Centre for
Financial
Market
Integrity

The Committee of European Securities Regulators
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14th May 2009

Consultation paper on technical issues relating to Key Information Document (KID) disclosures for UCITS

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on the Committee of European Securities Regulators ("CESR") consultation paper on technical issues relating to Key Information Document (KID) disclosures for UCITS (the "Consultation").

Preamble

The CFA Institute Centre promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We attach great importance to the legislative proposals related to the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive, which establishes the common framework for laws, regulations, and administrative provisions relating to retail investment funds in the European Union.

The Consultation stems from the European Commission's efforts to revise the UCITS Directive through a package of legislative amendments. One such amendment relates to the provision of Key Investor Information (KII) disclosures for UCITS, subsequently termed the 'Key Information Document' (KID), which is proposed to replace the existing Simplified Prospectus (SP). The aim of the KID is to provide investors with clearer, more concise and relevant information about the essential characteristics of the UCITS concerned, over a 2-page document, in order to facilitate more informed decision making on the part of retail investors.

The Consultation addresses technical issues relating to (i) risk and reward disclosures; (ii) past performance; and (iii) charges.

Executive Summary

We recognise and applaud the work of CESR's Expert Group on Investment Management. The task of getting useful information that faithfully profiles the characteristics of a fund on two-sides of A4, and yet readily is assimilated by investors with little knowledge of investment is exceptionally challenging. Since writing our first letter on this topic last year, we have strongly argued that generic information should be largely removed from the KID and sign-posted to a common website. This information along with an integrated education section that takes the reader through each section of the KID, explaining both at high and detailed levels the utility of the information provided would do much to increase investor knowledge and improve the overall decision making process. On reading

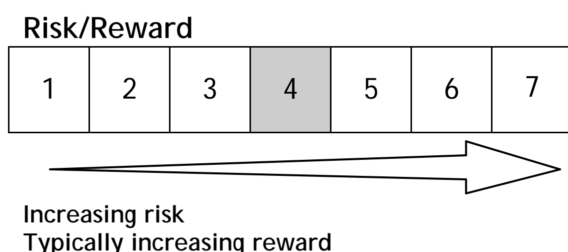
this consultation we are even more convinced of the necessity to provide this facility. The 'Dolceta'[1] website would be the most logical place to post this information.

Risk and reward disclosure

- We are concerned that representing risk and reward as one value might mislead investors, into believing that risk and return are the same. We recognise that the Level 1 directive prescribes the structure of the KID and article 78 (3) implies that risk and reward disclosure should be described through one measure. However we draw CESR's attention to the fact that while the two are related they are not the same. Risk studies the volatility of returns; reward reflects absolute and relative returns. In numeric terms risk can exceed reward by six to one, please refer our answer to question one. Reward can be addressed through the past performance section of the KID.

- We are concerned that to calculate risk, CESR is considering flanking and chain-linking[2] historic data from the index to the fund to arrive at the risk value. Flanking would risk breaching the Grid of Fundamental requirements. It is not a robust calculation methodology and would be open to manipulation. In the situation where the manager cannot provide information to fill this section, the best option is to leave the space empty and fill it with an appropriate explanation. For the same reasons we discourage the use of (!) annotation.

- Our view is that the risk category should be derived from the index, composite or a risk target set by the manager using the standard deviation of return. We support the 7 category scale illustrated on page 24 of the consultation with the suggested improvement sketched below.



Historical Volatility %

Years	0.5	1	3	5	7	10
Fund	8.0	13.0	-	-	-	-
Index	8.0	12.0	7.0	6.5	7.0	7.7

- The most significant change is the inclusion of the actual historical performance of the fund, plus the historical performance of the index, composite, or targeted risk measure. This additional information allows more sophisticated investors and supervisors to monitor the volatility of the fund against its reference risk indicator. Both groups can readily determine if the fund is conforming to its benchmark risk indicator and draw conclusions accordingly. For supervisors this could include changing the fund's categorization under the seven point scale.

- There are two additional features, i) the provision of up to 10 years of historical statistics, which improves the reliability of the information, ii) time points of 0.5 (6

[1] Please see http://www.dolceta.eu/
[2] The concatenation of return volatility of the fund with that of the index.

months) and one year, which permits new funds to enter values over short time periods that can be compared with the relevant index, composite or targeted risk value. The additional disclosure resolves the problem of developing a risk indicator that captures most funds but compromises the length of data series needed to provide a reliable indicator. Finally the illustration demonstrates that the additional disclosure does not consume much space on the space constrained KID.

Past Performance

- This section addresses specific issues concerning, firstly, funds with past performance history, or for which a proxy can be deemed representative of past performance; and secondly, issues concerning the presentation of 'performance scenarios' for funds without performance history or relevant proxies.

- We support the proposed bar chart presentation for past performance, which would show yearly net performance in percentage terms, alongside relevant narrative disclosures. The proposed calculation framework is sufficient and appropriate. In our view, firms should be required to supplement each annual fund return with the corresponding benchmark return, unless an appropriate benchmark is not available.

- The CFA Institute Centre believes that proxy performance data, or simulated performance data, should not be used instead of, or linked to, actual performance history. The use of proxy data in place of actual fund data for years in which the fund did not exist is potentially misleading and is not in the best interests of investors. However exceptional circumstances apply in the case of track record extensions (addressed below).

- We are supportive of harmonised implementation of these recommendations, which is necessary for investors to be able to make meaningful comparisons between fund offerings in different Member States.

- We are in broad agreement with CESR's proposals with regards to track record extensions, whereby fund performance is simulated or extended for the years before the fund existed only where there is a true and fair representation of performance. Please reference numbers 41 and 42 for additional comments.

- With regards to the use of performance scenarios (in place of past performance) for structured or guaranteed funds, it is critical that there is a disclosure stating clearly and prominently that these scenarios are manufactured and not representative of actual results. Such disclosure is necessary to protect investors from making misinformed decisions.

