.

[283] ESMA Opinion, paragraph 10.

3.2.1. <u>Common investment objective</u>

The common investment objective is, in ESMA's view, the most important defining element of share classes. According to wording of the Opinion in fact the qualifying characteristics of share classes is that they are all "*linked by a common investment objective which is realised through the investment in a common pool of assets*"[284].

Furthermore, in light of the consideration that "*the UCITS Directive does not specifically refer to share classes within the context of investment policies (Articles 49ff. of the UCITS Directive)*", ESMA took the view that the common investment objective also requires a common risk profile within the fund[285]. To this end, the Authority differentiates between *technical share classes* and *overlay share classes*. According to the ESMA Opinion technical share classes are characterised by the fact that they are set up with an administrative or accounting impact in mind and differentiate between groups of investors or by means of investment[286]. Since the characteristics of these classes do not affect the "*performance of the investment*" ESMA is of the view that they share a common investment objective[287].

On the other hand, overlay share classes can be identified by the use of a derivative arrangement aimed at hedging out one or more of the risk factors for investors in that class. Since the use of a derivative overlay at a share class level could result in the class having a risk profile, and therefore an investment objective, not in line with the overall investment objective of the fund, ESMA is of the view that hedging arrangements at share class level are not compatible with the requirement for share classes to have a common investment objective[288].

As an exception to the above statement, however, ESMA is of the view that currency risk hedging at a share class level is compatible with the principle of common investment objective. ESMA sees in fact currency hedging as "*a way to support the Single Market*", since, in consideration of the fact that not all European Member States share the

[284] ESMA Opinion, paragraph 11.

[285] ESMA Opinion, paragraph 16.

[286] According to paragraph 13 of the ESMA Opinion "technical share classes" include, *inter alia*, those providing different management fees, minimum investment amounts, voting rights, or unhedged classes denominated in different currencies.

[287] ESMA Opinion, paragraph 13.

[288] ESMA Opinion, paragraphs 16-17.

same currency, currency risk hedging could be utilised as a means to ensure that "*investors participate to the maximum extent possible in the same performance of the common pool of assets as other investors, even though their exposure to the fund is obtained through a different currency from the base currency of the fund*". Currency hedging is, in conclusion, the only type of hedging overlay currently allowed by ESMA in its Opinion.

3.2.2. Non-contagion

The principle of non-contagion implies the duty for UCITS management companies to implement appropriate procedures to minimise the risk that features specific to one share class could have an actual or potential adverse impact on other share classes of the same fund.

This principle has been developed by ESMA mainly in relation to hedge share classes (i.e. to currency hedge share classes since this is the only type of overlay allowed). Given the lack of segregation between share class assets, the derivatives used in currency overlays become part of the common pool of fund assets. This could disadvantage other investors by introducing counterparty or operational risks in the fund which otherwise would not exist and potentially lead to contagion for other classes.

ESMA therefore believes that, although recognising that the contagion risk cannot be fully eliminated, management companies should take all appropriate steps to mitigate and monitor the risk introduced through the use of derivative overlays so that, in the event of materialisation, they will only be borne by the investors in the respective class[289]. In this respect ESMA sets out a number of operational principles which are regarded as "*minimum operational standard*" expected to be followed by UCITS management companies[290]. In particular, it is required that the notional of the derivatives contracts entered into should not lead to payment obligations with a value exceeding that of the share class and, as such, management companies should prudentially assess the value of the obligations implied by the derivative overlay, making sure that they do not exceed the value of the share class.

289 ESMA Opinion, paragraph 23.

290 See paragraph 25 of the ESMA Opinion.

Moreover, a level of operational and accounting segregation should be put in place in order to ensure, on an ongoing basis, a clear identification of the values of assets and liabilities and profit and losses in the relevant share class. In this respect the management company should also implement stress tests in order to quantify the losses on all investors' classes in the event of the materialisation of a loss exceeding the value of the hedged class.

Finally, it is provided that the derivative overlay should be implemented according to a detailed, pre-defined and transparent hedging strategy[291].

To ensure that the said operational principles are met ESMA also set out a series of even more detailed conditions (relating, *inter alia,* to the minimum and maximum hedging exposures allowed and to the frequency of the reviews to be carried out) to be met at share class level[292].

3.2.3. Pre-determination

According to this principle all features of a share class should be determined *ex-ante*, before the class is set up. ESMA considers that this principle is required to allow investors to gain a full overview of the rights and features which will be attributed to their investment and that the pre-determination should also apply to any currency risk which is to be hedged out.

The principle of pre-determination plays an important role especially in relation to hedged share classes: since these arrangements expose the fund's assets to a contagion risk, investors need to be informed of any potential effect that hedged classes may have over their investment. Moreover, the principle also requires that the risk to be hedged and the general hedging strategy have to be properly disclosed to investors. This implies that a discretionary hedging of the overlay cannot be acceptable in a share class as it changes

[291] ESMA Opinion, paragraph 25, let. d).

[292] In particular, under paragraph 26 of the Opinion, it is provided that: (i) the exposure of any counterparty of a derivative transaction should be in line with the limits of Art. 52 UCITSD in relation to the NAV of the class; (ii) over-hedged positions should not exceed 105% of the NAV of the share class; (iii) under-hedged positions should not fall short of 95% of the portion of the NAV of the share class to be hedged; (iv) hedged positions should be kept under review on an ongoing basis, with at least the same valuation frequency as that of the fund; and (v) a procedure to regularly rebalance the hedging arrangement should be incorporated in order to ensure the respect of the levels stated above.

the fund's performance engine and could lead to a situation where investors are not aware of the potential negative implications of hedged classes over the fund's common pool of assets.

Notwithstanding the above however, ESMA is of the opinion that the requirements implied by the principle of pre-determination do not limit the manager's discretion as to the type of derivative instruments to be used to pursue the hedging of the currency risk, nor its operational implementation[293].