Charges

- The presentation of charges is a key disclosure feature to investors. The challenge is to display this feature in a fashion that is understood by investors with limited investment knowledge.

- We support the narrative presentation of entry and exit costs, ongoing charges and performance fees, in a manner that shows how they fit together (Option A), and we believe that this level of disclosure is adequate for readers of the KID.

- We also believe that in general percentage figures are more useful than cash charges. Percentages are more readily comparable across funds, are more transparent, and therefore more useful for investors.

- The remainder of this section of the Consultation focuses on the presentation of performance fees, new funds and changes to charging structures and the possible illustration of these charges through scenarios. In our view, the KID should include a fee schedule to alert prospective clients to the fees expected to be incurred and must reflect performance based fees.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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CFA INSTITUTE | Centre for Financial Market Integrity

The CFA Institute Centre is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 94,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 131 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and the transparency and integrity of global financial markets.

Our detailed comments follow the order of the Consultation's questions.

SPECIFIC COMMENTS

Chapter 1: Risk and Reward Disclosure

Questions for the consultation: *1. Would the proposed calculation methodology lead to a categorisation of funds' potential risk and rewards profiles which is clear, appropriate, comprehensive and easy to implement?* *2. To what extent does it provide a comprehensive approach to risks, including liquidity risk, counterparty etc.?* *3. Could implementation of the methodology and flanking measure lead to some funds being classified in a category significantly lower than the one in which they should belong?* *4. Does the methodology allow appropriate discrimination between different funds across the universe of UCITS funds so that there is no excessive 'bunching' of funds in one or two categories?*

1. The proposed calculation methodology is taking the right approach (appropriate and easy to implement), but under its current line of development will not be clear or comprehensive. We support the use of a historical volatility measure and support the use of standard deviation of return as a risk indicator.

   However, there are defects in the approach that will convey misleading information. The consultation paper discusses at length the methods of describing risk through a synthetic indicator, but does not discuss reward. Reward is a product of historical

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

returns, addressed through past performance in the next section of the consultation paper. We urge CESR to recommend that the title on the final KID is restricted to 'Risk disclosure'. To blur risk and reward in one section could erroneously lead investors to believe the potential returns are equal to risk as opposed to being a function of (proportionate to) risk. For example the average quarterly return and standard deviation of that return (risk) for the FT100 total return index between September 1993 and March 2009 is 1.26% and 7.74% respectively.
Finally, whilst recognising that most funds have limited trading histories, we argue that sampling a short time period of 3 or 5 years will not give investors a reasonable insight into the future[4]. We recommend that the historical volatility statistics of the fund and appropriate index or benchmark are displayed in parallel on the KID. The reference volatility (monthly/quarterly/yearly) should be aligned to the expected useful monitoring period of investors.

2. Overall, the synthetic risk indicator will capture all realised risks over time. In the short to medium term the single synthetic risk indicator may not reflect liquidity and counterparty risk, as these manifest themselves in near term return data. Over time changes in liquidity and counterparty risks will likely be reflected in this risk indicator.

3. We sympathise with the space constraints on the KID and the need to offer information that can be readily assimilated by a broad spectrum of investor ability. However, we caution against the 'flanking' concept. Flanking would risk breaching the Grid of Fundamental requirements stated in section 1.2.1. Flanking is not a robust calculation methodology and would be open to manipulation.

   Blending index data with fund data to generate a synthetic risk indicator is not statistically robust. Whilst the two are related, they are not the same; relative comparison is a more useful yardstick where overlapping data permit. Further we are concerned that the choice of index, unless carefully prescribed, would be problematic. The fund manager is conflicted to show the fund in the best light to the comparable index, which may not accurately reflect the underlying assets of the fund.

   Hence we suggest that CESR recommends the presentation of a synthetic risk indicator based on the index or composite, together with the historical volatility statistics of the index and fund (to the point where comparable data exists). This would give investors the option to review the risk characteristics of the fund relative to the index and likewise supervisors the tool to judge whether the fund is in the appropriate category of the 7 category scale.

4. We believe that 'bunching' is inevitable under this methodology, most funds are categorised as equity or bond funds, with variation upon these asset classes. Their risk characteristics will trend towards the normal behaviour of the underlying asset class. However, we recommend that CESR looks upon this as an opportunity for the industry rather than a constraint on the value of the KID. Bunching may create an incentive for the fund manager to design investment products that are currently not or scarcely available to investors. These new products would match customer risk preferences

[4] Note that limited time series data was held as a key factor behind model failure at the Credit Rating Agencies, when rating structured products.

that are not currently addressed. In short bunching creates product differentiation opportunities.

Questions for the consultation:

5. What are the merits and limits of using a risk 'add-on' when a large part of a fund's return is derived from a proxy?

6. Can you suggest another option to tackle situations where the methodology may not be expected to cover all risks for this kind of fund?

5. We disagree with risk 'add-on' methodology for the same reason as expressed in our answer to question 3 above. We believe that the best solution is to base the risk indicator off the chosen index or composite and to display in parallel the historical volatility values of the index and fund for investor comparison and supervisory review. We believe that an arbitrary 'add-on' has no value without empirical substance. On that basis where data is not available then it is best to leave a void rather than make something up.

   Strategy and Structured funds that cannot map themselves to an index or composite should discuss this issue in the strategy and objectives section of the KID and set a risk target in terms of standard deviation of return. The risk section of the KID thereby becomes a monitoring tool to assess the risk performance of the manager, in the same way that past return performance monitors the fund's return. We believe this approach offers sufficient flexibility to incorporate all funds under UCITS and indeed others that are not included under the UCITS regime.

6. We emphasise that risk management is an integral part of professional fund management. Hence encouraging the industry to set risk constraints in the strategy and objectives section of the KID that can be monitored through the risk section of the KID, gives investors critical information, on which to make investment decisions.

Questions for the consultation:

7. Does the methodology cover all UCITS types? More specifically, do you agree with the proposed approach of distinguishing between market funds, strategy funds, and structured funds (including guarantee funds) and the adaptation of the calculation methodology to each of these fund types?

8. As regards the use of a 'risk add-on' and an exclamation mark (!) in situations as presented in the above section, what are the merits and limits of each solution? Can you suggest another option to tackle the described situations?

7. Yes we do believe the methodology will cover all types of UCITS, providing these funds trade on a frequent basis and that the value of the unit (price) is calculated using reliable techniques.

   Due to the unpredictable behaviour of distribution tails, we do not support the use of reverse engineered volatility using Value-at-Risk (VaR) methodology for absolute return funds. Paragraph 66 notes that the approximation is derived in the absence of

a risk premium value. Under leveraged structures this would be a meaningfully high value.

With regards to total return funds, please refer to our answer to question 5, we believe that each of these funds should set risk constrains under the standard deviation of return methodology and manage the funds within those constraints.

Life-cycle funds are defined by a dynamic asset allocation and resulting risk profile. We note that where the dynamics of risk materially change (such as the time progression of a long dated bond portfolio whose maturity profile now more accurately reflects medium or short term bonds) then this should be identified and managed within the new constraint. We recognise that Life-cycle funds are inherently different and therefore this area requires further development and consideration.

Structured funds, particularly guaranteed funds, present a unique situation; if it is expected that the investor buys the product and holds it to maturity. Indeed there may be penalty redemption features to reinforce this expected behaviour. Therefore measuring volatility over a time period that is less than the maturity of the product serves no purpose. Hence this is another example that supports our comment in question 5, that it is best to leave a void. Manufacturing ex-ante risk does not add value for investors. Such situations are best addressed in the strategy and objectives section of the KID.

8. As discussed in earlier answers we do not support manufactured solutions to fill the risk section, if they cannot meet the defined ex-post methodology. Therefore, we cannot support a statistic suffixed with an exclamation mark (!). We do support a suitable narrative risk warning, consistent on what has been stated in the strategy and objectives section. For example "The nature of the assets within this fund can rapidly change its risk profile from very high to low. This is unusual for UCITS products, therefore we do not offer a single risk measure to describe the risk characteristics of this fund".

Questions for the consultation:

9. Are the proposed solutions (systematic classification into category 7, use of a 'risk add-on' or a modifier) to tackle situations of a potentially changing risk profile appropriate and commensurate? What are the merits and limits of each option?

10. In particular, do you agree that category 7 should be the highest risk and reward category as well as the special category for certain funds e.g. those with severe event risk?

11. Do you foresee any other situations where the methodology may not be expected to capture appropriately the risk profile of the fund? If so, what solution should be considered?

9. If the fund finds it impossible to conform to the suggested ex-post methodology, and cannot be compared to an index, we prefer the use of the narrative risk warning suggested in our answer to question 8 above. Therefore, we feel that it is neither fair

nor representative to automatically categorize the fund as category 7, or use the risk add-on or a modifier as a subjective enhancement on an immeasurable base risk.

10. We believe that a seven category scale is adequate. Where funds cannot conform to the suggested methodology then we prefer using a narrative risk warning. However, such disclosure should be a rare event and certainly convey that that the risk parameters of this fund are not conventional when compared to other UCITS products.

11. The methodology should capture the vast majority of UCITS products. We believe that where funds cannot conform to this methodology, then a narrative disclosure is a satisfactory solution. However, as discussed in number 10, such disclosure should be a rare event and certainly convey that the risk parameters of this fund are not conventional when compared to other UCITS products.

Questions for the consultation:

12. How easy would the methodology be for UCITS providers to implement and for regulators to supervise?

13. Should any other issues be taken into account regarding the calculation methodology?

12. In the presence of sufficient historical data for both the fund and a comparable index this methodology is readily supervised. Problems develop when ex-ante solutions and volatility based off reverse engineered VaR are used. On the latter as stated above the absence of the risk premium and instability of distribution tails makes this an unsatisfactory solution.

    Paragraph 81 develops a methodology for assessing the volatility of a guaranteed fund by converting this into a representative portfolio. We feel the approach is sound but should be used and referred to as the proxy index, and clearly disclosed that this is not the actual historical performance of the fund.

13. We have no specific comments.

Questions for the consultation:

14. Do you agree with the proposed scale and that the number of categories should be 7?

15. How should the methodology define appropriate volatility 'buckets'? Do you agree that a non-linear scale might be needed to tackle issues of stability, granularity and fair distribution of funds along the scale? Would it be sufficient to prescribe numeric parameters to each 'bucket', or would additional definitions be necessary?

16. Which form of non-linear scale would be the most appropriate? What would be the merits and drawbacks of such a scale?

17. Do you agree that the categories should not carry any descriptions other that a number (and the '!' modifier if appropriate)?

18. Do you agree that some funds belong in category 7 due to their special characteristics

(see above explanations)?

19. For funds which have a specificity in terms of risk, do you agree that the modifier should take the form of an exclamation mark (!)? Does an exclamation mark (!) have an overall meaning which might be contrary to the above-mentioned purpose for the general public in some Member States? If so, is there any other type of warning presentation that would be appropriate?

14. Yes, 7 gives a range of risk options that are meaningful to investors.

15. We believe a non-linear scale is appropriate to address the issues mentioned in the question. We suggest that the middle value '4' should approximately equate to the return on major large cap equity indices such as the FT100, CAC40, and DAX. We expect the volatility of these indices to be similar. The average volatility of these indices could provide the centre point of that bucket. A range could be constructed by multiplying the mean standard deviation of these indices with a fraction and adding and subtracting accordingly to develop a range around the mean value.