3.2.4. Transparency

Since share classes introduce a level of customisation it is important that differences between share classes of the same fund are disclosed to investors when they have a choice between two or more classes. According this principle both new and existing investors in a fund should therefore be informed in a timely manner about the creation and existence of new share classes and of any relevant amendment to their features, with particular reference to currency hedged classes since they also pose additional potential risks[294].

To ensure a common level of transparency ESMA also set up a number of operational principles considered to be minimum disclosure requirements that should be observed by fund managers. It is in particular required that: the information about existing share classes should be provided in the fund prospectus in the context of the description of the general characteristics of the units or shares; that UCITS management companies should provide a list of share classes with a contagion risk as a readily available information which should be kept up-to-date; and that stress tests (required under the principle of non-contagion described in Section 3.2.2 above) results should be made available to the competent national supervisory authorities on request[295].

3.2.5. Transitional provision

To mitigate the impact on investors in share classes which, following the issuance of the Opinion, will be deemed non-compliant with the principles therein provided,

[293] Paragraph 30 of the ESMA Opinion.

[294] Paragraph 31 of the ESMA Opinion.

[295] See Paragraph 32 ESMA Opinion.

ESMA shared the view that those classes should be allowed to continue to operate. However, in order to ensure a level playing field across the European Union, ESMA provided that share classes not in compliance with the Opinion should be closed for investment by new investors within 6 months from the date of the Opinion (i.e. by 30 July 2017) and be closed to additional investment from existing investors within 18 months from the date of the Opinion (i.e. by 30 July 2018)[296].

3.3. THE RELATIONSHIP BETWEEN "COMMON INVESTMENT OBJECTIVE" AND "COMMON RISK PROFILE" IN THE ESMA OPINION

The ESMA Opinion constitutes the first attempt of an European authority to introduce an harmonised framework for the treatment of share classes under European law, through the individuation of a series of high-level principles and further operational provisions aimed at orienting the supervisory activities of national competent authorities and thus also ultimately capable of serving as a guide for market operators in the arrangement of the investors' rights at a share class level.

In this respect the ESMA Opinion has filled the regulatory vacuum that characterised the legal treatment of share classes at a European level, also providing clarity in relation to many operational matters connected with the creation of multiple share classes.

Furthermore, the principles set forth in the ESMA Opinion also seem to be coherent with the general principles governing the European collective investment legislations, as many of its provisions can be considered in line with those operational indications that have been derived in Section 2.6 through the interpretation of the principles of fair treatment, absence of day-to-day discretion or control and common investment policy. The ESMA Opinion has in fact confirmed what has been envisaged as the key feature of investment funds and hence of any share class, namely the existence of a common investment policy. According to the ESMA's view in fact, the essential characteristics of share classes is the fact that, in spite of the possibility to differ in relation to certain

[296] See paragraph 30 of the ESMA Opinion.

features, they are all linked by a *common investment objective*, (expression that can be deemed relatable to the concept of "common investment policy"[297]) which is realised through the investment in a common pool of assets.

The ESMA Opinion also adopts a clear position in relation to the consideration to be given to the relationship between the common investment objective and the risk profile of the investment. In ESMA's view the fact that an undertaking for collective investment - and hence the parts in which it is divided - is ontologically characterised by a common investment objective/policy over a common pool of assets should also imply that it would not be possible for the asset manager to differentiate neither the rights associated with the "*performance*" of the investment vehicle, neither the common risk profile associated with the investment policy which hence should be unique for all investors and for all share classes[298].

This strict biunique correspondence among investment policy and risk profile has been however strongly criticised by the majority of market stakeholders in consideration of its operational implications that will result in a significant impact on a widely spread market practice, since the offering of share classes providing hedging overlays different from currency hedging has been deemed by ESMA non-compliant with the principle of common investment objective[299]. In this respect many respondents to the 2016 Discussion Paper have pointed out that the ESMA's conception of the principle of "common risk profile" and hence the subsequent exclusion of the admissibility of hedged classes have not been supported by sufficiently reasonable arguments[300].

The objections raised by the market stakeholders in their responses to the 2016 Discussion Paper are not unfunded. Indeed, the ESMA's view of a complete equality between a common investment objective and an equal risk profile does not appear to be supported by adequate reasonings and seems also inconsistent with other provisions of

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[297] The principle of "common investment policy" has been in fact derived from the interpretation of Art. 4 AIFMD, which, according to the consolidated doctrine, contains a definition of "undertaking for collective investment" applicable both to Alternative and UCITS funds. Furthermore, in the UCITS Directive it can be explicitly read that UCITS should share the same "*investment objectives and investment policy*".

[298] See paragraphs 11-16 of the ESMA Opinion.

[299] This view has in fact been shared by almost all of the respondents to the 2016 Discussion Paper.

[300] In this respect, see, among the many others, the EFAMA, AFG and DILLON EUSTACE replies to the 2016 Discussion Paper.

the Opinion that, as a matter of fact, allow for a certain differentiation of the risk profile attributable to different classes of investors.

In the first place, the practical implications of the principle of sharing a common investment objective, and hence a common risk profile are not properly explained by ESMA. From the ESMA's argumentations it could be intended that classes that share a common investment objective do not modify the "*performance*" of the investment[301]. This last concept however has not been further specified by ESMA. It should be possible to assume however that this should not imply that all investors should actually perceive the same investment outcome. Indeed, both from a theoretical and a practical point of view, the nature of the investment fund and of the fund-investor relationship does not seem, *per se,* to impede that, once the investment policy produced its results determining the investment outcome, it would be possible to apply on the generated outcome some sort of arrangements differentiating the amount effectively perceived by each class of investors, for example, by way of the impositions of different levels of fees or distribution arrangements[302]. Moreover, the fact that the concept of *"same performance*" should not be intended as "*same distribution of the investment outcome*" can be excluded, not only by the fact that there are no provisions in the UCITS Directive in that respect, but also from the same considerations of the ESMA Opinion since such an equation would lead to consider many of the "*technical share classes*" deemed admissible by ESMA not in compliance with the principle of having a common investment profile[303].