16. As mentioned above we support the use of a non-linear scale, using for example the average volatility of the major European market indices as the centre reference point (bucket 4) with a range described by plus or minus a fraction of standard deviation of that volatility. Our experience indicates that the risk return function on various asset classes is non-linear. All of the other buckets would take form from a non-linear scale contracting from bucket 4 with diminishing risk and expanding from bucket 4 as risk increases. Bucket 1 begins at the risk-free rate of return (we suggest the return on 3 month government assets as the risk-free rate). The seventh bucket could be open ended and defined as greater than the sixth bucket. The merits of this scale are that most investors should be able to 'frame' the volatility of the major market indices. The drawback is where they would perceive major stock market volatility within their own concept of risk. The assumptions of risk as defined by volatility must be clearly defined and explained in layman's terms – this is another example where sign-posting to discuss the underlying assumptions behind risk is required.

17. The two-page constraint on the KID is one of its most striking virtues. Yet it must provide germane utility to a broad range of investor ability to be successful. The seven box numeric scale should be readily assimilated by those with the most elementary knowledge of investment, however we believe this should be supported by the additional data discussed in our introductory comments to this section.

18. We believe that category 7 is defined by being of a higher risk than category 6, it is the remainder bucket. Due to the impression it would make on investors, the psychological impact as being at the top end of the scale, we believe that designers of UCITS would avoid getting their products categorised under bucket 7. In effect, buckets 1 through 6 will capture 99% of all UCITS vehicles that can conform to the methodology. We do not believe that funds which are unable to conform to the methodology should be automatically classified under bucket 7. Where funds cannot be classified, we suggest using a narrative description, as discussed in our response to question 8.

19. We do not believe the (!) notation adds to the investor decision making process. Blending short term fund data with a long term index data, ex-ante information or even simulated performance does not substitute the performance of the underlying investment vehicle. In our opinion the risk section is not only a guide to overall risk to the investor, but also a monitoring tool, equally as important as return performance to a relevant index. Funds that specify risks should disclose this attribute in the strategy and objectives section in KID, this then permits monitoring of that risk constraint in the risk section of the KID.

Questions for the consultation:

20. Do you agree with the proposed list of disclaimers to be used in relation to the synthetic risk and reward indicator?

21. Are any of the disclaimers not directly useful or helpful?

22. Can you suggest any other warnings that are missing from the proposal?

20. The proposed lists of disclaimers, with the exception of our opposition to the (!) annotation, are comprehensive. However, we note that these disclaimer titles occupy nearly one-half of a page in the consultation. If indeed these are to be included in the KID, the font size would have to be very small so as not to displace other useful content. In our original comments on the KID[5] of December 2007, we expressed concern that generic explanations would displace useful content. Hence we strongly reiterate our support for 'sign posting' generic explanations to a common website, thereby freeing up space on the KID for unique content that describes the fund.

21. Yes, please note our views expressed above on the (!) annotation.

22. Yes, in the case of guaranteed funds. It should be noted that the honouring of the guarantee depends the ability of the guarantor to meet that obligation. Whilst the institution may be currently solvent there is a risk that it might not be so in the future. Investors ought to be aware of that risk.

[5] Please see http://www.cfainstitute.org/centre/topics/comment/2007/pdf/cesr_response.pdf

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Chapter 2: Past Performance

This section addresses specific issues concerning funds with past performance history, or for which a proxy can be deemed representative of past performance; and secondly, issues concerning the presentation of 'performance scenarios' for funds without performance history or relevant proxies.

Past performance data is to be presented in the form of a bar chart, showing yearly net performance in percentage terms, alongside relevant narrative disclosures.

Questions for the consultation:

23. Is the proposed framework of general requirements for the presentation of past performance with a bar chart sufficient and appropriate?

24. To what extent is there a risk of divergent practices in different countries so that comparability of UCITS across the EU would be hampered?

25. Should CESR recommend a more prescriptive approach in terms of bar chart presentation?

26. Is the methodology easy for UCITS providers to implement?

27. Are the proposed technical recommendations in terms of presentation helpful, workable and sufficient?

28. Should any other issues be taken into account regarding presentation of past performance?

23. The Consultation sets out the following main recommendations for past performance presentation in the form of a bar chart:

- The size of the bar chart should not exceed half a page.
- The Y-axis scale should be linear, not logarithmic; the X-axis should be set at the level of a 0% performance.
- Funds with a track record of less than 5 years should use a template with slots for the last 5 years only; Funds with more than 5 years performance history should use a presentation template with slots for the last 10 years.
- The layout should be such that investors are not likely to mistake years for which there is no performance history with years for which performance was 0% (or very close to 0%).

  The CFA Institute Centre believes that these recommendations should be requirements. We agree that they are appropriate for the presentation of past performance.

  Regarding the use of proxies or 'simulated' data, we firmly believe that such performance information must not be used instead of, or linked to, actual performance history. CESR may care to refer to the Global Investment Performance

Standards (GIPS®)[6] for more information and guidance on calculating and presenting performance to investors.

The GIPS standards are a set of standardised, industry-wide ethical principles that provide investment firms with guidance on how to calculate and report their investment results to prospective clients. The Standards are designed to prevent misleading performance and increase comparability among funds across many countries.

24. We are supportive of harmonised implementation of these recommendations, which is necessary for investors to be able to make meaningful comparisons between fund offerings in different Member States. Given that the recommendations set-out above are relatively simple and unambiguous, the risk for significant divergent practices may be low. However, should any perceived risk of divergent practices arise, it would be helpful for CESR to subsequently issue 'level 3' guidance to ensure harmonised implementation of these recommendations in Member States.

25. A more prescriptive approach to bar chart presentation should not be necessary given the relative simplicity of the recommendations.

26. Yes, we believe the methodology is relatively easy for UCITS providers to implement.

27. We believe that the proposed technical recommendations are helpful and workable; however these recommendations should be 'requirements' to ensure more consistent application.

28. Presented performance should be actual historical data and not based on model, back-tested, or proxy performance. CESR may refer to the GIPS standards for more information and guidance on calculating and presenting performance to investors.