In this sense, however, it should theoretically be possible to provide investors with arrangements differentiating the exposure of their share of the common outcome to certain types of financial risks, since these arrangements, provided that they do not require

[301] As provided in paragraph 13, "technical classes" are deemed by ESMA compliant with the principle of having a common investment objective "[a]*s the performance of the investment as such is not modified by the characteristics of these types of share classes, they share a common investment objective*" (emphasis added). The same reasoning is also given in paragraph 16 to justify the admissibility of currency hedged classes as, in ESMA's view "[c]*urrency risk hedging is* […] *a means to ensure that investors participate to the maximum extent possible in the same performance of the common pool of assets as other investors*" (emphasis added).

[302] This view can also be considered in line with the provision of the ESMA Guidelines on key concepts of the AIFMD from which it can be intended, as noted in Section 2.6.4, that the existence of tailored distribution policies does not impact with the requisites that all investors in the fund should share the same risk profile.

[303] Share classes providing different levels of fees or different allocation of revenues impact, as a matter of fact, on the outcome perceived by the single group of investors.

an active management that would result in a differentiation of the investment policy and that also comply with the further principles laid down in the ESMA Opinion, would only impact the amounts effectively perceived by the share class[304].

Such possibility is, nevertheless, explicitly excluded by ESMA since hedged classes are deemed in contrast with the principle of sharing a common risk profile. The main element from which ESMA derives this conclusion raises however some concerns. The consideration that shall classes should all share the same risk profile has been implied by the fact that "*the UCITS Directive does not specifically refer to share classes within the context of investment policies (Articles 49 ff. of the UCITS Directive*)" but that instead the reference is made in the context of marketing to investors[305]. In the lack of more structured and logical argumentations, indeed, the simple fact that no reference to share classes is made in the part of the UCITS Directive regulating the fund's investment policy - also in consideration of the fact that the UCITS Directive does not actually contain any provision at all related to the structure of share classes[306] - does not seem particularly decisive even though ESMA considered so in excluding the possibility to differentiate the risk profile attributable to different share classes. It could be deemed, however, that ESMA is (roughly) implying that that the existence of a common risk profile within the fund could be encompassed from the fact that all investors should share a common investment policy, of which the risk profile constitutes a fundamental aspect[307].

Moreover, the reasons that led ESMA to deem currency hedging the only hedging overlay compatible with the principle of common investment objective cannot be supported.

The admissibility of currency hedging has been justified by ESMA on the basis of the fact that it represents a "*means to ensure that investors participate to the maximum extent possible in the same performance of the common pool of assets as other*

[304] This view is also shared by GUFFANTI, E. & SANNA, P. (2017), p. 475.

[305] Paragraph 16 of the ESMA Opinion.

[306] The UCITS Directive contains in fact only mere references to the term "share class" but no actual provision related to their legal framework.

[307] From the provisions of Articles 49 ff. of the UCITS Directive (which fall within Chapter VII UCITSD, entitled "*Obligations Concerning the Investment Policies of Ucits"*) it can be in fact broadly intended that the portfolio of a UCITS is characterised by an "*overall risk profile"* (Art. 51 UCITSD).

investors"[308]. However, this view seems inconsistent with the same ESMA's conception of the principle that views a tight link between common risk profile and common investment objective since, as a matter of fact, any hedging overlay, including currency hedging, impacts on the risk profile of the class, as investors are exposed not only to the risks inherent the common investment engine but also bear the additional risks (such as counterparty risks or the risk of underperformance of their classes in case on non-materialisation of the hedged event) and costs associated with the overlay. Furthermore, hedged classes also affect the risk profile of other investors as in the lack of legal segregation the derivatives entered into to pursue the hedging strategy became part of the common pool of assets.

In relation to the latter consideration it is however possible to assume that the admissibility of currency risk hedging has been deemed justifiable in consideration of the specific mechanics concerning the techniques utilised to purse the hedging strategy. ESMA could have in fact considered, from a functional rather than a strictly legal point of view, that, although all hedging overlays pose an ineradicable potential risk of contagion, the specific characteristics of currency hedging would ensure that, provided that sound risk management is put in place, the actual risk of spill-over could be contained at a level that will not constitute a significant threat for the common pool of assets.

Currency risk hedging can in fact be pursued by referring to pre-determined market indices, therefore limiting the discretion of the manager in relation to the general hedging strategy. Furthermore, these kinds of hedging strategies are often implemented through the use of low cost, highly liquid standardised derivatives (such as FX swaps or FX forwards) that provide regular calls or resets to adjust to market value, so that the associated liquidity and counterparty risks can be, if not entirely eliminated, kept under constant control[309]. In these sense, the further operational provisions provided for under the principles of non-contagion and pre-determination are aimed at ensuring that UCITS management companies put in place thorough risk monitoring and risk management policies so that the additional risk sources (such as the possibility of insolvency through over-exposure) that could lead to a contagion are kept under control.

[308] ESMA Opinion, paragraph 18.

[309] As noted in Section 2.3.7 liquidity and counterparty risks are two of the main sources that could lead to a contagion risk.

The same considerations can be however made in relation to different kinds of hedging strategies and in particular for interest rate hedged class. While certain investors seek protection against currency fluctuations, other investors may be concerned about the effects of rising interest rates on their fixed income investments. The portfolios of corporate credit UCITS, in addition to the exposure to the credit return of the corporate bonds, have also a natural sensitivity to movements in interest rates. Accordingly, offering interest rate hedged share classes would allow investors to pre-determine the sensibility of their return to interest rate fluctuation while maintaining the common exposure on the credit returns of the portfolio. In this sense, interest rate hedged classes, similarly to currency hedged classes, would not affect the general performance of the common investment engine but only reduce the volatility of the investor's return versus their desired risk profile.

Just as the foreign exchange risk, interest rate risk can also be managed passively and systematically by pegging the risk exposure of the class to a pre-determined market index. As a consequence, it would be possible to implement the hedging overlay systematically and in autonomy from the general investment policy ensuring compliance with the principle of pre-determination.

Furthermore, the instruments utilised for interest rate hedging pose a potential contagion risk which is equal, if not even lower, than that of the instruments used for currency hedging since futures and interest rate swaps, pursuant to the rules of the EMIR[310] Regulation, are now traded using a Central Clearing Counterparty[311] thus removing the risk of single counterparty default[312].

The ESMA's reasoning in favour of currency hedging seems therefore based rather on a political point of view than on an operational basis, as material distinction between

[310] Regulation EU/648/2018 on OTC derivatives, central counterparties and trade repositories, also known as the European Market Infrastructure Regulation ("**EMIR**").

[311] Central Clearing Counterparties ("**CCPs**") are entities that facilitate trading in OTC derivatives by acting as intermediaries in the transaction. The main function of a CCP is to interpose itself directly or indirectly between counterparties to assume their rights and obligations by acting as buyer to every seller and vice versa. This means that the original counterparty to a trade no longer represents a direct risk, as the CCP to all intents and purposes becomes the new counterparty. CCPs essentially reallocate default losses via a variety of methods including netting, margining and loss mutualisation. For an in-depth analysis on the role CCPs see GREGORY, J. (2014) p. 6 ff.

[312] This is in contrast to FX Forwards which face a larger risk of counterparty as they traded on a bilateral basis and are exempted from the EMIR clearing requirements.

currency hedging and hedging of other types are not actually revealed. In ESMA's view in fact, since not all European Member States share a single currency, "*currency risk hedging* [can be seen] *as a way to support a single market, as well as a means to level the playing field for investors from across the EU, by allowing them to invest in funds while mitigating the currency risk involved*"[313]. However, similar considerations can be made also in relation to other hedging share classes, and in particular for those providing interest rate protection, since they can be utilised to allow institutional investors to gain exposure on those national markets subject to higher degrees of interest rate volatility while maintaining at the same time their desired risk profiles.

Furthermore, a literal interpretation of the given reasoning would result in considerably negative repercussions for the UCITS industry. In case the ESMA's argument would have to be taken as an indication of the scope of eligibility of currency hedged classes, the admissibility of classes providing an hedge on non-European currencies would be uncertain, eventually resulting in a huge negative impact for European asset managers, given that he most widespread currency hedged classes currently offered "*hedge foreign exchange risk on rates between Euro and U.S. Dollars, Yen or Sterling and not on Romanian leu or Croatian Kune*[314]".

ESMA's decision of allowing only one type of hedging overlay at a share class level, namely currency hedging, and the consequent exclusion of any different hedged class seems therefore rather arbitrary. Nonetheless it has provided clarity in reference to the relationship between common investment policy and risk profile and to the admissibility of share classes providing an hedging overlay levelling the playing field in the EU. At the moment, currency hedging has to be considered the only accepted overlay, notwithstanding there are reasonable grounds to sustain the admissibility of other arrangements providing variations to the investment returns that could be implemented according to a detailed, pre-defined and transparent strategy.

3.4. ESMA'S SUPERVISORY CONVERGENCE ACTIVITY

[313] ESMA Opinion, paragraph 18.

[314] GUFFANTI, E. & SANNA, P. (2017), p. 475.

The ESMA Opinion, adopted on the basis of Article 29 of the ESMA's founding Regulation, has been issued by ESMA in the context of its supervisory coordination and convergence activity (hereinafter "**supervisory convergence**") which is, together with regulatory governance, risk assessment and direct supervisions, one of the four major prerogatives conferred to ESMA in its role as a European Supervisory Authority[315].

ESMA's supervisory convergence powers has been designed to support consistency and coordination in the financial markets area. Relying on flexible, soft, coordination-based methods, the conferral of supervisory convergence powers to ESMA is designed to bring expert and specialised decision-making, flexibility, responsiveness, and credible commitments in ensuring the effectiveness of the Internal Market, by creating a level playing field and preventing regulatory arbitrage[316].

There is as yet no single definition of ESMA's supervisory convergence function as it is expressed indirectly in the ESMA Regulation through the pattern of ESMA's empowerments related with the promotion of the common supervisory culture in the European financial markets law. The recitals in the ESMA Regulation, however, expressly appeal on ESMA to "*actively foster supervisory convergence across the Union with the aim of establishing a common supervisory culture*"[317], and the notion of supervisory convergence is also a recurring theme in the ESMA's self-characterisation of its role[318]. Recently, ESMA's supervisory convergence agenda has been described in ESMA's 2018 Supervisory Convergence Work Program as the fostering the effective and consistent application of the EU regulatory framework, the facilitation of the exchange of experience between National Competent Authorities ("**NCAs**"), the development and coordination of effective national supervisory approaches, the identification of best

[315] Pursuant to Art. 1 of the ESMA Regulation, the Authority's main objective is to "*protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses"*. The main purpose is accompanied by a number of subsidiary and diffuse objectives, which include improving the functioning of the internal market, ensuring the integrity, transparency, efficiency and orderly functioning of financial markets, strengthening international supervisory coordination, preventing regulatory arbitrage and promoting equal conditions of competition, ensuring the taking of investment and other risks are appropriately regulated and supervised, and enhancing customer protection (Art. 1(5), let. (a)–(f)).

[316] In this sense, MOLONEY, N. (2018), p. 188.

[317] ESMA Regulation, recital 41.

[318] See MOLONEY, N. (2018), p. 173.

practices as well as barriers to convergent supervision, the assessment of NCAs' actions through peer reviews and, if needed, the taking of remedial action[319].

Article 8(1) of the ESMA Regulation confers a number of supervisory convergence tasks on ESMA which are concerned with the development of a common approach to the practical supervision of the single rulebook by NCAs[320]. These broad empowerments are linked to more specific powers under the ESMA Regulation which entail ESMA to adopt guidelines and recommendations direct to NCAs supervisory practices (Article 16), to coordinate colleges of supervisors (Article 21), to provide risk assessments (Articles 22, 23, 32 and 35) to engage in peer reviews (Article 30) and to provide coordination, in particularly where adverse events could jeopardize the European financial stability. Furthermore, Article 29 (on the basis of which the 2017 Opinion on share classes of UCITS has been issued), directly calls on ESMA to *"play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union*"[321], allowing the Authority to provide opinions to NCA's and to contribute to the development of high-quality and uniform supervisory standards and to develop new practical instruments and convergence tools to promote common supervisory approaches and practices.