Questions for the consultation:

29. Is the proposed framework on past performance calculation sufficient and appropriate to allow comparability?

30. In particular, are the proposed technical recommendations concerning the inclusion of charges and fees, display of currency, the selection of the NAV date and the treatment of income helpful, workable and sufficient?

31. Do any other issues need to be addressed to achieve a sufficient level of harmonisation?

29. The past performance calculation framework noted in the Consultation provides for disclosures explaining that:

- ongoing charges are taken into account but not entry/exit fees;

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[6] CFA Institute created and administers the GIPS standards and partners with local country sponsors around the world to promote the GIPS standards. For more information, visit http://www.gipsstandards.org/

- the currency of the NAV should be repeated in the past performance section;
- the NAV dates selected should allow for a full calendar year's performance return (such that the dates are adjusted to take account of non-business days); and
- all distributable income should be treated as having been reinvested (but that this need not be made explicit to investors).

  We believe that this framework is sufficient and appropriate to allow comparability between funds.

30. We agree with the proposed framework set-out above and believe it to be workable.

31. In order to achieve consistent calculation and presentation of past performance data, we recommend that due consideration be given to the GIPS standards.

Questions for the consultation:

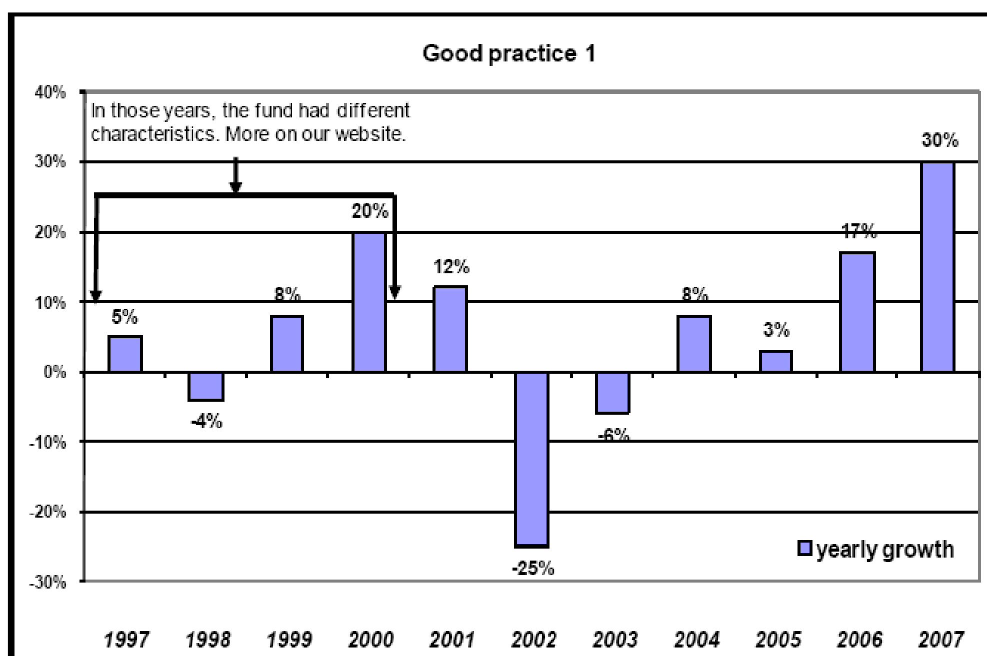
32. Regarding the display of past performance that occurred prior to a material change, do you think that both options (good practice 1 and good practice 2) should be allowed?

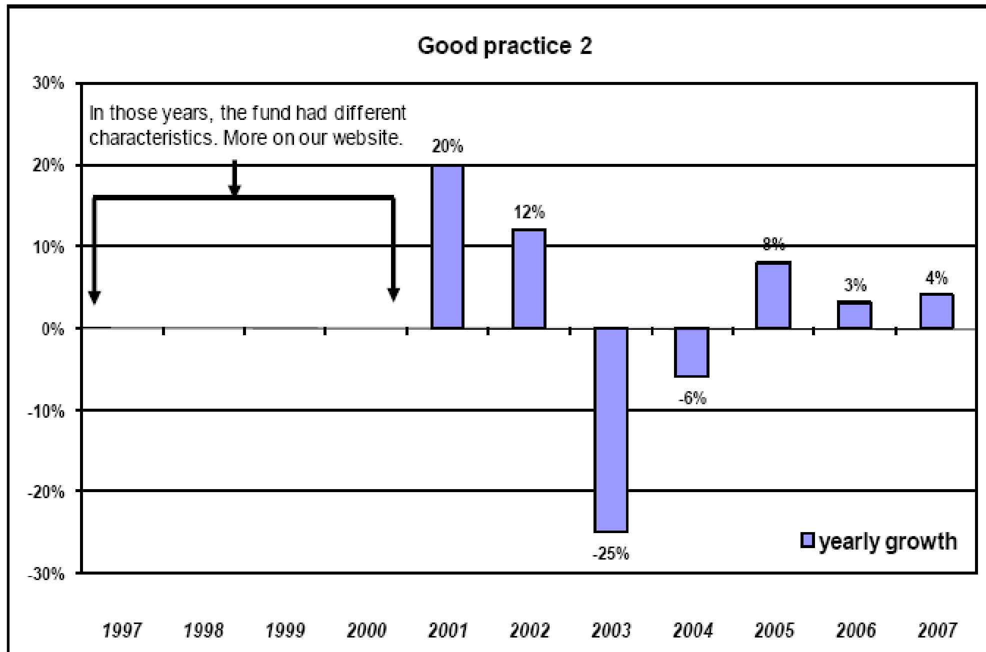
33. Or, for the sake for comparability should only one good practice be retained? If so, which one?

34. Is there a need for harmonised guidelines at a European level concerning the definition of material changes or do you think that it should be addressed by each Member State at a national level?

35. Do you see any other issues that should be taken into account as regards the presentation of past performances where there are materiality changes?