Through the use of these powers ESMA has produced a vast array of "*convergence products*", including guidelines, opinions, Q&As, supervisory briefings, templates for

[319] ESMA, *Supervisory Convergence Program 2018,* ESMA42-114-540, paragraph 2.

[320] Article 8(1) of the ESMA Regulation provides in fact that ESMA should have, *inter alia*, the following tasks: "*(b) to contribute to the consistent application of legally binding Union acts, in particular by contributing to a common supervisory culture, ensuring consistent, efficient and effective application of the acts referred to in Article 1(2), preventing regulatory arbitrage, mediating and settling disagreements between competent authorities, ensuring effective and consistent supervision of financial market participants, ensuring a coherent functioning of colleges of supervisors and taking actions, inter alia, in emergency situations; (c) to stimulate and facilitate the delegation of tasks and responsibilities among competent authorities;* […] *(e) to organise and conduct peer review analyses of competent authorities, including issuing guidelines and recommendations and identifying best practices, in order to strengthen consistency in supervisory outcomes; (f) to monitor and assess market developments in the area of its competence;* […] *(i) to contribute to the consistent and coherent functioning of colleges of supervisors, the monitoring, assessment and measurement of systemic risk, the development and coordination of recovery and resolution plans, providing a high level of protection to investors throughout the Union and developing methods for the resolution of failing financial market participants and an assessment of the need for appropriate financing instruments*".

[321] Art. 29(1) of the ESMA Regulation.

cooperation and information exchange and opinions on NCAs on specific supervisory matters to build a common supervisory culture among NCAs to promote sound, efficient, and consistent supervision throughout the EU[322].

In particular, ESMA made extensive use of its soft regulatory powers to steer NCAs towards a common approach on supervision. ESMA has in fact developed a vast soft-law book at the basis of which are its Article 16 guidelines and its Article 29 measures. The rich production of soft measures has been regarded by scholars as forming a proper "*coaching manu*al" [323], directed at shaping supervisory decision making by NCAs and driving them towards the Europeanisation of financial supervision.

The 2017 Opinion on share classes of UCITS can therefore be regarded as a further piece in the construction of this "coaching manual" which provided a technically-informed clarification in an area where divergent national practices were in place, thus encouraging the harmonisation of the NCAs supervisory approach, and consequently to the market practitioners' approach, to the matter of UCITS share classes.

3.5. ENFORCEABILITY OF THE ESMA OPINION AND IMPACT ON EXISTING SHARE CLASSES

The ESMA Opinion on UCITS share classes can be regarded as a typical act of "soft law". Soft law is an umbrella concept often captured by way of negation, contrasting with the concept of hard law. European hard law, which arises from the Treaties and normally takes the form of Regulations, Directives and Decisions (Article 288 TFEU[324]), is usually described as having a binding legal force, generating general and external effects and being adopted by European institutions according to a specific legal procedure and a specified legal basis in the Treaties[325].

In contrast, soft law is typically understood to refer to rules of conduct that are not legally binding as such but may have practical and legal effects[326]. At the core of the legal

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[322] See further MOLONEY, N. (2018), p. 186.

[323] The expression is taken from MOLONEY, N. (2018), p. 191-214.

[324] Treaty on The Functioning of the European Union ("**TFEU**").

[325] In this sense KORKEA-AHO, E. (2009), p. 274.

[326] This view is commonly accepted in literature. See, by way of example, SKJÆRSETH J. B., STOKKE O. S. & WETTESTAD J. (2006), 104-120.

conception of soft law lies therefore the difference between legal bendiness and legal effects. If hard law corresponds to a situation of legal bindingness, which can be ultimately understood as the possibility to ultimately enforce the legal instruments by means of a legal sanction, soft law instruments are generally perceived as lacking this binding character but still having some legal relevance since they nonetheless have the potential to create legitimate expectations[327].

Soft law is hardly new in the sphere of financial regulation, soft governance can be in fact regarded as the most dominant means of coordinating the financial markets, both globally and on a European level[328]. Indeed, the flexibility of soft law instruments allows for easy anticipation on the dynamics of societal and technological developments. Sitting outside the procedural and oversight formalities that apply to traditional rulemaking, soft low measures are an attractive means for providing prompt responses into the complex and often uncertain financial market environment. Soft law can, for example, clarify the content of complex regulatory rules, provide case studies and best practices and send signals to regulated actors.

Despite its functional appeal, soft law measures pose legitimation challenges, in particular with reference to the soft regulatory powers of ESMA and the other ESAs[329], which have often been charged of using soft governance as a tool for expanding their technocratic influence[330]. Although ESA's soft rulemaking acts are not legally binding,

[327] This clear-cut distinction between "binding hard law", on the one hand, and "non-binding soft law", on the other, which has been used only for ease of explanation, is actually challenged by the most recent doctrine. Soft law can be actually perceived as a concept that lies in between the two opposite concepts of hard law and non-legal norms. As it has been clearly explained by TERPAN, F. (2015) hard law corresponds to the situation where hard obligation and hard enforcement are connected and non-legal norms follow those situations where no legal obligation and no enforcement mechanism can be identified. Soft law may therefore come into those intermediate forms that combine "*hard obligation/soft enforcement (a precise treaty-based rule combined with an arbitration or optional dispute settlement), hard obligation/no enforcement (a unilateral act adopted by an international institution, without control of any kind), soft obligation/hard enforcement (an imprecise treatybased rule with a coercive mechanism of enforcement), soft obligation/soft enforcement (an imprecise treaty-based rule with an optional dispute settlement such as the ICJ) and soft obligation/no enforcement (a practice being transformed into a custom*)".

[328] For an overview of the importance and of the main sources of soft regulation in the financial markets area at an international level see SCHLEMMEL, J. (2016), pp. 458ff.

[329] European Supervisory Authorities (ESAs), namely: the European Banking Authority (EBA); the European Securities and Markets Authority (ESMA); and the European Insurance and Occupational Pensions Authority (EIOPA). Together with the European Systemic Risk Board (ESRB) they form the European System of Financial Supervision (ESFR).

[330] For an in-depth analysis of this matter see MOLONEY, N. (2018), pp. 145ff.

they nonetheless retain an important authoritative function in legal practice so that they are often referred to as having "*quasi-binding*" effects as they exercise high market pressures on NCAs and financial institutions to comply[331]. In this respect, different scholars tend to regard ESA's soft law regulation as an exercise of public powers with *de facto* binding effects whose legitimation arrangements are however rather weak. Notwithstanding their quasi-regulatory nature ESA's soft law are in fact not dependent on prior legislative mandates from the Commission or other European Institutions and are also free from most of the procedural and oversight mechanisms that apply to the production of "traditionally binding" European acts.

The above consideration are particularly viable also in relation to the ESMA's soft rulemaking power which, was granted to the Authority (and to other ESAs) for the pursue of its purposes of protecting "*the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses*"[332].

ESMA's soft regulation may come in two forms: "strong" Article 16 guidelines and recommendations, which are subject to thin procedural control but are also strengthened by a "comply or explain" mechanic; and other soft measures adopted under Article 29 which are not subject to any procedural requirement.

According to Article 16, ESMA may issue guidelines and recommendations (hereinafter "guidelines") for "*establishing consistent, efficient and effective supervisory practices within the ESFS*", and for "*ensuring the common, uniform and consistent application of Union law*". Guidelines can be addressed either to market participants or (as is often the case) directly to NCAs and can be adopted by ESMA on its own initiative, provided that both the abovementioned requirements are met. Furthermore, prior to the adoption of the guidelines (although only "*where appropriate*") public consultations and impact assessments shall be undertaken, and the Stakeholder Group consulted[333]. The

[331] In this respect see MOLONEY, N. (2018), p. 158, and in particular footnote 349.

[332] Article 1 of the ESMA Regulation.

[333] See Article 16(2) of the ESMA Regulation.

adoption of guidelines also requires a qualified majority voting within the Board of Supervisors[334].

ESMA's guidelines cannot be legally enforced, however a high compliance level is fostered by the political commitment to the goal of the harmonisation of financial markets law, which is reflected in the ESMA Regulation as the injunction to NCAs and market participants to "*make every effort to comply with* [the] *guidelines and recommendations*"[335].

A stronger hardening effect comes from the "comply or explain" requirement which stimulates compliance with guidelines, eventually moulding them into national binding rules or supervisory practices[336]. Within two months from the adoption of an Article 16 guideline, each NCA must confirm whether it intends to comply and, in case it intends not to comply, the NCA must inform ESMA, providing adequate reasons[337]. In any case ESMA must publish any NCA's non-compliance which are disclosed in its regularly updated online compliance tables[338]. The "comply or explain" mechanic theoretically allows NCAs defeated in a qualified majority vote to disregard certain guidelines and explain the non-compliance. In practice, however, the "explain" element and the practice of labelling national authorities in compliance tables raises serious doubts with regard to the non-binding character of this kind of soft law measures, since it may entail some sort of "naming and shaming" mechanism which results in intensive pressure on Member States to comply[339]. In practice, ESMA guidelines are very rarely not complied with, as of the 22 guidelines sets that have compliance tables (as of June 2017) only five have recorded non-compliance, which in three cases was due to only one NCA[340].

[334] The Board of Supervisors is ESMA's decision making body. It is composed by the (voting) heads of the NCAs responsible for the supervision of financial markets, the ESMA Chair (who is non-voting); one non-voting Commission representative; and one (non-voting) representative of each of the ESRB, EBA and EIOPA. See Articles 40-44 of the ESMA Regulation.

[335] Art. 16(3) of the ESMA Regulation.

[336] In this sense MOLONEY, N. (2018), p. 146.

[337] See Art. 16(3) of the ESMA Regulation.

[338] Available online at: https://www.esma.europa.eu/document-types/compliance-table

[339] In this sense VAN RIJSBERGEN, M. (2014), p. 123.

[340] The data has been gathered by MOLONEY, N. (2018), p. 147.

Sitting alongside Article 16 guidelines is the host of more "informal" Article 29 measures that ESMA has used in a similar often expansionist manner to shape the single rule book and NCA behaviour[341]. Article 29, which requires ESMA to *"play an active role in building a common Union supervisory culture and consistent supervisory practices"*, empowers ESMA to adopt a wide range of supervisory convergence[342] measures that in practice have the same quasi-regulatory effects of the ESMA guidelines.

The array of supervisory convergence tools granted to ESMA include the possibility to provide opinions to NCAs, to contribute to the development of high-quality and uniform supervisory standards, and to develop new practical instruments and convergence tools to promote common supervisory approaches and practices.

Article 29 has been used by ESMA to deliver a wide range of soft-law measures, including extensive Q&As, which accompany most of the major financial market measures (including the AIFMD and UCITS regimes) and a wide range of opinions, which have typically been issued where divergences are identified in how NCAs apply the single rule book or where there is a lack of clarity, as in the case of the 2017 Opinion on UCITS share classes.

Article 29 measures are not proceduralised to any extent, not subject to consultation requirements nor to a quality majority voting of the Board of Supervisors. Nonetheless they are often regarded a similar quasi-binding effect as the Article 16 guidelines, as they often display a high level of prescription and have also been used in a similar way to Article 16 soft law in an expansionistic approach[343]. The legitimation of Article 29 soft law can however be regarded as based on output legitimacy, as it can be used to flexibly and nimbly provide, often in direct response to market calls for technical clarification, expert solutions to the complex issues characterising the financial markets industry[344].