32. 'Good practice 1' would allow past performance that occurred prior to a material change to be retained, but subject to disclosure that the circumstances under which that performance was achieved no longer apply. 'Good practice 2' would allow such performance to be deleted with an accompanying annotation. The Consultation illustrates these options as follows:





Both options would be acceptable. However, in our view, option 1 provides for greater transparency towards the investor, and therefore would be the preferred option.

33. Please refer to our previous response; good practice 1 would be the preferred option and we believe that firms should not be allowed to choose between the two options.

34. We support harmonised guidelines at a European level concerning the definition of material changes. This would minimise the risk of different interpretations amongst member states and hence should improve the consistency and comparability of such disclosures.

35. We have no further comments.

Questions for the consultation:

36. Are the conditions identified by CESR, under which inclusion of a benchmark alongside the fund performance could be allowed, sufficient and appropriate? In particular:
i) Do you agree that a UCITS should not be required to display a benchmark unless one is identified in the fund's objectives and strategy? Is it appropriate to permit a benchmark to be displayed in other cases?
ii) Is there a need for harmonised guidelines regarding the choice of a benchmark in the 'strategy and objectives' or can this continue to be left to the discretion of each Member State?

37. Should any other issues be taken into account regarding the inclusion of a benchmark alongside the fund performance?

36. The CFA Institute Centre believes that, where the fund's strategy and objectives contains a benchmark, this must be included alongside the fund's performance in the

performance history disclosures. UCITS operators should also include a relevant benchmark in the performance disclosures even when such a benchmark is not disclosed in the strategy and objectives. However, where no appropriate, relevant benchmark is disclosed or exists, a benchmark should not be displayed to avoid providing misleading information.

We support the provision of harmonised guidelines regarding the choice of benchmark in the fund's strategy and objectives, in order to minimise the potential for inconsistent practices across Member States.

37. In circumstances where a performance fee is calculated by reference to a benchmark, but where that benchmark is not disclosed in the fund's strategy and objectives, paragraph 26 of the Consultation suggests that the benchmark's performance need not be displayed in the KID. We firmly disagree with this notion. In the interests of transparency, where a performance fee is conditional upon the performance of a benchmark, that benchmark must be disclosed alongside the fund's performance history.

    Additionally, it is not clear from the Consultation exactly where the performance of the benchmark would be displayed in the KID. In our view, best practice would be to supplement each annual fund return with the corresponding benchmark return, where applicable.

    With regards to the treatment of income in benchmarks, we agree that where the fund reinvests income, the benchmark return should also be calculated on the same basis with income reinvested.

Questions for the consultation:

38. Does the proposed recommendation rejecting the use of a benchmark as a proxy for no-existent performance data provide appropriate investor protection?

39. To what extent could the lack of inclusion of a benchmark for years in which the fund did not exist hamper the disclosure of the risk and reward profile fund?

40. Are there any conditions under which such a practice could be allowed without prejudicing investor protection?

38. We agree that simulated performance, by use of a benchmark as a proxy for actual fund performance, should not be allowed. It is potentially misleading to link actual fund performance to a proxy. Therefore, such disclosures do not provide appropriate investor protection.

39. We do not believe that the absence of a benchmark performance history for years in which the fund did not exist would materially hamper the risk and reward profile disclosures.

40. We are not aware of any such conditions. The use of proxy data in place of actual fund data for years in which the fund did not exist is potentially misleading and is not in the best interests of investors.

Questions for the consultation:

41. Has CESR correctly identified all the conditions under which a track record extension could be allowed? In particular:

i) Do you foresee any other situations where a track record extension could be used?

ii) Is there a need for harmonised guidelines at a European level concerning conditions under which a track record extension could be used?

iii) Regarding new classes of shares of an existing fund or sub-fund, is CESR's approach sufficient and appropriate?

iv) Regarding feeder funds, what are the merits and limits of each of the two above options? Which one should be retained?

42. Do you agree with the CESR's approach that track record extension should be allowed when fund changes its legal status in the same Member State? If this were to be addressed by each Member State at a national level, how great a risk is there of divergence and a lack of comparability? Should the approach be more prescriptive in this case? If so, please explain why?

41. Paragraph 41 of the Consultation notes the following recommendations with regards to track record extension (whereby fund performance is simulated or extended for the years before the fund existed):

- A new share class of an existing fund or sub-fund could simulate the performance of another share class, provided the two classes are not materially different in their participation in the fund's assets.
- A feeder fund may simulate the performance of its master, provided:
  - (option 1) the feeder's strategy and objectives do not allow it to hold assets other than units and ancillary cash; or
  - (option 2) the feeder fund's characteristics do not differ materially from the master's.
- A fund changing its legal status in the same Member State may retain its performance record, provided that the change of status would not materially affect the fund's performance.
- In all cases, there should be prominent disclosure in the performance bar chart where performance has been simulated.

i.) We are not aware of any other circumstances in which it would be appropriate to apply a track record extension.

ii.) Yes, there should be harmonised guidelines at the European level concerning conditions under which a track record extension could be used. This is necessary to ensure consistent application across funds.

iii.) For new share classes of an existing fund or sub-fund, the approach set out above is appropriate, provided that the fund's common scheme property (e.g. non class-

specific income or expenses) is apportioned according to the relative net asset values of the share classes, and that the two share classes in question do not have materially different fee structures.

Where two share classes are the same except for the annual management charge, the share class with the lower management fee will naturally outperform the share class with the higher fee. If the difference in management fees is material, this outperformance could be significant and will diverge over time (all other factors being equal). Under such circumstances, it would be inappropriate to extend the track record of one share class to the other.

In addition, if, for example, the new share class accumulates distributable income but the existing share class does not, then the track record of the existing share class should only be extended to the new share class if it is calculated retrospectively with income having been reinvested.

iv.) Regarding the options for track record extension for feeder funds, option 1 (see above) would be the preferred option only if there is an immaterial amount of cash in the fund. If material amounts of cash are held in the feeder fund, this may render it not representative of the master fund. This option is clear and unambiguous. In contrast, option 2 is imprecise and therefore open to interpretation, which could result in inconsistent practices.