A strong contribution to the *de facto* binding effect of ESMA soft law can also be ascribed to the particularly strong influence it exerts on financial institutions. In contrast

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[341] *Ibid.* p. 153.

[342] See, *supra* Section *3.4*.

[343] The effect of Article 29 measures however is often perceived as "less binding" than that of the "hard" ESMA guidelines, because they have often been regarded by ESMA as launchpads for subsequent Article 16 intervention. See further MOLONEY, N. (2014), p. 935.

[344] In this sense, MOLONEY, N. (2018), p. 158.

to supervisory authorities, institutions face hard enforcement of soft law measures since the enforcement powers of NCAs may well translate non-binding standards into actual hard law[345]. From the perspective of the regulated subjects in fact, soft law measures produce the so called "*lawfulness effect*" according to which the conduct of a subject which is in compliance with the provisions of a soft law instrument has to be considered, as a general rule, legitimate[346]. Furthermore, ESMA's soft law is provided with significant legal relevance when applied by NCAs as its content may well become law through the embedment in the national supervisory culture either by transposition by the national authorities in different soft or hard law instruments or through the interpretation of the supervisors.

As for the ESMA Opinion on UCITS share classes, many NCAs have already declared their intention to comply, either through the publication of a statements or by transposing the prescriptions of the ESMA Opinion into national hard or soft law instruments. In particular, in Luxembourg the CSSF (*Commission de Surveillance du Secteur Financier*) updated its FAQs on UCITS funds in order to implement the ESMA Opinion and clarify its impact on existing Luxembourg funds[347]. The French AMF (*Autorité des marchés financiers*), after publicly stating its intention to comply has implemented the ESMA Opinion and modified its framework on investment funds' share classes both by amending its General Regulation[348] and its position/recommendation on regulatory documents governing collective investment undertakings[349] which governs, *inter alia,* the creation of share classes for French funds. In Ireland, the Central Bank amended both the Central Bank UCITS Regulation and the Guidance Note 3/99 to comply with the ESMA provisions, which caused a huge impact for Irish UCITS industry since this resulted in the ban on the possibility to issue interest rate hedged classes, which were previously admitted by the Irish Central Bank[350]. With regard to Italy, neither Consob nor the Bank of Italy have yet published any statement in relation to UCITS share classes,

[345] On the different ways in which the ESMA soft instruments can be implemented in national systems see SCHLEMMEL, J. (2016), and also VAN RIJSBERGEN, M. (2014), p. 126ff.

[346] This view is put forward by MOSTACCI, E. (2008), p. 41.

[347] The new FAQs are available at: https://www.cssf.lu/en/supervision/ivm/ucits/faq/

[348] General Regulation of the *Autorité Des Marchés Financiers*, Order of 13 April 2018.

[349] AMF Position - Recommendation DOC-2011-05.

[350] See Section 2.5.2 above.

maybe on account of the fact that, since share classes are not a common practice, the majority of Italian funds are already in compliance with the provisions of the ESMA Opinion.

3.6. FINAL CONSIDERATIONS ON THE CURRENT LEGAL FRAMEWORK FOR SHARE CLASSES UNDER EUROPEAN LAW

This Dissertation tried to fulfil the purpose of dealing with the issues connected with the possibility to differentiate, between groups of investors, those economic and administrative rights that have been identified as characterising the "fund-investor relationship".

In particular, the structuring of multiple share classes has been conceived as an effective tool that allows asset managers to meet the individual needs of investors without detracting them from the common investment policy and without the need of setting up separate investment funds, thus also allowing to obtain benefits (both from an investor and a manager point of view) related to cost reduction and the creation of economies of scale.

Notwithstanding share classes are a common market practice, it has been noted that, at a European level, neither the primary nor the secondary legislation, although recognising the phenomenon in passing by, contain any indication of the scope of differentiation of investors' rights achievable through share classes and of the criteria to be followed when arranging these structures.

In this context of regulatory vacuum, and with an aim of providing some minimal practical guidance to market operators, an attempt was made to derive a legal and operative framework for share classes through the interpretation of some fundamental principles of the European collective asset management legislation that come into play when dealing with the differentiation of investors' rights.

As a result of this interpretative work it has been identified that the qualifying characteristics of each investment fund, which can be derived from its very legal notion, is the fact that all investors share a common investment policy. Consequently, all the parts in which it is divided would need to be equally subject to the common investment policy, since otherwise this would result in the creation of a different investment fund. Further implications were also derived from the principle of fair treatment of investors, which can be considered the leading principle to take into consideration in structuring hedge class arrangements (and in evaluating their legitimacy), that, although not impeding the possibility to differentiate investors' rights among classes of investors, provides as a corollary that such differentiation has to be carried out respecting some minimal safeguards and in particular that in no case the structuring of a share class should result in a prejudice for other investors. Finally, a general limit to the differentiation of voice and administrative rights has been individuated in the principle of separation between fund and managers, that implies that investors cannot be involved in the operating management of the fund.

In the prosecution of the work it has also been noted that the described situation of legal uncertainty related to the matter of share classes has been recently addressed by ESMA, that, in the context of its supervisory convergence activity, following two sets of public consultation with stakeholders, eventually developed an Opinion on share classes of UCITS. In this respect the ESMA Opinion can be considered the first attempt to introduce a level of Europeanisation in a practice, namely the creation of multiple share classes, that remained among the few sectors of the collective asset management regulations still not covered by a strong level of harmonisation. The Opinion, which is addressed to NCAs, lays down a number of high-level principles and further operational provisions with an aim of fostering a common supervisory approach on the matter thus ultimately levelling the playing field for the structuring of these arrangements.

The provisions laid down in the ESMA Opinion are not disruptive of the framework envisaged in Chapter II. Indeed, the Opinion, although through a different line of interpretation, has generally confirmed the validity of many of the indications that have been deduced from the analysis of the principles of fair treatment and common investment policy. In the first place the common investment policy (or *common investment objective* in the ESMA's wording) has been confirmed as the qualifying characteristic of share classes. Furthermore, the principles of "non-contagion", "pre-determination" and "transparency" confirm the high-level operational indications implied from the reading of the principle of fair treatment and can be also further considered as a specification of the latter, as they are inspired at ensuring that the characteristics of share classes are based on pre-determined, objective criteria, to be properly disclosed to investors and that the equality of investors is respected, so that the creation of a share class does result in a prejudice for other investors. All these conditions are, as a matter of fact, perfectly consistent with the corollaries that have been derived from the application of the principle of equal treatment to the matter of share classes[351].

The ESMA Opinion and the legal framework envisaged in Chapter II are not only highly compliant but also complement each other. On the one hand in fact, the consideration expressed in the envisaged legal framework consolidate the ESMA's position since they tie the legal and practical implications of the Authority to the fundamental principles of the European collective asset management legislation, thus strengthening the Opinion's legitimacy in a contest in which, giving the ever-increasing expansion of ESMA's technocratic influence, the lawfulness of the ESMA soft governance is becoming increasingly criticised[352].

On the other hand, the operational provisions laid down by ESMA can be further regarded as constituting a practical specification of the broad considerations derived through the interpretation of the principles of fair treatment, separation between fund and managers and common investment policy, by setting down those minimum operational requirements that, if followed by management companies, will ensure compliance with the said principles and their corollaries. Furthermore the ESMA Opinion also solved one of the issues still unresolved in the framework provided in Section 2.6, namely the possibility to consider a common risk profile as another defining element, together with the common investment policy, of the notion of undertaking for collective investment. In this respect the ESMA Opinion, notwithstanding the expressed reservations on the lack of a proper justifications of such conclusions, provided clarity by stating that a strict biunique relationship exists between a "common investment policy" and a "common risk profile" so that share classes providing a differentiation in the latter cannot be considered

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[351] In particular, the principle of non-contagion ensures the respect of the condition that the creation of a share class shall not result in a negatively affect other shareholders. The principles of pre-determination and transparency aim at ensuring that the fair treatment of investors is guaranteed by providing that share classes should be set up on the basis of a series of *ex ante* identified objective criteria that should be properly disclosed. All of these conditions were also identified in Section 2.6.2 as implied in the general principle of fair treatment of investors.

[352] In this respect the Commission's 2013-14 ESA Review (COM(2014)509 final) dogged ESMA's soft law from the outset and multiple concerns on the legitimacy of the Authority's soft governance have also been expressed in the responses to the 2017 ESA Review (European Commission's *Public consultation on the operations of the European Supervisory Authorities*).

compliant with the principle of having a "common investment objective". As a consequence, ESMA concluded that the setup of hedged share classes is not in line with the principles regulating the legitimacy of share classes. The ESMA's view did not however push as far as to ban the creation of currency hedged share classes that, although apparently not compatible with said principle, are nonetheless regarded as the only allowed (intentional) exception[353].

However, from the underwriter's point of view, there is no reason why, if it is accepted that currency-related variation in returns can be isolated and adjusted, this shouldn't apply equally to other techniques that eliminate or adjust other market factors, so long as the hedging technique can be implemented systematically and in accordance with a detailed, pre-defined and transparent strategy.

Finally, since the arrangement of administrative rights does not fall within the scope of any of the principles laid down in the ESMA Opinion, the envisaged legal framework still provides some operational guidelines that could guide market operators in the structuring of these types of share classes.

As a final consideration, it can be expected that the ESMA's provision are likely to have a considerable impact on the industry of share classes. Notwithstanding the ESMA Opinion is an act of soft law and as such not legally enforceable, it has been noted that it has a *de facto* binding force so that a high level of compliance has to be expected. The ESMA expectations for high compliance seem also to be suggested by the prescriptive wording provided in many parts of the Opinion, which actually calls on NCAs to ensure the adoption by financial institutions of a detailed set of additional safeguards requirement which may well result in increased regulatory burdens for market practitioners. Furthermore, the fact that the ESMA Opinion clarifies the content of some of the fundamental principles of the European collective asset management legislation, leaves limited grounds for NCAs and market operators to justify the non-adherence to its provisions.

As such, the ESMA Opinion is likely to translate in an intensification of the, already consistent, regulatory burdens of collective asset managers. In creating multiple share classes, UCITS management companies will likely be required to implement additional

[353] In this respect see also GUFFANTI, E. & SANNA, P. (2017), p. 475.

procedural and monitoring safeguards, such as the conduction of additional stress tests at a share class level and the creation of additional disclosure materials, resulting in an increase of the operating costs of setting up multiple share classes and thus reducing the positive impact that these structures generate through the creation of economies of scale. In this respect it can be thus considered that ESMA may have pushed too far in the level of detail of the operational indications deemed necessary to ensure compliance with the high-level principles of the Opinion, since this eventually played against what can be considered the main advantage of share classes, namely the possibility to increase the fund size through an arrangement that limits the incurrence in additional set up and operating costs.

The greatest impact of the ESMA Opinion on the UCITS industry, however, will be due to the ban of hedged classes and in particular of duration hedged classes which, according to Morningstar, currently account for more than USD 10 billion of assets under management[354]. In this context however, the lack of a proper justification of the ESMA's assessment of the need of a common risk profile for share classes and the numerous inconsistencies that have been highlighted in Section 3.3 in relation to the treatment of currency hedged classes, on the one hand, and of other share classes providing systematic hedging overlays, on the other, can be utilised as a basis for market practitioners or market associations to push for a reassessment, at a national or European level, of the general admissibility of duration hedged classes or at least for the possibility to receive case-by-case exemptions.

By way of conclusion, it has to be noted that the ESMA Opinion won't have any direct impact on the industry of Alternative funds, as its object is expressly limited to UCITS. In respect of AIFs the considerations of the legal framework envisaged in Section 2.6 will thus remain valid, whose legitimacy has also been strengthened by the fact that many of the implications of the envisaged framework have been acknowledged in a particularly relevant regulatory act of the European Securities and Markets Authority.

[354] The data is taken from BROWNE M., MARTIN, S. & O'SULLIVAN D. (2017).

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