42. We agree that a track record extension should be allowed when a fund changes its legal status in the same Member State, provided that there are no other changes in the fund's characteristics. The economic substance of the fund should prevail over its legal form. CESR may wish to issue 'level 3' guidance to national competent authorities if it deems necessary in order to avoid divergent implementation amongst Member States.

Questions for the consultation: *43. Has CESR identified the right conditions under which track extension for fund mergers could be allowed?* *44. Should any other issues be taken into account regarding track extension for fund mergers?*

43. The Consultation sets out the following three options with regards to track record extension for fund mergers (paragraph 44):

    a) Requiring the absorbing fund to display its own past performance record together with past performance of any absorbed funds.

    b) Requiring the absorbing fund to compute an 'average past performance' which would incorporate the past performance of the absorbed fund.

    c) Requiring the absorbing fund to display only its past performance. Other aspects such as disclosure of the merger and the performance of the absorbed fund should be included in a source other than the KID, such as the prospectus or the fund operator's website.

We agree with CESR's recommendation that only option c) should be used in the KID. This option is the simplest, most transparent disclosure, and is best suited to the 2-page space constraint of the KID. It is sufficient for all other information relevant to the fund merger to be made available through more detailed documents such as the prospectus, annual report, and the website of the fund operator. CESR may care to refer to the GIPS Guidance Statement on Performance Record Portability at http://www.gipsstandards.org/standards/guidance/archive/pdf/GSPerfPortRevised.pdf.

44. We have no further comments.

> *Questions for the consultation:*
>
> *45. Do you agree with the approach proposed by CESR as regards back-testing?*
>
> *46. Are you aware of any other merits that might support further consideration of this option?*

For structured or guaranteed funds[7], for which past performance or a proxy cannot be used, one of the options of simulating past performance is to use back-testing ("option A"). As the Consultation notes (in paragraph 49), *"back-testing methodology consists of showing, on the basis of illustrative scenarios, how the fund would have performed under historical market conditions. The methodology is based on assumptions, using historical data to simulate the rate of return that the fund would have realised if it had been launched at specific dates."*

45. We agree with CESR's recommendation not to go forward with this approach. We believe that the back-testing approach is misleading towards investors, is subjective (dependent upon assumptions), and is hence at risk of manipulation.

46. No, we are not aware of other merits that might support this option.

> *Questions for the consultation:*
>
> *47. Do you agree that Option B is capable of meeting the Directive requirement for performance scenarios?*
>
> *48. Regarding the graph or table presentation, what are the technical merits and limitations of each option?*
>
> *49. To what extent does each option provide the investor with the elements needed for an appropriate understanding of how the fund works? Is one option clearer and more comprehensive from the investor's perspective? Is there any technical feature which may*

[7] The Consultation notes that *"Structured funds typically promise predetermined pay-offs at given dates (fixed investment horizon), which may depend on computations (formulas) elaborated on certain parameters, such as financial indexes as well as single given instruments or other assets. Moreover, the techniques used often require closing the offering of the shares of structured funds within a limited period from its initial launch (generally up to six months for formula funds). Hence, by nature there is no past performance."*

be subject to misinterpretation by the investor?

50. Is there a need for a more prescriptive approach to the number and type of scenarios that should be selected in order to ensure appropriate comparability of funds? Should any technical feature be supplemented?

51. Is comparability with the possible risk-free asset return helpful?

52. Is this approach easy for UCITS providers to implement?

53. Should any other issues be taken into account regarding prospective scenarios?

This section of the Consultation is concerned with the use of prospective scenarios ("option B") for structured and guaranteed funds for which past performance or a proxy cannot be used. Paragraph 53 notes that *"prospective scenarios involve calculating the expected return of the fund under either favourable, adverse, or average hypotheses regarding market conditions".*

47. Disclosing a range of performance outcomes, if under pre-determined, limited hypothetical scenarios, can be effective in providing retail investors with an illustration of the possible outcomes from investment in structured or guaranteed funds. However there should be adequate disclosure that the illustrated scenarios are manufactured and are not actual outcomes

48. The tabular presentation, as set-out in Annex C, is preferable to the graphical presentation. The table shows four distinct performance scenarios for the underlying index, makes explicit the return assumptions for the index, and the fund price at maturity, along with accompanying explanations. This provides retail investors with a useful indication of how their investment may perform over the (fixed) investment horizon of such funds.

49. We believe that it is critical that there is a disclosure stating clearly and prominently that these scenarios are manufactured and not representative of actual results.

50. In order to avoid inconsistency across funds, and to avoid confusing investors, the number and type of scenarios should be prescriptive and made uniform in the KID.

51. Yes, it would be helpful to provide a comparison of the different return outcomes with the risk-free return, in order for investors to be able to measure the opportunity cost of their investment.

52. We are unable to comment as to how easy UCITS operators could implement this approach.

53. We have no further comments.

Questions for the consultation:

54. Are the methodological requirements which underpin probability tables sufficient, clear and appropriate?

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55. Would such an approach cover all types of funds for which neither past performance nor a proxy can be used?

56. Is this approach easy for UCITS providers to implement?

57. Should any other issues be taken into account as regards the use of probability tables?

This section of the Consultation is concerned with the use of performance scenarios based on probability tables for structured funds ("option C"). Such a presentation would display, in tabular form, a set of pre-determined outcomes for the fund (such as "performance of the fund is positive but lower than the return on risk-free assets", etc), with associated probability percentages.

54. The methodological assumptions underlying the proposed probability tables involve identifying the underlying financial variables and their stochastic processes, calibrating relevant parameters, and simulating returns according to pre-determined formulas or algorithms.

    We are not able to comment on the appropriateness of this methodology. However we are concerned that the dependence on model assumptions and parameters is too subjective for consistency and comparability across funds. Such an approach may also be difficult for supervisors to effectively monitor.

55. We are not able to comment further on the appropriateness or applicability of this approach. Please refer to our response to question 54.

56. We are concerned that this approach may be difficult to implement consistently, having regard to its subjective nature. Please refer to our response to question 54.

57. We have no further comments.

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Chapter 3: Charges

Questions for the consultation:

58. Do you think a summary measure of changes would help investors to understand the overall cost of investment in a UCITS?

59. Which presentation would be preferable: using a narrative with a percentage figure or a table of cash figures?

58. Marginally yes, if supplemented with option A (improving the existing disclosures of ongoing charges). We strongly urge that the content in option A is retained. Outlining entry, exist, ongoing and performance fees is a crucially important disclosure feature. The benefit of the 'summary measure' needs to be weighed against the space it occupies on the document. On balance, we believe that this additional feature cannot justify its space in the document.

59. A narrative presentation with a percentage figure is more accurate and independent of subjective assumptions, the veracity of which may vary from fund to fund. In addition, cash charges are largely a function of net asset value and the numbers of unitholders, which of course vary from fund to fund. Accordingly, cash charges are less directly comparable across funds than percentage disclosures.

Question for the consultation:

60. Do you agree that the Option 1, using a single ex-post figure, is the best one?

60. Yes, a single ex-post figure of ongoing charges based on the existing TER methodology is the simplest, most transparent measure, and is easiest for investors to understand. It is also easiest for UCITS operators to implement. We support the inclusion of a current fee schedule in addition to the ex-post figure as stated in number 68.

Question for the consultation:

61. Do you agree with the proposed methodology in Annex B for identifying which items should be included in the ongoing charges figure and for harmonising the calculation?

61. We agree with the proposed methodology in Annex B regarding the component items of the ongoing charges figure and the basis of the calculation, which we recognize as being broadly similar to the existing Total Expense Ratio (TER) methodology [(ongoing charges / average NAV) for each share class based on annualised audited figures].

Question for the consultation:

62. *Do you agree with the proposals to:*

i) Show the ongoing fund charges figure excluding performance fees?
ii) Explain performance fees through a narrative description?
iii) Not show an actual figure for the amount previously charged?

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63. Do you agree with the proposal to signpost where more detailed information can be found?

62. We agree with these proposals. Performance fees may not be charged on a consistent basis; however, they are an ongoing consideration and may alter the fees considerably depending on the success or failure of the investment as outlined in the fee agreement. It would be in investors' best interests to quote the percentage charge (or reference calculation) of the performance fees to give investors an indication of the magnitude and potential frequency of this type of cost (a one sentence disclosure would suffice).

63. Yes; as noted throughout, we support sign-posting.

Question for the consultation:

64. Do you agree with the proposal to highlight the potential impact of portfolio transaction costs on returns through a warning in the charges section and, in the certain circumstances, the strategy/objectives or risk and reward sections of the KID?

64. A warning in the charges section would be sufficient. To avoid overloading disclosures, portfolio transaction costs could be referenced or 'sign-posted', these costs are usually small and not likely to materially influence investors' decision making processes.

    For further reference, the GIPS standards offer guidance on the impact of transaction costs on returns. For example, the Standards note that returns must reflect the deduction of transaction costs.

Question for the consultation:

65. Do you agree with the proposal to include in the warning?

66. Are there circumstances not covered in the proposals which could lead to investors being misled about potential increases in charges?

65. Paragraph 40 notes that CESR proposes to accompany the ongoing fund charges disclosure with the warning that *"The ongoing charge is based on the expenses for the [year being shown]. These can vary slightly each year"*.

    We agree with this proposal as it improves fund-specific transparency; however, we recommend removing the word 'slightly' from the disclosure as it may be misleading and there can be no assurance unless there is a cap on the fees that the fees may only vary slightly.

66. We are not aware of any other circumstances.

Question for the consultation:

67. Have all the relevant issues in estimating an ex-ante ongoing charges figure for a new fund been identified?

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68. Do you agree with the proposed manner of dealing with these issues?

67. We are not aware of any other issues.

68. No, we do not agree with the approach to dealing with funds for which it is not possible or applicable to present an ex-post ongoing charges figure. The approach set-out, which is dependent upon assumptions of the likely level of investment into the fund and the number of unitholders, is too subjective and hypothetical.

    Aside from funds for which the annual management charge is the only expense borne by the scheme property of the fund, and funds with fee caps, the ex-ante approach is too subjective. For funds with standard charging structures, whereby ongoing charges, such as registrar's fees, custody fees, etc, are all expensed to the scheme property of the fund, estimation of a single ongoing charges figure (or a ratio of expenses to average net assets) is problematic. An estimate of net assets is dependent upon the estimated level of net subscriptions into the fund and the performance of the investment portfolio, both of which are difficult to reliably estimate, even with seed capital. Furthermore, estimation of those expenses which are not a function of net assets poses further difficulties.

    It would therefore be more useful to present a fee schedule showing the percentage fee for each type of relevant charge. This would provide investors in new funds with appropriate ex-ante measures of the likely costs involved.

Question for the consultation:

69. Do you agree with the proposal to replace an ex-post figure with an estimated ex-ante figure where there are material changes in the charging structure?

70. Do you agree with the proposed wording to explain the estimated figure?

71. Can you suggest how materiality should be defined in the context of changes to the disclosed charges figure?

69. We do not agree with this proposal. It would be simpler and more transparent to just show the ex-post ongoing charges figure and supplement this with a narrative to explain that the charging structure has changed and how it has changed. Actual data is more reliable than estimated data.

70. Please refer to our previous answer.

71. We believe that any changes in charges ought to generate an updated KID, let alone notification to existing investors. Placing this rigidity on change would discourage managers from changing fee structures, or at least make this additional cost of updating the KID a factor in deciding whether to change the fee or not.